DIS

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, -against- TEXAS GULF SULPHUR COMPANY, a Texas corporation, CHARLES F. FOGARTY, RICHARD D. MOLLISON, RICHARD H. CLAYTON, WALTER HOLYK, KENNETH H. DARKE, DAVID M. CRAWFORD, THOMAS S. LAMONT, FRANCIS G. COATES, CLAUDE O. STEPHENS, THOMAS P. O'NEILL, JOHN A. MURRAY. EARL L. HUNTINGTON and HAROLD B. KLINE, Defendants.	65 Civ. 1182

TRIAL MEMORANDUM FOR DEFENDANT COATES

Plaintiff charges defendant Coates, as a director of Texas Gulf Sulphur Company, with violation of Section 10(b) of the Securities Exchange Act of 1934 and of Rule 10b-5 thereunder in connection with purchases of Texas Gulf stock on April 16, 1964, following a public announcement by the Company at a news conference concerning the results of Texas Gulf's drilling near Timmins, Ontario.

The transactions in respect of which Coates is sought

to be held liable are (i) his purchase of 2,000 shares of Texas Gulf stock for the account of certain family trusts and (ii) the purchase by his Houston broker (and son-in-law) H. Fred Haemisegger of 1,500 shares for his own account and for the accounts of certain of his customers.

The relief sought against Coates is (i) an injunction against any future use of inside information in the purchase or sale of Texas Gulf securities or the transmission of such information to others, (ii) an order directing Coates to offer "rescission" to each of the sellers of the stock purchased by him, and (iii) damages (described as "restitution") to be paid to the sellers of the stock purchased by Haemisegger and his customers.

The Facts

Coates has been a director of Texas Gulf since 1949. At the time of the transactions in question he was, and he is now, a partner in the Houston law firm of Baker, Botts, Shepherd & Coates.

Coates had no specific knowledge of the results of Texas Gulf's drilling near Timmins, Ontario, prior to April 15, 1964, although he was aware that Texas Gulf had been exploring the Canadian Shield for hard minerals for approximately seven years. On Thursday and Friday, April 9 and 10, 1964, the

Canadian press reported widespread rumors that Texas Gulf had made a significant mineral discovery near Timmins and on both days Texas Gulf stock was third on the list of most active stocks on the New York Stock Exchange. After the rumors were given further publicity in the New York papers on Saturday and Sunday, April 11 and 12, the management of Texas Gulf concluded that it was obligated* to issue a release which it did on April 12 and which was published in the morning papers on Monday, April 13, 1964. That release confirmed that preliminary indications from the Timmins drilling justified further drilling but pointed out that:

> "The work done to date has not been sufficient to reach definite conclusions and any statement as to size and grade of ore would be premature and possibly misleading. When we have progressed to the point where reasonable and logical conclusions can be made TGS will issue a definite statement to its stockholders and to the public in order to clarify the Timmins project."

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* The rules of the New York Stock Exchange state:

> "Occasions may also arise when rumors have been circulated which have no basis in fact or which require clarification or interpretation and which also result in unusual activity or price changes in a particular security. Under such circumstances the most effective procedure is the quick and speedy denial of such rumors through a release to the public Press." (N.Y.S.E. Company Manual p. A-22)

The first information that Coates received concerning the Timmins exploration activities was that contained in the Company's release of April 12, 1964. That release, which appeared in the Wall Street Journal on April 13, was read by Coates on that day. His attention was called to the Wall Street Journal article in a telephone conversation with Stephens, President of Texas Gulf, concerning whether or not Coates would attend the regular monthly meeting of the Board of Directors scheduled for Thursday, April 16, 1964.

On Wednesday, April 15, Coates flew from his home in Houston to New York. He went to the Company's offices late in the afternoon. There he saw a rough draft of the announcement then being prepared for release at a press conference which had been called for 10:00 a.m. on April 16, immediately following the Board meeting. Coates was also told that the Minister of Mines for the Province of Ontario would make an announcement of the Timmins discovery on the radio at 11:00 p.m. on April 15.

At 9:00 a.m. on Thursday, April 16, Coates attended the Board of Directors meeting where the press release in final form was read and the directors were told by Stephens (mistakenly, as it subsequently developed) that the Ontario Minister of Mines had announced the discovery the night before. The previously arranged press conference began at approximately 10:00 a.m. Present were representatives of wire services,

both public and private, including the Dow Jones "Instant" News Service, brokerage houses, and other news media. Stephens read the press release. Immediately thereafter, a number of those present, including the Dow Jones representative, left the room to telephone their offices. The press conference continued with a question and answer period and ended 10 or 15 minutes after it had begun.

Coates sat through the entire press conference. At its conclusion, Coates telephoned Haemisegger, a registered representative of Rauscher Pierce & Co. in Houston, and placed an order for 2,000 shares of Texas Gulf stock for the account of four family trusts. At the time in question, the trusts held an aggregate of 5,100 shares of Texas Gulf which had been acquired over a number of years and Coates had been waiting for an anticipated decline in price to increase the investment. Following that telephone conversation, Rauscher Pierce & Co. executed Coates' orders in part on the New York Stock Exchange and in part on the Midwest Stock Exchange in Chicago. Haemisegger, who understood from his telephone conversation with Coates that a public announcement of the Texas Gulf discovery had been made, then purchased additional shares for his own account and for the accounts of four of his customers.

Relevant Statutes and Rules

Securities Exchange Act of 1934, Section 10(b)

(15 U.S.C. § 78j):

"§ 78j. Manipulative and deceptive devices

"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--

". . . .

"(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:

"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,

(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

(c) 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."

Section 21(e) of the Act (15 U.S.C. 78u(e)):

> "Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this chapter, or of any rule or regulation thereunder, it may in its discretion bring an action in the proper district court of the United States . . . to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. The Commission may transmit such evidence as may be available concerning such acts or practices to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this chapter."

POINT I

THE ACTS OF DEFENDANT COATES WERE NOT UNLAWFUL UNDER SECTION 10(b) OR RULE 10b-5.

Plaintiff's charges against Coates are based upon the contention that at the time of the purchases for which it seeks to hold him liable the fact that Texas Gulf had made a major discovery in the Timmins area was still inside information and that it was unlawful for him either to purchase Texas Gulf stock or to disclose the information to others until some as yet unspecified time. Plaintiff's position on this point is stated as follows (Br. pp. 34-35):

> "It is the Commission's position that even after corporate information has been published in the news media insiders still are under a duty to refrain from securities transactions until there has elapsed a reasonable amount of time in which the securities

industry, the shareholders and the investing public can evaluate the development and make informed investment decisions."

Although presumably able to promulgate a rule to that effect, the SEC has not done so.* Instead, it asks this court to make such a rule and apply it retroactively, under the guise of finding that the conduct complained of is a violation of the existing "antifraud provisions of Rule 10b-5" (SEC Br. p. 1). Plaintiff is in error both on the facts and on the law.

1. In the Absence of Market Manipulation or an Affirmative Statement in Connection with the Purchase of Securities, Section 10(b) and Rule 10b-5 Are Not Applicable to Mere Non-Disclosure of Inside Information.

We recognize, of course, that inside information may be used in market manipulation and also that the non-disclosure of inside information may make misleading statements made in connection with the purchase of a security. In the absence of such statements or market manipulation, however, Section 10(b) has no relation to the mere non-disclosure of inside information in making an investment on a stock exchange.

In enacting the Securities Exchange Act of 1934,

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* Indeed, in its answer to Coates Interrogatory 9, the Commission discloses that it has not yet defined what it means by "a reasonable amount of time".

Congress was fully aware of the problems involved in stock trading by insiders.* It treated such problems in Section 16 of the Act as separate and distinct from its treatment in Sections 9 and 10 of the Act of such manipulative practices as pooling arrangements, wash sales and matched orders. See Senate Reports Nos. 792 and 1455 (73rd Congress, Second Session).

The matter of insider trading was dealt with in Section 16 by providing for recovery of profits in the case of

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* Such problems had previously been considered by the courts in common law terms. Thus in Goodwin v. Agassiz, 186 N.E. 659 (Mass. 1933), the plaintiff sued to recover damages in connection with his sale of shares in a mining company (which were purchased on the Boston Stock Exchange by the defendant directors) on the theory that defendants had not disclosed significant geological data concerning a specific exploration of the company. In affirming a decree dismissing the complaint, the court said:

> "Purchases and sales of stock dealt in on the stock exchange are commonly impersonal affairs. An honest director would be in a difficult situation if he could neither buy nor sell on the stock exchange shares of stock in his corporation without first seeking out the other actual ultimate party to the transactions and disclosing to him everything which a court or jury might later find that he then knew affecting the real or speculative value of such shares. Business of that nature is a matter to be governed by practical rules. Fiduciary obligations of directors ought not to be made so onerous that men of experience and ability will be deterred from accepting such office. Law in its sanctions is not coextensive with morality. It cannot undertake to put all parties to every contract on an equality as to knowledge, experience, skill and shrewdness. It cannot undertake to relieve against hard bargains made between competent parties without fraud." 186 N.E. at 661.

short-term trading and by reporting requirements in the case of long-term investment. The reasons for that treatment are stated in Blau v. Max Factor & Co., 342 F.2d 304 (9th Cir.), cert. denied, 382 U.S. 892 (1965), where the Court said (at 308):

> "The reasons which led Congress to declare insider profits on stock transactions forfeit only when purchase and sale both occurred within less than six months, though not spelled out in the legislative materials, are nonetheless clear. Improper use of inside information by corporate insiders is most likely to occur in short-term, in-and-out trading. The temptation to trade upon inside information is enhanced when the period for which capital must be committed is short. And ordinarily the useful life of 'confidential' inside information is brief. The evidence upon which Congress acted indicated that the abuse occurred almost entirely in short-swing transactions. Moreover, few if any reasons could be advanced for encouraging such trading by insiders. On the other hand, in long-term investment the risk of abuse of inside information was relatively slight, and the affirmative value of long-term personal financial commitments by insiders to the prosperity of the companies which they controlled was obviously great. Thus, by basing forfeiture of profits upon the length of the insider's investment commitment, Congress sought to minimize misuse of confidential information, without unduly discouraging bona fide long-term investment."

Matter of Cady, Roberts & Co., 40 SEC 907 (1961), is the only action of the SEC prior to the present case involving the application of Rule 10b-5 to mere non-disclosure of inside information, unaccompanied by any affirmative state-

ment in connection with the purchase or sale of securities.*
In that proceeding, a partner of a brokerage firm was determined by the SEC to have violated the Rule by trading on the basis of information about a dividend reduction given to him by a director of the company prior to its release to the public. The public announcement was made by sending a telegram to the New York Stock Exchange which, although transmitted to Western Union prior to the director's telephone call to the broker, was delayed in delivery to the Exchange for more than an hour thereafter. Apart from the fact that the transaction there in question took place before a public announcement had actually been made, that proceeding differs from the present action in two significant respects:

(1) The decision was based upon an offer of settlement made on the condition that no sanction be entered in excess of a 20-day suspension of the broker from the New

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* In support of its assertion that such non-disclosure "constitutes a violation of the antifraud provisions" of Section 17 and Rule 10b-5, the SEC cited Speed v. Transamerica Corporation, 99 F. Supp. 808, 828-29 (D. Del. 1951); Kardon v. National Gypsum Co., 73 F. Supp. 798, 800 (E.D. Pa. 1947); and Ward LaFrance Truck Corp., 13 S.E.C. 373, 380, 381 (1943). Those cases, however, involved not individual transactions on an Exchange but formal offers by the holders of controlling stock interests to purchase the stock of other holders without disclosing pre-existing arrangements materially affecting its value.

York Stock Exchange and, accordingly, it was not subject to judicial review; and

(2) in reaching its decision, the SEC itself distinguished cases denying recovery for non-disclosure to purchasers or sellers of securities in exchange transactions* on the ground that such cases "concern the remedy of the buyer or seller vis-a-vis the insider" (id. at 914-15) and therefore were not relevant to that proceeding--which, unlike the present case, was solely a disciplinary proceeding against the broker.

The attempted application of Section 10(b) to stock purchases by others (Haemisegger and his customers in the case of Coates) is even more remote from the purpose of the legislation.

In Blau v. Lehman, 368 U.S. 403 (1962), the Supreme Court rejected an analogous attempt (supported by the SEC as amicus) to expand the application of the Act where a claim was made under Section 16(b) to recover short-term profits realized by investment banking firm partners of a director. The Court

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* E.g., Joseph v. Farnsworth Radio and Television Corp., 99 F. Supp. 701 (S.D.N.Y.), aff'd, 198 F.2d 883 (2d Cir. 1952); Donovan v. Taylor, 136 F. Supp. 552 (N.D. Cal. 1955).

said (at 410-412):

> "Both the petitioner and the Commission contend on policy grounds that the Lehman partnership should be held liable even though it is neither a director, officer, nor a 10% stockholder. Conceding that such an interpretation is not justified by the literal language of § 16(b) which plainly limits liability to directors, officers, and 10% stockholders, it is argued that we should expand § 16(b) to cover partnerships of which a director is a member in order to carry out the congressionally declared purpose 'of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer. . . .' . . .
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> "The argument of petitioner and the Commission seems to go so far as to suggest that § 16(b)'s forfeiture of profits should be extended to include all persons realizing 'short swing' profits who either act on the basis of 'inside' information or have the possibility of 'inside' information. One may agree that petitioner and the Commission present persuasive policy arguments that the Act should be broadened in this way to prevent 'the unfair use of information' more effectively than can be accomplished by leaving the Act so as to require forfeiture of profits only by those specifically designated by Congress to suffer those losses. But this very broadening of the categories of persons on whom these liabilities are imposed by the language of § 16(b) was considered and rejected by Congress when it passed the Act."

The Court pointed out that Congress had specifically considered and rejected making the disclosure of confidential "inside" information illegal* and concluded (at 413):

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* The proposed legislation rejected by Congress (quoted in a footnote in 368 U.S. at 412-13) would have made it unlawful for a director to disclose to a third person confidential information regarding a registered security and would have made any short-swing profit by the third person recoverable by the issuer.

> ". . . Congress can and might amend § 16(b) if the Commission would present to it the policy arguments it has presented to us, but we think that Congress is the proper agency to change an interpretation of the Act unbroken since its passage, if the change is to be made."

The Commission's attempt in the present case to expand § 16(b) by a novel "interpretation" of § 10(b) has been criticized by a recent commentator [Painter, "Inside Information: Growing Pains For The Development Of Federal Corporation Law Under Rule 10b-5" (65 Col. L. Rev., 1361, 1381)]:

> "Since this interpretation is apparently inconsistent with the legislative scheme in the Section 16(b) area, it must be viewed as an administrative sortie into the realm of legislation and thus of doubtful legality. . . ."

The law is clear that if Rule 10b-5 goes beyond what Congress has authorized in § 10(b) of the Act, it is void. As stated by the Supreme Court in Manhattan Co. v. Commissioner, 297 U.S. 129, 134, rehearing denied, 297 U.S. 728 (1936):

> "The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law - for no such power can be delegated by Congress - but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity."

2. The Acts of Coates Did Not Involve Fraud and Therefore Did Not Violate Section 10(b) or Rule 10b-5.

Even if Section 10(b) were applicable to mere non-disclosure of inside information in buying stock on an Exchange, there still can be no liability under Section 10(b) without proof of fraud. Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Weber v. C.M.P. Corp., 242 F. Supp. 321 (S.D.N.Y. 1965 Wyatt J.); Thiele v. Shields, 131 F. Supp. 416 (S.D.N.Y. 1955 Kaufman J.).

Clause (b) of Rule 10b-5 refers to non-disclosure in connection with the purchase or sale of a security but only in terms of an omission to state a material fact necessary in order to make statements made not misleading; and it is not contended that Coates made any statements in connection with the purchases in question.

Plaintiff has evidently not yet decided which of the other clauses of Rule 10b-5 it regards as applicable to Coates' purchases, i.e., the "device, scheme, or artifice to defraud" of clause (a) or the "act, practice, or course of business which operates or would operate as a fraud or

deceit upon any person" of clause (c), stating merely (SEC Br. p. 17) that this "is a question of purely academic interest".

In either case, however, plaintiff must prove fraud. The elements of a civil action for fraud (apart from damages) are (i) a misrepresentation, (ii) actual or constructive knowledge of its falsity (scienter), (iii) a purpose or intent to induce action in reliance and (iv) action in reliance. Restatement, Torts, §§ 525-548 (1938). While plaintiff argues (Br. 23-28) that it may establish violation of Rule 10b-5 without proving all of the traditional elements of fraud, the fact is that its case against Coates fails on each of those elements.

In the context of the charges against Coates, the first three elements must be restated as (i) non-disclosure, under circumstances requiring disclosure, of the fact that Texas Gulf had made a major discovery in the Timmins area, (ii) knowledge (or reason to believe) that the information with respect to the Timmins discovery was still "inside", and (iii) an intent to induce the sale of stock by non-disclosure of such information.

(a) Non-Disclosure

It is unnecessary at this point to argue the question whether Coates was under any duty to disclose because, at the times of the transactions in question, the fact that Texas Gulf had made a major discovery in the Timmins area had been disclosed and was no longer "inside" information.

The purchases in question were made following a public announcement at a news conference. Those present at the conference included representatives of American Metal Market, Business Week, Canadian Press, Chemical and Engineering News, Chemical Week, Dow, Jones & Co. Inc. (Dow Jones News Service and Wall Street Journal), Francis I. du Pont & Co., Engineering and Mining Journal, Investors Reader (a publication of Merrill Lynch Pierce Fenner & Smith), The Journal of Commerce, Mining Engineering Magazine, Newsweek, New York Herald Tribune, New York Times, The Telegram (Toronto), Time Magazine and United Press.

Even if the alleged "inside" information had been created that morning (as, for example, by the declaration of a dividend), it would be difficult to conceive of a more effective means of making the information public.

The rules of the New York Stock Exchange provide, with respect to dividend news:

". . . . To insure adequate coverage, dividend news

should be released to one or more of the newspapers of general circulation in New York City which regularly publish financial news or to one or more of the national news-wire services (Associated Press, United Press International), in addition to such other release as the company may elect to make. Release should also be made, simultaneously, to the news-ticker service operated by Dow Jones & Company, Inc. which has agencies in various cities and whose New York City address is 30 Broad Street." (N.Y.S.E. Company Manual, pp. A-38-39.)

These provisions of the New York Stock Exchange rules for publicizing important corporate developments were cited by the SEC with approval in Matter of Cady, Roberts & Co. (40 S.E.C. 907 at 915) and described as having:

". . . established explicit requirements and recommended procedures for the immediate public release of dividend information by issuers whose securities are listed on the Exchange. . . ."

The adequacy of the press conference as a means of public announcement was recently recognized by one of the trial counsel for plaintiff:

"The insider might convey his information to the stock exchange which, in turn, could publicize it via the 'tape'. Or, he might hold a press conference or utilize some other means at his disposal in order to make public the information. It seems doubtful that an insider, having taken reasonable steps to publicize material information prior to entering into a stock transaction, would nevertheless be held civilly liable under rule 10b-5 to a purchaser or seller whom the information did not reach." Joseph, Civil Liability Under Rule 10b-5--A Reply, 59 Nw. L. Rev. 171, 182, 183.

But the information as to the Timmins ore discovery was not dividend news created that morning. On the contrary, in the days immediately preceding the press conference, the

market generally had been alerted to the possible significance of the discovery to such an extent that the volume of orders at the opening of trading on April 16 was ample notice in and of itself that the importance of the discovery had been confirmed.

Reference has already been made to the widespread rumors that preceded the Company's release of April 12 which appeared in the papers on the morning of April 13, 1964.

During the 3-day period from the morning of Monday, April 13, to the evening of Wednesday, April 15, a series of significant events took place.

On the morning of Monday, April 13, the drilling of two holes which had been started a few days before was completed and additional data as to the content of the mineral body thereby became available. On that morning, a reporter from the Northern Miner visited the drilling site at the invitation of the Company, observed the holes and the cores taken therefrom and was informed of the substance of the assay reports then available. On the basis of such observations and information, the reporter made his own estimates of mineral content and grades and, during the day, wrote the story which appeared in the Northern Miner of Thursday, April 16.

On the morning of Wednesday, April 15, Mollison

and Holyk met with Wardrope, Canadian Minister of Mines, and his deputy Douglas, and gave them a statement for radio release at 11:00 p.m. that evening which stated in part:

> "There are still only six drill holes complete enough to be important in evaluating the sulphide body being explored and actual assays from only one hole. But the information available from this limited work gives the company confidence to allow me to state that Texas Gulf Sulphur has a mineable body of zinc, copper, or sulphur ore that will be developed and brought to production as quickly as possible."

On April 15, 1964, Mollison and Holyk flew from Toronto to New York bringing with them the results of the drilling operations subsequent to Sunday, April 12. In the afternoon of Wednesday, April 15, invitations were sent (by telephone, with telegraphic confirmation) to the press conference to be held at the Company's offices at 10:00 a.m. on Thursday, April 16.

At 8:30 a.m. (E.S.T.) on the morning of Thursday, April 16, the issue of the Northern Miner containing the Texas Gulf story appeared on the newsstands in Toronto and was delivered to brokerage houses in that city. At about the same time it was available in a number of brokerage houses in New York (having been printed the night before and sent down by air mail). In addition, prior to the opening of the market on April 16, many New York brokerage houses learned of the Northern Miner article from branch offices or

contacts in Canada. Although the Minister of Mines had not made the expected radio announcement the night before, he did deliver a release to the Press Gallery at the Ontario Parliament Building at about 9:40 a.m. on April 16. And, shortly after the Texas Gulf press conference in New York, the news appeared on a number of private wire services, including the widely used service of Merrill Lynch, Pierce, Fenner & Smith which carried the announcement at 10:29 a.m.

Against this background, plaintiff's contention that news of the Timmins discovery was "inside" information as late as 10:30 a.m. on Thursday, April 16, is completely unrealistic. At that point, all of the individuals present at the press conference and all of the organizations that they represented were presumably free to enter orders on the Exchange to buy or sell Texas Gulf stock on the basis of the public announcement. So far as Coates is concerned, there is nothing more that he could reasonably be expected to have done by way of disclosure; and, as we have pointed out, the SEC has not adopted any rule requiring a director not to buy or sell his company's stock in these circumstances.

Plaintiff's suggestion (Br. pp. 38-39) that Coates' telephone call to Haemisegger was an unlawful disclosure of "confidential information" is patently absurd. But for the fact that Haemisegger's office was in Houston, he could just

as well have attended the news conference along with representatives of Merrill Lynch Pierce Fenner & Smith, Inc. and Francis I. du Pont & Co.

(b) Scienter

Whatever conclusion be reached as to the effectiveness of the public disclosure, there can be no doubt that Coates reasonably believed that the news of the Timmins discovery was no longer "inside" information.

At the time of the transactions in question, he knew that the information reported at the news conference had been widely disseminated to the organizations there represented. He assumed--and was entitled to assume--that the report would be on the Dow Jones broad tape in a matter of minutes.* Furthermore, he had been informed (although erroneously) that the Ontario Minister of Mines had made a radio announcement the night before.

Coates' good faith is further demonstrated by the fact that he waited until the completion of the public announcement on April 16, notwithstanding the fact that he could readily

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* The Dow Jones reporter present at the conference has testified that if normal procedures had been followed "this would have appeared [on the tape] within a matter of two or three minutes after I dictated it". Bishop dep. p. 44. Cf. Cady, Roberts & Co., supra, where it was noted that news given Dow Jones at 11:45 a.m. appeared on the tape at 11:48 a.m. (40 S.E.C. at 909).

have placed his order on the afternoon of April 15 when he saw the draft of press release, or on April 16, prior to the commencement of the press conference.

The Senate Report on the Securities Exchange Act of 1934 states in part:

> ". . . the bill provides that any person who unlawfully manipulates the price of a security, or who induces transactions in a security by means of false or misleading statements, or who makes a false or misleading statement in the report of a corporation, shall be liable in damages to those who have bought or sold the security at prices affected by such violation or statement. In such case the burden is on the plaintiff to show the violation or the fact that the statement was false or misleading, and that he relied thereon to his damage. The defendant may escape liability by showing that the statement was made in good faith." [S. Rep. No. 792, 73d Cong. 2d Sess. 12-13 (1934).]

In Thiele v. Shields, 131 F. Supp. 416 (S.D.N.Y. 1955), Judge Irving Kaufman compared § 12(2) of the Securities Act of 1933 with § 17 and Rule 10b-5 and stated:

> ". . . Sections 17(a) and 10(b) . . . do not, on their face, purport to apply to a negligent misrepresentation nor, without an express provision as under 12(2), should they be construed to shift the burden of proving intention, knowledge, or negligence (if applicable) to the defendant. Therefore . . . a claim under Sections 17(a) and 10(b) would still be sustainable [only] if knowing or intentional misrepresentation . . . were alleged (and proven) by the plaintiff." 131 F. Supp. at 419.

More recently, in Weber v. C.M.P. Corporation, 242 F. Supp. 321, 324-5 (S.D.N.Y. 1965), Judge Wyatt dismissed for insufficiency two counts of a complaint which

alleged violations of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the 1934 Act but which did not allege that the defendants had knowledge of the falsity of their statements. Judge Wyatt held that Section 10(b) and Rule 10b-5 were not violated by mere misstatements which might be innocent or negligent but would be violated only by "real fraud".

The SEC itself took a similar position in Matter of Cady, Roberts & Co., supra, a disciplinary proceeding against a broker to whom a director supplied dividend information before a public announcement had been made.* The SEC made no charge against the director, stating merely that he "probably assumed, without thinking about it, that the dividend action was already a matter of public information." (40 S.E.C. at 917.)

Although in its brief in the present case (Br. 26-28) plaintiff confuses the issues of scienter and intent, and argues erroneously that neither is an element of the offense, it apparently does accept at least the burden of proving "that the alleged violator should have known that his conduct was

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* Contrary to the statement contained in plaintiff's brief (p. 34), that case did not involve "news that had been released to the news media but had not yet been reported by the media to the public." The transactions there in question took place before the news was released to the Wall Street Journal; the announcement appeared on the Dow Jones ticker tape three minutes after it was received (40 S.E.C. at 909).

deceptive"--even that burden cannot be sustained as to defendant Coates.

(c) Intent to Defraud

A fortiorari, plaintiff cannot prove--and does not assert--that Coates acted with an intent to defraud. Plaintiff relies, instead, upon the contention that Rule 10b-5 does not require a specific intent to defraud (Br. 26-28). As plaintiff points out (Br. pp. 23-25) there are situations in which a regulatory statute may be violated even in the absence of specific intent to defraud or action in reliance. Thus in S.E.C. v. Capital Gains Bureau, 375 U.S. 180 (1963), the Court held that an investment advisor's practice of purchasing shares for his own account shortly before recommending such shares for long-term investment violated the Investment Adviser's Act of 1940, even in the absence of intent to defraud. The Court's opinion makes clear, however, that intent o defraud was not a necessary element of the violation because the Investment Adviser's Act reflects a Congressional intent to eliminate, or at least expose, not only fraudulent conduct but all conflicts of interest which might incline an investment advisor consciously or unconsciously to render advice which was not disinterested.

By contrast, the element of intent is essential to civil and criminal violations of Section 10(b) and Rule 10b-5.

see Frank v. United States, 220 F.2d 559 (6th Cir. 1955); S.E.C. v. Glass Marine Industries, Inc., 208 F. Supp. 727 (D. Del. 1962); III Loss, Securities Regulation, 1441 (2d ed. 1961). Fraud cannot exist if intent to deceive is absent. I Harper and James, Torts, § 7.3 (1956).

In Frank v. United States, supra, the Sixth Circuit reversed a conviction for selling securities in violation of Section 17(a) of the Securities Act of 1933 as a result of the trial judge's charge that a violation could be found even if the defendant acted in good faith. The Court held that Section 17(a) is violated only if defendant makes false statements, knowing them to be false with an intent to defraud.

In S.E.C. v. Glass Marine Industries, Inc., supra, the Court rejected the SEC's attempt to enjoin alleged violations of Section 17(a) of the 1933 Act, Section 10(b) of the 1934 Act and Rule 10b-5 on the ground that the SEC failed to prove fraudulent intent which the Court held to be "essential to a scheme to defraud".

(d) Action in Reliance

We have no information as yet as to the evidence that plaintiff will offer to sustain its burden of proof on the issue of the reliance of the sellers in the transactions for which Coates is charged with responsibility. Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701 (S.D.N.Y.), aff'd, 198 F.2d 883 (2d Cir. 1952). The

sellers of stock on the morning of April 16 knew that there was at least a strong likelihood that Texas Gulf had made a major ore discovery and that the company would shortly make an announcement as to the extent of the discovery. In electing to sell, they did so with full knowledge that the market might be significantly affected by the forthcoming announcement. As the court stated in Goodwin v. Agassiz, supra, 186 N.E. 659, 661-2 (Mass. 1933):

> ". . . He acted upon his own judgment in selling his stock. He made no inquiries of the defendants or of other officers of the company. The result is that the plaintiff cannot prevail."

In the present case, there will be proof that the purchases of stock for which Coates is sought to be held liable were made from sellers who similarly acted on their own judgment and not upon anything said or not said by Coates. For example, John Billings of Billings & Company, from whom a substantial part of such stock was purchased, has testified by deposition that he was the specialist in Texas Gulf stock on the Midwest Exchange; that on the morning of April 16, 1964, he wanted to accumulate Texas Gulf stock and sold only to discharge his obligation to maintain an orderly market; that in selling, he did not rely on anything said or omitted to be said by any defendant; that it would have made no difference to him whether such sales

were made before or after the announcement appeared on the Dow Jones broad tape; that he asserted no claim against defendant Coates; and that he had not authorized either the SEC or its counsel to assert any claim on his behalf.

The facts lend no support whatever to the charge that Coates engaged in any act which operated as a fraud or deceit upon any person and consequently there is no basis for the contention that he violated Section 10(b) or Rule 10b-5.

3. Rule 10b-5 May Not Constitutionally Be Applied as Plaintiff Here Seeks to Have it Applied.

The SEC in this case seeks to apply Rule 10b-5 to purchases of stock in transactions on a Stock Exchange merely on the basis of an alleged failure to disclose inside information. If so applied, Rule 10b-5 is unconstitutionally vague for failing to provide an ascertainable standard of conduct.

Although plaintiff's claims are predicated upon its assertion that Coates made improper use of "inside" information, neither the statute nor rule states or even suggests the point in time at which information ceases to be "inside" and is deemed to be in the public domain. The absence of an ascertainable standard is attested to by plaintiff which now states:

> "The Commission does not contend that the information concerning Texas Gulf Sulphur's drilling results in Kidd Township was reported to the public at any single precise moment. It contends that this information was reported to the public by means of a continuing process of reporting and dissemination of news, involving various news media, including wire services, newspapers of general circulation, financial newspapers, and other financial publications, which process commenced in the United States following the meeting with reporters described in paragraph 96 of the complaint and which process continued for several days thereafter." (Answer to Coates Interrogatory 9)

Defendants are entitled to know exactly what conduct is proscribed. United States v. National Dairy Products Corp., 372 U.S. 29 (1963).

A statute or rule imposing criminal liability must provide an ascertainable standard of conduct so that those subject to the law will know what it is they are prohibited from doing. A. B. Small Company v. American Sugar Refining Company, 267 U.S. 233 (1925); Champlin Refining Co. v. Corporation Commission, 286 U.S. 210, 242 (1932). Winters v. New York, 333 U.S. 507, 515 (1948).

In A. B. Small Company v. American Sugar Refining Company, supra, at 239, the Court said:

> ". . . It was not the criminal penalty that was held invalid, but the exaction of obedience to a rule or standard which was so vague and indefinite as really to be no rule or standard at all. . . ."

The doctrine is applicable not only to statutes but to administrative rules and regulations implementing them. Kraus & Bros. Inc. v. United States, 327 U.S. 614 (1946)

(price regulation under Emergency Price Control Act); Boyce Motor Lines, Inc. v. United States, 342 U.S. 337 (1952) (I.C.C. regulation affecting transportation of explosives).

In Kraus, the charge was made that the defendant had violated the price regulation by tie-in sales, thereby "evading" the provisions of the regulation. In reversing the conviction, the Court recognized the power of the administrator to prohibit a wide variety of evasive conduct but stated (at 621-622):

> ". . . The dividing line between unlawful evasion and lawful action cannot be left to conjecture. The elements of evasive conduct should be so clearly expressed by the Administrator that the ordinary person can know in advance how to avoid an unlawful course of action."

As more fully set forth above, the purchases here challenged were made after the so-called inside information had been publicly disclosed by numerous methods including a detailed article appearing in the Northern Miner, the delivery of a press release by the Ontario Minister of Mines to its press gallery in Toronto and a news conference in New York and at a time when Coates believed, and correctly so, that the information with respect to Timmins was no longer inside information.

Assuming, arguendo, that Section 10(b) of the Act is broad enough to permit the SEC to adopt a rule thereunder

dealing with the mere non-disclosure of inside information, the SEC has not promulgated such a rule. If Rule 10b-5 is now to be construed to make unlawful the conduct of Coates, the Rule as thus applied lacks the ascertainable standard of conduct required by the Fifth Amendment of the United States Constitution.

POINT II

IN ANY CASE, INJUNCTIVE RELIEF IS NOT APPROPRIATE AS TO DEFENDANT COATES.

The plaintiff brings this action under Section 21(e) of the 1934 Act, which provides that it may seek an injunction when it appears that "any person is engaged or about to engage in any acts or practices, which constitute or will constitute a violation of the provisions of this chapter, or of any rule or regulation thereunder . . . . and upon a proper showing a permanent or temporary injunction or restraining order shall be granted . . . ."

Past violations are not, in themselves, sufficient grounds for an injunction. S.E.C. v. Casper Rogers & Co., 194 F. Supp. 589 (S.D.N.Y. 1961). We recognize, of course, that the fact that illegal activities (assuming any are established in this case) have ceased does not preclude an injunction, SEC v. Culpepper, 270 F.2d 241 (2d Cir. 1959);

SEC v. Electronic Security Corp., 217 F. Supp. 831 (D. Minn. 1963).

But the Culpepper case lays down the parallel standard that before an injunction may issue after violations have ceased, the Commission must show a reasonable expectation that the defendant will thwart the policy of the Act by engaging in proscribed activities. This standard has been applied in numerous cases. SEC v. Broadwall Securities, Inc., 240 F. Supp. 962 (S.D.N.Y. 1965); SEC v. Kamen & Co., 241 F. Supp. 430 (S.D.N.Y. 1963); SEC v. Bond & Share Corp., 229 F. Supp. 88 (W.D. Okla. 1963); SEC v. Scott Taylor & Co., 183 F. Supp. 904 (S.D.N.Y. 1959). In Culpepper and in other SEC cases in which an injunction issued, it was because the Court found that there was a reasonable expectation of future violations.

The SEC cases are to be viewed against the broader background of the law in general relating to judicial injunctions sought by government agencies pursuant to specific statutory authority. The Supreme Court spoke on this subject in United States v. W. T. Grant, 345 U.S. 629 (1953). That case was the first occasion for the Supreme Court to consider § 8 of the Clayton Act's prohibition against interlocking directorates. The government had asked the District Court for injunctions against three corporations and one

individual, Hancock, a director common to all three. By affidavit it was disclosed that Hancock had resigned from the directorships after the complaint was filed. The District Court dismissed the action, concluding that there wasn't "the slightest threat that the defendants will attempt any future activity in violation of § 8 (if they had violated it already) . . . ." 112 F. Supp. 336, 338. The Government appealed directly to the Supreme Court.

On appeal, both sides conceded that voluntary cessation of an alleged illegal activity does not make the issue moot as to a determination of whether or not the activity is an illegal practice. "For to say that the case has become moot means that the defendant is entitled to a dismissal as a matter of right." (345 U.S. at 632).

The Supreme Court, in an opinion by Mr. Justice Clark, affirmed the dismissal below. It was stated that where an allegedly illegal activity has ceased the case may be moot if the defendant can demonstrate that there is no reasonable expectation that the wrong will be repeated. The Court observed that:

> ". . . . The purpose of an injunction is to prevent future violations, Swift & Co. v. United States, 276 US 311, 326 . . . (1928) and, of course, it can be utilized even without a showing of past wrongs. But the moving party must satisfy the court that relief is needed. The necessary determination is that there exists some cognizable danger of recurrent violation, something more than the mere possi-

> bility which serves to keep the case alive. The chancellor's decision is based on all the circumstances; his discretion is necessarily broad and a strong showing of abuse must be made to reverse it. To be considered are the bona fides of the expressed intent to comply, the effectiveness of the discontinuance and, in some cases, the character of the past violations." (345 U.S. at 633).

POINT III

IN NO EVENT IS THE PLAINTIFF ENTITLED TO AN ORDER DIRECTING RESCISSION OR "RESTITUTION" BY COATES.

1. There is No Statutory Authority for the Extraordinary Relief Sought by the Plaintiff.

Proceeding under Section 21(e) of the Securities Exchange Act of 1934, as amended (15 U.S.C. 78u(e)) plaintiff asks this Court to enter an order directing Coates to offer to rescind his purchases of stock and to make "restitution" to the sellers of stock purchased by Haemisegger and his customers. The Act does not authorize such orders and rescission and restitution would constitute a penalty which the Court does not have jurisdiction to impose.

This case is the first one in which the SEC has requested that affirmative relief be granted to individual traders. Kennedy & Wander, Texas Gulf Sulphur, A Most Unusual Case, 20 Bus. Law 1057, 1073 (1965). A similar request has recently been rejected by the Arizona District Court. SEC v. National Securities, Inc. (D. Arizona, Feb. 11,

1966), CCH Mar. 30, 1966, 95,406, 95,408, where the court said:

> "Finally, plaintiff's demand for relief allegedly 'necessary to rectify and correct the consequences of the wrongful and unlawful conduct of defendants', includes a prayer for an accounting for unjust enrichment and other relief, which would be inappropriate [cf. Note, 79 Harv. L. Rev. 656 (1966); but see: III Loss, Securities Regulation 1824-1829 (2nd Ed. 1961); Cary, Book Review, 75 Harv. L. Rev. 857, 861 (1962)], and would, in all events, fall outside the scope of available relief provided in § 21(e) of the 1934 Act [15 U.S.C. § 78u(e)]; . . ."

In SEC v. Wong, (SEC Br. 51 and Appendix), the District Court for the District of Puerto Rico denied a motion to dismiss a complaint under Section 10(b) and Rule 10b-5 that included a prayer for restitution. Significantly, that action was brought not only under the Securities Exchange Act of 1934 but also under the Investment Company Act of 1940 which vests in the SEC power to closely regulate investment companies and expressly grants it the power to seek removal of officers and directors for gross misconduct or abuse of trust. Even if a right to seek restitution could properly be implied under that statute in the case of registered investment companies, which are the wards of the SEC, no such right can be implied on behalf of the public at large from the Securities Exchange Act of 1934.

In United States v. Parkinson, 240 F.2d 918 (9th Cir. 1956), the Court distinguished the rent control cases on the ground that the language of the statute there involved [Section 205(a) of the Emergency Price Control Act of 1942, 50 U.S.C.

Appendix § 925(a)] gives the court jurisdiction to enter a "permanent or temporary injunction, restraining order or other order."

The Court distinguished the Fair Labor Standards Act cases on the ground that Congress had by a 1949 amendment withdrawn from the court the power to order the payment of wages los as a result of a discriminatory discharge. This interpretation was later proved to be erroneous [Mitchell v. Robert DeMario Jewelry, Inc., 361 U.S. 288, 80 Sup. Ct. 332 (1960) (amendment limits power to require the disbursement of underpayment but not the power to order reimbursement of lost wages instant to a wrongful discharge)] but the District Court opinion in Parkins approved by the Court of Appeals offers another and much broader ground for distinguishing the rent control and labor cases. It is that effectuation of the policies of those two Acts requires the payment of proper sums of money, but that prevention of violations of the Food, Drug & Cosmetic Act such as misbranding can be accomplished by an injunctive order. This rationale is clearly applicable in securities cases where no specific sum has been wrongfully withheld or charged. It is one thing to order payment of back wages or refund of excessive rents. It is quite another to undo a vast number of impersonal securities transactions on an exchange when the measure of liability and the identity of those entitled to relief are both undetermined.

2. Even If Rescission or Restitution Would be Appropriate in the Case of Some Security Transactions, Such Relief Would Be Wholly Inappropriate in the Case of Transactions on a Registered Stock Exchange.

Even if we were to assume, contrary to fact, that Coates acted improperly with respect to the transactions in question, rescission and restitution are wholly inappropriate remedies. The alleged sellers of Texas Gulf stock on whose behalf this relief is sought did not in fact sell to Coates or to Haemisegger or his customers. The alleged sellers identified by plaintiff are merely persons or institutions whose sell orders were, through a multiple of chance occurrences, matched with buy orders of the persons in question. To grant rescission or restitution to those sellers by reason of the accidental matching process would bestow on them a windfall unrelated to the alleged wrong.

The roulette-like process through which buy and sell orders are matched emerges clearly from a brief review of the mechanics of exchange trading. A broker, instructed to sell shares of Texas Gulf, has the choice of having that order executed on six national securities exchanges, i.e., New York, Midwest, Pacific Coast, Philadelphia-Baltimore-Washington, Boston and Detroit. If, for example, he decides to sell on the New York Stock Exchange, he wires the sell order to his floor representative. The floor representative then approaches the post at which Texas Gulf is traded. He

can effect his transaction through the specialist who will either match the sell order with one of the buy orders in his book or purchase the shares for his own account, or the floor representative can sell the shares to another broker on the floor of the exchange. If the seller's broker sells the shares of more than one seller at the same price and time, he must again arbitrarily match buyer with seller. The same options, of course, are available to the buyer's broker.

The chance aspect of exchange transactions is further demonstrated by the procedure followed when two sellers' brokers come to the trading post at the same time and offer the same number of shares at the same price. In those circumstances, determination of which broker has the right to buy the offered stock depends on the toss of a coin. The brokers either toss for the entire transaction or agree to divide the offered stock. For example, if 500 shares were offered and each broker wanted to buy 500, they could either toss for the 500 or agree to divide it 300 and 200 and toss for that division.

The grant of rescission or restitution to certain sellers solely because their trades were matched by the above-described process with those of Coates or of Haemisegger and his customers would result in a windfall to those

sellers justified neither by the Securities Act nor the equities of the transactions.

3. No Seller of the Stock Involved in the Transactions Attributed to Coates Sustained Any Loss as a Result of the Acts of Defendant Coates.

If it be the fact that any seller of Texas Gulf shares involved in the transactions attributed to Coates sold because he was uninformed as to the Timmins discovery--a fact which has yet to be proved by the plaintiff--his order to sell was placed without regard to and was unaffected by the acts of Coates.* At the time of the telephone calls made by Coates, the public announcement to representatives of the press and of the financial community had already been made and all steps taken by the Company that could reasonably be required or expected in order to make the information public. The fact that Dow Jones delayed from half to three-quarters of an hour before putting the announcement on its broad tape is manifestly not chargeable to defendant and there was nothing else that Coates could have done to

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* It should be noted that even if a causal connection could be established between the acts of Coates and the sellers' sales, the maximum extent of any loss or damage to the sellers would be the difference between the price at which he sold and the price at which the stock could be repurchased after the Dow Jones broad tape carried the announcement. Galigher v. Jones, 129 U.S. 193 (1889); see Hall v. Paine, 112 N.E. 153 (Mass. 1916); Gervis v. Ray, 144 A. 529 (Pa. 1928).

affect the decision of those sellers to sell Texas Gulf shares. Under those circumstances, it is an absurdity to contend that those sellers sustained any loss or damage as the result of the acts of Coates.

CONCLUSION

The complaint should be dismissed as to defendant Coates.

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Respectfully submitted,

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