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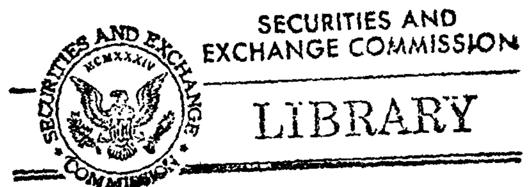

The Texas Gulf Sulphur Case - What It Is and What It Isn't

The Commission's action this past spring in bringing a civil action against Texas Gulf Sulphur Company and several individual defendants is one which has been widely publicized, roundly cussed and discussed. Although the case seeks new remedies, the basic theories underlying the action are not new. The Commission has brought both court and administrative actions in the past embodying those same theories. It is perhaps more important to you as Corporate Secretaries than to any other group that the Commission's position in these cases be understood.

The Commission's allegations in the Texas Gulf suit center primarily on the activities of certain insiders of that company. The Commission has alleged that those directors, officers, and key employees of the company were aware of a highly promising test drilling near Timmins, Canada, and that some of them on the basis of that information recommended the stock to their friends. In essence, the complaint states that the insiders or their friends purchased shares in the company, bought calls entitling them to purchase the shares later, or received stock options from the company at a time when the company's shareholders and the investing public had no knowledge about the potential new mining area. The Commission also alleges that the company itself issued a misleading release to the press four days prior to its release announcing that the company had made a major discovery. Further, the complaint includes an allegation that two directors of the company relayed certain information about the find to their associates which resulted in substantial purchases of Texas Gulf stock. This information was relayed after the announcement of the find had been given to the press but before its contents had been generally disseminated to the investing public.

The SEC's complaint filed in federal court here in New York asks that the insiders be enjoined both from trading in the company's stock on the basis of undisclosed material facts and from relaying confidential material information to their friends for use in stock transactions. The Commission seeks to rescind the insiders' stock acquisitions, to hold them responsible for the profits made by their friends, and to cancel the stock options they received from the company. The Commission also has requested that the company be enjoined from the issue of misleading releases concerning material facts about the company's activities. Of course, the Commission

has the burden to prove the facts which it has alleged and to sustain the constructions which it has placed upon those facts. The final decision as to the facts and as to the legal conclusions to be drawn from those facts properly will lie with the courts. My discussion here should be accepted in that vein.

Although the Texas Gulf case has received widespread publicity, it is not the only Commission case awaiting trial which involves the principles of corporate disclosure and insider trading. Another pending case is of particular interest to me because it concerns the merger of two mining companies in my home state. In that case the Commission has alleged that before the terms of that merger were publicly announced, an individual who was a director of both companies profitably traded upon his inside knowledge of the exchange ratio tentatively agreed upon and ultimately approved by both boards. It is also alleged that he passed the unannounced information to the board of an investment company of which he was a director, officer, and substantial stockholder. The Commission claims that he thereby enabled the investment company to engage in substantial profitable trading on the unannounced information. Its complaint alleges that both the individual and the investment company purchased the common stock of the company, the market price of which could be expected to rise, and sold the common stock of the company, the market price of which could be expected to fall. In its action the Commission seeks an order permanently enjoining both the individual and the investment company from trading in any security on the basis of material facts unavailable to stockholders or public investors. And, as in Texas Gulf Sulphur, restitution of profits to the persons with whom both dealt is also sought. In assessing the importance of the Texas Gulf and similar cases, I think we should consider both sides of the coin. What the Commission is attempting to establish in these cases and what it has not attempted to do should be treated together.

The two basic principles which the Commission is seeking to apply in these cases are not new. Rather, they are the long-standing concepts; first, of corporate disclosure, and second, of fair play by insiders.

Public disclosure of information of such significance as to materially affect an investor's judgment in the future of the company and the value of its securities is the very foundation of the securities acts. As you know, the 1933 Act requires that every company which sells its shares to the public make full disclosure about its operations. The 1934 Act, which requires a company periodically to file certain information about its management, operations and finances, has in the

past primarily applied to companies listed on the exchanges. However, its coverage was greatly increased by the Congress last year, when those disclosure requirements, as well as the insider trading provisions of that Act, were extended to many hundreds of companies which are traded over-the-counter and to their insiders.

In addition to the statutory disclosure requirements, the Commission has, down through the years, endeavored to encourage prompt release of corporate information and to foster the release of accurate information. It is not alone in this endeavor, for the self-regulatory agencies have also pursued this goal. Within the past year, the American Stock Exchange and the New York Stock Exchange have refined their guidelines regarding disclosures of corporate information by companies listed on their exchanges. The New York Stock Exchange's policy, which has been in existence for several years, is that important corporate developments which might affect security values or influence investment decisions should be promptly disclosed. As amended, it now also insists that corporate news be handled in proper perspective. This requires careful adherence to the facts in news releases, that any projections of financial data be soundly based, and that announcement of corporate developments should avoid overly optimistic forecasts, exaggerated claims, and unwarranted promises. Conversely, it seems clear that misleading, pessimistic understatements are inherently included in the Exchange's policy. In addition, its president has just recently made some suggestions on how insiders can best time their purchases of shares in their own companies.

The American Stock Exchange similarly requires listed companies to make public, speedily and equitably, any financial data, corporate action, or development which may affect securities values. It requires that corporate statements be factual and that judgment and restraint be used in publicizing information which may be construed as overoptimistic, slanted, or promotional. Here again misleading understatements would also be proscribed. The NASD also now requires that over-the-counter companies quoted in news media promptly disclose significant company developments which may influence investors' decisions. The Commission believes that the progress of the self-regulatory agencies in fostering prompt and accurate release of corporate information has greatly improved the dissemination of corporate news.

A second concept, much older even than the acceptance of corporate disclosure, is the duty long-imposed in the law to the effect that a corporate officer or director has the duty of a fiduciary

to the company's shareholders. The theory is that once stockholders have pooled their assets in a cooperative undertaking, the selection, usually from among their ranks, of directors and officers to act for the shareholders carries certain obligations with it. One prime obligation is that the director or officer not use his position of trust for his personal gain to the exclusion or detriment of the shareholders. The original statutory scheme for federal securities regulation incorporated this principle. Section 16 of the 1934 Act permits a corporation to recover from its officers, directors, and controlling shareholders any short-swing profits which they have made by trading in their company's shares. As all of you know, this provision virtually precludes insiders from trading in their company's shares if purchases and sales occur within a six-month period. Whether the purchase be for speculation or investment is irrelevant; the rationale being that the inherent potential for abuse of inside information is so great that the opportunity to profit by short-swing trading should be removed. Further, the statutory scheme of the 1933 Act required that an insider in control of a company register his shares in that company before they may be sold. These original provisions regarding corporate insiders have been expanded by a growing body of judicial law in cases brought under Section 10 of the 1934 Act.

The two theories of honest disclosure and fair play by corporate insiders meld in that section and in Rule 10b-5 adopted by the Commission under that section. The statute and the rule, among other things, prohibit one person in a securities transaction from misleading another person by either something said or by something that should be said but isn't. In the present actions pending before the courts including the Texas Gulf Sulphur case, the Commission is attempting to implement both the principle of full and accurate disclosure by a corporation and the precept that corporate officers, directors, and other insiders must meet fiduciary standards when they trade in their company's shares. It is specifically urging the court to adopt the following premises:

1. False or misleading statements made in connection with the purchase or sale of a security are forbidden. Affirmative misrepresentations, whether they grossly overstate or understate a new development, are included within Rule 10b-5. Should a corporation make affirmative misrepresentations about facts which will have a substantial effect on the price of the stock, then the Commission may seek appropriate enforcement action.

2. The disclosure principles of Rule 10b-5 also apply where there has been no disclosure whatsoever. Omissions of material fact can be just as misleading as false statements. While normally

non-disclosure of significant information by a corporation during brief periods when dictated by good business reasons is permissible, neither the corporation nor its insiders may trade in the company's stock during this period. If material information is not disclosed, the Commission believes that under the fiduciary theory a corporate insider may not capitalize on that undisclosed information for his personal profit.

3. The restrictions placed on insiders may apply to persons active in corporate affairs who are not controlling shareholders, officers, or directors. Of course, the latter persons traditionally have had the fiduciary's obligation to both the corporation and to their fellow shareholders. Similar reasoning imposes the same high duty on company employees who have been placed in positions of confidence and high trust. The mere fact that a general manager is not elected by the shareholders should not relieve him of his duty of fair dealing with the company and its owners. Only by virtue of his position does such an employee have access to confidential corporate information. The information thus comes to the employee in his official capacity, and he is expected to use it for corporate purposes. Accordingly, the employee who holds a position of high trust and confidence in the corporate structure must be treated like the officer, director, or controlling shareholder.

4. It is urged, then, that neither officers, directors, controlling shareholders, nor employees in positions of trust and confidence who obtain significant non-public information should utilize that information to trade in the issuer's securities when that information is unavailable to persons with whom they are dealing. The John Q Public shareholder or investor should be able to deal on an equal footing with the insider. The insider must not use confidential information to make personal purchases or sales of the issuer's security, thereby taking advantage of the fact that other shareholders and potential shareholders do not have access to that significant information.

5. If the insider does use significant non-public information to make personal profit in his own securities transactions, it is the Commission's position that he should offer to rescind his transactions with the persons who dealt with him.

6. In that context, the Commission also contends that an insider is responsible and should be held liable for those trading profits which he enables others to make. This should be the case whether the insider gives significant inside information to his friends or urges them to buy on the basis of that information.

Thus, if an insider passes along significant confidential information to his friends, he must not only offer rescission and thus lose his own profits, but also he will be held personally liable for the profits of those who trade on the information they received from him. In my opinion, if an insider tells his pals and they then profit on the use of undisclosed material information, the stockholders and investors should be told at the same time. Otherwise, the insider's pals are in a position to take unfair advantage of the investor's fellow shareholders as well as the investing public.

7. The Commission also believes that an insider, who has access to material information unknown to the public must neither trade in the company's shares nor enable his friends to trade on that information until it is actually disseminated to the investing public. Accordingly, it is the Commission's view that during the interim period after material information is given news media but before it is actually disseminated, insiders must forgo both trading and enabling their friends to trade.

The above capsules the Commission's contentions as I understand them. It is equally as important to recognize what the Commission is not attempting to do as it is to set forth the objectives which it seeks. For example, it is significant that the Commission as a plaintiff in these suits has not sought restitution for all persons who purchased or sold stock. Rather, it has confined its action to those who dealt directly with an insider or an insider's so-called "tipee." That does not mean, however, under the law of Rule 10b-5 as it is being developed by the courts, that private suits by individual plaintiffs who did not deal directly with the insiders will not lie.

Another result which the Commission does not seek is to prohibit an insider from investing in his company. There are important benefits which accrue to the shareholders of a company and to the economy generally when officers, directors, and other insiders including key employees have a financial stake in the company. Their investments provide them with a personal incentive to manage the company's affairs efficiently and to strive for its long-term prosperity. In this regard, the Commission seeks only to prevent insider trading based on undisclosed information which is not known to the other party to the trade and which is material.

Determining what is material is one very difficult practical problem which faces insiders in their trading. They must decide whether the information which they have but of which the public is

not aware is material. The test of materiality has been variously stated. One suggested test is whether the information is important enough that it would normally influence the judgment of the other party in a securities transaction. Another suggested test of materiality which also seems appropriate to me is that if the information could be expected to have a significant effect on the price of the stock if it were disclosed, then it is material. The insider who wishes to trade must thus exercise his sound discretion to determine if any unreleased information is material to investors with whom he trades. Conversely, if an insider is aware of corporate information which is not material, he may freely trade even though the information is not generally known to investors.

Another related area in which corporate officers and directors must exercise their sound discretion is in determining when the company should release significant news to the public. Timely and accurate release of corporate information is a primary objective of the Securities and Exchange Commission. By bringing the present cases, the Commission certainly does not wish to inhibit or discourage full, prompt, and accurate disclosure of significant corporate developments, be they favorable or unfavorable. In fact, I would be appalled to think that any action it may have taken could be so interpreted. While some have suggested that the Commission's actions will make corporate officials hesitate to give any news to anyone, it should be noted that much of the corporate information concerned in the Texas Gulf Sulphur case was volunteered by certain insiders to their select friends. It is the Commission's view that a leak of corporate information to a few buddies is quite distinct from the normal release of corporate information. For instance, the hot news tip from the inside to friends bears little relation to a public corporate announcement of major news to the recognized media of news distribution.

The Commission does recognize that sometimes a corporation may and should withhold certain significant information, at least for a while, in furtherance of the legitimate objectives of the corporation and its stockholders. Sound discretion is again the standard which corporations must meet. When a corporation decides to withhold information, its judgment must reflect the exercise of reasonable discretion under all the circumstances. In balancing the factors of disclosure versus corporate silence, I personally would apply the following test: If an important and legitimate corporate purpose is served by delaying release of significant information for a reasonable time, the corporation may and should do so. It should be pointed out that the Commission is not claiming that the corporation's silence in the Texas Gulf case was wrongful.

The exercise of the legitimate right to withhold information is not absolute, however. If the secret is not well kept and rumors concerning the withheld news become rampant, then general standards of corporate conduct should require an accurate, clarifying statement by the company. The Commission alleges that the Texas Gulf's first release -- issued only four days prior to the announcement of its large mining strike -- failed to meet that standard of accuracy. In fact, the only conduct of the Texas Gulf Company itself involved in the Commission's action is that allegedly misleading first release; and the only relief sought against the company is the requested injunction against the issue of misleading news releases. Of course, if there is no important and legitimate corporate purpose for a delay in releasing or withholding news, then the company should make prompt disclosure. A greater latitude for reasonable corporate discretion is present on news items which are not material to investment decisions and which would not affect the value of a security. The same is true of the great mass of data which might be of some interest but which is too voluminous for release to investors. In other areas, such as trade secrets, public release has never been required.

In determining whether to bring action either against an insider for trading on undisclosed information or against a company for release of misleading information, the Commission realizes that the decisions which corporate officials must make are not easy. This is an area where corporate officers, directors, and other insiders, as they have in the past, must make decisions on a day-to-day basis through the exercise of their sound discretion. I would hope that the Commission in its enforcement actions will endeavor to pursue only those cases which present evidence of clear violations. Of course, even then, the courts must ultimately resolve whether the law has been violated.

Turning to the realm of possible defendants in the present and potential civil actions, the Commission certainly does not contemplate suing every person who may have come across inside information. In the Texas Gulf action neither tipees nor persons in the vast rank and file of employees have been named as defendants. In my view, the Commission in future cases normally should not join rank and file employees or persons outside the company such as an analyst or reporter who learns of inside information. Obviously, persons such as the taxi driver, the barber, or the caddie who by chance overhear a bit of corporate news should not be named as defendants in civil actions brought by the Commission.

In summary, my view is that when the decision is made that significant corporate information is not to be disclosed because it would not be in the best interest of the company, then the company

and its insiders must forgo personal securities transactions until disclosure has been made. When disclosure is made, it should be complete and accurate.

I hope that my remarks may be of some help in delineating what the Commission is and is not trying to do in the two areas of corporate disclosure and insider trading.