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Texas Gulf Sulphur: Its Holdings and Implications

I. INTRODUCTION

In the past few years the developments in the field of federal securities law have come at an ever-increasing rate,[1] but seldom has any development been met with such a reaction by the financial press as that which followed the decision of the Second Circuit Court of Appeals in its recent opinion in *S.E.C. v. Texas Gulf Sulphur Co.*[2] The uneasiness of the investment community began with the filing of the complaint in 1965[3] and reached a peak in the days following the reversal of the trial court by the Second Circuit.[4] The filing of a complaint against Merrill, Lynch, Pierce, Fenner & Smith only a few days later contributed to this reaction.[5]

These recent developments have come in an era of almost unprecedented investment by small speculators trying to realize quick profits in the stock market. The interest in the investment market has reached a level where new issues, which may be almost worthless, must be apportioned to the investors[6] and may often double and triple in value in only a few days.[7] Under these conditions, the need for investor protection becomes clearly apparent.

The effect of the *Texas Gulf Sulphur* decision on the business world was immediately evident. Corporate executives announced new policies against discussing developments with anyone, including brokers and investment analysts, and some corporations were advised not to name brokers to their boards of directors.[8] Perhaps the most widespread reaction in the investment community has been confused

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1. *See, e.g.*, Kennedy & Wander, *Texas Gulf Sulphur, A Most Unusual Case*, 20 BUS. LAW. 1057 (1965); Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968); Posner, *Developments in Securities Regulation*, 20 BUS. LAW. 595 (1965).

2. 401 F.2d 833 (2d Cir. 1968).

3. *See* Shapo, *Rule 10b-5 and Texas Gulf Sulphur: An Evolution of Questions and Answers*, 20 U. MIAMI L. REV. 939 (1965-66).

4. *See, e.g.*, NEWSWEEK, Aug. 26, 1968, at 66; Green, *SEC Sees Court Rulings on 'Insider' Trading Changing Brokers' Method of Operations*, Wall Street Journal, Sept. 3, 1968, at 24, col. 1; Green, *SEC Considers Telling 'Insiders' How Long To Wait Before Trading On Company News*, Wall Street Journal, Aug. 30, 1968, at col. 3; Wall Street Journal, Aug. 21, 1968, at 8, col. 1; Wall Street Journal, Aug. 16, 1968, at 1, col. 6.

5. SEC Administrative Proceeding File No. 3-1680, [Current] CCH FED. SEC. L. REP. ¶ 77,596 (August 26, 1968).

6. Berton, *A Piece of the Action*, Wall Street Journal, Aug. 7, 1968, at 1, col. 6.

7. *Id.*

8. Wall Street Journal, Aug. 16, 1968, at 1, col. 6.

anxiety.[9] The purpose of this note is to analyze the holding in the *Texas Gulf Sulphur* case as it relates to prior law and to consider some of the problems raised by the decision. Some suggestions will also be made for possible resolution of the most disturbing questions raised by the decision.

II. THE FACTUAL SETTING

In order to understand the holding in the case and some of the implications which seem to follow, it is essential to have some comprehension of the facts involved. As early as 1957, Texas Gulf Sulphur (hereinafter TGS) had begun a search for mineral deposits by aerial exploration of the Canadian Shield. Surface examinations of strong anomalies, or variations in conductivity, were made, and if further exploration seemed to be warranted, core drilling was commenced and the findings evaluated. Prior to November, 1963, TGS had drilled some 65 of these anomalies, but most had revealed only barren pyrite, graphite, or "marginal mineral deposits in insufficient quantities to be commercially mined."[10] On November 8, 1963, drilling was commenced on the most promising quarter section then controlled by TGS near Timmins, Ontario. The group in charge of the drilling consisted of: defendant Mollison, a mining engineer and vice-president of TGS; defendant Holyk, the company's chief geologist; defendant Clayton, an electrical engineer and geophysicist; and defendant Dorke, a geologist. The drilling of the initial hole, K-55-1, was completed on November 12, and visual estimates of the mineral content of over 599 feet of the core indicated an average zinc content of 8.64 per cent and an average copper content of 1.15 per cent. Relying on this visual estimate by Holyk, defendant Stephens, the president of TGS, decided that the company should acquire the remainder of the Kidd 55 segment. In order to facilitate the acquisition, Stephens instructed the exploration group not to disclose the results even to other directors, officers and employees of TGS. The core sample was flown to the United States for chemical analysis, and usual security measures in the mining industry were put into effect.[11] During a period beginning on November 12 and continuing up until April 8, defendants Fogarty, the executive vice-president and a director,

9. NEWSWEEK, Aug. 26, 1968, at 66.

10. SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 271 (S.D.N.Y. 1966).

11. Cut saplings were stuck into the drill hole and a barren core was drilled off of the anomaly.

Clayton, Holyk, and Mollison purchased shares of TGS stock in the market at prices ranging from 17 3/4 to 18 1/8 dollars a share.

The results of the chemical assay were received by TGS in mid-December and revealed an average mineral content for over 602 feet of the core of 1.18 per cent copper and 8.26 per cent zinc, as well as 3.94 ounces of silver per ton of ore. "These were the only chemical assay reports on any drill hole which TGS received prior to April 16, 1964."[12] In December, January, February and March, defendant Dorke and those to whom he had made recommendations to buy TGS made calls and purchases of TGS stock. The other defendants also continued to buy stock during this period at prices from 20 3/8 to 25 dollars a share. On February 20, 1964, the TGS Stock Option Committee met and extended options to defendants Stephens, Fogarty, Kline, vice-president and general counsel, Mollison and Holyk, all of whom accepted the options without revealing their knowledge of the K-55-1 drilling to the members of the Committee. On February 26 and March 3, defendant Huntington, an attorney who knew only about the land acquisition program around the Kidd segment, purchased stock and calls. Prior to the period from November 12, 1963 to March 31, 1964, the defendants had owned 1,135 shares of TGS and no calls; thereafter they owned 8,235 shares and possessed 12,300 calls.[13]

On March 31, 1964, the land acquisition program having reached a satisfactory point, drilling was resumed with the commencement of K-55-3, located west of K-55-1 and drilled at an angle so as to form a vertical plane with K-55-1; daily reports were sent to Stephens and Fogarty by Mollison and Holyk. Visual estimates of K-55-3 indicated percentages of copper and zinc similar to K-55-1 over 641 feet of the 876 foot length. On April 7, the same day that K-55-3 was completed, K-55-4 was commenced, and by 7:00 P.M. on April 9, K-55-4 had produced mineralization over 366 feet of its core. K-55-6 was

12. SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 271 (S.D.N.Y. 1966).

13. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 844 (1968). During this same period of time, however, there were other developments which could have influenced the decision to buy TGS stock: the development of a phosphate project and potash mine (November 15, 1963); the prediction by security analysts that there would be a turnabout in the price of sulphur stocks; the acquisition of Canadian oil properties (December 16, 1963); the new high level of free world sulphur use and output (December 30, 1963); the launching of the world's largest liquid sulphur tanker by TGS (December 30, 1963); the entry into service of a large liquid sulphur tanker for domestic shipment (January 18, 1964); the sulphur expansion program in Canada (February 20, 1964); new four-year high in sales for 1963 (February 20, 1964); and $2 per ton price increase for sulphur (April 1, 1964).

commenced on April 8 with a second drilling rig, and on April 10, a third rig commenced drilling K-55-5. There were no geologists at the site on April 8 and 9, but it was apparent by April 10 that all holes had encountered substantial mineralization.[14] Certain of the defendants and their "tippees" continued to buy shares and calls up to April 8 at prices from 25 7/8 to 28 1/8 dollars a share.

Because of rumors which had begun to circulate in Canada and unauthorized reports implying a rich strike which appeared in the *New York Herald Tribune* and the *New York Times* on Saturday, April 11, Stephens became concerned and telephoned Fogarty at his home. Fogarty then contacted Mollison for a current report on the drilling progress.[15] The following day, Fogarty, along with Carroll, a public relations consultant, drafted a press release to quell the rumors. After being channeled through Stephens and Huntington, the release was issued at 3:00 P.M. on Sunday, April 12, and appeared in the Monday morning newspapers.[16] "The evidence as to the effect of this release on the investing public was equivocal and less than abundant."[17] The release purported to give the results of drilling operations as of April 12, although Fogarty was only in possession of the results as of 7:00 P.M. on April 10; a definite statement was promised as soon as more conclusive results were available. This release was the first attempt by either the company or any of the individual defendants to make any public disclosure of the drilling operation.

Drilling with the three rigs had continued over the weekend, and a fourth rig had been put into operation on April 12. "Between April 12 and April 15 five additional holes had been drilled . . . and by April 15 at 7:00 P.M. 5198 feet of core had been drilled compared with 2776 feet on April 10."[18] The additional holes which were completed between April 12 and April 15 also established mineralization in several planes. On April 13, TGS began to take steps toward ultimate disclosure of the discovery. A reporter for the

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14. The trial court found that a substantial body of commercially mineable ore existed at 7:00 P.M. on April 9, and that knowledge of the results to that time constituted material information. 258 F. Supp. at 282.

15. Mollison was apprised of the results only to 7:00 P.M. on April 10.

16. The release stated that drilling operations were in progress but that the unauthorized reports exaggerated the scale of operations. It indicated that drilling near Timmins, though inconclusve and insufficient to reach definite conclusions, indicated that more drilling was warranted. A definite statement was promised as soon as sufficient data was available.

17. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 846 (1968).

18. *Id.* at 880.

Northern Miner, a Canadian mining journal with a small circulation in the United States, visited the site and prepared an article confirming a ten million ton ore strike. Mollison examined the article and returned in on April 15 for publication in the April 16 issue. A statement was also given to the Canadian Minister of Mines for release to the Canadian media at 11:00 P.M. on April 15, but for some reason the release was not made until 9:40 A.M. on the 16th. An official detailed statement announcing a "find" of some twenty-five million tons was read to the American press on April 16 from 10:00 A.M. until 10:10 or 10:15 A.M. The item appeared on Merrill, Lynch's private wire at 10:29 A.M. and on the Dow Jones ticker at 10:54 A.M.

The only defendants who engaged in market activity between the April 12 release and the April 16 release were Clayton, an engineer, Crawford, Secretary of TGS, and Coates, a director. Clayton bought 200 shares on April 15; Crawford had entered orders for 300 shares at midnight on the 15th and for another 300 at 8:30 A.M. on the 16th, which were executed at the opening of the market on the 16th; Coates left the press conference early on the 16th and ordered 2,000 shares at 10:20. Coates' broker, who was also his son-in-law, bought another 1,500 shares for himself and his customers. TGS climbed to a high of 37 on April 16 and closed at 58 1/4 on May 15. Subsequently the Kidd mine has proven to be one of the richest finds in modern times, and its economic value is further enhanced by the low cost of extraction due to the proximity of the ore to the surface.

III. THE LEGAL SETTING AND THE HOLDING OF THE COURT

A. Background of Rule 10b-5

At the time the 73d Congress passed the Securities Act of 1933[19] and the Securities Exchange Act of 1934,[20] the United States was emerging from the greatest financial trauma in its history. President Roosevelt was determined to see that the wild speculation and deceptive practices which contributed to the 1929 stock market crash would not be allowed to recur. In his message to Congress calling for the passage of the 1933 Act, President Roosevelt advocated a securities act based on a policy of complete disclosure, rather than an act—similar to many present Blue Sky Laws—embodying a protective policy

19. 15 U.S.C. §§ 77a-aa (1964).

20. 15 U.S.C. §§ 78a-hh (1964).

whereby the government would interpose its financial judgment for that of the investor.[21]

This same policy found expression in the reporting requirements of the Securities and Exchange Act of 1934, but to these provisions were added proscriptions against manipulative devices. A House of Representatives Committee, reporting on the bill which became the 1934 Act, announced the general purpose of the Act to be the regulation of "the relationships of the investing public to corporations which invite public investment,"[22] and in the preamble the Act itself expressed its purpose to be "to prevent inequitable and unfair practices and to insure fairness in securities transactions generally . . . ."[23] Unfortunately, the legislative history underlying section 10(b) is almost nonexistent. The House Committee commented on the provision which became section 10: "False and misleading statements *designed* to induce investors to buy when they should sell and to sell when they should buy are also outlawed and penalized."[24] The Senate Committee reported only that section 10(b) was intended to empower the Commission to prohibit or regulate "manipulative or deceptive practices which it finds detrimental to the interests of the investor."[25]

Pursuant to the authority granted to it, the SEC adopted Rule 10b-5 on May 21, 1942.[26] The new rule purported to close a "loophole in the protections against fraud *administered by the Commission* by prohibiting individuals or companies from *buying* securities if they engage in fraud in their *purchase*."[27] In a recent decision the Commission stated: "These anti-fraud provisions [10b-5] are not intended as a specification of particular acts of practices which constitute fraud, but rather are designed to encompass the

21. S. REP. No. 47, 73d Cong., 1st Sess. 6-7 (1933).

22. *Id.* at 2.

23. 2 CCH FED. SEC. L. REP. ¶ 15,051.

24. H.R. REP. No. 1383, 73d Cong., 2d Sess. 10 (1934).

25. S. REP. No. 792, 73d Cong., 2d Sess. 18 (1934). For a more complete discussion of the legislative history, see Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. U.L. REV. 627, 642-58 (1963).

26. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1968) provides: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

27. SEC Securities Exch. Act Release No. 3230 (May 21, 1942) (emphasis added).

infinite variety of devices by which undue advantage may be taken of investors and others."[28]

With this scant background and with no provision for civil liability, the courts and the SEC have made Rule 10b-5 a powerful weapon against fraudulent practices in securities transactions and have used it as the foundation on which to build an emerging body of federal corporate law.[29]

B. Liability of "Insiders"

1. *Definition of "Insiders."*—Although both the statute and the rule make it unlawful for "any person" to engage in the proscribed practices, the provision has been applied most frequently to corporate "insiders."[30] The courts and the SEC recognized the inequities of allowing those closely connected with a corporation to buy and sell stock in their company on the basis of information which was unavailable to the public. A major problem, however, in protecting against improper actions by insiders is that there is no precise delineation of those to be included in this category. Section 16(a) of the 1934 Act, which was directed against "short-swing" profits by insiders, extends its coverage to "[e]very person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security . . . or who is a director or an officer."[31] In addition to the classes of investors covered by section 16(a), Professor Loss suggests that the coverage should be extended to members of those persons' immediate families, their "tippees" who knew or should reasonably have inferred that the tip was a "breach of trust," a person who picks up information in the course of business negotiations with a corporation as long as that information remains private, and brokers who trade for insiders and who have knowledge of inside information.[32] Despite the suggestion that "tippees" should also be liable, this premise had found little or no support in the case law prior to the district court opinion in *Texas Gulf Sulphur*.

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28. Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961).

29. See text accompanying notes 67-71 *infra*.

30. *See* 3 L. Loss, SECURITIES REGULATION 1445-74 (2d ed. 1961) [hereinafter cited as Loss].

31. 15 U.S.C. § 78p(a) (1964).

32. Loss, *supra* note 30, at 1451-52. *See also* Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*. 51 VA. L. REV. 1271 (1965).

Chairman Cary of the SEC stated the Commission's views on insiders in the 1961 decision against Cady, Roberts & Co. Mr. Cary there said that the definition of an "insider" rests on two principal elements:

> the existence of a relationship giving access to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. . . . [O]ur task here is to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities. Intimacy demands restraint lest the uninformed be exploited.[33]

Although it had been suggested previously that the definition should include any employee who had knowledge of undisclosed corporate information,[34] the opinion of the district court in the *Texas Gulf Sulphur* case was the first court to so hold.

In upholding the district court's statement of the law on who is an insider, the Second Circuit stated that Rule 10b-5 applies to one possessing the requisite information even if he does not come within the specific terms of Section 16(b) of the Exchange Act. Accordingly, the court affirmed the liability of employees who were apprised of the drilling results when they traded TGS stock. The court also affirmed the SEC's determination in *Cady, Roberts* and held that "anyone in possession of material inside information" must either disclose such information or abstain from trading in or recommending the securities of the company.[35] Although the question of the liability of "tippees" was not squarely presented, since the SEC chose to proceed against the insiders who gave the tips and not against the "tippees" themselves, the court in dictum said that if "tippees" "acted with actual or constructive knowledge that the material information was undisclosed, their conduct . . . could be equally reprehensible."[36]

2. *Type of Conduct Prohibited.*—Since the first decision which

33. Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961).

34. Fleischer, *supra* note 32.

35. 401 F.2d at 848.

36. *Id.* at 853. In Kuehnert v. Texstar Corp., 286 F. Supp. 340 (S.D. Tex. 1968), a "tippee" was held to be in pari delicto with the source of his tip and thereby precluded from recovering from him in a 10b-5 suit. Although civil liability under 10b-5 exists only by judicial implication, the public interest might be better served by cutting off illicit tips at their source, and one method of realizing this objective would be the disallowance of the in pari delicto defense in a suit by a tippee. It does seem unconscionable, however, to allow a tippee who voluntarily took advantage of a breach of trust by an insider to recover his loss from the source of his information. *But cf.* Perma Life Mufflers, Inc. v. International Parts Corp., 392 U.S. 134 (1968).

implied a civil remedy under Rule 10b-5,[37] the courts have struggled with the question of which elements a plaintiff should be required to prove in such an action. This problem became even more difficult when the implied private remedy under Rule 10b-5 was extended to buyers of securities, in spite of the express congressional provisions for buyers' remedies under section 11 and section 12 of the 1933 Act. In *Fischman v. Raytheon Manufacturing Co.*, the Second Circuit held that "when, to conduct actionable under § 11 of the 1933 Act, there is added the ingredient of fraud, then that conduct becomes actionable under § 10(b) of the 1934 Act and the Rule . . . ."[38] Because of the language used in the Rule, most early decisions required some proof of the elements of common law fraud—either proof of some form of scienter, knowledge on the part of the defendant, or some "semblance of privity"—in order to find liability,[39] but there has been a growing trend toward liability where there is no proof of scienter or intent.[40] Although some writers still contend that proof of scienter should be necessary for relief under Rule 10b-5,[41] they urge a more modern definition of the terms which would vary according to the circumstances surrounding each defendant's activities and which would include negligent conduct when, as in the case of an insider, there is a duty to disclose.[42] The requirements for a private action are relaxed somewhat in an enforcement proceeding, so that less proof is required in an action by the Commission for injunctive relief than in a private action.[43]

The court in *Texas Gulf Sulphur* held that whether the

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37. Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946), subsequent opinions, 73 F. Supp. 798 (1947) (accounting granted); 83 F. Supp. 613 (1947) (additional conclusions of law).

38. 188 F.2d 783, 786-87 (2d Cir. 1951).

39. Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.) (privity), *cert. denied*, 343 U.S. 956 (1952); Trussell v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Colo. 1964); Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701, 706 (S.D.N.Y. 1951), *aff'd*, 198 F.2d 883 (2d Cir. 1952) (scienter); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946) (both privity and scienter present). For a more complete discussion on the demise of privity, see text accompanying notes 75-95 *infra*.

40. SEC v. Van Horn, 371 F.2d 181 (7th Cir. 1966) (§ 17 of 1933 Act); Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965); Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Hendricks v. Flato Realty Invs., [Current] CCH FED. SEC. L. REP. ¶ 92,290 (D.C. Tex. 1968); Dack v. Shanman, 227 F. Supp. 26 (S.D.N.Y. 1964). *See generally* Comment, *Negligent Misrepresentation Under Rule 10b-5*, 32 U. CHI. L. REV. 824 (1965).

41. Note, *Proof of Scienter Necessary in Private Suit Under SEC Anti-Fraud Rule 10b-5*, 63 MICH. L. REV. 1070 (1965).

42. *Id.* at 1080.

43. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

proceeding were treated as an SEC enforcement proceeding or as a private action,[44] "proof of a specific intent to defraud is unnecessary,"[45] since the broader interpretation would better effectuate the remedial purpose of the Act. The court also said that the traditional requirement of scienter might be defined as lack of diligence, constructive fraud, or unreasonable or negligent conduct. Therefore, the court concluded that the only defense available to the insider who sells or purchases securities while in possession of undisclosed material information is the reasonable belief that the information had been disclosed when his trade took place. The court found that none of the defendants could carry this burden, since neither Crawford nor Clayton could reasonably have believed that the information had been disseminated when they traded and all others had clearly traded before any attempt at disclosure was made.

C. *The Definition of "Materiality"*

One element that has consistently been required for liability of insiders under Rule 10b-5 is that the information which they possess be "material."[46] The only definition of this term which is given in the official rules and regulations of the securities laws is found in Rule 405 of Regulation C under the Securities Act of 1933. This Rule defines "material" as "those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security . . . ."[47] In Rule 10b-5 cases, the courts have applied a variety of tests in determining whether a fact was material. Information has been found to be material when it "would materially affect the judgment of the other party to the transaction,"[48] when "in reasonable and objective contemplation [it] might affect the value of the corporation's stock"[49] and when it would affect the investor's

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44. The complaint, brought by the SEC pursuant to §21(e) of the Exchange Act, sought both an injunction against TGS and the individual defendants and rescission of the transactions which were allegedly in violation of the law.

45. 401 F.2d at 854.

46. Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963); List v. Fashion Park, Inc., 227 F. Supp. 906 (S.D.N.Y. 1964), *aff'd*, 340 F.2d 457 (2d Cir. 1965), *cert. denied*, 382 U.S. 811 (1965); Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951), *reaff'd on later motions*, 100 F. Supp. 461 (1951), 103 F. Supp. 47 (1952).

47. 17 C.F.R. § 230.405(*l*) (1968).

48. List v. Fashion Park, Inc., 227 F. Supp. 906 (S.D.N.Y. 1964).

49. List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir. 1965); Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951).

decision on whether to sell or buy.[50] The *Restatement of Torts* definition of materiality, whether "a reasonable man would attach importance [to the fact not disclosed] in determinining his choice of action in the transaction in question,"[51] has been adopted by several courts.[52] In all of these tests the information must be essentially extraordinary in nature. Another test which has been suggested is that information is material if it clearly places the insider in a position superior to that of the average investor and protects him from normal market risks.[53] In the *Cady, Roberts* decision, the SEC applied the test of whether the information would affect the outsider's investment judgment, but also looked to the actions of the insider in trading immediately upon receipt of the information as evidence of its materiality.[54]

Recognizing that an insider is not obligated to disclose educated guesses based on his superior financial or other expert analysis, the Second Circuit in *Texas Gulf Sulphur* held that an insider must disclose only material "basic facts," leaving outsiders to use their own powers of evaluation. The test of materiality applied by the court was " 'whether a *reasonable* man would attach importance . . . in determining his choice of action in the transaction in question.' "[55] However, the court held that a "reasonable man" includes not only the conservative investor but also the speculator and the chartist, so that information which might affect the desire of investors to buy, sell, or hold the securities would include facts which affect the probable future of the company as well as those facts concerning earnings and distributions. The court stated that the materiality of a fact depends upon a balancing of the "indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity."[56] The court also accepted the contentions of the SEC and held that the importance attached to a fact by those who knew about it constitutes "highly pertinent evidence and the only truly objective evidence of the materiality . . . ."[57]

50. Escott v. BarChris Construction Corp., 283 F. Supp. 643, 681 (S.D.N.Y. 1968); List v. Fashion Park, Inc., 227 F. Supp. 906 (S.D.N.Y. 1964). *See also* 3 Loss, *supra* note 30, at 1461.

51. RESTATEMENT OF TORTS § 538(2)(a) (1938).

52. *See, e.g.*, List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir. 1965).

53. Fleischer, *supra* note 32, at 1290.

54. 40 S.E.C. at 911-12.

55. 401 F.2d at 849, *quoting* List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965).

56. 401 F.2d at 849.

57. *Id.* at 851.

Applying these standards, the court held that the trial court had erred in finding that the drilling results were not material until 7:00 P.M. on April 9 and found that knowledge of the "visual" results of K-55-1 constituted material information so that all transactions made by those apprised of such results were made in violation of Rule 10b-5. The court found that defendant Dorke, who was in possession of such facts and who tipped others, also violated the Rule. In addition, the court concluded that Huntington, who knew only about the land acquisition program, had a "readily inferable and probably reliable" understanding of the Kidd operations and therefore possessed material information so as to make his purchases in violation of the Rule.[58]

D. *When Insiders May Trade*

Prior to the lower court opinion in *Texas Gulf Sulphur*, the problem of how long insiders must wait after disclosure before trading had not been considered by a court. If insiders are required to abstain from trading until disclosure is made by the company, the question must be answered as to when insiders may trade after a public announcement has been made. In the trial of the *Texas Gulf Sulphur* case, the Commission contended that insiders must wait until the information is "absorbed" by the public.[59] Former Chairman Cary reiterated this view in a symposium held on November 22, 1965,[60] and Arthur Fleischer, Jr., Cary's former executive assistant, suggested that insiders should wait for an arbitrary period of 24 hours.[61] The district court opinion in the instant case held that insiders could trade as soon as the information was made public and found that defendant Coates did not violate Rule 10b-5 by leaving the press conference on April 16 and trading at 10:20 A.M., since the announcement had been made at that time.[62] This holding has been criticized as allowing insiders too much freedom to take advantage of their early knowledge of developments, and it has been suggested that insiders should wait until the news appears on the "broad tape."[63]

58. Judge Moore, dissenting, felt that the majority had incorrectly substituted their findings of fact for those of the trial court and had ignored both the testimony of the experts and the company's other developments. Quoting the Commission's own standards in regard to "proven ore," he concluded that there was not enough evidence to support the majority's finding that knowledge of the results of the first hole was material information and therefore that the district court's findings should be affirmed. *Id.* at 870-89.

59. 258 F. Supp. at 267, 289.

60. Cary, *Symposium—Insider Trading in Stocks*, 21 BUS. LAW. 1009, 1015 (1966).

61. Fleischer, *supra* note 32, at 1291.

62. 258 F. Supp. at 289.

63. 80 HARV. L. REV. 468 (1966).

Although the circuit court failed to set any definite standards for the timing of insider trading after disclosure, it held that before insiders may act, the information must have been "effectively disclosed in a manner sufficient to insure its availability to the investing public."[64] The court emphasized that where a formal announcement has been promised in a prior official release, insider activity must await dissemination of the promised official release. The court held that at the minimum, even where the contents of the release could be instantaneously acted upon, an insider must wait until the news could reasonably be expected to have appeared over the Dow Jones broad tape, the media of widest circulation. The court also indicated that when the news is of a sort which could not be readily translatable by investors, insiders cannot "take advantage of their advance opportunity to evaluate the information by acting immediately upon dissemination."[65] Accordingly the court found that Coates had acted before dissemination and reversed the district court finding that he had not violated Rule 10b-5.[66]

E. Purchase of Stock Options

One of the most recent trends in the cases brought under Rule 10b-5 has been the development of a federal corporate law whereby stockholders can sue derivatively to enforce the fiduciary duties owed by officers and directors to their corporation.[67] There was some initial objection to sustaining such suits when the plaintiff stockholders had neither bought nor sold securities,[68] but this objection has been ignored by subsequent decisions.[69] Fleischer has suggested that Rule

64. 401 F.2d at 854.

65. *Id.* n.18.

66. The district court also found that defendant Lamont, who had traded at 10:41 A.M. after the press release, had not violated the Rule. Since Lamont died while the case was pending appeal, the action was dropped as to him, and the Second Circuit did not have the opportunity of deciding whether or not his trade was also too soon after the announcement.

67. McClure v. Borne Chem. Co., 292 F.2d 824 (3d Cir. 1961); *see, e.g.*, deHaas v. Empire Petroleum Co., 286 F. Supp. 809 (D. Colo. 1968). *See generally* Fleischer, *"Federal Corporate Law": An Assessment*, 78 HARV. L. REV. 1146 (1965). *Contra*, Ruder, *Pitfalls in the Development of a Federal Law of Corporations Through Rule 10b-5*, 59 NW. U.L. REV. 185 (1964).

68. O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964); Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

69. Mader v. Armel, 402 F.2d 158 (6th Cir. 1968) (merger); Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540 (2d Cir. 1967) (tender offer); Symington Wayne Corp. v. Dresser Indus., Inc., 383 F.2d 840 (2d Cir. 1967) (tender offer); A.T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967); Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir. 1967). *See generally* Lowenfels, *supra* note 1.

10b-5 should cover the situation where an insider causes an uninformed majority of the board of directors to issue options to him without disclosing the information known to him.[70] In *Ruckle v. Roto American Corp.*,[71] the Second Circuit held that even a majority of the directors can defraud the corporation where they approved the issuance of shares of stock to a third party without disclosing material information which would have made such issuance unwise. The district court held in the *Texas Gulf Sulphur* case that Stephens and Fogarty (the president and executive vice-president of the company) were top management officers and therefore would have violated Rule 10b-5 by failing to disclose the information which they possessed before accepting the options issued to them if such information had been material.[72]

The Second Circuit affirmed the district court's position that a member of top management, before accepting a stock option, must disclose material inside information to the Stock Option Committee. Since the appellate court had determined that the information possessed by the defendants was material at the time that the options were accepted, it found that they had violated the Rule and remanded for a determination of whether injunctions should issue against Stephens and Fogarty.[73] The court also found that Kline, as secretary of the company, was a member of top management and directed rescission of his option.[74]

F. The Corporate Press Release and the "In Connection With" Clause

Both section 10(b) and Rule 10b-5 require that the proscribed conduct be "in connection with the purchase or sale of any security." Early decisions under the Rule interpreted this requirement to be equivalent to some form of common law contractual privity,[75] but this requirement has been substantially eroded by later decisions. In

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70. Fleischer, *supra* note 32, at 1301-03.

71. 339 F.2d 24 (2d Cir. 1964). *See also* Weitzer v. Kearns, 271 F. Supp. 616 (S.D.N.Y. 1967); New Park Mining Co. v. Cranmer, 225 F. Supp. 261 (S.D.N.Y. 1963).

72. 258 F. Supp. at 292.

73. These defendants had already surrendered their options.

74. In a discussion at 401 F.2d at 857 n.24, the court recognized that when corporate purposes are best served by not requiring insiders to make information known to the Option Committee, it might be better to require merely that the insiders abstain from exercising the options rather than from accepting them. Since the suggestion was not presented, the court made no determination on the issue.

75. Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946); Ward La France Truck Corp., 13 S.E.C. 373 (1943).

Joseph v. Farnsworth Radio and Television Corp., the plaintiffs had bought securities some thirteen days after the defendants had sold, and recovery was denied because "[a] semblance of privity between the vendor and purchaser of the security in connection with the improper act, practice or course of business was involved seems to be requisite and it is entirely lacking here."[76] Some relaxation of the requirement of privity was found in *Fischman v. Raytheon Manufacturing Co.*,[77] where the plaintiffs were held to have stated a cause of action when they allegedly purchased preferred stock in the defendant corporation in reliance on misleading statements in a registration statement for common shares. Although the *Farnsworth* case was affirmed the next year by the same court, Judge Frank's dissent hastened the demise of the privity doctrine by calling for a replacement of that requirment by proof of the plaintiff's reliance on the misrepresentation and proof of foreseeability on the part of the defendant that the class of people including the plaintiff might be injured.[78] Although some courts still require a "semblance of privity,"[79] the trend is toward a complete abandonment of the concept[80] because of the desire to eliminate the technical restrictions of the common law and to interpret the securities act as broadly as possible in order to "effectuate [their] remedial purposes."[81] Consequently, most courts do not now limit a Rule 10b-5 action to a suit against the other party to the transaction, but allow recovery against a third person "if in connection with the purchase or sale [by the plaintiff] that person defrauded [the plaintiff]."[82] Some courts have even eliminated the requirement that the plaintiff be a purchaser or seller.[83]

As a result of the gradual liberalization in interpreting the "in

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76. 99 F. Supp. 701, 706 (S.D.N.Y. 1951), *aff'd*, 198 F.2d 883 (2d Cir. 1952).

77. 188 F.2d 783 (2d Cir. 1951).

78. 198 F.2d 883 (2d Cir. 1952) (Frank, J. dissenting). *See also* Ruder, *supra* note 25, at 673-74.

79. Meisel v. North Jersey Trust Co., 218 F. Supp. 274 (S.D.N.Y. 1963).

80. Miller v. Bargain City, U.S.A., Inc., 229 F. Supp. 33 (E.D. Pa. 1964); Freed v. Szabo Food Serv., Inc., [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,317 (N.D. Ill. 1964); Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962); *see* Note, *Civil Liability Under Section 10B and Rule 10B-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658 (1965).

81. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963).

82. New Park Mining Co. v. Cranmer, 225 F. Supp. 261, 266 (S.D.N.Y. 1963). *See also* Rustic V. Werblin, [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,637 (S.D.N.Y. 1966).

83. *See* cases cited note 69 *supra*. *Contra*, Entel v. Allen, 270 F. Supp. 60 (S.D.N.Y. 1967).

connection with" clause, the present state of the law has been summarized by one leading writer thusly:

> [The] impact [of 10b-5] apparently extends to persons, such as issuers, who are not engaged in any buying or selling of securities but who violate the rule's prohibition in such manner as to injure someone who is a buyer or seller, and perhaps to officers and directors simply owing fiduciary duties to their corporations if a purchase or sale of securities is somehow involved.[84]

Although corporations who neither purchased nor sold have been held liable, the courts have generally required the additional element that the defendant's conduct be intentional or economically motivated.[85] Corporations have been held liable when they participated in a common scheme to defraud the plaintiffs through their officers and directors;[86] where they made conscious attempts to affect the market price of their stock—either to depress the price in contemplation of a merger[87] to to inflate the price during a selling effort;[88] and where officers and directors in control caused the issuance of misleading statements while trading in the corporation's stock for personal profit.[89]

The Second Circuit has apparently reached the broadest possible interpretation of the "in connection with" clause. This court granted injunctive relief but denied recovery of damages when plaintiffs had purchased shares in a company in reliance on an allegedly misleading tender offer made by defendant to third parties.[90] In *A. T. Brod & Co. v. Perlow*, the Second Circuit stated that Rule 10b-5 prohibits "*all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud or present a unique form of deception."[91] In that case a complaint was held to state a cause of action when the plaintiff, a broker, had bought securities *for the defendant*, who, it was alleged,

84. Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340, 1365 (1966).

85. *See* Note, *supra* note 80, at 686-87. *See also* Fleischer, *supra* note 67, at 1157-58.

86. Texas Continental Life Ins. Co. v. Bankers Bond Co., 187 F. Supp. 14 (W.D. Ky. 1960); Thiele v. Shields, 131 F. Supp. 416 (S.D.N.Y. 1955).

87. Puharich v. Borders Electronics Co., [Current] CCH FED. SEC. L. REP. ¶ 92,141 (S.D.N.Y. 1968); Freed v. Szabo Food Serv., Inc., [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,317 (N.D. Ill. 1964). *But see* Heit v. Weitzen, 260 F. Supp. 598 (S.D.N.Y. 1966) (appeal pending); Howard v. Levine, 262 F. Supp. 643 (S.D.N.Y. 1965).

88. SEC v. North Am. Research & Dev. Corp., 280 F. Supp. 106 (S.D.N.Y. 1968).

89. Gann v. Bernzomatic Corp., 262 F. Supp. 301 (S.D.N.Y. 1966); *see* Halleran, *Symposium Insider Trading in Stocks*, 21 BUS. LAW 1009, 1025 (1966).

90. Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540 (2d Cir. 1967).

91. 375 F.2d 393, 397 (2d Cir. 1967).

refused to pay unless the value increased. A complaint in the Southern District of New York was held to state a cause of action when an escrow agent had wrongfully sold shares of stock pledged as security for a loan to finance their purchase. The court stated that Rule 10b-5 is "not limited to the portion of the transaction involving an exchange of consideration . . . ."[92] In *Vine v. Beneficial Finance Co.*,[93] the plaintiffs were held to have stated a cause of action even though they had not purchased or sold, since others in the class to which they belonged had sold in reliance on the alleged scheme.

Despite these developments, the district court in the *Texas Gulf Sulphur* case held that the "in connection with" requirement would be satisfied only if the purpose of the misleading statement is "to affect the market price of a company's stock to the advantage of the company or its insiders."[94] The court found that "[t]here is no evidence that TGS derived any direct benefit from the issuance of the press release or that any of the defendants who participated in its preparation used it to their personal advantage."[95] Therefore the court held that there was no violation of section 10(b) or Rule 10b-5 by the press release, since it was not issued "in connection with the purchase or sale of any security."

After reviewing the history of section 10(b) and Rule 10b-5, the Second Circuit concluded in *Texas Gulf Sulphur* that the phrase "in connection with the purchase or sale of any security" was intended to mean only that the device employed be of a sort that would cause reasonable investors to rely thereon and, so relying, purchase or sell a corporation's securities. The court did not require that the corporation or persons responsible for the statement engage in related transactions or act with wrongful motives to benefit the corporation or themselves at the expense of the investing public.[96] The court also reasoned that the public may be injured as much by a misleading statement caused by negligence as by one published intentionally and that to require proof of wrongful purpose might permit issuers of misleading statements "to seek an advantage but to escape liability if the advantage fails to materialize to the degree contemplated, or

92. Cooper v. North Jersey Trust Co., 226 F. Supp. 972, 978 (S.D.N.Y. 1964).

93. 374 F.2d 627 (2d Cir. 1967).

94. 258 F. Supp. at 293.

95. *Id.* at 294.

96. This part of the holding has been followed in Sprayregen v. Livingston Oil Co., [Current] CCH FED. SEC. L. REP. ¶ 92,272 (S.D.N.Y. Sept. 25, 1968), and Waltman v. Silverman, 66 Civ. 1182 (S.D.N.Y. Sept. 25, 1968).

cannot be demonstrated."[97] The court felt that the Commission has the duty to police management in order to protect investors, and therefore that it is not unfair to impose a duty on corporate management to ascertain the truth of statements in releases to shareholders or to the investing public. Finally, the court held that Rule 10b-5 is violated "whenever assertions are made . . . in a manner reasonably calculated to influence the investing public . . . if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes."[98] As a defense, the corporate management must demonstrate that it was diligent in ascertaining that the statements were the whole truth and that such information was disseminated in good faith. Since the only relief sought by the Commission against the corporation was an injunction, the court found it unnecessary to decide whether mere lack of due diligence, absent a showing of bad faith, would be sufficient to subject the corporation to civil liability and held only that in an action for injunctive relief, the injunction could issue if the misleading statement resulted from a lack of due diligence. The court remanded for a determination by the trial court as to whether the release was misleading and if so, whether due diligence was exercised.[99]

In a lengthly dissenting opinion, Judge Moore, joined by Chief Judge Lumbard, disagreed with the majority's broad interpretation of the "in connection with" clause and stated that such an interpretation was "unwarranted as a matter of statutory construction and unwise as a matter of policy."[100] The dissenters felt that the statute requires a much closer connection between the conduct complained of and the transaction than that which the majority would allow. They also felt that the majority interpretation might have the effect of deterring the dissemination of corporate news, despite the strong policy of securities legislation to encourage disclosure. The dissenting judges emphasized the findings of the trial court that the release was not misleading and found that "if the facts and conclusions presented were accurate (as they were) and if they were not presented in a manner that would mislead a reasonable investor (which they were not) then there can be no violation of 10b-5."[101] The dissent concluded that TGS was not negligent and that there should be no remand on this issue.

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97. 401 F.2d at 861.

98. *Id.* at 862.

99. The majority indicated that it felt that due diligence had not been exercised in the preparation of the release. *Id.* at 864.

100. *Id.* at 884.

101. *Id.* at 880.

IV. IMPLICATIONS OF THE TGS HOLDINGS

A. *Liability of Insiders*

The holding in *Texas Gulf Sulphur* did not really change the basic definition of "insiders," since the court chose to apply the language used by the Commission in *Cady, Roberts*. The significant part of the holding was the clear extension of the definition of insiders to include employees who were in possession of material, undisclosed information and the application of Rule 10b-5 to the practice of "tipping" by insiders. Although the issue was not actually presented, the court also indicated that "tippees" should also be liable for their trades. The investment community has expressed deep concern over the possibility that this language may extend to brokers and analysts and thereby impose serious restrictions on the conduct of their business.[102] It is quite probable that the definition of insiders would apply to brokers who were "tipped" by insiders about undisclosed corporate developments, and indeed such a situation should be covered by Rule 10b-5 because of the inherent unfairness of allowing one broker to use undisclosed information for the benefit of his own customers at the expense of the uninformed public. There is no reason, however, why legitimate investment analysis should not be able to continue uninterrupted. The court expressly permits trading, even by insiders, which is based on financial or other expert analysis of "basic facts" which are generally available. Therefore advice which is based on expert analysis of past performance, industry trends, and company forecasts would clearly be permissible. The only time that an analyst would be precluded from trading or advising his clients would be when some material, undisclosed fact were uncovered in the course of a general study of the company in question; in this case the analyst would undoubtedly be under an obligation to make the information public or to refrain from trading or advising others to buy on the basis of his discovery.[103]

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102. Green, *SEC Sees Court Rulings on 'Insider' Trading Changing Brokers Method of Operations*, Wall Street Journal, Sept. 3, 1968, at 24, col. 1.

103. *See In re* Merrill, Lynch, Pierce, Fenner & Smith, Inc., SEC Administrative Proceeding File No. 3-1680, [Current] CCH FED. SEC. L. REP. ¶ 77,596 (Aug. 26, 1968). In a panel interview at the Fall Conference of the Financial Analysts Federation, Mr. Phillip A. Loomis, General Counsel for the SEC, "warned that an analyst who, in the course of his duties with a corporation, fortuitously receives inside information, might well be advised to arrange for the release of the information before using it for his own benefit or that of his clients." [Current] CCH FED. SEC. L. REP. ¶ 77,624 (Oct. 7, 1968). This same warning should apply to information discovered during an investigation as well.

Where "tippees" receive their information directly from corporate officers or directors, there should certainly be no doubt that the same obligations imposed on insiders should be imposed on them. The harder cases are those where the tip is accidental or is received indirectly. In such circumstances, the duty imposed on the "tippee" should depend on the facts of each case, but a court should consider such factors as: how the information was obtained, from whom it was obtained, how reliable the information or the source was, what the nature of the information was, what degree of financial sophistication the "tippee" possessed and whether he reasonably believed the information had already been made public.[104]

The Second Circuit has continued to follow the trend of relaxing the requirements of proof to find liability of insiders who purchased or sold. The court held in *Texas Gulf Sulphur* that the plaintiff need not prove any intent on the part of the defendant and that there will be liability so long as the insider purchased or sold while in possession of material, undisclosed information. Since the policy of Rule 10b-5 is to prevent insiders from taking advantage of their position at the expense of the public, no proof of intent should be required. The plaintiff who is injured should only be required to prove that the insider purchased or sold and that he possessed material information at the time; the mere fact that the insider purchased or sold should be conclusive evidence that he intended to take advantage of his information. The court held defendant Huntington liable because his possession of information was "readily inferable." If proof of intent is not required, it seems that a plaintiff in a civil action should have to prove that the insider *actually* possessed the information. To hold insiders liable when their knowledge is only inferable might tend to preclude even legitimate trading by insiders; it should not be the policy of Rule 10b-5 to discourage all insider trading, but only that trading which is actually based on undisclosed information.

B. Definition of Materiality

Although the *Texas Gulf Sulphur* opinion adheres to the same basic test of "materiality" which has been followed by other courts, the court did expand the meaning somewhat by defining a "reasonable investor" to include the "speculators and chartists of Wall and Bay Streets."[105] The type of information which might affect

104. *See* Kennedy & Wander, *supra* note 1, at 1065.

105. 401 F.2d at 849.

the Wall Street speculator's decision to buy or sell might be much less extraordinary in nature from that which would affect the normal, small investor. It seems, however, that in defining materiality the court still contemplates information about the extraordinary situation which is "reasonably certain to have a substantial effect on the market price of the security . . . ."[106] The court added the consideration of balancing the indicated probability that the event will occur and its anticipated magnitude in light of the company's other activities. What may be material in connection with a small company may be insignificant in a large one and this test realistically approaches such a possibility. When the size of TGS[107] and the other activities in which it was engaged at the time K-55-1 was drilled[108] are considered, the court may be found to have misapplied its own standard. The indicated probability that a large mine will be found to exist on the basis of one encouraging drill hole is very small indeed.[109]

The court seemed to place its primary emphasis in determining materiality on the insiders' own purchases. When insiders such as the defendants in *Texas Gulf Sulphur* buy large amounts of stock on the basis of certain information and when they previously had owned only a small number of shares, such purchases must be regarded as highly pertinent evidence of the materiality of the information to those who knew about it. Such evidence should never be conclusive on the issue of materiality; however, since it tends to ignore other developments within the company which may have had a bearing on the insiders' purchases. Also, while the insider activity indicates the significance which they attached to the information, their reliance may be based on some technical understanding not possessed by the ordinary investor; too much weight placed on such evidence may unreasonably penalize the insider. However, since it is unfair to allow insiders to purchase stock on the basis of information which indicates that there may be a significant development and to sell with no loss if such development does not materialize, insider purchases should definitely be considered on the issue of materiality in order to balance the risks of all investors.

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106. Fleischer, *supra* note 32, at 1289. Mr. Loomis, in his interview, *supra* note 103, interpreted "material" to mean information which would have "substantial" impact on the securities price.

107. TGS's total assets less current liabilities had a book value of over $169,000,000 as of December 31, 1963. Its annual sales were in excess of $62,000,000 for 1963. 258 F. Supp. at 268.

108. See note 13 *supra*.

109. 401 F.2d at 872.

C. The Timing of Insider Trading

Although the court set no definite standards as to when insiders could trade after disclosure had been made, it did hold that they must wait until the information is effectively disclosed in a manner to insure availability and that when a prior release has promised complete disclosure, insiders must await dissemination of the later announcement. The court indicated that insiders should not be able to act immediately after disclosure on the basis of their opportunity to evaluate the information before public disclosure. The clearest result of *Texas Gulf Sulphur* is that an insider cannot trade immediately after a release has been read to the press when he has had the prior opportunity to evaluate the information.

The court expressed a desire that the SEC use its rulemaking power to establish some standards for timing of insider trading. The SEC seems to feel that insiders must wait until the information is absorbed by the public; the problem, however, is in setting a definite waiting period which, while meeting that objective, allows some certainty. Fleischer has suggested that insiders be required to wait some arbitrary period, such as 24 hours.[110] The biggest drawback to this approach is that some types of information require more time to be analyzed and understood than others. If the prohibition against insider trading is to be effective, the delay must be sufficient to allow the public to be meaningfully informed; on the other hand, however, the objective is to put insiders and outsiders on an equal footing—not to put the insiders at a disadvantage. The interests of the investing public can best be served by encouraging corporate officers and management to participate in the fortunes of their company by sharing in its ownership, but unless definite guidelines as to when they can trade are formulated, the present uncertainties will discourage such participation.[111] The competing interests must be balanced against one another, and perhaps the most equitable result can be achieved by guidelines which vary the length of the delay according to the nature of the disclosure. For example, a short waiting period would be required when an increase in dividends was announced, but a longer period would be necessary when a development was announced which did not indicate an immediately apparent benefit to the company.

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110. Fleischer, *supra* note 32, at 1291.

111. *See* Wall Street Journal, August 16, 1968, at 1, col. 6.

D. The Stock Options

Now that a shareholder can utilize Rule 10b-5 to enforce corporate fiduciary duties, a new body of federal corporate law with Rule 10b-5 as its basis has developed.[112] Although it seems that the enforcement of corporate duties should be left to state law,[113] derivative recovery probably should be allowed under 10b-5 where the officer or insider has defrauded the company by causing the issuance of stock or options to him.[114] Despite the advisability of allowing a shareholder to recover where an insider has defrauded his own company, it does not seem appropriate to allow the SEC to become the watchdog of corporate fiduciary standards. When an insider defrauds his corporation, the recovery should belong to the corporation or its shareholders and should not be enforced by a federal regulatory agency.

The purpose of stock options is to provide an additional incentive by allowing management to share in the increases in the stock prices. As the Second Circuit correctly stated, benefits derived at the expense of the uninformed public are not the appropriate form of management incentive: top management which controls the flow of information both within and without the corporation should not be able to take advantage of options when in possession of undisclosed information. Employees who have fully reported to their superiors, however, should not be so restricted. Once members of top management have been apprised of material developments by lower echelon employees, it should be the superior's duty to give the option committee such information; if the corporate purpose is best served by restricting dissemination of the information, the employees who have fulfilled their obligation should be able to accept their options without fear of reprisal. Perhaps the most equitable result can be reached in the case of top management by application of the suggestion of the court in *Texas Gulf Sulphur* that where corporate security must be preserved, insiders should not be required to reject their options but only to abstain from exercising them until full disclosure has been made.

E. The Corporate Press Release

The Second Circuit remanded the case for a determination of whether the April 12th press release was misleading, and if so,

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112. See text accompanying notes 67-71 *supra*.

113. *See, e.g.*, Note, *supra* note 80, at 681.

114. *Cf.* Fleischer, *supra* note 67, at 1163; Lowenfels, *supra* note 1, at 277.

whether it resulted from a lack of due diligence on the part of those who prepared it. In such a situation, when some new discovery is developing rapidly, the corporation is placed in a dilemma. If it speaks too soon and is too optimistic in its reporting, it may be liable to those who bought in reliance on such report if the development proves to be unsuccessful. If the company waits too long, in an attempt to get more definite results, it may find itself liable for failing to disclose the developments. Although the courts have consistently refused to interfere with the business judgment of corporate officers, the decision of when to make corporate announcements must be made with reference to the investing public and the duty to keep them informed. The courts should be hesitant to impose liability on a corporation for a voluntary statement which is accurate and which is made in an honest effort to dispel rumors, even though it may appear to be unduly pessimistic. In judging such a statement, the courts must not consider the issue with the advantage of hindsight, but must examine the statement in light of the circumstances which then existed. When, as in *Texas Gulf Sulphur,* there is such varied testimony upon the interpretation given a release by the public, the errors should be quite clear before the court finds it misleading.

If there was a mistake by the TGS officers, it was probably in purporting to represent the facts as of the date of the release without actually having obtained current reports. Considering the rapidity with which results were becoming known with three drilling rigs in operation, some attempt should have been made to keep the reported information eurrent. Perhaps the release should have made a more specific statement of the basic facts, as suggested by the court, but a comprehensive report of detailed drilling data might have confused the public. It does seem, however, that at least a simplified report of the current findings should have been given.

The most far-reaching holding of the court was that concerning the "in connection with" clause and the possible liability of the company. Since the basic policy of the federal securities acts is disclosure, the courts should not hinder that objective. Voluntary corporate press releases are probably the most valuable source of information for investors, but if the requirements are made so strict that these releases must read like prospectuses, the result may be a serious curtailment of the flow of corporate information.[115]

Despite the interest in the availability of corporate information,

115. *See* Fleischer, *supra* note 32, at 1294.

there must be some assurance that these reports be accurate. The public may be injured as much by a report that is misleading through negligence as by one that is intentionally misleading, but the remedial sanctions for negligent conduct should not be as severe as those for the intentional conduct. Where intentional deception is used to further some ulterior corporate purpose, the object of granting civil liability should be the restoration of damages to the injured public, as well as the imposition of punitive sanctions to discourage such activity; where a release is merely negligently misleading, the objective of any proceedings against the company should not be punitive. Although an investor may be damaged to some degree by a negligent release, he may ultimately suffer even greater harm if restrictions on voluntary releases are so severe as to discourage their use.[116] When a corporation is held civilly liable, the loss falls on its shareholders. Placing such a burden on the corporation for mere negligence in reporting where there is no ulterior motive seems to be unadvisable.

The public interest in assuring accurate reporting can be served best by the use of the SEC's injunctive powers. Such a remedy would be consistent with the SEC's duty of policing corporate reporting, yet would not unduly penalize the corporation. The burden should be on the complainant to prove that the questioned release was misleading, and the defendant should be able to offer proof in its defense that it had exercised due care. Although the corporation should not be civilly liable for a negligent statement in the absence of some ulterior motive, the corporate defendant should have the burden of proving its good faith, since in some cases an ulterior motive may have existed but also would be extremely difficult to prove if its objective was not realized. Such requirements would be consistent with section 18 of the 1934 Act, which imposes liability on a corporation for false or misleading statements in required reports unless the defendant can prove good faith and a lack of knowledge of the misleading nature of the statements.[117] It seems quite doubtful that Congress intended higher

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116. *E.g.*, Wall Street Journal, August 21, 1968, at 1, col. 2.

117. 15 U.S.C. § 78r (1964) provides: "(a) Any person who shall make or cause to be made any statement in any application, report, or document, filed pursuant to this chapter . . . which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading." The Eastern District Court of Pennsylvania held that a complaint alleging inaccurate and misleading statements in required

standards to be placed on voluntary releases through Rule 10b-5 than it chose to place on mandatory reports through the express language of section 18.

Where the corporation or the insiders who control its press releases have engaged in related securities transactions in connection with a misleading release, the corporation should be subjected to civil liability regardless of the nature of its conduct in the preparation of the release. The company should be able to offer proof of its good faith as a defense; if the proper weight is given to the fact of the purchase or sale, however, this burden would be extremely difficult to carry. There is no doubt that a corporation should also be liable where a misleading statement was published either intentionally or recklessly, regardless of the motive behind its issuance.[118] The courts must balance the interests of the investor in the availability of corporate news against the necessity for absolute accuracy in voluntary releases, while realizing that too much emphasis on the latter may result in more harm than benefit to the investor. If Congress feels that the public interest warrants the imposition of civil liability for negligence in voluntary reports, then it should provide the remedy with appropriate safeguards, but an *in terrorem* approach can only stifle the flow of information which is essential to investment judgment.

V. Conclusion

The *Texas Gulf Sulphur* decision has added little clarity to the confused areas under Rule 10b-5, but it has strengthened the SEC's arsenal of weapons against misconduct in securities transactions. Some degree of certainty in this area of the law is essential if corporations or their insiders are to be allowed to engage in legitimate trades in the company's stock without constant fear of possible liability. The questions which the court left unanswered need to be resolved—either by the Supreme Court or by Congress. Since TGS has petitioned for certiorari,[119] the Supreme Court will be given the opportunity to take its first Rule 10b-5 case and to resolve some of this confusion which the rapidly expanding developments of the past

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reports filed with the SEC stated a cause of action under Rule 10b-5, although such an action is expressly covered by section 18. Miller v. Bargain City, U.S.A., Inc., 229 F. Supp. 33 (E.D. Pa. 1964). This holding is in direct disregard of the express congressional statement on the issue. *See* Cohen, *supra* note 84, at 1366.

118. *Cf.* Note, *supra* note 80, at 661-67.

119. [Current] CCH FED. SEC. L. REP. ¶ 77,589.

few years have created. Should the court refuse to hear the case, then Congress should act to clairfy the extent of the coverage of 10b-5. Even if the interpretation by the courts is approved, congressional action should at least add to the sparse language of section 10(b) some of the safeguards imposed by other civil liability sections of the federal securities acts. Regardless of the outcome of this case, a final resolution of the problems must be made with the realization that the desire to give relief to an injured individual must not be allowed to obscure the long-range interests of the investing public.

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