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Corporate Silence and Rule 10b-5: Does a Publicly Held Corporation Have an Affirmative Obligation to Disclose

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CORPORATE SILENCE AND RULE 10b-5: DOES A PUBLICLY HELD CORPORATION HAVE AN AFFIRMATIVE OBLIGATION TO DISCLOSE?

BY ALAN L. TALESNICK*

INTRODUCTION: THE PROBLEM

DISCLOSURE represents the cornerstone of federal securities regulation. The Securities Act of 1933 requires registration and disclosure for a public offering.[1] Section 14 of the Securities Exchange Act of 1934 requires disclosure upon solicitation of proxy material.[2] Section 16 of the 1934 Act requires disclosure of trading by officers, directors, and major owners of a corporation's stock.[3] Section 13 of the 1934 Act requires disclosure at the end of certain fiscal periods.[4] Rule 10b-5, promulgated under section 10(b), requires disclosure of material corporate information by one who is buying or selling an issuer's securities.[5]

Yet is there any requirement to disclose material corporate information when none of the above situations exists? That is, does a corporation have an obligation to disclose material information when it is not trading in its own securities, when it is not in the formation or the process of a public offering, when it is not soliciting proxies, when none of its insiders are trading in its stock, when it has not reached the end of a reportable fiscal period, and when there are no traders taking advantage of undisclosed material information?

A key term in the question presented is "material information." An acknowledged standard for determining materiality is "whether a reasonable man would attach importance [to the fact] in determining his choice of action in the transaction."[6] With this definition in mind, the presence of materiality will

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1 Securities Act of 1933, §§ 5, 6, 7, 10, 15 U.S.C. §§ 77e, f, g, j (1970).

2 Securities Exchange Act of 1934, § 14, 15 U.S.C. § 78n (1970) [hereinafter cited as SEA].

3 SEA § 16, 15 U.S.C. § 78p (1970).

4 SEA § 13, 15 U.S.C. § 78m (1970).

5 17 C.F.R. § 240.10b-5 (1972).

6 SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968); List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965).

be assumed for the purpose of this article. Therefore, the issue in question is the following: Assuming that a corporation possesses information which is material, does the corporation have an affirmative obligation to disclose it?

An illustration of this issue is a mining company's discovery of a significant mineral deposit. Certainly this discovery is a fact to which a reasonable man would attach importance in determining whether to sell his stock in the company. The question then becomes whether, in the absence of insider trading, the corportation must disclose its discovery to the investing public. Throughout the text, this issue will be referred to as the "principal question," the "hypothesized situation," or the "issue in question." The terms "affirmative disclosure" and "affirmative duty (or obligation) to disclose" will be a shorthand for referring to the requirement of disclosure of material information by a corporation not involved in any of the aforementioned activities.

The disclosure requirements pertaining to public offerings, proxy solicitations, and insider trading specifically concern the activities to which they refer and are therefore inapplicable to the foregoing definition of affirmative disclosure. On the other hand, the periodic and current reporting requirements of the Securities Exchange Act of 1934 are not so aligned to particular events; they will be examined in this article to determine to what extent affirmative disclosure might be accomplished thereunder. This examination is followed by analysis of the timely disclosure policies of the two major stock exchanges. Analyzing the strengths and limitations of the stock exchange policies will help to delineate the extent to which affirmative disclosure exists in that setting as well as the extent to which such policies may be used as a possible source for further imposition of a duty of affirmative disclosure. Following these necessarily brief appraisals, the article focuses on rule 10b-5 as the most probable source of an affirmative duty to disclose. This consists of a detailed analysis of the text of the rule to see if the words, on their face, provide a duty of affirmative disclosure. The second look at rule 10b-5 is an analysis of some of the pertinent case holdings, judicial reasoning, and SEC pronouncements to see if these authorities might provide a source for a duty of affirmative disclosure. The final section of the article deals with the consequences resulting from affirmative disclosure: the advantages gained and the impracticalities confronted as a result of implementation.

I. Periodic and Current Reporting Requirements

A. *The Reports Required*

Section 13 of the Securities Exchange Act of 1934 provides continuing disclosure (reporting) requirements for issuers which fall into any of the following classifications: (1) An issuer with a class of security registered on a national securities exchange;[7] (2) an issuer with at least $1,000,000 of total assets and at least 500 persons who are holders of record of a class of the company's equity security;[8] or (3) any issuer which has filed a registration statement that has become effective pursuant to the Securities Act of 1933 on or after August 20, 1964, for at least one class of securities which is held of record by 300 or more persons.[9] Pursuant to section 13(a) of the 1934 Act, the SEC has the power to require registered companies to provide such information and reports as it may deem "necessary or appropriate for the proper protection of investors and to insure fair dealing in the security . . . ."[10]

The rules promulgated by the Commission under section 13(a) require the filing of annual reports (form 10-K),[11] quarterly reports (form 10-Q),[12] and current reports (form 8-K).[13] The effectiveness of form 10-K in disclosing significant business events is limited by two factors: the 12-month interval between filings and the 4-month time lag allowed between the end of the fiscal year and the submission of all data pertinent to the 10-K.[14]

The same problems of infrequency and time lag are not as serious with form 10-Q. It is filed quarterly and involves a reporting time lag of 45 days.[15] Form 10-Q fails as a vehicle for current disclosure because its contents consist only of uncertified statements of profit and loss, earnings per share, capitalization, and stockholders' equity. There are numerous

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7 SEA § 12(b), 15 U.S.C. § 781(b) (1970).

8 SEA § 12(g)(1), 15 U.S.C. § 781(g)(1) (1970). Section 12(g)(2) does exempt certain companies within this classification, but such exemptions are not important to the discussion herein. Registration under § 12(g)(1) is no longer required if an issuer has fewer than 300 stockholders of record at the end of a fiscal year.

9 SEA § 15(d), 15 U.S.C. § 78o(d) (1970). Companies registered under the 1933 Act prior to August 20, 1964, are subject to the reporting requirements of § 15(d) only if they had expressed an undertaking at the original registration to adhere to such requirements.

10 SEA § 13(a), 15 U.S.C. § 78m(a) (1970).

11 17 C.F.R. § 240.13a-1 (1972).

12 17 C.F.R. § 240.13a-13 (1972).

13 17 C.F.R. § 240.13a-11 (1972).

14 2 CCH Fed. Sec. L. Rep. ¶ 31,102 (1972).

15 SEC Securities Act Release No. 9004 (Oct. 28, 1970).

material events which could occur but which would not be reported in form 10-Q.

Form 8-K is a current, rather than a periodic, report. It is to be filed "within ten days after the close of any month during which any of the events specified in that form occurs . . . ."[16] It apparently is intended to elicit disclosure of material business occurrences, but the actual requirements of form 8-K prevent it from attaining this objective.[17] The form's weakness as a current disclosure device stems from the fact that only items 1 through 11 are mandatory. Thus the corporation has complete discretion to decide whether to report an occurrence under item 12 if it does not fit into any of the specific categories.[18] The significance of this corporate discretion is illustrated by noting that a mineral strike by the Texas Gulf Sulphur Company in Canada[19] failed to necessitate a form 8-K current report. Because the discovery constituted a material event which was not enumerated within the general instructions to form 8-K, the corporation could decide whether to report it under item 12 as "Other Materially Important Events." Although it seems that such events should be required in a form 8-K, the SEC has rejected the idea of mandatory current reporting of all material events on the grounds that (a) the standard is vague, (b) significant risks of corporate liability would arise, and (c) determining the occurrence of material events would be difficult.[20]

Form 8-K fails as a current report not only because of its optional item 12, but also because it need not be filed until 10

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[16] 17 C.F.R. § 240.13a-11 (1972).

[17] CCH FED. SEC. L. REP. ¶ 31,003 (1972). The following company events are included in a current report: (1) Changes in control of registrant; (2) Acquisition or disposition of assets; (3) Legal proceedings; (4) Changes in securities; (5) Changes in security for registered securities; (6) Defaults upon senior securities; (7) Increases in amount of securities outstanding; (9) Options to purchase securities; (10) Revaluation of assets or restatement of capital share account; (11) Submission of matters to a vote of security holders; (12) Other materially important events.

[18] *Id.*

[19] *See* Section I. C. *infra.*

[20]
> Proposals to make mandatory the current reporting of all material events have been rejected in the past by the commission, apparently on the ground that compliance with this standard would be very difficult because it is so vague; furthermore, it might expose corporations to significant risks of liability. . . .

Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 VA. L. REV. 1271, 1300 (1965).

> Such a provision might also be difficult for the staff of the commission to administer, as the staff would not ordinarily be in possession of facts enabling it to determine whether a material event had occurred.

Id. at 1300 n.133.

days after the end of the month in which the reportable event occurred.[21] Nevertheless, the Wheat Report indicated that these characteristics were not weaknesses because the SEC's current reporting requirements "are not intended to . . . duplicate the timely disclosure policies of the self-regulatory agencies."[22]

In considering the effectiveness of the reporting requirements as disclosure devices, one must realize that there is a difference between filing a report with the Commission and publicly disclosing that report by disseminating it to the public. Forms 10-K, 10-Q, and 8-K, insofar as they require disclosure, require disclosure into the Commission's files rather than into the public's awareness. Furthermore, these disclosures do not necessarily become available even for those members of the public who take the initiative and the trouble to seek them out. Section 24(b) of the 1934 Act provides that the issuer may make a written objection to public disclosure of its SEC filings. In this situation, the Commission will make such information available to the public only when it deems that "disclosure of such information is in the public interest."[23] If the Commission fails to sustain an issuer's objection to public disclosure of its filed reports, both the Commission[24] and the exchange with which the issuer is listed[25] shall make all information filed under sections 12, 13, 14, and 16 of the 1934 Act available for public inspection.

Thus the Securities Exchange Act of 1934 subjects those issuers under its jurisdiction to a very limited obligation of continuing disclosure. Forms 10-K, 10-Q, and 8-K do contain valuable information, but they do not create an "informed" market at any point in time.[26]

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[21] 2 CCH FED. SEC. L. REP. ¶ 13,002 (1971).

[22] SEC, DISCLOSURE TO INVESTORS 332 (1969) (commonly referred to as The Wheat Report). The Wheat Report's recommendations concentrated on making the current reports more comprehensive in content rather than on improving their timeliness.

[23] SEA § 24(b), 15 U.S.C. § 78x(b) (1970).

[24] 17 C.F.R. § 240.80 (1972).

[25] 17 C.F.R. § 240.24b-3 (1972).

[26] Former SEC Chairman Cohen has described the situation quite well:

> 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 fcr the rapid and widespread dissemination of current material information to the investing public.

Address by Manuel F. Cohen, Chairman, Securities and Exchange Commission before the Baltimore Security Analysts Society, Jan. 6, 1969, in '67-'69 Transfer Binder CCH FED. SEC. L. REP. ¶ 77,652 at 83,420.

B. *Sanctions for Violation of the Reporting Requirements*

Violation of the reporting requirements of the Securities Exchange Act of 1934 can involve sanctions in the form of civil action by both private and public parties. Section 18(a) of the Act provides recovery of damages to any person who relied— in the purchase or sale of a security — on a false or misleading statement in a report filed under the Act.[27] In order to recover under section 18(a), the plaintiff must prove not only that a statement in the report was false or misleading, but also that the price of the security transferred was affected by the statement and that his disposition of the security was in reliance upon the statement. Even if the plaintiff presents the requisite proof, the defendant can still prevail upon a showing that in making the statement, "he acted in good faith and had no knowledge that such statement was false or misleading."

Proving both that the statement was misleading and that the plaintiff's purchase or sale was made in reliance on the statement are not without difficulties. Moreover, proving a causal relationship between any single factor and the price of an actively traded security is "an almost impossible task with actively traded securities."[28] The fact that this significant barrier to recovery is followed by the availability of the good-faith-and-lack-of-knowledge defense makes section 18 an extremely difficult and highly improbable means of penalizing the presence of a misleading statement in a required report.

The Commission may take civil action for violation of the reporting requirements pursuant to its authorization in section 15(c)(4),[29] 15(c)(5),[30] or 19(a)(4).[31] Section 15(c)(4) authorizes the Commission to order an issuer to comply with the reporting requirements of the 1934 Act after notice and opportunity for a hearing. If the issuer persists in its failure to comply, the Commission can then enforce its order in court. As of 1968, this procedure had been utilized fewer than 10 times.[32] Such infrequency was probably due both to the relatively large time period involved in implementation and to the lack of deterrence imposed by the actual sanction.

Sections 15(c)(5) and 19(a)(4) authorize the Commission to suspend trading in a security for a period not exceeding 10

[27] SEA § 18(a), 15 U.S.C. § 78r (1970).

[28] Knauss, *A Reappraisal of the Role of Disclosure,* 62 MICH. L. REV. 607, 627 (1964).

[29] SEA § 15(c)(4), 15 U.S.C. § 78o(c)(4) (1970).

[30] SEA § 15(c)(5), 15 U.S.C. § 78o(c)(5) (1970).

[31] SEA § 19(a)(4), 15 U.S.C. § 78s(a)(4) (1970).

[32] SEC, *supra* note 22, at 387.

days if "the public interest and the protection of investors so require."[33] They apply, respectively, to securities not listed on a national exchange and to securities listed on a national securities exchange. (In addition, section 19(a)(2)[34] authorizes the Commission to suspend for up to 12 months, or to withdraw, the registration of a security for failure to comply with the Act.) The effectiveness of these sanctions against violation of the reporting requirements should be considerable, for their result is serious, perhaps even extreme. Furthermore, their effectiveness is strengthened by section 21(e), which provides the Commission with injunctive relief by authorizing federal district courts to compel adherence to SEC orders pursuant to the 1934 Act.[35]

Finally, the Commission may initiate criminal action for a willful violation of the reporting requirements pursuant to section 32(a) of the 1934 Act.[36] Under section 32(a) a defendant can successfully defend himself upon showing that his conduct was not "willful." Furthermore, he can avoid imprisonment, although not the fine, by proving that he had no knowledge of the rule which he allegedly violated. Nevertheless, neither of these provisions has helped defendants significantly in the past.[37]

C. *Summary of Reporting Requirements*

The effectiveness of the reporting requirements in achieving continuing disclosure can be summarized by consideration of two factors: (a) the substance of the requirements and (b) the sanctions imposed for violations. Periodic disclosure is achieved under the Securities Exchange Act in connection with the general longer-range reports (form 10-K and form 10-Q), but the form 8-K has not been effective in timely reporting of specific material events. The principal limits to its efficacy result from four factors: (1) The time lag involved: form 8-K does not involve *immediate* disclosure; (2) The limited scope of form 8-K: an issuer has complete discretion in reporting a material event if it is not included within one of the 11 enumerated items for form 8-K; (3) The lack of dissemination of form 8-K reports: they are filed with the Commission without further regard for public dissemination of their contents;

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[33] SEA § 15(c)(5), 15 U.S.C. § 78o(c)(5) (1970); SEA § 19(a)(4), 15 U.S.C. § 78s(a)(4) (1970).

[34] SEA § 19(a)(2), 15 U.S.C. § 78s(a)(2) (1970).

[35] SEA § 21(e), 15 U.S.C. § 78u(e) (1970).

[36] The maximum penalty under this section is a $10,000 fine and two years' imprisonment. SEA § 32(a), 15 U.S.C. § 78ff(a) (1970).

[37] 2 A. BROMBERG, SECURITIES LAW § 10.3 (1971).

and (4) The limited number of companies required to file form 8-K because of the limited applicability of the reporting requirements: they apply only to those companies which are subject to section 12(b), section 12(g), or section 15(d) of the Securities Exchange Act of 1934. A final evaluation of the substantive content of these requirements depends upon whether one believes that their primary purpose is to provide information which is complete or to provide information which is timely.

The sanctions available to the Commission are certainly adequate for the present system of disclosure. Furthermore, sections 15(c)(5) and 19(c)(4) appear to provide the discretion and immediacy which would be necessary for a system requiring a greater degree of timely disclosure. On the other hand, the private remedy under section 18(a) entails too many complexities of proof to be practical.

II. Disclosure Policies of the Major Stock Exchanges

A. *Requirement of Timely and Adequate Disclosure*

Both the New York Stock Exchange and the American Stock Exchange have policies of timely disclosure which require the immediate public disclosure of material information concerning a listed company. The policies are designed to serve two principal purposes: (1) public access to the information necessary to make informed investment decisions and (2) maintenance of a fair and orderly securities market.[38] Because the policies are so similar, the description which follows will pertain to both unless otherwise indicated.[39]

According to these policies of timely disclosure, the listed company must make immediate public disclosure of any information which might reasonably be expected to affect the market for the company's securities. Such disclosure should be implemented in a manner to reach as many people as quickly as possible. Thus, at a minimum, release to the press and to the wire services is contemplated.[40] The exchanges note that for

[38] NYSE Company Manual A-28; American Stock Exchange Guide §§ 401, 402 [hereinafter cited as ASE Guide].

[39] Secondary sources indicate that the National Association of Securities Dealers also has a policy of timely disclosure, but I have been unable to locate the NASD Manual. Milton H. Cohen indicates that Section 7 of the NASD Manual stipulates minimum requirements of timely disclosure for all companies desiring to be included in the NASD over-the-counter national listing. Cohen, *Truth in Securities Revisited,* 79 Harv. L. Rev. 1340, 1364, n.69 (1966). But this list includes only a very small percentage of the numerous O-T-C stocks. Therefore, delisting from this small group is not significant. Furthermore, many newspapers add issues which they find to be of particular interest to the list suggested by the NASD.

[40] NYSE Company Manual A-18, A-22; ASE Guide §§ 402, 403.

certain corporate developments immediate disclosure might endanger the company's goals, provide information helpful to a competitor, or provide a confusing impression of a development whose status is to become more certain almost immediately thereafter. When there is no doubt that such a situation exists, a company may withhold material information until the exceptional circumstances no longer justify failure to disclose.[41] Thus, the disclosure policies of both exchanges presume immediate disclosure, but can be modified by a showing that in a particular situation, the unfavorable consequences of disclosure outweigh the favorable.

Despite this flexibility, the policies provide that there can be no justification for withholding material information when unusual price and volume changes are occurring in the trading of any of the company's securities. Under such circumstances, the company will usually be requested by the exchange to make any undisclosed information public at once.[42] If further investigation indicates the existence of rumors which are affecting trading in the company's securities, the company is required to clarify, confirm, or correct such rumors.[43]

Both exchanges recommend an "open door" policy for dealing with security analysts, financial writers, stockholders, and others with an investment interest in the company. No individual or group should be given any information concerning material corporate developments before there has been complete public disclosure and dissemination of such information.[44]

B. *Impact of the Stock Exchange Policies*

The disclosure policy described above is included in the listing agreement between the issuer and the exchange. Yet the rules of the exchange are not enforced so rigorously that each minute violation will result in a suit or penalty against the violating company.[45] If a solution to the particular problem is unavailable or impractical under the exigencies (usually time) present, the exchange may suspend trading in the secur-

41 NYSE COMPANY MANUAL A-22; ASE GUIDE § 403.

42 NYSE COMPANY MANUAL A-18; ASE GUIDE §§ 402-03.

43 NYSE COMPANY MANUAL A-23; ASE GUIDE §§ 402-03.

44 NYSE COMPANY MANUAL A-20; ASE GUIDE § 403.

45 "[T]he Exchange looks for strict observance of the listing agreement. However, it is realized that, occasionally, conditions will arise which make literal compliance with one, or another, of its requirements difficult, if not impossible. In such a case the Exchange is inclined to place the emphasis upon the spirit, rather than upon the letter, of the agreement, and will endeavor to work out with the company some way of relieving the difficulty, while preserving the purpose of the agreement." NYSE COMPANY MANUAL A-28.

ities of the company or companies involved. If this sanction is not sufficient, the exchange may delist the securities involved.[46]

Temporary suspension of trading could prove effective as a means of assuring that the market was adequately informed of the material information. However, its effectiveness as a deterrent against nondisclosure depends upon a company's concluding that the adverse effects of a suspension of trading, modified by the probability that such nondisclosure would be detected, are prohibitory. Delisting, on the other hand, is an extreme sanction — so extreme that it cannot be used merely to encourage or even force compliance with the timely disclosure policy.

The force of the stock exchange disclosure requirements has been upheld in court. In *Intercontinental Industries, Inc. v. American Stock Exchange*,[47] the Fifth Circuit upheld the exchange's decision to enforce timely disclosure by delisting the company involved. Yet, the Supreme Court recently held that such rules are not binding upon the courts.[48]

Thus, each of the two major exchanges has a timely disclosure policy with virtually all of the stipulations of affirmative disclosure. Furthermore, the courts have upheld the exchanges' right to delist as the ultimate sanction. Yet there are still two significant drawbacks to these policies as a source of affirmative disclosure: (1) The policies apply only to those companies which are listed on the two major exchanges, and these tend to be the relatively large companies about which more is known anyway; (2) A company can choose to be exempt from these disclosure policies by not being listed on either of the major exchanges.

III. RULE 10b-5

Having examined the extent of disclosure resulting from the reporting requirements of the 1934 Act and the timely disclosure policies of the major exchanges, it is necessary to consider whether rule 10b-5 imposes an affirmative duty to disclose. The text of rule 10b-5 is reproduced below for convenience.[49]

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[46] NYSE COMPANY MANUAL A-29 (NYSE Rule 499); ASE GUIDE § 1002. *See also* § 12(d) and Rule 12d2-1 (17 C.F.R. § 240.12d2-1 (1972)) of SEA.

[47] 452 F.2d 935 (5th Cir. 1971).

[48] "[A] policy of the New York Stock Exchange, although entitled to considerable respect, cannot bind the Commission or the Courts." Silver v. New York Stock Exch., 373 U.S. 341 (1963).

[49] "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails,

The first question which arises is whether a literal interpretation of the words of the rule would show that failure to execute affirmative disclosure violates its express or implied provisions. The section on textual analysis, which follows, attempts to ascertain such a literal interpretation.

A. *Textual Analysis of Rule 10b-5*

1. Introductory and Final Clauses

Clauses (1), (2), and (3) of rule 10b-5 describe the prohibited activities, while the introductory and final clauses provide additional elements which must be present in order for the rule to apply.

The introductory clause stipulates the jurisdictional means which must be used, "directly or indirectly," if rule 10b-5 is to be applicable. Ascertaining whether a corporation has used "any means or instrumentality of interstate commerce, or of the mails, or of any facility of a national securities exchange" is pragmatically difficult where neither the corporation nor its insiders are trading. By its very nature, the act complained of — silence — involves the use of nothing. Therefore, a narrow interpretation of the necessary jurisdictional means would present a significant obstacle.

However, the courts have interpreted the jurisdictional requirement rather broadly. It is not necessary that the fraudulent representations be made through the mails.[50] It is sufficient that the securities transactions connected to the allegedly unlawful acts or omissions otherwise involve use of the jurisdictional means.[51] Thus, a 10b-5 suit against a nonpurchasing, nonselling corporation for failure to disclose material facts does not present a problem of finding jurisdictional means which is peculiar to an allegation of nondisclosure; as long as the securities transactions indirectly connected to the corporation's non-

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or of any facility of a national securities exchange,
(1) to employ any device, scheme or artifice to defraud,
(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5 (1972). Rule 10b-5 was promulgated by the Securities Exchange Commission on May 21, 1942, pursuant to authority granted under § 10(b) of the Securities Exchange Act of 1934, 48 Stat. 881, 15 U.S.C. § 78j (b) (1958).

[50] *See* SEC v. Midland Basic, Inc., 283 F. Supp. 609 (D.S.D. 1968) (dictum).

[51] *See* Fratt v. Robinson, 203 F.2d 627 (9th Cir. 1953); SEC v. Midland Basic, Inc., 283 F. Supp. 609 (D.S.D. 1968).

disclosure involve the proper jurisdictional means, the rule's jurisdictional means are satisfied.

The final clause of rule 10b-5 stipulates that the alleged violation must occur "in connection with the purchase or sale of any security." The question raised here is whether such clause is an attempt to require the strict privity of contract required by common law fraud. Such an interpretation certainly would exclude application of rule 10b-5 to a corporation which was not involved in trading, issuing, or exchanging its shares: "literally, the 'connection' requirement seems not to be satisfied when neither the company nor insiders are buying or selling any securities."[52] Furthermore, although the relatively early case of *Joseph v. Farnsworth Radio & Television Corp.*[53] dismissed a complaint in which the plaintiffs did not buy the stock until 2 weeks after the defendant insiders had ceased selling, on the basis that at least "a semblance of privity" is required under 10b-5, subsequent cases indicate no reluctance to find violation of the rule even when the defendant is not a purchaser or seller. In *SEC v. Texas Gulf Sulphur, Co.*,[54] despite the corporation's noninvolvement in purchasing or selling its securities, Judge Waterman held that the "in connection with" clause was satisfied because the alleged violation by the corporation was "of a sort that would cause reasonable investors to rely thereon, and . . . so relying, cause them to purchase or sell a corporation's securities." This reasoning was corroborated in *Heit v. Weitzen*,[55] where the court found no need for the defendant to be purchasing or selling the securities involved as long as the alleged violation had an impact on the market. Thus, a showing that a corporation's lack of disclosure has an impact on the market for its securities will satisfy the "in connection with" requirement of rule 10b-5.

After having established the applicability of rule 10b-5 in regard to the jurisdictional means and the "in connection with" phrase, one must look to clauses (1), (2), or (3) to establish a violation of the rule.

2. Rule 10b-5, Clause (1)

Clause (1) need not be dealt with at length because it is not only similar to but also subsumed by clause (3). Clause (1) makes it unlawful "to employ any device, scheme or artifice to defraud," whereas clause (3) proscribes engaging in

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[52] 1 A. BROMBERG, SECURITIES LAW § 7.2(2) (1969).

[53] 99 F. Supp. 701, 706 (S.D.N.Y. 1951), *aff'd*, 198 F.2d 883 (2d Cir. 1952).

[54] 401 F.2d 833, 860 (2d Cir. 1968).

[55] 402 F.2d 909, 913 (2d Cir. 1968).

"any act, practice or course of business which operates or would operate as a fraud or deceit upon any person." Clause (3) includes all conduct falling under clause (1) in addition to some which does not for the following reasons: First, "to engage in any act, practice or course of business" [clause (3)] is certainly broad enough to include all conduct covered by "to employ any device, scheme or artifice" [clause (1)]. In fact, the term "course of business" should be broad enough to permit consideration of the cumulative effect of a series of acts of which none would be fraudulent by itself.[56] Second, clause (3) includes deceit as well as fraud as an indication of a violation; clause (1) includes only the latter. Third, inclusion in clause (1) of the infinitive phrase "to defraud" implies the requirement of intent.[57] Employment of a "scheme . . . to defraud" necessarily involves the actor's state of mind. On the other hand, the language of clause (3) —*i.e.*, an "act . . . which operates or would operate as a fraud . . . . "—is concerned with the difficulties of proving anything about the actor's state of mind. Accepting the above reasoning that everything that falls within clause (1) also falls within clause (3) and fortified by Professor Bromberg's concurrence,[58] one can proceed to an analysis of clause (3).

3. Rule 10b-5, Clause (3)

In order to find a violation of clause (3) by a corporation which has failed to disclose material information but which is not purchasing or selling its shares, the allegations must satisfy two requirements: (a) the corporation's failure to disclose must be construed as an "act, practice or course of business," and (b) the corporation's failure to disclose must "operate . . . as a fraud or deceit."

Classifying a corporation's failure to disclose material information within a phrase so broad as "any act, practice or course of business" should not be difficult. Although one could argue that total inaction is not an "act," it is more reasonable to assume that failure to disclose or silence itself would be construed as an act. An even more persuasive argument is that a corporation's failure to disclose material information constitutes a "practice or course of business," since such conduct has a definite effect on a company's creditors, competitors, and

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[56] 1 A. BROMBERG, SECURITIES LAW § 2.6(1) (1967).

[57] Note, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. CHI. L. REV. 824, 826 (1965).

[58] "Nothing comes to mind that would be in clause 1 but not in clause 3." 1 A. BROMBERG, *supra* note 56.

shareholders and is therefore part of the ordinary conduct of the corporation's business.

Further substantiation for the contention that silence can be construed as "an act, practice or course of business" is provided by administrative and judicial authority. The SEC has contended that an accountant's failure to disclose his discovery that financial statements which he had certified 6 months earlier were false is an "act or course of business" under rule 10b-5(3).[59] By the same token in *Speed v. Transamerica Corp.*[60] the court stated that nondisclosure can constitute a violation of clause (3), thereby implying that failure to disclose must be an "act, practice or course of business." Although the *Speed* case and others[61] found nondisclosure to be a violation of clause (3), these cases involved trading or some other sort of advantage gained by the nondisclosing parties. Rather than detracting from the force of the argument that failure to disclose constitutes an "act, practice or course of business," these holdings merely emphasize the importance of showing that the hypothesized situation "operates or would operate as a fraud or deceit."

Assuming then that a corporation's failure to disclose material information in the absence of insider or corporate trading qualifies as an "act, practice or course of business," one must show that such conduct "operates or would operate as a fraud or deceit." Such proof entails determining what constitutes conduct which operates as a fraud or deceit. A careful examination of the language of clause (3) reveals that a literal interpretation would not require involvement of the common law element of fraud in proving a violation, but rather that the only requirement of clause (3) is that the conduct in question have the same effect — "*would* operate" — as that of a fraud or deceit upon any person. Thus, under this interpretation any conduct which has the same effect as a fraud or deceit — that of misleading a reasonable but unsuspecting and relying individual — would fall within clause (3).

Textual analysis of this part of the rule is particularly difficult because "the courts have traditionally refused . . . to define fraud with specificity."[62] Nevertheless they have arrived at an interpretation similar to that above by taking the vague

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[59] *Id.* § 7.4(2) at 167 n.103.7 *citing* brief for SEC as amicus curiae, Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967).

[60] 99 F. Supp. 808, 829 (D. Del. 1951).

[61] Cochran v. Channing Corp., 211 F. Supp. 239, 243 (S.D.N.Y. 1962); *In re* Cady, Roberts & Co., 40 S.E.C. 907, 913 (1961).

[62] 3 L. LOSS, SECURITIES REGULATION 1436 (2d ed. 1961).

position that "the use of 'fraud' in rule 10b-5(3) cannot be interpreted in its narrow common law sense,"[63] or that "the fraud provisions in the SEC acts . . . are not limited to circumstances which would give rise to a common law action for deceit."[64] Although proof of common law fraud is not necessary, there must be allegations of deception to support a 10b-5 action.[65] Therefore, a corporation's failure to disclose material information will qualify as a fraud or deceit under rule 10b-5(3) if the nondisclosure operates to deceive the allegedly injured party.

The above analysis indicates that the words of rule 10b-5(3) could provide a source of an affirmative duty to disclose material facts only when failure to disclose would result in the deception of a reasonable investor. Such deception arguably occurs in three types of situations. In situation A, the company is subject to the timely disclosure policy of one of the national exchanges or the NASD (see section III concerning disclosure policies of exchanges). As a result, it is under a duty to disclose. Silence in the place of such a duty would certainly amount to the deception[66] of an investor who reasonably expected the corporation to adhere to the obligations incurred in the listing agreement.[67] Situation B involves the contention that a corporation's continued silence since its last public announcement may have reasonably led an investor to believe that nothing had changed in the interim. If in fact the corporation had experienced a major discovery but the shareholder had sold his stock in reliance on the corporation's silence indicating no change from its already declining position, the shareholder in situation B would have been deceived by the corporation's failure to disclose and would have a claim within the literal meaning of rule 10b-5(3). Situation C concerns a corporation which has pursued a policy of immediate disclosure of all material events. It would be reasonable for an investor to rely on the corporation's continuing such a policy

63 SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 278 (S.D.N.Y. 1966), *aff'd in part and rev'd in part*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 404 U.S. 1005 (1971), *rehearing denied*, 404 U.S. 1064 (1972).

64 3 L. Loss, *supra* note 62. The statement is made in indicating the general position of the courts on the matter. Often cited cases, in addition to *Texas Gulf Sulphur*, include Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965), and Ellis v. Carter, 291 F.2d 279 (9th Cir. 1962).

65 O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964); Entel v. Allen, 270 F. Supp. 60 (S.D.N.Y. 1967); Carliner v. Fair Lanes, Inc., 244 F. Supp. 25 (D) Md. 1965).

66 W. Prosser, The Law of Torts § 106 (4th ed. 1971).

67 Even this duty to disclose is subject to an exception based on the reasonable business judgment of the corporate decisionmakers.

of timely disclosure. If the corporation violated this policy and failed to disclose a major occurrence, and if the investor purchased or sold the corporation's stock to his detriment by relying on the traditional disclosure policy so as to conclude that the company's prospects had not changed, then he would be able to claim deception in an action against the corporation for failure to disclose.

The key difference among these three situations is the persuasiveness of the allegation that the investor acted reasonably in being deceived, for it is necessary to establish a causal relationship between the lack of disclosure and the injury suffered,[68] and in order to do so, the plaintiff must show that he was reasonable in relying upon the corporation's silence:

> [T]he duty to speak which is implicit in Rule [X-] 10B-5 arises in those circumstances . . . where there is a justifiable expectancy of disclosure or reliance upon the superior knowledge of another . . . .[69]

Of the three situations, the strongest for arguing that the corporation's failure to disclose violated clause (3) is situation A, which involves a company whose stock is listed on one of the two major exchanges. As indicated above, pursuant to its listing agreement, the company in situation A is under an obligation to make timely and adequate disclosure of all material information.[70] An investor who is aware of this obligation is certainly acting reasonably in relying on his expectation that the company will adhere to it. Silence on the part of one who has a duty to speak is very close to common law deception.[71]

Situation C, in which the investor relied on the corporation's silence as an indication of "no change" because of the company's policy of making immediate public disclosure, is not quite as strong a case because the corporation had no explicit obligation to disclose. Nevertheless, given that the corporation had always disclosed material information immediately, and that all recent disclosures had been consistent with a future trend in one direction, then the corporation's failure to disclose material information which indicated a modification of this trend could be held to be "deception" in violation of rule 10b-5(3). Of course this holding under situation C could be

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[68] Smith v. Murchison, 310 F. Supp. 1079 (S.D.N.Y. 1970); Barnett v. Anaconda Co., 238 F. Supp. 766 (S.D.N.Y. 1965).

[69] Connelly v. Balkwill, 174 F. Supp. 49, 59 (N.D. Ohio 1959), *aff'd*, 279 F.2d 685 (6th Cir. 1960).

[70] This discussion assumes that the "business judgment" exception is not applicable.

[71] W. PROSSER, *supra* note 66.

valid only if an investor had relied on the silence — in conjunction with the past disclosure policy — to indicate no change in the recent trend.

Situation B presents the weakest of the three arguments. Yet it may still have a chance for vindication under clause (3) because the investor can claim that his deception resulted from the corporation's failure to inform him of material information which was inconsistent with the general impression resulting from earlier disclosures. But the argument is weakened significantly by the contention that a reasonable investor in situation B would not have been deceived by the corporation's silence, since there was no reason to think that the corporation would immediately disclose any material information.

The difficulty in finding a violation of rule 10b-5(3) under situation B emphasizes the problem of applying 10b-5(3) to the general hypothetical posed in this article. The strongest argument in favor of applying rule 10b-5(3) to situation B is that the investor was deceived. As a result he could attempt to sue for deception because the nondisclosure involved information indicating a change in the corporation's business fortunes. Yet all undisclosed material information does not involve a change in the company's business, and therefore situation B cannot be applied to the general question of affirmative disclosure. In fact, the material information withheld might be consistent with the business trends indicated in the company's most recent disclosures. In this situation, the above analysis indicates that the plaintiff must show that his deception resulted from reasonable reliance on the corporation's silence. But absent a specific obligation such as a stock exchange listing agreement or a definite company policy to make immediate disclosure, a reasonable investor would not rely on a public corporation to disclose all material facts at once. The corporation's silence regarding material facts cannot constitute deception unless a reasonable investor could expect disclosure of such facts. Absent required periodic reports and special factors similar to those noted, there is no reason to expect that the corporation will disclose.[72] Thus, under these circumstances, a reasonable investor would not rely on the corporation's silence.

From a relatively strict construction of the words of

[72] If there were corporate trading or insider trading of which the nontrading top executives were aware, then the investor could reasonably expect the corporation to disclose the material facts. The application of rule 10b-5 to instances when those trading have unequal information or to other situations in which the nondisclosing party takes unfair advantage is not discussed because of its exclusion from the question at hand.

clause (3), one must conclude that corporate silence does not "operate as a fraud or deceit" in the general case of a material nondisclosure. This conclusion renders the words of clauses (1) and (3) inapplicable to the situation posed.

4. Rule 10b-5, Clause (2)

Clause (2) appears to be more conducive to a literal interpretation because the terms do not have common law connotations such as those which cause so many problems with clauses (1) and (3).[73] The first phrase of clause (2), "to make any untrue statement of a material fact" does not apply to the general situation posed because in a situation of nondisclosure there is no statement made. However, the alternative conduct proscribed by clause (2)[74] requires further analysis.

A corporation's failure to disclose material information certainly qualifies as an omission to state a material fact. The real question of the applicability of clause (2) to a corporation's failure to disclose is whether such omission is "necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . ."[75] If as in the situation presented the corporation said absolutely nothing, then there were no statements made and clause (2) — by its very words — is inapplicable. Indeed, there is substantial authority to the effect that clause (2) cannot apply to a complete failure to disclose because there has been no statement made.[76]

Yet even on their face, the words of clause (2) leave some question about their applicability to corporate silence in response to a material occurrence. The clause proscribes omissions of material facts which, if disclosed, would prevent "the statements made" from being misleading. There is no indication of the time period involved during which an omission to state a material fact must be coupled with a misleading "statement made" in order to constitute a violation of clause (2). Unless the omission and the statement made pertain to the same specific transaction, delineation of such a time period would be extremely difficult. This is because a failure

[73] The term "material" has been assumed for the purposes of this paper. *See* INTRODUCTION *supra*.

[74] "[T]o omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . ." 17 C.F.R. § 240 10b-5 (1972).

[75] *Id.*

[76] Trussel v. United Underwriters, Ltd., 228 F. Supp. 757, 767 (D. Colo. 1964); Cochran v. Channing Corp., 211 F. Supp. 239, 243 (S.D.N.Y. 1962). *See also* 1 A. BROMBERG, *supra* note 56, § 2.6(2); 3 L. LOSS, *supra* note 62, at 1439.

to disclose often cannot be pinpointed to have occurred at any particular time. Of course if the omission and the statement made involve facts concerning the same transaction, then the omission actually occurred when the statement was made. But if a corporation becomes aware of favorable material information (such as an important mineral strike) one week, and aware of specifically unrelated unfavorable material information (such as a foreign government's intention to expropriate the company's valuable mine in that country) the next week, then its disclosure of the latter and silence concerning the former raise certain questions.

Presumably an investor could prove that it was very misleading for the company to disclose the intended expropriation without disclosing the discovery of the previous week. If this is true, then the corporation could be liable for violating rule 10b-5(2) because disclosure of the mineral discovery was necessary in order to make the announcement of the intended expropriation not misleading insofar as the company's expectations for the future are concerned. According to this construction of clause (2), a corporation can be found within the proscribed conduct if it has failed to disclose material information at the time at which it discloses other material information having inconsistent implications. The principal question regarding the acceptability of this interpretation is whether the courts will allow a claim in which the omitted material fact and the statement made do not pertain to the same specific transaction or information. At this point, there is no such indication. Nevertheless, in a release dated October 15, 1970, the SEC indicated its intention to pursue such a holding.[77]

A more appropriate situation for applying rule 10b-5(2) to corporate silence concerns the relation between timely disclosure and the reporting requirements. A corporation's quarterly report (form 10-Q) requires relatively little data, and is concerned mainly with revenue, income, per-share earnings, etc. The figures to be presented in this report could show a significant downtrend, but at the time of disclosure of the report there could be material undisclosed information existing which is so favorable to the company that the current operating figures on the form 10-Q are misleading. Assuming that this material in-

[77] "Corporate releases which disclose personnel changes, the receipt of new contracts, orders and other favorable developments but do not even suggest existing adverse corporate developments do not serve the public needs and may violate the anti-fraud provisions of the Securities Exchange Act of 1934." Securities Act Release No. 5092, Securities Exchange Act Release No. 8995, Investment Company Act Release No. 6209 (Oct. 15, 1970).

formation does not fit within one of the mandatory categories of the form 8-K, then the corporation need not disclose it. This situation also would seem to fit the words of clause (2) because the statements made on the form 10-Q certainly are misleading unless the more recent information is disclosed.

Even if the above arguments are accepted, the words of rule 10b-5(2) still cannot be said to apply to the general case of a corporation's failure to disclose material information. They have merely been found to apply to special fact situations, similar to those mentioned above.

5. Summary of Textual Analysis of Rule 10b-5

In summation, a literal interpretation of rule 10b-5 leads to the conclusion that the rule lacks the substance to provide an adequate basis for a general corporate duty to disclose material information relevant to its operations, except in the case of the special fact situations enumerated earlier within this section. Clause (2) would impose such a duty only during those periods in which the corporation might be making other public statements *and* in which full disclosure would be necessary to avoid misleading impressions upon reasonable investors. A literal interpretation of clause (3) would impose such a duty only if an investor reasonably could expect such disclosure and if, in acting under such expectation, he was misled to his detriment. Nevertheless, as indicated in the following section, the courts thus far do not seem to have been strictly inhibited by rigorous interpretations of rule 10b-5,[78] and it is in such court decisions that a stronger basis for an affirmative duty of disclosure must lie.

B. *Rule 10b-5: Judicial Holdings and Rationale*

The literal interpretation suggests that the words of rule 10b-5 do not provide an adequate basis for imposing an affirmative obligation of corporate disclosure of material information when there is no insider or corporate trading. At this point, one should look to the case law to determine whether the courts have utilized the "flexibility" prescribed by the Supreme Court for construing anti-fraud securities legislation.

The SEC suit against Texas Gulf Sulphur Company is an excellent place to begin.[79] In this factual situation, the com-

[78] "Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation 'enacted for the purpose of avoiding frauds,' [footnote omitted] not technically and restrictively, but flexibly to effectuate its remedial purposes." SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963).

[79] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

pany had begun drilling for minerals at a Canadian site in November 1963. After 5 days, drilling was suspended to ascertain results of a chemical assay. The results of this assay persuaded the company to purchase or secure options on the land without any further drilling. On March 31, 1964, the drilling resumed.[80] By April 11, rumors concerning the magnitude of the strike were circulating, and the following day the company issued a press release to discount the rumors. The Commission's suit claimed that the company had violated rule 10b-5 because the press release created a misleading and deceptive picture of the drilling progress as of the date of its issuance. The Commission claimed that the company had favorable facts which should have been disclosed in the release. In an en banc opinion, the Second Circuit Court of Appeals held that if the press release were found to be misleading, then its issuance by the corporation constituted a violation of rule 10b-5.[81]

In applying *Texas Gulf Sulphur* to the question of affirmative disclosure, one must remember that in *Texas Gulf Sulphur* the corporation was *not* held liable for the failure to disclose its discovery, but rather for the misleading nature of its statements. The court held that once a corporation decides to speak, only then must it be responsible for the truth and accuracy of its disclosures.[82] The thrust was not toward an affirmative duty to disclose. Indeed, in a footnote to the opinion, Judge Waterman stated:

> We do not suggest that material facts must be disclosed immediately; the timing of disclosure is a matter for the business judgment of the corporate officers entrusted with the management of the corporation within the affirmative disclosure requirements promulgated by the exchanges and by the SEC.[83]

Moreover, the cases indicate that in order for nondisclosure to constitute a violation of rule 10b-5, there must also be evidence of manipulation,[84] disregard of a duty to speak created

[80] In the interim, corporate insiders had been purchasing shares and calls on the corporation's stock, and the SEC suit also concerned this insider trading. However, insider trading is outside the topic of this paper and this aspect of any of the cases will only be mentioned where central to that portion of the court's holding or reasoning cited.

[81] 401 F.2d at 863. Upon remand the District Court found that the release was misleading; therefore the company had violated rule 10b-5. SEC v. Texas Gulf Sulphur Co., 312 F. Supp. 77 (S.D.N.Y. 1970).

[82] 401 F.2d at 861-62. *But see* Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 110 (10th Cir. 1971), *cert. denied,* 404 U.S. 1004 (1971), *rehearing denied,* 404 U.S. 1064 (1972).

[83] 401 F.2d at 850 n.12. Although this statement explicitly denies an obligation of affirmative disclosure, its mention of the exchanges and the SEC does allow for inferences to the contrary. *See* Section III, B, *infra.*

[84] *See, e.g.,* List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir. 1965), *cert. denied,* 382 U.S. 811 (1965); Financial Industrial Fund, Inc. v. McDonnell Douglas Corp., 315 F. Supp. 42 (D. Colo. 1970); Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962).

by a special relationship,[85] or some other form of deception or unfair behavior through which the undisclosed information was taken advantage of.[86] Absent such special facts, there are no cases holding that a corporation has a general affirmative obligation to disclose material information. In fact, in *Wessel v. Buhler*,[87] the Ninth Circuit seemed to rule out such a possibility. Therein the complaint alleged that an independent auditor, by failing to disclose his knowledge of a corporation's deficient financial records, had aided and abetted the corporation in violating rule 10b-5. The court replied that "[w]e find nothing in rule 10b-5 that purports to impose liability on anyone whose conduct consists solely of inaction."[88] Nevertheless, *Wessel* should not influence determination of a corporation's affirmative duty to disclose for the following reasons: first, the suit was not against the corporation, but was against a remote agent who had no relation to the public; secondly, as indicated in the textual analysis, if failure to disclose is to be covered by clause (2) or clause (3) then such nondisclosure cannot be considered to consist solely of inaction — it will need to be of a misleading or deceptive nature; finally, the holding in *Brennan v. Midwestern United Life Insurance Co.* directly contradicted *Wessel.*[89]

Despite the above indications, the issue is not at all settled. There are a least four recent cases which have mentioned, but have expressly left unanswered, the question of whether a corporation has an affirmative duty to disclose.[90] Furthermore there is a considerable amount of judicial language implying the possibility of such a duty. In Judge Waterman's *Texas Gulf Sulphur* opinion, there are several phrases which imply an objective of full disclosure: a clause criticizing "the hiding and secreting of important information;" an indication that a public

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[85] *See, e.g.*, Brennan v. Midwestern United Life Ins. Co., 417 F.2d 147 (7th Cir. 1969); Rothschild v. Teledyne, Inc., 328 F. Supp. 1054 (N.D. Ill. 1971); Phillips v. Reynolds & Co., 294 F. Supp. 1249 (E.D. Pa. 1969).

[86] *See, e.g.*, A.T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967); Ruckle v. Roto American Corp., 339 F.2d 24 (2d Cir. 1964); Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951).

[87] 437 F.2d 279 (9th Cir. 1971).

[88] *Id.* at 283.

[89] Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673 (N.D. Ind. 1966). The district court's holding that silence and inaction might violate rule 10b-5 as aiding or abetting was noted approvingly by the Seventh Circuit Court of Appeals in deciding the appeal of the case on its merits. However, such approval was only dictum. Brennan v. Midwestern United Life Ins. Co., 417 F.2d 147 (7th Cir. 1969).

[90] Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 99 (10th Cir. 1971); Janigan v. Taylor, 344 F.2d 781, 783 n.1 (1st Cir. 1965), *cert. denied*, 382 U.S. 879 (1965); Reynolds v. Texas Gulf Sulphur Co., 309 F. Supp. 548, 562 (D. Utah 1970), *aff'd*, 446 F.2d 90 (1971); Astor v. Texas Gulf Sulphur Co., 306 F. Supp. 1333, 1338 (S.D.N.Y. 1969).

corporation should not have a general "right to secrecy;" the stated objective that the markets should be "indices of real value."[91] In addition, in the earlier-quoted footnote, Judge Waterman indicated that the court would abide by the disclosure requirements of the exchanges.[92] In fact, by referring to the corporate purpose served by the nondisclosure as a justification for the nondisclosure, the court strengthened the inference that it considered the timely disclosure policy of the New York Stock Exchange to be applicable.[93] If so, *Texas Gulf Sulphur* can be said to require affirmative disclosure according to the rules of the exchange upon which a company's securities are listed. Nevertheless, even assuming this interpretation the case could not be said to apply an affirmative disclosure obligation to unlisted companies.

In a successful suit by former shareholders against *Texas Gulf Sulphur* for damages resulting from reliance on the April 12 press release, the Tenth Circuit emphasized the following:

> [T]he duty to disclose facts when they become material has not been altered by this decision . . . . [W]hen the material information is available and ripe for publication, the difficulties inherent in formulating a release cannot overbear the accuracy of the statements contained therein.[94]

Although the court does not define "available and ripe," the context from which the above quote is taken is conducive to the inference of an affirmative duty of disclosure.

Another judicial statement implying an affirmative duty to disclose was made by the Supreme Court when it asserted that a fundamental purpose of the Act was "to substitute a philosophy of full disclosure for the philosophy of caveat emptor."[95]

Notwithstanding the above, there is also some judicial language which implies that a corporation may withhold material information as long as no one is taking advantage of it.

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[91] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 858-59 (2d Cir. 1968). Nevertheless, when considered in context it is difficult to argue that these phrases are meant to apply to anything other than misrepresentations.

[92] "We do not suggest that material facts must be disclosed immediately; the timing of disclosure is a matter for the business judgment of the corporate officers entrusted with the management of the corporation within the affirmative disclosure requirements promulgated by the exchanges and by the SEC." SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 850 n.12 (2d Cir. 1968).

[93] The New York Stock Exchange policy of timely and adequate disclosure allows withholding material information in order to further a proper corporate purpose.

[94] Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 100 (10th Cir. 1971).

[95] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963). Also *quoted in* Herpich v. Wallace, 430 F.2d 792, 801 (5th Cir. 1970).

A prime source is Judge Waterman's *Texas Gulf Sulphur* opinion:

> Thus anyone in possession of material inside information must either disclose it to the investing public . . . or [*if*] *he chooses not to do so*, must abstain from trading in or recommending the securities concerned . . . .[96]

Clearly, if the insider may "choose" not to disclose, then there could not be a corporate duty of affirmative disclosure.

In a Second Circuit opinion by Judge Friendly, the court stated that a corporation has no duty to correct rumors started by others:

> While a company may choose to correct a misstatement in the press not attributable to it . . . we find nothing in the securities legislation requiring it to do so.[97]

The implication here is that if a corporation is not required to correct a rumor concerning material information, then it would not be required — under the same legislation — to affirmatively disclose material information.

Thus the existing judicial precedents under rule 10b-5 do not impose a corporate duty of affirmative disclosure, yet they do not deny it. Although there is judicial language which might imply such a duty, there is also language which implies the contrary. The situation is ambiguous. In search of classification, one can refer to the actual policy and reasoning pursued by the courts in individual rule 10b-5 cases. There are two lines of rule 10b-5 violations which are particularly relevant: (1) violations for a misleading corporate statement in the absence of trading by the corporation and its insiders, (2) violations for nondisclosure of later discovered facts which render previously made statements false. The analysis which follows each issue includes a discussion of its relevance to the establishment of an affirmative duty of disclosure.

1. Corporate Liability for a Misleading Statement in the Absence of Trading by Insiders

In its en banc *Texas Gulf Sulphur* opinion,[98] the Second Circuit Court of Appeals erased any remaining doubt that a corporation (or individuals) could violate rule 10b-5 although not engaging in related securities transactions or otherwise acting

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[96] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (emphasis added).

[97] Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937, 949 (2d Cir. 1969).

[98] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 404 U.S. 1005 (1971), *rehearing denied,* 404 U.S. 1064 (1972).

with wrongful motives.[99] The court reasoned that insofar as the congressional purpose of investor protection is concerned, its holding — which rendered insider trading and ulterior motives unnecessary — was consistent because the investing public may be harmed just as much by a statement whose inaccuracies are caused by negligence as by a statement whose inaccuracies are created intentionally in furtherance of a wrongful purpose. Secondly, the possibility of wrongful purpose is not eliminated merely because there has been no insider trading. The misleading statement could have failed to affect the market sufficiently to encourage insider trading, or the purpose could have been something other than beneficial trading. Therefore, finding a violation for misleading statements regardless of any evidence of wrongful intent fulfills the primary purpose of investor protection without necessarily punishing innocent intentions.

Nevertheless, the issue was not completely settled either by the Second Circuit's opinion in *Texas Gulf Sulphur* or by the district court's actual finding upon remand that a rule 10b-5 violation did exist, based upon the misleading nature of the press release, the lack of due diligence by the issuers of the statement, and the use of due care by the injured investors.[100] Because this case involved merely an injunctive action by the Commission, it still had to be determined whether a private action for damages could be sustained by alleging that a company had made a misleading statement without alleging the existence of any corporate or insider trading.

Two months after the *Texas Gulf Sulphur* case, the Second Circuit decided *Heit v. Weitzen*,[101] applying the same *Texas Gulf Sulphur* reasoning to find a private right of action for damages for a misleading statement in the absence of insider trading under rule 10b-5. In *Heit*, the corporate defendant failed to disclose that a substantial amount of its income for the 1964 fiscal year was derived from various overcharges on government contracts. The court held that plaintiffs who purchased securities of the defendant corporation in reliance on the misleading information in the press release were entitled to relief under rule 10b-5 despite the lack of any evidence of corporate or insider trading.

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99 "There is no indication that Congress intended that the corporations or persons responsible for the issuance of a misleading statement would not violate the section unless they engaged in related securities transactions or otherwise acted with wrongful motives." *Id.* at 860.

100 SEC v. Texas Gulf Sulphur Co., 312 F. Supp. 77 (S.D.N.Y. 1970).

101 402 F.2d 909 (2d Cir. 1968).

Although *Heit v. Weitzen* establishes a private right of action for a misleading statement in the absence of trading by the issuer of the statement, the facts do not necessarily justify a private right of action as broad as the injunctive right established in *Texas Gulf Sulphur.* Because the corporate defendant in *Heit* was trying to conceal the source of its profits from government officials, the misleading statements may be said to have been motivated by a wrongful purpose. Therefore, the case can be distinguished from a holding that insider trading or other wrongful motives are not necessary for a violation of rule 10b-5(2). *Heit v. Weitzen* thus establishes that a violation of rule 10b-5(2) in private suits can be found in the absence of insider trading,[102] but, in that the corporation was aware of the statement's misleading nature, it cannot be said that this case negates the possibility of such a violation where no wrongful purpose exists.

Thus, although the *Texas Gulf Sulphur* and *Heit* cases may stand for the principle that a violation of rule 10b-5(2) can occur by a corporation not trading in its securities and not otherwise acting for wrongful puposes, it cannot be said whether the same factors are sufficient to sustain a private suit for damages. Furthermore, given the fact that a corporation need not be trading in its own securities in order to violate rule 10b-5 through a material misstatement, the courts are not in agreement as to what — if any — degree of knowledge or intent (*i.e.* wrongful purpose) on the part of the corporation is necessary to sustain a private suit for damages.

The *Texas Gulf Sulphur* opinion held that proof of negligence in issuing a misstatement was sufficient to sustain an action for injunctive relief under rule 10b-5(2), but declined to decide whether mere negligence was sufficient in a private suit for damages.[103] The *Heit* court held that an allegation of actual knowledge of the falsity was a sufficient pleading to sustain the action even if a strict scienter test were ultimately applied.[104] In its 1969 *Globus* decision, the Second Circuit again indicated that something more than negligence, although less than an actual intent to mislead was necessary in a private suit for damages:

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102 *Id.*; Sprayregen v. Livingston Oil Co., 295 F. Supp. 1376 (S.D.N.Y. 1968).

103 SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 863 (2d Cir. 1968). In fact, a majority of the court indicated that they would require some sort of scienter in a private suit for damages. *See* concurring opinion of Judge Friendly joined by Judges Kaufman and Anderson, 401 F.2d at 864; and dissenting opinion of Judge Moore, joined by Chief Judge Lumbard, 401 F.2d at 870.

104 402 F.2d at 914.

> [The jury must conclude that defendants] knew the statement was misleading or knew of the existence of facts, which if disclosed, would have shown it to be misleading.[105]

On the other hand, the Eighth Circuit has stated explicitly that mere negligence is enough for 10b-5 liability in a private suit against the maker of a misleading statement.[106]

Similarly, in a suit by former shareholders of Texas Gulf Sulphur claiming that the April 12, 1964, press release violated rule 10b-5 because of its allegedly misleading nature,[107] the Tenth Circuit seems to be adopting the negligence standard as well. In *Mitchell v. Texas Gulf Sulphur Co.*, the court held that the corporate defendant would prevail only if it sustained the burden of proving that, in the exercise of reasonable care, the corporation could not have known that the statement included a misrepresentation or an omission.[108]

It is thus uncertain to what degree the corporate defendant must intend or know of the misleading nature of its statements in order to be liable in a private suit for damages under rule 10b-5(2). Nevertheless, the reasoning of the Second Circuit has prevailed: the application of rule 10b-5(2) to misleading statements does not depend upon contemporaneous trading by the corporation and its insiders nor does it depend upon the existence of an ulterior motive in the issuance of a misleading press release.

In holding that rule 10b-5 can be violated by issuing a misleading statement, despite the violator's failure to take advantage of his statement, the courts have moved away from some of the traditional premises identified with rule 10b-5. Former SEC Chairman Cary had defined the duty of disclosure in his *In re Cady, Roberts & Co.* opinion.[109] In Cary's view it was not until an insider attempted to take advantage of the information that a violation of rule 10b-5 occurred. This rationale had continued and was repeated as recently as the original district court proceeding against Texas Gulf Sulphur.[110]

105 Globus v. Law Research Service, Inc., 418 F.2d 1276, 1290 (2d Cir. 1969).

106 City National Bank v. Vanderboom, 422 F.2d 221, 229-30 (8th Cir. 1970).

107 Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir.), *cert. denied,* 404 U.S. 1004 (1971), *rehearing denied,* 404 U.S. 1064 (1972).

108 *Id.* at 102. The *Mitchell* court cites City National Bank v. Vanderboom, 422 F.2d 221 (8th Cir. 1970) and Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961), for holding that scienter is not required to maintain a private 10b-5 damage action.

109 *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961).

110 SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y. 1966). In fact, on the basis of the lack of any attempt by the corporate defendant to take advantage of the misleading press release, Judge Bonsal held that the company had not violated rule 10b-5, 258 F. Supp. at 294. As noted in the text, the Second Circuit reversed this issue. 401 F.2d at 860-62.

A second premise rendered inconsistent by the "taking advantage is not necessary" holding was set forth in a 1951 opinion of the Delaware Federal District Court, *Speed v. Transamerica Corp.*, when the court asserted that equalization of bargaining position was the goal of rule 10b-5.[111] Of course, this reasoning was modified in order to apply the expansion of rule 10b-5 to impersonal transactions on open-market exchanges, and a modified version was restated in the Second Circuit opinion in *Texas Gulf Sulphur*:

> The core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions . . . that all members of the investing public should be subject to identical market risks . . . . The insiders here were not trading on an equal footing with the outside investors.[112]

The contention here is not that such equal access to material information is no longer a goal of rule 10b-5, but rather that by holding that taking advantage of material inside information is not necessary for a violation of rule 10b-5, the courts are recognizing policy objectives in addition to the two stated in *Cady, Roberts* and in *Speed.* If a corporation is held to have violated rule 10b-5 by issuing a misleading press release of which the company did not attempt to take advantage, then, (1) the courts are no longer saying that it is the *use* of the material information which constitutes a violation of rule 10b-5,[113] and (2) enforcement of rule 10b-5 involves objectives other than equal access to material information, because in the case of the false financial statements in *Heit* (and theoretically in the case of the misleading press release in *Texas Gulf Sulphur*) all of those trading had equal access to the false information and no access to the correct information. In other words, the courts are pursuing the objective that the investing public be accurately informed.

As indicated above, some courts have pursued an implicit policy that investors be accurately informed. Other courts, however, have made this policy explicit. In fact, several courts have stated unequivocally that the congressional policy was, and that the judicial policy is, to assure investors the continuous receipt of accurate information. In his *Texas Gulf Sulphur* opinion, Judge Waterman indicates that the dominant purpose of the Securities Exchange Act of 1934 is the promotion of free

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[111] Speed v. Transamerica Corp., 99 F. Supp. 808, 829 (D. Del. 1951).

[112] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 851-52 (2d Cir. 1968).

[113] Cases cited notes 109 & 110 *supra*, in addition to Cochran v. Channing Corp., 211 F. Supp. 239, 243 (S.D.N.Y. 1962).

and open securities markets. He then underscores the importance of a policy oriented toward accurate information by quoting from a house committee report on the bill which eventually became the 1934 Act:[114] "There cannot be honest markets without honest publicity." Later in the opinion, Judge Waterman repeats what he considers to be the overriding concern in cases involving inaccurate corporate publicity:

> Of even greater relevance to the Congressional purpose of investor protection is the fact that the investing public may be injured as much by one's misleading statement containing inaccuracies caused by negligence as by a misleading statement published intentionally to further a wrongful purpose.[115]

If Judge Waterman had considered the sole policy of rule 10b-5 to be equality among investors, then his statement quoted above would have been inappropriate.

Given the fact that the courts, under rule 10b-5, are holding companies responsible for the accuracy of the information they issue even when they are not taking advantage of its inaccuracy, the question arises whether this policy includes holding these companies responsible for complete disclosure of all material information. In other words, does a policy which requires that all publicity be accurate and not misleading in effect require that the publicity be complete? Can a corporation's public statements be totally accurate and not misleading if there is material information which the corporation has not stated or will not state when it becomes known? One cannot say that a corporation's public statements are accurate unless such statements include all material information available to the corporation.

This position has been corroborated by judicial pronouncements which proclaim that the congressional purpose of investor protection can only be obtained by pursuing accurate *and complete* disclosure for the investing public. One of the most direct statements of this argument was made by the Third Circuit Court of Appeals in a 1970 opinion:

> The [Securities Exchange] Act was designed to eliminate deceptive and unfair practices in security trading and to protect the public from inaccurate, incomplete and misleading information.[116]

The court then proceeded to explain that, by protecting the public from "inaccurate, incomplete and misleading informa-

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[114] 401 F.2d at 858.

[115] *Id.* at 860.

[116] Kahan v. Rosenstiel, 424 F.2d 161, 173 (3d Cir. 1970).

tion," the investing public is given the opportunity "to make knowing and intelligent decisions" in trading securities.[117]

An equally recent opinion of the Fifth Circuit Court of Appeals also indicates that disclosures must be complete as well as accurate in order to carry out the purposes of both the 1934 Act and rule 10b-5:

> Congress meant to afford investors a reasonable opportunity to make knowing, intelligent decisions regarding their purchases and sales of securities . . . and the loss resulting in connection with purchases and sales made without benefit of such an opportunity is the type of injury section 10(b) and Rule 10b-5 seek to prevent.[118]

Thus, the courts seem to be arriving at the conclusion that responsibility for the *accuracy* of disclosures, (regardless of the motives for issuing them) entails responsibility for the *completeness* of disclosures. When considered in regard to an investor's attempt to make a rational investment decision, this conclusion becomes inevitable. An investor who lacks knowledge of some undisclosed material information is theoretically no more able to make a rational investment decision than one possessing information which is somewhat untrue. Lack of knowledge of such facts as a recently executed lucrative contract or a rich mineral strike may leave the investor just as uninformed as if he had received an understatement of the company's earnings. In either case he possesses inaccurate information. Therefore, if the courts desire to protect investors from inaccurate information, they should require corporations to disclose *all* material information.

2. Liability for Failure to Disclose Information which Renders Previous Statements False

In *Fischer v. Kletz,*[119] a New York federal district court held that a company's independent auditors could be liable to open-market investors under rule 10b-5 for a failure to disclose newly acquired information that the company's published financial statements, certified by defendants, were false. The helpfulness of the holding in finding support for the affirmative duty of disclosure described above is limited by the court's failure to mention which clause of the rule would be applicable. Such a lumping of the clauses of rule 10b-5 is not unusual.[120]

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117 *Id.*

118 Herpich v. Wallace, 430 F.2d 792, 806 (5th Cir. 1970).

119 266 F. Supp. 180 (S.D.N.Y. 1967).

120 Most of the earlier rule 10b-5 cases are not concerned with distinguishing the clauses. 1 A. BROMBERG, *supra* note 56, § 2.6(3); Note, *supra* note 57, at 826-27. Although many of the more recent cases do refer to a particular clause or clauses, in the opinion of the author, this is still not a predominant practice.

The amicus curiae brief filed by the SEC in *Fischer v. Kletz* indicates the Commission's view that the accountants' failure to disclose constituted a violation of clause (3):

> Failure by an accountant to disclose that financial statements of a company which it has certified are false when it has become aware of that fact is, under Rule 10b-5(3), an act or course of business which operates as a fraud on persons in connection with the purchase or sale of securities of that company.[121]

If the court agreed with the Commission and was thinking of clause (3) in upholding the action based on the accountants' failure to disclose, its reasoning would be consistent with that expressed in *Cochran v. Channing*:

> Fraud may be accomplished by false statements, a failure to correct a misleading impression by statements already made or . . . by not stating anything at all when there is a duty to come forward and speak.[122]

The interesting question which emerges from this language is why the nondisclosure operates as a fraud under rule 10b-5(3): Is it because the accountants failed to corrrect the misleading impression made by the original financial statements or because, as certified public accountants, they had a special duty of disclosure to the public?

The answer should not be clear and simple. It probably involves a combination of the facts that (a) the defendants' certification of financial statements is for investor protection and (b) their earlier certification had become unwarranted. Although the case emphasizes the special duty of an independent auditor to the public, such emphasis was necessary in order to distinguish the case from all available precedent which at that time indicated that a violation of rule 10b-5 could not occur unless the misleading or undisclosed information were somehow used to benefit the defendant.[123] Nevertheless, the important point is that the court found a violation of rule 10b-5 by the accountants' failure to disclose newly acquired information that the earlier statements were false. The court, and the SEC, are saying that an investor can be defrauded by this failure to disclose. But the "fraud" does not involve any "cheat-

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121 Brief for SEC as amicus curiae, Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967) *quoted in* 1 A. BROMBERG, SECURITIES LAW § 7.4(2) n.103.7 (1968).

122 211 F. Supp. 239, 243 (S.D.N.Y. 1962).

123 Even in the *Texas Gulf Sulphur* case, the lower court had followed precedent by saying that there could be no violation of rule 10b-5 for issuing a misleading press release unless those responsible, including the corporation, somehow took advantage. SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 293-94 (S.D.N.Y. 1966). The Second Circuit Court of Appeals later reversed Judge Bonsal on this issue. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 860-62 (2d Cir. 1968).

ing" or unfair advantage taken by the accountants — the court recognizes that they are not receiving any gain. Nor does the fraud involve unfairness between any two transacting or negotiating parties. Rather, the court is saying that the nondisclosure operates as a fraud upon the public because they are dealing with inaccurate, although not unequal, information.

The above reasoning is prescribed as a basis for holding a corporation liable for failure to disclose material information in the absence of corporate and insider trading. In both situations, nondisclosure does not confer any unfair advantages to any parties. In both situations, the fraud involved is the misleading nature of the information possessed by the public. This argument — that nondisclosure results in the same use of misleading information by the investing public as does false disclosure — parallels the argument made in the previous section concerning misleading statements.

However, the *Fischer* case represents the use of clause (3) and therefore the taking of one additional step by the courts. The *Fischer* court recognized that *nondisclosure* itself can operate as a fraud even when no one is taking advantage of the fraud.[124] The *Texas Gulf Sulfur* and *Heit* cases stated the same conclusion but with respect to misleading statements rather than to nondisclosures.

Even if the *Fischer* case can be said to hold that a nondisclosure operates as a fraud when no one is taking unfair advantage, the facts still present two variations from the hypothesized situation. First, the nondisclosure involved correction of a statement previously made. On this basis one could argue that the court did not recognize an initial affirmative duty to disclose, but rather a duty based only upon the former misleading statement. Although this distinction may be theoretically accurate, its significance is questionable. In a normal business setting, a corporation continually makes certain disclosures.[125] When a material event occurs but is not disclosed, earlier statements made by the corporation become misleading to the extent that they are relied upon by investors. Thus, imposing an affirmative obligation to disclose material information in the hypothesized setting serves to avoid misleading impres-

124 As stated earlier, this assumes that the court was looking to clause (3). There is the remote possibility that the *Fischer* court was concerned with clause (2). However, application of clause (2) would necessitate an argument that there is absolute liability for a false statement even though no one has taken unfair advantage of it. Thus denial of even the defense of due diligence seems extremely unlikely, particularly at the time of the *Fischer* decision.

125 *See* Sections I & II *supra* concerning corporate reporting requirements.

sions created by previous disclosures just as does the imposition of a duty to correct previous statements known to be false. The only difference is that in the former situation, the subsequent disclosure might not pertain to the specific topics dealt with in the original disclosure.

The second distinguishing factor in the *Fischer* case is the fact that the nondisclosing party was an independent certified public accountant whose task was to certify the financial statements for the protection of public investors. It might be argued that there is a unique relationship between an independent auditor and the public which might impose a "duty to come forward and speak."[126] Indeed, in *Drake v. Thor Power Tool Co.*,[127] the court cited *Fischer* in emphasizing the special position of an independent auditor. But the court's purpose in holding that "[t]he issuance of a financial statement by an independent auditing firm is not the same as the issuing of a press release"[128] was to establish that independent auditors, as opposed to other corporate insiders, could be held liable for misstatements which they had caused even if they did not benefit from them. As indicated earlier, after the appellate decisions in *Texas Gulf Sulphur* and *Heit,* such a showing was no longer necessary. In fact, the *Heit* court, with essentially the same facts as the *Drake* court, found a cause of action to exist under rule 10b-5 without an allegation of a special relationship between an independent auditor and the public.[129]

Even if one includes *Fischer* within the "duty to come forward and speak" category, a corporation's duty to disclose material information should also be included within this same category. It seems artificial to argue that there is more of a special relationship between an independent auditor hired by corporate management and the investing public than there is between corporate management and the very shareholders by whom they were elected. A duty arising from this latter relationship is recognized in *SEC v. Shattuck Denn Mining Corp.*[130] In that case, the president of a corporation had issued an accurate press release on February 6. Within 2 weeks, unfavorable developments rendered the release misleading, but the company made no announcement of the changed circumstances until May 12. The court's initial reaction was that:

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[126] Cochran v. Channing Corp., 211 F. Supp. 239, 243 (S.D.N.Y. 1962).
[127] 282 F. Supp. 94 (N.D. Ill. 1967).
[128] *Id.* at 105.
[129] Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968).
[130] 297 F. Supp. 470 (S.D.N.Y. 1968).

> The public had the right to know that negotiations were no longer concluded . . . [because these] facts . . . would have put investors on notice that the February 6th release was no longer worthy of reliance.[131]

Speaking of the corporation, the court found that "[i]ts silence in the face of such knowledge is inexcusable."[132] Although the corporation was held not to have violated rule 10b-5 because there was no showing that it derived any benefit, the language of the court makes it clear that such a violation would have been found under the "no gain is necessary" doctrine which was subsequently accepted in *Texas Gulf Sulphur* and *Heit*. Thus the *Shattuck* court found that the corporation's relationship to its shareholders obliged it to disclose the falsity of previously made statements. Therefore, although in light of *Heit* the *Fischer* holding does not depend upon the "unique" relation of an independent auditor to the shareholders of the corporation,[133] any argument supporting the significance of this relationship would have to acknowledge *Shattuck*'s determination that the relationship between management and the shareholders is equally special.[134]

Thus once more, the courts are utilizing rule 10b-5 to insure dissemination of complete and accurate information in order to enable investors to make intelligent investment decisions. In so using rule 10b-5, the courts have indicated that failure to disclose material information to the investing public operates as a fraud upon investors. As expressed above, this policy cannot be pursued effectively unless companies are compelled to make timely disclosure of all material information.

C. *Position of the SEC*

In addition to the holdings and implications of past cases, the position of the Securities and Exchange Commission is likely to be an important determinant of whether rule 10b-5 provides an affirmative obligation to disclose. It is noteworthy that the Commission did not claim that Texas Gulf Sulphur's failure to disclose its discovery was itself a violation of rule 10b-5. Indeed, this has been taken by some to indicate that, at least in 1966, the Commission felt that a corporation had a right to withhold material information as long as it was not trading in

[131] *Id.* at 475-76.

[132] *Id.* at 476.

[133] Any obligation emanating from the relationship between corporate management and the corporation's shareholders is immediately expanded to apply to the public. *In re* Cady, Roberts & Co., 40 S.E.C. 907, 913-14 (1961).

[134] *See also* Rothschild v. Teledyne, Inc., 328 F. Supp. 1054 (N.D. Ill. 1971), in which the Court dismissed a 10b-5 action for nondisclosure, but implied that the cause might be valid if defendants occupied a management-shareholder relationship with plaintiffs.

its stock.[135] On the other hand, the publication of two relatively recent releases indicates that the Commission is taking a more aggressive stand.

In a 1970 release, the Commission directly stated that corporations should be making "prompt disclosure . . . of material corporate developments, both favorable and unfavorable" in order to maintain investor confidence in the securities market.[136] The statement asserted that a company "has an obligation to make full and prompt announcements of material facts regarding the company's financial condition" in addition to compliance with the statutory reporting requirements. In a statement especially relevant to this article, the Commission asserted the following:

> Not only must material facts affecting the company's operations be reported; they must also be reported promptly. Corporate releases which disclose personnel changes, the receipt of new contracts, orders and other favorable developments but do not even suggest existing adverse corporate developments do not serve the public needs and may violate the anti-fraud provisions of the Securities Exchange Act of 1934 . . . .[137]

These quotes tend to indicate that the SEC believes that publicly held corporations have an affirmative obligation to make timely disclosure of material corporate developments and that failure to do so involves a violation of rule 10b-5. Nevertheless, the Commission's statement involves somewhat special facts and is not necessarily applicable to the hypothesized case.

The SEC's position concerning a corporation's affirmative duty to disclose material information is corroborated by a subsequent 1971 release concerning mandatory disclosures in registration for a public offering:

> Disclosure of factual information in response to inquiries or *resulting from a duty to make prompt disclosure under the anti-fraud provisions of the securities acts* . . . at a time when a regis-

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135 Address by David Ferber, Solicitor, SEC, Before the New York Society of Security Analysts, Feb. 17, 1966, p. 4-5. (Text furnished on loan basis by Mr. Ferber's office).

Furthermore, in Chris-Craft Indus., Inc. v. Bangor Punta Corp., 426 F.2d 569 (2d Cir. 1970), the Commission contended in its amicus brief that neither Bangor Punta nor Piper Corporation was obligated to announce a material agreement between them as long as there was no trading by those privy to the information. (Dissenting opinion of Chief Judge Lumbard, 426 F.2d at 579). The significance of this position is difficult to assess because of its self-serving nature for the Commission: The suit claimed that Bangor Punta had violated § 5 of the 1933 Act by disclosing an estimate of the value of the agreement. The defendant contended that it had an obligation to disclose the material fact. Such obligation had to be denied in order to support this action for violation of § 5 of the Securities Act.

136 Securities Act Release No. 5092, Securities Exchange Act Release No. 8995, Investment Company Act Release No. 6209 (Oct. 15, 1970).

137 Sources cited note 136 *supra*.

> tered offering . . . is . . . in process, . . . should be effected in a manner which will not unduly influence the proposed offering.[138]

Thus, the SEC appears ready to require affirmative disclosure by corporations not trading in their stock. At the present time, however, they have not yet done so. As with the issues in *Texas Gulf Sulphur,* the Commission will probably wait for arrival of the right facts and circumstances in order to enhance its chances of success.

D. *Summary of Rule 10b-5 as Source of an Affirmative Duty*

In the search for a source to provide an affirmative corporate obligation to disclose, a brief tour through the extensive world of rule 10b-5 leaves one with many possibilities but no actualities. The words of the rule provide hope, particularly in certain "special" — but not extraordinary — circumstances. But under a strict or literal construction, the words require the following interpretational help from the courts: (1) Can failure to disclose material information *as it becomes available* be misleading because it modifies a statement made some time previously? (2) Is a former shareholder being "reasonable" in assuming that nondisclosure indicates the absence of any material developments?

The cases provide no explicit help. Several courts have reached, but have not touched, the question of affirmative disclosure. The holdings have repeatedly avoided the issue. Nevertheless, the tools are presently available for an ambitious court, desiring to take advantage of them, to rule on the issue. From its recent statements, the SEC appears ready — either as a plaintiff or as an amicus — to argue for affirmative disclosure. Furthermore, the courts have made policy statements concerning the legislative objectives of investor protection which seem rationally to justify an affirmative obligation to disclose. For example, judicial pronouncements have focused on the importance of the following: (a) integrity and honesty in securities markets, (b) accurate and complete information to investors, (c) investor confidence in the securities markets, and (d) sufficient information to make rational and knowledgeable investment decisions. In addition, most courts agree that the anti-fraud provisions are to be interpreted flexibly in order to realize the congressional purpose of investor protection.

Finally, and most importantly, among the tools available are the rationale and policy objectives expressed by the courts

[138] Securities Act Release No. 5180 (Aug. 16, 1971).

in reaching past decisions. The policy goal of protecting investors from misleading statements or from failure to disclose the subsequently discovered falsity of a previously issued statement cannot be attained without protecting the investor from material nondisclosures. The effect of each is the same.

In conclusion, under present law rule 10b-5 does not impose a general affirmative obligation for a corporation to disclose material information. Yet, given the words of the rule, the judicially acknowledged congressional purpose, the posture of the SEC, and the reasoning and policy behind the existing judicial precedent, rule 10b-5 provides the tools and material for formally constructing such an obligation.

IV. Consequences of Affirmative Disclosure

The preceding sections of this article have attempted to locate authority for imposing an affirmative obligation to disclose upon a publicly held corporation. At this point, the focus shall shift to an examination of the advantages gained and the practicalities encountered in implementing such an obligation.

A. *Advantages Resulting from Affirmative Disclosure*

Full and immediate disclosure of material information eliminates the possibility that insiders will take unfair advantage of their proximity to inside information. Not only would timely disclosure significantly reduce unfair trading by insiders and their tippers, but it would also prevent the unfair trading which is made possible by inevitable leaks of information to those not even employed by the particular corporation.[139] This result would increase the opportunity for all traders to have equal access to material information concerning publicly held corporations. As a result, the Second Circuit's objective of "equal access to the rewards of participation in securities transactions"[140] would be greatly enhanced.

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[139] This idea was reaffirmed in informal individual interviews held in April 1972, with two portfolio managers in Boston. In spite of their different perspectives, they reacted to the idea of affirmative disclosure with surprising similarity. Each of the portfolio managers felt that the most important consequence of affirmative disclosure would be the virtual elimination of insider trading. The two portfolio managers interviewed had quite different outlooks. One is involved in eliciting full and nontraditional forms of disclosure from publicly held corporations. He is particularly concerned with disclosure regarding a corporation's policy toward minority employment and environmental issues. He immediately suggested that his views not be regarded as typical because of his personal commitment to full disclosure. The other portfolio manager is a more traditional financially oriented analyst. Both individuals are employed by nationally prominent financial institutions. Because of his company's very rigid policy, the name of one of the portfolio managers must be withheld. For the sake of uniformity, the name of the other will be withheld as well.

[140] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 850-51 (2d Cir. 1968).

The current state of the law presents a second advantage which would result from affirmative disclosure. At the present time, even in the absence of insider trading, a corporation will be held responsible for the misleading nature of its statements once it has decided to speak.[141] But if the corporation decides not to disclose, it does not risk liability. Under these circumstances, a corporation is encouraged to adhere to a policy of nondisclosure. However, if an affirmative duty of disclosure were imposed upon the corporation, it would then be forced to speak. Thus, a steady stream of corporate information would flow into the securities markets.

A third group of advantages to be gained from full disclosure concern those accruing to the investing public. The SEC's *Special Study of Securities Markets* reported that "[t]he deliberate withholding of news by companies can be as harmful to investors as the release of inaccurate or overoptimistic news."[142] Given more timely and complete information, investors will be able to make more rational and knowledgeable decisions. They will have more confidence in the securities markets, and should be better able to compare the value of one security with that of another. As a result, investors could buy securities at a more accurate price and would be less prone to "uneconomic" investments.

Finally, and closely related to the advantages for the investing public, are the advantages gained by the securities markets themselves. If a policy of affirmative corporate disclosure were adopted, the consequence of a continuous and timely flow of corporate information would help to bolster investor confidence in the integrity of the securities markets. In all likelihood, this increased confidence would give rise to a constant or even increased level of investor participation. Increases in both investor confidence and participation are important because of the crucial role which the securities markets play in financing business.

The economy also gains from full disclosure because of the resulting improvement in the allocative efficiency of the capital markets.[143] With full and timely disclosure, investors will make more rational investment decisions, and more funds

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[141] Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir. 1971).

[142] U.S. SECURITIES AND EXCHANGE COMMISSION, REPORT OF SPECIAL STUDY OF SECURITIES MARKET 92 (1963).

[143] *Id.* at 16. *See also* Schoenbaum, *The Relationship Between Corporate Disclosure and Corporate Responsibility*, 40 FORDHAM L. REV. 565, 577 (1972).

will be channeled into the more efficient and productive companies. However, normal trading between investors (*i.e.*, on the exchanges or over-the-counter) has no direct effect on the allocation of capital resources because the companies receive nothing. But when a company later comes out with an offering of securities to raise more capital, investors will use the additional information to determine if this particular issue represents a more efficient use of their funds. This improved allocation of capital resources represents a *long-term gain* for the national economy.

B. *Practical Problems of Implementation*

Given the above advantages realizable from a corporation's duty to affirmatively disclose all material information, there are definite problems presented by the implementation of such a duty. The first major problem is determining what should be disclosed. Corporate management will be forced to make continual determination of what is material. This is certainly not a new problem because determinations of materiality have already been necessary to comply with various provisions of the securities acts.[144] Yet, because of the existence of an affirmative duty, the number of such determinations will increase. There is certainly information which an investor might find to be material at the moment it first appears, but which would not be considered material if disclosed with a good deal of other information at the end of a 30-day or 90-day period.

If in doubt concerning what should be disclosed, management would tend to "play it safe" by disclosing everything. This leads to two undesirable consequences. First, the investing public will be flooded with disclosures. Rather than being able to use the information most rationally, there is the danger that they will be confronted with an unmanageable amount and tend to ignore it altogether. Secondly, by disclosing everything, directors will become more vulnerable to liability for disclosures which are misleading because they were made prematurely.

The problem of what to disclose is real but not overwhelming. Although there would undoubtedly be more determinations of materiality, after a short time a corporation should be able to handle them almost mechanically. In general, the type of information would ordinarily fit into recurring patterns. Should the public begin to ignore certain kinds of disclosures

144 *E.g.*, Securities Act of 1933 §§ 12, 17(a), 15 U.S.C. §§ 77l, 77g(a) (1970); SEA § 18, 15 U.S.C. § 78r (1970).

because of their continual appearance, it would seem that the test for materiality could be accommodated to exclude those types of information which a reasonable investor would not utilize.[145] Finally, a careful corporate management could avoid undue liability for premature disclosure by qualifying its initial statements with honest indications of the possibility of contrary developments.

Related to the problem of materiality, the question arises as to whether a duty of affirmative disclosure would result in a flood of litigation overflowing the courts. For example, an investor who purchased a company's common stock on June 1 might realize a loss by selling the stock on July 8 in the wake of the company's timely disclosure that its June operations were subpar. If he later found that the company had taken some undisclosed action in May, such as firing one of its 25 vice-presidents, it is conceivable that he could sue for failure to disclose on the basis that he would not have purchased had he known of the intervening action. If such suits were permitted to prevail, the courts could conceivably be inundated with them. However, it seems reasonable to assume that the courts would be able to avoid this problem by a few initially strict holdings concerning proof of materiality and actual reliance. Knowledge of such precedent should be effective in discouraging further frivolous litigation.

Another major problem area concerns dissemination. Assuming that all of the proper information is disclosed, how can it be circulated to everyone equally? Even if it were agreed that publication in the *Wall Street Journal* would satisfy the obligation of equal dissemination, the problem would not be ultimately solved since any single newspaper cannot be expected to have room for all such disclosures requested by diverse corporate managements. It is likewise doubtful that the financial wire services have the capacity to carry all such disclosures. Notwithstanding the above, it must still be admitted that dissemination is a difficult problem for the smaller publicly held companies even under present disclosure requirements. The financial media have space limitations and are not likely to print news concerning relatively few people or dollars. Yet, an increased number of disclosures would aggravate this problem considerably.

A suggested solution to the dissemination problem is to compel a mailing of the disclosure to each shareholder. But this

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[145] See definition of materiality in INTRODUCTION *supra*.

is not only extremely expensive, it also presents problems of timing and, most objectionably, gives an unfair advantage to shareholders over nonshareholders. For smaller regional companies, dissemination might be accomplished by publication of disclosures in newspapers located in areas of stockholder concentration. Although there are no entirely satisfactory solutions to the dissemination problem, it must be recognized that this problem exists under existing disclosure requirements and is therefore not unique to affirmative disclosure.

Affirmative disclosure entails a third major problem area: the possible negative effects of disclosure on the corporation's business or competitive position. The courts have been quick to recognize the urgency of this problem, and have justified a company's failure to disclose on the basis of a valuable corporate purpose[146] or competitive reasons[147] without having declared nondisclosure by itself to be improper.

If the corporate purpose doctrine or competitive position theory were allowed to justify nondisclosure in a situation compelling affirmative disclosure, the latter duty would be considerably undermined. A corporation desiring not to disclose something could theoretically find some corporate purpose by which to justify its silence. The problem of setting standards for judging the existence of a proper corporate purpose is an extremely perplexing one. In the end, such standards would have to place tremendous reliance and pressure upon the courts. Judicial rejection of a defense of proper corporate purpose would entail detailed examination of the operations of the business involved. Furthermore, corporate management would be left with few objective criteria by which to plan its future disclosures. Although there is little doubt that over time the courts could develop adequate doctrines and standards for applying the "corporate purpose" exception to affirmative disclosure, the difficulties, ambiguities, and numerous litigation certain to arise represent significant costs in implementing an affirmative duty to disclose.

In addition to the above advantages and disadvantages resulting from affirmative disclosure, one must also consider what sanctions to impose upon the corporation for violation of such a duty. There are numerous issues to be considered in determining when and why an individual should be able to recover from a corporation which has not derived any benefit from the im-

[146] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 850 n.12 (2d Cir. 1968).
[147] Doglow v. Anderson, 438 F.2d 825, 829 (2d Cir. 1971).

proper disclosure.[148] But most of these issues are also encountered in cases of misleading statements made in the absence of corporate trading and are therefore not unique to the situation being considered.[149]

As indicated in the discussion of pertinent case law herein, the various circuits differ as to whether mere negligence is sufficient to sustain an action for private damages under rule 10b-5.[150] In the Second Circuit, although actual knowledge of the falsity of a statement is enough to sustain the action,[151] something more than mere negligence is required. In the Tenth Circuit, failure to exercise due care is sufficient for allowing private damages.[152] Therefore, if affirmative disclosure were required, a private action for damages for failure to disclose would involve no new problems in the Tenth Circuit. Upon a showing that the defendant had abrogated his duty to disclose and that the plaintiff had relied to his detriment, the outcome would depend upon whether defendant's failure to disclose resulted from a lack of due diligence.

On the other hand, in the Second Circuit, the plaintiff would have to show that the defendant possessed some degree of scienter.[153] But in a case in which the defendant has been completely silent and has derived no benefit from this silence, scienter — even of a minor degree — could be extremely difficult to prove. In *Heit v. Weitzen*,[154] the scienter requirement was fulfilled by defendant's knowledge of the falsity. Analogously in a suit for nondisclosure, one would have to establish the defendant's knowledge of the materiality of the information withheld. In the absence of any statement by defendant regarding this information or of any benefit to defendant for withholding it, such knowledge would seem very difficult to prove.

In the *Globus* case[155] the court seemed to apply a less demanding standard. The scienter requirement was satisfied if defendants were aware of facts which, if disclosed, would have made the statements in question misleading. Applying this standard to an abrogation of affirmative disclosure, one would have

148 *See, e.g.*, Note, *supra* note 57.

149 Other such questions include the huge potential liability and whether innocent shareholders should have to pay indirectly.

150 *Texas Gulf Sulphur* held that mere negligence could sustain an action for injunctive relief.

151 Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968).

152 Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir. 1971).

153 Globus v. Law Research Service, Inc., 418 F.2d 1276, 1290-91 (2d Cir. 1969).

154 402 F.2d 909 (2d Cir. 1968).

155 418 F.2d at 1290.

to prove that defendants were aware of undisclosed facts which would be considered material. This standard seems easier to prove in the case of a nontalking, nondealing corporate defendant than is the standard in *Heit*. Nevertheless, it is much more difficult to prove the state of knowledge possessed by a silent defendant who is making no use of the undisclosed information.

Therefore, in a jurisdiction requiring more than mere negligence to establish private damages under rule 10b-5, a plaintiff's chances of success may be lessened as a result of the difficulty of proving even a limited degree of scienter. In other words, if some degree of willfulness is necessary to establish damages in a suit for failure to disclose, then the vast majority of such suits may be forced to limit recovery to injunctive relief.

On the other hand, in a jurisdiction requiring only negligence for recovery under rule 10b-5, the imposition of an affirmative obligation to disclose will raise the usual objections concerning fairness to the innocent shareholder and the enormous potential liability to the corporation.[156]

C. *Conclusion and Proposal*

Given the foregoing consequences of an affirmative obligation to disclose, the net gains to be realized would be maximized if the civil sanction resulting from all violations of affirmative disclosure were limited to *injunctive relief*. The injunctive measures available should include the suspension of trading of the securities involved as well as ordering compliance with the requirement of affirmative disclosure.[157] Limiting the civil sanctions to injunctive relief of this nature will allow realization of the advantages of affirmative disclosure: (1) insider cheating is still deterred; (2) a steady flow of information to the securities markets is maintained; and (3) investors are given the advantage of full disclosure. On the other hand, some of the major disadvantages of an affirmative disclosure requirement are avoided: (1) spurious, court-clogging suits are eliminated; (2) management is not forced to waste time and resources in over-disclosing as a means of "playing it safe;" and (3) innocent shareholders avoid indirect liability. Most importantly, the objectives of the 1934 Act including those of general fairness are satisfied simultaneously. Investors are provided maximum information by a requirement of full disclosure, but

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[156] *See* concurring opinion of Judge Friendly. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 866-67 (2d Cir. 1968).

[157] These remedies are presently available for violation of the reporting requirements of the 1934 Act. *See* text accompanying notes 29-35 *supra*.

they are not given windfall profits for losses sustained in dealing at arm's length with someone who had no more access to corporate information than they.

By limiting actions for nondisclosure (when there is no corporate benefit) to a remedy of injunctive relief, the plaintiff need only establish negligence on the part of the corporate defendant. Therefore, the difficulties inherent in proving some degree of scienter by a silent, nondealing corporation are eliminated. Nevertheless, a private party may still recover damages for nondisclosure involving willful conduct if he can prove a claim either of manipulation or deception,[158] or of aiding and abetting.[159] The SEC may also sue for willful nondisclosure through section 32(a) of the 1934 Act.[160]

V. SUMMARY

The issue of whether a corporation has an affirmative obligation to disclose material information has been presented by many sources but remains unresolved. The reporting requirements of the 1934 Act succeed as periodic reports but fail as current disclosures. They fail to achieve timeliness, and they lack the dissemination necessary to inform the investing public. The disclosure policies of the major stock exchanges are also insufficient. They qualify substantively but are inadequate because of their limited applicability.

Rule 10b-5 is the most promising basis for affirmative disclosure. Yet a literal interpretation of this rule does not provide sufficient authority for a general obligation to disclose. The cases treating rule 10b-5 have also failed to address the question directly. Nevertheless, they offer logical reasoning and judicial policy which are consistent with an obligation of affirmative disclosure. Given these precedents and the position of the SEC, a progressive court could reasonably find an affirmative duty of corporate disclosure.

The prospective consequences of a duty of affirmative disclosure suggest that the availability of an action for private damages would create many problems without significantly increasing the benefits. For this reason, it is submitted that the rationale of rule 10b-5 should be extended to impose an affirmative corporate obligation to disclose material information and the sanction for violation of such obligation should be limited to injunctive relief.

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158 *See* cases cited notes 84-86 *supra.*

159 *See* note 89 *supra.*

160 15 U.S.C. § 78ff(a) (1970).