VETERANS DAY

Special Address

by

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A seminar on
Corporate and Personal Liability
Under SEC Rule 10b-5

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Your program for today's meeting suggests that I will make a "special address". At the outset, I must disclaim the impressive title; there will be, as I am sure you will soon agree, nothing "special" about my remarks. The title merely reflects McGraw-Hill's way of acceding to my unwillingness--or, more truthfully, my inability--to select a topic in time for inclusion in the program. It is, however, a great pleasure to be with you today and to join even on this somewhat insulated basis, such distinguished and knowledgeable speakers. Each of them has, in his own way, contributed significantly to the development of what Judge Friendly has aptly called "a federal common law of corporate responsibility." Another preliminary remark is in order. I will not attempt today to develop any new interpretations or applications of Rule 10b-5. My remarks will be limited to a brief discussion of the Commission's role in this development and some general observations on what has been happening recently.

I wish also to make clear that I do not intend to discuss the merits of the Texas Gulf Sulphur case. Appeals in that case are awaiting decision in this Circuit. It is appropriate, however, to point out that the "federal common law of corporate responsibility", of which that case is a facet, has been with us for some time, and will grow rather than diminish--whatever the results of any particular case.

The Commission took its first important public action under Rule 10b-5 in 1943, when it issued a report of a public investigation involving purchases by Ward LaFrance Truck Corporation of its own stock. In the light of current discussions, it is interesting to recall that the accompanying release noted that the Commission issued the report, in part, "to call attention" to the existence of the rule. More significantly, of course, the report spelled out the corporate conduct which the Commission believed had violated the rule. Subsequent Commission actions expanded and elaborated on the principle involved in Ward LaFrance. At nearly every opportunity, the courts joined in this effort. Kardon v. National Gypsum Co. in 1947 and Speed v. Transamerica Corp. in 1951 were the early landmark cases.

The idea that the rule provides a basis for the articulation of a code of corporate fiduciary conduct involving securities transactions was specifically dealt with by the courts and by the Commission in 1961. In July of that year, the Court of Appeals for the Third Circuit stated in McClure v. Borne Chemical Co. that "Section 10(b) imposes broad fiduciary duties on management vis-a-vis the corporation and its individual stockholders. It can fairly be said that the Exchange Act constitutes far-reaching federal substantive corporation law." This theme was echoed four months later in an opinion written for the Commission in the Cady Roberts case by Chairman Cary. He stated that "the securities acts may be said to have generated a wholly new and far-reaching body of Federal corporation law." Characteristically, Bill Cary acknowledged an important assist from Art Fleischer in the development of that opinion. So much for ancient history. I hope that neither Bill nor Art resents this consignment.

In recent years we have witnessed titanic clashes between ingenious lawyers for the plaintiff continually trying to expand the opening wedges and corporate counsel resisting these onslaughts. The resulting private litigation has not, I think it is fair to say, given rise to complete

unanimity of views by the courts. In general, however, decisions in these cases, have tended to elevate the standards of conduct applicable to those who assume directorships or other important corporate posts. In a real sense they are modern manifestations of efforts which go back hundreds of years, and are consistent with our common law tradition that persons having fiduciary duties must rise above the morals of the market place. Therefore, it is important to emphasize that the protections afforded by Section 10(b) of the Exchange Act and Rule 10b-5 were never intended to be limited to transactions involving securities of publicly-held companies. Indeed, the case of Kardon v. National Gypsum, which I mentioned earlier, involved a closely-held corporation. Nor were the statute and rule intended solely to protect individual investors affected directly by action of corporate insiders. It is, therefore, not surprising that the courts have held that the rule also prohibits those insiders from defrauding the corporation itself--which, of course, is merely a company of individual shareholders. Simply stated, these provisions prohibit insiders from taking advantage of their preferred position--regardless of the identity of the person on the other side of the transaction.

Questions continue to be asked, however, whether Rule 10b-5 should be the basis upon which the Commission and the federal courts may articulate fiduciary standards and whether, in so doing, they are usurping the traditional prerogatives of state legislatures and state courts. The answer to these questions, not surprisingly, is not simple.

I should point out, initially, that the federal courts are not pre-empting the state courts' jurisdiction in problems which are recognized under Rule 10b-5. Nothing in the federal courts' action in 10b-5 cases precludes investors from instituting parallel actions in state courts for violation of state law. The growth of the modern corporation, however, has meant that problems of corporate law frequently transcend state lines. Judge Friendly has written that one of the benefits of the decision in Erie v. Tompkins is that it has freed the federal courts to deal with problems of national concern. He cites corporation law as one such area. Indeed, it has been suggested that the activities of many corporations, and related corporation law, now or soon will transcend national boundaries. George Ball, in a recent speech to the British National Committee of the International Chamber of Commerce, argued that the corporation of the future would be

an "international" corporation. He proposed, in effect, the creation of international corporation law. This is not visionary; it has been under way for some time. And, on a more limited basis, it was contemplated by the founders of the Common Market in their attempts to "harmonize" existing laws.

The exapnsion of corporations points to one potential danger arising from too great a reliance on state courts to handle every corporate problem. That danger is the greater possibility for lack of uniformity of the standards of corporate responsibility. This seems inevitable when courts in 50 states are asked to consider similar problems. In saying this, I do not wish for one moment to deprecate the importance of the work of state courts. It is just a fact of life that different judges will bring different views and precedents, born out of their own personal expereinces and the differing development and points of view of the communities in which they live, to bear on questions about which men may reasonably differ. The federal courts, on the other hand, tend to produce a more uniform result, as Judge Friendly has pointed out. This may be due in part to the fact that there are fewer of them and in part because the federal appellate courts have a variety

of fare not normally found within a single state. It is, of course, true that from time to time federal judges do differ in their decisions. Inevitably, the Supreme Court sorts out the differences when the issues are important enough.

There is also the danger, as recent changes in statutory corporation law suggest, that all of the states will not be equally vigorous in their concern for shareholders. It is impossible to generalize about the development of state corporation and securities law, but recent changes do suggest certain trends. On the one hand, some states are strengthening their laws to increase or to add to the protections available to shareholders. North Carolina is one example; California is another. It may be of interest to point out here that the proposed new California Corporate Securities Law of 1968 borrows its anti-fraud provisions heavily from Rule 10b-5. One provision deserves verbatim reading here:

> "It is unlawful for any person who is an officer, director or controlling person of an issuer or any other person whose relationship to the issuer gives him access, directly or indirectly, to information about the issuer not generally available to the public, to purchase or sell any security of the issuer in this state at a time when he knows information about the issuer which would significantly affect the market price of that security and which is not generally available to the public, unless he has reason to believe that the person selling to or buying from him is also in possession of the information."

The other side of the coin is less happy and more representative. It has been well described by Professor Folk of North Carolina. He points to the recent tendency of some state legislatures to weaken rather than to strengthen their corporation codes--a tendency, I am certain, which has not gone unnoticed by the federal courts. With each change of the statute in these states, the shareholders enjoy fewer and fewer protections or stated otherwise, management enjoys ever greater protections.

As has been true in many other areas of the law, the federal courts have stepped in to fill a void where a problem exists for which the states cannot provide a solution. Of course, one of the principal reasons for the various antifraud provisions of the federal securities laws and in other federal statutes was the realization that national problems could not be dealt with adequately by the states. This is not intended as a criticism of state legislatures, some of which have enacted more thoroughgoing statutes than those found at the Federal level. It is just true that jurisdictional limitations render state laws, no matter how well conceived or comprehensive, ineffective across state lines. It is also true that a national legislature is frequently less susceptible to influences which sometimes tend to force local

statutes into narrower molds.

It is interesting to contrast, by way of an aside, what is happening in Canada with developments in our country. Unlike the situation in the United States, Canada does have a federal Corporations Act. But, it governs only a few of the larger companies, and no general body of federal corporation law has developed. Instead, the provinces have jealously guarded against alleged inroads by the federal government. This is manifested by the development, in their own corporation and securities statutes, thoroughgoing standards for the conduct of corporations and their managers. I do not have time today to discuss them, but I commend to your attention the Kimber Committee Report on the Securities Act in Ontario, the Lawrence Committee Report on the Ontario Corporations Act and the legislation arising from these reports in that and other provinces in Canada.

It is clearly too late (even if it were desirable) to stem the development of the application of principles of federal law to the rights and duties of stockholders and corporate officials. Reasoned attempts, in law review articles and elsewhere, to restrain this growth have encountered little acceptance. However, an argument does continue whether private persons are proper parties to

initiate the lawsuits which make this growing body of law possible. The courts; willingness to imply a right of action to persons, for whose benefit Rule 10b-5 and other provisions of the securities laws were adopted, is a happy and healthy development. Since this concept has as yet not received universal acceptance, and its merits are not yet free from debate, I believe it deserves some consideration, and I anticipate that it will be a subject of discussion this afternoon.

As one who shares the responsibility for running a small regulatory agency, I view the private right of action as important, if not indispensable, for a number of reasons. First, as a practical matter, the Commission could not have initiated all the suits which have reached the Courts of Appeals in recent years. We just don't have the manpower. As is true with much of our work, we rely on other people and institutions to assist in the enforcement and development of the securities laws. This has been one of the secrets of success elsewhere. It is essential in the area of corporate responsibility. Of course, we do institute injunctive actions in important cases, particularly where immediate action is required to stop on-going violations of the securities laws, and we will continue to do

so. We do institute administrative proceedings, when appropriate, to curb violations of the rule, and we will continue to do that. It is important, however, to emphasize that the limitations on our resources of men and money require that we set priorities. We cannot take on all cases no matter how meritorious, even if we were able to learn about all of them. It seems almost embarrassing to find it necessary to argue, from time to time, that proper redress of private wrongs must not be denied because of the inadequacy of our resources or because of our unwillingness, for any reason, to champion every cause.

Indeed, the existence of the private right of action enables the Commission to make a more substantial contribution to the growth of the law of corporate responsibility than it could otherwise. Whatever expertise we have, we offer through our amicus curiae participation in cases which we or the courts believe particularly significant. The amicus curiae brief, which we submit usually at the appellate level and generally only as to issues of law, has enabled the Commission to formulate its own views carefully, and to present those views to the court objectively, unencumbered by the need to develop or to defend the factual basis for the initiation and conduct of a lawsuit. The courts have not always accepted our views. But they frequently express their belief that the Commission's

amicus participation is of benefit to them. In a related context, Judge Friendly recently testified before a committee of the Congress that, if the Investment Company Act is amended as we suggest, the Congress should consider a requirement that the Commission be a party to every private lawsuit challenging the reasonableness of the management fees charged to mutual funds. In this way, he suggested, the Commission could assist the Courts in developing uniform policy. Needless to say, we at the Commission are encouraged by Judge Friendly's views; for, as all of you know he has authored or participated in some of the leading opinions dealing with private rights of action, and with securities law questions in general. While we are pleased that our participation is helpful, it must be conceded that a substantial contribution has been made by the courts. It has been said elsewhere that, if there were no Rule 10b-5, the courts would have invented one.

By way of summary and conclusion, our increasingly sophisticated and complex corporate life has not lessened the need for continual review and raising of the standards of those who manage other people's money. Rule 10b-5 is making an important contribution towards the attainment of that goal. We, at the Commission, with aid and comfort from the courts, will continue to provide such assistance as our resources permit.