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# Tipping Violations and Civil Liability under Rule 10b-5

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# NOTE

## TIPPING VIOLATIONS AND CIVIL LIABILITY UNDER RULE 10B-5

### INTRODUCTION

On August 13, 1968, the United States Court of Appeals for the Second Circuit handed down what has become, and what was expected to be,[1] one of the most significant decisions in the area of securities law rendered in the past decade.[2] *S.E.C. v. Texas Gulf Sulphur* dealt comprehensively with the expanded application of Rule 10b-5,[3] promulgated under Section 10(b) of the Securities and Exchange Act of 1934,[4] as a device to control insider trading.

Perhaps one of the most noteworthy aspects of *Texas Gulf Sulphur* was its holding that "tipping"[5] is a violation of Rule 10b-5.[6] It was clear at the outset from the cases interpreting Rule 10b-5 that

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[1] *See, e.g.*, Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 U. VA. L. REV. 1271 (1965); Kennedy & Wander, *Texas Gulf Sulphur, A Most Unusual Case*, 20 BUS. LAW. 1057 (1965); Mundheim, *The Texas Gulf Sulphur Complaint, A Major Step in Restricting Insider Trading in Corporate Securities*, 1966 J. BUS. L. 284.

[2] SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968), *aff'g in part and rev'g in part*, 258 F. Supp. 262 (S.D.N.Y. 1966), *cert. denied*, 394 U.S. 976 (1969) (Justice White dissenting). For commentary on the District Court decision, *see, e.g.*, Ruder, *Corporate Disclosures Required by the Federal Securities Laws, The Codification Implications of Texas Gulf Sulphur*, 61 SW. U.L. REV. 872 (1967); Wiesen, *Disclosure of Inside Information — Materiality and Texas Gulf Sulphur*, 28 MD. L. REV. 189 (1968); Note, *SEC v. Texas Gulf Sulphur Co.: The Inside and Outside of Rule 10b-5*, 46 B.U.L. REV. 205 (1966); Note, *Texas Gulf Sulphur and the Duty of Disclosure, Another View*, 55 GEO. L.J. 664 (1967); Note, *Securities Transactions — SEC Rule 10b-5 — Disclosure of Material Information by Corporate Stock Optionees*, 41 TUL. L. REV. 722 (1967); Note, *Rule 10b-5 and Texas Gulf Sulphur: An Evolution of Questions and Answers*, 20 U. MIAMI L. REV. 939 (1966); Comment, 8 B.C. IND. & COM. L. REV. 353 (1967); Comment, 80 HARV. L. REV. 468 (1966); Comment, 65 MICH. L. REV. 944 (1967); Comment, 12 N.Y.L.F. 318 (1966). For commentary on the Circuit Court decision, *see, e.g.*, Bromberg, *Corporate Information: Texas Gulf Sulphur and its Implications*, 22 SW. L.J. 731 (1968); Note, *Scienter and Rule 10b-5*, 69 COLM. L. REV. 1057 (1969); Note, *Texas Gulf Sulphur Expanding Concepts of Corporate Disclosure Under SEC Rule 10b-5*, 43 ST. JOHN'S L. REV. 425 (1969); Note, *Securities — Rule 10b-5 is Violated Whenever an Insider Purchases Stock Without Disclosing Information that Would Affect the Judgment of a Reasonable Investor*, 47 TEXAS L. REV. 509 (1969); Note, *Texas Gulf Sulphur: Its Holdings and Implications*, 22 VAND. L. REV. 359 (1969); Comment, 35 BROOKLYN L. REV. 326 (1969); Comment, *Inside Trading on the Open Market: Nondisclosure and Texas Gulf Sulphur*, 42 S. CAL. L. REV. 309 (1969); Comment, *Securities Regulation — Trading by Insiders*, 10 WM. & MARY L. REV. 755 (1969).

[3] 17 C.F.R. § 240. 10b-5 (1969).

[4] 15 U.S.C. § 78a-hh-1 (1964).

[5] For definitions of "tipping," see text accompanying notes 29 & 34 *infra*.

[6] SEC v. Texas Gulf Sulphur, 401 F.2d 833, 852 (2d Cir. 1968).

a corporate or organizational insider, who purchases or sells securities issued by the corporation in a direct transaction with a member of the investing public without disclosing material inside information possessed by him, could be held in violation of 10b-5 and could be held civilly liable to the purchaser.[7] It also appeared that the "tippee"[8] of such an insider would be held to be in violation of the Rule and civilly liable, in the same manner as the corporate insider himself.[9] *Texas Gulf Sulphur* enlarged the scope of tipping regulation one step further in holding a *tipper who did not trade* in the securities in question to be in violation of the Rule.[10]

*Texas Gulf Sulphur* resolved some significant issues but also raised new ones to which it did not address itself. The most important of these is: Can *civil liability* be imposed on one who "tips" — *i.e.*, selectively discloses material inside information to one who thereafter trades in the security in question? If so, under what circumstances can the "tipper" be held liable, and to what extent?

The importance of this issue is clear. A tipper who is merely a violator of the Rule may be subject to an SEC action for injunctive or other administrative relief.[11] A tipper who is held civilly liable for his violation may be subject to a multiplicity of claims for damages suffered by those trading on the securities in question, as a result of the tipper's violation.[12]

Although a great number of factors may become involved in considering the primary question of "tipping" violations of Rule 10b-5, four underlying questions seem to be of crucial importance in discussing the imposition of civil liability for tipping violations:

(1) Who may be held to be subject to the Rule?

(2) What are the theoretical bases for holding "tipping" to

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[7] *See* text, section IV(C)(1) *infra.*

[8] A "tippee" is one who receives inside information by selective disclosure in breach of trust. However, the distinction between an "insider," as defined in the text accompanying note 25 *infra,* and a "tippee," as defined in the text accompanying notes 29 & 34 *infra,* is often blurred. As further discussion will point out, once a violation of Rule 10b-5 is found, it is felt that the distinction should not be crucial in determining the civil liability of such a person.

[9] *See* text, section IV(C)(2) *infra.*

[10] SEC v. Texas Gulf Sulphur, 401 F.2d 833, 852 (2d Cir. 1968).

[11] "It is not necessary in a suit for equitable or phophylactic relief to establish all the elements required in a suit for monetary damages." SEC v. Texas Gulf Sulphur, 401 F.2d 833, 863 (2d Cir. 1968), *quoting from,* Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 547 (2d Cir. 1967), *and* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 193 (1963).

[12] *See* Ruder, *Texas Gulf Sulphur — The Second Round: Privity and State of Mind In 10b-5 Purchase and Sale Cases,* 63 Nw. U.L. REV. 423, 441-44 (1968).

Approximately 59 private actions have been filed against Texas Gulf Sulphur Company, et al. Cannon v. Texas Gulf Sulphur Co., [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 97,372 n.2 (S.D.N.Y. Mar. 20, 1969). Only one of these is known to have been decided on the merits at this time. Reynolds v. Texas Gulf Sulphur Co., CCH FED. SEC. L. REP. ¶ 92,494 (Civil No. 132-66) (D. Utah Oct. 17, 1969).

be a violation of the Rule and the doctrinal grounds for imposition of civil liability therefor?

(3) In view of the fact that Rule 10b-5 requires that the prohibited acts be performed "in connection with the purchase or sale of any security,"[13] what types of transactions are subject to the Rule, and what constitutes a sufficient "connection with" the transaction?

(4) What additional factors must be considered in answering the above questions in connection with a civil action for damages, rather than an SEC action for injunctive or other administrative relief?

This Note will analyze the primary question generally, in terms of these four aspects of a Rule 10b-5 civil action. To clarify the considerations involved with each of the four aspects, they will be analyzed more or less independently of each other before attempting to determine the relationships between them and their combined effect upon the question of *liability*. For this reason and to provide the legal context in which the issues arise, the persons, the acts, and the transactions which fall within the ambit of 10b-5 for purposes of determining a *violation*, will first be considered.

## I. PERSONS WHO MAY VIOLATE THE RULE

### A. *Insider Violations under 10b-5*

Rule 10b-5 was promulgated in 1942 under section 10(b) of the Securities Exchange Act of 1934[14] and is one of many provisions in the securities laws designed to prevent fraud.[15] Rule 10b-5 states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interestate [sic] commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
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> (c) To engage in any act, practice, or course of business which

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[13] *See* text of Rule quoted in text accompanying note 16 *infra*.

[14] 15 U.S.C. § 78a-hh-1 (1964).

[15] SEC Securities Exchange Act Release No. 3230 (May 21, 1942) states:

> The Securities and Exchange Commission today announced the adoption of a rule prohibiting fraud by any person in the connection with the purchase of securities. The previously existing rules against fraud in the purchase of securities applied only to brokers and dealers. The new rule closes a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase.

operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.[16]

The Rule does not utilize the word "insider." Nevertheless, the courts have interpreted Rule 10b-5 to mean "that a corporate insider purchasing stock from an outsider must disclose any material fact known to him by reason of his inside position but not known to the outsider."[17] In deciding who was to have the status of an insider, the courts have applied the rule to officers and directors,[18] and controlling shareholders.[19] The Commission has taken the position that any person trading unfairly in the stock of the corporation while knowingly possessed of information unavailable to the general public should be regarded as violating Rule 10b-5.[20] The SEC expanded the definition of insider by developing an "access test"[21] relying on the "any person" language in the Rule.[22] This expanded reading of the Rule was first presented in *Cady, Roberts & Co.*,[23] in which the Commission stated:

> We have already noted that the anti-fraud provisions are phrased in terms of "any person" and that a special obligation has been traditionally required of corporate insiders, e.g., officers, directors and controlling stockholders. These three groups, however, do not exhaust the classes of persons upon whom there is such an obligation. Analytically, the obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and

[16] 17 C.F.R. § 240.10b-5 (1969).

[17] Ross v. Licht, 263 F. Supp. 395, 408 (S.D.N.Y. 1967).

[18] List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir.), *cert. denied,* 382 U.S. 811 (1965); Ross v. Licht, 263 F. Supp. 395 (S.D.N.Y. 1967); Northern Trust Co. v. Essaness Theatres Corp., 103 F. Supp. 954 (N.D. Ill. 1952); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946), *rehearing on other grounds,* 73 F. Supp. 798, *modified on other grounds,* 83 F. Supp. 613 (1947).

[19] Rogen v. Ilikon Corp., 361 F.2d 260 (1st Cir. 1966); Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951); Robinson v. Difford, 92 F. Supp. 145 (E.D. Pa. 1950).

[20] Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961). *See also* Comment, *Liability for Failure to Disclose Under Rule 10-b-5,* 20 STAN. L. REV. 347, 352-53 (1968) [hereinafter cited as *Failure to Disclose*].

[21] Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961). *See also* Bromberg, *Corporate Information: Texas Gulf Sulphur and Its Implications,* 22 SW. L.J. 731 (1968) [hereinafter cited as Bromberg, *TGS*].
Bromberg states:

> The SEC laid down an "access test" which treats as an insider anyone with a relationship to an issuer giving access, directly or indirectly, to information intended to be available only for a corporate purpose of the issuer. The test was adopted by both lower and upper courts in TGS, and was described by the latter as "the essence of Rule 10b-5."

*Id.* at 739.

[22] Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961). *See also* Comment, *Insider Liability Under Securities Exchange Act Rule 10b-5: The Cady, Roberts Doctrine,* 30 U. CHI. L. REV. 121, 131 (1962); Daum & Phillips, *The Implications of Cady, Roberts,* 17 BUS. LAW. 939, 947-53 (1962).

[23] 40 S.E.C. 907 (1961).

> second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. In considering these elements under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications. Thus our task here is to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities.[24]

The "access test" thus defines or treats as an insider anyone who has a relationship to a corporation and either directly or indirectly is given access to information intended for corporate purposes.[25] The courts seem to be willing to accept this expanded definition.[26] In *SEC v. Texas Gulf Sulphur Co.*,[27] the Court of Appeals for the Second Circuit, speaking of the access test, stated:

> The essence of the Rule is that anyone who, trading for his own account in the securities of a corporation has "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone" may not take "advantage of such information knowing it is unavailable to those with whom he is dealing," i.e., the investing public.[28]

The door is thus opened for liability extending to many persons who receive inside information from the corporation.

B. *First Generation Tippees*

Tipping is generally "the selective disclosure of material inside (nonpublic) information for trading or other personal purposes."[29] The first case finding a 10b-5 violation by a tippee was *Cady, Roberts & Co.*,[30] which was also the first case applying the "access test."[31] Gintel, a partner in the broker-dealer firm, was given information by Cowdin, a director of Curtiss-Wright, prior to its public release. Upon receiving this information, Gintel called his associate at Cady, Roberts, and instructed him to buy Curtiss-Wright stock. In its opinion, the Commission stated: "Cowdin's relationship to the company clearly prohibited him from selling the securities affected by the information without disclosure. By logical sequence,

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[24] *Id.* at 912 (footnotes omitted).

[25] *Id.*

[26] *See* material quoted in note 21 *supra.*

[27] 401 F.2d 833 (2d Cir. 1968).

[28] *Id.* at 848 (footnote omitted).

[29] A. BROMBERG, SECURITIES LAWS: FRAUD — SEC RULE 10b-5 § 7.5(2) (1969) [hereinafter cited as BROMBERG, FRAUD]. For a discussion of the obligation of tippees to disclose, see 3 L. LOSS, SECURITIES REGULATION 1451 (2d ed. 1961) [hereinafter cited as LOSS].

[30] 40 S.E.C. 907 (1961).

[31] *See* note 24 *supra* and accompanying text. It is possible that Cady, Roberts & Co. is more properly classified as an insider under the "access test." *See* note 10 *supra* and text accompanying note 25 *supra.* However, *Ross v. Licht*, 263 F. Supp. 395 (S.D.N.Y. 1967), cited *Cady, Roberts & Co.* for the proposition that *tippees* are subject to the same duty as insiders. *Id.* at 410.

it should prohibit Gintel, a partner of registrant. This prohibition extends not only over his own account, but to selling for discretionary accounts and soliciting and executing other orders."[32] More force was added to the prohibition against trading by tippees in *Ross v. Licht.*[33] The court in that case defined tippees as "persons given information by insiders in breach of trust . . . ."[34] Although this was a civil action brought under Rule 10b-5, a finding of violation by the "tippees" is implicit[35] in the court's holding that the "tippees" were civilly liable.[36] Also, the court's opinion in *Texas Gulf Sulphur* stated that an insider will be found in violation for "tipping," and intimates that tippees would be found to be in violation, as well, because their conduct could be as reprehensible as the insider's.[37]

### C. *Subsequent Generation Tippees*

An expansion of the tippee concept is that of the tippee's tippee. If an insider has told another, thus making the other a tippee, then that tippee may in turn disclose this information to still another, making him a second generation tippee. Information travels rapidly and may reach many ears after it has been initially divulged. Thus, in a matter of hours the number of subsequent generation tippees could be large. A 10b-5 violation has not yet been found on the part of subsequent generation tippees, but the possibility is not remote.

The question which must be resolved relates to how far the disclosures can go in the ladder of tippees and still be a violation of 10b-5. Bromberg suggests that "not all tippees are in the same position."[38] He proposes the following criteria for determining a tippee's violation: "A tippee violates if he (1) trades with specific material information which he knows (or should reasonably know) comes from an inside source and (2) knows (or should reasonably know) that the information is undisclosed to the public."[39] Such a test might be an answer to the problem of avoiding a finding of violation on the part of remote tippees who may not be cognizant of the quality of their information.

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[32] Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961) (footnote omitted).

[33] 263 F. Supp. 395 (S.D.N.Y. 1967).

[34] *Id.* at 410.

[35] In order to find someone civilly liable under 10b-5, there must, of course, be a violation of the Rule.

[36] Ross v. Licht, 263 F. Supp. 395, 410 (S.D.N.Y. 1967). This holding is somewhat weakened by the fact that the court also held the "tippees" liable on the alternative ground of aiding and abetting a violation of 10b-5.

[37] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 853 (2d Cir. 1968).

[38] Bromberg, *TGS, supra* note 21, at 747.

[39] *Id.* at 749.

## II. TIPPING AS A VIOLATION OF THE RULE

The above discussion has focused primarily on the question of finding a violation of Rule 10b-5 on the part of certain classes of persons, particularly tippees, when such persons *trade* in the stock in question. However, the question here under consideration involves a tipper who does *not* trade in the stock. Civil liability, if any, must be based upon the act of tipping — selective disclosure to a "tippee" who trades in the stock. The status of tipping as a violation of 10b-5 will be briefly considered here.

Perhaps the classic and most common tipping situation is that suggested by the *Cady, Roberts case*.[40] In that case a partner of Cady, Roberts & Co., a broker-dealer firm, received material inside information from an insider of the issuer of the securities in question. The partner thus became a tippee or "first generation tippee" of the insider. Although the *Cady, Roberts* decision held that such a tippee was prohibited from trading the securities affected by the information not only for his own account, but for discretionary accounts as well,[41] the "first generation tippee" (broker-dealer) could just as well have passed the inside information on to the discretionary accounts or other preferred customers ("second generation tippees"), thus allowing *them* to trade the securities based upon the inside information.

The problem is one of deciding what action was permitted the broker-dealer on receipt of the corporate information. Superior knowledge in the field of securities and a greater understanding in the interpretation of information received are the skills of a broker. Yet, does the broker have the duty to disclose all information he receives to his customers? In *Cady, Roberts*, Commissioner Cary answered the question negatively by stating:

> While Gintel [the broker] undoubtedly occupied a fiduciary relationship to his customers, this relationship could not justify any actions by him contrary to law. Even if we assume the existence of conflicting fiduciary obligations, there can be no doubt which is primary here. On these facts, clients may not expect of a broker the benefits of his inside information *at the expense of the public generally*.[42]

Although the *Cady, Roberts* case itself involved a trading violation by a tippee, the recent *Texas Gulf Sulphur* case squarely held tipping to be a violation of Rule 10b-5.[43]

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

[41] *Id.* at 912.

[42] Cady, Roberts & Co., 40 S.E.C. 907, 916 (1961) (emphasis added) (footnote omitted). *See also* Comment, *Insider Liability Under Securities Exchange Act Rule 10b-5: The Cady, Roberts Doctrine,* 30 U. CHI. L. REV. 121, 155 (1962).

[43] SEC v. Texas Gulf Sulphur, 401 F.2d 833, 852 (2d Cir. 1968). *See also* SEC v. Glen Alden Corp., SEC Litigation Release No. 4080, [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,280 (S.D.N.Y. August 7, 1968).

It is interesting to note that the disclosure problem of broker-dealers is not confined to the infrequent receipt of "tips" from corporate insiders. Broker-dealers frequently undertake to underwrite a securities issue of a corporation, thus becoming an insider of the issuer having special access to inside information. In this situation, if the broker does not have a primary duty to disclose to his clients the information he receives, what procedure should be employed when he receives such information?[44] Three alternatives seem to exist. He could disclose to the public the information he possesses; he could refrain from trading in the stock and from disclosing the information to others until the corporation disseminates this information; or underwriting departments could be kept entirely separate from sales departments.

Complications arise in using either of the first two alternatives. First, most brokerage firms do not possess the facilities to disseminate this information quickly to the public.[45] Also, dissemination by the broker (who is also an underwriter) may violate his duty to the corporation.[46] It has been suggested that if a broker were to reveal the information to all of his clients to their satisfaction, this would relieve him from liability.[47] However, it has been held that when specific antifraud sections are violated, it is not a defense that all the broker's clients are content.[48] This is justified on the grounds that the broker's duty is to the general public and is not limited to his clients.[49]

There are also problems in using the second alternative — prohibiting the broker from making a market in securities about which he possesses inside information. If a client should request to sell the specific stock, and the broker must reply that he is unable to trade that stock this week, the broker's function may be substantially impaired. One author suggests that the refusal to trade may deter legitimate investments.[50] Loss, on the other hand, states that "a broker or dealer who becomes a corporate insider must

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[44] *See* Note, *Civil Liability Under Section 10B And Rule 10b-5: A Suggestion For Replacing The Doctrine Of Privity,* 74 YALE L.J. 658, 675 (1965). *See also* Cary, *Corporate Standards and Legal Rules,* 50 CAL. L. REV. 408, 415 (1962). The broker should not be permitted to remain silent, while continuing to deal in the security, "by reason of the inherent unfairness involved where a person takes advantage of information knowing it is unavailable to those with whom he is dealing." *Id.*

[45] *See* Comment, 75 HARV. L. REV. 1449, 1451 (1962).

[46] 3 Loss, *supra* note 29, at 1453.

[47] Hughes v. SEC, 174 F.2d 969, 974 (D.C. Cir. 1949).

[48] *Id.*

[49] Cady, Roberts & Co., 40 S.E.C. 907, 916 (1961); Comment, *Insider Liability Under Securities Exchange Act Rule 10b-5: The Cady, Roberts Doctrine,* 30 U. CHI. L. REV. 121, 155-58 (1962).

[50] *Failure to Disclose, supra* note 20, at 356.

assume the risk that his duty to the corporation may sometimes prevent him from making a market in its securities."[51]

The third alternative appears to be the most satisfactory. By keeping the underwriting and sales departments entirely separate, the problem of conflicting interests may be alleviated by preventing the information from reaching the point at which it could be used in trading in violation of the Rule.[52]

It is worthy of note that this problem is not unique to underwriting and sales departments of brokerage firms. Similar problems exist as to attorneys, C.P.A.'s, banks,[53] and financial specialists. They are in constant contact with corporations and have access to inside information. Speaking to the question of who may be an insider, the court in *SEC v. Texas Gulf Sulphur Co.*[54] stated: "Thus, *anyone* in possession of material inside information must either disclose it to the investing public, or, *if he is disabled from disclosing it in order to protect a corporate confidence,* or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed."[55] Under the court's ruling, if an attorney, accountant, or bank were to relay his corporate information to another or trade in the stock, he would be in violation of Rule 10b-5. In normal circumstances, a means to avoid liability would be to disclose to the public the information. However, in the case of this select group, such disclosure would frequently constitute a breach of their fiduciary duty to the corporation. Thus the only course of action open to these individuals, once they receive the corporate confidence, is to refrain from trading in or recommending the stock while the information is undisclosed.

Financial specialists, however, present a somewhat different problem. They are theoretically not allowed access to the corporate confidences, yet, due to their expertise in the evaluation of information, a fact not material to the general public may have high significance to the specialist. The SEC, in *Cady, Roberts,* stated that "perceptive analysis of generally known facts" would not constitute a violation of the Rule.[56]

Sections I and II above have presented part of the legal context in which the questions raised at the beginning of this Note must

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[51] 3 Loss, *supra* note 29, at 1453 (footnote omitted).

[52] The Commission has taken this position in its *Statement of Policy* appended as Exhibit A to its ruling *Merrill Lynch, Pierce, Fenner & Smith, Inc.,* Securities Exchange Act Release No. 8459, [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,629, at 83,351 (SEC November 25, 1968).

[53] *See generally,* Harfield, *Texas Gulf Sulphur and Bank Internal Procedures Between the Trust and Commercial Departments,* 86 BANKING L.J. 869 (1969).

[54] 401 F.2d 833 (2d Cir. 1968).

[55] *Id.* at 848 (emphasis added).

[56] Cady, Roberts & Co., 40 S.E.C. 907, 915 (1961).

be considered. It appears that Rule 10b-5 has been extended to first generation tippees who trade in the securities in question. Coverage may be extended to subsequent generation tippees who trade in the securities. The focus of this Note, however, is directed to the question of whether such a person can be held civilly liable for tipping — selective disclosure to a subsequent generation tippee who trades in the stock. Although tipping has been found to be within the prohibition of Rule 10b-5, the resolution of the question of civil liability for such acts depends upon certain legal considerations to be discussed in subsequent sections of this Note.

## III. Transactions Subject to the Rule

Securities transactions have traditionally fallen into two categories:

(1) *direct* face-to-face transactions in which the parties have an opportunity to disclose to one another anything that may be required;

(2) *indirect* or market transactions in which the parties have no direct dealings and may make representations and disclosures only indirectly through the public media.

Rule 10b-5 case law developed initially in direct transactions, but courts gradually have begun to find 10b-5 violations in indirect transaction cases.[57] This section will address itself to a brief survey of the cases finding violations in both types of transactions. It will not be the purpose of this section to analyze all of the developments concerning transaction violations, but to establish a point of reference for a discussion of civil liability in various transaction situations discussed in section IV of this Note.

### A. *Direct Transactions*

Direct transactions may be of varied types. For example, when a seller holding stock in a closed corporation sells directly to a purchaser, without using a broker, nondisclosure of a material fact in connection with such a transaction, while disclosing other facts, is a violation of the second clause of Rule 10b-5.[58] Another example of a direct transaction violation is a broker failing to disclose a material fact during negotiations with his customer.[59] A survey of the myriad

[57] *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968); Cady, Roberts & Co., 40 S.E.C. 907 (1961).

[58] Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946) *rehearing on other grounds*, 73 F. Supp. 798, *modified on other grounds*, 83 F. Supp. 613 (1947) (where failure to disclose the possibility of a sale of corporate assets during negotiations was held a violation).

[59] Van Alstyne, Noel & Co., 33 S.E.C. 311 (1952) (holding a broker in violation for failure to disclose to its investors the deteriorating financial condition of the issuer of securities).

of direct transactions is beyond the scope of this Note, and the area has been thoroughly explored by Professor Bromberg.[60] Suffice it to say that direct transactions are clearly within the scope of Rule 10b-5.[61] Furthermore, in private 10b-5 actions based on direct transactions of all types, the courts will entertain the suit, acknowledging that privity and the other requirements based upon the relationship of the parties to the transaction are present.[62]

B. *Indirect Transactions*

The typical indirect transaction is the open market purchase, where the seller has no face-to-face contact with the purchaser. While early cases involved direct transactions, the *Cady, Roberts* and *Texas Gulf Sulphur* decisions set precedents for market transaction violations.[63] The SEC in *Cady, Roberts* stated that "[n]either the statutes nor Rule 10b-5 establish artificial walls of responsibility,"[64] in applying the Rule to a market transaction violation. In *Texas Gulf Sulphur* the Second Circuit cited the *Cady, Roberts* decision with approval in holding the corporate defendant in possible violation of the Rule for trading in an indirect transaction.[65]

In another administrative action,[66] the Commission has taken the position that a 10b-5 violation can be found where the registrant, a broker-dealer, did not trade in the market itself, but effected transactions in the market for its preferred customers based on inside information.[67]

The discussion of civil liability in the next section of this Note will assume, for purposes of analysis, a violation of 10b-5.[68]

## IV. CIVIL LIABILITY UNDER THE RULE

Prior discussion has focused upon the questions of whether or not a "tipper" can be found to be in violation of Rule 10b-5 for selectively disclosing material inside information to subsequent generation tippees who thereafter trade in the securities, and whether

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60 BROMBERG, FRAUD, *supra* note 29, §§ 4.1-6.6.

61 *Id.*

62 *Id.*

63 Early cases brought for broker violations of 10b-5 raised the issue of indirect transaction violation but did not resolve the issue due to decisions on other grounds. Fry v. Schumaker, 83 F. Supp. 476 (E.D. Pa. 1947); Hughes & Treat, 22 S.E.C. 623 (1946).

64 40 S.E.C. 907, 913 (1961).

65 401 F.2d 833, 848 (2d Cir. 1968).

66 Merrill Lynch, Pierce, Fenner & Smith, Inc., Securities Exchange Act Release No. 8459, [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,629 (SEC November 25, 1968).

67 *Id.* at 83,349.

68 The reader who seeks a detailed discussion of indirect transaction violations will find such a discussion in BROMBERG, FRAUD, *supra* note 29, §§ 7.1-7.6.

or not such a violation can be found where the tippee trades in an indirect transaction. Assuming that a violation can be found in such a situation, the remaining discussion will center on the question of whether or not civil liability can arise from these situations, and, if so, what is or ought to be the extent of liability? The analysis here will be in terms of the distinctions drawn in the first three sections of this Note.

## A. *The Development of a Theory of Liability*

Rule 10b-5 does not specifically provide for a private cause of action for a violation of its provisions. Sections 12(2)[69] and 17(a)[70] of the Securities Act of 1933, and section 16(b)[71] of the Securities Exchange Act of 1934 also relate to the regulation of insider securities transactions, but have not been utilized to protect the outsider to the same extent as Rule 10b-5.[72]

Civil liability under 10b-5 began, and is presently based on an implied right of recovery.[73] *Kardon v. National Gypsum Co.*[74] was an early case establishing insider civil liability based on a tort theory that violation of a statute (section 10b) makes the actor liable in a private action for injury to another.[75] Some decisions have attached

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[69] Securities Act of 1933, 15 U.S.C. § 77*l* (1964). The relevant portion of section 12 states:

> Any person who —
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> . . . .
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> (2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof) [by the use of interstate commerce] . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in exercise of reasonable care could not have known, of such untruth or omission, shall be liable *to the person purchasing* such security from him . . . . (Emphasis added).

This section, in imposing civil liability for violations similar to 10b-5 violations, seems to be the logical statutory provision under which an action for misrepresentation would be brought by a purchaser under the securities laws. Nevertheless, 10b-5 has found more favor as a remedial cause of action. It may be surmised that this is so because of the *scienter* criteria stated in section 12(2), because of the early expansion of Rule 10b-5 liability by the courts, and because 10b-5 provides a remedy for the seller as well as for the purchaser. *See* text accompanying notes 80 & 81 *infra.*

[70] Securities Act of 1933, 15 U.S.C. § 77q (1964). This section reads very nearly the same are Rule 10b-5.

[71] Securities Exchange Act of 1934, 15 U.S.C. § 78p(b) (1964).

[72] Note that section 16(b) is rather restrictive in limiting liability to corporate officers, directors and principal stockholders who sell within 6 months of date of purchase. Thus, its utility as a pervasive antifraud provision is similarly restricted.

[73] For a discussion of the development of an implied right of recovery see BROMBERG, FRAUD, *supra* note 29, § 2.4(1).

[74] 69 F. Supp. 512 (E.D. Pa. (1946), *rehearing on other grounds,* 73 F. Supp. 798. *modified on other grounds,* 83 F. Supp. 613 (1947).

[75] *Id.* at 513.

liability based on the theory that section 29(b) of the Exchange Act[76] makes a contract consummated in contravention of section 10(b) voidable at the option of the innocent party.[77] The existence of a private cause of action under Rule 10b-5 is now well established.[78]

Less established has been the right of a *buyer* to sue under the Rule. Early decisions[79] did not recognize the right of recovery by a defrauded buyer, though the *Kardon* case[80] had previously permitted recovery by a defrauded seller. More recent decisions have permitted a buyer to bring suit under Rule 10b-5.[81] Thus, case law has developed the notion that private causes of action by defrauded buyers or sellers may be brought under Rule 10b-5.

B. *Doctrines Limiting Liability*

Where 10b-5 cases have been prosecuted by the SEC, the only showing necessary for injunctive or other relief has been a violation of the Rule.[82] However, when private litigants initially brought suits under 10b-5, the notion of privity came to the forefront, along with materiality, reliance, and causation as the elements of common law deceit. In private actions, the courts felt that there must be some relationship between the defendant's violation of the Rule and the plaintiff's injury to permit recovery.[83] This requirement was described in 1951 as "[a] semblance of privity between the vendor and purchaser of the security. . . ."[84] Since 1951 the trend has been away from requiring any direct dealings between plaintiff and

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[76] 15 U.S.C. § 78cc(b) (1964).

[77] Bromberg discusses the development of the notion of statutory voidability in BROMBERG, FRAUD, *supra* note 29, § 2.4(1)(b).

[78] Ten of the eleven courts of appeal have recognized a private cause of action. *See* J.I. Case Co. v. Borak, 377 U.S. 426 (1964); 6 LOSS, *supra* note 29, at 3871-73; Annot., 37 A.L.R.2d 649 (1954), and authorities cited therein.

[79] Montague v. Electronic Corp. of America, 76 F. Supp. 833 (S.D.N.Y. 1948); Rosenberg v. Globe Aircraft Corp., 80 F. Supp. 123 (E.D. Pa. 1948).

[80] Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946), *rehearing on other grounds*, 73 F. Supp. 798, *modified on other grounds*, 83 F. Supp. 613 (1947).

[81] Doelle v. Ireco Chemicals, 391 F.2d 6, 9 (10th Cir. 1968); Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Miller v. Bargain City, U.S.A., Inc., 229 F. Supp. 33 (E.D. Pa. 1964). The *Ellis* case specifically considered the development of the notion of a buyer's right to recovery concluding that such right was concomitant with that of a seller. Ellis v. Carter, *supra* at 272-74.

[82] Cady, Roberts & Co., 40 S.E.C. 907, 914-15 (1961). *See also* Merrill Lynch, Pierce, Fenner & Smith, Inc., [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,629 at 83,345 n.5 (SEC November 25, 1968).

[83] *See* text accompanying note 112 *infra*.

[84] Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701, 706 (S.D.N.Y. 1951), *aff'd*, 198 F.2d 883 (2d Cir. 1952). *See also* Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952). For an interesting discussion of what is meant by the term "semblance of privity," see H. BLOOMENTHAL, SECURITIES LAW 600 (1966).

defendant.[85] Decisions in the Second and Sixth Circuits have minimized the importance of privity between plaintiff and defendant in private actions.[86] The current approach seems to be that absence of privity "does not amount to a fatal defect of proof."[87]

A requirement that a defendant only be sued by those to whom he sold or from whom he bought has the advantage of limiting potential damages. If the class of potential plaintiffs is expanded to include all persons who bought or sold in the market, the possibility of recoveries against one defendant for an amount greater than the damages caused by his own transactions greatly increases.[88] This would be possible because once a causal link is established to one plaintiff in the market, a similar link could be found with many other potential plaintiffs in the same position. One way to avoid this pitfall would be to limit the plaintiffs' recovery to the amount of the defendant's profit. But such an approach would cause other problems such as a rush to get an early execution of judgment before the defendant's liability limit was reached.

On the opposite side of this question there is the argument that equating plaintiffs' recovery to defendant's profit would mean that plaintiffs could have no cause of action where the defendant did not make a profit. This would seem to be contrary to the intent of the Rule and to holdings that a person may be in violation of 10b-5 even when he loses money in the transaction.[89] Elimination of a significant avenue of recourse in 10b-5 private actions in this manner would decrease their deterrent effect.[90]

If materiality of the information is assumed and privity is found present, factors such as causation and reliance are assumed to be present.[91] When privity limitations on the relationship between

[85] Note, *Civil Liability Under Section 10(b) and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity,* 74 YALE L.J. 658, 663 n.31 (1965).

[86] Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242 (6th Cir. 1962); Brown v. Bullock, 194 F. Supp. 207, 229-30 (S.D.N.Y.), *aff'd,* 294 F.2d 415 (2d Cir. 1961). *But see* Kuenhert v. Tekstar Corp., 412 F.2d 700, 702 (5th Cir. 1969).

[87] Cochran v. Channing Corp., 211 F. Supp. 239, 245 (S.D.N.Y. 1962). *See also* 3 LOSS, *supra* note 29, at 1767-71; 6 LOSS, *supra* note 29, at 3896; BROMBERG, FRAUD, *supra* note 29, § 8.5 n.28.

[88] *See* Ruder, *Texas Gulf Sulphur — The Second Round: Privity and State of Mind In Rule 10b-5 Purchase and Sale Cases,* 63 NW. U.L. REV. 423, 441-44 (1968).

[89] "[W]e are not convinced of any difference in substance between a successful fraud and an attempt. The statutory phrase 'any manipulative or deceptive device,' 15 U.S.C. § 78j(b), seems broad enough to encompass conduct irrespective of its outcome." Kuenhert v. Texstar Corp., 412 F.2d 700, 704 (5th Cir. 1969).

[90] J.I. Case Co. v. Borak, 377 U.S. 426, 431 (1964). The *Borak* case, a section 14 Exchange Act case, lends judicial sanction to the notion that private actions have a strong position in the scheme of federal securities laws and that appropriate civil remedies should be provided to effect the purpose of these laws.

[91] Note, *Civil Liability Under Section 10b and Rule 10b-5: A Suggestion For Replacing The Doctrine of Privity,* 74 YALE L.J. 658, 684-85 (1965); Ruder, *Texas Gulf Sulphur — The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases,* 63 NW. U.L. REV. 423, 433-34 (1968).

the parties were removed, these other factors were looked to independently in order to establish (or limit) liability.[92] It is the development of causation and reliance and to a lesser extent forseeability as tests of liability, and specifically their application to insider and tippee violations involving market transactions, that will be discussed in the following subsections.

C. *Civil Liability in Direct Transactions*

It is now seen that in order to sustain a private civil action under Rule 10b-5, a plaintiff must not only show a violation of 10b-5, but must also show some sort of relationship between his loss and the defendant's violation — whether this relationship be couched in terms of a concept of privity or a formulation for causation and reliance or foreseeability.[93] The remainder of this analysis will consider this theory of civil liability in terms of the distinctions delineated in sections I, II, and III of this Note.

1. Corporate Insiders

A face-to-face transaction between an insider acting in violation of Rule 10b-5 and an innocent purchaser has generally been held to result in insider civil liability. For example, when the purchaser of securities in a direct transaction is the deceiving party (though incomplete disclosure or nondisclosure), and the seller, in reliance[94] on the presumed full disclosure of the purchaser, suffers damage, liability of the purchaser ensues.[95] The courts, whether through a theory of tort liability[96] or statutory voidability of the transaction,[97] have permitted recovery in these direct transactions.[98]

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[92] Ruder, *Texas Gulf Sulphur — The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases,* 63 Nw. U.L. Rev. 423, 434 n.61 (1968); *see* text accompanying note 112 *infra.*

[93] The element of "scienter," which is also arguably necessary to sustain liability in 10b-5 cases, will not be considered in this analysis. For a general discussion of "scienter" in 10b-5 civil actions, see *Weber v. C.M.P. Corp.,* 242 F. Supp. 321 (S.D.N.Y. 1965) and authorities cited therein.

[94] "Reliance is an essential element of a cause of action under Rule 10b-5." Ross v. Licht, 263 F. Supp. 395, 410 (S.D.N.Y. 1967).

[95] *Id.* at 411; Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946), *rehearing on other grounds,* 73 F. Supp. 798, *modified on other grounds,* 83 F. Supp. 613 (1947).

[96] Miller v. Bargain City, U.S.A., Inc., 229 F. Supp. 33 (E.D. Pa. 1964); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946), *rehearing on other grounds,* 73 F. Supp. 798, *modified on other grounds,* 83 F. Supp. 613 (1947).

[97] Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946), *rehearing on other grounds,* 73 F. Supp. 798, *modified on other grounds,* 83 F. Supp. 613 (1947). The *Kardon* case also discussed the alternative holding that the contract involved in the transaction would be voidable under section 29 of the Exchange Act.

[98] A recent decision has permitted recovery also where the corporate insider failed to disclose material information to *existing* shareholders of the corporation. Reynolds v. Texas Gulf Sulphur Co., CCH Fed. Sec. L. Rep. ¶ 92,494, (Civil No. 132-66) D. Utah Oct. 17, 1969).

2. First Generation Tippees

While the language of Rule 10b-5 refers to "any person" who "directly or indirectly" engages in certain acts,[99] early cases required privity — similar to privity in contract law — in the transaction between plaintiff and defendant to sustain a private cause of action.[100] Though the requirement of privity has been generally obviated,[101] the notion retains some validity here in a discussion of tippee liability in a direct transaction. In a face-to-face transaction where a first generation tippee sells directly to or purchases directly from a party, privity of contract is present. Certainly a tippee in such a situation, being under the same duty as an insider,[102] and meeting the criteria of the Rule as "any person," should be a logical person to hold liable in a private 10b-5 action. Notions of statutory tort liability and statutory voidability are applicable to such a tippee who is the violator of the Rule.[103] *Ross v. Licht* was a private action where tippee liability was mentioned but was not the sole ground for imposing liability. The court noted that "[i]f Sidney Grapel and Bluestone were not insiders, they would seem to have been 'tippees' (persons given information by insiders in breach of trust) and subject to the same duty as insiders."[104]

More recently, the Fifth Circuit, in a private action involving a tippee who had violated Rule 10b-5 has noted that "tippees . . . present the same threat to the investigating public as do insiders . . . ."[105] Although this case involved the denial of recovery to a tippee seeking redress from a tipper for giving a false tip, the court said in dictum that if the information had been true, the *tippee* would, "of course, be liable to his vendors or vendees . . . ."[106]

While the courts have not considered tippee liability in direct transactions to any great degree, the reasoning of the *Ross* case is persuasive in extending liability in a private action to such persons.[107]

3. Subsequent Generation Tippees

A tippee's tippee who violates Rule 10b-5 should stand in much the same position, insofar as civil liability is concerned, as

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99 *See* text accompanying notes 16 and 22 *supra*.

100 *See, e.g.*, Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701 (S.D.N.Y. 1951), *aff'd* 198 F.2d 883 (2d Cir. 1952) (requiring some "semblance of privity").

101 Cochran v. Channing Corp., 211 F. Supp. 239, 243-45 (S.D.N.Y. 1962); Texas Continental Life Ins. Co. v. Bankers Bond Co., 187 F. Supp. 14, 24 (W.D. Ky. 1960). *But see* Kuenhert v. Texstar Corp., 412 F.2d 700, 702 (5th Cir. 1969).

102 Ross v. Licht, 263 F. Supp. 395, 410 (S.D.N.Y. 1967). *See* 3 Loss, *supra* note 29, at 1451.

103 *See* BROMBERG, FRAUD, *supra* note 29, § 2.4(1)(a-b).

104 263 F. Supp. 395, 410 (S.D.N.Y. 1967).

105 Kuenhert v. Texstar Corp., 412 F.2d 700, 705 (5th Cir. 1969).

106 *Id.*

107 *See* Bromberg, *TGS*, *supra* note 21, at 749.

the tippee himself. No case law has been found, however, sustaining such liability.[108] Nevertheless, the purpose of protecting the investing public from unfair inequalities in bargaining power would be furthered if liability were imposed on a subsequent generation tippee in a direct transaction.[109] Similarly, the fact that privity exists in a direct transaction sustains this theory of liability. Unlike the indirect transaction,[110] the extension of liability to persons who materially misrepresent in a face-to-face transaction does not raise the question of holding persons liable whose acts in fact have no causal relation to the losses of the innocent party. In this context it should not ordinarily matter how a defendant received his inside information, but only that in a transaction with the plaintiff he failed to disclose such information. Certainly the defendant falls within the meaning of the Rule's criterion of "any person."

4. Persons Subject to Civil Liability in Direct Transactions

In summary, it appears that persons who violate Rule 10b-5 through direct transactions may also be subject to civil liability for the violation. The requirement of privity can easily be met by the plaintiff who has traded directly with the person who has violated Rule 10b-5. However, as indicated in section I of this Note, subsequent generation tippees have not yet been held to be in violation of the Rule.

D. *Civil Liability in Indirect Transactions*

As mentioned in section III(B) *supra,* the courts have recently extended the scope of application of Rule 10b-5 to include indirect transactions for purposes of determining a violation of the Rule.

For purposes of finding civil liability under 10b-5, however, the fact that the transaction involved is indirect is significant. It will have a decisive effect in determining the existence of privity — or causation and reliance — which is necessary in a civil action under the Rule. Certainly privity is not present between a plaintiff and a defendant who have traded the same security in an impersonal market. However, the requirement of privity has not been emphasized in recent decisions. The courts have, rather, looked to the elements of reliance or causation in order to find a connection between a defendant's violation of 10b-5 and a plaintiff's losses. The status of

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108 However, the *Cady, Roberts* opinion suggests such liability when it states: "Section 17 and Rule 10b-5 apply to securities transactions by any person. Misrepresentations will lie within their ambit, *no matter who the speaker may be.*" Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961) (emphasis added).

109 The *Cady, Roberts* opinion indicates that the purpose of the antifraud provisions is to prevent the taking of undue advantage of investors and others. *Id.*

110 *See* section IV(D) *infra.*

concepts limiting civil liability under Rule 10b-5 has been well summarized by the Court of Appeals for the Second Circuit:[111]

> [A] requirement of privity was at first suggested ... but has more recently been ignored .... However, the search for limiting doctrine has continued. Thus, some courts have looked to see whether a plaintiff actually relied on the allegedly fraudulent statement, whether such reliance was reasonable, whether the fraud actually caused harm to the plaintiff, whether the plaintiff's injury was foreseeable, and whether plaintiff falls within the category of buyer or seller of securities.[112]

This subsection will consider briefly the application of these various limiting doctrines to a violation of 10b-5 occurring in connection with an indirect or market transaction.

1. Causation and Reliance

In *Barnett v. Anaconda Co.*,[113] the court stated that in order to sustain a claim under section 10(b) there must be "at least some causal relationship to the damage complained of."[114] It has been suggested, though not held, that the causal relationship should be one of proximate cause.[115] Whether characterized as proximate cause or not, the question of causation is one of ultimate fact.[116]

Without any further refinement of the test of causation, a finding of a causal relationship between a person who violates Rule 10b-5 by nondisclosure or selective disclosure of inside information in connection with a market transaction and a person who has traded the stock in the same market would be difficult at best, because in an indirect transaction there is no face-to-face contact or communication between plaintiff and defendant.

In *List v. Fashion Park, Inc.*[117] the court did refine the test of causation when it discussed the requirement that reliance be placed on the misrepresentation in a civil suit under Rule 10b-5.[118] After equating the reliance requirement with the principle of causation in fact,[119] the court set forth the following test: "[T]he proper test is whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the

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[111] Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540 (2d Cir. 1967).

[112] *Id.* at 543-44 (citations and footnotes omitted); *see also* section IV(B) *supra.*

[113] 238 F. Supp. 766 (S.D.N.Y. 1965).

[114] *Id.* at 775. *See also* West v. Zurhorst, 280 F. Supp. 574, 580 (S.D.N.Y. 1967); Globus, Inc. v. Jaroff, 271 F. Supp. 378, 381 (S.D.N.Y. 1967); Miller v. Steinbach, 268 F. Supp. 255, 279 (S.D.N.Y. 1967). *Cf.* Weber v. Bartle, 272 F. Supp. 201, 204 (S.D.N.Y. 1967).

[115] Smith v. Bear, 237 F.2d 79, 88 (2d Cir. 1956); Barnett v. Anaconda Co., 238 F. Supp. 766, 775 n.6 (S.D.N.Y. 1965).

[116] West v. Zurhorst, 280 F. Supp. 574, 580 (S.D.N.Y. 1967).

[117] 340 F.2d 457 (2d Cir. 1965).

[118] *Id.* at 463.

[119] *Id.*

undisclosed fact."[120] This test has been followed by a number of courts,[121] and although it was originally formulated in a direct transaction case, its potential application to an indirect transaction case would not be beyond the bounds of logic: If the duty upon an insider or tippee trading in a security is to make his inside information public,[122] and the plaintiff can show that he would have acted

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[120] *Id.* (citations omitted). This test has been characterized as a constructive reliance test, applicable to cases of nondisclosure. That is, plaintiff *would have* relied *had* he been informed. Note, *Insider Trading on the Open Market: Nondisclosure and Texas Gulf Sulphur,* 42 S. CAL. L. REV. 309, 322 (1969).

It has been suggested that the court did not properly phrase its test question. "[W]hat the court should have been asking in *List* was whether the plaintiff would have sold if defendants had refrained from trading, not whether he would have sold if defendants had disclosed." Note, *Insiders' Liability Under Rule 10b-5,* 78 YALE L.J. 864, 871 (1969). This attack on the test is derived from the premise that the "formula's basic defect is its implicit assumption that insiders are subject to an unconditional duty to disclose." *Id.* at 870. Although this attack on the *List* test is appropriate in some fact situations, the situation under consideration here involves selective disclosure rather than partial disclosure or nondisclosure. *See* note 124 *infra.* The fact that selective disclosure is involved has significance for two reasons. First, it establishes an apparent violation of at least the Rule's intent to have all segments of the investing public equally informed. Second, such selective disclosure should take away any defense based on the business judgment rule's implication that total secrecy is a matter for determination by the corporation without interference from the courts. Clearly these business reasons that dictate secrecy cannot be agued to exist if part of the public has already been told. *See* Note, *Civil Liability Under Section 10b and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity,* 74 YALE L.J. 658, 677 (1965). Although the *List* test may assume the disclosure requirement, if the duty to disclose exists independently of the test, the test should be applicable.

[121] *See, e.g.,* Myzel v. Fields, 386 F.2d 718, 735 (8th Cir. 1967); Vanderboom v. Sexton, 294 F. Supp. 1178, 1193 (W.D. Ark. 1969).

[122] *See* note 120 and text accompanying note 55 *supra.* The recent case of *Reynolds v. Texas Gulf Sulphur Co.,* CCH FED. SEC. L. REP. ¶ 92,494 (Civil No. 132-66) (D. Utah Oct. 16, 1969), appears to support the conclusion that the *List* test can be applied to cases of nondisclosure in connection with indirect transactions, where a duty to disclose can be found. In considering the claims of Plaintiff Karlson, the court said:

> Plaintiff Karlson sold his stock on December 11, 1963, through a stock exchange. There was no face-to-face transaction. Fogarty did not purchase the particular shares sold by Karlson. While it is not necessary for Karlson to establish privity of contract in order to recover for violations of the statute or rule, and the fact that there was a total non-disclosure would not prevent recovery if some form of manipulation was involved [citing *List v. Fashion Park, Inc.*], it nevertheless is necessary for Karlson to prove some causative connection between Fogarty's actions or omissions and the damage Karlson claims he suffered. The court finds no such causative effect.

*Id.* at 98,314 (footnotes omitted). The court goes on to explain the lack of causation in terms of the fact that the duty which the corporation owes to its stockholders to keep them reasonably informed as to corporate affairs does not surpass all other duties owed to stockholders: For instance, the duty to not make information concerning the mineral discovery public until the company could first protect itself by acquiring mineral interests in adjoining lands. The court concluded that "it is not necessary to pass upon the materiality of the information available to defendants on December 11, 1963, because of his findings that there was *no duty* at that time on the part of either defendant to disclose the information then available with respect to drilling results, and that Fogarty's violations of the statute and the rule by purchasing TGS stock did not cause any damage to Plaintiff Karlson." *Id.* at 98,314 (emphasis added). Although the court denied recovery to Plaintiff Karlson for nondisclosure where there was no duty to disclose, other plaintiffs in this case recovered on the basis of the false and misleading press release issued in connection with the indirect transactions involved in the case. *Id.*

differently than he did had he been informed prior to his market transaction, then it can be said that the defendant's failure to disclose the information — his violation of 10b-5 — caused the injury to plaintiff.

2. Privity or "Semblance" Thereof

Few cases, however, have actually sustained a private cause of action for a violation of Rule 10b-5 in connection with an indirect or market transaction, and judges faced with a claim that 10b-5 liability should be imposed in indirect transactions have wrestled with the requirement of privity or a "semblance" thereof.

In one such case, *Drake v. Thor Power Tool Co.*,[123] the situation was that the plaintiff's claim involved misrepresentation by false or misleading statements in connection with an indirect transaction, rather than selective disclosure[124] or nondisclosure of material inside information. The court dismissed the privity requirement but appeared to rely on the fact that the alleged misstatements (financial statements) *were intended for public information and to induce the public to buy securities.*[125] The court also found reliance on the alleged misstatements and concluded that the registrant's accounting firm could be liable regardless of whether it had benefited from the supposedly inflated market price.[126]

It is possible to suggest that privity, or rather a "semblance" thereof, deserves rehabilitation as a limiting doctrine in the context of indirect or market transactions. Professor Bloomenthal discusses, with reference to the "faceless" transaction, the relationship of a defendant's *intent to induce action* to the requirement of privity in terms of foreseeability:

> The key to what the [United States District Court for the Southern District of New York, per Judge Sugarman, speaking in *Joseph v. Farnsworth Radio & Television Corp.*,[127]] meant by "semblance of privity" can perhaps be found in its quotation from Judge Frank's opinion in [*Fischman v. Raytheon Mfg. Co.*,[128]] suggesting that the plaintiff amend his complaint so as to allege that the corporation made false statements for the purpose of inducing the plaintiffs to purchase the common stock in the market. On this basis the

[123] 282 F. Supp. 94 (N.D. Ill. 1967).

[124] It should be noted that there is a difference between selective and partial disclosure. *Selective* disclosure is disclosure of information to some but not all, while *partial* disclosure is a disclosure of some but not all facts to the same person or persons. The former is akin to nondisclosure in that the public is denied information provided to select individuals; the latter is the substance of a 10b-5 violation in that the partial nondisclosure makes the disclosed information false or misleading.

[125] Drake v. Thor Power Tool Co., 282 F. Supp. 94, 104 (N.D. Ill. 1967).

[126] *Id.* at 104-05.

[127] 99 F. Supp. 701 (S.D.N.Y.), *aff'd* 198 F.2d 883 (2d Cir. 1952).

[128] 88 F.2d 783, 788 (2d Cir. 1951).

> required semblance of privity would be present if the issuer or insiders made false statements which they intended to (or could have foreseen would) be relied upon by others purchasing the security in the market even though the issuer or insiders themselves were not selling the particular shares being purchased. Conceiveably, this could be extended to cover the failure to disclose material information and could be equally applicable to false or misleading statements or failure to disclose material facts intended to (or which could have been foreseen would) induce persons to sell the particular security.[129]

*Joseph v. Farnsworth Radio & Television Corp.*, much cited — and maligned[130] — for its requirement that 10b-5 liability cannot be found in the absence of at least a "semblance of privity," may actually be enunciating a requirement which is not practically differentiable from the classic requirement of proximate cause connecting a plaintiff's loss and the misrepresentation of defendant. According to Prosser,

> [T]he damage upon which a deceit action rests must have been "proximately caused" by the misrepresentation. So far as the fact of causation is concerned, any loss which follows upon a transaction into which the misstatement induces the plaintiff to enter may be said to be caused by it; but the same *considerations which limit liability* in cases of tangible harm have operated here. In general, with only a few execptions, the courts have restricted recovery to those *damages which might foreseeably be expected to follow from the character of the misrepresentation itself.*[131]

Analogizing the Federal tort law of Rule 10b-5 to the common law of deceit, the *List* test of reliance — *would* the plaintiff have acted differently, *if* he had known[132] — can be seen as a formulation for causation in fact. The *List* test, however, is conceivably over-

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[129] H. BLOOMENTHAL, SECURITIES LAW 600 (1966).

Professor Loss' most recent comment regarding "privity" is worthy of note:

> Again, more and more under the impact of *Texas Gulf* and *Heit v. Weitzen,* on which the Supreme Court denied certiorari the other day, and similar cases, we have a great problem that nobody can answer today: the unexplored consequences of imposing liability on corporate insiders to the market generally, without regard to traditional notions of privity. I know it's fashionable for law professor's particularly to pooh-pooh privity as a concept in deceit, and I have done it along with others, but when you abandon the privity concept and make a director or officer liable to everybody who has bought or sold in the market because there is a false press release or a false report, or something of that sort, the potential liability is, really, quite horrendous in relation to the crime, if it be a crime.

Loss, *The American Law Institute's Federal Securities Code Project,* 25 BUS. LAW. 27, 35 (1969) (citations omitted).

[130] In *Miller v. Bargain City, U.S.A., Inc.,* 229 F. Supp. 33, 37 (E.D. Pa. 1964), Judge Lord, in speaking of the *Farnsworth* decision, said: "The language of the district court in that case was: ' . . . . A semblance of privity . . . seems to be requisite . . . .' I find it unnecessary to attempt a definition of this, at best, cloudy phrase, for if 'a semblance of privity' means 'privity' (like 'a little bit pregnant'), I reject it."

[131] W. PROSSER, LAW OF TORTS 748 (1964). *See also* Palsgraf v. Long Island R.R. Co., 248 N.Y. 339, 162 N.E. 99 (1928).

[132] *See* note 120 *supra* and accompanying text.

broad. It is well enough to concentrate on reliance or causation alone in cases where foreseeability and privity are never mentioned because they are not a problem. In such cases — cases involving direct transactions — one is dealing with people whose relationship to defendant's action is clear and direct. However, difficulties arise in attempting to go from those cases to cases of faceless, indirect nondisclosure (or selective disclosure). In the latter cases the *List* test could be answered in the affirmative by almost anybody. It is suggested that the *List* test of reliance is not overbroad, however, if a foreseeability test — *Farnsworth's* "semblance of privity" — is coupled with it. This "semblance of privity" requirement, thus understood, may, needless to say, bear less kinship to the classic concept of privity of contract than it bears to the classic concept of foreseeability, viewed as an element of proximate or legal cause in the law of torts.[133] In any event, it should not be overlooked as an available, and arguably appropriate, limiting doctrine in a context where application of now established 10b-5 law in connection with an indirect transaction might raise the specter of unlimited liability to an unlimited class of plaintiffs. Moreover, it is also suggested that limiting the *extent* of liability, an arguably valid consideration,[134] should not be so regarded as to preclude liability altogether.[135]

3. Persons Who May be Liable in Indirect Transactions

This subsection has not analyzed civil liability for violations of 10b-5 in terms of the three classifications of persons described in section I *supra* — corporate insiders, first generation tippees, and second generation tippees. It has been assumed for purposes of this subsection that, if a violation were found on the part of a member of any of these categories, concepts of causation, reliance and foreseeability would apply equally to each class of violators.[136] It would seem that the legal criteria for determining a violation on the one hand, and civil liability via causation, reliance and foreseeability, on the other, ought to operate more or less independently.

E. *Civil Liability for Tipping*

The original question posed at the beginning of the Note is, Can civil liability be imposed on one who "tips" — *i.e.*, selectively discloses material inside information to one who thereafter trades

[133] For the suggestion that proximate cause ought to be required in 10b-5 cases see, Smith v. Bear, 237 F.2d 79, 88 (2d Cir. 1956); Barnett v. Anaconda Co., 238 F. Supp. 766, 775 n.6 (S.D.N.Y. 1965).

[134] The courts view underwriting in its present form to be vital to the growth of American industry. *See* United States v. Morgan, 118 F. Supp. 621 (S.D.N.Y. 1953).

[135] For a discussion of alternative limitations on *extent of liability,* see p. 480 *infra.*

[136] Such a conclusion was reached in section IV(C)(4) *supra.*

in the security in question? If so, under what circumstances can the tipper be held liable, and to what extent?

The aspect of this question which has not been considered is whether a person with inside information can be held *civilly liable* for tipping.

It has been established that tipping is itself a violation of the Rule.[137] However, no case has yet imposed civil liability for tipping.[138] This subsection will consider various theories by which the legal conclusion that civil liability might be imposed for tipping might be reached.

1. Violation Plus Causation and Reliance

An orthodox theory that civil liability should exist whenever a 10b-5 violation occurs which causes the injury of another does not on its face appear to be unreasonable. Applying the *List* test of reliance,[139] the problem of proving reliance and causation and perhaps foreseeability as well, should not be impossible for a prospective plaintiff. There are two problems, however, which should be considered.

First, the tipper did not trade in the stock in question. Rule 10b-5 requires that the prohibited acts be performed "in connection with" a purchase or sale of securities.[140] This problem, however, is one inherent in finding a *violation* of the Rule, and it has been assumed for purposes of this discussion that tipping *is* a violation.[141] It is also probable that the tipper's tippees will have traded in the stock,[142] thus providing a "connection" with a transaction, and, even if they have not, it is possible to view the plaintiff's purchase or sale which was "caused" by the tipper's selective disclosure as sufficiently "connected with" the tipper's actions to establish a violation.

The second problem is that any damages which were sustained did not accrue to the benefit of the tipper — but rather accrued to the benefit of the tipper's tippees.[143] Although this may be a legitimate objection, at least one case has sustained civil liability

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[137] *See* text accompanying note 43 *supra.*

[138] Bromberg, *TGS, supra* note 21, at 746. For the nearest case so holding, see Ross v. Licht, 263 F. Supp. 345 (S.D.N.Y. 1967), *noted in* 70 STAN. L. REV. 347 (1968).

[139] *See* note 120 *supra* and accompanying text.

[140] *See* text of Rule quoted in text accompanying note 16 *supra.*

[141] *See* text accompanying note 137 *supra.*

[142] According to Bromberg, "there can hardly be liability unless it [tipping violation] results in some damage, *e.g.*, through trading by the tippees." Bromberg, *TGS, supra* note 21, at 746.

[143] If the tipper is himself a tippee, then *his* tippees would be subsequent generation tippees.

in the face of the objection. In *Drake v. Thor Power Tool Co.*,[144] the court, after rejecting the privity requirement, said, "[d]efendant Peat, Marwick, in independently auditing Thor's financial statement, remains liable regardless of whether it had benefited from the supposedly inflated market price. The position of an independent auditor is different from that of other corporate insiders."[145] Although the position of an independent auditor may be different from that of an underwriter, for instance, or that of a tippee who tips, the cases holding independent auditors liable for fraudulent disclosure or nondisclosure may provide initial theoretical justification for holding someone liable who does not directly benefit from his tortious conduct.[146] The problem should be one of determining what sort of duty is owed to the public by one possessed of inside information.

2. Aiding and Abetting

Another theory of liability applicable to cases involving tipping is that of "aiding and abetting." This concept has evolved from the law of torts and has been applied in 10b-5 cases.[147] The statement of the theory was borrowed from the *Restatement of Torts:* "For harm resulting to a third person from the tortious conduct of another, a person is liable if he . . . (b) [k]nows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself . . . ."[148]

The application of this theory to a set of facts can best be seen in the case of *Brennan v. Midwestern United Life Ins. Co.*[149] In that case, replete with a complex set of facts, the defendant insurance company was found to be an aider and abettor to a fraudulent securities broker dealing in its stock, by referring potential customers to the broker while knowing of the broker's fraudulent dealings. The court found "that MULIC [Midwestern United Life Ins. Co.] engaged in an *affirmative* course of conduct which aided and abetted Dobich's violations of Section 10(b) and Rule 10b-5."[150] The de-

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144 282 F. Supp. 94 (N.D. Ill. 1967).

145 *Id.* at 104-05.

146 For another case involving the 10b-5 civil liability of an accounting firm who did not trade in the securities in question but *failed to disclose* certain after-acquired information relevant to a financial statement, see *Fischer v. Kletz,* 266 F. Supp. 180 (S.D.N.Y. 1967). Here the court sustained liability on the basis of an "aiding and abetting" theory.

147 Brennan v. Midwestern United Life Ins. Co., 286 F. Supp. 702, 708 (N.D. Ind. 1968). *See also* Errion v. Connell, 236 F.2d 447 (9th Cir. 1956); Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967); Ross v. Licht, 263 F. Supp. 395, 410 (S.D.N.Y. 1967); Pettit v. American Stock Exchange, 217 F. Supp. 21 (S.D.N.Y. 1963); Thiele v. Shields, 131 F. Supp. 416 (S.D.N.Y. 1955).

148 RESTATEMENT OF TORTS § 876 (1939).

149 286 F. Supp. 702 (N.D. Ind. 1968).

150 *Id.* at 708 (emphasis added).

fendant argued that it could not be liable for plaintiff's damages because such damages would have occurred despite defendant's conduct. The court rejected this argument stating that the notion "that liability might . . . result from aiding and abetting a violation of Section 10(b) and Rule 10b-5 — has continued to find acceptance in the courts."[151] Finally, the court observed that defendant could also be found guilty of aiding and abetting by mere failure to report the broker's fraudulent activities to the Indiana Securities Commission.[152]

Analogizing the reasoning of the *Brennan* case to the situation of an insider or tippee tipping another leads to a theory of liability for tipping in certain circumstances. Where the insider or tippee tips and pursues an affirmative course of conduct[153] in assisting *his* tippee (or second generation tippee) in violating the Rule,[154] or fails to report his tippee to proper authorities when he knows the latter is violating the Rule, the tipper would be liable as an aider and abettor of his tippee's violation. The application of this theory of liability "cannot be confined to an abstract rule but must be fashioned case by case as particular facts dictate."[155]

3. Vicarious Liability

Professor Bromberg has suggested another theory for holding a person civilly liable as a tipper. His suggestion is analogous to vicarious liability for tipping:

> Although tipping is itself a violation [of Rule 10b-5], there can hardly be any liability unless it results in some damage, *e.g.*, through trading by the tippees. Given the nature of the financial world, an insider who tips a friend should probably be charged with *foreseeing* the friend will tell one or two others and that the information will continue to spread. Quite conceivably he will be liable for all the trades which can be traced to information emanating from him. In the abstract, there is reason to hold the original tipper even for trades by tippees which — because of the muted form in which the information reaches the tippees — are not violations by them. If the overriding policy is to prevent informational inequities in the market, it would be served by such a rule, which would also operate as a powerful deterrent to tipping.[156]

The theory rests on the tort principle of foreseeability, and would probably require proof of a chain of causation running from defendant to plaintiff. If a test of factual causation were to be employed,

[151] *Id.* at 725.

[152] *Id.* at 727.

[153] It may be suggested that the mere act of "tipping" is sufficient "affirmative conduct" to establish this element of aiding and abetting

[154] For a discussion of first and second generation tippee violations of 10b-5, *see text* sections I(B-C) *supra.*

[155] Kohler v. Kohler Co., 319 F.2d 634, 637-38 (7th Cir. 1963).

[156] Bromberg, *TGS, supra* note 21, at 746 (footnotes omitted) (emphasis added).

inequities might be prevented. Holding tippers liable for the actions of their tippees might have the benefit of discouraging all forms of dissemination of information in violation of the Rule, because the sources of the information would be deterred from divulgence.[157] While there is merit in holding a tipper liable in a private action, care should be taken to assure that a defendant is not held liable where his action (in disclosing or not disclosing) is innocent and could result in no foreseeable harm.

## CONCLUSION

The question raised at the beginning of this Note is, Can civil liability be imposed on one who "tips" — *i.e.*, selectively discloses material inside information to one who thereafter trades in the security in question? If so, under what circumstances can the tipper be held liable, and to what extent?

The answer to this question is that no court has ever so held, but the theoretical framework exists which would rationally justify such a holding, even where the tipper's tippees traded in an indirect transaction.

First, it was concluded that a first generation tippee could be held civilly liable for a violation of 10b-5, at least for a violation involving trading in a direct transaction. Once a trading violation of Rule 10b-5 has been established, the status of a person as an insider, first generation tippee, or subsequent generation tippee should not ordinarily be relevant to the question of imposing civil liability on the person for his violation. The status of a violator does become relevant, however, in considering the question of imposing civil liability for a tipping violation. The three theories by which a "tipper" could possibly be held civilly liable — causation and reliance, aiding and abetting, and vicarious liability — seem to suggest that the tipper's liability depends upon *his* tippee's violation of 10b-5. Although this reasoning is not absolutely necessary to the causation and reliance liability approach, such reasoning would raise the problem of determining a violation by the tipper's tippee. If the tipper is *himself* a tippee, then his "subsequent generation tippee" would have to be found in violation of 10b-5.

A second problem arises in attempting to hold a tipper liable for his tippee's violation, if the tipper's tippee (or second generation tippee) has traded in an indirect transaction. It was concluded, however, that existing notions of causation, reliance and foreseeability, as well as the meager authority addressing the issue, would not be offended by imposing civil liability on the basis of an indirect

[157] *Failure to Disclose, supra* note 20, at 357.

transaction, particularly if some limiting notion such as proximate cause were retained.

Although no court has yet held an insider or tippee liable for tipping — selectively disclosing material inside information to subsequent generation tippees who trade the securities in question in an indirect or market transaction — such a legal conclusion does not seem to be beyond the realm of possibility or sound reasoning. The major objection to such a holding is that the potential liability could be unconscionable — unlimited liability to an unlimited number of plaintiffs.

However, it is suggested that considerations regarding the *extent* of liability should not necessarily preclude liability itself, so long as there are alternative limitations on the extent of liability.

Several factors bearing on the damages question might be considered to reduce the extent of liability so that the total potential recovery by all plaintiffs would be one which a court could countenance.[158]

A court could:

(1) Include only the plaintiff's measure of actual damage losses on shares bought during days when subsequent generation tippees sold, and limit the number of shares upon which recovery could be based to the number the subsequent generation tippees sold each day or the number plaintiff bought that day, whichever was greater;

(2) Require that the damages question be decided in an action wherein the subsequent generation tippees were joined as parties, but only require for the plaintiff to recover a showing that the subsequent generation tippees traded in the relevant period, that they had received the tip, and that they had reason to know it was inside information. This would have the effect of mandatorily spreading the liability to more of the culpable parties without making the burden on plaintiff excessive.

(3) Limit recovery in the normal case to the amount of profit actually realized. Provisions for punitive re-

[158] An example of the method in which courts compute damages is the recent case in Utah based on the facts of the *Texas Gulf Sulphur* decision. Reynolds v. Texas Gulf Sulphur Co., CCH FED. SEC. L. REP. ¶ 92,494, (Civil No. 132-66) (D. Utah Oct. 17, 1969). In this case the court applied the "New York Rule" which determines that the measure of damages in a stock transaction is "the highest intermediate value reached by the stock between the time of the wrongful act complained of and a reasonable time thereafter, to be allowed to the injured party to place himself in the position he would have been in had not his rights been violated." The court determined a reasonable time to be 20 trading days, and then computed the average of the high market prices on those 20 days to arrive at a figure to compute damages. *Id.*

coveries could be provided to avoid the possibility of blatant violations without recourse in cases where no defendants made profits or the small profits made by the solvent defendants are inadequate compensation for plaintiff's loss in light of the nature and intent of defendant's violation.[159]

The question of damages should not, however, influence the question of liability. Persons, whether insiders or first generation tippees, who selectively disclose material inside information which they know will cause trading based on the information, should be held liable to those defrauded in the market by such a violation of Rule 10b-5. The more properly debatable question is to what extent should they be held liable?

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[159] But in connection with the suggestion that punitive damages should be allowed, see the arguably contrary holding in *Globus v. Law Research Service, Inc.*, [1967-1969 Transfer Binder] CCH FED. SEC. REP. ¶ 92,474 (S.D.N.Y. Sept. 9, 1969). indicating that punitive damages could not appropriately be allowed in an action based on alleged violations of section 17(a) of the Securities Act of 1933, which parallels Rule 10b-5 in many respects.

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