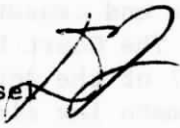


M E M O R A N D U M

August 30, 1966

TO: All Staff Attorneys

FROM: Office of the General Counsel 

RE: Securities and Exchange Commission v. Texas Gulf Sulphur Co., et al. (S.D. N.Y., No. 65 Civ. 1182, August 19, 1966)

In the attached opinion, following a four-week trial, Judge Bonsal dismissed the Commission's complaint against Texas Gulf Sulphur Co. and ten individual defendants but found that two other individual defendants committed violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 under that act by purchasing Texas Gulf stock on the basis of material inside information. In so doing the Court adopted certain of the legal positions urged by the Commission, and some of these legal rulings may be most useful to the Commission in its administration of the Federal Securities Laws.

Texas Gulf Sulphur Company began exploratory drilling of a segment of land near Timmins, Ontario, in Canada on November 8, 1963; and on April 16, 1964, it issued a press release announcing that the company had made a major discovery of copper, zinc and silver there. The Commission charged that officers, directors and employees of Texas Gulf violated Section 10(b) and Rule 10b-5 by purchasing Texas Gulf stock and calls during this period on the basis of undisclosed inside information about the drilling results and by divulging this information to their relatives and friends so that these outsiders could also purchase Texas Gulf securities on this basis. Some of the individual defendants were also charged with accepting stock options from the corporation during this period without disclosing the information within their possession about the drilling results to those making the decision to issue the options. Finally, the Commission charged that the corporation violated Section 10(b) and Rule 10b-5 by issuing a false and misleading press release four days before the press release announcing the discovery.

The defendants argued that the Commission must prove scienter, intent to deceive, reliance and causation in order to establish violations of Rule 10b-5. The Court held that "in a regulatory proceeding under Section 27 of the Act, the Commission is not required to prove these common law elements."

The Court also rejected arguments of the defendants that Section 16 of the 1934 Act is the only limitation on inside trading. The Court held that Section 10(b) and Rule 10b-5 also impose limitations on insider trading, and that under those provisions "an insider's liability for failure to disclose material information which he uses for his own advantage in the purchase of securities extends to purchases made on national securities exchanges as well as to purchases in 'face-to-face' transactions."

The Court ruled in addition that "insiders subject to the disclosure requirements of Section 10(b) and Rule 10b-5 may include employees as well as officers, directors, and controlling stockholders who are in possession of material undisclosed information obtained in the course of their employment."

On the basis of these legal rulings the Court found that two of the individual defendants who purchased Texas Gulf securities on April 15 and April 16, 1964, violated Section 10(b) and Rule 10b-5. In so doing the Court rejected their contentions that they were free to trade merely because rumors about the discovery were current in the press and financial circles, an article emanating from the corporation had appeared in a trade publication of limited circulation and an official of the Canadian government had issued a statement of undetermined circulation. It referred to the press release by the corporation as the "official announcement."

Contrary to the position urged by the Commission the Court held that two insiders who purchased stock and gave tips on April 16, 1964, did not commit violations, stating that insiders are free to trade on the basis of inside information once this information has been delivered to the news media, even though it has not appeared anywhere. The Court also decided that purchases of stock and calls and the giving of tips by insiders prior to April 9 did not violate

Rule 10b-5 because the results of the mineral exploration did not constitute material facts at that time. In this connection the Court held that the definition of materiality must be a "conservative one."

With respect to the stock options, the Court agreed with the Commission that corporate officials responsible for the issuance of stock options are entitled to rely on the information furnished to them by management. The Court concluded that a member of the higher echelon of management who accepts a stock option without disclosing to the responsible officers all material information violates Section 10(b) and Rule 10b-5. The Court held, however, that employees of the company who are not members of the higher echelon of management are entitled to assume that information already known to their superiors will be reported by them to the appropriate corporate officials. It held that, in any case, the results of exploration in this case were not material at the time the options were accepted.

In clearing the corporation of charges of violation the Court ruled that a press release issued by a corporation is issued "in connection with the purchase or sale of any security" and, therefore, comes within Section 10(b) and Rule 10b-5 only "if its purpose is to affect the market price of a company's stock to the advantage of the company or its insiders;" but it found no such purpose in this case. Alternatively, the Court held that the accuracy of the corporate press release must be judged only on the basis of information actually known to the drafters of the press release at the time of its issuance, and that on the basis of such information the press release in this case was not false or misleading.

Attachment

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