LECTURE AT PROGRAM ON OBLIGATIONS TO STOCKHOLDERS AND STOCKHOLDER LITIGATION, SPONSORED BY ILLINOIS INSTITUTE FOR CONTINUING LEGAL EDUCATION, CHICAGO, ILLINOIS, MARCH 6, 1969

"The Corporation's Obligations When It Is Not Trading in Its Stock"

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I. INTRODUCTION

Important developments in the federal securities laws will be discussed at this program. Those of us at the Commission who are involved in these developments have recently been speaking throughout the country to assist the public in understanding them. This is the first opportunity that I have had to appear in Chicago. It is a particular pleasure for me, since I was born and raised here. Although I have been away for a number of years now, it is always good to come home.

As a matter of policy the Commission disclaims responsibility for any private publication by its employees. My remarks this morning will represent only my own personal views. They do not necessarily reflect the views of the Commission or my colleagues on its staff. In addition, the Texas Gulf Sulphur case [1/] is still in the courts, and I am of counsel to the Commission in that case. It would not be appropriate for me to attempt to argue the questions involved there. I shall merely assume the holdings of the Court of Appeals for the Second Circuit as correct and discuss their implications with respect to corporate disclosure obligations.

1/ SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y. 1967), aff'd in part & rev'd in part, 401 F.2d 833 (2d Cir. 1968) (en banc), petitions for cert. filed, 37 U.S.L.W. 3250 (U.S. Jan. 3, 1969) (No. 897), 37 U.S.L.W. 3264 (U.S. Jan. 13, 1969) (No. 937).

II. AFFIRMATIVE DISCLOSURE OBLIGATIONS

Absent a public offering of its securities or some participation in sales by others, a corporation does not have any affirmative disclosure obligations under the Securities Act of 1933.[2/] Consequently, we may turn directly to the Securities Exchange Act of 1934.[3/]

A. Registration and Reporting Under the Act

Pursuant to Section 13 of the Act[4/] the Commission has established a comprehensive system of periodic and other corporate reports. This reportin system is applicable to all corporations that (1) have registered a security under Section 12,[5/] (2) have filed a registration statement under the Securities Act of 1933 on or after August 20, 1964, or (3) filed such a registration statement prior to that date and included an undertaking to furnish the required reports.[6/] The pertinent statutory provisions and the Commission's rules under them are quite complex, both in terms of the requirements for registration and reporting and in terms of the exemptions from those requirements. I shall not have time to give you more than a quick thumbnail sketch.

2/ 15 U.S.C. §§ 77a-77aa (1964).

3/ 15 U.S.C. §§ 78a-78jj (1964) ("Act").

4/ 15 U.S.C. § 78m (1964).

5/ 15 U.S.C. § 78l (1964).

6/ Section 15(d) of the Act, 15 U.S.C. § 78o(d) (1964).

statement be filed with the Commission by any corporation with total assets in excess of $1,000,000 and a class of equity security held of record by more than 500 persons. Any other security may also be registered. There are many exemptions from this registration requirement, including those for listed securities and securities issued by governments, registered investment companies, savings and loan associations (withdrawable capital only), charities and co-operatives.[9/] In addition, insurance companies are exempt if the pertinent state insurance regulation meets certain standards.[10/] Although banks are subject to the registration and reporting requirements, they are administered by the federal bank regulatory agencies.[11/] Finally, the Commission has specific exemptive power with respect to securities of foreign issuers and general exemptive power with respect to all securities.[12/] Registration under subsection (g) may be terminated if the number of record holders of the pertinent class of security falls below 300.[13/]

As I have already indicated,[14/] a corporation may also become subject to the reporting requirements of Section 13 by virtue of having filed a registration statement under the Securities Act of 1933. This additional

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9/ Subsections (g)(1), (2)(A)-(F).

10/ Subsection (g)(2)(G).

11/ Subsection (i).

12/ Subsections (g)(3), (h).

13/ Subsection (g)(4).

14/ *See* p. 2, *supra*.

basis for reporting is established by Section 15(d) of the Act. The reporting requirements imposed by Section 15(d) are automatically suspended as to any year after that of registration in which the registered securities are held of record by less than 300 persons. Section 15(d) does not apply to securities issued by foreign governments.

2. Timing and Content of Registration Statements

Under Section 12(a) a security may not be traded on an exchange until the registration statement is effective. Unless the Commission grants acceleration, it becomes effective 30 days after the Commission receives a certification from the exchange that the security has been approved for listing and registration. [15/] The Commission had promulgated Form 10 for registration of the securities of most corporations. [16/] This form requires general information about the corporation, details about its parents and subsidiaries, a description of its business and property, details as to its organization (if within five years of registration), pending legal proceedings, directors and officers and their indemnification and remuneration, options to purchase securities, principal holders of securities, number of equity security holders, interest of management and others in certain transactions, securities being registered and recent sales of unregistered securities. [17/] The exhibits to the

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15/ Subsection (d).

16/ 17 C.F.R. § 249.210 (1968).

17/ Items 1-17.

registration statement must include a certified balance sheet and certified profit and loss statements for three years.[18/]

If registration is required under subsection (g), the registration statement must be filed within 120 days after the last day of the fiscal year in which the corporation first becomes subject to registration under the subsection.[19/] Form 10 is also used for registering securities under subsection (g).

3. Timing and Content of Corporate Reports

There are three principal reports required to be filed under Section 13: annual reports on Form 10-K, semiannual reports on Form 9-K and current reports on Form 8-K.[20/] Although there are other reports that must be filed by special types of issuers, these are the only reports that are required for the ordinary industrial, commercial or financial corporation.

The annual report on Form 10-K usually must be filed within 120 days after the end of each fiscal year after the latest one for which certified financial statements were included in the registration statement.[21/] In general, the report must contain the information necessary to

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18/ Item 18; Instructions as to Financial Statements A(1)-(2).

19/ Subsection (g)(1).

20/ Form 10-K appears in 17 C.F.R. § 249.310 (1968). The full text of Forms 8-K and 9-K does not appear in the Code of Federal Regulations or the Federal Register. These forms are reprinted in 2 CCH Fed. Sec. L. Rep. ¶¶ 31,001, 31,051.

21/ Rules 13a-1, 15d-1 under the Act, 17 C.F.R. §§ 240.13a-1, .15d-1 (1968).

bring the registration statement up to date.22/ Certified financial statements for the reporting year are also required.23/

The semiannual report on Form 9-K usually must be filed within 45 days after the end of the first half.24/ It consists principally of figures as to profit and loss and earned surplus, which need not be certified.25/

Current reports on Form 8-K usually must be filed within 10 days after the close of any month in which one or more of the events specified in the form has occurred.26/ These events are change in control, acquisition or disposition of assets, legal proceedings, change in securities, change in collateral for registered securities, default upon senior securities, increase or decrease in the amount of securities outstanding, grant or extension of options to purchase securities, revaluation of assets or restatement of capital share account and submission of matters to a vote of security holders.27/ Other important corporate events may be reported on Form 8-K, but there is no requirement to do so.28/ For example, no current report was required of Texas Gulf about its mineral discovery

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22/ Items 1-9.

23/ Item 10; Instruction as to Financial Statements 1(a).

24/ Rules 13a-13, 15d-13 under the Act, 17 C.F.R. §§ 240.13a-13, .15d-13 (1968).

25/ General Instruction C.

26/ Rules 13a-11, 15d-11 under the Act, 17 C.F.R. §§ 240.13a-11, .15d-11 (1968).

27/ Items 1-11.

28/ Item 12.

in Canada. Any financial statements as of a date subsequent to the close of the preceding fiscal year need not be certified. 29/

B. Section 10(b) of the Act and Rule 10b-5

As former Chairman Cohen recently described the Commission's reporting system, it

> provide[s] a permanent record of the most important information about these corporations and a framework within which other information can be assessed. But, the nature and timing of these reports prevent them from serving as an adequate medium for the rapid and widespread dissemination of current material information to the investing public. 30/

Although the Commission's Disclosure Study under the leadership of Commissioner Wheat is now in the process of formulating recommendations for improvement of the reporting system, 31/ no change is expected with respect to the usefulness of the reports as a medium for immediate disclosure. 32/ Thus, the question arises whether Section 10(b) of the Act and Rule 10b-5 under the Act 33/ should be used to impose requirements of timely disclosure.

29/ Financial Statements of Business Acquired 2.

30/ Address by Chairman Manuel F. Cohen, Balt. Sec. Analysts Soc'y, Jan. 6, 1969, at 12, in CCH Fed. Sec. L. Rep. ¶ 77,652, at 83,420.

31/ *See* SEC, Securities Act Release No. 8197 (Nov. 29, 1967), in CCH Fed. Sec. L. Rep. ¶ 77,501.

32/ 15 U.S.C. § 78j(b) (1964).

33/ 17 C.F.R. § 240.10b-5 (1968).

In essence, Section 10(b) and Rule 10b-5 prohibit all deceptive or manipulative conduct in connection with securities transactions. 34/ Prior to the Texas Gulf Sulphur case, these provisions were not generally considered to impose affirmative disclosure requirements on the corporation in the absence of securities transactions by the corporation itself. Indeed, any such duty under the antifraud provisions would have been inconsistent with the instruction to Item 12 of Form 8-K, which provides: "The registrant may, at its option, report under this item any events, with respect to which information is not otherwise called for by this form, which the registrant deems of material importance to security holders." 35/

34/ Section 10(b) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
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> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
> (1) to employ any device, scheme, or artifice to defraud,
> (2) 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
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
> in connection with the purchase or sale of any security.

35/ In 1 CCH Fed. Sec. L. Rep. ¶ 31,003, at 21,996 (emphasis added).

After the Texas Gulf case had been filed, there was considerable discussion whether a corporation was affirmatively required by Section 10(b) and Rule 10b-5 to disclose material corporate information as soon as possible, even though it was not trading in its securities. This issue was raised by the Commission's position with respect to the fiduciary duty to disclose material inside information, coupled with its position with respect to the general applicability of these provisions to corporate publicity.[36/] The Commission has never encouraged the view that there is such a duty—at least not under the general language of Rule 10b-5. Indeed, when one of its employees participated in writing a law review note taking the position that the rule did affirmatively require disclosure in these circumstances, the Commission requested that an unusual disclaimer be used.[37/] Nevertheless, the possibility that a court might hold against a corporation for not releasing news as soon as possible was a matter of serious concern among the corporate bar and corporate officials.

The first indication that the courts might not read Rule 10b-5 so expansively came from the Court of Appeals for the Second Circuit in a little-noticed footnote in the majority opinion in Texas Gulf itself. In that footnote the court stated:

> We do not suggest that material facts must be disclosed immediately; the timing of disclosure is a matter for the business judgment of the corporate officers entrusted

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36/ See pp. 12-13, infra.

37/ Note, "Texas Gulf Sulphur and the Duty of Disclosure, Another View," 55 Geo. L.J. 664 & n., 695-99 (1967); cf. Brief of SEC, Amicus Curiae, at 34-35 & n.45, Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968), petition for cert. filed, 37 U.S.L.W. 3250 (U.S. Jan. 2, 1969) (No. 894), views of United States invited, 37 U.S.L.W. 3307 (U.S. Feb. 24, 1969).

> with the management of the corporation within the affirmative disclosure requirements promulgated by the exchanges and by the SEC. 38/

This footnote, however, did not completely allay the fears of concerned corporate officials and attorneys because of its reference to the exchanges. More recently, in Electronic Specialty Company v. International Controls Corporation, 39/ the same court has been even more specific in this regard. In that case a claim was made that the defendant corporation had a duty to correct rumors about it that were emanating from other sources. In an opinion written by Judge Friendly the court stated: "While a company may choose to correct a misstatement in the press not attributable to it . . ., we find nothing in the securities legislation requiring it to do so." 40/

In my own view, this is the appropriate result. The major stock exchanges and the NASD have their own comprehensive timely disclosure requirements for companies within their jurisdiction. 41/ Phillip L. West of the New York Stock Exchange will be describing its disclosure policies to you at lunch today. Except in the case of the Commission's own specific disclosure provisions, timely disclosure should ordinarily be enforced informally by the self-regulatory bodies rather than formally by the Commission. The proper timing of disclosure is

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38/ 401 F.2d at 850 n.12.

39/ CCH Fed. Sec. L. Rep. ¶ 92,342 (Jan. 24, 1969).

40/ Id. at 97,635.

41/ American Stock Exchange, Company Guide §§ 401-24 (April 15, 1968); National Association of Securities Dealers, Inc., Manual ¶ 2155, at 2073 (1967); New York Stock Exchange, Company Manual A-18 to -24 (July 18, 1968).

primarily a matter of business judgment. Premature disclosure is equally as undesirable as delayed disclosure. Moreover, as several members of the Commission stated soon after the Texas Gulf case was started, a corporation may postpone disclosure of significant corporate developments when there is a good business reason for doing so.[42/] A great deal of flexibility is needed in applying timely disclosure requirements, and considerable deference should be given to the businessman's honest discretion. This is not an area that ordinarily lends itself to enforcement by injunction or by criminal proceedings, which are the principal weapons in the Commission's arsenal. The more informal procedures used by the self-regulatory bodies are preferable. As long as the self-regulatory bodies are effective in this area, I do not see any need for the Commission to promulgate specific rules to exercise its own authority under Sections 10(b) and 13.

III. FALSE OR MISLEADING STATEMENTS

A. Statements Subject to the Act

Registration statements and corporate reports filed with the Commission and the stock exchanges pursuant to Sections 12, 13 and 15(d) are, of course, subject to the Act. These corporate statements, as well as many others of a more informal nature, are also included within the coverage of Section 10(b) and Rule 10b-5 under the principles laid down in Texas Gulf and subsequent cases.

42/ Address by Commissioner Hamer H. Budge, N.Y. Chapter, Am. Soc'y of Corp. Sec'ys, Nov. 18, 1965, at 4-5; Address by Commissioner Hugh F. Owens, Okla. B. Ass'n, Dec. 3, 1965, at 7; Address by Commissioner Francis M. Wheat, Harvard Bus. & L. School Alumni of So. Cal., Oct. 1965, at 5.

Both Section 10(b) and Rule 10b-5 apply by their terms only "in connection with the purchase or sale of any security." One of the major holdings in the Texas Gulf Sulphur case was that a corporate press release is subject to these provisions even though neither the corporation nor those officials responsible for its issuance engage in related securities transactions or issue it for the purpose of affecting the market. The court stated:

> Congress intended to protect the investing public in connection with their purchases or sales on Exchanges from being misled by misleading statements promulgated for or on behalf of corporations irrespective of whether the insiders contemporaneously trade in the securities of that corporation and irrespective of whether the corporation or its management have an ulterior purpose or purposes in making an official public release. Indeed, the Commission has been charged by Congress with the responsibility of policing all misleading corporate statements from those contained in an initial prospectus to those contained in a notice to stockholders relative to the need or desirability of terminating the existence of a corporation or of merging it with another. 43/

Thus, the court held that Section 10(b) and Rule 10b-5 apply to all corporate statements "made . . . in a manner reasonably calculated to influence the investing public, e.g., by means of the financial media . . . ." 44/

Many different types of public statements by corporations may be subject to Section 10(b) and Rule 10b-5 under this broad standard. Texas Gulf, of course, involved a press release. 45/ In Heit v. Weitzen, 46/ on which the

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43/ 401 F.2d at 860-61.

44/ 401 F.2d at 862.

45/ Accord, SEC v. Great Am. Indus., Inc., CCH Fed. Sec. L. Rep. ¶ 92,325, at 97,537 (2d Cir. Dec. 23, 1968) (en banc).

46/ 402 F.2d 909 (2d Cir. 1968), petition for cert. filed, 37 U.S.L.W. 3250 (U.S. Jan. 2, 1969) (No. 894), views of United States invited, 37 U.S.L.W. 3307 (U.S. Feb. 24, 1969).

Supreme Court has recently requested the Commission's views as to the pending petition for certiorari, the Court of Appeals for the Second Circuit extended that holding to corporate reports filed with the Commission under Section 13 and an annual report to shareholders. District court decisions have interpreted the "in connection with" standard to encompass material furnished to Standard & Poor's Corporation,[47/] product promotional activities[48/] and a speech by two directors of the corporation to a meeting of security analysts.[49/]

How are corporate officials to know whether any particular statement will come within Section 10(b) and Rule 10b-5? In a sense, this should not be a matter of concern except in subsequent litigation. No responsible corporate official would feel free to deceive the public merely because he thought these provisions inapplicable. When the question does arise, a number of factors must be considered. The principal one will be the subject matter of the statement. The balance sheet of a food company is more likely to influence investors than an advertisement for a new brand of soup. On the other hand, an advertisement for a revolutionary new product might well be expected to have a market impact. The character of the medium in which the statement is made is also important. A story about a new product in a trade publication stands on considerably different footing from the same story in The Wall Street Journal. In any event, whether any particular corporate statement can reasonably be expected to influence the investing public must be decided upon the facts of that particular case.

47/ Robbins v. Banner Indus., Inc., CCH Fed. Sec. L. Rep. ¶ 92,309 (S.D.N.Y. Nov. 27, 1968).

48/ SEC v. Electrogen Indus., Inc., CCH Fed. Sec. L. Rep. ¶ 92,156, at 96,719 (E.D.N.Y. Feb. 26, 1968).

49/ Sprayregen v. Livingston Oil Co., CCH Fed. Sec. L. Rep. ¶ 92,272 (S.D.N.Y. Sept. 25, 1968).

B. Standards for Judging False or Misleading Character

1. Registration Statements and Filed Reports

Unless expressly provided to the contrary, the requirement that registration statements under the Securities Act of 1933 be accurate and complete is an absolute one; the fact that omitted material was not actually known to the corporation does not prevent its omission from being a violation. 50/ Although the absolute requirement of accuracy and completeness under that act is based in part upon the express statutory liability of the corporation to persons who purchase part of the registered offering, 51/ the same rule should be applicable to all registration statements and reports filed with the Commission. The registration and reporting provisions have not been complied with unless all the required information has been set forth correctly. 52/

The corporate duty of compliance should be absolute up to the pertinent date, Consequently, it is clear that corrections as to matters arising before that date must be made. The pertinent date with respect to registration statements under Section 12(b) is their effective date,

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50/ Franchard Corp., [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,113, at 82,044-45 & n.27 (SEC July 31, 1964); see Herman Hanson Oil Syndicate, 2 S.E.C. 743, 746 (1937); Haddam Distillers Corp., 1 S.E.C. 37, 47, followed, 1 S.E.C. 48 (1934).

51/ See Section 11(a) of the Securities Act of 1933, 15 U.S.C. § 77k(a) (1964).

52/ Ambrosia Minerals, Inc., 39 S.E.C. 734-35 n.1 (1960); Eureka Co., 38 S.E.C. 475, 476 n.2 (1958); Great Sweet Grass Oils, Ltd., 37 S.E.C. 683, 684 n.1 (1957), aff'd per curiam, 256 F.2d 893 (D.C. Cir. 1958).

and the pertinent date with respect to Section 12(g) registration statements and corporate reports filed with the Commission under Section 13 is the date of the filing.

A more interesting question is whether there is ever a duty to report events occurring after the pertinent date and for which there is no independent disclosure requirement, but which are necessary to bring previous statements up-to-date. For example, merger negotiations need not be reported to the Commission. Suppose, however, that a corporation nevertheless decides to describe the existence of merger negotiations in a Form 10-K report. If the merger negotiations later fall through, is the corporation then required to amend its 10-K or file a new 8-K to report this fact? The proxy rules expressly require the disclosure of information ". . . necessary to correct any statement in any earlier communication . . . ." 53/ There is no such express provision in the registration and reporting requirements. Although the question is an open one, I think that the information should be reported if it is necessary to make the statements made not misleading.

2. Informal Corporate Statements

The standards for judging informal corporate statements, such as press releases, must necessarily be more lenient. Informal corporate statements are often issued under pressure. Texas Gulf indicates that it would not be reasonable to charge the corporation with knowledge of all

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53/ Rule 14a-9(a) under the Act, 17 C.F.R. § 240.14a-9(a) (1968).

existing information, whether or not the corporation should have known it. Moreover, informal corporate statements cannot be expected to be as comprehensive as filed documents, nor would it be desirable to impose a rigid format upon them. As members of the Commission have already stated, "[W]e do not expect to become after-the-fact rewrite men for all corporate publicity." 54/

As to the accuracy or completeness with which the pertinent information must be set forth, Texas Gulf establishes the general standard that the statement must not be ". . . deceptive or misleading to the reasonable investor . . . ." 55/ If specific facts are known, and their evaluation is a matter of judgment, they should be set forth— at least in condensed form; the corporation's own evaluation is not enough. As the court of appeals stated in Texas Gulf, "The choice of an ambiguous general statement rather than a summary of the specific facts cannot reasonably be justified by any claimed urgency." 56/

In determining whether the pertinent information has been properly set forth, the corporation is not charged with knowledge of all existing information. Under the Texas Gulf decision the responsible corporate

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54/ Address by Commissioner Richard B. Smith, Counselors Section, Pub. Rel. Soc'y of Am., Nov. 17, 1968, at 6; Address by Chairman Manuel F. Cohen, supra note 30, at 13, CCH Fed. Sec. L. Rep. ¶ 77,652, at 83,420.

55/ 401 F.2d at 863.

56/ 401 F.2d at 864.

officials are not required to do more than exercise "due diligence" to ascertain this information.57/ If due diligence would not have revealed more than the responsible officials of the corporation actually knew, then the corporate statement is to be judged on the basis of known facts.

Finally, we reach the question of the duty to correct previous statements or bring them up to date. If subsequently ascertained information that would not have been discovered in the exercise of due diligence indicates that a prior statement was inaccurate or incomplete when made, I believe that there is a duty under Section 10(b) and Rule 10b-5 to correct the prior statement promptly.58/ In one Commission injunctive action the court stated that, when a corporation has previously announced the successful completion of negotiations for a corporate acquisition, and the deal later falls through, the corporation should issue a corrective statement.59/ Although the Commission itself had not argued for a duty to correct in that case, I think that the principle is sound— at least when some continuing event such as negotiations for a merger or drilling for a mineral prospect is concerned. On the other hand, if the subsequent event is not part of a continuing process, and the prior statements were proper as of the pertinent date, I do not believe that Section 10(b) and Rule 10b-5 should be read to require disclosure when the

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57/ 401 F.2d at 863.

58/ _Cf._ _Fischer_ v. _Kletz_, 266 F. Supp. 180, 184-89 (S.D.N.Y. 1967) (duty of independent certified public accountants under common law).

59/ _SEC_ v. _Shattuck Denn Mining Corp._, CCH Fed. Sec. L. Rep. ¶ 92,177, at 96,825 (S.D.N.Y. April 2, 1968). The court held, however, that Section 10(b) and Rule 10b-5 were not violated because they were inapplicable to a corporate press release. _See_ pages 12-13, _supra_, for the subsequent contrary holdings of the Court of Appeals for the Second Circuit on the "in connection with" issue.

corporation is not trading in its stock. For example, the fact that a corporation not subject to the reporting requirements has voluntarily disclosed its 1967 earnings in a press release should not require it to announce its 1968 earnings. Otherwise, there would be an implied reporting system created through the back door.

IV. REQUIRED METHODS OF DISSEMINATION

The Texas Gulf decision made it clear that Section 10(b) and Rule 10b-5 prohibit a corporation from divulging material inside information to favored persons for their use in transactions in the corporation's securities without disclosure.[60/] Thus, caution must be exercised that corporate disclosures are not made in such a manner as to constitute the corporation a "tippor."

These problems will not normally arise in the case of registration statements under Section 12 of the Act or corporate reports under Section 13, since filing with the Commission or the stock exchanges is ordinarily the initial dissemination of these documents. If they contain significant new information about the corporation, the filing is generally accompanied by the issuance of a press release. But advance notice to favored persons of

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60/ 401 F.2d at 852-53; accord, Ferraioli v. Cantor, 281 F. Supp. 354 (S.D.N.Y. 1968); Merrill Lynch, Pierce, Fenner & Smith, Inc., CCH Fed. Sec. L. Rep. ¶ 77,629 (SEC Nov. 25, 1968); cf. Kuehnert v. Texstar Corp., 286 F. Supp. 340 (S.D. Tex. 1968); Ross v. Licht, 263 F. Supp. 395, 410 (S.D.N.Y. 1967) (alternative holding); Blyth & Co., CCH Fed. Sec. L. Rep. ¶ 77,647 (SEC Jan. 17, 1969); Herbert L. Honohan, 13 S.E.C. 754, 757-58 (1943), modified in other respects, 16 S.E.C. 297 (1944); 3 L. Loss, Securities Regulation 1450-51 (2d ed. 1961). See also, Mosser v. Darrow, 341 U.S. 267 (1951).

the material to be filed would expose the corporation to legal action. Similar exposure might result from a tip about the filing before it can come to the attention of the public. 61/

Other public statements by corporations should similarly raise no great problems under Section 10(b) and Rule 10b-5. An exclusive interview to a news medium of widespread publication is clearly permissible. 62/ Even an exclusive interview with a local newspaper would not ordinarily expose the corporation to legal action, although it may not be sufficient disclosure to allow insiders to trade. On the other hand, a distinction must be made between limited disclosure to news media and limited disclosure to investors or their advisers. Certain favored investors should not be given an opportunity to "beat the news" 63/ by advance disclosure to them either directly or through their advisers. For example, I am troubled by the practice of inviting a few selected broker-dealers to press conferences. If the press conference is to be the first dissemination of important corporate news, then only news disseminators should be present.

61/ Compare the analogous holding in Texas Gulf with respect to the permissible timing of insider trading. 401 F.2d at 853-54.

62/ Letter from Chairman Manuel F. Cohen to Joseph M. Guilfoyle, Oct. 4, 1968, quoted in Wall St. J., Oct. 9, 1968, at 16, col. 1.

63/ This phrase was used to describe one of the individual defendants in Texas Gulf. 258 F. Supp. at 287.

A more bothersome question is raised by requests by individuals for previously undisclosed corporate information. I refer particularly to the relations between a corporation and security analysts. A great deal has already been said about this problem,[64/] and we do not have time to explore it in any depth. Suffice it to say that the principal concern in this area should be the prevention of any form of favoritism. As the president of the New York Stock Exchange has aptly put it, "[A] caste system for release of corporate information . . . is not consistent with our disclosure standards."[65/] An important reason for the Commission's action against Glen Alden Corporation[66/] was our belief that its officials had given highly confidential corporate information to certain selected investors and would not have given that information to any responsible shareholders or other investors who requested it. On the other hand,

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64/ E.g., Address by Chairman Manuel F. Cohen, supra note 30; Address by David Ferber, N.Y. Soc'y of Sec. Analysts, Nov. 12, 1968; Address by Commissioner Richard B. Smith, supra note 54, at 4-5; Address by Commissioner Francis M. Wheat, supra note 42, at 5; New York Stock Exchange, supra note 41, at A-20; Panel Interview with Philip A. Loomis, Jr., Fin. Analysts Fed'n, Oct. 7, 1968, summarized in CCH Fed. Sec. L. Rep. ¶ 77,624; Public Statement by George S. Bissell, Sept. 19, 1968, reported in Wall St. J., Sept. 20, 1968, at 6, cols. 3-4; Statement of Chairman Hamer H. Budge Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency, 91st Cong., 1st Sess. 37 (March 6, 1969).

65/ Remarks by Robert W. Haack, Fin. Execs. Inst., Oct. 26, 1968, at 6, quoted in Address by Chairman Manuel F. Cohen, supra note 30, at 11, CCH Fed. Sec. L. Rep. ¶ 77,652, at 83,419.

66/ SEC v. Glen Alden Corp. CCH Fed. Sec. L. Rep. ¶ 92,280 (August 7, 1968).

security analysts do serve as an important vehicle for the collection and evaluation of corporate information for the public. Any decision about specific situations in this area must take into account both the unfairness of any form of favoritism and the very useful function served by the analysts.

V. MANIPULATION

A connection between corporate activities and the securities markets may exist even when corporate statements are not involved. Any corporate misconduct, if perpetrated for the purpose of affecting the market for its securities, may constitute a manipulation of the market in violation of Section 10(b) and Rule 10b-5. In both cases that have thus far raised this possibility,[67/] there was an allegation that the corporation had kept its dividends to a minimum in order to depress the market price of its stock and buy it up at bargain prices. It is not clear whether the rationale of these cases would apply in the absence of an allegation of prospective securities transactions by the corporation. If so, a manipulation case can be made out of almost any kind of corporate misconduct when a purpose to affect the market is also claimed. Of course, such an allegation would have to be proved. But the Court of Appeals for the Second Circuit has recently held that summary judgment may not ordinarily be granted to a defendant in a derivative suit when questions of its purpose or intent are in issue.[68/] Moreover, if the case goes

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67/ Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 546-47 (2d Cir. 1967); Cochran v. Channing Co., 211 F. Supp. 239, 243 (S.D.N.Y. 1962).

68/ Schoenbaum v. Firstbrook, CCH Fed. Sec. L. Rep. ¶ 93,327, at 96,567-68 (Dec. 30, 1968) (en banc).

to trial, a pendent state law claim may be adjudicated even if the federal claim is eventually rejected.[69/] The federal courts may find themselves deciding many more corporate mismanagement cases in the future.

VI. AIDING AND ABETTING

Willful violations of the securities acts are criminal offenses.[70/] The Criminal Code provides that any person who ". . . aids, abets, counsels, commands, procures or induces . . ." the commission of ". . . an offense against the United States . . . is punishable as a principal."[71/] Thus, when a willful violation of the securities acts has occurred, and the corporation has aided or abetted that violation, it has also committed a criminal offense. The courts, however, have not limited the aider-and-abettor doctrine to criminal violations.

As set forth in the Restatement of Torts, one person may be liable for the tortious conduct of another if he "knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself . . . ."[72/] In two fairly early cases the Commission obtained injunctions on the basis of the aider-and-abettor doctrine without any proof of a criminal violation.[73/]

69/ *E.g.*, *Mine Workers* v. *Gibbs*, 383 U.S. 715, 721-29 (1966); *Hurn* v. *Oursler*, 289 U.S. 238, 245-46 (1933).

70/ *See* Section 24 of the Securities Act of 1933, 15 U.S.C. § 77x (1964); Section 32(a) of the Act, 15 U.S.C. § 78ff(a) (1964).

71/ 18 U.S.C. § 2(a) (1964).

72/ Section 876(b) (1939).

73/ *SEC* v. *Timetrust, Inc.*, 28 F. Supp. 34, 43 (N.D. Cal. 1939), *injunction granted*, 39 F. Supp. 145 (N.D. Cal. 1940), *appeal dismissed per curiam on stipulation*, 118 F. 2d 718 (9th Cir. 1941), *remanded for further findings*, 130 F.2d 214 (9th Cir. 1942), *rev'd on the facts*, 142 F. 2d 744, 746 (9th Cir. 1944); *SEC* v. *Scott Taylor & Co.*, 183 F. Supp. 904, 909 n.12 (S.D.N.Y. 1959) (alternative holding).

In another early case a private complaint for damages was sustained against a broker-dealer because of its participation in the civil violation by another person.[74/] More recent cases have expressly upheld complaints against corporate insiders,[75/] a firm of certified public accountants[76/] and broker-dealer firms[77/] as aiders and abettors on this basis.

If a corporation knows that other persons are engaging in transactions in its securities in violation of the securities acts, and it takes affirmative steps to assist or encourage the violations, there does not seem to be any reason why the corporation should not also be considered a violator. Of course, a corporation cannot act for itself. Therefore, it is necessary in each case to determine whether the conduct of corporate officials should be charged to the corporation or should be considered as only their own individual acts. But, aside from the agency problem, this aspect of the aider-and-abettor doctrine is not troublesome.

The doctrine has not, however, been limited to affirmative assistance or encouragement. In one case, a complaint alleged that a national securities exchange and its officers had failed to take disciplinary action against the principal violators; it was sustained on the basis of the aider-and-abettor doctrine without any discussion of the difference between affirmative participation and inaction.[78/] In Brennan v. Midwestern United

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74/ Fry v. Schumaker, 83 F. Supp. 476 (E.D. Pa. 1947).

75/ Ross v. Licht, 263 F. Supp. 395, 410 (S.D.N.Y. 1967) (alternative holding).

76/ Fischer v. Kletz, 266 F. Supp. 180, 196-97 (S.D.N.Y. 1967); see H. L. Green Co. v. Childree, 185 F. Supp. 95 (S.D.N.Y. 1960).

77/ Anderson v. Francis I. duPont & Co., 291 F. Supp. 705, 709 (D. Minn. 1968) (alternative holding).

78/ Pettit v. American Stock Exchange, 217 F. Supp. 21, 28 & n.20 (S.D.N.Y. 1963).

Life Insurance Company, 79/ a district court expressly held that corporate inaction could constitute aiding and abetting. In that case the complaint alleged that a broker-dealer was manipulating the market for the securities of the corporation, that the corporation was aware of the situation, that it failed to report the situation to the Commission or the state securities authorities and that the corporation and its officers and directors benefited from the manipulation in their own securities transactions. The court conceded that "[c]ertainly, not everyone who has knowledge of improper activities in the field of securities transactions is required to report such activities," 80/ and that a full trial would be necessary to determine whether the corporation's silence in this case actually constituted aiding and abetting. But it did hold that because of the fiduciary relationship between the corporation and its shareholders, particularly in the light of the benefits derived from the violations, affirmative action was not required to constitute aiding and abetting. 81/

If this expansion of the aider-and-abettor doctrine is followed by other courts, substantial new obligations could be imposed upon the corporation in a variety of areas.

79/ 259 F. Supp. 673, 676-82 (N.D. Ind. 1966); accord, Anderson v. Francis I. duPont & Co., 291 F. Supp. 705, 709 (D. Minn. 1968) (dictum)

80/ 259 F. Supp. at 681; accord, Fischer v. Kletz, 266 F. Supp. 180, 195 (S.D.N.Y. 1967).

81/ In a later opinion, on the basis of the evidence developed at the trial, the court found that the corporation had affirmatively aided and abetted the violation of the broker-dealer by referring to it inquiries about late delivery and nondelivery of the corporation's securities. 286 F. Supp. 702 (N.D. Ind. 1968).

Corporate officials often follow the market for its securities. They will frequently be aware of suspicious developments in that market. In many cases the corporate transfer records will also indicate the identity of the persons who are doing the trading. Thus, the corporation may be aware of a manipulative scheme, as in Brennan, an unregistered distribution of its securities by controlling persons or other irregularities. Under the Brennan case, the corporation may find that it has participated in the violations if it fails to report these circumstances to the Commission. Other circumstances can also be envisioned in which a corporate duty to come forward might be imposed.

The agency problem is particularly complex in the case of inaction. When should the silence of corporate officials be charged to the corporation? When should it be considered only their own personal misconduct? If affirmative assistance or encouragement is involved, we can at least look to see whether the corporate official purports to act for the corporation or only for himself. But, when there is only a failure to act, we must rely upon other tests.

Let us assume for example, a situation in which a corporate vice president is trading in the corporation's securities on the basis of material inside information. If he is the only corporate official who knows about this, it seems somewhat arbitrary to charge the corporation with his knowledge and then conclude that the corporation is an aider and abettor for not taking any action to stop him. The law would not ordinarily impute his knowledge to the corporation in these circumstances.[82/] Conversely, if high corporate officials who are not themselves trading are aware that other officials are improperly doing so, the result could be different.

I have mentioned these examples only to indicate the kinds of situations to which the aider-and-abettor doctrine could be applied. I do not mean to imply that the Commission is presently contemplating bringing any lawsuits in these situations. It did not, for example, charge Texas Gulf with aiding and abetting insider trading by its officials. But, except for the possibility of filing amicus briefs, the Commission has no control over the many private actions based on Section 10(b) and Rule 10b-5. In my own view, it would be advisable for a corporation to police the trading of its officials, regardless of whether the securities laws require it to do so. I recommend that you keep the aider-and-abettor doctrine in mind in deciding what to do about suspicious circumstances that come to your attention.

VII. THE SEPARATE PROBLEM OF DAMAGES

Before I conclude my remarks, I want to say just a few words about the monetary implications of expanding corporate liability under Section 10(b) and Rule 10b-5.

Professor Knauss will be speaking to you next about the various remedies available against the corporation when a violation of these provisions has occurred. I do not want to anticipate his comments on that subject. Nevertheless, a reading of the various individual opinions in Texas Gulf[83/]

82/ *E.g.*, *Restatement* (Second), *Agency* §§ 280, 282(1) (1958).

83/ 401 F.2d at 863 (opinion of the court by Waterman, J.), 866-68 (Friendly, J., concurring), 869 (Kaufman, J., concurring; Anderson, J., (concurring).

makes it apparent that, in deciding the issue of statutory coverage, the courts have been concerned by the monetary liabilities that may flow from a finding of violation. The principal reason for this concern is the fact that the ultimate financial burden of any recovery against the corporation will fall upon its shareholders, who may be equally as innocent as those investors who have been injured by the corporation's violation.

The Commission is sensitive to this problem. In its court of appeals brief in Heit v. Weitzen it had the following to say:

> The Commission recognizes that the application of Section 10(b) and Rule 10b-5 to activities affecting large numbers of investors, rather than only specific individuals, and the private rights of action that this Court and other courts have held to flow from the violation of these provisions raise important questions with regard to the extent of the monetary liabilities that could result. As an agency that has devoted many years of effort to increasing the flow of accurate and meaningful information about securities and otherwise protecting public shareholders, the Commission would be the last to suggest that the courts should impose liabilities that might actually interfere with these important objectives.
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> Consequently, when, as in these cases, a member of the investing public has alleged that by reason of a serious violation of Section 10(b) and Rule 10b-5 he has suffered significant injury, we believe that he is entitled to his day in court, and that his complaint should not be summarily dismissed. On the other hand, it may well be premature to endeavor to determine at this stage the extent of the monetary liability that might result if the plaintiffs are successful in proving their allegations. This should properly await the trial of the case, which will provide a complete record as to exactly what the defendants did, why they did it and how this affected the plaintiffs. We believe the Court will then be in a better position to examine and resolve questions with respect to the appropriate remedy, giving consideration

> to how a damage award against the issuer would affect the issuer and all of its stockholders, including those who neither bought nor sold. In so doing the Court will be able to utilize its traditional flexibility with respect to remedies, avoiding, on the one hand, Draconian relief and, on the other hand, an opportunity for violators to profit from their wrongdoing. 84/

The court quoted from this passage in deferring all questions of damages until the facts have been fully developed at trial. 85/

Although the problem of damages seems to be a difficult and perplexing one in this context, there is no reason to hold the statute and rule inapplicable in order to solve it. The courts have repeatedly stated that the requirements of proof in a private action for damages are both stricter and more extensive than in a Commission enforcement action. 86/ The private right of action has been implied because it is "a necessary supplement" to Commission enforcement. 87/ It should be allowed only to the extent that—to borrow a phrase from another context—it in fact "make[s] the Securities Exchange Act work . . . . ." 88/ I believe that the courts have acted wisely in treating problems about the extent of damages as separate and not allowing their concern with these problems to deny the investing public the benefits of Commission enforcement that, standing by itself, is not only unobjectionable but desirable.

84/ Pp. 31-32.

85/ 402 F.2d at 917 & n.8.

86/ E.g., SEC v. Capital Gains Bureau, 375 U.S. 180, 192-93, 200-01 (1963); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 863 (2d Cir. 1968) (en banc); Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 547 (2d Cir. 1967).

87/ J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964).

88/ Silver v. New York Stock Exchange, 373 U.S. 341, 357 (1963).

VIII. CONCLUSION

In reporting out the bill that eventually became the Act, the House committee stated that "[n]o investor, no speculator, can safely buy and sell securities upon exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells." 89/ To carry out this objective the Act imposes important obligations upon corporations even when they are not trading in their stock. Compliance with some of these obligations entails the expenditure of considerable time and money. In some cases, the obligations are necessarily somewhat indefinite, and it is not always possible to delineate them with precision. Nevertheless, the success of our economic system depends upon the confidence of investors, which, in turn depends in large part upon the ease with which they can ascertain the pertinent facts about their investments. It is no secret that the ready availability of such information in this country, as compared to the secrecy in which foreign corporations often shroud their activities, is one of the principal reasons behind the increasing flow of foreign investment capital to the American securities markets. 90/ Although a corporation's obligations when it is not trading in its stock are substantial, in the long run they are well worth the price.

89/ H.R. Rep. No. 1383, 73d Cong., 2d Sess. 11 (1934).

90/ See e.g., Address by Commissioner Richard B. Smith, supra note 42, at 3-4. In 1968, net purchases of United States equity securities by foreigners were 2.264 billion dollars, and net foreign purchases of United States corporate debt securities by foreigners were 1.903 billion dollars. 1969 Fed. Res. Bull. A 82.