IN THE MATTERS OF

INVESTORS MANAGEMENT CO., INC. ET.AL*

File No. 3-1680. Promulgated July 29, 1971

Securities Exchange Act of 1934—Sections 15(b), 15A and 19(a)(3)

Investment Advisers Act of 1940—Section 203(e)

USE OF NON-PUBLIC INFORMATION

Where respondent investment advisers, mutual funds and investment partnerships received, from broker-dealer which they knew was prospective managing underwriter of issuer's debentures, non-public information it had been given by issuer concerning sharp drop in earnings and reduction of earnings forecasts, and respondents thereupon effected sales and short sales of issuer's stock, *held*, respondents violated antifraud provisions of securities acts, the requisite elements of violation having been shown, namely, receipt of information that was material and non-public, recipient knew or had reason to know it was non-public and had been obtained improperly by selective revelation or otherwise, and information was factor in decision to effect transactions; and censure of respondents by hearing examiner affirmed.

Information concerning security or its issuer which is non-public because not disseminated in manner making it available to investors generally, is material in nature under antifraud provisions where it is of such significance that it could reasonably be expected to affect judgment of investors as to security's merits and, if generally known, to affect materially its market price.

Among factors to be considered in determining whether information is material are degree of its specificity, extent to which it differs from information previously publicly disseminated, and its reliability in light of its nature and source and circumstances under which it was received.

That recipient of non-public information acts immediately or shortly after receipt to effect securities transaction consistent with such information is evidence of information's materiality.

Where recipient of material non-public information which he knows or has reason to know is non-public effects securities transaction of kind indicated by information, prior to its public dissemination, such circumstances give rise to inference that information was factor in decision to effect transaction.

*Madison Fund, Inc.; J. M. Hartwell & Co.; Hartwell Associates; Park Westlake Associates; Van Strum & Towne, Inc; Fleschner Becker Associates; A. W. Jones & Co.; A. W. Jones Associates; Fairfield Partners; Burden Investors Services Inc.; William A. M. Burden & Co.

44 S.E.C.—34——9267

APPEARANCES:

Irwin M. Borowski, Alfred E. T. Rusch, Richard H. Kogan, John J. Kelleher, Ralph K. Kessler, Daniel Glickman, and *Allan A. Martin,* for the Division of Trading and Markets of the Commission.

John E. Hoffman, Jr., W. Foster Wollen, and *Lewis C. Evans II,* of Shearman & Sterling, for Investors Management Co., Inc.

Frederic L. Ballard, Oliver C. Biddle, Duncan O. McKee, and *Frederic W. Clark,* of Ballard, Spahr, Andrews & Ingersoll, for Madison Fund, Inc.

Joseph A. McManus, Stephen Sayre Singer, David H. Smith, and *Charles R. Stevens,* of Coudert Brothers, for J. M. Hartwell & Co., Hartwell and Associates, and Park Westlake Associates.

William E. Jackson, Andrew J. Connick, and *Anthony C. Stout,* of Milbank, Tweed, Hadley & McCloy, for Van Strum & Towne, Inc.

Marvin Schwartz and *M. Blane Michael,* of Sullivan & Cromwell, for Fleschner Becker Associates.

Eugene P. Souther and *Anthony R. Mansfield,* of Seward & Kissel, for A. W. Jones & Co. and A. W. Jones Associates.

Joseph B. Levin and *Wendell Lund,* of Brown Lund & Levin, for Fairfield Partners.

Samuel E. Gates, Richard D. Kahn, and *Standish F. Medina, Jr.,* of Debevoise, Plimpton, Lyons & Gates, for Burden Investors Services, Inc., and William A. M. Burden & Co.

FINDINGS, ORDER AND OPINION

Introduction

This is a limited review on our own motion of the hearing examiner's initial decision in these proceedings pursuant to Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 203(e) of the Investment Advisers Act of 1940. The examiner found that the above-captioned respondents willfully violated or aided and abetted violations of the antifraud provisions of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder in the sale of stock of Douglas Aircraft Co., Inc. without disclosing to the purchasers material information as to a reduction in Douglas' earnings which they had received from the prospective managing underwriter of a proposed Douglas debenture offering, Merrill Lynch, Pierce, Fenner &

Smith, Inc. ("Merrill Lynch").[1] The examiner ordered that those respondents be censured.

No petition for review of the examiner's decision was filed by any of the parties, and we were of the opinion that there was not sufficient reason to review on our own motion the examiner's factual findings or inferences, or the adequacy of the sanction of censure imposed upon the respondents who he found had committed violations, or his determinations that the proceedings should be discontinued or dismissed as to three other firms.[2] However, since we felt that the legal issues raised respecting the obligations of persons other than corporate insiders who receive non-public corporate information (sometimes referred to as "tippees") had significant implications for the securities industry and investing public, we deemed it appropriate to consider those issues and express our views on them.[3] The Division filed a brief in support of the examiner's conclusions of law, certain of the censured respondents filed a statement of views and reply briefs in opposition, and the Division filed a reply brief.

FACTUAL BACKGROUND

The following summarizes the principal facts which were found by the hearing examiner and are described in detail in his initial decision.

In 1966 Douglas was a leading producer of commercial transport aircraft and its common stock was actively traded on the New York Stock Exchange and the Pacific Coast Stock Exchange. Immediately prior to the events described below, many analysts had viewed Douglas' earnings outlook as favorable, and the company itself estimated that per share earnings would be $4 to $4.50 for 1966 and $8 to $12 for 1967.[4] On June

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[1] Merrill Lynch and fourteen of its officers and employees has been named as respondents in the order for proceedings. They submitted an offer of settlement, and pursuant thereto we found violations of the stated antifraud provisions and imposed certain sanctions. *Merrill Lynch, Pierce, Fenner & Smith, Inc. et al.*, 43 S.E.C. 933 (1968). Another respondent named in the order for proceedings also submitted an offer of settlement, which we accepted, providing for censure. *City Associates*, Securities Exchange Act Release No. 8509 (January 31, 1969).

[2] The hearing examiner dismissed the proceedings as to an investment adviser which he found did not commit the violations charged in the order for proceedings; and he discontinued the proceedings with respect to two other firms which he found had no connection with the activities in question other than that they each occupied a control relationship to a censured respondent.

[3] *Investors Management Co., Inc., et al.*, Securities Exchange Act Release No. 8947 (July 30, 1970). Contrary to the contention of some of the respondents, we find that our order undertaking review of the examiner's initial decision was made within the time prescribed by our Rules of Practice, 17 CFR 201.17(c), since our records show service of that decision on June 30, 1970 upon the last respondent to be served.

[4] References herein with respect to Douglas' quarterly, six-month and annual earnings are for its fiscal year, ending November 30.

20, 1966, Douglas informed the Merrill Lynch vice-president in charge of the proposed underwriting of Douglas debentures, of substantially reduced Douglas earnings and earnings estimates. It advised that it had a loss in May, that earnings for the first six months of 1966 were expected to be only 49c per share, it would about break even for 1966, and it expected 1967 earnings to be only $5 to $6. The next day, June 21, this information was relayed to Merrill Lynch's senior aerospace analyst, who gave it to two salesmen in Merrill Lynch's New York Institutional Sales Office. The latter informed three other Merrill Lynch employees and the five employees began imparting it to decision-making investment personnel of respondents which were investment companies or partnerships with substantial capital or the advisers or managers for such interests. All of the respondents knew that Merrill Lynch was the prospective underwriter of the anticipated public offering of Douglas debentures, and some of them had indicated to Merrill Lynch an interest in buying debentures in such offering. Most of them had shortly before purchased Douglas stock.

Upon receiving the unfavorable Douglas earnings information between June 21 and June 23, respondents on those days sold a total of 133,400 shares of Douglas stock from existing long positions, which constituted virtually all of their holdings of Douglas stock, and sold short 21,100 shares, for an aggregate price of more than $13,300,000. The price of Douglas stock, which had a high of 90 on June 21, rose to 90½ the next day, apparently because of an optimistic newspaper article on the aerospace industry, and fell to 76 when Douglas publicly announced the disappointing earnings figures on June 24. On the following trading day, when those figures received further publicity the price of Douglas stock fell to 69, and subsequently declined to a low of 30 in October 1966.

As set forth below, the circumstances under which the information from Merrill Lynch was received and Douglas shares sold by the various respondents were similar in their essential aspects, although in some cases they differed in certain respects.

Respondent Madison Fund, an investment company, had purchased 6,000 shares of Douglas stock in early June 1966 on the basis of a favorable assessment of Douglas' earnings prospects for its second quarter and for 1966, and on June 13 had advised Merrill Lynch of its interest in purchasing Douglas debentures in the anticipated public offering. However, on June 21, within 15 minutes of being advised of the adverse

Douglas earnings figures by one of the Merrill Lynch employees, it placed an order with Merrill Lynch for the sale of all those shares, which was executed that day. Respondent Investors Management Co., Inc. ("IMC") acted as investment adviser to several mutual funds, two of which had on its recommendation purchased 100,000 and 21,000 shares of Douglas stock, respectively, between January and April 1966. On the afternoon of June 21 and the morning of June 22, one of the Merrill Lynch salesmen called the IMC vice-presidents who were the fund managers for the two funds and told them that Douglas would have disappointing earnings for the first six months and break even for 1966. After an unsuccessful effort to verify that information with a Merrill Lynch analyst, IMC advised the two funds to sell all their Douglas shares, and part of the shares were sold on June 22 and the balance over the next three trading days. Respondent Van Strum & Towne, Inc., which was the investment adviser to the Channing Growth Fund, and also considered the Douglas stock to be a desirable acquisition as late as June 20, when it caused that fund to buy 1,500 shares. On June 22, while attending a luncheon for professional investors, the firm's president overheard remarks implying that Douglas would have no earnings. When on making inquiry he was told that a portfolio manager for a large fund had received similar information from Merrill Lynch, he called a Merrill Lynch employee and was given the new Douglas earnings figures. He thereupon caused the 1,500 shares of Douglas stock to be sold that day.

Respondents William A. M. Burden & Co., a family investment partnership, and Burden Investors Services, Inc., which acted as investment adviser to other members of the Burden family, had on the advice of a broker purchased a total of 11,000 shares of Douglas stocks on the morning of June 21. That afternoon, one of the Merrill Lynch salesmen informed a principal Burden partner that Douglas' earnings for May were very disappointing, that its quarterly earnings would be down, and that its earnings for 1966 would be "flat". Inquiries to three analysts did not produce any verification of the information, although at the June 22 luncheon for professional investors the Burden partner heard rumors that Douglas' earnings would be very disappointing. Early on June 23, the broker on whose advice the Douglas shares had been purchased reported that he had just been cautioned about the Douglas situation and he recommended the sale of those shares. Such sale was effected later that day.

Respondent Fleschner Becker Associates, a family investment partnership formed in April 1966 which operated as a hedge fund,[5] had informed Merrill Lynch early in June of its interest in purchasing debentures in the forthcoming offering. On June 21 one of the Merrill Lynch salesmen advised respondent that Douglas' earnings would be disappointing and would show a loss for May. When the optimistic aerospace article appeared the following morning respondent decided that if the price of the Douglas stock rose, it would effect short sales of the stock. The opening price on June 22 did reflect a rise and respondent sold short 5,000 shares that day and 3,500 shares the next day.[6] Respondents A. W. Jones & Co. and A. W. Jones Associates were partnerships, with the same general partners, which operated as hedge funds. On the afternoon of June 21, a managing partner was informed by a Merrill Lynch salesman that Douglas' earnings would be disappointing and show a loss for May 1966. The next day the partner effected short sales of 2,000 shares on behalf of each of the partnerships.[7]

Respondent J. M. Hartwell & Co. managed on a discretionary basis about 200 individual and institutional securities portfolios including that of Hartwell and Campbell Fund, Inc. and a $2,000,000 segment of the portfolio of A. W. Jones & Co. Principal partners were also partners of respondents Hartwell Associates and Park Westlake Associates, hedge funds, whose investments they managed. Earlier in June 1966 a total of 1,600 shares of Douglas stock had been purchased for two of the managed portfolios. Those shares were immediately sold on June 21 when one of the Merrill Lynch salesmen advised that Douglas' earnings for the second quarter would probably show a loss and for the year would be "flat". Following the optimistic aerospace article the next day, short sales were made on behalf of Hartwell Associates, Park Westlake Associates and A. W. Jones & Co., of 2,500, 1,500 and 2,000 shares, respectively. Respondent Fairfield Partners, which operated as a hedge fund and managed about $31,000,000, had been

[5] The term "hedge fund" is frequently used to identify a limited partnership which engages in securities trading by means that customarily include the use of borrowed money, options and short sales.

[6] In recognition of the Merrill Lynch salesman's assistance with respect to the Douglas stock respondent directed a $3,000 give-up to the salesman's credit on June 28. A give-up is in effect a division of the commission received by an executing broker with another broker designated by the customer. In December 1968, the New York Stock Exchange prohibited such practice.

[7] The facts were similar with respect to City Associates, an investment partnership which as noted *supra* was censured pursuant to an offer of settlement. That respondent also effected short sales of Douglas stock after receipt of the Merrill Lynch information. It thereafter directed give-ups to Merrill Lynch. The discussion hereinafter as to violations of the antifraud provisions is also appliable to the conduct of that respondent.

skeptical about Douglas' ability to improve its earnings and had developed a short position in Douglas of 7,100 shares by June 2, 1966. When on June 21 a Merrill Lynch salesman called a partner and informed him that Douglas would show a loss for May, the firm immediately sold short an additional 900 shares.

APPLICABLE ANTIFRAUD PRINCIPLES

The maintenance of fair and honest markets in securities and the prevention of inequitable and unfair practices in such markets are primary objectives of the federal securities laws.[8] Congress has recognized the essential importance of providing full information for both the buyer and seller:

> "The concept of a free and open market for securities necessarily implies that the buyer and seller are acting in the exercise of enlightened judgment as to what constitutes a fair price. Insofar as the judgment is warped by false, inaccurate, or incomplete information regarding the corporation, the market price fails to reflect the normal operation of supply and demand."[9]

And the Supreme Court, in discussing the securities laws, has stated:

> "A fundamental purpose, common to these statutes, was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry . . . 'It requires but little appriciation . . . of what happened in this country in the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail' in every facet of the securities industry."[10]

The federal securities laws contain provisions specifically prohibiting fraudulent or deceptive acts or conduct by any person in connection with securities transactions, and we have adopted various rules implementing those provisions. The antifraud prohibitions have been applied and enforced in administrative and judicial proceedings dealing with a wide variety of securities activities which were found to have been improper in light of the statutory objectives. A number of cases have not only established that the antifraud prohibitions embrace transactions by persons who occupy a special relationship to the issuer giving them access to non-public information, but have indicated that under certain circumstances they extend to transactions by others who have received such information as a result of its selective disclosure.

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[8] See the preamble and Section 2 of the Exchange Act. See also the preamble to the Securities Act.

[9] S. Rep. No. 1455, 73d Cong., 2d Sess. 68 (1934). See also *id* pp. 55-68; S. Rep. No. 792, 73d Cong., 2d Sess. 3 (1934); H. Rep No. 1383, 73d Cong., 2d Sess. 11 (1934).

[10] *S.E.C.* v. *Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963).

In *Cady Roberts & Co.*,[11] a broker had received information of a corporate dividend reduction from a salesman in the broker's firm who was a director of the corporation. The broker thereupon sold shares of the corporation's stock, on the exchange on which it was listed, for his customers and wife before such information became public. We held that the broker violated the antifraud provisions, stating that any person who is in a relationship giving access, directly or indirectly, to material information intended to be available only for a corporate purpose, violates those provisions if having such information and knowing it is unavailable to those with whom he is dealing, he effects a securities transaction without disclosing it to them.

In a number of other cases, one prior to *Cady Roberts*, we also found violationf of antifraud provisions where persons effected transactions after having obtained non-public information. In the earlier case a broker obtained from an employee of a trust company administering a bond sinking fund confidential information relating to tenders by other bondholders, and with the benefit of such information he purchased bonds and successfully tendered them to the fund at higher prices.[12] In another case, an investment adviser effected purchases of securities after receiving information of a sharp rise in sales and earnings obtained through a director of the issuer.[13] In a third, similar information was obtained from the issuer in connection with a prospective underwriting of its stock by a broker-dealer which together with partners and employees purchased securities of the issuer for themselves and customers.[14] And another case involved transactions in government securities effected by a broker-dealer who had received advance information concerning the terms of new government financings from a Federal Reserve Bank employee.[15]

The *Cady Roberts* principles were cited with approval and applied in the leading judicial decision in this area, *S.E.C.* v. *Texas Gulf Sulphur Co.* ("Texas Gulf").[16] There market purchases of a company's stock by persons connected with it who had obtained non-public information concerning a major ore strike by the company were held violative of Section 10(b) and Rule 10b–5. The Court stated that the Rule ". . . is based in

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[11] 40 S.E.C. 907 (1961).

[12] *Herbert E. Hanahan*, 13 S.E.C. 754, 757–8 (1943).

[13] *Mates Financial Services*, 44 S.E.C. 245 (1970).

[14] *Van Alstyne, Noel & Co.*, 43 S.E.C. 1080 (1969).

[15] *Blyth & Company, Inc.*, 43 S.E.C. 1037 (1969).

[16] 401 F.2d 833 (C.A. 2, 1968), *cert. denied* 394 U.S. 796 (1969).

policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information," and is not limited to traditional corporate insiders. In that case the persons who had obtained the information had also communicated it to certain other persons who then purchased stock. Although the latter were not defendants in the case and the Court expressly refrained from deciding whether they had committed violations, the Court nevertheless saw fit to observe that if they acted with knowledge that the material information was undisclosed, their conduct "certainly could have been equally reprehensible."

The *Cady Roberts* rationale was also referred to in another case in which it formed the foundation for the imposition of legal liability, based on violation of Rule 10b–5, upon purchasers of securities who were close friends of officers and directors of the issuer and had received from them, pursuant to an arrangement to share profits, undisclosed information of proposed offerings by the issuer at much higher prices. The Court considered that under the circumstances the defendants in question could be deemed "insiders," but stated that if they were not insiders they would seem to have been "tippees" and "subject to the same duty as insiders."[17]

It is clear that in light of the foregoing principles the conduct of respondents in this case came within the ambit and were violative of the antifraud prohibitions of the securities laws. All the requisite elements for the imposition of responsibility were present on the facts found by the examiner. We consider those elements to be that the information in question be material and non-public; that the tippee, whether he receives the information directly or indirectly, know or have reason to know that it was non-public and had been obtained improperly by selective revelation or otherwise, and that the information be a factor in his decision to effect the transaction.[18] We shall discuss these elements in turn in light of the contentions that have been presented by the parties and pertinent considerations under the securities laws.

[17] *Ross* v. *Licht*, 263 F. Supp. 395, 410 (S.D.N.Y. 1967).

[18] Our formulation would clearly attach responsibility in a situation where the recipient knew or had reason to know the information was obtained by industrial espionage, commercial bribery or the like. We also consider that there would be potential responsibility, depending on an evaluation of the specific facts and circumstances where persons innocently come into possession of and then use information which they have reason to know is intended to be confidential. Our test would not attach responsibility with respect to information which is obtained by general observation or analysis.

With respect to materiality, we held in our findings with regard to Merrill Lynch in these proceedings that the information as to Douglas' earnings that it divulged was material because it "was of such importance that it could be expected to affect the judgment of investors whether to buy, sell or hold Douglas stock and, if generally known, . . . to affect materially the market price of the stock."[19] Among the factors to be considered in determining whether information is material under this test are the degree of its specificity, the extent to which it differs from information previously publicly disseminated, and its reliability in light of its nature and source and the circumstances under which it was received. While the test would not embrace information as to minor aspects or routine details of a company's operations, the information received by the respondents from Merrill Lynch was highly significant since it described a sharp reversal of Douglas' earnings realization and expectations. Although all respondents did not receive identical information, in each instance the information received was specific and revealed the existence and significant extent of the adverse earnings developments. Such extraordinary information could hardly help but be important to a reasonable investor in deciding whether he should buy, sell or hold Douglas stock. The information's significance was immediately clear; it was not merely one link in a chain of analytical information.[20]

Respondents are not aided by their claim that as far as the earnings projections were concerned such projections in the aerospace industry are uncertain. Douglas was an established company with a history of operations and its adverse earnings projections were short-term and of such specific importance as would necessarily affect the judgment of investors to buy, sell or hold the company's securities. Moreover, the fact that respondents acted immediately or very shortly after receipt of the information to effect sales and short sales of Douglas stock, is in itself evidence of its materiality.[21]

The requirement that the information divulged be non-

[19] *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933, 937 (1968).

[20] The probability of the accuracy of the information was strongly indicated by the fact that it was highly adverse and, as all the respondents knew, the informant was engaged in acting for Douglas as prospective managing underwriter of an offering seeking to raise new funds from the public, at a time when it was thus the company's and the underwriter's interest to promote a favorable earnings picture. *Cf. Texas Gulf, supra*, at p. 849: "Whether facts are material within Rule 10b-5 when the facts relate to a particular event . . . will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in the light of the totality of the company activity."

[21] See *Texas Gulf*, at p. 851.

public was also satisfied here. Information is non-public when it has not been disseminated in a manner making it available to investors generally.[22] Although during the first half of 1966 some aerospace analysts had indicated pessimism concerning Douglas' earnings prospects, and there were adverse rumors circulating in the financial community on June 21, 22 and 23 regarding Douglas' earnings, the information conveyed to respondents by Merrill Lynch personnel was much more specific and trustworthy than what may have previously been known to those analysts or could be said to have been general knowledge. The rumors circulated at the June 22 luncheon, which was attended by about 50 representatives of professional investors, to the effect that Douglas' earnings would be disappointing and that it was having production problems and would not be able to meet its delivery schedules, did not, as respondents urge, reflect specific public knowledge of the earnings information disclosed by Merrill Lynch. Unlike that information, the rumors did not include specific figures of actual and projected earnings and were not attributed to a corporation-informed source. Moreover, even if the rumors had contained the more specific data, their circulation among the limited number of investors present at the luncheon could not constitute the kind of public disclosure that would suffice to place other investors in an equal position in the marketplace. It was not until after Douglas had issued its press release that the earnings data became available to the investing public.

The specific Douglas earnings information imparted to respondents having thus been of the material and non-public character bringing it within the scope of the antifraud provisions, we turn to the question of the awareness on the part of respondents that is required to establish a violation. As has been indicated, in our opinion the appropriate test in that regard is whether the recipient knew or had reason to know that the information was non-public and had been obtained improperly by selective revelation or otherwise. We reject the contentions advanced by respondents that no violation can be found unless it is shown that the recipient himself occupied a special relationship with the issuer or insider corporate source giving him access to non-public information, or, in the absence of such relationship, that he had actual knowledge that the information was disclosed in a breach of fiduciary duty not to reveal it.

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[22] *Id.* at p. 854: "Before insiders may act upon material information, such information must have been effectively disclosed in a manner sufficient to insure its availability to the investing public."

We consider that one who obtains possession of material, non-public corporate information, which he has reason to know emanates from a corporate source, and which by itself places him in a position superior to other investors, thereby acquires a relationship with respect to that information within the purview and restraints of the antifraud provisions. Both elements are here present as they were in the *Cady Roberts* case. When a recipient of such corporate information, knowing or having reason to know that the corporate information is non-public, nevertheless uses it to effect a transaction in the corporation's securities for his own benefit, we think his conduct cannot be viewed as free of culpability under any sound interpretation or application of the antifraud provisions.

Considerations of both fairness and effective enforcement demand that the standard as to the requisite knowledge be satisfied by proof that the recipient had reason to know of the non-public character of the information, and that it not be necessary to establish actual knowledge of that fact or, as suggested by respondents, of a breach of fiduciary duty. The imposition of responsibility where one has reason to know of the determinative factors in violative conduct is in keeping with the broad remedial design of the securities laws and has been applied under other of their provisions[23] as well as the antifraud provisions.[24] That standard is clearly appropriate in the situation where it is shown that the respondent received and made use of information that was material and non-public. In such situation, the question of whether the recipient had the requisite "reason to know" is properly determinable by an examination of all the surrounding circumstances, including the nature and timing of the information, the manner in which it was obtained, the facts relating to the informant, including his business or other relation to the recipient and to the source of his information, and the recipient's sophistication and knowledge of related facts.

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[23] See *S.E.C.* v. *Mono-Kearsarge Consolidated Mining Company*, 167 F. Supp. 248, 259 (D.C. Utah, 1958); *S.E.C.* v. *Culpepper*, 270 F.2d 241, 250 (C.A. 2, 1959); *Kennedy, Cabot & Co., Inc.* 44 S.E.C. 215, 218 (1970).

[24] See *Texas Gulf*, where the Court stated (at p. 855) ". . . a review of other sections of the Act from which Rule 10b-5 seems to have been drawn suggests that the implementation of a standard of conduct that encompasses negligence as well as active fraud comports with the administrative and the legislative purposes underlying the Rule." The Court noted that such standard satisfies the "fraud" concept as reflected in the legislation which "whether it be termed lack of diligence, constructive fraud, or unreasonable or negligent conduct, remains implicit in this standard, a standard that promotes the deterrence objective of the Rule." See also *Stone* v. *U.S.*, 113 F.2d 70, 75 (C.A. 6, 1940); *U.S.* v. *Schaefer*, 299 F.2d 625, 629 (C.A. 7, 1962), *cert. denied* 370 U.S. 917.

In this case, it is clear that respondents had the knowledge requisite to a finding of violation of Rule 10b–5. They knew Merrill Lynch, from whom they obtained the Douglas information, was the prospective underwriter of the company's securities. As professionals in the securities industry, they knew that underwriters customarily receive non-public information from issuers in order to make business judgments about the proposed public offering. Although such information is not publicly disclosed, it may be conveyed to the prospective underwriter by the issuer for a valid corporate purpose; however, the prospective underwriter, as we have previously held, may not properly disclose or use the information for other than that purpose. Under the circumstances there can be no doubt that respondents, all of whom were sizeable existing or potential customers of Merrill Lynch, knew or had reason to know that they were selectively receiving non-public information respecting Douglas from Merrill Lynch.[25] Respondents cannot successfully argue that their obligations under the antifraud provisions were any less because they were "remote tippees" who received their information from Merrill Lynch salesmen who were themselves "tippees." It would appear that the corporate insider position that Merrill Lynch in effect occupied by virtue of its role in assisting Douglas in its corporate financing functions would embrace anyone in its organization who obtained and transmitted the Douglas information, and not merely those in its underwriting division. But even if respondents are viewed as indirect recipients of the Douglas information, the same criteria for finding a violation of the antifraud provisions by the respondents properly apply. Although the case of such an indirect recipient may present more questions of factual proof of the requisite knowledge, the need for the protections of those provisions in the tippee area is unaffected. While there are some express restraints on transactions by traditional insiders, such as the prohibition against short-swing trading under the Exchange Act and the requirement for registration under the Securities Act of securities received from the issuer which they desire to sell, they do not apply to other persons who receive and act upon non-public

[25] Some of the respondents have pointed out that they received the information from Merrill Lynch without solicitation by them. While under some circumstances a finding with respect to whether the recipient knew or had reason to know that information was non-public might be affected by whether or not it had been soliciated by him, it did not under the facts of this case, as the examiner held.

information. In addition, the ability of a corporate insider to take action with the benefit of non-public information may be limited by his position in the company and his own personal resources. However others may have a greater capacity to act, particularly those who, like the respondents here, are engaged in professional securities activities and have not only access to or advisory functions with respect to substantial investment funds but also the sophistication to appraise and capitalize upon the market effect of the information.[26]

We appreciate the concerns that have been expressed about the need to facilitate the free flow of information throughout the financial community. We have consistently required or encouraged the broadest possible disclosure of corporate information so as to provide public investors and their professional financial advisers with the most accurate and complete factual basis upon which to make investment decisions. We also recognize that discussions between corporate management and groups of analysts which provide a forum for filling interstices in analysis, for forming a direct impression of the quality of management, or for testing the meaning of public information, may be of value.[27] In some cases, however, there may be valid corporate reasons for the nondisclosure of material information. Where such reasons exist, we would not ordinarily consider it a violation of the antifraud provisions for an issuer to refrain from making public disclosure. At the same time we believe it necessary to ensure that there be no improper use of undisclosed information for noncorporate purposes.

Turning next to the requirement that the information received be a factor in the investment decision, we are of the opinion that where a transaction of the kind indicated by the information (*e.g.*, a sale or short sale upon adverse information) is effected by the recipient prior to its public dissemination, an inference arises that the information was such a factor. The recipient of course may seek to overcome such

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[26] The instant case is illustrative of the potential magnitude of tippee trading. As noted above, the information concerning the change in the Douglas earnings picture precipitated sales of Douglas stock with a value of more than $13,300,000 by the respondents as to whom the examiner found violations.

[27] See New York Stock Exchange Company Manual A-20: "The competent analyst depends upon his professional skills and broad industry knowledge in making his evaluations and preparing his reports and does not need the type of inside information that could lead to unfairness in the marketplace." See also *Haack, Corporate Responsibility to the Investing Public*, CCH FED. Sec. L. Rep. ¶ 77,554 at 83, 173: "If, during the course of discussion [between the issuer and analyst], some important information is divulged that has not yet been published—information which could affect the holding or investment decision of any stockholder—that information should be made the subject of an immediate and comprehensive news release."

inference by countervailing evidence. Respondents did not meet that burden in this case.[28]

We do not find persuasive the claim made by respondents that as persons managing funds of others they had a fiduciary duty to their clients to sell their Douglas stock upon learning of the poor Douglas earnings, and that a failure to do so might have subjected them to liability for breach of such duty. The obligations of a fiduciary do not include performing an illegal Act,[29] and respondents could have sold the Douglas stock in a legal manner if they had secured the public disclosure of the information by Douglas.[30] And there is no basis for the stated concern that a fiduciary who refrains from acting because he has received what he believes to be restricted information would be held derelict if it should later develop that the information could in fact have been acted upon legally. If that belief is reasonable, his non-action could not be held improper.

CONCLUSION

We find no reason for disturbing the hearing examiner's conclusion that each of the respondents be censured. Although the facts in this case may be novel in certain respects, the findings of violation here do not represent an impermissible application of new standards, as respondents have claimed. The ambit of the antifraud provisions is necessarily broad so

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[28] The examiner rejected contentions by various of the respondents that their sales of Douglas stock were motivated by factors other than the Merrill Lynch information. Van Strum had contended that its decision to sell Douglas stock two days after its purchase was based on an "unconfirmed rumor" that cast doubt on the assumption which formed the basis of its decision to buy the stock; the Jones respondents contended that their short sales of June 22, 1966 resulted from "a careful, painstaking analysis of Douglas made over a period of years"; Fleschner-Becker contended that it sold Douglas short as a result of the stream of bearish information on Douglas and because of its own analysis that production problems would have an adverse affect on Douglas' earnings; and the Burden respondents stress that they did not act for several days after receiving the information and not until after they were advised to do so by the broker who originally recommended purchase of their Douglas shares.

On the other hand, in dismissing the proceedings with respect to one respondent, an adviser to a large investment fund, the examiner credited its defense that a junior analyst who received the Merrill Lynch information and thereupon recommended sale of all Douglas holdings to his superior, who made the investment decisions for the fund, did not advise his superior of such receipt, and that other considerations led to the fund's sales. We consider it appropriate to observe that in future cases we would view as suspect and subject to close scrutiny a defense that there was no internal communication of material non-public information and its source by a member of a broker-dealer firm or other investment organization who received it, where a transaction of the kind indicated by it was effected by his organization immediately or closely thereafter. A showing of such receipt and transaction prior to the time the information became public should in itself constitute strong evidence of knowledge by the one who effected the transaction and by the firm.

[29] See *Cady Roberts, supra*, at p. 916; *Restatement of Trusts*, 2d (1959) § 166; *Scott on Trusts* (3d ed. 1967) § 166.

[30] Since respondents did not disclose to their immediate purchasers of Douglas securities the non-public information they had received from Merrill Lynch, we need not decide whether it would have nonetheless constituted a violation of the antifraud provisions had they done so.

as to embrace the infinite variety of deceptive conduct.[31] The inherent unfairness of the transactions effected by respondents on the basis of the non-public information imparted to them from an inside source should have been evident to respondents.

Accordingly, IT IS ORDERED that the imposition by the hearing examiner of the sanction of censure upon the above-captioned respondents be, and it hereby is, affirmed.

By the Commission (Chairman CASEY and Commissioners OWENS, HERLONG and NEEDHAM), Commissioner SMITH concurring in the result.

Commissioner SMITH, concurring in the result:

The Commission here spells out, in effect, four questions to be asked in determining the applicability of Rule 10b–5 to an inside information trading case: One, was the information material? Two, was the information non-public? Three, was the person effecting the transaction an insider or, if not an insider but a "tippee", did he know or have reason to know that the information "was non-public and had been obtained improperly by selective revelation or otherwise"? And four, was the information "a factor" in the person's decision to effect the transaction?[1]

I agree generally with the progression of elements set forth in the majority opinion as requisite to a finding of violation of Rule 10b–5 under the facts of this case and with the conclusion that respondents' conduct constituted a violation of the rule. However, I would have formulated the third and fourth elements differently. It is important in this type of case to focus on policing insiders and what they do, which I think appropriate, rather than on policing information *per se* and its possession, which I think impracticable. I believe the emphasis in the law should continue to be upon the conduct of corporate insiders and their privies, as it has been since *Strong* v. *Repide*, 213 U.S. 419 (1909) and as it was in *Cady Roberts*, *Texas Gulf* and *Merrill Lynch*, rather than upon a concept—too vague for me to apply with any consistency—of relative informational advantages in the marketplace.

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[31] See *S.E.C.* v. *Captial Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963). *Cf. Chasins* v. *Smith Barney & Co., Inc.*, 438 F.2d 1167 (C.A. 2, March 2, 1971); *Opper* v. *Hancock Securities*, 200 F. Supp. 668, 676 (S.D. N.Y. 1966), *aff'd* 367 F.2d 157 (C.A. 2, 1966).

[1] I do not understand later summaries in the majority opinion of the requisite elements of a violation as departing from this explicit formulation, despite some apparent inconsistencies in expression.

The significance of this case is undoubtedly in recognizing the inhibitions on primarily large institutional investors which might otherwise indirectly receive inside information by reason of their investing power and attractiveness as business customers. While the problem may not be as simple in all cases as implied by the majority, they are right in not permitting such abuse of power to be hidden behind claims of fiduciary obligations institutions have to their beneficiaries. The majority is also right in not permitting inside information to be cloaked as "research" or "analysis." Nevertheless, in accomplishing the objectives of Rule 10b–5, it is important not to over-generalize and thereby to penalize or thwart the quest for new knowledge by analysts and researchers. That quest keeps practical pressure on corporate managements to disclose business affairs and contributes valuably to more informed investing and consequently to more accurate market pricing. The relatively high threshold of materiality for purposes of Rule 10b–5, as set forth in the majority opinion, and the explicit recognition of the analyst's role, go some distance in this regard. It must be recognized, of course, that investors willing and able to engage in research and analysis will have a quantum informational advantage over investors who do not. But so far as I know, this is not violative of the securities laws even if the two transact with each other—so long as, the majority opinion reserves, there is no specific extraordinary information not generally known that was improperly obtained by one side of the transaction and not disclosed to the other.

With that reservation—in the sense that in this case the impropriety consisted of Merrill Lynch's disclosure to respondents of material non-public information that had been obtained from the issuer for a corporate purpose by the firm in its capacity, known to respondents, as the issuer's prospective underwriter—I agree. But I think the nexus of the special relationship between Merrill Lynch and Douglas and respondents' knowledge of that relationship as the source of the information is essential to the case. It is not necessary here to decide whether impropriety would attach in other cases less clearly involving a breach of duty by an insider or other person having a particular relationship with the issuer. Certainly there is no need to dispute Chief Examiner Blair's acceptance of the appropriate test in this regard, indicated by *Texas Gulf,* that the tippee must know or have reason to know "that the company was the source of informant's knowledge" (Initial Decision, p. 34). The company source is what makes the infor-

mation "inside" and the special relationship (as director, employee, consultant, prospective underwriter, etc.) is what creates the duty. Elaboration of the duty of tippees viewed as part of the evolution of federal regulation of securities fraud, should not dispense with the requirement that the tippees have this knowledge. I would therefore have framed the third test in terms of the respondents knowing or having reason to know that the material non-public information became available to them in breach of a duty owed to the corporation not to disclose or use the information for non-corporate purposes.[2] Such knowledge, in effect, renders the tippee a participant in the breach of duty when he acts on the basis of the information received. I would hope that is what the majority means by "improperly obtained".

I do not see that it is important to require proof of actual or constructive knowledge that the information was non-public. Its non-public status is an objective—not subjective—fact just as is its materiality. Nor do I understand what "selective revelation" adds. To the extent that selective revealment (by the tippor I assume) is not simply a redundant way of saying the information is still non-public, it is improper only if done in breach of a duty owed to the corporation. The fact that the tippor tells only A and not B hardly seems germane to whether either the tippor or the tippee has any responsibility. Would Merrill Lynch or any of the respondents have none if Merrill Lynch had passed on the Douglas information indiscriminately? At what point does the revelation cease being selective, if at all? And if anything short of a public announcement constitutes selective revelation, then its simply means non-public.

I also have difficulty with the expression of the causation test. The Commission's staff in this case, and in *Cady Roberts* and *Texas Gulf*, accepted the burden of proving that the inside information was the motivating factor, and not just a factor, in the decision to effect the transaction. The burden was satisfied in each of these cases and it is evidently not an unduly difficult one to meet in the proper case—especially where a transaction of the kind indicated by the inside information is effected within a relatively short period of time after its receipt, and

[2] This would, I believe, cover the situations not involved in this case about which the majority seems concerned, where a person purloins corporate information, or knowingly receives such purloined information, or accidentally finds a lost document containing inside information in circumstances indicating that the document is confidential and belongs to the corporation. A duty not to steal or knowingly receive stolen goods or execise dominion over goods known to be owned by others exists toward the corporation even without the presence of a special relationship.

there is the inference (which I consider appropriate) that the information substantially contributed to the recipient's decision to buy or sell. The majority's opinion may appear to do violence to the traditional concept of causation, but I do not read its requirement that the information be "a factor" as, for instance, encompassing situations where a firm decision to effect a transaction had clearly been made prior to the receipt of the information and the information played no substantial role in the investment decision.

In sum, I believe the tippee responsibility must be related back to insider responsibility by a necessary finding that the tippee knew the information was given to him in breach of a duty by a person having a special relationship to the issuer not to disclose the information, and that the information must be shown not only to have been material and non-public, but also to have substantially contributed to the trading which occurred. I agree with the examiner's finding of facts which satisfy the requirements in this case.