TEXAS GULF SULPHUR: A VIGOROUS ASSAULT ON INSIDER TRADING AND MISLEADING PRESS RELEASES

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Directors, officers, and major shareholders of corporations may at times find themselves in possession of confidential corporate information. Such information may be valuable if important enough to influence the price of the corporation's stock. The temptation if obvious — if the confidential information, when finally disclosed to the public, will cause the stock to rise, the insider will want to purchase the stock before disclosure and ride it up. On the other hand, if the information is unfavorable, he will want to sell short[1] and make his profit as the stock declines. As might be expected, the law has placed restrictions on this type of activity.

The traditional common law view, however, was that such trading by insiders was permissible.[2] The obvious unfairness of this position gave rise to a minority rule under which an insider had a duty to disclose material facts which he obtained by virtue of his position before he could purchase the stock of any shareholder.[3] The federal courts adopted a third view, imposing the duty of disclosure only if the insider was aware of "special facts," or if there were "special circumstances" warranting the imposition of the duty.[4]

These common law attempts at regulation of insider trading were for the most part inadequate. The Great Depression, with its disastrous effects on the stock market, brought the whole problem of fraudulent stock transactions to a head.[5] As a result, Congress passed two major acts[6] which have formed the basis of federal securities regulations. These statutory provisions were followed and amplified by rules laid down by the Securities and Exchange Commission. Presently, there are five general anti-fraud provisions in federal securities law.[7] Of these, Securities and

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1 Short selling in anticipation of a declining market is the practice of borrowing stock, selling it, and then repurchasing at a later date so that the borrowed stock may be returned. The profit, if any, is the amount by which the sale price exceeds the repurchase price.

2 Board of Comm'rs v. Reynolds, 44 Ind. 509, 15 Am. Rep. 245 (1873); Gladstone v. Murray Co., 314 Mass. 584, 50 N.E.2d 958 (1943); Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659 (1933).

3 Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903); Stewart v. Harris, 69 Kan. 498, 77 P. 277 (1904).

4 Strong v. Repide, 213 U.S. 419 (1909).

5 *See* 1 L. LOSS, SECURITIES REGULATION 119-21 (2d ed. 1961).

6 Securities Act of 1933, 15 U.S.C. § 77a (1964); Securities Exchange Act of 1934, 15 U.S.C. § 78a (1964).

7 Securities Act of 1933 § 11(a), 15 U.S.C. § 77k (1964) (civil liabilities on account of false registration statement); Securities Act of 1933 § 12(a), 15 U.S.C. § 77*l* (1964) (civil liabilities arising in connection with prospectuses and communications); Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (1964) (fraudu-

Exchange Commission rule 10b-5 is the most comprehensive and therefore the most frequently used.[8] Rule 10b-5 prohibits "*any person*" from using fraudulent or deceptive devices "in connection with *the purchase or sale* of any security."[9] Because of its broad phraseology, the rule applies to both buyers and sellers, and is flexible enough to cover a wide range of fraudulent or deceptive practices. On its face, 10b-5 appears to be a relatively simple criminal provision; it has been interpreted, however, as creating both criminal and civil liability.[10] As a result of continued judicial expansion, the rule now affects areas that were formerly unregulated,[11] and overlaps into areas covered by other provisions.[12] The rule is based on the justifiable expectation that in the securities marketplace all investors have relatively equal access to material information

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lent interstate sales); Securities and Exchange Commission rule 10b-5, 17 C.F.R. § 240.10b-5 (1968) (fraud by any person in connection with purchase or sale of security); Securities and Exchange Commission rule 15c1-2, 17 C.F.R. § 240.15c1-2 (1968) (fraud in over-the-counter transactions by broker-dealers).

[8] *See* A. BROMBERG, SECURITIES LAW: FRAUD, SEC RULE 10B-5 § 1.1.

[9] 17 C.F.R. § 240.10b-5 (1968) (emphasis added). The text of the rule follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
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> (a) to employ any device, scheme, or artifice to defraud,
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> (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
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> (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. The rule was promulgated by the Securities and Exchange Commission under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (1964). The text of § 10(b) follows:

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

[10] Criminal penalties include a fine of up to $10,000, or up to two years imprisonment, or both. Securities Exchange Act of 1934 § 32(a), 15 U.S.C. § 78ff (1964). Cases allowing civil recovery include Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir. 1967); Janigan v. Taylor, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960); Fratt v. Robinson, 203 F.2d 627 (9th Cir. 1953); Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Ross v. Licht, 263 F. Supp. 395 (S.D.N.Y. 1967); Dack v. Shanman, 227 F. Supp. 26 (S.D.N.Y. 1964); Speed v. Transamerica Corp., 135 F. Supp. 176 (D. Del. 1955), *aff'd*, 235 F.2d 369 (3d Cir. 1956); Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947).

[11] *See* BROMBERG, *supra* note 8, at § 1.1. Bromberg states that the rule is now applied so as to prevent unfairness, rather than what either lawyers or laymen think of as fraud.

[12] *See* BROMBERG, *supra* note 8, at § 2.5.

concerning the securities,[13] and is intended to prevent inequitable and unfair practices in securities transactions, whether conducted face-to-face, over-the-counter, or on the exchanges.[14]

In August, 1968, the Court of Appeals for the Second Circuit in *SEC v. Texas Gulf Sulphur Co.*[15] further expanded the interpretation of rule 10b-5 in a decision significant both for its far-reaching impact on the state of the law as it then existed and for the serious questions which it raises. Because of the importance of the issues which were presented to the court, an examination of the factual setting in which the decision was rendered is appropriate.

In November of 1963 a Texas Gulf Sulphur Company (hereinafter referred to as TGS) prospecting team, as part of its exploratory program to develop new mineral deposits in eastern Canada, drilled a test hole which disclosed an unusually high content of copper and other minerals. The team immediately ceased drilling in the area and camouflaged the drill site in order to facilitate the acquisition of neighboring land. Drilling was resumed late in March of 1964. By April 9 two, and by April 16, six additional drillings were completed. Each drilling showed a high ore content, and made it increasingly probable that there was a substantial body of commercially mineable ore. Rumors that TGS had made a large copper strike began circulating in Canada, and on April 11 were reported in the New York papers. On April 12 the company issued a press release that appeared in papers of general circulation the following day. The release, based on drilling results as of April 10, stated that the rumors were exaggerated, that test drilling had indicated nothing conclusive, and that drilling would be continued. On April 13 TGS officials at the site in Canada helped a newsman from *The Northern Miner*, a Canadian mining publication, prepare a story announcing a major ore strike that appeared April 16 and reached a few New York investment firms on the morning of the 16th. A statement announcing the discovery was given to the Ontario Minister of Mines for release the night of the 15th, but, for undisclosed reasons, it was not released until the morning of the 16th. At a 10 a.m. press conference on April 16, the company announced that there had been a major strike. This went out over the Merrill Lynch private wires at 10:29 and appeared on the Dow-Jones "broad" tape at 10:54.

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[13] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968).

[14] *Id.*

[15] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *rev'g and aff'g in part*, 258 F. Supp. 262 (S.D.N.Y. 1966). Certiorari has been denied by the Supreme Court as to defendant Coates, who was found to have violated 10b-5 by purchasing and giving tips while in possession of inside information, and as to defendant Kline, who accepted a stock option while in possession of such information. Coates v. SEC, 37 U.S.L.W. 3399 (U.S. Apr. 22, 1969); Kline v. SEC, 37 U.S.L.W. 3399 (U.S. Apr. 22, 1969). These defendants, as well as the others, may still petition for certiorari on the question of remedies, which was remanded to the district court for determination.

Between the first drilling and the press conference of April 16, three officers and five employees, aware of the possible strike, bought or recommended TGS stock or "calls" on TGS stock.[16] During this period, three officers and two employees accepted stock options from TGS. Shortly after the press conference, but before the news appeared on the "broad" tape, associates and relatives of two directors purchased TGS stock as the result of tips received from the directors.

The SEC initiated a civil action against these officers, directors and employees alleging that each had violated section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 by purchasing or recommending TGS stock or "calls" on the basis of undisclosed material inside information concerning the results of the drilling, and against TGS itself alleging that the company had violated these provisions by issuing a false and misleading press release on April 12. The SEC requested injunctive relief against the company, and a decree for recission against the individual defendants for the securities transactions allegedly conducted contrary to law. The lower court dismissed the complaint against the company and all the individual defendants except those two who had purchased TGS stock between April 9 and the press conference on April 16. These defendants appealed from that part of the decision holding they violated section 10(b) and rule 10b-5, and the SEC appealed from the remainder of the decision. Pursuant to stipulation by the parties, the question of appropriate remedies was deferred and only the question of liability was at issue on appeal.[17] The Court of Appeals for the Second Circuit, in an opinion authored by Judge Waterman, held that the other individual defendants who knew of the drilling results, as well as the corporation, had violated rule 10b-5, and remanded the case to the district court for determination of the appropriate relief.

In rendering its decision, the court in *Texas Gulf Sulphur* has extended the application of rule 10b-5 in several important respects: by broadening the traditional concept of "insider" to include company employees who are not officers or directors; by establishing the culpability of "tippers"; by redefining the requirement of materiality in the context of insider trading; by denying the availability of good faith as a defense in an enforcement proceeding against an insider for equitable or prophylactic relief;[18] by determining that top management insiders may not accept stock options without disclosing material information to the issuer;

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[16] A "call" is a negotiable option contract giving the bearer the right to buy from the writer of the contract a certain number of shares of a particular stock at a fixed price on or before a certain agreed-upon date.

[17] 401 F.2d at 839 n.1.

[18] Prophylactic relief consists of an injunction enjoining future violations. The desirability of such a remedy lies mainly in its value as a precedent, since it is unlikely that the defendants in the particular action would again have the opportunity to repeat their transgressions. It allows the court to create new law without criminally punishing those who, in effect, violated the law before it was created.

by increasing the measures necessary to make inside information "public"; and by holding that a corporation may be enjoined from issuing a misleading press release. Perhaps more significant are the questions left unanswered: Does rule 10b-5 apply to tippees having no "special relationship" to the issuer? At what point is disclosure of material information sufficient to insure its availability to the investing public so that insiders may act upon such information with impunity? To what extent should civil liability be imposed for violation of rule 10b-5? What is the proper measure of damages when civil liability is imposed?

Since the standards applicable to the individual defendants as compared to the corporate defendant necessarily differ in such overlapping aspects as materiality, good faith, and extent of civil liability, it is important to distinguish between them, as did the court, in discussing the various ramifications of the *Texas Gulf Sulphur* decision.

THE INDIVIDUAL DEFENDANTS

Abuse of Inside Information

The essence of rule 10b-5 as applied to insider trading is that anyone having access to "information intended to be available only for a corporate purpose and not for the personal benefit of anyone" may not trade on the basis of such information knowing that it is unavailable to the one with whom he is dealing.[19] Traditionally, to violate the rule against insider trading, one must first have been an "insider."[20] This, however, is no longer true, although apparently there are still some restrictions on those to whom the rule applies.

At the outset it may be helpful to distinguish between the three categories of persons who may possess confidential corporate information. First, there are the "true" insiders—officers, directors, and major shareholders. Second, there are those with a "special relationship" to the corporation which gives them access to confidential information, such as employees, financial consultants, and underwriters. Third, there are those with no connection to the corporation, other than the fact that they have received confidential corporate information from an insider. These are commonly referred to as "tippees." In addition, there are the so-called "tippers"—those who convey the confidential information to "tippees."[21]

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[19] *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961).

[20] Until 1961, rule 10b-5 was thought to be limited to the traditional "insider," since § 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p (1964) dealing with "short-swing" profit-taking by insiders is expressly limited to officers, directors, and shareholders owning at least ten per cent of the outstanding stock. For a discussion of § 16(b) see Comment, *Insider Liability Under § 16(b): A Whole New Can of Worms*, 11 ARIZ. L. REV. 309 (1969).

[21] The word "tippee" was apparently coined by Professor Loss, and is a term of art in the field of securities regulations, meaning one who has received confidential

True insiders are of course prohibited under federal regulations from trading while in possession of material inside information unless they first disclose it to the party with whom they are dealing. Since, on a national securities exchange, the insider has no way of knowing in advance the identity of the person with whom he will be dealing, the effect is to prohibit altogether trading on exchanges by insiders in possession of inside information. In addition to true insiders—directors, officers, and majority shareholders—this class has been held to include the corporation itself.[22]

The traditional limitation to true insiders has been expanded to include those with some sort of "special relationship" to the corporation, giving the person access to confidential corporate information. This doctrine was first espoused in 1961 when the SEC decided *In re Cady, Roberts & Co.*[23] There the Commission held that rule 10b-5 prohibited a broker from trading for discretionary accounts after receiving confidential information from an associate who was a board member of the issuing corporation, thereby extending the meaning of "insider" to include "those persons who are in a special relationship with a company and privity to its internal affairs."[24] In 1967 the southern district of New York, in *Ross v. Licht*,[25] applied the "relationship giving access" test of *Cady, Roberts* to find liable under 10b-5 persons who had acted as intermediaries for officers of the corporation in purchasing stock from shareholders without disclosing inside information. Finally, in *Texas Gulf Sulphur*, the court included company employees who were not officers or directors as "insiders" with affirmative duties to disclose material information before trading.[26]

Tippees

Recent developments indicate that mere tippees, persons without any special relationship to the corporation, may also be held liable under 10b-5. In *Texas Gulf Sulphur* the court so indicated, stating in dictum:

> As Darke's [a defendant] 'tippees' are not defendants in this action, we need not decide whether . . . their conduct is as equally violative of the Rule as the conduct of their insider source, though we note that it certainly could be equally reprehensible.[27]

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corporate information from an insider. 3 L. Loss, Securities Regulation 1451 (2d ed. 1961). "Tipper" is often used to mean the conveyor of such information.

[22] Speed v. Transamerica Corp., 135 F. Supp. 176 (D. Del. 1955), *aff'd*, 235 F.2d 369 (3d Cir. 1956).

[23] 40 S.E.C. 907 (1961).

[24] *Id.* at 912.

[25] 263 F. Supp. 395 (S.D.N.Y. 1967). The court actually based its finding of liability on an agency theory, but as an alternative holding, applied the "special relationship" doctrine of *Cady, Roberts.*

[26] 401 F.2d at 842-43, 848.

[27] *Id.* at 852-53. In addition, the court, perhaps too loosely, states that "*anyone* in possession of material inside information" must either disclose it or

In addition, a complaint filed by the SEC against a number of investment firms doing business with Merrill Lynch, Pierce, Fenner & Smith, Inc., the country's largest brokerage firm, charged that the investment firms had violated 10b-5 by trading on the basis of tips from Merrill Lynch, which had access to inside information in its capacity as underwriter of convertible debentures of an aircraft company.[28] The *Merrill Lynch* complaint is significant not only because the investment firms were mere tippees, but also because these firms had received the information third-hand—Merrill Lynch acquired the information by virtue of a "special relationship" and then passed it on to the investment firms. Merrill Lynch, the tipper, agreed to a settlement with the SEC,[29] but the investment firms, the tippees, have not as of the time of this writing reached any agreement with the Commission. It seems likely, however, that if no such settlement is reached and the action is litigated, the investment firms will be held to have violated 10b-5 in view of the apparent trend in this area.[30]

One may wonder why everyone with confidential corporate information should not be forced to disclose that information to one with whom he is trading, regardless of whether he bears any relationship to the corporation. Why, in other words, have courts been hesitant to require disclosure unless the person with the information is a true insider or has some special relationship to the corporation? A possible answer, although not articulated by the courts, might be that any other rule would be unworkable. It is certainly likely that "hot tips" frequently circulate among those dealing in stocks, and often as not turn out to be nothing more than false or unfounded rumors. It would seem to be impossible to enforce rules restricting trading on the basis of such rumors. In addition, the courts may feel that criminal and civil sanctions should be limited to those persons who are close enough to the corporation to know with an appreciable degree of certainty that the information is more than just another rumor. It is submitted the best rule would be to include tippees

refrain from trading (emphasis added). *Id.* at 848.

[28] *In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., CCH FED. SEC. L. REP. ¶ 77,596 (1968).

[29] *Id.* at ¶ 77,629. A settlement is an agreement between the SEC and the defendant whereby the defendant agrees not to litigate the SEC claim and to accept certain agreed-upon sanctions for the violation.

[30] SEC v. Glen Alden Corp., CCH FED. SEC. L. REP. ¶ 92,280 (S.D.N.Y. 1968), a settlement, also indicates that a tippee is liable for trading on inside information under rule 10b-5.

Another recent settlement with the SEC, *In re* Blyth & Co., CCH FED. SEC. L. REP. ¶ 77,647 (SEC 1969), indicates that a tippee may be held liable under 10b-5. However, the *Blyth* case involved government bonds instead of corporate securities. A Federal Reserve Bank employee had leaked information concerning upcoming government bond offerings to a brokerage firm, which used the information to trade on its own account. The SEC brought an action against the firm, charging that the firm violated 10b-5 when it traded while in possession of the inside information. Arguably, *Blyth* may be used by way of analogy in future proceedings against tippees when the information concerns corporate securities rather than government bonds.

as "insiders" only when they have reason to know that the tipper has direct access to the confidential information. This rule would include such tippees as a golf partner of the president of the company, but would exclude persons receiving tips from acquaintances who are not known to have any way of ascertaining their reliability. Although the SEC seems to be moving toward general tippee liability,[31] it is possible that courts will find it desirable to restrict such liability in some manner, perhaps as suggested above.

Tippers

The trial court in *Texas Gulf Sulphur* found that a TGS geologist who had given tips to others before April 9th had not violated 10b-5 since the information was not considered "material" until that time.[32] The Second Circuit, however, found that the information was material at the time the tips were given, and held that the geologist had acted in violation of 10b-5 by passing on inside information to others.[33] The SEC sought to hold the tipper liable for the damages suffered by those with whom his tippees traded, and although the court remanded for the determination of the appropriate remedy, it seems clear that the Second Circuit intended that the tipper be liable for the damages of those who traded with the tippee, stating that the tipper's violations "encompass not only his own purchases but also the purchases by his son-in-law and the customers of his son-in-law, to whom the material information was passed."[34]

While such a rule may be criticized on grounds that it may lead to liability disproportionate to culpability, particularly where the tipper acted in good faith, it may be the best solution from a practical point of view, since only in this manner can the job of "policing" be turned over to the public by means of allowing a private right of action.

Should the tipper be found liable for damages suffered by those with whom his tippee traded, the question arises as to whether the tipper should be entitled to indemnification, or at least contribution, from the tippee. Although this may seem equitable since denying indemnification would allow the tippee to keep his profits at the expense of the tipper, it is possible that recovery may be denied on grounds that the parties are in pari delicto.

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[31] Should tippees be found liable, the question arises as to whether "sub-tippees" —those who receive confidential corporate information from tippees—should also be held liable. This question is as yet unanswered; however, it would seem that at this level, such information is actually little more than a mere rumor.

[32] SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 282 (S.D.N.Y. 1966).

[33] 401 F.2d at 852.

[34] *Id.* at 856, n.23.

Materiality

Insiders are prohibited from trading only when they have confidential information important enough to be considered "material." Thus, insiders are not prohibited from trading merely because they are more familiar with the general operations of the corporation, or are aware of unimportant corporate information.[35] The trial court in *Texas Gulf Sulphur* held that information is not material "merely because it would be of interest to the speculator on Bay Street or Wall Street."[36] The court added that, since many 10b-5 actions are brought on the basis of hindsight, the test of materiality must be a conservative one. "It is information which, if known, would clearly affect 'investment judgment.'"[37] Applying these tests, the district court found that the information concerning a possible copper discovery did not become material until the third test hole had been drilled on April 9, in spite of its finding that the first hole drilled nearly five months earlier was "unusually good" and that it "excited the interest and speculation of those who knew about it."[38] Therefore, only the two defendants purchasing after April 9 and before the April 16 press release were held to have violated 10b-5.

The Second Circuit reversed,[39] finding that the information became material immediately upon visual examination of the first test hole. The reversal was not based upon an erroneous finding of fact, but rather upon the court of appeal's dissatisfaction with the legal standard adopted by the district court to determine materiality.[40] The Second Circuit rejected the lower court's "conservative" test of materiality, stating that "the speculators and chartists of Wall and Bay Streets are also 'reasonable' investors entitled to the same legal protection afforded conservative traders."[41] The court of appeals based its test of materiality primarily on two factors: First, it looked to the effect on the market, holding that the information is material if it would be "reasonably certain to have a substantial effect on the market price of the security if disclosed."[42] Sec-

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35 *Id.* at 848.
36 258 F. Supp. 262, 280 (S.D.N.Y. 1966).
37 *Id.*
38 *Id.* at 282.
39 The arguments on appeal were heard by a three judge panel in March of 1967. The panel reached a decision, but on May 2, 1968, Chief Judge J. Edward Lumbard ordered the case to be considered by the full panel of nine judges without further argument. The decision of the full panel was reached August 13, 1968, with Judge Waterman writing the majority opinion. Judges Feinberg and Smith concurred. Judge Friendly wrote a concurring opinion, joined in part by Judge Anderson, devoted primarily to the issue of damages for a misleading press release. Judge Kaufman concurred in the result in Judge Waterman's opinion and in the part of Judge Friendly's opinion concerned with damages. Judge Hays concurred with Judge Waterman, and dissented in part, on the ground that the press release should be held misleading as a matter of law. Judge Moore, joined by Judge Lumbard, dissented.
40 401 F.2d at 850.
41 *Id.* at 849.
42 *Id.*

ond, the court looked to the reasonable investor, finding the test to be "whether a *reasonable* man would attach importance . . . in determining his choice of action in the transaction in question."[43] To determine the effect on the market, the court set forth a formula whereby materiality is determined by 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."[44]

Changes in earnings or dividends,[45] increases in the value of corporate assets,[46] plans to sell assets not in the ordinary course of business,[47] and projected sales and earnings figures[48] have also been found to be material. Materiality, of course, is a question of fact. As such, it may often be difficult, if not impossible, for insiders to know in advance whether a particular piece of information will be considered material when later judged by hindsight. The tests laid down in *Texas Gulf Sulphur*, based on the "reasonable investor" and a "substantial effect on the market," give little guidance. Since it is necessary to apply these tests by hindsight, difficult situations may arise, particularly where, at the time of the transaction in question, one could not predict that the information was "reasonably certain to have a substantial effect on the market," but which subsequently has such an effect. The problems involved in convincing a judge or jury of the non-materiality of such information are readily apparent. It would seem that the effect of all this will be to induce a certain amount of painful over-cautiousness among corporate executives,[49] who may be eager to turn a quick profit by trading on inside information, but who are troubled by the vagueness and uncertainty of the test of "materiality" as set forth by the court. Although a set of inflexible rules delineating the various types of information which will be deemed material would add certainty to the law, such rules would also be likely to encompass, in particular instances, information that is not really material and exclude, in other instances, information that is material. Even though certainty in the law is generally desirable, in a case such as this it appears unattainable without a concommitant sacrifice in the effectiveness of control over insider trading.

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[43] *Id.*

[44] *Id.*

[45] Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962); *In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., CCH FED. SEC. L. REP. ¶ 77,629 (SEC 1968); *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961); *In re* Ward La France Truck Corp., 13 S.E.C. 373 (1943). *But see* Hafner v. Forest Laboratories, Inc., 345 F.2d 167 (2d Cir. 1965).

[46] Speed v. Transamerica Corp., 135 F. Supp. 176 (D. Del. 1955), *aff'd*, 235 F.2d 369 (3d Cir. 1956).

[47] Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947).

[48] SEC v. Glen Alden Corp., CCH FED. SEC. L. REP. ¶ 92,280 (S.D.N.Y. 1968).

[49] Some American executives have exercised their caution in a different manner. It has been reported that American executives can and do avoid American securities laws against insider trading by dealing through anonymous Swiss bank accounts. *The Shenanigans of the Swiss Banks*, NEWSWEEK, Dec. 23, 1968, at 65.

Therefore, the test of materiality as set forth by the court of appeals in *Texas Gulf Sulphur*, even with its accompanying uncertainty, would appear to be as precise a standard as can be formulated under the circumstances.[50]

"Digestion" Time—When May an Insider Act?

After the information has become sufficiently public, the insider may deal in the stock since he would again occupy an equal bargaining position with the other party. The trial court in *Texas Gulf Sulphur* held that the information in question became public immediately following the reading of the April 16 press release to reporters.[51] The Second Circuit disagreed, however, and held that insiders should wait at least until the information has appeared on the Dow-Jones "broad" tape before trading, since this is the media of widest circulation for stock market information.[52] Thus, those defendants who dealt in the stock or gave tips between the time the first test hole was drilled in November of 1963 and the time the news of the discovery appeared on the broad tape on April 16, 1964, were held to have violated 10b-5. Neither the rumors that were printed in the New York papers nor the press conference of April 16 were sufficient to make the information public.

Although the court held that insiders must wait *at least* until the information appears on the broad tape, it noted in dictum 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,"[53] indicating that where the news is of a technical nature, appearance on the broad tape may not be sufficient. The court added that a ruling by the SEC setting a definite "digestion" or reaction time would be appropriate.[54] The SEC, for example, could set up regulations providing that insiders wait at least 24 hours after the news has appeared on the broad tape or in certain financial publications, whichever is sooner, before they may deal in the stock. As the court recognized, this sort of rule has the advantage of lending certainty to the situation, and of insuring that the investing community has time to react to the new development before insiders may step in and take advantage of information which they have had time to pre-evaluate.[55]

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[50] For a thorough discussion of materiality as related to insider trading see Wiesen, *Disclosure of Inside Information—Materiality and Texas Gulf Sulphur*, 28 MD. L. REV. 189 (1968).

[51] 258 F. Supp. 262, 287-88 (S.D.N.Y. 1966).

[52] 401 F.2d at 854.

[53] *Id.* at 854 n.18.

[54] *Id.*

[55] As the court in SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 289 (S.D.N.Y. 1966) noted, an anomalous situation may be presented by the non-insider who learns of the information before it has appeared on the tape. What, for example, of the reporter at the press conference who makes a quick call to his

Good Faith as a Defense

The *Texas Gulf Sulphur* decision established the rule that good faith is not a defense to an SEC enforcement action under 10b-5.[56] Several of the defendants asserted they believed that the information had become public at the time they dealt in the stock. Both the trial court and the Second Circuit nevertheless held they had violated 10b-5, concluding that liability attaches even for a negligent violation. Although it has often been held that scienter is not required in a private action under 10b-5,[57] *Texas Gulf Sulphur* is the first case to hold that scienter is not required in an enforcement proceeding. The court, noting that good faith is no defense to enforcement actions under other securities regulations,[58] determined that "the common law standard of deceptive conduct has been modified in the interests of broader protection for the investing public so that negligent insider conduct has become unlawful."[59]

The common law roots of rule 10b-5 have been modified in another respect. Even though 10b-5 is worded in terms of "fraud" and "deceit," the common law fraud element of an active representation[60] is not required. It is now established that mere silence is enough for private recovery since 10b-5 imposes, by implication, an affirmative duty to disclose material facts.[61]

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broker before heading back to the office? The non-insider in this situation has the same inside information as the insider, yet the non-insider presumably may trade and take full advantage of the still non-public information, and the insider may not. There is probably no satisfactory way of avoiding this, as a practical matter. Once the press conference has been held, the cat is out of the bag, even though the market has not yet reacted. The market, of course, is going to react, and the first to buy will be the ones who make the profit. Since someone is going to make the profit, it does not seem unreasonable to allow it to be those whose ears are closest to the sources of news, such as those who attend press conferences and who keep up with the ticker tapes.

[56] 401 F.2d at 854.

[57] SEC v. Capital Gains Res. Bureau, Inc., 375 U.S. 180 (1963); Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967); Berko v. SEC, 316 F.2d 137 (2d Cir. 1963); Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963); Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Barlas v. Bear, Stearns & Co., CCH FED. SEC. L. REP. ¶ 91,674 (N.D. Ill. 1966); Texas Continental Life Ins. Co. v. Bankers Bond Co., Inc., 187 F. Supp. 14 (W.D. Ky. 1960), *rev'd on other grounds*, 307 F.2d 242 (6th Cir. 1962). *But see* 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); Trussell v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Colo. 1964); Thiele v. Shields, 131 F. Supp. 416 (S.D.N.Y. 1955).

[58] The court cited Berko v. SEC, 316 F.2d 137 (2d Cir. 1963), where good faith was held to be no defense after a securities salesman was found to have violated § 15 A(b)(4) of the Securities Exchange Act of 1934, 15 U.S.C. § 78*o*-3 (b)(4) (1964), and SEC v. Capital Gains Res. Bureau, Inc., 375 U.S. 180 (1963), where good faith was held to be no defense to a violation of § 206(1-3) of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-6(1-3) (1964).

[59] 401 F.2d at 854-55.

[60] *See* W. PROSSER, LAW OF TORTS 710 (3d ed. 1964).

[61] Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967); List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir. 1965), *cert. denied*, 382 U.S. 811 (1966); Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961).

Acceptance of Stock Options

A problem closely related to insider trading, and governed by many of the same principles, arises when an insider who possesses material information unknown to the board of directors accepts stock options without disclosing such information. In *Texas Gulf Sulphur*, three members of top management and two employees who knew of the test drilling results were offered stock options at a time when the board of directors was still unaware of these favorable developments. The trial court found that the three members of top management had violated 10b-5 by accepting the options, but that the two employees had not. The court reasoned that the two employees had no duty to inform the board of the drilling results[62] and held that they were entitled to rely on the members of top management to inform the board of the test hole.

Since the SEC did not appeal the dismissal of the employees, this question was not before the court on appeal. However, the Second Circuit held that the members of top management had a duty to inform the board concerning the drilling results before accepting the stock options, and that their failure to do so was a violation of rule 10b-5.[63] The court added that ratification of the options by the board, after they had learned of the discovery, was of no effect.[64] Even though all the members of top management except one had voluntarily surrendered the options after the SEC had filed its complaint, the court held that this did not satisfy the SEC's claim, and remanded to the district court the question of whether an injunction should issue. As to the member of top management who had not surrendered his option, the court ordered rescission. Although it might seem that ratification should excuse such a violation since the rule is here designed to protect the corporation, the court applied the better rule in holding that it did not, because acceptance of the option without disclosure was a violation of the law at the time of acceptance, and subsequent ratification by the "victim" of the violation should not legalize it.

Members of top management thus have two alternatives open to them if they are offered options while in possession of secret material information — they may disclose the information to the board of directors and accept the option, or remain silent and reject it. If they choose to disclose the information, this may increase the chances of "leaks," particularly where there are numerous directors, and thus defeat the very purpose of 10b-5. If they reject the options, such rejection might lead to speculation about the economic health of the corporation, resulting in unwarranted selling of securities and an accompanying price decline. The court, recognizing this dilemma, suggested that in such a case top manage-

[62] SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 291 (S.D.N.Y. 1966).
[63] 401 F.2d at 856-57.
[64] *Id.* at 857 n.24.

ment personnel could accept the options, but refrain from exercising them until the board has learned of the information and ratified the options.[65] Even though the facts in *Texas Gulf Sulphur* indicate that this is exactly what was done, the court nonetheless found that the members of top management had violated 10b-5, adding that "as this suggestion was not presented to us, we do not consider it or make any determination with reference to it."[66]

Judge Friendly, concurring, indicated that TGS may have a claim against the members of top management not only for rescission of their options, but also for damages suffered by TGS as a result of granting options to other employees, on the theory that the options would not have been granted had top management performed its disclosure obligation.[67] In addition, Friendly was unimpressed with the majority's suggestion that the officers could accept the options but refrain from exercising them to prevent the possibility of leaks, since "it should be possible for officers to communicate with directors, of all people, without fearing a breach of confidence."[68]

Remedies and Extent of Liability

Remedies

Once it is established that prohibited insider trading has taken place, questions arise concerning possible remedies. A violation of rule 10b-5 may give rise to both criminal and civil liability. Criminal penalties include a fine of up to $10,000, and up to two years imprisonment.[69] In addition, the SEC may bring a civil action for prophylactic relief to secure an injunction against future violations.[70]

More important, however, is the right of civil recovery.[71] Insiders are of course liable when they trade in stocks in violation of 10b-5. When the transaction occurs on a securities exchange, however, the question is, liable to whom? In *Texas Gulf Sulphur*, the SEC sought rescission.[72] This is the first time it has asked for such a remedy, and it may give some indication of the type of remedy that may develop for future 10b-5 violations. Rescission, of course, gives relief only to those sellers who happened to deal with the insider, a wholly fortuitous circumstance on a national exchange. Thousands of transactions take place every day, and it is only by chance that a seller happens to deal with an insider. Absent

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65 *Id.*
66 *Id.*
67 *Id.* at 865.
68 *Id.*
69 Securities Exchange Act of 1934 § 32(a), 15 U.S.C. § 78ff (1964).
70 Securities Exchange Act of 1934 § 21(e), 15 U.S.C. § 78u(e) (1964). *See* 401 F.2d at 858.
71 *See* BROMBERG, *supra* note 8, at § 2.4(1).
72 On appeal, however, the question of remedies was deferred pending a determination of liability. 401 F.2d at 839, n.1.

the insider, the seller presumably would have sold his stock to someone else at the same price. Why then should the seller who happened to sell his stock to the insider recover while other sellers cannot? It certainly cannot be said that there was any reliance, because the seller had no way of knowing that he was dealing with an insider.

The answer may be that rescission, as inconsistent as it may seem, is the best of several unsatisfactory solutions. One such solution would be to allow recovery by all who sold at the time the insider purchased. If the stock is active, this would open the door to tremendous liability in relation to the wrong. Another possibility would be to apportion, pro rata, the profit of the insider among all who sold at the time the insider purchased. This would limit liability to the profit realized by the insider, but would have the disadvantage, in some cases, of distributing only a very small amount to each of the sellers. If the action were brought by the SEC, as in *Texas Gulf Sulphur*, this would not be a serious criticism. On the other hand, if there were no enforcement action by the Commission, such small recoveries might remove the incentive for a private action. Therefore, rescission may well be the preferable solution.[73]

Measure of Damages

Relatively few 10b-5 cases have dealt with the measure of damages. One reason for this is that a high proportion of the reported decisions involve motions to dismiss for failure to state a cause of action.[74] Once it is found that there is a cause of action, many of the cases are apparently settled. However, it is generally agreed that defrauded buyers of securities are entitled to rescind and recover the purchase price.[75] Defrauded sellers pose a more interesting problem. Some cases have awarded damages on an "out-of-pocket" basis, allowing recovery for the difference between the sale price and the "fair value" at the time of the sale.[76] This measure of damages, of course, allows the wrongdoer to retain any benefits received from subsequent appreciation. As a result, at least two cases have allowed a constructive trust so that these profits could be returned to the seller,[77] and another recent case has allowed a rescission measure of damages giving the same result.[78]

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[73] For a discussion of this problem see 80 HARV. L. REV. 468 (1966).

[74] BROMBERG, *supra* note 8, at § 9.1.

[75] Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965); Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962).

[76] Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963); Ross v. Licht, 263 F. Supp. 395 (S.D.N.Y. 1967).

[77] Speed v. Transamerica Corp., 135 F. Supp. 176 (D. Del. 1955), *aff'd*, 235 F.2d 369 (3d Cir. 1956); Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947).

[78] Baumel v. Rosen, 283 F. Supp. 128 (D. Md. 1968).

THE CORPORATE DEFENDANT—LIABILITY FOR MISLEADING PRESS RELEASES

Perhaps the most far-reaching aspect of the *Texas Gulf Sulphur* decision was the holding by the Second Circuit that a corporation may be held liable under rule 10b-5 for a misleading press release. The trial court, in holding that there was no violation, relied on the last clause of 10b-5 which requires that the fraudulent act be done "in connection with the purchase or sale of any security." The trial court determined that since there was no evidence that the release was issued for the personal benefit of any of the defendants or that it was designed to affect the market price of TGS stock, it was not issued "in connection with the purchase of sale of any security." It further concluded that even had this requirement been satisfied, there would have been no violation because it was not shown that the release was false, misleading or deceptive. The lower court also found that "[w]hile, in retrospect, the press release may appear gloomy or incomplete, this does not make it misleading or deceptive on the basis of the facts then known,"[79] and added that the defendants who had prepared the release had "exercised reasonable business judgment under the circumstances."[80]

The Second Circuit, concluding that the press release did violate 10b-5, held that the "in connection with" requirement meant only that reasonable investors might rely on the release, and in so relying, deal in the stock.[81] Even before *Texas Gulf Sulphur*, however, the "in connection with" requirement had often been construed broadly.[82] Courts have found the requirement satisfied when the corporation made the untrue statement to aid in a proxy solicitation,[83] to promote the distribution of corporate stock,[84] or to affect the market price of stock to the advantage of the corporation.[85] No court, however, had previously construed the requirement as broadly as did the Second Circuit in *Texas Gulf Sulphur*.[86] This broadened construction has the effect of making

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[79] SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 296 (S.D.N.Y. 1966).
[80] *Id.*
[81] 401 F.2d at 860.
[82] Puharich v. Borders Electronics Co., Inc., CCH FED. SEC. L. REP. ¶ 92,141 (S.D.N.Y. 1968); Bredehoeft v. Cornell, 260 F. Supp. 557 (D. Ore. 1966); Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966); Miller v. Bargain City, U.S.A., Inc., 229 F. Supp. 33 (E.D. Pa. 1964); Cooper v. North Jersey Trust Co., 226 F. Supp. 972 (S.D.N.Y. 1964); Freed v. Szabo Food Serv., Inc., CCH FED. SEC. L. REP. ¶ 91,317 (N.D. Ill. 1964). *But see* Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701 (S.D.N.Y. 1951).
[83] SEC v. National Securities, Inc., CCH FED. SEC. L. REP. ¶ 92,334 (U.S. Sup. Ct. 1969).
[84] SEC v. North Am. Res. & Dev. Corp., CCH FED. SEC. L. REP. ¶ 92,149 (S.D.N.Y. 1968).
[85] Freed v. Szabo Food Serv., Inc., CCH FED. SEC. L. REP. ¶ 91,317 (N.D. Ill. 1964).
[86] Two cases since *Texas Gulf Sulphur* have also construed the "in connection with" requirement this broadly. Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968); SEC v. Great Am. Indus., Inc., CCH FED. SEC. L. REP. ¶ 92,325 (2d Cir. 1968).

the "in connection with" requirement almost meaningless, since almost any release of misleading information by the corporation might cause investors to purchase or sell the stock.

Whether a release is misleading is a question of fact. The test, as set forth by the court of appeals in *Texas Gulf Sulphur*, is whether the reasonable investor, in the exercise of due care, would have been misled by the release.[87] The court indicated that it may be preferable to set forth technical data and let the investors draw their own conclusions, rather than to state a conclusory opinion in the release.[88] Thus, TGS might well have been better off had it released only the technical specifications and ore content of the drill hole on April 12, instead of the general statement it did release.

Although the decision in *Texas Gulf Sulphur* might be thought to have a "chilling" effect on releases of corporate information, since a release which proved to be misleading would expose the corporation to liability, a countervailing force is the New York Stock Exchange rule requiring prompt and adequate release of matters of significance to the investing public.[89] The corporation is thus in the position of being required to say something, but being subject to liability if what it does say proves misleading.

Good faith, according to *Texas Gulf Sulphur*, is no defense for a misleading press release. However, liability will be imposed only if there is a lack of "due diligence."[90] The standard of care thus appears to be something akin to that for negligence.

From a corporate point of view, the most frightening aspect of *Texas Gulf Sulphur* is the possibility of implying from 10b-5 a private right of civil recovery for a misleading press release similar to the right of civil recovery for other violations of 10b-5. The possible judgments in such a case could be enormous, particularly where an active stock was involved. Allowing recovery for everyone who traded in reliance on a misleading press release could completely wipe out even some of the largest companies in a single class action. It has been calculated, for instance, that if such liability were imposed, a total recovery of up to $390 million would be possible in *Texas Gulf Sulphur*.[91] If civil recovery were allowed, each investor who sold in reliance on the misleading release could

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[87] In *Texas Gulf Sulphur*, the Second Circuit remanded the question of whether the release was misleading for determination by the district court. In a subsequent case, however, the Second Circuit held a press release misleading where it was stated that a company mine could be in production within 120 days when it was not known whether the ore was commercially mineable. SEC v. Great Am. Indus., Inc., CCH FED. SEC. L. REP. ¶ 92,325 (2d Cir. 1968).

[88] 401 F.2d at 864.

[89] NEW YORK STOCK EXCHANGE COMPANY MANUAL, FORM OF LISTING AGREEMENT pp. A-28, A-37 to A-47.

[90] 401 F.2d at 863.

[91] *See* Ruder, *Speech*, 24 BUS. LAWYER 565, 566 (1969).

presumably recover the difference between the selling price and the price of the stock a reasonable time after the misleading release has been corrected.[92] Imposing this sort of liability could result in judgments out of all proportion to the violation. In addition, this policy would no doubt work against full and prompt disclosure of corporate developments since an innocent mistake could expose the company to a devastating lawsuit. Judge Friendly, concurring in *Texas Gulf Sulphur*, expressed these fears and indicated that although the question of civil liability for a misleading press release was not before the court, the court should nevertheless let it be known that civil recovery would not be allowed.[93] In view of Judge Friendly's express caveat and the possibility of ruinous lawsuits, it seems unlikely that civil liability will be imposed for a misleading press release, at least where the release was made in good faith.

CONCLUSION

The Second Circuit in *Texas Gulf Sulphur* has contributed to the continued expansion of rule 10b-5 and has thus enhanced its importance as a powerful weapon for the SEC in its struggle to police the securities markets, and as a private remedy for the defrauded investor. The decision has helped shape the future of 10b-5 in seven important respects:

1. It has extended the rule against insider trading to include ordinary employees of the corporation, and indicated, in dictum, that mere tippees may also be included.

2. It has established the liability of tippers.

3. It has expanded the test of materiality to include any information that would have a substantial effect on the market price of the stock or the decision of a reasonable investor to buy or sell the security.

4. It has increased the measures necessary to make inside information "public," so that insiders may deal in the security. At a minimum, information will not be considered public before it has appeared in the media of widest circulation, normally the Dow-Jones broad tape for securities information, and there are indications that a "digestion" time may be required even after this, to allow the market to assess the information and react thereto.

5. It has established that good faith is no defense to prophylactic action by the SEC.

6. It has extended the rule against insider trading to cover the acceptance of stock options from the corporation by insiders.

7. It has applied rule 10b-5 to the issuance of a misleading press

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[92] Texas Gulf Sulphur stock was selling at 17¾ on Nov. 12, 1963, the date of the first test hole. By April 16, 1964, the date of the final press release, it was selling at 30⅛.

[93] 401 F.2d at 866.

release by the corporation, regardless of whether the corporation dealt in the stock or acted in good faith.

There can be no doubt that *Texas Gulf Sulphur* is a significant decision which will have important immediate and long range effects. The shock waves may be expected to create a certain amount of dissatisfaction in some quarters, but it seems likely that the ultimate effect will be to foster a fairer securities market.