The Second International Securities Law Conference

Spring 1975

London, England, April 3-4, 1975

WHERE ARE WE NOW -- U.S. LAW

Outline of talk by Ray Garrett, Jr.
Chairman, U.S. Securities and
Exchange Commission

I. THE COMMON LAW

The problem centers on the duty to disclose material information or the duty not to trade unless disclosure has been made, as distinguished from the duty not to make misleading statements.

Judicial decisions under the common law of our states had gone so far as to impose an affirmative duty upon company officers and directors when dealing face-to-face with their own stockholders. It was at best unclear whether there was any such duty with regard to transactions on stock exchanges.

II. RULE 10b-5

The intrusion of Federal law into the problem came with the SEC's adoption of Rule 10b-5 under Section 10(b) of the Securities Exchange Act of 1934.

The rule was adopted in 1942 to solve a specific problem. The president of a company in Boston, Massachusetts, learned that the company's earnings were going to be quadrupled for the coming year. And he was visiting the company's stockholders telling them that the company was doing very badly and buying their shares at prices that he knew were far below their value. Nothing in the Federal securities laws explicitly governed such behavior in the purchase, as distinct from the sale, of securities, so the SEC had no authority to challenge this activity. It created the law and the authority by the adoption of Rule 10b-5.

The rule makes no reference to whether the person making false statements or failing to make necessary statements is an officer or director or otherwise related to the company or whether the transaction is face-to-face or on an exchange, nor does it explicitly purport to create a private right of action in the injured party.

Our courts began to hold that the rule does create a private right of action, but for many years it was applied only to cases where some representations were made and they were misleading either because they were incorrect or because they were incomplete. The earlier cases did not reach the ordinary stock exchange transaction where no representations at all are made and the identities of the principals are concealed.

III. CADY, ROBERTS

In 1959, the brokerage firm of Cady, Roberts & Co., had an employee who was also a member of the board of directors of Curtiss-Wright Corporation, whose stock was traded on the New Stock Exchange. The company had paid a dividend, although not earned, of 62.5 cents per share, for each of the first three quarters of 1959, but it was having a bad year, and at a meeting held on November 25, 1959, the board approved a dividend for the fourth quarter at the reduced rate of 37.5 cents per share. During a recess in the meeting, and prior to effective public announcement of the dividend news, the Cady, Roberts employee telephoned the news to one of the partners of his firm, who proceeded to sell out the Curtiss-Wright shares held by accounts subject to his management. The sales were made on the exchange at prices which did not reflect the dividend announcement. In an administrative proceeding brought to discipline the firm, the SEC held that the sales were made in violation of Rule 10b-5.

IV. TEXAS GULF SULPHUR CO.

In this famous case, the undisclosed information was the results of test drilling for minerals on company land in Canada. The tests indicated the possible discovery of extremely valuable ore deposits. Several company employees, knowing the results of the tests, which were unknown to the public, purchased Texas Gulf shares on the New York Stock Exchange. These persons included some company officers but also some non-officer employees, such as a staff mining engineer. In a suit brought by the SEC they were all held to have violated Rule 10b-5.

At one point, when rumors of the positive test results became widespread, the company issued a press release expressing doubt as to the value of the deposits (which, in fact, turned out to be enormous). The SEC claimed, among other things, that the press release was misleading and a violation of Rule 10b-5. A majority of the Court of Appeals for the Second Circuit (which sits in New York) finally agreed with the SEC.

A week after the issuance of the first press release, the company's board of directors decided to issue a new press release, which correctly described the new ore deposits. Immediately after this release was given to reporters for the news services, one Texas Gulf director, who was also a director of a major bank, telephoned the executive vice-president of the bank and informed him that good news about Texas Gulf had come out or would be coming out on "the tape". The bank officer got the "message" and placed orders to purchase shares of Texas Gulf before the information contained in the press release appeared on the Dow-Jones and Reuters tapes. The SEC claimed that these purchases occurred too soon, before the marketplace had received or digested the information and had had an opportunity to evaluate it.

Several employees of the company who knew of the test results while they were still secret, told friends who bought shares. In some cases they told the actual facts. In other cases they simply advised friends to buy. The SEC sued these employees for violations of Rule 10b-5, and the court agreed. The Commission did not sue the "tippees" in this case. But see INVESTORS MANAGEMENT CO., below.

V. BANKERS AND THE "CHINESE WALL".

Many of our brokerage firms also act as financial advisers and underwriters to companies. In 1966, one of our major firms was preparing to manage an underwriting of a public offering of securities for a company engaged in aircraft manufacture. In the course of its inquiries for the purpose of preparing the prospectus, it was informed by the company of substantially reduced earnings and earnings estimates than had been estimated previously by the company or generally expected by the investment community. This information was relayed to the firm's institutional brokerage department, which in turn advised some large accounts to sell, which they did, before the company publicly announced the disappointing earnings figures. The SEC held this to be a violation of Rule 10b-5, and, in the administrative proceeding instituted to discipline the firm, named as respondents the firm's "tippees" who sold securities on the basis of their inside information.

Similar problems have arisen where the commercial lending officers of a bank get inside information which is relayed to the managers of investment funds in the trust department.

It is the Commission's view that non-public information received on a confidential basis, through a lending or underwriting relationship, ought not to be used for trading purposes. And, to avoid misuse of such information, many brokerage firms and banks have adopted a policy of non-communication, a "Chinese Wall", between the separate departments of the firm or bank. Such "Chinese Walls" appear to have served well to prevent firms from taking advantage in the marketplace, of material non-public information received, on a confidential basis, by their underwriting departments (or, in the case of the bank, their commercial loan departments) and thus incurring liability under Rule 10b-5. But, a recent case raised the question whether the so-called "Chinese Wall" will suffice to insulate a broker-dealer or bank from Rule 10b-5 liability to a customer who purchases or sells a security on the recommendation of the firm's retail sales department, <u>when</u> the recommendation is contrary to material non-public information about the security which is known, not to the firm's retail sales department, but to the investment banking department -- on the other side of the "Chinese Wall".

The Commission has expressed the view that a broker-dealer may not make a recommendation to its customers on the basis of information which it knows to be substantially inaccurate, even though its knowledge results from material inside information which it cannot use in effecting securities transactions. And we suggested that firms should seek to avoid this dilemma by establishing a "restricted list" of securities with respect to which it has, or is likely to receive, inside information, through an investment banking relationship or otherwise. The firm then, we opined, should withdraw any outstanding recommendation with respect to a security at the time it goes on the list, and decline to issue further recommendations. Finally, without specifying exactly how we expected such a feat to be accomplished, we concluded that "it should then be possible for the firm to withdraw a recommendation without creating an inference that inside information has been received or as to the nature of that information".

Unfortunately -- as is often the case with respect to our attempts to provide some sort of guidance or certainty with respect to the law applicable to the use of inside information -- the views we expressed in our brief inspired lawyers and members of the securities industry to raise at least ten new questions for each one we had attempted to answer.

VI. SECURITY ANALYSTS AND SELECTIVE LEAKS

When a company officer gives one security analyst material information not generally available to the public, and the analyst then uses it for trading purposes, we have sued the company, as well as the analyst, for violations of Rule 10b-5.

VII. SUMMARY AND QUANDRIES

It seems well settled that persons having a special relationship with a company -- directors, officers, employees, auditors, lawyers, bankers -- who acquire information of market significance not generally available to investors, may not trade on that information.

Some unresolved questions

> Is anyone who acquires material, non-public information with respect to a company thereby precluded from using that information in connection with the purchase or sale of the company's securities?

Is material, non-public information learned by customers, suppliers or competitors of a company "inside" information? Does it matter how the information was obtained?

Is so-called "market information" material, non-public information about a company or its securities? Suppose one learns in advance that some market commentator shortly will publish a recommendation about the company?

When do the inquiries and research of analysts result in material, non-public information about a company which the analyst is precluded from using by virtue of Rule 10b-5? Must the analyst obtain one piece of specific material non-public information in order for the prohibitions of Rule 10b-5 to apply? Is an analyst permitted to use material, non-public information he has obtained by piecing together bits of non-material, public and non-public information about the company? Do the sources of the information pieced together by the analyst matter? ("Mosiac theory")

What constitutes effective dissemination of material information to the public? Filings with the SEC or other governmental agencies; releases to all major financial publications and wire services; telephone calls to exchanges, NASDAQ, or principal market makers; letters to all existing shareholders? What if the news media doesn't publicize the information -- perhaps because the issuer is a small or medium-sized company?

When do a company or its insiders have an affirmative duty or disclosure rather than merely a duty not to trade on the basis of material, non-public information about the company?

Does a company have an affirmative obligation to disclose material, non-public information in order to correct, affirm or deny rumors or written statements about the company circulating in the marketplace, even where the rumors or information originated from a source outside the company?

When is information about a company deemed to be generally available to the public? Do corporate insiders of other persons who receive non-public, material information about a company have an obligation to wait until the public has time to "digest" the news before they trade on the basis of that information? If so, how long?