ADDRESS BY

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Before the

BALTIMORE SECURITY ANALYSTS SOCIETY

Baltimore, Maryland
January 6, 1969

The decision of the Court of Appeals in Texas Gulf Sulphur[1/] last August 13th has generated a great deal of discussion on the scope and meaning of that decision. Unfortunately much of the talk has been uninformed and emotional. There were predictions that the "wells of corporate information" would soon dry up, that the decision would effectively silence corporate officials and that financial analysts would be compelled to rely on information available to everyone as a basis for analysis. The Commission, it was charged, was sailing into new and uncharted seas and it was hinted rather strongly that neither the Commission nor the courts knew very much about the securities business--especially the use and distribution of information and investment advice.

In recent months some of these comments and predictions have been subjected to analysis at meetings from one end of the country to the other. By now some light has begun to emerge from the heat and the nonsense about uncharted seas and judicial usurpation has been replaced by more reasoned counsel. There may, nevertheless, be need for further discussion--especially since loose analysis is still being indulged in by some people who should know better. I hope therefore, that you will forgive me for a rather extended--perhaps too extended--discussion after such a delightful lunch. Incidentally, I am flattered by the presence here today of so many of our regular customers--particularly as this is a shortened market day.

First, then, to some of the specific points I wish to make. I take it that certain issues have been clarified so that we are at least speaking in common terms. By now several things are fairly clear.

1) Texas Gulf was not a departure from previous precedent--it was in fact a natural and predictable outgrowth of Cady Roberts[2/], Capital Gains[3/], and earlier cases.

1/ S.E.C. v. Texas Gulf Sulphur Co., C.A. 2, en hanc, Docket No. 30882 (Aug. 13, 1968).

2/ 40 S.E.C. 907 (1961).

3/ 375 U.S. 180 (1963).

2) The law is and has been clear: insiders in possession of material non-public information cannot purchase or sell securities for their own benefit (or for the benefit of their customers or friends for that matter) on the basis of that material information before it has been made public. While some may disagree on what is or is not material, once the test of materiality has been met the prohibition is clear.

3) The limitations on the use of material non-public "inside" information extends not only to officers, directors and large stockholders; it also covers any employee who learns of the material information and, as the Commission held in its decision in the Merrill Lynch case, it also covers, at the least, others who are entrusted by company officials and employees with significant information about it before that information has been made public.

4) Information is material when importance would be attached to it by an investor or trader in reaching a decision whether to buy, sell or hold the security in question. If generally know, it could be expected to affect materially the market price of the security.

5) Since "insiders" in possession of material non-public information about the corporation may not trade in its securities, the surest way for the company to prevent violations by its insiders is to make public material developments promptly. If there is a good corporate reason which outweighs the obligation to its own shareholders and the investing public generally to publicize significant information which may reasonably be expected to influence investment decisions and the market for the securities of the company not to make an announcement immediately, strict security should be maintained and those persons who know of the information should be warned not to trade in the company's securities and not to give tips to their friends. In view of certain pending matters, I will not deal with the question whether those who obtain such information directly or indirectly from such persons may use such information for themselves, their customers or other persons to whom they may have communicated such information.

6) The necessary prior disclosure means publication broad enough to inform the investing public fairly. There may be some argument on <u>when</u> information becomes sufficiently public to permit trading and <u>what media</u> meet these tests, but these issues do not affect the soundness of the general rule that a corporate insider should not use material non-public information for his advantage in purchasing or selling securities of his corporation.

7) Corporate publicity should not be misleading. Surely that is not too much to ask. Informed investment decisions are made possible by adequate and continuing corporate information that is reliable. In no small measure, this is the reason why our securities markets are attractive abroad and why many foreign governments are adopting requirements patterned after those we have come to expect as a matter of course.

I now turn to a brief discussion of several cases which have provided the basis for current discussions.

We might begin with the injunctive action the Commission brought against Glen Alden Corporation.[4] The Commission charged that Glen Alden had provided certain institutional investors (who were potential purchasers of Glen Alden shares) with important corporate information including five-year sales, earnings and cash flow projections and plans for future acquisitions. This information had not been disclosed to the general public and was considered highly confidential. by management. Without admitting the allegations of the complaint, Glen Alden consented to the entry of a permanent injunction prohibiting it from disclosing material information about its affairs to selected persons for their possible use in connection with transactions in the securities of the corporation or its related companies.

Shortly after the filing of the Glen Alden complaint, the full bench of the United States Court of Appeals for the Second Circuit handed down its decision in Texas Gulf Sulphur. It is very important to be clear on what the court said--and what it did not say. As you know there were two major aspects to that decision: 1) insider trading and 2) corporate publicity. Both are pertinent to any consideration of corporate disclosure policy.

With regard to insider trading, the court unanimously affirmed the district court's holding that officers, directors and employees of a corporation in possession of material inside information "must either disclose it to the investing public," or abstain from trading in the securities concerned on the basis of that information.[5] This included the acceptance of stock options. It is important to note that the restrictions of Rule 10b-5 were not limited by the court to those ordinarily referred to as "insiders."

4/ (S.D. N.Y.) Litigation Release No. 4080 (August 8, 1968.)

5/ Slip Opinion, p. 3607.

The court also held, unanimously, that Rule 10b-5 prohibited the defendants from passing inside information on to their friends, relatives or associates for their use in securities transactions. At least a majority of the court included, within the restriction, a bare recommendation to buy or sell the securities, even though the underlying information on which the recommendation was based was not actually discussed.

Since these prohibitions apply only to "material" information, the court undertook to define the term "material", as used in this context. The court referred to the test previously defined in List v. Fashion Park[6/] and Kohler v. Kohler:[7/] ". . . whether a reasonable man would attach importance . . . [to the information] in determining his choice of action in the transaction in question".[8/] The court, it should be noted, included speculators and short-term investors within the category of reasonable men. The test was also described by the court as encompassing any fact that " . . . in reasonable and objective contemplation might affect the value of the corporation's stock or securities."[9/] And, the court added, if those who are in possession of the information engage in securities transactions because of it, such action was significant evidence of materiality.[10/]

The court also ruled unanimously that previously undisclosed material information about a corporation continues to be inside (or non-public) information until it has " . . . been effectively disclosed in a manner sufficient to insure its availability to the investing public."[11/] The court held that information does

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6/ 340 F. 2d 457 (C.A. 2), cert. den. 382 U.S. 811 (1965)

7/ 319 F. 2d 634 (C.A. 7, 1963)

8/ Slip Opinion, p. 3608

9/ Slip Opinion, p. 3608

10/ Slip Opinion, p. 3612

11/ Slip Opinion, p. 3618

not become publicly available the moment that it is given to the press; it continues to be non-public until it is effectively disseminated to the public. The court held that the information remained non-public at least until it could reasonably have been expected to appear over the Dow Jones broad tape. Whether or not publication on the broad tape alone was sufficient publication to permit insider trading was left open.

In his concurring opinion, Judge Friendly described the corporate publicity aspect of the case, as ". . . transcending in public importance all others in this important case . . . ."12/ The court held that corporate publicity is subject to Section 10(b) of the Exchange Act and Rule 10b-5 whenever it is issued ". . . in a manner reasonably calculated to influence the investing public, e.g., by means of the financial media . . . ."13/ This test involves questions whether the corporate publicity "was deceptive or misleading to the reasonable investor . . . " and whether ". . . corporate management demonstrates that it was diligent in ascertaining that the information it published was the whole truth and that such diligently obtained information was disseminated in good faith. . . ."14/

On November 25th the Commission published its first decision in the Merrill Lynch proceeding.15/ Pursuant to an offer of settlement by Merrill Lynch and certain individuals, we found that Merrill Lynch, as the prospective managing underwriter of a proposed public offering, received adverse information about the past and prospective earnings of Douglas Aircraft Corporation and, together with certain individual respondents, passed on the information to favored investors before these material developments were disclosed to the public. We found that the information was material because it was of such importance that

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12/ Slip Opinion, p. 3642

13/ Slip Opinion, p. 3634

14/ Slip Opinion, p. 3634, 3636

15/ Securities Exchange Act Release No. 8459 (Nov. 25, 1968) it could (and in fact did) affect the judgment of investors. We found that, if publicly disclosed, the information could be expected to have a material affect on the market price of Douglas stock. Since Merrill Lynch and certain of the individual respondents were entrusted by Douglas with this information in connection with the proposed underwriting, we held that they were subject to the same restrictions on the use of such information prior to public disclosure as Douglas' own officials. The proceeding is still pending against certain of the institutional clients of Merrill Lynch who were charged by our staff with having made use of information they received. At present these are, of course, only charges by our staff. The Commission itself has not determined the issues involved.

The decision of the Court of Appeals for the Second Circuit issued on December 23 in S.E.C. v. Great American Industries, may help to put at least one aspect of our discussion into perspective.16/ In that case the court held that injunctive relief was appropriate because certain press releases issued by Great American and reports filed by it with the Commission, were misleading. In the preamble to a discussion of the complaint, the Court expressly rejected a narrow construction of the phrase "in connection with the purchase or sale of any security." This is given additional meaning by Judge Kaufman, in a concurring opinion, who stated that the limits of "fraud" under the securities law are not identical with those of common law deceit. He referred to a statement by Professor Bromberg that the prescriptions of Rule 10b-5 are "closer to unfairness than what either lawyers or laymen usually think of as fraud."17/ The judge noted that, in transactions involving the securities of publicly owned companies, the harm caused by unfair dealing is not limited solely to the parties to the transaction. In such cases, Judge Kaufman points out, as do Judges Waterman and Hays in their concurring opinions, the harm may extend to passive shareholders not directly involved in the transaction, to potential purchasers and others. In consequence, Congress determined that special rules--not the older

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16/ S.E.C. v. Great American Industries, C.A. 2, en banc Docket No. 31010 (Dec. 30, 1968).

17/ Slip Opinion, p. 3711.

common law doctrines of fraud--should apply to the "intricate merchandise" represented by securities. This admonition is also found in the separate concurring opinions of Judges Waterman and Hays.18/

It may also be of interest to recall that, last February in a New York State Court action, then Judge Botein, held that an insider who trades on the basis of inside information breaches his fiduciary obligations to the corporations, in that he converts into money for his own use something belonging not to him but to his corporation--inside information; and that the corporation may recover his profits.19/ Of course, the corporation itself has no right to trade on the basis of inside information.19a/

It has been suggested that some corporate executives have been frightened by these developments (or by their advisers) into believing that it is no longer safe to talk to security analysts or to the press. Presumably, some overcautious corporate advisers have counseled a policy of silence--at least until, as they put it, the law is clarified. Although my colleagues on the Commission, and some of our senior staff members, have attempted at various meetings and conferences to put these cases into perspective, it may be worthwhile to elaborate on some of the six points I listed at the outset.

First, Glen Alden, Texas Gulf and Merrill Lynch represent recent applications of certain basic legal principles which are not new. As early as 1909, the Supreme Court held that a controlling shareholder of a corporation defrauded a minority shareholder by purchasing his stock without disclosing the current status of negotiations for the sale of the corporation's property.20/

18/ Slip Opinion, pp. 3710, 3714.

19/ Diamond v. Oreamuno, et. al., 287 N. Y. Supp. 300 (1968), see also Black v. Shearson Hammill & Co., 72 Cal. Repts. 157 Ct. of Appeals (1968).

19a/ **Kohler v. Kohler, 319 f.2d 63d (C.A. 7, 1963).**

20/ Strong v. Repide, 213 U.S. 419.

In 1943, less than a year after the promulgation of Rule 10b-5, the Commission stated that a corporation had violated the rule by repurchasing its stock without disclosing greatly improved earnings, a plan to liquidate the corporation at a large premium over the average purchase price of its stock, the sale of the remaining assets at a premium price, and that the issuer and another were the purchasers.[21/] Later that year the Commission disciplined a broker-dealer for improperly inducing a corporate insider to furnish him with tips.[22/]

In 1951, in Speed v. Transamerica,[23/] a majority shareholder neglected to tell the minority holders of a great increase in the value of the company's tobacco inventory. The conduct was held to have violated 10b-5. Judge Leahy there stated:

> "The rule is clear. It is unlawful for an insider, such as a majority stockholder, to purchase the stock of minority stockholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholders, which information would have affected the judgment of the sellers."

Cady Roberts[24/] was decided in 1961. There is nothing basically new about proscriptions concerning the use or misuse of inside information. In at least one instance--trading by certain insiders within a six month period--the Congress did not even

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21/ Ward La France Trucking Corp., 13 S.E.C. 373

22/ Herbert L. Honohan, 13 S.E.C. 754, 757-758, modified in other respects, 16 S.E.C. 297 (1944).

23/ 99 F. Supp. 808 (D. Del. 1951), 135 F. Supp. 176 (D. Del. 1955), modified on other grounds, 235 F.2d 369 (3d Cir. 1956).

24/ Cady Roberts and Co. 40 S.E.C. 907 (1961) require proof that insiders used inside information. In such cases any profits realized by themselves are automatically recoverable by or on behalf of the corporations.[25]

Second, there is no need for corporations to view recent developments as an excuse to close their doors. An important reason for the creation of the Commission, and the enactment of the statutes it administers, has been the conviction that the public and private interests are best served when more accurate and continuous information is made available to the public. Undoubtedly, one of the important policy reasons for prohibiting persons from trading on the basis of non-public material inside information is that without such a prohibition those privy to such information would have a personal interest in withholding--or at least delaying--disclosure to the general public.

It is an old adage that it is not enough to do justice, it is also important to appear to be doing justice. If you will permit the twisting of that adage, the more material information a corporation makes available to the public, the easier it will be for insiders to keep their securities transactions above suspicion. The more material information is available to the public, the less guarded corporate executives will have to be when discussing their business with friends, relatives and others. I am confident that the trend for the future is more, rather than less corporate disclosure.

Thus far, my remarks have related to the question of transactions by "insiders". I should now address myself to what a distinguished judge has described as the more important issue. It may be unnecessary before this group, but I think it important, to draw your attention to a booklet entitled "Expanded Policy on Timely Disclosures" issued last July by the New York Stock Exchange. In that booklet, which I understand has become a best-seller, the Exchange provides a number of useful guidelines.

25/ Section 16(b), 15 U.S.C. 78 p (b), 48 Stat. 896-97.

I should also note that the President of the New York Stock Exchange, at a recent panel session before the Financial Executives Institute, suggested that the business and legal communities have over-reacted to Texas Gulf and Merrill Lynch. Some of his remarks bear repeating here:

> Disclosure now is inextricably bound up in the concept of a publicly-held corporation, since it seeks to provide material information on a timely and equal basis to the public. Despite the complexity of modern business, this approach is neither naive nor unworkable, but is pursued by the most reputable, most hard-nosed and most successful corporations in the country. The result has been a level of communication between companies and investors unknown anywhere else in the world.
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> Without such a flow of corporate information it is very doubtful that today's high level of public confidence in the securities markets and broad ownership of stock would have occurred.
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> Once the word of a material pending development has gone beyond the top management of a company and their individual confidential advisers, the company takes an unwarrantable risk in not making prompt disclosure. I think the posture here should be one of leaning over backwards to insure that no market advantage is created for anyone.
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> The relationship between companies and security analysts is another area that deserves specific comment. Our concern is whether anything of a substantive nature is revealed to the analyst-- some new product development, proposed acquisition, or significant change in personnel. If this happens, we believe the need for full and immediate disclosure is clear and that a press release should be issued.

A caste system for release of corporate information-telling the sophisticates first and the general investing public later or not at all-is not consistent with our disclosure standards.

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It seems clear that some decisions on disclosure can only be a matter of judgment rather than the simple application of precise rules. That is why the intent of disclosure and its philosophy must be understood. You in the publicly-owned corporations and we in the securities markets have invited the public to participate in our business-as owners of corporate securities and as buyers and sellers in the securities markets. The public has accepted our invitation-by the thousands, indeed, by the millions. This places responsibilities on us as businessmen.

Quite aside from the advantages that accrue both to the corporations and to the securities markets in terms of public confidence, ethics demand that all investors be treated equally and fairly. It should be clear that the personal interests of management and the corporate good must be treated separately. This may mean passing up an opportunity to realize a profit on information, or to pass such information on to family or friends.

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And finally:

Every once in a while we must remind ourselves that we are involved with businesses that are, literally, publicly owned. To be sure, the basic mission of a publicly-owned corporation is to make a profit. We should on occasion remind ourselves <u>for whom</u> the corporation earns the profit. Not for the managers personally-

> though they are entitled to a share. Not for the suppliers. Not for the security analysts of brokerage firms and institutions and their clients and personal friends. Publicly-owned corporations earn their profits for their shareowners-for all of the, according to the extent of their shareownership. If from time to time as we go about the daily routine of corporate responsibilities we recall that basic condition of corporate life, day-to-day problems such as the application of disclosure rules should be much easier to resolve.

In a similar vein, I recommend a recent article appearing in the Financial Executive by Philip West of the New York Stock Exchange.[26] Finally, and by way of providing you with sufficient reading material, I direct your attention to what are described as "timely disclosure" standards recently adopted by the Ontario Securities Commission and by the Toronto Stock Exchange.

By this time, I hope that I have made clear that the rule in Texas Gulf is not designed to compel, nor should it result in, a "clamming up" in the corporate community. On the contrary, it should lead to better and more timely disclosure of material information to the public. This is an important goal for those who believe in a healthy securities market as a comfortable repository for public savings and a ready source for the growing needs for capital by American industry.

As you know, the statutes administrated by the Commission call for periodic reporting by corporations whose securities are widely held. These reports provide a permanent record of the most important information about these corporations and a framework within which other information can be assessed. But, the nature and timing of these reports prevent them from serving as an adequate medium for the rapid and widespread dissemination of current material information to the investing public. You are all aware that about a year ago, I established

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26/ "Information Disclosure: What and When; Phillip L. West, Financial Executive, p. 13. December, 1968.

a special disclosure study group within the Commission under the guidance of Commissioner Frank Wheat. Its work is in the later stages of completion. I understand that the group is presently considering whether, and the extent to which, changes should be made in the scope and frequency of the existing reporting system. Whatever changes are suggested, I doubt that their implementation will eliminate the need and desire-ability for more frequent disclosures by means of releases, press conferences, letters to shareholders, meetings with security analysts and other techniques.

At the risk of boring you, I should reemphasize that in developing an appropriate corporate policy with respect to publication of material information, three factors deserve careful attention: Accuracy and adequacy, promptness and breadth of dissemination.

Information should be disclosed just as soon as the corporation has something material to say. As Mr. Haack pointed out, from a practical view point, once important information is available to more than the top group of corporate officials and their advisers, there is a real risk of leaks which can bring in its wake concern and resentment if not worse. Obviously, judgment is the key to specific disclosures but it must be matched by a willingness by corporate executives to take the initiative as promptly as possible. Not only does this promote good management--shareholder relationships, it also provides insulation against questions concerning transactions by persons who may be included within the category of "insiders".

An accurate and balanced presentation is obviously important. Top officials would do well to take time to review any release to make certain that it is as accurate and fair as possible under the circumstances. The Commission has no wish or intention to act as an after-the-fact rewrite man for corporate publicity. Those of you who have been privy to our discussions through the years know that the Commission has gone out of its way, sometimes too far out of the way in the view of some, to encourage wide corporate publicity. So far as we are concerned, that is the "name of the game". We believe it inconsistent with the public and investor interests to develop rules or attitudes which would inhibit reliable and useful corporate publicity.

Finally, the breadth of public interest in our publicly owned companies requires that corporate news be disseminated broadly. No one segment of the public should be favored over another.

I hope that my remarks here may be of some assistance in reassuring the corporate and investment communities that we at the Commission are aware of the concerns that have been expressed. We stand ready to offer whatever assistance we can in ironing out any rough spots. I suppose that a new legal decision, no matter how venerable its precedents, is often like a new pair of shoes. No matter how long we have been wearing shoes, a new pair may be a little stiff at first. But leather is flexible. Eventually the shoes are broken in and conform to our feet, and we become used to the feel of a slightly different shoe. Then the shoes feel as comfortable as though we had always worn them. I suggest that the decisions in _Glen Alden_, _Texas Gulf_, and _Merrill Lynch_ afford equal flexibility, and that we will find them equally comfortable.

There is a tendency all of us indulge in at times. We concern ourselves with superficial effects and forget underlying principles. It _is_ important to emphasize that a market that is unfair is a market where investor confidence is necessarily lacking--where the public fears to bring its savings. The decisions I have discussed should be welcomed by analysts, by investors, by broker-dealers and by corporate officials. As the president of the Financial Analysts Federation correctly pointed out very recently, the Texas Gulf decision should not be used by corporate executives as an excuse to shut the door of corporate information; and that on the contrary, the rule will produce more, not less, information for the public.

If our markets are to continue to deserve the confidence of the investing public, those markets must be fair. Public confidence is not a mere catch phrase. Our securities markets depend upon it. The President of the American Stock Exchange put it well in his recent remarks to the Corporate Financial Reporting Conference:

"It might appear that recent legal developments in the disclosure area represent a new departure. Actually, the SEC and the exchanges have been concerned for many years with insuring fair dealing in the markets.

The securities markets are now public markets both in fact and contemplation of law. The markets of the twenties were professional markets which represented themselves as public markets. Now the markets have become truly public markets which must be shared with professionals, including institutions. If the individual investor is to continue to have confidence in the markets, he must be assured that these markets do, in fact, serve individual investors."

I am sure that you, more than most, appreciate the importance of the implicit promises in these remarks. I am also sure that the Commission will continue to receive your support and cooperation in carrying out its responsibility to insist that these promises be fulfilled.