


**SECURITIES AND
EXCHANGE COMMISSION**

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AN INSIDE LOOK AT RULE 10b-5

An Address By

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In 1961, the Commission entered a decision in a private administrative proceeding involving the utilization of nonpublic material corporate information. The decision -- Cady, Roberts & Co. ^{1/} -- was written largely by former Chairman Bill Cary, at a time when the Landis Report, ^{2/} written in 1960 at the behest of President-elect Kennedy, shamed all commissioners into being less lazy than we are today. The opinion was written to memorialize a settlement of our administrative action and to permit the Commission to articulate the standards to which a person who receives inside information must adhere.

The Commission there recognized the establishment of a special relationship between a company and persons privy to internal corporate information not yet made public, and the imposition upon them of duties to the trading markets not to utilize that information for their own benefit.

^{1/} 40 S.E.C. 907 (1961).

^{2/} [Landis, James L.], Report on Regulatory Agencies To The President-Elect, Submitted by the Chairman of the Subcommittee on Administrative Practice and Procedure to the Senate Committee on the Judiciary (Comm. Print 1960).

The Commission's development of the law, at least in our own decisions and in the injunctive actions we have brought, has, no doubt, expanded the traditional Cady, Roberts concept of a special relationship and special obligations in terms of application, but not in terms of principle.

Our more recent decisions in the Investors Management ^{3/} and Faberge ^{4/} cases have dealt with persons who, by virtue of their special position, have, or may have, become privy to material nonpublic inside information which was not intended for the private use of anyone. And nothing we have done has eroded the essential concept we espoused in each of these cases -- that Rule 10b-5 was never intended to be what, in sports parlance, is often referred to as "the great equalizer." Our rule does not, and cannot, seek to counteract the same human differences that exist in every other field of endeavor or occupation, namely diligence, intelligence, perception, quickness alertness, purchasing power or good luck.

Yet, I for one am somewhat concerned about the tendency of our law to work through inexorable logical deduction from Cady, Roberts to a concept of flat egalitarianism. It is

^{3/} 44 S.E.C. 633 (1971).

^{4/} SEC Docket, No. 18, p. 21 (May 25, 1973).

very easy to find lawyers who can construct a series of impressive syllogisms to justify an absurd result. A number of courts have shown themselves quite capable of this exercise as well. The life of the law is not logic, however, but experience. And the unfortunate possibility is that the salutary purposes of Rule 10b-5 will be distorted, and possibly subverted, in the long run if the Commission's injunction -- that simply knowing what the other fellow does not, cannot, and should not, in and of itself, create 10b-5 liability -- is ignored.

As Judge Waterman noted in the Texas Gulf Sulphur case: ^{5/}

"An insider is not, of course, always foreclosed from investing in his own company merely because he may be more familiar with company operations than are outside investors. An insider's duty to disclose information or his duty to abstain from dealing in his company's securities arises only in those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if [the extraordinary situation is] disclosed." * * *

"Nor is an insider obligated to confer upon outside investors the benefit of his superior financial or other expert analysis by disclosing his educated guesses or predictions."

^{5/} Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F. 2d 833, 848 (C.A. 2, 1968), certiorari denied, 394 U.S. 976 (1969).

Perfect equality in information and judgment are not even desirable goals. Once judgment and analysis become standardized, the diversity of viewpoints that insure market liquidity also will be lost. And, even if this were desirable, it's a hopelessly unattainable goal.

I suppose there is nothing wrong, necessarily, with seeking unattainable goals. We all do this to some extent and the law, after all, is predicated upon the unattainable goal of perfect justice. But, particularly in the case of Rule 10b-5, pursuing this unattainable goal may be more than harmless frolic, it may be disastrous.

After all, the essential functions of 10b-5 are fairness to individuals and the maintenance and restoration of confidence in the fairness of our securities markets. Fairness in this context certainly does not require equality. But, if lawyers and the courts pursue a concept of equality as the goal 10b-5 should ultimately effect, the likely result will be a society in which corporations are afraid to act or speak and larger investors are afraid to trade.

Our goal should be to strike a workable balance between fairness and practicality, and to encourage industry, diligence and quality in financial research and analysis. Accomplishing this task is one of the most difficult problems we face today. Ironically, the more cases there are under Rule 10b-5, the greater the confusion about the scope and

application of the rule. I think the outlines prepared for this seminar bear this out.

For example, a number of circuit courts have opined that scienter is an integral element of any 10b-5 case; ^{6/} a number have said it isn't; ^{7/} at least one has said scienter is irrelevant; ^{8/} and others have said

^{6/} See, e.g., Clegg v. Conk, 507 F. 2d 1351, 1361 (C.A. 10, 1974); Zabriski v. Lewis 507 F. 2d 546, 554 (C.A. 10, 1974); Vohs v. Dickson, 495 F. 2d 607, 622 (C.A. 5, 1974); Securities and Exchange Commission v. Coffey, 493 F. 2d 1304, 1314-1316 (C.A. 6, 1974) certiorari denied, 95 S. Ct. 826 (1975). See also Lanza v. Drexel & Co., 479 F. 2d 1277, 1304-1305 (C.A. 2, 1973); Fischman v. Raytheon Mfg. Co., 188 F. 2d 783-787 (C.A. 2, 1951).

^{7/} See, e.g., Tomera v. Galt, [Current] CCH Fed. Sec. L. Rep. ¶94,975, at 97,369-70 (C.A. 7, Feb. 5, 1975); City National Bank v. Vanderboom, 422 F. 2d 221, 229-230 (C.A. 8) certiorari denied, 399 U.S. 905 (1970); Myzel v. Fields, 386 F. 2d 718, 734-735 (C.A. 8, 1957). See also Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F. 2d 833, 854-855 (C.A. 2, 1968), certiorari denied, 394 U.S. 976 (1969).

^{8/} White v. Abrams, 495 F. 2d 724, 734-735 (C.A. 9, 1974). Accord, Marx v. Computer Sciences Corp., 507 F. 2d 485, (C.A. 9, 1974).

scienter is not a necessary element in an action brought by the Commission. ^{9/} The Birnbaum ^{10/} line of cases -- both on corporate mismanagement and on standing to sue -- are equally confused.

SEC guidelines are one possible means of providing more certainty and clarity in this area of the law, but Commission guidelines may not provide the best solution to this problem and may, in fact, cause more confusion and uncertainty than presently exists.

9/ See, e.g., Securities and Exchange Commission v. Dolnick, 501 F. 2d 1279, 1284 (C.A. 7, 1974); Securities and Exchange Commission v. Spectrum, Ltd., 489 F. 2d 535, 541 (C.A. 2, 1973); Securities and Exchange Commission v. Manor Nursing Centers, Inc., 458 F. 2d 1082, 1096 (C.A. 2, 1972).

10/ Birnbaum v. Newport Steel Corp., 193 F. 2d 461 (C.A. 2), certiorari denied, 343 U.S. 956 (1952).

I can't help wondering what the Commission may have had in mind when it first suggested its 10b-5 guidelines project. If the courts find it exceedingly difficult to decide whether or not a fraud perpetrated by all of a company's directors is actionable as deception, under Rule 10b-5, ^{11/} or when the same court says an aborted tender offeror can sue this month, but not the next, ^{12/} all on specific facts, I am not sure I see how the Commission can do much better dealing with hypotheticals and non-existent facts. The Commission formally abandoned its guidelines project on directors' liability and many people, including many of us at the Commission, wonder whether the insiders' guidelines project is headed for the same fate.

11/ Compare Schoenbaum v. Firstbrook, 405 F. 2d 200, on rehearing (en banc), 405 F. 2d 215 (C.A. 2, 1968), certiorari denied, 395 U.S. 906 (1969) with O'Neill v. Maytag, 339 F. 2d 764 (C.A. 2, 1964).

12/ Compare Crane Co. v. Westinghouse Air Brake Co., 419 F. 2d 787 (C.A. 2, 1969), certiorari denied 400 U.S. 822 (1970) with Iroquois Industries, Inc. v. Syracuse China Corp., 417 F. 2d 963 (C.A. 2, 1969), certiorari denied, 399 U.S. 909 (1970).

Initially, our project on the use and misuse of material, nonpublic information was conceived of as a magnificent treatise, something that surely would rival Lou Loss's classic work. ^{13/} After about a year, and the marked and noisy absence of any product, however, we lowered our sights and determined to try our hand -- initially at least -- at a less formidable project; a shorter release devoted less to the history and development of Rule 10b-5 and more to a nuts and bolts discussion of the need for morality and so on.

After another six months went by, the silence seemed to grow even louder. This past fall, therefore, we waited until Al Sommer was once again away from the office for a day or so, and thus unable to defend himself, and then the rest of us elected him to undertake the task of overseeing and directing the preparation of an even more limited release, covering a narrower segment of this broad subject.

Our goal was, and still is, to complete this limited portion of our project, and if we are successful, to continue on from there.

Al originally had been the one to suggest that we abandon our detailed treatise approach and attempt something along the lines of the Commission's 1957 "gun-jumping" release ^{14/}

^{13/} L. Loss, Securities Regulation (2d ed. 1961).

^{14/} SEC Securities Act Release No. 3844 (October 8, 1957).

a presentation of a series of specific, factual questions and answers, based on actual and hypothetical cases, with a discussion of the reasoning applied in reaching each of our conclusions.

In his absence, and particularly in light of our gratitude to him for assuming a personal interest in the project, the rest of us agreed to try this approach. A "firm" deadline of January, 1975, for a draft to the Commission was agreed upon, and I, along with others, eagerly awaited the draft with blue pencils close at hand. By using hypothetical "questions and answers," as our approach, we were hopeful that persons faced with analogous situations would be in a better position to resolve their problems. But that January deadline has come and gone, and the point on my blue pencil is still sharp.

There is still a substantial question whether anyone actually will benefit from SEC guidelines. When I formally announced the abandonment of the Commission's corporate directors' guidelines project, to an audience comprised largely of corporate executives, the news was received with great applause. Guidelines may provide some certainty where people are now perplexed, but the cost of that certainty may be pretty high.

In any event, we have prepared an outline defining the scope of our new, less ambitious, 10b-5 guidelines project. We decided that our first inside information release, if and when it is produced, would be limited to a discussion of the problems likely to be faced by broker-dealers and professional financial analysts, in the conduct of their day-to-day affairs. Such persons, and particularly analysts, by the very nature of their professional duties, are continually seeking information from and about issuers of publicly-held securities. Thus, they, more so than other persons, are likely to be faced with difficult questions concerning the legal implications of using information which they obtain from various sources, and make a case for needing guidance.

This seemed like the logical place to start for other reasons, as well. Our involvement in Texas Gulf Sulphur prompted some persons to assume that we were out to muzzle corporate management and cut off the flow of corporate news. Our subsequent salvos in the Investors Management, ^{15/} Faberge and Avis ^{16/} cases did not allay these fears.

^{15/} Investors Management Co., 44 S.E.C. 633 (1971); Faberge, Inc., 1 SEC Docket, No. 18, p. 21 (May 25 1973); Securities and Exchange Commission v. Avis, Inc., 74 Civ. 1065 (S.D.N.Y., March 21, 1975), and see SEC Lit. Rel. No. 6797 (Mar. 24, 1975), 6 SEC Docket, No. 13, p. 534 (April 8, 1975).

I don't think that we have any reason to apologize for those cases. They involved what to us seemed like startling breaches of duty, and that is why we pursued them. In fact, the materiality of the information in those cases -- extraordinary and price sensitive information -- was higher than the courts have held necessary.

Nevertheless, the Commission does not wish to discourage analysts from talking to issuers and vice versa, since it is abundantly clear, at least to us, that the information-gathering and dissemination functions performed by professional financial analysts are essential elements of our nation's capital-raising mechanism, and are extremely beneficial to the investing public. On the other hand, we do want to discourage issuers from disclosing, and analysts from seeking and using, material, nonpublic corporate information. Notwithstanding our seemingly never-ending stream of cases, one can grow callous, at times, by reviewing some of the flagrant abuses our Enforcement Division keeps turning up.

This has been a particularly troublesome theme in a number of the cases we recently have brought and, in some instances, settled. Corporate officers, eager to promote their company and the trading markets for its stock, perhaps even optimistic that our capital markets once again will become receptive to equity offerings, have taken to talking to analysts privately.

There need be nothing wrong with this, and we have not yet gone so far as to say it is per se unlawful, although the results of such meetings may be. Sometimes, the company's officers are careless and let certain tidbits of information slip out. At other times, however, they are just insensitive to their fiduciary positions and their obligations under the federal securities laws, and particularly Rule 10b-5, and they seek out certain analysts they wish to cultivate, and disseminate to those analysts material, nonpublic corporate information.

In such instances, of course, we have no alternative but to sue the management personnel and the companies involved, in order to reinforce our view that this is not the way new information ought to reach our securities markets. Selective disclosure of information, where the largest investors and the more savvy analysts always know when to bail out or buy in, has done more to engender disaffection with our system than almost anything else, save the economic malaise which has produced a radical drop in the market price of most companies' stock.

It hardly seems necessary to remind corporate officers not to divulge nonpublic information on a selective basis, but then, there are those cases that keep cropping up. There really isn't much we can say, however, about selective disclosure of material, nonpublic corporate information after we've said it is bad.

What can our guidelines add to this area? The publicity may be good, but something more substantive should be accomplished by our project. If guidelines are to be helpful at all, they must provide answers to some unresolved questions, such as:

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

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

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

-- When do the inquiries and research of analysts result in material, nonpublic information about a company which an analyst is precluded from using by virtue of Rule 10b-5? Must the analyst obtain one

piece of specific material, nonpublic information in order for the prohibitions of Rule 10b-5 to apply? Is an analyst permitted to use material, nonpublic information he has obtained by piecing together bits of non-material, public and nonpublic information about the company? Do the sources of the information pieced together by the analyst matter?

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

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

-- Does a company have an affirmative obligation to disclose material, nonpublic information in order

to correct, affirm or deny rumors or written statements about the company circulating in the marketplace, even where the rumors or information originated from a source outside the company?

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

You all come to these programs to learn something, though perhaps not too much at lunch. No doubt Mike Eisenberg, Art Matthews and others were hoping for a dramatic announcement of the publication of guidelines at this time. But all I can leave you with, in fact, is the knowledge that we are still aware and concerned and trying. And now you have a new number to call with your complaints and great thoughts. Don't call me, call Al Sommer. More seriously, I still retain some hope that the efforts of the staff people working with him can and will bear useful fruit before too much longer.