REMARKS OF RICHARD B. SMITH, COMMISSIONER,
UNITED STATES SECURITIES AND EXCHANGE COMMISSION,
BEFORE THE MINNESOTA CHAPTER OF THE PUBLIC RELATIONS
SOCIETY OF AMERICA, MINNEAPOLIS, MINNESOTA,
MARCH 18, 1969

"The SEC Looks at Disclosure"

When I appeared before the counselors section of your society at its national meeting last November, I confessed to some trepidation. At that time a number of people were reacting, perhaps overreacting, to the recent decision in the Texas Gulf Sulphur case. As a result, a number of corporations were reported as reluctant to discuss their affairs except in formal reports and press releases. The Public Relations News even predicted that the case, if permitted to stand, would mean the extinction of your profession. In my November speech I attempted to calm some of these fears and sought to put the Texas Gulf decision in perspective. It is my impression that the dust has settled a bit since then. At least no major slowdown of corporate disclosure seems to have resulted, and, I am happy to see, most public relations counselors still seem to be gainfully employed.

While the cries of alarm about Texas Gulf seem to have lessened, it is no less important for us to understand the importance of corporate disclosure to the functioning of our economic system, the reasons for the Commission's concern about misuse of inside information and the role that the restrictions in this regard play in carrying out disclosure policies. An appreciation of this double nexus, between the strength of our private capital system and disclosure, and between disclosure and restrictions on insider trading, is crucial. That is what I shall discuss today, as well as the various direct requirements for timely and accurate corporate disclosures.

I add, in accordance with our usual custom, that these are my own views and not necessarily those of my colleagues on the Commission or the staff.

Why Disclosure?

Disclosure about the affairs of publicly held corporations helps to effectuate certain immediate policies. It also serves certain broader economic and social objectives.

In the first place, disclosure provides information to the public upon which intelligent investment decisions may be based. In the absence of such information investing, to the extent there would be any, could be little more than a numbers game. As Congress stated in enacting the Securities Exchange Act of 1934,

> No investor, no speculator, can safely buy and sell securities upon exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. 1/

Secondly, disclosure requirements actually tend to deter improper, or even imprudent, activity. Most people, even if tempted, would rather forego questionable activity than submit themselves to public scrutiny. Immersion in the disclosure process produces a cathartic impact on a management not theretofore accustomed to living in a fish bowl. Anyone who has participated in the process of an enterprise's preparing itself for a public market for its securities has seen this. Justice Brandeis wrote more than fifty years ago:

> Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman. 2/

It was this principle that played a large role in Congress' decision to rely primarily upon disclosure in many areas in formulating the two securities acts.

These fairly immediate effects of disclosure tie in to the broader social objectives that it serves.

Our capitalist system depends upon free and open markets to allocate capital among competing investment opportunities by providing a mechanism for the interaction of independent investment decisions. The collective investment judgment that emerges

---

1/ H.R. Rep. No. 1383, 73d Cong., 2d Sess. (1934), p. 11.

2/ Other People's Money 92 (1st ed. 1914).

from the market system is only as good as the individual investment judgments that are fed into it. If those individual judgments are not based on analysis of sufficient information, it is difficult to see how the markets can properly allocate investment capital.

In a sense, I suppose every investment judgment reflects a balancing of information and lack-of-information. Price ideally reflects not only the risks disclosed by available information, but also the risk that all relevant and material information is not available. The trouble is this latter risk is an imponderable. To the extent the lack of information is large, it almost geometrically expands the risk to the point of making the investment sheer speculation.

Congress long ago decided, and I believe most students of the markets agree, that the best market is where this latter risk of no information is minimized to the extent possible. Some important information, of course, is never available -- the total future, for instance. And there are points of diminishing return -- the system cost of producing total disclosure would outweigh the assistance it provides to the pricing function. The integrity of the price over time, nevertheless, depends on general availability of material information about the issuer of the security. And that price is the touchstone for the market's general function of allocating capital among companies and industries.

Equally as important as pricing, it seems unlikely that investors will be willing to risk their savings in the securities markets unless they have sufficient information about the corporations seeking to raise capital from them. Nor will investors be willing to retain those securities or purchase others in the secondary markets if they are not assured a continuing flow of such information. We can see this at work in the interest of foreign investment capital in this country. A number of European investors, dissatisfied with the secrecy with which foreign corporations often shroud their activities and the limited trading markets such an attitude results in, prefer to place their capital in securities of corporations that keep them informed about the status of their investments, and are traded

in the stronger markets that require such disclosure. It is no accident that the healthiest securities markets and the greatest degree of public participation are both found here in the United States, where disclosure concepts are most effectively administered.

Does Prohibiting Insider Trading Serve the Same Purpose?

Under Section 10(b) of the Securities Exchange Act of 1934 Congress has given the Commission broad rule-making power to prohibit deceptive or manipulative conduct in connection with securities transactions. The Commission has used these powers to promulgate Rule 10b-5, which prohibits such conduct in somewhat general terms. These provisions have been interpreted by the Commission and the courts to impose restrictions on the use of inside information.

Such restrictions have a direct impact in maintaining confidence in the securities markets. Investors will be hesitant to entrust their savings to the markets if they think that favored persons have an unfair advantage over them. As I have already mentioned, investor confidence is one of the aims of disclosure. In this respect, disclosure and restrictions on insider trading serve the same end. But insider trading restrictions are also directly tied to disclosure itself.

If insiders were free to trade upon the basis of material inside information, they would have an impelling incentive to withhold or delay corporate disclosure. In the meantime, they could take advantage of the secret information. The existence of a personal interest in not disclosing is obviously inconsistent with any full disclosure policy. As I shall explain in more detail later, I do not believe that the business judgment of corporate managements in determining when to disclose information should ordinarily be subject to review under the Commission's enforcement powers. Therefore, it is particularly important that this business judgment be exercised without any conflicting self-interest to withhold or delay disclosure.

How Can Insider Trading Be Detected and Prevented?

I was asked to comment in my remarks on how insider trading is detected. In order for restrictions on the use of inside information to be effective, the Commission must have adequate means of

discovering violations. It must also have effective enforcement tools to deal with these violations.

There are a number of ways that the Commission can discover abuses of inside information. Securities transactions by officers, directors and ten percent shareholders of all corporations whose securities are listed or widely held must be reported to the Commission under Section 16(a) of the Securities Exchange Act of 1934. By correlating these reports with later announcements of important developments by the corporation, the Commission staff can discover circumstances inviting inquiry. Unusual trading activity in terms of volume or price changes may also call our attention to a questionable situation. Further study may then show that the trading activity is due in part to persons who have not filed the reports required by Section 16(a) or to other corporate personnel who are not subject to these reporting requirements. There are also the usual number of complaints from individuals and other special warning signals. For example, in Texas Gulf itself the Commission initially looked into the matter because of an apparent inconsistency between two press releases issued less than four days apart, both reported on the broad tape. The staff came upon the insider trading in the course of investigating the basis for the apparent discrepancy between the two releases.

This is not to say that all insider trading violations can be uncovered. But this is no reason not to deal with those that are. Such enforcement as is possible reduces the number of violations. Even more important, it helps to educate the public and create the moral self-restraint that is always the principal tool of law enforcement.

When the Commission does discover a violation, there are several enforcement alternatives:

(1) The most severe action that we can take is a recommendation to the Attorney General that he institute criminal proceedings against the violator. Absent a reporting violation, the Commission has not applied this severe remedy to insider trading.

(2) The Commission is also authorized to seek an injunction against any person misusing inside

information in securities transactions. And in Texas Gulf, for instance, we requested that the alleged violators be required to disgorge their profits as ancillary relief to the injunction.

(3) The Commission might also issue a public report of its investigation into the insider trading, temporarily suspend trading in the security that is being traded on the basis of inside information, or institute an administrative proceeding to bar or suspend the violator from being associated with any broker-dealer in securities.

In addition, of course, investors who are injured by a misuse of inside information may bring their own lawsuits to recover damages. The scope of any private remedy in the insider trading situation -- particularly in transactions executed on a national securities exchange or in the organized over-the-counter market -- is still an open question.

What Is "Insider Trading" In a Particular Case?

In order to determine whether a misuse of inside information is actually involved, three questions must be answered: Is the alleged violator an insider or otherwise subject to the restrictions on the use of non-public information? Is the information that he used in his trading material? Was it already available to the investing public when he traded?

1. An Insider?

In Texas Gulf it was held that, in addition to the traditional categories of officers, directors and 10 percent shareholders, corporate employees are also to be considered insiders with respect to the restrictions. In the administrative proceedings against Merrill Lynch and Van Alstyne, Noel, the Commission held that a prospective underwriter of a proposed public offering of securities by the corporation, and the arranger of a private placement of the securities by the corporation, are insiders with respect to the information that they receive in these capacities. Of course, the corporation itself is an insider, too. A person who is entrusted with highly significant information for a corporate purpose by virtue of a special

relationship with the corporation would seem to be an insider with respect to the information that is furnished to him in that capacity. The corporation's outside legal counsel, accountants, financial consultants and -- I am sorry to say -- public relations counsel could be in that situation under particular circumstances. For example, public relations counsel will usually be given advance information of a proposed merger so that he can begin preparation of the appropriate press release. He should not trade on the basis of that information until it is also available to the public.

In addition, certain other persons who do not have any formal business relationship with the corporation may also be subject to trading restrictions. They have been denominated "tippees." This was the status of the respondents in the Commission's recent administrative proceeding against Blyth & Company involving government bond trading. It has not yet been determined, however, exactly who is a tippee, and whether the duties of these persons go as far as those of the insiders themselves.

2. Material?

The standard of materiality is somewhat more difficult to define. Like many other concepts in the law, such as that of negligence, each factual situation must be evaluated individually. I am reminded of what Justice Stewart said with respect to the difficulty of defining "hard-core pornography,"

> [P]erhaps I could never succeed in intelligibly doing so. But I know it when I see it 3/

Perhaps this is something of what the president of the New York Stock Exchange had in mind when he said he thought a good rule of thumb would be to ask yourself "Would you buy or sell securities for your own account on the basis of this information?" Of course, he also suggested a good hedge, "When in doubt, disclose."

This is not to say that no guidance is possible in determining whether particular information is material. The

---

3/ Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (concurring opinion).

courts have generally phrased the standard of materiality in two ways: (1) the importance of the information to a reasonable investor in reaching a decision whether to buy, sell or hold the security and (2) the likelihood in reasonable and objective contemplation that disclosure of the information would affect the market price of the corporation's securities. The cases so far decided have involved such striking developments as a dividend cut of 40 percent, a major mineral discovery, a sharp decline in earnings, a five-fold increase in earnings and the timing and price of a major new offering of government securities.

In applying the two phrasings of the standard to other situations, various factors must be considered. The size of the company is important. So is its present financial condition. Information about a promising new product for a relatively small company could be material while the same information might not be material if the product were developed by a giant like General Motors or duPont. A similar distinction might be drawn between corporations of the same size if one is dynamic and rapidly growing, and the other had long been in a depressed condition. If the information is not definitive -- in the sense that it relates to the possibility of a future development that has not yet occurred -- both the likelihood of the development and its potential importance to the corporation must be considered. Drilling information indicating the possibility of a $1 billion mine may be material while information indicating a similar degree of likelihood for a $10 million mine would not.

3. Non-Public?

Finally, it must be determined when the information can be considered to be available to the public for purposes of the insider trading restrictions. In Texas Gulf the court of appeals held that insiders may not trade upon the basis of material information until that information has been disclosed in a manner sufficient to insure its availability to the investing public. On the facts of that case the court held that the information was not sufficiently available until the corporation's announcement appeared over the Dow Jones broad tape. It also stated that a further waiting period might be desirable but suggested that the Commission should provide for it by rule or regulation.

Another holding of the Texas Gulf case was that insiders who are themselves prohibited from trading on the basis of material inside information may not divulge that information to friends, relatives or associates for their use in securities transactions on an undisclosed basis. This was also one of the points involved in the Commission's proceeding against Merrill Lynch. The combination of this holding -- that the information cannot be passed on -- and the holding that corporate information continues to be "inside" until sufficiently available to the public has raised some questions as to the appropriate relations between a corporation and security analysts. As I said in my November speech, these points should not prevent the discussion of corporate affairs with analysts, either singly or in groups. I see no reason why management may not give previously undisclosed information to a particular analyst if it would give the same information to any other responsible person who requested it. Of course, if the information is of major significance, then fairness requires that it be given to all investors simultaneously through the news media.

Good Corporate Policy?

Thus far, we have been looking at the importance of disclosure from the public investor's point of view. But looked at from the corporate issuer's point of view, disclosure is also valuable, indeed a matter of business necessity.

Unless important corporate information can be kept within a very small circle of corporate personnel, it will be almost impossible to maintain corporate security. If the information leaks out rather than being announced to all members of the public at the same time, the result may be embarrassing for the corporation and for its officials. Moreover, if the price of a policy of corporate silence is that management must refrain from buying or selling securities in the corporation for extended periods, they will hesitate to impose such a policy unless absolutely essential. On the other hand, if the corporation does follow a policy of timely and full disclosure, it will be difficult to suggest that its officials have engaged in improper securities transactions.

Finally, and perhaps most fundamental of all, the attraction of investors to corporations that do keep them informed about their affairs tends to create a capital flow in the same direction. Security analysts also tend to be more

interested in corporations that provide them with sufficient raw data upon which they can base their evaluations, and analyst interest inspires investor interest. A full disclosure policy may be an important factor in the competition for investment capital. Good disclosure is also good business.

Disclose When?

As I have indicated, restrictions on the use of inside information have an important indirect effect in terms of encouraging corporate disclosures. The Commission also enforces a number of direct disclosure requirements.

In addition to the registration requirements of the two securities acts, the Commission has established a comprehensive system of periodic reporting requirements to keep these initial corporate disclosures relatively up-to-date. These reporting requirements generally apply to corporations whose securities are listed on a national securities exchange, or are traded in the over-the-counter market and widely held. The ordinary commercial, industrial or financial corporation must file annual and semi-annual reports, as well as monthly reports of certain specified events. I am sure that you are all familiar with the so-called 10-K's, 9-K's and 8-K's. This corporate reporting system serves an important function as a permanent repository of information about the corporation. Nevertheless, the timing and format of the reports do not lend to their serving as an effective medium for the initial dissemination of corporate information. This is presently done through corporate press releases and other informal statements.

In the best tradition of self-regulation, timely disclosure policies (as distinct from periodic reporting requirements) have been promulgated by the New York Stock Exchange and the American Stock Exchange and, in a more general way, by the NASD. Later in this symposium you will be hearing about the New York Stock Exchange's work in this area from Merle Wick, vice president in charge of its Department of Stock List.

A question has been raised, however, whether the federal securities laws also impose duties of timely disclosure (again, as distinct from periodic reporting) that can be enforced by the

various remedies at the Commission's disposal and might also give rise to private actions for damages. Some commentators have advocated such a position. The Commission, however, has never done so. It did not charge Texas Gulf with violating the securities laws for failing to announce its mineral discovery sooner than it did. Under Section 10(b) and Rule 10b-5, a corporation may postpone disclosure of significant corporate developments -- at least when there is a good business reason for doing so.

Whatever uncertainty formerly existed about this question appears to have been resolved by the same court that decided the Texas Gulf Sulphur case. In that case itself the court used the following language in a little noticed footnote in the majority opinion:

> We do not suggest that material facts must be disclosed immediately; the timing of disclosure is a matter for the business judgment of the corporate officers entrusted with the management of the corporation within the affirmative disclosure requirements promulgated by the exchanges and by the SEC. 4/

More recently that court has elaborated further upon this subject. In the later case it had been claimed that the defendant corporation had a duty under Section 10(b) and Rule 10b-5 to correct inaccurate rumors in the market about its affairs. These rumors had not emanated from the corporation. As you know, there is such a duty under the self-regulatory timely disclosure policies. In an opinion written by Judge Henry Friendly the court stated:

> While a company may choose to correct a misstatement in the press not attributable to it ..., we find nothing in the securities legislation requiring it to do so. 5/

I think that this is an appropriate result. The proper timing of disclosure is primarily a matter of business judgment.

4/ Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F.2d 833, 850 n.12 (C.A. 2, 1968) (petitions for certiorari pending).

5/ Electronic Specialty Co. v. International Controls Corp., CCH Fed. Sec. L. Rep. ¶ 92,342, at 97,635 (Jan. 24, 1969).

Premature disclosure may be as undesirable as delayed disclosure. There has recently been considerable discussion in the press about the premature disclosure of merger negotiations and other future corporate transactions. Even if a corporate development is sufficiently definite to be announced, there is a good deal of further judgment involved in determining whether there are other good business reasons for postponing disclosure. Flexibility is needed in applying timely disclosure requirements. Considerable deference should be given to the businessman's decision on the firing line, a decision that I hope will be made with the assistance of members of your profession. In my view this area lends itself more to the informal procedures used by the self-regulatory bodies than to injunctive or criminal proceedings, which are the principal weapons in our enforcement arsenal. Except in the case of the Commission's own specific disclosure provisions or where insider trading abuses occur, it seems to me timely disclosure should ordinarily be enforced informally by the self-regulatory bodies rather than formally by the Commission.

How Good Must Disclosure Be?

It is not enough merely to achieve timely disclosure. Inaccurate or misleading corporate disclosures will often be more harmful than none at all. It was also held in Texas Gulf that a false or misleading corporate press release may violate Section 10(b) and Rule 10b-5. It is not necessary that either the corporation itself or those officials responsible for the issuance of the release engage in related securities transactions, or that the release be issued for the purpose of affecting the market. The court put it in very comprehensive terms:

> Congress intended to protect the investing public in connection with their purchases or sales on Exchanges from being misled by misleading statements promulgated for or on behalf of corporations irrespective of whether the insiders contemporaneously trade in the securities of that corporation and irrespective of whether the corporation or its management have an ulterior purpose or purposes in making an official public release. Indeed, the Commission

> has been charged by Congress with the responsibility of policing all misleading corporate statements from those contained in an initial prospectus to those contained in a notice to stockholders relative to the need or desirability of terminating the existence of a corporation or of merging it with another. 6/

Thus, the law as it now stands is that false or misleading corporate statements "made ... in a manner reasonably calculated to influence the investing public, e.g., by means of the financial media ..." 7/ constitute violations of Section 10(b) and Rule 10b-5. Indeed, certain district court decisions have applied this standard to material furnished to Standard & Poor's Corporation, product promotional activities and a speech by two directors of the corporation to a meeting of security analysts. Since Russell Morrison, the president of Standard & Poor's, is here with us today, I suppose that I shouldn't comment whether these decisions may go too far.

In judging whether corporate press releases and other informal public statements satisfy the requirements of the securities laws, we obviously cannot use the same criteria by which we judge formal filings with the Commission. Press releases and other information statements are often issued under pressure. Thus, the Texas Gulf court held that a corporation has satisfied its obligations if it uses due diligence to ascertain available information and sets forth that information in a manner that will not be deceptive or misleading to the reasonable investor. If specific facts are known, and their evaluation is a matter of judgment, a summary of the facts themselves should be set forth rather than merely including the corporation's own evaluation. The court of appeals stated in Texas Gulf:

> The choice of an ambiguous general statement rather than a summary of the specific facts cannot be justified by any claimed urgency. 8/

6/ 401 F.2d at 860-861.

7/ 401 F.2d at 862.

8/ 401 F.2d at 864.

Responsible corporations and their officials should not be concerned by the application of the securities laws to corporate publicity. Insofar as the Commission is able to use this power to deal with those few reckless individuals who take a public-be-damned attitude towards investors, the increased public confidence will benefit all corporations. The Commission intends to use its power in this area only in clearly abusive cases. We have neither the desire nor the resources to look over the shoulders of corporate management every time it issues a press release. As I said in my November speech, "[W]e do not expect to become after-the-fact rewrite men for all corporate publicity."

I have attempted to give you a quick thumbnail sketch of recent developments in disclosure from the point of view of a member of the SEC. The Commission's interest in sound disclosure policy should also be, and I am sure is, shared by the members of your profession. After all, in addition to your concern as citizens in healthy and prosperous securities markets, more disclosure means a larger role for you. A public relations counselor is not required to tell a corporation how to keep quiet! And despite the recent comments of some people (I think that they must be lawyers), this area has not become so complex that only lawyers can advise corporations when they do speak out. Indeed, I would think an independent and professional public relations counselor can be uniquely helpful in assisting a corporation to reach disclosure judgments.

The Commission and your profession have a common responsibility in this area. I surely trust that we can work together to carry it out.

Thank you.