A D D R E S S

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DISCLOSURE OF CORPORATE INFORMATION

I wish to express my thanks for the invitation to speak here today. I would like to discuss a few of the problems in the application of the anti-fraud provisions of Rule 10b-5 under the Securities Exchange Act of 1934 to the disclosure of corporate information by corporations themselves, by corporate officers, directors and employees, and by persons unaffiliated with corporations. It has been suggested recently that the law under Rule 10b-5 has been developing to a point where insiders are practically precluded from trading in the shares of their corporations [1/] and that the recent action taken by the Commission against Texas Gulf Sulphur Company and various of its officials has resulted in a blackout of corporate information. [2/] For reasons I shall try to make clear, I disagree with both of these suggestions. While the latter suggestion is the one which is probably of more concern to you, I think that a discussion of the former will be helpful to an understanding of the disclosure problem in general and to specific problems which you -- as security analysts -- might face.

I do not intend to argue the merits of the Commission's position in the Texas Gulf litigation. I shall, however, discuss certain problems which that case seems to have highlighted, particularly in the area of anonymous securities transactions -- in the

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1/ Ruder, Civil Liability under Rule 10b-5: Judicial Revision of Legislative Intent?, 57 Nw. U. L. Rev. 627, 629.

2/ Business Week, May 8, 1965, p. 142.

sense of transactions that occur on the stock exchanges or organized over-the-counter markets, where neither the purchaser nor seller normally has any idea as to who is the other principal in the transaction. The views I shall express are my own and not necessarily those of the Commission or of my colleagues on the Commission's staff.

The legal restrictions upon the use of corporate information in securities transactions are by no means new. As early as 1909 the Supreme Court, in the case of Strong v. Repide,[3/] held that the controlling stockholder and general manager of a corporation defrauded a minority stockholder by purchasing his stock without disclosing the current status of negotiations for the sale of the corporation's property. The first two so-called federal securities laws were enacted in 1933 and 1934 and Rule 10b-5 was promulgated by the Commission in 1942. By 1951 Judge Leahy of the United States District Court for the District of Delaware, in the often-quoted case of Speed v. Transamerica Corp.,[4/] had interpreted the rule as follows:

> "The rule is clear. It is unlawful for an insider, such as a majority stockholder, to purchase the stock of minority stockholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholders, which information would have affected the judgment of the sellers."

In that case a majority stockholder had purchased stock from minority stockholders without disclosing an enormous increase in the market value of the corporation's tobacco inventory. More recently, the

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3/ 213 U.S. 419.

4/ 99 F. Supp. 808, 828-829.

Commission itself in the case of Cady, Roberts & Co.[5/], found that a broker-dealer violated Rule 10b-5 by selling for discretionary accounts stock in a listed corporation which had reduced its dividend but had not yet released the news of the reduction to the public. In that case the broker-dealer was not an insider of the corporation, but learned of the reduction from an associate who was a director of the corporation.

Rule 10b-5 in essence prohibits fraudulent and deceptive practices by any person in connection with the purchase or sale of securities. It is derived from but is broader than Section 17(a) of the Securities Act of 1933, which is limited to fraudulent sales of securities; that section does not relate to fraudulent purchases.

Also, the forbidden activities under Rule 10b-5 are in connection with the sale or purchase, while Section 17(a) is limited to transactions in -- not "in connection with" -- securities sales. This difference might be important in the Texas Gulf case, since the only violation with which the Texas Gulf Sulphur Company itself is charged is the issuance of what the Commission alleges was a materially misleading press release respecting its ore strike near Timmins, Ontario, Canada. It is not alleged that Texas Gulf was selling or purchasing securities at that time (although it is alleged that various officials had been purchasing the Texas Gulf securities in the period prior thereto). The complaint alleges, however, that at

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5/ 40 S.E.C. 907.

the time of the company's press release rumors of an ore strike had just been reported in the financial pages of the New York press and suggests that the company's statement to the effect that the rumors were greatly exaggerated necessarily had a substantial effect on the market for its shares. Whether an untrue statement by a company which might reasonably be expected to have a substantial impact on the price at which its securities are trading on a stock exchange is made in connection with the purchase or sale of securities may be a very different question from whether the statement was made in the purchase or sale of securities. I am not suggesting that a negative answer to this question would necessarily be dispositive of the case against Texas Gulf, since there may also be involved the question whether a corporation does not violate Rule 10b-5 when it issues a false statement as to a material fact respecting the value of its property at a time when knowledge may be attributed to it that its officials have been engaging and might continue to engage in a course of securities transactions without appropriate disclosure.

I think it is significant that in the Texas Gulf case the Commission (unlike the plaintiffs in certain of the private actions which have been brought against Texas Gulf) has not charged the company itself with any violation of Rule 10b-5 during the period preceding the issuance of the allegedly false press release, although officials and employees of the company are charged with violations during this period. This would seem to indicate that the Commission is of the view that when a corporation is not trading in its stock

it would not be violating Rule 10b-5 if there are legitimate corporate reasons for its not disclosing facts known to the corporation, even though, if known, such facts might be expected to have a substantial effect upon the market price of its stock. These would normally include situations where by disclosure the company might lose some competitive advantage. However, as suggested in the New York Stock Exchange Manual, disclosure should normally be made of "important developments which might affect security values or influence investment decisions," as promptly as may be consistent with the corporation's legitimate interests. The sooner such facts are disclosed the less danger there is of violating Rule 10b-5 by the corporation or by its officers and employees.

Officials and employees of Texas Gulf who were purchasing its stock (or calls on its stock) when they allegedly knew of the Timmins strike, but before it had been publicly disclosed, have been charged in the Commission's action with violations of Rule 10b-5. According to the complaint, the facts known by these insiders were so significant that the failure of the insiders to disclose them when they purchased Texas Gulf stock violated the rule. If their duty to the company precluded such disclosure, under the Commission's theory they should have refrained from purchasing Texas Gulf stock at that time.

This position does not mean that it is never safe for corporation officials to trade in securities of their corporation. Of

course, there are limitations on such trading even apart from Rule 10b-5; thus, as you may be aware, Section 16(a) of the Securities Exchange Act requires that officers, directors and 10% shareholders of corporations with stocks listed on an exchange or other corporations with stock registered with this Commission under Section 12(g) of the Securities Exchange Act must report all their transactions in their companies' equity securities, and, under Section 16(b), in the absence of an exemption, they are liable for any profits derived from a purchase and sale or sale and purchase within a six-month period. Also, a distribution of a controlling person's shares must normally be registered under the Securities Act of 1933. Rule 10b-5 does make unsafe certain other sales and purchases by insiders, including employees who do not fall within the classes covered by Section 16 (i.e., who are not officers, directors, or 10% stockholders). But the fact that corporate officials normally know a great many facts about their corporation that may be unknown to the party who is at the other end of the transaction, including facts that they may not be at liberty to disclose, does not necessarily preclude their investing in their corporation's stock. It would be my position that insiders, however, cannot trade in the securities until disclosure could be made where the undisclosed facts are of such a nature that, if disclosed, they might reasonably be expected to have a substantial effect on the price of the company's securities -- as where there has been an unusual profit

or loss not yet made public, where it has been determined that dividends will be substantially increased or decreased, or, as is alleged in another pending Commission lawsuit under Rule 10b-5, where there is to be a merger through an exchange of securities at variance with their current ratios. If the undisclosed facts, however, are such that it could not reasonably be expected that public disclosure would have any appreciable effect on the market price of the stock, there would appear to be no violation of Rule 10b-5 through an insider's purchase or sale on the stock exchange or the organized over-the-counter market. Such facts as that employee morale appears high, that orders appear to be as strong as last year or that next year's models appear to be especially attractive, would normally not be of the category that would be expected to have a significant impact on the market price. On the other hand, it may well be a material fact to be disclosed that an officer or employee is purchasing an unusually large amount of stock of, or calls on the stock of, his corporation. In any event, this would be some evidence that he thought it could reasonably be expected that a fact known to him and unknown to the general public would, when disclosed, significantly affect the market price.

Occasionally, a question might arise as to the point in time at which certain facts should be disclosed. An example of this is found in a proposed merger situation. Assume Corporation A is making overtures to purchase Corporation B through an exchange of stock at a

time when Corporation A's stock is selling at 20 and Corporation B's stock is selling at 50. Suppose further that officials of Corporation B insist that the exchange be at a ratio of three shares of A stock for each share of B stock. Before it appears reasonable to expect a merger will go through at this ratio, the possibility should probably not be announced. But once the officials of Corporation A have also agreed to the proposed ratio, the situation has changed even though formal approval by directors and stockholders of both companies must be had. The ratio agreed upon can reasonably be expected to be firm. In such a situation, I believe that the safest course would be to make an announcement of just what the situation is, stating all the facts, including all of the possibilities for occurrence or non-occurrence. In this manner the risk of Rule 10b-5 violations by knowledgeable officials and employees is removed and still the company cannot be accused of issuing a misleading statement in the event that the merger ultimately fails to take place. For the reason that the danger of violations of 10b-5 by corporations and their officials and employees can presumably be eliminated only when and if significant facts have been made public, it seems to me that Rule 10b-5 would tend to encourage corporations to make public these facts as soon as practical and thus increase the ready availability of corporate information.

Nevertheless, as I noted earlier, it has been suggested that actions by the Commission under Rule 10b-5 have tended to cut down on publicly available corporate information. This view apparently stems from the Commission's position in the Texas Gulf case that company

officials who are alleged to have given tips to outsiders, or "tippees", should be held accountable for the profit made by the tippees in their resulting transactions in the company's stock. That position, however, is not based upon allegations that corporate insiders answered inquiries as to information which could be important to an analyst but would probably not be considered of sufficient general interest to be published in the financial press. Rather, it is based upon allegations that the information made available to the tippees related to a drill hole subsequently characterized "as one of the most impressive drill holes completed in modern times." In addition, the complaint alleges (or, in one case, strongly indicates) that the defendants who are asked to make restitution with respect to tippees' profits volunteered their recommendations or suggestions that the company's stock be purchased. Finally, the information allegedly made available to the tippees, according to the complaint, had been the subject of a strict policy of secrecy.

It is thus difficult to perceive why the Commission's position based upon facts such as these should lead corporate officials to refrain from disclosing to persons making legitimate inquiries the type of information I mentioned earlier with respect to morale or current figures for short periods that might indicate

continuation of a trend or other information which the corporation has no business reason for concealing. There would appear to be no reason why items of information considered to be of a more or less routine nature may not be disclosed to any inquiring analyst, reporter or other interested person. The fact that the company may not have considered such items to be of sufficient significance to be the subject of a press release does not mean that it should consider the information to be confidential. Only as to the more newsworthy kinds of information which could reasonably be expected to have a direct effect upon the market price of a company's securities has the Commission indicated that discriminatory tips should not be given. As I suggested earlier, the sooner a corporation is able publicly to disclose such information, the less is the danger of violation of Rule 10b-5 by the company or its officials and employees who might wish to trade in the company's securities. If anything, then, I believe that the Commission's action in Texas Gulf should encourage dissemination of corporate information rather than discourage it.

I suppose it is also conceivable that a corporate blackout could stem from the Commission's charge that the Texas Gulf Sulphur Company issued a false and misleading press release, thereby causing corporate officials to remain silent rather than risk

giving out inaccurate information and perhaps bringing about formal charges against the company. Again, I do not believe such a result would be jusitified, nor do I think it will follow from the Texas Gulf case. Rather, I would hope that the result would be to cause corporate officials to be certain of the accuracy of the public statements they issue with respect to matters which may be expected to have a material effect on the securities market.

A further area of significance to you might be where an analyst wishes to act upon information given him by a corporate official by purchasing or selling the company's stock himself, depending upon the nature of the information. If a corporate secret has been revealed to him, involuntarily or otherwise, which when public would presumably have a significant effect on the market, in my view he may not trade in the corporate securities until the information has been made public. Rule 10b-5, it must be remembered, applies to "any person". The bulk of the cases that have arisen under the Rule have involved corporate insiders presumably because it is insiders who are generally in a position in which they know of material facts which are unknown to the public. But where an analyst or any other person is in the same position the risk of violation might well be the same and he should govern his actions by the same standards I have discussed as applicable to the insider. And while in certain instances it might appear difficult to determine when information is material information which would bring the Rule into play, the test I have suggested is one long known to the law in many areas apart from the securities

markets -- the test of reasonableness: whether it is reasonable to assume that information is of the sort that its disclosure would affect the market price of the stock to which it relates.

I would like briefly to touch upon one other possible problem which may be faced by security analysts -- particularly those who are employed by firms which render investment advice -- and which is only indirectly related to the corporate information itself, but is more directly related to the actual publication of the information in the form of investment advice. An example of one aspect of the problem I refer to is found in the case of SEC v. Capital Gains Research Bureau, 6 / where the Supreme Court found violations of anti-fraud provisions similar to those of Rule 10b-5 when an investment adviser carried out a pattern of purchasing stocks which were the subjects of forthcoming recommendations for long-term capital gains and then sold the same stocks shortly after publication of its recommendation without disclosure to his advisory clients. Investment advisers, or persons associated with investment advisers might violate Rule 10b-5 not only by carrying out a practice such as this -- known as "scalping" -- which operates as a fraud upon those who receive the investment advice, but also when they simply purchase the stock which is the subject of a forthcoming recommendation likely to cause an upsurge in the market price, without disclosing this fact to the seller.

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6 / 375 U.S. 180 (1963).

More authoritative answers to certain of the problems I have discussed and other problems arising out of the application of Rule 10b-5 may be expected to be given by the Federal courts in their decision in cases that are now pending.