MEMORANDUM

October 9, 1968

TO: All Staff Attorneys

FROM: Office of the General Counsel

RE: Securities and Exchange Commission v. Texas Gulf Sulphur Co., ___ F.2d ___ (C.A. 2, 1968), CCH Fed. Sec. L. Rep. ¶ 92,251

In this en banc decision that has previously been distributed to you, 1/ the Commission's position, both with regard to trading on inside information and with regard to corporate publicity, has been upheld in virtually every major respect.

There are six separate opinions. Judge Waterman wrote the majority opinion, joined in by Judges Smith and Feinberg and in which Judges Kaufman and Anderson concurred. Judge Hays wrote a separate opinion, concurring in part and dissenting in part (to take a stronger position in support of the Commission). 1a/ Judge Friendly wrote a concurring opinion, which agreed "with the result reached by the majority and with most of Judge Waterman's searching opinion" but expressed "a rather different approach with respect to stock options and the Texas Gulf April 12 press release." 1b/ Judges Kaufman and Anderson each concurred also in portions of Judge Friendly's concurring opinion. Judge Moore wrote the dissenting opinion in which Chief Judge Lumbard concurred. That opinion agreed with the majority, however, in upholding the determination of the district court that Crawford and Clayton had violated Rule 10b-5 and also agreed with the majority as to Coates in reversing the district court's determination that Coates had not violated the rule (p. 3691).

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1/ Page references are to the slip sheet copy previously distributed.

1a/ On the question of stock options to Stephens and Fogarty, he would have directed that an injunction be issued instead of remanding the issue. Similarly, he would have directed that an injunction issue against Texas Gulf with respect to the April 12 press release because, in his view, it was misleading and, assuming arguendo that the corporation could be enjoined only on a showing of lack of due diligence, this had been met. Accordingly, he disagreed with the majority that these issues should be determined on remand.

1b/ As to stock options, he suggested that the top officials might well have postponed the option plan or communicated the inside information to the directors. As to the April 12 press release, he apparently agreed with Judge Hays that it was misleading but expressed doubt whether an injunction would be appropriate. He also stated that in a damage action a corporation should not be liable ". . . for merely negligent misstatement, as distinguished from the kind of recklessness that is equivalent to wilful fraud . . ." (p. 3647).

Judges Kaufman and Anderson appear to agree with this last point. Judge Anderson also appears to question whether an injunction against the corporation would be appropriate.

The court's rulings on the major legal issues follow:

1. Duty to Disclose:

All nine judges agree that a corporate insider in possession of material inside information about his corporation "may not take 'advantage of such information knowing it is unavailable to those with whom he is dealing,' i.e., the investing public" (p. 3606). This duty is equally applicable to stock exchange transactions as it is to face-to-face transactions and transactions in the organized over-the-counter market. If the insider "is disabled from disclosing . . .[the information] in order to protect a corporate confidence, or he chooses not to do so, [he] must abstain from trading . . ." (p. 3607). The quoted language from Judge Waterman's opinion was apparently concurred in by the "dissenting" judges, since they joined with the majority in holding Crawford, Clayton and Coates in violation of Section 10(b) and Rule 10b-5. 2/

2. Tipping:

All nine judges also appear to agree that the practice of tipping is unlawful, although they have some differences as to the scope of the prohibition. A majority of the court, consisting of Judges Smith, Feinberg, Friendly, Kaufman and Hays, are of the opinion that one who may not himself purchase securities without disclosing inside information known to him may not pass that information on to others for their use in securities transactions. These judges include "recommending the securities concerned" within the prohibition of Section 10(b) and Rule 10b-5 (p. 3607) This latter point could be considered a dictum, since they upheld the district court's finding as to Darke, which they interpreted to mean that he had actually told his tippees about the first drill hole. Judges Waterman (who dissented from his own opinion in a footnote) and Anderson, who voted to remand for further findings with respect to the tips made by Darke, would apparently invoke the prohibition only when there is "any indication" given to the outsiders "expressly or by implication" of the actual information possessed by the insiders (pp. 3615-3616 n.16). Although it is not entirely clear, Chief Judge Lumbard and Judge Moore appear to go at least as far as Judges Waterman and Anderson, since they "agree with the majority as to Coates . . ." (p. 3691). The majority reversed the district court

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2/ There is some language in the Waterman opinion that indicates that the majority might be willing to place the duty to disclose on a broader basis than concepts of fiduciary duty. For example, it is stated that the Exchange Act was designed "to insure fairness in securities transactions generally . . ." (p. 3606), and that "[t]he core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions . . . [and] should be subject to identical market risks . . ." (p. 3616). Generalizations such as these could support the imposition of a duty of disclosure even upon persons who neither are insiders themselves nor have obtained information from insiders but nevertheless have material nonpublic information about corporate affairs. This issue was not involved in the case, however, since all of the individual defendants were officials or employees of Texas Gulf.

holding that Coates had not violated Section 10(b) and Rule 10b-5 when he "purchased stock and gave information on which his son-in-law broker and the broker's customers purchased shares" (p. 3595); it also specifically stated that Coates' violations encompassed the purchases of his son-in-law and the latter's customers.

3. Insider Status:

All nine judges agreed that the concept of "insider" under Section 10(b) and Rule 10b-5 is not limited by Section 16(b) of the Exchange Act. This is necessarily the holding of the entire court, since they all affirmed the district court's holding as to Clayton, who was only an employee of the company.

The majority went even further than required by the facts of the case and stated that "anyone in possession of material inside information" (p. 3607) (emphasis added) has a duty of disclosure under Section 10(b) and Rule 10b-5. But, since the "tippees" were not defendants in this case, the court did not actually decide whether their purchases also violated Section 10(b) and Rule 10b-5. The Waterman opinion said by way of dictum, however, that, if the "tippees" acted with actual or constructive knowledge that the material information was undisclosed, their conduct "certainly could be equally reprehensible" (pp. 3615-3616). These dicta appear to be the view of all seven majority judges. The dissenters expressed no opinion on them. 3/

4. Materiality:

In reversing the district court on this key issue, Judges Waterman, Smith, Feinberg, Friendly, Kaufman, Anderson and Hays, citing List v. Fashion Park Inc., 340 F. 2d 457 (C.A. 2, 1965), were of the opinion that the basic test of materiality is "whether a reasonable man would attach importance . . . in determining his choice of action in the transaction in question" (p. 3608) (emphasis in original). The court stated that this standard encompasses any fact that "in reasonably and objective contemplation might affect the value of the corporation's stock or securities" (p. 3608) (emphasis in original). Under the former standard "[t]he speculators and chartists of Wall and Bay Streets are also 'reasonable' investors entitled to the same legal protection afforded conservative traders" (pp. 3606-3609). Moreover, whether any particular fact is material "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity" (p. 3609). Finally, the majority held that in determining whether facts are material a major factor is the "importance attached" by those who know them (Op. 3613). Thus, evidence of trading by those persons, particularly in short-term calls is "highly pertinent . . . and the only truly objective

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3/ Some of the purchases were made by the wives of insiders, and the court stated that it would be "unrealistic to include any of these purchases as having been made by other than the defendants, and unrealistic to include them as having been made by members of the general public receiving 'tips' from insiders" (Op. 3592 n.4). This analysis offers substantial support for the Commission's position on beneficial ownership in the family context. See Securities Exchange Act Release No. 7824 (February 14, 1966).

evidence of materiality . . ." (Op. 3613). Recognizing the breadth of these standards, the majority suggested stock-options and employee purchase plans as better ways of compensating management. Judge Moore and Chief Judge Lumbard were of the opinion that the district court's determination that the information about the drilling was not "material" until a much later point in time was supported by the evidence and therefore should not be disturbed on appeal. Furthermore, they thought that disclosure could not have been made without a serious risk of violating Section 10(b) and Rule 10b-5, and that further rule-making or legislation is necessary.

5. Timing of Insider Transactions:

All nine judges agreed that "[b]efore insiders may act upon material information, such information must have been effectively disclosed in a manner sufficient to insure its availability to the investing public" (Op. 3617-3618). Fragmentary reports not confirmed by the corporation are insufficient, particularly when it has promised an official statement to the public. Moreover, the fact that the information has been released to the press by the corporation itself is not sufficient, the court stating that " . . at the minimum . . . [the insider] should have waited until the news could reasonably have been expected to appear over the media of widest circulation, the Dow Jones broad tape . . ." (Op. 3618-3619). This language, which is found in the Waterman opinion, must necessarily also be the view of the two dissenting judges, since they agreed with the majority as to Crawford, Clayton and Coates, stating with regard to Coates that "for all practical purposes the information had not become public at the time of his purchase order" (Op. 3671). 4/

The necessity of a "reasonable waiting period" after the news has appeared on the broad tape was not decided, since the appeal was discontinued because of death as to the only insider who acted after the news appeared on the broad tape (Lamont). The Waterman opinion did note, however, that "where the news is of a sort which is not readily translatable into investment action, insiders may not take advantage of their advance opportunity to evaluate the information by acting immediately upon dissemination" (Op. 3618 n.18). And all nine judges were of the view that "the permissible timing of insider transactions after disclosures of various sorts is one of the many areas of expertise for appropriate exercise of the Securities and Exchange Commission's rule-making power, and which we [the judges] hope will be utilized in the future to provide some predictability of certainty for the business community" (Op. 3618 n.18).

6. Good Faith:

Coates, Crawford, and Clayton have raised the defense that they honestly believed that the news of the ore strike had become public at the time that they placed their orders. Judge Waterman's opinion stated that proof of specific intent to defraud was unnecessary in this action, since Rule 10b-5

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4/ The majority stated, and the dissenters apparently agreed that "[t]he effective protection of the public from insider exploitation of advance notice of material information requires that the time that an insider places an order, rather than the time of its ultimate execution, be determinative for Rule 10b-5 purposes" (Op. 3616 n.17).

encompasses negligence, which was viewed as a form of scienter, as well as actual fraud. In any event, although a mistake of fact not amounting to negligence may be a defense, "a mistaken belief as to the applicable law . . . does not insulate . . . [insiders] from the consequences of their acts" (Op. 3614 n.15). The four separately concurring judges apparently agreed with this holding, and Judge Friendly specifically stated that "[w]hile . . . an erroneous view of the law is pardonable, it is not 'good faith' in the legal sense" (Op. 3646 n.4). Since the dissenters concurred as to these three defendants, they apparently also agreed with these statements of law.

7. Acceptance of Stock Options:

All seven majority judges held that members of top management have a duty to disclose to their corporation (presumably through those who act on its behalf: the board of directors or its stock option committee) any undisclosed material information about its affairs before they accept stock options. The district court had limited the duty to disclose in this context to members of top management, and the Commission did not appeal this holding. 5/ The Waterman opinion therefore does not deal with the top management issue, but Chief Judge Lumbard and Judges Friendly and Moore expressed their agreement with the district judge. Finally, the majority held, without comment by the dissenters, that neither surrender of the options subsequent to the time that disclosure is required nor ratification by the directors after full disclosure is a defense. 6/

8. Applicability of Section 10(b) and Rule 10b-5 to Corporate Publicity:

In sweeping language Judges Waterman, Smith, Feinberg, Friendly, Kaufman, Anderson and Hays concluded that " . . . 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

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5/ We did, however, appeal the holding that Kline, the vice president and general counsel, was not a member of top management for this purpose; and the majority reversed as to his status. The two dissenters found it unnecessary to reach this question.

6/ It is suggested in a footnote to the Waterman opinion that, when disclosure to those granting the options could seriously endanger corporate security, it might be better for disclosure (followed by ratification) to be made before exercise rather than before acceptance. The two dissenters expressly adopted this suggestion. Judge Friendly was "unimpressed" (Op. 3641) by it; he thought that corporate officers should be able to communicate confidentially with their own directors, and, in any event, that directors would not normally challenge a recommendation from the highest officers of the corporation to postpone the granting of options.

the existence of a corporation or of merging it with another" (Op. 3632). Thus they held that the "in connection with" requirement is satisfied when " . . the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities" (Op. 3630) or " . . . whenever assertions are made . . . in a manner reasonably calculated to influence the investing public, e.g., by means of the financial media . " (Op. 3634). This is true " . . . irrespective of whether the insiders contemporaneously trade in the securities of . . . [the corporation issuing a press release] and irrespective of whether the corporation or its management have an ulterior purpose or purposes in making an official public release" (Op. 3632). Judge Moore and Chief Judge Lumbard read the majority opinion as holding that "Section 10(b) was . . intended to be a mandate to the Commission to erect a comprehensive regulatory system policing all corporate publicity . . ." (Op. 3679), and they strongly dissented. As did the district court, they would have required proof of intent to affect the market for the advantage of the company or its insiders.

9. Deceptive Character of the Press Release:

In determining whether or not the April 12 press release was deceptive within the meaning of Rule 10b-5(2), all seven majority judges were of the opinion that the character of the release must be determined " . . . in the light of the facts existing at the time of the release, by applying the standard of whether the reasonable investor, in the exercise of due care, would have been misled by it" (Op. 3636). They went on to state that, in the event the press release was found to be misleading under this standard, it would then be necessary to determine whether the issuance of the release resulted from a lack of due diligence. Although Judges Waterman, Smith, Feinberg and Kaufman expressed fairly clear sentiments in the Commission's favor on both these issues, including an explicit preference for a summary of specific facts rather than ambiguous generalities, they determined to remand to the district court "to decide whether the release was misleading to the reasonable investor and if found to be misleading, whether the court in its discretion should issue the injunction the SEC seeks" (Op. 3638). 7/ Both Judges Friendly and Hays were of the opinion that the evidence established as a matter of law that the press release was misleading under the legal standard described above. Judge Hays expressly reached the same conclusion with respect to due diligence; but Judge Friendly's opinion is somewhat ambiguous on this point, although he seems to agree. It is not clear from Judge Anderson's separate opinion

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7/ There is some confusion whether the due diligence issue is still open on remand or has already been decided in our favor. There is language in the Waterman opinion supporting both possibilities. Judges Hays and Friendly clearly read that opinion as remanding the issue to the trial court. At a conference of counsel on September 20, 1968, however, the trial judge indicated a tentative view that it had been decided in our favor.

whether he agreed with the Waterman opinion or with the other two concurring judges on the need for a remand. Judge Moore and Chief Judge Lumbard were of the opinion that the district court judge had used the proper standards in concluding that the press release did not violate Section 10(b) and Rule 10b-5. They specifically disagreed that more details should have been given in the release.

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## REMEDIES

The parties had agreed to bifurcate this case into (1) violation and (2) remedy. Only the violation aspect of the case was tried to Judge Bonsal and was actually before the Court of Appeals. Nevertheless, at various points in their opinions several of the judges did discuss remedies, in some respects even beyond the four corners of our lawsuit.

1. Commission Remedies:

(a) Acceptance of Stock Options:

The seven majority judges, without comment by the two dissenters, held that surrender of the stock options by some defendants after the commencement of our suit did not preclude the granting of injunctions as to the future and thus remanded the issue to the trial court. Judge Hays would have ordered that the injunctions be granted. In addition, the seven majority judges--again without comment by the two dissenters and, indeed, without any specific discussion of their own--implicitly recognized the general right of the Commission to seek ancillary relief by ordering the rescission of the stock option granted to Kline and " . . . such further remedy . . . as may be proper by way of an order of restitution . . ." (Op. 3639).

(b) Press Release:

Judges Waterman, Smith, Feinberg and Kaufman voted to let the district court consider in its discretion whether to issue an injunction against Texas Gulf if it found the issuance of the press release to constitute a violation. Judge Hays, of the opinion that the evidence established as a matter of law that the press release was misleading and resulted from a lack of due diligence, would have granted the injunction sought by the Commission. Judge Friendly, who was also of the opinion that the evidence established as a matter of law that the press release was misleading, and Judge Anderson believed that, although the district court had the power to issue an injunction under the facts and circumstances of this case, an injunction might not be appropriate. They suggested that on the remand the district court judge determine whether "there is equity in this portion of the bill" (Op. 3648). The two dissenters would apparently deny an injunction even if a violation is found on remand.

2. Other Remedies:

(a) Acceptance of Stock Options:

Judge Friendly went further than the majority and took the position that the top management optionees had an obligation to inform the stock option committee that it was an inadvisable time for the granting of options. "Silence, when there is a duty to speak, can itself be a fraud" (Op. 3641). He therefore suggested that Texas Gulf might have a claim against the top management optionees "for the entire damage suffered as a result of the untimely issuance of options, rather than merely one for rescission of the options issued to them" (Op. 3642) None of the other judges commented on this suggestion.

(b) Corporate Publicity:

Judges Waterman, Smith, Feinberg and Hays declined to reach the possible liability of Texas Gulf for damages in the private actions if the issuance of the press release is found to constitute a violation. Judge Friendly found "frightening" (Op. 3644) the possibility that Texas Gulf might be subject to huge damage claims as the result of a press release resulting from " . . . merely negligent misstatement, as distinguished from the kind of recklessness that is equivalent to wilful fraud . . ." (Op. 3647). He stated that this question was one "transcending in public importance all others in this important case" (Op. 3642) and wanted any such possibility rejected then and there, despite the fact that neither the issue itself nor the interested parties were before him. In reaching his conclusion he particularly pointed out that such liability would fall upon the innocent shareholders of the corporation, might discourage the prompt disclosure of corporate developments through press releases and might be beyond the statutory authorization for Rule 10b-5. 8/ Since Judges Anderson and Kaufman joined in these dicta, and the two dissenters would surely agree, at least five of the nine active judges on the court are apparently opposed to liability for a merely negligent press release. 9/

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On September 20, 1968, all of the defendants involved in the appeals petitioned the court for a rehearing. On October 7, 1968, the petition of defendant Coates was denied. As of this date the petition of the other defendants is still pending.

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8/ Judge Friendly would not, however, deny enforcement power to the Commission in this situation, since he was "not disposed to hold that Congress meant to deny a power whose use in appropriate cases can be of such great public benefit and do so little harm to legitimate activity" (Op. 3647).

9/ The district court had held that under Section 27 of the Act service of process may be made anywhere in the world. Although Clayton had contested this holding on appeal, the court of appeals affirmed as to him without discussing it.

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