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CASE NOTES

Securities Regulation—Rule 10b-5—Insider's Duty to Disclose Material Information—Liability for Misleading Press Release.—SEC v. Texas Gulf Sulphur Co.1—In November 1963, defendant mining company sank a test drilling hole at a possible mining site near Timmins, Ontario. A visual inspection of the extracted core indicated extensive concentrations of copper-zinc ore through most of its length. Chemical tests, completed in mid-December, also revealed traces of silver ore. In order to prevent a rise in land costs, the company took steps to maintain secrecy,2 then bought up surrounding properties, and, in March 1964, drilled a second core intersecting the first. A visual inspection of the second extracted core on April 7 reinforced earlier findings of heavy mineral concentration. On the same day, a third hole was begun in a plane parallel to that of the first two. By 7:00 p.m. on April 9, a third core had likewise indicated substantial mineral concentrates.

At various times after each of these drillings, the individual defendants, including the president, vice-president, and several directors of the company, as well as company lawyers, geologists, and an accountant, purchased Texas Gulf Sulphur stock and calls on stock. In February 1964, some of the individual defendants accepted stock options from a company committee that had no knowledge of the drilling operations.3

On April 12, 1964, amid growing rumors of a major copper strike, the company issued a press release to the effect that the reports were exaggerated and that the find was merely a "prospect." Four days later it issued another press release announcing a major ore strike. Two company officials bought stock only minutes after this news was released to the press.

The Securities and Exchange Commission alleged that from the time the visual estimates of the first drilling were known, the individual defendants possessed material information which, as long as it was not disclosed to the public, prohibited these individuals from trading in the stock of their company. The Commission further alleged that the press release issued by the company on April 12, 1964, was false and misleading. On the strength of these allegations, the Commission instituted action in the district court against the company and the individuals, seeking decrees: (1) that individual defendants be restrained from trading in company stock on the basis of material inside information; (2) that they be required to offer rescission to the sellers of the shares; (3) that those defendants who had transmitted inside information to "outsiders" be required to make restitution to the sellers; (4) that the stock options be cancelled and any shares or profits from them be returned to the company; and, (5) that the company be enjoined from issuing materially false or misleading press releases in connection with the purchase or sale of

2 The company suspended further drilling on the electromagnetic substance that promised to contain ore. Members of the exploration group were instructed to keep results secret. The drill rig was moved away from the hole. Cut saplings were inserted in the ground, in the area of the hole, to conceal its location. A decoy hole was drilled for the benefit of the curious.
3 Members of the committee were ignorant of the company's finds at Timmins because of a company policy of keeping information of prospective mineral finds secret from nonmanagement directors.
its securities. These remedies were sought under Section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 of the Commission, promulgated pursuant to section 10(b). The district court HELD: The test of materiality under rule 10b-5 must be a conservative one, since company insiders ought to be judged by what they knew at the time they traded, and not by judicial hindsight. When a company is confronted with inaccurate press reports that might inflate the price of its stock, it is not misleading for it to issue a press release which, though "gloomy or incomplete," was drafted with good business judgment for the purpose of countering the reports. In addition, the court declared that it is a legislative or administrative function, not a judicial function, to decide how soon after disclosure of material information insiders are permitted to trade in their company's stock.

This case was widely discussed even before it came to trial and has aroused serious concern in legal and financial circles. There were fears that if the Commission were supported in its claim regarding the April 12 press release, companies would thereafter hesitate to release information to the public and "corporate information will dry up." It was anticipated that companies would be subject to suit if they did not disclose information which might later be adjudged material, or if they did release information which might later be adjudged deceptive.

The company contended that the April 12 press release did not fall within rule 10b-5, because it was not issued "in connection with the purchase of..."
or sale of any security.\textsuperscript{10} This argument was rejected in the light of \textit{Freed v. Szabo Food Serv., Inc.},\textsuperscript{11} which held that a communication does fall within the rule if its purpose is to affect the market price of the stock to the advantage of the company's insiders. Although that case concerned prospectuses mailed to individual customers, rather than press releases, the court suggested that the principle of the rule should be applied identically in both situations. The rule encompasses "any means or instrumentality of interstate commerce, or of the mails," "any device," "any untrue statement," or "any act . . . which operates or would operate as a fraud . . ." It would be incongruous to allow a rule generally proscribing manipulative devices to apply to prospectuses but not to press releases, which reach a much larger portion of the investing public.

The SEC had argued that the April 12 press release was misleading in that the core results of five holes were available to company officials when they drafted it, and that these results established the existence of substantial reserves of proven ore.\textsuperscript{12} The court found, however, that the officials who drafted the release used reasonable business judgment in order to counter what they considered to be exaggerated and inaccurate rumors. The court's decision seems to be based on this alone, and gives little consideration to the more basic question of whether the release \textit{in fact} tended to mislead the trading public. It can concededly be argued, in support of the court's decision, that no single sentence of the release is literally deceptive, and that the use of the word "prospect" to describe the company's discovery is not clearly inaccurate. In the common parlance by which press releases are interpreted, evidence of a body of commercially mineable ore, as derived from a series of test drillings, does not cease to be a "prospect."

It is submitted, however, that the whole thrust of the release was contrary to the known facts. The press release stated that "recent drilling on one property near Timmins has led to preliminary indications that more drilling would be required for proper evaluation of this prospect."\textsuperscript{13} This sentence is not literally false, but it leads naturally to the inference that the company knew nothing definite about its find, and that inference is incorrect. "The drilling done to date has not been conclusive," the press release continued.\textsuperscript{14} These words raise the false inference that no reliable information could yet be drawn from the drilling. "[T]he statements made by many outside quarters are unreliable and include information and figures that are not available to TGS."\textsuperscript{15} This is literally true, but it falsely connotes that none of the printed rumors had any basis in fact. By failing to acknowledge its anticipation, as of the date of the release, that it had made a substantial discovery, the company probably implied to the average investor that it had made no significant discovery at all. The creation of this impression was, under the circumstances,

\textsuperscript{10} 258 F. Supp. at 293.
\textsuperscript{12} Post-Trial Memorandum of the SEC, July 5, 1966, pp. 55-63.
\textsuperscript{13} 258 F. Supp. at 293.
\textsuperscript{14} Ibid.
\textsuperscript{15} Ibid.
deceptive and misleading. The company argued that it had intended simply to control the rumors, not to mislead investors. Intent, however, is not an essential element of a 10b-5 action brought by the SEC, as this court recognized. Lack of intent was held immaterial to the court’s finding that two defendants had violated the rule by their purchases of securities. But there is no reason to differentiate between a manipulative purchase of stock and a deceptive press release in the trying of a 10b-5 action, because either of these activities misleads traders. Both practices contravene "the end sought by the Act, to-wit, the lessening of fraudulent and sharp practices on the securities market." Therefore, the company’s good business judgment in drafting the April 12 press release to counteract rumors should have been deemed immaterial to the decision.

The court then concluded that the April 16 release was the first full disclosure. Some individual defendants argued that the previous reports and rumors satisfied the disclosure requirements, but the court pointed out that the actions of the company officers manifested a belief that such reports were not effective as a disclosure:

Had they thought that their effect was to make the material information public there would have been little purpose in making the arrangements for a press conference, and issuing a detailed announcement on April 16. The material information did not become public knowledge prior to TGS's official announcement. Therefore, insiders who purchased stock prior to TGS's announcement may not assert as a defense that the material information had already become a matter of public knowledge.

The conclusion of the court is probably based on the assumption that reported rumors, not attributed officially to the company, do not materially affect investor judgment. The decision that the April 16 release was the first full disclosure seems to rely also on an estoppel argument. In other words, since the company acted as if it were making its first full disclosure, it will be held to the consequences of this position. It is submitted, however, that an

16 Under rule 10b-5, statements made by a company must be considered "in the light of the circumstances under which they were made . . . ." 17 C.F.R. § 240. 10b-5 (rev. 1964).
18 258 F. Supp. at 286-87.
20 258 F. Supp. at 286. The defendants were called "insiders" throughout the case, although the word "insider" is not used in the section or the rule. As used in 10b-5 actions, an "insider" is anyone who possesses material information that is not available to the public. He need not be associated with the company. He becomes an "insider," for the purpose of the rule, by "a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone," and by the "inherent unfairness" of his taking advantage of such information, "knowing it is unavailable to those with whom he is dealing." In the Matter of Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961). Although a 10b-5 action could be maintained without reference to the concept of "insider," the term has, nevertheless, been associated with the act since its enactment.
argument of estoppel is improper. The court's duty was to make a simple factual finding of whether the information about the company's discovery had actually been fully disclosed to the trading public. The company's public attitude with respect to previous disclosures may be of assistance in making this decision, but should not be, as it was here, conclusive. 

The exoneration of all but two of the thirteen individual defendants was considered to be a major defeat for the Commission. The findings as to the defendants who were acquitted were grounded on two basic conclusions of law: (1) the test of materiality must necessarily be a conservative one; and, (2) use by an insider of his special interpretive ability and "educated guesses" is not to be considered violative of rule 10b-5.

The holding that the test of materiality must be conservative is new to the case law of the field. Simply stated, the effect of this test is to allow an insider to withhold more information as "not material." The institution of a conservative guideline actually results in a presumption in favor of the defendant, giving him an advantage he did not have under the common law. At common law, "a fact is material if... its existence or nonexistence is a matter to which a reasonable man would attach importance in determining his choice of action in the transaction in question..." This rule is plainly neutral; no presumption in favor of the defendant can be inferred from it.

The common law occasionally, but not usually, required a person in possession of secret material information to disclose it to persons with whom he was trading, or to forego the transaction. It was sometimes held that a fiduciary relationship between the company insider and the person with whom he was trading imposed this duty. In cases that used this rule, there was no statement or implication that the test of materiality is to be applied conservatively. The Securities Exchange Act of 1934, however, was intended to extend the concept of fiduciary relationships to more transactions than had been covered under the common law. According to the report that began House debate on the act:

Unless the constant extension of the legal conception of a fiduciary relationship—a guarantee of straight shooting—supports the constant extension of mutual confidence which is the foundation of a maturing and complicated economic system, easy liquidity of the resources in which wealth is invested is a danger rather than a prop to the stability of that system.

The courts have concurred in interpreting the act to require the extension

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22 The court cited for this conclusion one law review article, Fleischer, supra note 7. 258 F. Supp. at 280-81.
26 78 Cong. Rec. 7703 (1934).
of fiduciary concepts to the laws of securities transactions.\textsuperscript{27} \textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquoteright\textquote
CASE NOTES

a narrow vein. The SEC estimated, on a hypothetical extension of the ore body in a zone only one foot to each side of the plane drilled, that at that time a field of copper-zinc ore worth about $750,000 was indicated. This hypothetical extension was, of course, markedly conservative, as was the estimate derived from it. It is submitted, therefore, that trading, after results of this drilling were known, was based on undisclosed material information.

The SEC argued that the defendants themselves believed the results of these drillings to be highly significant. The Commission was unsuccessful, however, in arguing that the defendants' subjective estimate of the significance of the discovery was sufficient to indicate objective materiality to a "reasonable trader." This SEC argument, while persuasive, seems inconclusive. The court felt that a company insider, trained in his work, will necessarily be able to evaluate information more thoroughly than the hypothetical reasonable trader. The fact that an insider can take a given body of information, and through his superior analytical ability reach certain conclusions, does not make that body of information material by objective standards.

On the issue which may represent the greatest shortcoming in the opinion, it is submitted that the court should have decided that trading a short time after disclosure, before the market has had a chance to absorb the information, is a manipulative device and contrary to the rule. The court could have made this decision without laying down an inflexible rule as to what this "short time" must be, by recommending a flexible test to be applied with discretion from case to case. The court could have found precedent for such a decision in SEC v. Capital Gains Research Bureau, Inc., construing the purposes of the Investment Advisers Act of 1940, which contains language parallel to that of rule 10b-5. That case held that an investment adviser's practice of purchasing securities for his own account shortly before recommending that security for long-term investment, and then immediately selling the shares at a profit after a rise in market price, constituted a "device, scheme or artifice to defraud" a client or prospective client. Mr. Justice Goldberg, construing the purpose of the securities acts of 1933 and 1934 and the Investment Advisers Act, wrote that "a fundamental purpose, common to these statutes, was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry." It is submitted that buying stocks in one's company, minutes after material inside information is released to the

34 Post-Trial Memorandum of the SEC, July 5, 1966, at 46-47.
35 Id. at 48.
36 Id. at 13-17.
37 The company held a press conference beginning at 10:00 a.m. April 16, and lasting 10 or 15 minutes. Summaries of the announcement were carried over one brokerage house's news wire at 10:29 a.m. and over the Dow Jones Broad Tape between 10:54 and 11:02 a.m. Two individual defendants telephoned orders for stock at about 10:20 a.m. and 10:40 a.m.
40 375 U.S. at 186.
press, falls below a high standard of business ethics and completely vitiates
the goals of the rule.41

STEPHEN C. UNSINO

Trade Regulation—Administrative Law—All Writs Act—Power of
Court of Appeals to Issue Preliminary Injunction upon Petition of
Federal Trade Commission.—FTC v. Dean Foods Co.1—The Federal
Trade Commission petitioned the Seventh Circuit to enjoin temporarily the
consummation of a merger between the respondents, Dean Foods Company
and Bowman Dairy Products. The Commission had issued a complaint
against the respondents under Section 7 of the Clayton Act2 and Section 5
of the FTC Act,3 but no hearing had been held on the complaint.4 The
Commission applied for the preliminary injunction on the grounds that it
was “probable” that the proposed merger would be found illegal, and that
upon consummation of the merger, Bowman would lose its identity as a
separate enterprise and the two companies could not then be effectively
restored to their original status.5 The Seventh Circuit dismissed the petition
on the basis that the FTC had no authority to institute proceedings for
temporary relief in the court of appeals.6 The Supreme Court granted
certiorari, and then, in a 5-4 decision, reversed and remanded.7 HELD:
The court of appeals has the authority to grant a preliminary injunction
against the consummation of a merger that will probably be found illegal,
and the FTC has the authority to apply to the court of appeals for such
preliminary relief. The court of appeals derives its power to grant injunctive
relief from the All Writs Act.8 The Commission has the “incidental power”
to petition the court of appeals for injunctive relief under the All Writs Act

41 The SEC has recently expressed great concern over the fact that, despite com-
pliance with strict disclosure standards, corporate insiders are able to trade on the basis
of material information well before it has had time to be adequately disseminated to
the public. This, it is felt, “raises serious questions of law and propriety.” Wall Street

4 Normally, under the procedures of the FTC, a complaint is issued against parties
whose conduct is believed to be in violation of the Clayton Act, a hearing is held on
the complaint, and a “cease and desist” order is issued if a violation is found at the
hearing. See FTC Enforcement and Procedure, 3 Trade Reg. Rep. ¶ 9574 (1966). This
is the only way the FTC itself can prevent a merger.
5 Under the terms of the merger, Dean was to acquire all of Bowman’s dairy opera-
tions, which Dean was to consolidate into its own. Bowman was to cease to be a dairy
business and was to take the form of an investment fund with the name “Bowfund Cor-
poration.” The assets of the fund were to be the cash and securities excepted from the
sale of the assets to Dean. Brief for Petitioner, p. 8.
6 FTC v. Dean Foods Co., 356 F.2d 481 (7th Cir. 1966).
7 On remand the Seventh Circuit granted the injunction. No. 15493, 7th Cir., July
18, 1966. Subsequently, the FTC ruled that the merger was illegal. 3 Trade Reg. Rep.
¶ 17,765 (1966).