1979

Rule 10b-5 and the Corporation’s Affirmative Duty to Disclose

Jeffrey D. Bauman
Georgetown University Law Center

This paper can be downloaded free of charge from:
https://scholarship.law.georgetown.edu/facpub/1559

Jeffrey D. Bauman, Rule 10b-5 and the Corporation’s Affirmative Duty to Disclose, 67 Geo. L.J. 935 (1979)

This open-access article is brought to you by the Georgetown Law Library. Posted with permission of the author.
Follow this and additional works at: https://scholarship.law.georgetown.edu/facpub

Part of the Banking and Finance Law Commons
Rule 10b-5 and the Corporation’s Affirmative Duty to Disclose

JEFFREY D. BAUMAN*

In order to make responsible investment decisions investors must be adequately informed. In this article Professor Bauman argues that the existing disclosure requirements of the federal securities laws do not meet the informational needs of investors because there is no affirmative duty to disclose all material information. In order to fill this substantial gap in the existing disclosure scheme, Professor Bauman argues that rule 10b-5 should be read to require prompt disclosure of all material information subject only to limited exceptions and should be applicable even in the absence of trading or prior inaccurate disclosure.

Corporations today live in an age of disclosure. Not only must they comply with the formal disclosure requirements of federal securities laws, but they must also disclose to avoid liability under rule 10b-5 for trading on the basis

---

*Associate Professor of Law, Georgetown University Law Center. B.A., Yale University 1959; M.A., Yale University 1962; LL.B., Yale Law School 1963.

I would like to acknowledge the considerable assistance given in the preparation of this article. My colleague Donald E. Schwartz gave immeasurably of his time, encouragement, and stimulation. Many helpful comments and criticisms came from my colleagues John C. Coffee, Jr. and Roy A. Schotland and from Lloyd Feller and Elliott J. Weiss. I received invaluable help throughout from my student assistants; special thanks to David P. Buchholtz, Norman Dupont, Howard J. Ross and Mark A. Wainger. Finally, I would like to thank Kathleen M. Russo and other members of the Georgetown Law Journal for their editorial assistance.


Various rules have been adopted pursuant to these statutory provisions. See 17 C.F.R. §§ 240.13a-1, 240.13a-11, 240.13a-13 (1978) (requiring annual, current, and quarterly reports on forms provided by SEC); 17 C.F.R. §§ 249.308, 249.308(a), 249.310 (1978) (specifying forms to be used for reports); 17 C.F.R. § 239.11 (1978) (specifying required disclosure in registration statement).

2. 17 C.F.R. § 240.10b-5 (1978). The rule provides:

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 or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,
(b) 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
(c) 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.

Rule 10b-5 is promulgated pursuant to Section 10(b) of the 1934 Act, 15 U.S.C. § 78(b) (1976), which
of nonpublic information\(^3\) or failing to correct their previous misstatements.\(^4\) In addition, corporations disclose because they perceive that rule 10b-5 may require them to do so even in the absence of trading or prior inaccurate disclosure.

The parameters of some of these disclosure obligations are now reasonably clear. The extent to which rule 10b-5 imposes a duty to disclose in the absence of trading or prior inaccurate disclosure, however, remains relatively undefined.\(^5\) Although no case has so held, a few courts have suggested that there is a general duty to disclose.\(^6\) The Securities and Exchange Commission (SEC), while suggesting the existence of such a duty, has not embodied it in a rule or administrative decision.\(^7\) Indeed, only the major stock exchanges

\(^3\) See Kohler v. Kohler Co., 319 F.2d 634, 638 (7th Cir. 1963) (directors found to have exercised due diligence in ascertaining and disclosing material facts when corporation purchased stock from minority stockholder); In re Ward La France Truck Corp., 13 S.E.C. 373 (1943) (corporation held liable for failing to disclose material facts to shareholders of another corporation acquired in tender offer); cf. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 852 (2d Cir. 1968) (en banc) (holding directors liable for trading on basis of inside knowledge of mineral strike), cert. denied, 394 U.S. 976 (1969).


\(^6\) See Bauman, Corporate Disclosure and Dissemination, in PRACTICING LAW INSTITUTE, CORPORATE NEWS DISSEMINATION 63, 153-54 (1976) (Bibliography) [hereinafter cited as CORPORATE NEWS DISSEMINATION].

\(^7\) The SEC originally did not espouse a duty to disclose in the absence of trading. Cf. Brief of the Securities and Exchange Commission, Amicus Curiae, at 27, Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968), cert. denied, 395 U.S. 903 (1969) (applicability of § 10(b) and rule 10b-5 should not depend on trading by corporation or its insiders if there has been widespread dissemination of affirmatively false or misleading corporate statements); Note, Texas Gulf Sulphur and the Duty of Disclosure, Another View, 55 GEO. L.J. 

states:

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, or of any facility of any national securities exchange . . .

\(\cdots\)\(\cdots\)\(\cdots\)

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

3. See Kohler v. Kohler Co., 319 F.2d 634, 638 (7th Cir. 1963) (directors found to have exercised due diligence in ascertaining and disclosing material facts when corporation purchased stock from minority stockholder); In re Ward La France Truck Corp., 13 S.E.C. 373 (1943) (corporation held liable for failing to disclose material facts to shareholders of another corporation acquired in tender offer); cf. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 852 (2d Cir. 1968) (en banc) (holding directors liable for trading on basis of inside knowledge of mineral strike), cert. denied, 394 U.S. 976 (1969).


5. For convenience, this duty will be referred to in the balance of the article as the duty to disclose. The duty to disclose has been discussed by various commentators, but few have attempted to analyze it fully. See generally 1-4 A. BROMBERG, SECURITIES LAW: FRAUD §§ 4.2, 5.2, 7.4, 8.2, 12.2-.6, at 69, 91, 165, 197, 267; 5 A. JACOBS, THE IMPACT OF RULE 10b-5 §§ 87-94, at 4-1,-27 (rev. 1st ed. 1978); Feuerstein, The Corporation's Obligation of Disclosure Under the Federal Securities Laws When It Is Not Trading in Its Stock, 15 N.Y.L.F. 385 (1969); Talesnick, Corporate Silence and Rule 10b-5: Does a Publicly Held Corporation Have an Affirmative Obligation to Disclose?, 49 DENVER L.J. 369 (1973). See also Bauman, Corporate Disclosure and Dissemination, in PRACTICING LAW INSTITUTE, CORPORATE NEWS DISSEMINATION 63, 153-54 (1976) (Bibliography) [hereinafter cited as CORPORATE NEWS DISSEMINATION].


7. The SEC originally did not espouse a duty to disclose in the absence of trading. Cf. Brief of the Securities and Exchange Commission, Amicus Curiae, at 27, Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968), cert. denied, 395 U.S. 903 (1969) (applicability of § 10(b) and rule 10b-5 should not depend on trading by corporation or its insiders if there has been widespread dissemination of affirmatively false or misleading corporate statements); Note, Texas Gulf Sulphur and the Duty of Disclosure, Another View, 55 GEO. L.J. 
impose a general duty to disclose, and their requirements apply only to a small fraction of all publicly held corporations. In addition, it is uncertain whether a corporation has a duty to correct materially false and misleading statements that it did not make. Similarly, it is unclear to what extent a corporation must update its own prior statements that, although accurate when made, have become materially misleading. The few cases that have attempted to deal with these questions are marked by analytic uncertainty and imprecision.

Recently, however, courts have shown a renewed interest in these problems. One court, in dicta, raised anew the question of the general duty to disclose under rule 10b-5. Another court recently held that a corporation violated rule 10b-5 when it failed to update its own prior statements that had become materially false and misleading over a period of time.

This article explores the extent of a corporation’s duty to disclose material information. It asserts that rule 10b-5 requires prompt disclosure of all material information even in the absence of trading or prior inaccurate disclosure, and subject only to limited exceptions. After tracing the source

664, 695 n.174 (1967) (citing Address of David Ferber, Solicitor, SEC, Before New York Society of Security Analysts, Feb. 17, 1966, p.6) (noting that SEC did not charge Texas Gulf Sulphur with violation of 10b-5 in absence of trading or prior misstatement). In 1970, however, the SEC, in what has become its principal statement on timely disclosure, emphasized the corporation’s duty to make prompt and accurate disclosure of material developments. Securities Exchange Act of 1934 Release No. 8995, [1970-1971 Transfer Binder] FED. SEC. L. REP. (CCH) § 77,915, at 80,035 (Oct. 15, 1970). In this release, the SEC implied that the duty exists in the absence of trading or prior inaccurate disclosures. See id. The SEC also pointed out that this duty is distinct from the duty to comply with statutory reporting requirements and that, although the two obligations may overlap, compliance with one duty will not necessarily satisfy the other. Id. See also Securities Exchange Act of 1934 Release No. 10569, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) § 79,607, at 83,629 (Dec. 20, 1973) (companies obliged to disclose impact of fuel shortages on their operations); Securities Exchange Act of 1934 Release No. 9650, [1972-1973 Transfer Binder] FED. SEC. L. REP. (CCH) § 78,852, at 81,865 (June 22, 1972) (defense and other long term contractors obliged to disclose engineering and technical problems and significant dollar amounts, as well as progress towards completion).

8. The duty to disclose imposed by the New York Stock Exchange (NYSE) is set forth in its Company Manual but not in its listing agreement. See NEW YORK STOCK EXCHANGE COMPANY MANUAL § A-22, at A-18 (1968) [hereinafter cited as COMPANY MANUAL]. The American Stock Exchange (AMEX) includes the duty to disclose in both the listing agreement and its Company Guide. See AMERICAN STOCK EXCHANGE COMPANY GUIDE §§ 401-406 & app. 1 (1973) [hereinafter cited as COMPANY GUIDE]; notes 211-25 infra and accompanying text.

The National Association of Securities Dealers, Inc. also has a duty to disclose that applies to all corporations whose securities are listed on NASDAQ. The sanction for violation of the duty is delisting. NASD Bylaws, Art. XVI, § 3, Schedule D, part II § B.3.b (1979).

9. See Goldberg v. Meridor, 567 F.2d 209, 221 n.10 (2d Cir. 1977) (recognizing the issue but not deciding whether there is an affirmative duty to disclose under 10b-5 in the absence of trading), cert. denied, 434 U.S. 1069 (1978).


11. Neither the 1933 Act nor the 1934 Act define “material,” although both statutes use the term. See 1934 Act §§ 9, 14, 15 U.S.C. §§ 78a(14), 78n(c); 1933 Act §§ 11, 12, 15 U.S.C. §§ 77k(a), 77(0)(G). The rules under those acts, however, define material information as that “as to which an average prudent investor ought reasonably to be informed" before entering into a securities transaction. See 17 C.F.R. § 230.405(j) (1978); id. § 240.12b-2(j) (1978).

The Supreme Court recently defined materiality in the context of a section 14(a) action. See TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (omitted fact material if “substantial likelihood that reasonable shareholder would consider it important” when making voting decision) (emphasis added). The same standard of materiality is applicable in 10b-5 actions. See Haravy v. Apparel Indus., 571 F.2d 737,
of the duty and examining the problems of form, manner, and timing of disclosure, the article addresses some special problems under rule 10b-5—the duty to update, the duty to correct, and the duty to disclose financial projections. Finally, the article examines alternative sources of liability for failure to disclose. Although two other sources are available, the article concludes that rule 10b-5 is the most appropriate vehicle for imposing liability.

I. THE DUTY TO DISCLOSE: AN OVERVIEW

The fraud element of a 10b-5 cause of action is satisfied by a finding of deception. There are two theories why failure to disclose material information constitutes deception in violation of rule 10b-5. Failure to disclose may constitute a breach of the corporation’s implied representation that it will disclose material information. Alternatively, if a corporation permits previous disclosures that are no longer accurate to remain uncorrected, it implicitly

741 n.5 (2d Cir. 1978).

Once the standard of materiality is defined, however, the concept of materiality will still vary with the context in which it is to be determined; information may be defined as material for some purposes but not for others. The SEC itself has recently stated that in determining materiality, “there is no litmus paper test...” [The consideration whether particular information should be disclosed necessarily depends on the context in which the question arises.] SECURITIES AND EXCHANGE COMMISSION, REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES 22 (May 1976) [hereinafter cited as SEC REPORT]. Former SEC Chairman Ray Garrett, Jr., has suggested that the disclosure requirements could vary depending on whether disclosure was in connection with an investment or a voting decision. Ray Garrett, Jr., The Uses of Disclosure 6, 10 (National Investor Relations Institute, Sept. 30, 1975); see SEC REPORT, supra at 34 & n.24 (disclosure in proxy statement of material facts regarding corporate officer’s questionable payments may be required if conduct relevant to quality of management, any prior disclosure occurred significantly earlier, and management has not disclosed intent to stop practices); cf. Rafal v. Gense, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,505, at 92,441 (E.D. Pa. 1972) (action for securities law violation against candidates for director relevant to election and should have been disclosed in proxy statement).

Courts have also recognized that the context may alter the standard of materiality. See SEC v. Geon Indus., Inc., 531 F.2d 39, 48 (2d Cir. 1976) (potential merger material for purposes of imposing duty to abstain from tipping, but not necessarily material for purposes of disclosure in SEC report); Spielman v. General Host Corp., 402 F. Supp. 190, 194 (S.D.N.Y. 1975) (materiality in abstract is meaningless concept), aff'd, 383 F.2d 39 (2d Cir. 1967) (per curiam); Feit v. Lasso Data Processing Equip. Corp., 332 F. Supp. 544, 571 (E.D.N.Y. 1971) (because formal legal document, 1933 Act prospectus should have disclosed surplus even if only small number of potential traders would want to know). For a comprehensive treatment of the concept of materiality, see Hewitt, Developing Concepts of Materiality and Disclosure, 32 BUS. LAW. 887 (1977).

For the purpose of applying the duty to disclose, the context in which materiality must be defined is that of the trading market in which ongoing investment decisions are being made. In this context, information is material and disclosure is required if the information would have a reasonably immediate impact upon the reasonable investor's investment decision. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (en banc) (suggesting that information material if it affects desire of investors to buy, sell, or hold company's securities), cert. denied, 394 U.S. 976 (1969); cf. Fleischer, Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding, 51 VA. L. REV. 1271, 1289 (1965) (management's duty to disclose should be limited to extraordinary situations reasonably certain to affect substantially market price of security). This standard is similar to the English concept of “price-sensitive information.” See Lipton, English Company Law Reform Proposals, 2 SEC. REG. L.J. 16, 27 (1974). See also ALI, FED. SEC. CODE § 257 (Proposed Official Draft, Mar. 15, 1978) (definition of “fact of special significance”). Clearly, this determination will often be difficult; indeed, many duty-to-disclose cases will turn on the materiality of the undisclosed fact. For the purposes of this article, materiality will be assumed.
permits those disclosures to represent present conditions. Either of these failures to disclose may be considered deceptive.

Because the situations giving rise to the duty are often so complex, a corporation should have some discretion to determine the form, manner, and timing of disclosure. Of these the last is the most complex. For example, it would be unfair to penalize a corporation for what appears in hindsight to be untimely disclosure if the corporation has made a reasonable effort to disclose. Additionally, a balance must often be struck between the legitimate informational needs of investors and the equally legitimate need of the corporation and its nontrading stockholders for silence. These competing needs are particularly difficult to harmonize because, at any given time, the corporation's nontrading stockholders far outnumber those investors who are trading in the corporation's securities.

Were the duty to disclose rigidly interpreted, innocent nontrading stockholders would ultimately bear either the business losses that the corporation could suffer from premature disclosure or the burden of any damages assessed against the corporation for breach of the duty. Although stockholders always bear the ultimate loss whenever corporations pay damages, the difficulty in deciding when to disclose adds to the potential unfairness of imposing such losses on innocent stockholders and suggests a need to limit the duty. Courts generally consider timing to be a question of management's discretion and have hesitated to disturb the exercise of that discretion. Courts should examine closely the question of timing, however, and give weight, but not complete deference, to the corporation's judgment. Added judicial scrutiny will encourage corporations to consider the need for disclosure without affording unreasonably wide latitude to corporate management in deciding the timing of disclosure. Because the duty is designed to encourage full and prompt disclosure rather than to penalize corporations for failure to disclose, satisfaction of the duty should turn on a corporation's disclosure procedures and whether the corporation has acted reasonably in determining whether, when, and how to disclose.

One element of any action brought under rule 10b-5, which raises particularly difficult questions in the context of timing, is scienter. Clearly, when a corporation actually intends to deceive by failing to disclose, the requisite scienter is present. It is more difficult, however, to determine when intent to deceive should be inferred. If actual knowledge of the undisclosed material fact establishes a constructive intent to deceive, scienter would exist in almost every duty-to-disclose case because a corporation delaying disclosure almost certainly is aware of both the materiality of the information and the fact of nondisclosure. Consequently, a corporation could be found to have violated rule 10b-5 even if it were acting reasonably in determining the timing of disclosure. To avoid this result, scienter should not be inferred if a corporation acts with due care and good faith with respect to its duty to

12. See notes 94-123 infra and accompanying text.
disclose. Reckless conduct in connection with the duty to disclose, however, should constitute scienter.\(^4\)

In addition, there are some special problems that arise out of the duty to disclose. In some situations, a corporation will have a duty to update its own previously disclosed information that, although accurate when made, has become materially misleading because of subsequent events. A corporation has a duty to update previously disclosed information if an investor could reasonably rely on the continuing accuracy of that information. Similarly, although a corporation cannot be held responsible for the accuracy of all publicly available information, it will be required to correct misstatements made by corporate officials or by persons outside the corporation. Like the duty to update, this obligation is not absolute; it will arise only when the misstatement has been made either by an outsider who has a special relationship with the corporation, or by a corporate officer whose position creates an added expectation that the disclosure is reliable. Even then, a corporation should not have a duty to correct if it has established procedures to prevent such misstatements, and these procedures are breached through no fault of the corporation.

Some words of caution are appropriate. The potential scope of this article is almost as broad as the potential scope of the duty to disclose, and some limits on both are necessary. The principal purpose of this article is to propose both a normative duty to disclose and the standards required to comply with that duty.\(^5\) The article raises, but does not purport to answer completely, questions of who could enforce the duty to disclose and what remedies could be obtained for its breach. It is clear that the SEC, through its existing statutory powers, can enforce the duty and obtain injunctive relief if it can establish a breach.\(^6\) Similarly, injured investors could recover damages under

---

14. See notes 131-40 infra and accompanying text.

15. Hence, the article does not discuss the obligations of corporate management in connection with their own securities transaction or with the liability arising from breach of these obligations.

16. In order to prevail in a rule 10b-5 action, the SEC must prove the following: (1) The defendant used interstate commerce, the mails, or a national securities exchange in committing the alleged violation, see 1934 Act § 10, 15 U.S.C. § 78j; 17 C.F.R. § 240.10b-5, quoted at note 2 supra; (2) the defendant made a misrepresentation or misleading omission, or committed some other deception or fraud, see 1934 Act § 10(b), 15 U.S.C. § 78j(b); (3) the misleading or undisclosed information was material, 17 C.F.R. § 240.10b-5; see TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (information material if it has substantial likelihood of affecting deliberations of reasonable investor); and (4) the prohibited act occurred "in connection with the purchase or sale of [a] security," 1934 Act § 10(b), 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5. Although the SEC must show some relationship between the prohibited act and the purchase or sale of a security, it need not prove that the prohibited act caused any actual injury. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 860-61 (2d Cir. 1968) (en banc) ("in connection with" requirement met when device causes reasonable investor, relying thereon, to purchase or sell security), cert. denied, 394 U.S. 976 (1969). It is unclear whether the SEC must prove that the defendant acted with scienter or whether a showing of negligence is sufficient to impose liability. See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1976) (leaving open question whether scienter necessary element of injunctive action). Compare SEC v. Bausch & Lomb, Inc., 420 F. Supp. 1225, 1240-41 (S.D.N.Y 1976) (proof of scienter required in 10b-5 injunctive proceeding by SEC), aff'd on other grounds, 565 F.2d 8 (2d Cir. 1977) with SEC v. Aaron, [1979] FED. SEC. L. REP. (CCH) § 96,800, at 95,128-32 & n.10 (2d Cir. Mar. 12, 1979) (proof of scienter not required in 10b-5 injunctive actions by the SEC). Cf SEC v. American Realty Trust, 586 F.2d 1001, 1005-07 (4th Cir. 1978) (proof of scienter not required in injunctive action by the SEC under § 17a of 1933 act); SEC v Universal Major Indus. Corp., 546 F.2d 1044, 1047 (2d Cir. 1976) (proof of negligence only required in SEC injunctive proceeding under § 5 of the 1933 Act), cert.
rule 10b-5 if they could satisfy the elements of a private cause of action.\textsuperscript{17} It is also clear that, to the extent a similar duty exists under the stock exchange rules, the exchanges could enforce that duty in a delisting proceeding.\textsuperscript{18} Alternatively, an investor could seek to develop an implied right of action for breach of the stock exchanges' existing duty to disclose. Such liability, premised on either a theory that a breach of the exchanges' duty to disclose constitutes a breach of a rule adopted pursuant to the federal securities laws or on the theory that investors are third-party beneficiaries under state common law contract principles, would be difficult to establish.

Finally, it must be recognized that this article espouses the creation of a duty under rule 10b-5 at a time when the Supreme Court has been giving the federal securities law an increasingly narrow interpretation.\textsuperscript{19} Nonetheless, defined, 434 U.S. 834 (1977); SEC v. World Radio Mission, 544 F.2d 535, 540-41 (1st Cir. 1976) (dictum) (proof of scienter not required in 10b-5 injunctive action; injunction to protect public not to punish state of mind). Most recently, courts have declined to decide this issue, either by inferring scienter from the defendant's conduct or by finding that the complaint sufficiently alleged scienter. See SEC v. Wills, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,102, at 91,972-73 (D.D.C. 1977) (SEC complaint alleging defendant used devices and schemes to defraud sufficiently alleges scienter); SEC v. American Beef Packers, Inc., [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,079, at 91,876 (D. Neb. 1977) (scienter found in § 14(a)(9) action; president signed proxy statement and annual report with knowledge that certain credit transactions had been omitted from it). See generally 90 HARV. L. REV. 1018 (1977) (comparing Bausch & Lomb with World Radio Mission; suggesting that if focus of inquiry is future undesirable conduct, scienter will be found if court concludes that future conduct likely).

17. The courts have long recognized a private cause of action for breach of rule 10b-5. See Kardon v. National Gypsum Co., 73 F. Supp. 798, 800 (E.D. Pa.) (private claim withstood motion to dismiss), modified on other grounds, 83 F. Supp. 613 (E.D. Pa. 1947). Like the SEC, a private plaintiff must show the use of jurisdictional means and the commission of a prohibited act. See the 1934 Act § 10, 15 U.S.C. § 78j(); 17 C.F.R. § 240.10b-5, quoted at note 2 supra. In addition, the private plaintiff must show the following: (1) Standing to sue because he purchased or sold the corporation's securities, and was not merely a potential investor, see Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 749 (1975); (2) the defendant acted with scienter, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976), see Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 44 (2d Cir. 1978) (recklessness held to constitute scienter when alleged aider and abettor owed fiduciary duty to defrauded party), cert. denied, 97 S. Ct. 642 (1978); and (3) the prohibited act occurred "in connection with the purchase or sale of [a] security," 17 C.F.R. § 240.10b-5.


For a general discussion of the elements of a 10b-5 cause of action, see 2 A. Bromberg supra note 4, §§ 8.2, 8.3, 8.5, 8.7-9, 10.1; 5-5A A. Jacobs, supra note 5, pts. 2-9.

18. See notes 226-95 infra and accompanying text.

The duty to disclose, although not expressly mandated by rule 10b-5, is consistent with the language of the rule, the legislative history of the 1934 Act, and the policies underlying both the Act and the rule. The duty would provide investors with additional information about corporations and would enhance investor trust and confidence in the securities markets. Moreover, it is a needed supplement to the existing mandatory disclosure system of the 1934 Act, a system that often results in investors either not obtaining certain information at all or obtaining it when it is less useful in making an investment decision. Furthermore, however narrow the Court’s recent interpretations of rule 10b-5, the Court has continued to recognize that the basic purpose of the federal securities laws is to protect investors in their securities transactions. It is this end that the duty to disclose is designed to further.

20. The decision with the most bearing on the duty to disclose is Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977), which defined “deceptive” and “manipulative” for purposes of section 10(b). In that case, the plaintiffs, minority shareholders in a 95%-owned subsidiary of Santa Fe Industries, alleged that the merger of Santa Fe and the subsidiary, though valid under the Delaware short-form merger statute, violated section 10(b) and rule 10b-5. Id. at 467-68. The asserted bases of the violation were the lack of notice of the merger, the absence of a valid business purpose for the merger, and the unfair price offered the minority shareholders. Id. The Court held that the merger was neither “deceptive” nor “manipulative” because there was no misrepresentation, omission, or any artificial effect on market activity designed to mislead investors. Id. at 471-72.

This article agrees that either deception or manipulation is necessary to state a cause of action under section 10(b). The duty to disclose simply expands the concept of a misrepresentation or omission necessary to a finding of deception.

21. See, e.g., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (goal of securities laws to give all investors trading on impersonal exchanges relatively equal access to material information), cert. denied, 394 U.S. 976 (1969); 4 A. Bromberg, supra note 4, §§ 12.2-6, at 269-77 (listing purposes of 10b-5); Feuerstein, supra note 5, at 403 (success of economic system depends on investor confidence, which in turn depends on ease with which investors can ascertain pertinent facts regarding investments).

22. See 1934 Act, § 13, 15 U.S.C. § 78m (1976); 17 C.F.R. §§ 240.13a-1, 240.13a-11, 240.13a-13; Forms 10-K, 8-K, 10-Q. Current reports must be filed upon the occurrence of any of the following events: change in the control of the registrant, acquisition or disposition of a significant amount of assets, institution of material legal proceedings, change in the registrant’s certifying accountant, bankruptcy or receivership, or resignations of registrant’s directors. Form 8-K, Items 1-6.

23. See Form 8-K, General Instruction B (current report to be filed within 15 days of occurrence of specified event); Form 10-Q, § A(b) (quarterly report to be filed within 45 days after end of each of first three quarters of each fiscal year); Form 10-K, General Instruction A(b) (annual report to be filed within 90 days after end of fiscal year).

24. See Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472 (1977) (in 1934 Act, Congress intended to prohibit full range of manipulative devices; manipulation does not include majority shareholder’s breach of fiduciary duty to minority); Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 35 (1977) (section 14(e) of 1934 Act enacted to protect shareholders of target corporations, not tender offerors); TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448 (1976) (section 14(a) of 1934 Act intended to ensure disclosure by corporate management in order to enable shareholders to make informed choice in voting); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 200-01 (1976) (in order to accomplish remedial goals of securities laws, Congress did not uniformly accept negligence standard; language of § 10(b) requires showing of intentional misconduct); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 728, 731-34 (1975) (1933 and 1934 Acts enacted to prevent fraud in securities market, but Congress intended to limit civil remedy under § 10(b) to actual purchasers or sellers).
II. Source of the Duty to Disclose

The source of the duty to disclose under the federal securities laws is rule 10b-5.25 Although the language of the rule does not impose this duty, the duty is consistent with the legislative history and underlying policies of both the 1934 Act and rule 10b-5.26

In order to establish a violation of rule 10b-5 a plaintiff must prove the existence of fraud “in connection with the purchase or sale of a security.”27 The Supreme Court has held that only transactions involving either manipulation or deception constitute fraud under the rule.28 The failure to disclose information under the duty to disclose, however, meets both of the tests.

Under existing law the “in connection with” requirement of rule 10b-5 is satisfied if the corporation either purchases or sells its own securities29 or issues a materially false or misleading statement. In the latter case, the misstatement affects the market for the corporation’s stock by making inaccurate the information on which investors trade.30 As a result, the misstatement issued by the corporation causes the harm investors suffer if they trade on the basis of the misinformation.31 If the corporation breaches its duty to disclose, the “in connection with” requirement will be satisfied.

25. See note 2 supra (text of rule 10b-5).

The Supreme Court has indicated that the appropriate method of interpreting the federal securities laws is to examine the language of the statute first. E.g., Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975) (Powell, J., concurring). Then, if the language is not clear, the legislative history should be consulted. See Santa Fe Indus., Inc. v. Green, 430 U.S. at 473; Ernst & Ernst v. Hochfelder, 425 U.S. at 201; Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 756 (Powell, J., concurring). Only if neither the language nor the legislative history is dispositive should the underlying statutory policies be considered. See Santa Fe Indus., Inc. v. Green, 430 U.S. at 476-77, 478; Ernst & Ernst v. Hochfelder, 425 U.S. at 214 n.33. Some members of the Court have commented that given the inherent breadth of § 10(b) and rule 10b-5, policy considerations should always be reviewed. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 737 (Rehnquist, J., writing for plurality).

27. See note 2 supra (text of rule 10b-5).
28. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473-74 & n.15 (1977) (Court refused to find violation of 10b-5; conduct alleged did not constitute deception or manipulation).
29. See Kohler v. Kohler Co., 319 F.2d 634, 637, 642 (7th Cir. 1963) (dictum) (duty to disclose material facts when corporation purchasing its own securities from minority stockholder; no liability because reasonable disclosure made).
31. The plaintiff must be a purchaser or seller of securities in order to have standing to sue. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731, 749 (1975). In a derivative suit the plaintiff stockholder need not have purchased or sold securities if the corporation, on whose behalf he is bringing suit, has bought or sold its own securities. See Goldberg v. Meridor, 567 F.2d 209, 221 (2d Cir. 1977) (stockholder’s complaint stated a cause of action in derivative suit under 10b-5 against parent corporation that received subsidiary’s stock in exchange for its assets), cert. denied, 434 U.S. 1069 (1978); cf. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 738 (shareholders who have not bought or sold securities may be able to bring derivative suit on behalf of corporate issuer if issuer is purchaser or seller of securities).
because nondisclosure, like the issuance of a false or misleading statement, causes harm to investors who make decisions on the basis of inaccurate or incomplete information.  

Similarly, a court could find that a corporation's failure to disclose constitutes deception, necessary for a finding of fraud under the rule. Disseminated information that has become materially misleading will be left in the market if a corporation fails to disclose. This theory is premised on the assumption that investors rely on the accuracy of previously disclosed information. Failure to disclose new information would be viewed as a decision by the corporation to permit previous disclosures to represent present conditions. If the corporation knows that that information no longer is accurate, it would constitute deception under rule 10b-5.

Alternatively, deception could be found by applying to corporations the duties expressed in the "shingle theory" and the "trust and confidence doctrine" presently applicable only to broker-dealers. These theories of liability emphasize the complexity of securities and the sophistication usually possessed by broker-dealers. Under the shingle theory the broker, by doing business with the public, is held to an implied representation that "he will deal fairly with his customers in accordance with the standards of his profession." Cases based on this theory stress that the broker's obligation exists even in the absence of any special dependence or reliance by the customer on


Recently one court suggested in dicta that there might be no duty to disclose absent trading. See *Fridrich v. Bradford*, 542 F.2d 307, 318 (6th Cir. 1976) (duty to disclose not absolute; insider who abstains from trading has right to keep information secret), cert. denied, 429 U.S. 1053 (1977). In *Fridrich*, however, the only issue was whether the particular plaintiffs bringing the action could recover damages in excess of those placed in escrow pursuant to an earlier SEC enforcement action for an undisputed violation of rule 10b-5. *Id.* at 309, 311, 314. In light of this, *Fridrich* should be limited to its facts and not interpreted to define a corporation's duty to disclose. *Compare id.* with Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d 228 (2d Cir. 1974) (causation necessary to justify damages when defendant under duty either to abstain from trading or disclose information, and plaintiff had no knowledge of defendant's actions; causation in fact existed because of trading).


34. *Cf.* 2 A. Bromberg, supra note 4, § 10.1 (rule 10b-5 "on the way to creating a 'shingle' rule of fair trading for insiders").


36. *Id.* at 702-03; see Charles Hughes & Co., Inc. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943) (dealer cannot charge prices not reasonably related to prevailing market price without disclosing that fact), cert. denied, 321 U.S. 786 (1944); *In re Duker & Duker*, 6 S.E.C. 386, 388 (1939) (customer should be dealt with fairly, in accordance with standards of profession).
the broker. The trust and confidence doctrine is somewhat narrower, but is closely related to the shingle theory. This theory of liability is based on the premise that a special relationship of trust and confidence exists between the broker-dealer and his customer. Because of that relationship, the broker-dealer must disclose to his client the extent and nature of any interest he may have in the transactions he conducts for the client and must act in the client's best interests.

If these theories are applied to a corporation, it would be held to have incurred a duty to investors under the shingle theory by creating a public market in its securities. In addition, by cultivating investor trust and confidence through its public statements and financial reports and by encouraging investor reliance on these documents, the corporation makes an implicit representation: it will deal fairly with and do nothing to deceive investors and it will make full disclosure to them of all material information, whether or not it has traded or previously spoken. The failure to disclose, unless otherwise justified, would thus constitute a breach of the corporation's implied representation and would constitute "deception" of investors in violation of rule 10b-5.

37. Cohen & Rabin, supra note 35, at 704; see In re Aircraft Dynamics Int'l Corp., 41 S.E.C. 566, 570 (1963) (salesman who gives opinion on market impliedly represents he has adequate basis for it); In re Heft, Kahn & Infante, Inc., 41 S.E.C. 379, 383 (1963) (implied representation that customer will be dealt with honestly and fairly inherent in dealer-customer relationship); In re Mac Robbins & Co., 41 S.E.C. 116, 118 (1962) (basic to relationship between broker-dealer and his customers is representation customers will be dealt with fairly in accordance with standards of profession).

Mac Robbins & Co. is an excellent example of the application of the shingle theory. The registrant was a "boiler-room" brokerage firm, in which salesmen would call unknown individuals and make high pressure sales pitches for highly speculative investments. In re Mac Robbins & Co., 41 S.E.C. at 119-20. Commissioner Cohen noted in the case that "the making of representations... without a reasonable basis... and designed to induce purchases, is contrary to the basic obligation of fair dealing borne by those who engage in the sale of securities to the public." Id. at 119 (footnote omitted).

38. See Cohen & Rabin, supra note 35, at 702.

39. Id. at 703; see In re Arleen W. Hughes, 27 S.E.C. 629, 634, 637 (1948) (furnishing investment counsel on fee basis cultivates confidential relationship imposing duty to act in best interests of clients and to disclose fully all material information).

40. Id.

41. The American Stock Exchange has accepted the idea that a corporation has a duty of fair dealing: "A company which lists its shares on the Exchange in effect invites the public to invest in these securities." COMPANY GUIDE, supra note 8, § 401; cf. Voege v. American Sumatra Tobacco Corp., 241 F. Supp. 369, 373-75 (D. Del. 1965) (shareholder who agrees, in the event of merger, to sell his shares to surviving corporation relies upon honesty and fair dealing of that corporation).

The theory of an implied representation of fair dealing could be extended to the entire area of corporate management. See Schneider, Nuts, Grits, and Soft Information in SEC Filings, 121 U. PA. L. Rev. 254, 296-97 (1972). See also Address by Harvey L. Pitt, General Counsel, SEC, Practicing Law Institute, Materiality—Search for Elusive Truth 13 (June 24, 1976).

In addition, one court has noted in another context that:

[T]he American investing public listing on the New York Stock Exchange carries with it implicit guarantees of trustworthiness. The public generally understands that a company must meet certain qualifications of financial stability, prestige, and fair disclosure, in order to be accepted for that listing, which is in turn so helpful to the sale of the company's securities. Similarly it is held out to the investing public that while dealing in securities listed on the New York Stock Exchange the investor will be dealt with fairly and pursuant to the law.


42. See notes 113-23 & 191-210 infra and accompanying text for discussion of reasons justifying delay of disclosure or, in the case of projections, permanent nondisclosure.
Just as a broker incurs a duty to disclose because he has expressly or implicitly solicited a customer to enter into a transaction, a corporation incurs a similar duty when it solicits new investors. The pages of various publications, for example, often contain corporate advertisements soliciting inquiries from potential investors. Additionally, a corporation depends upon its stockholders and investors as a source of financing and support for management's policies. This dependence is based in part on disclosure; the failure to disclose may thus cause stockholders to be reluctant to continue their support of the corporation.

The recent Supreme Court decision in *Santa Fe Industries, Inc. v. Green*, which appears to cut back on the use of rule 10b-5 in cases involving a duty of fair dealing, does not undermine the use of the shingle theory and trust and confidence doctrine as rationales for the duty to disclose. *Santa Fe* involved the question whether traditional fiduciary duties, cognizable at state law, could be read into rule 10b-5. The Court held that allegations of mere unfairness, in the absence of manipulation or deception, did not constitute a violation of rule 10b-5. The Court recognized, however, that when some element of deception, including nondisclosure, is involved, "section 10(b) must be read flexibly, not technically and restrictively." The duty to disclose is premised not on fiduciary duty or fairness, although there are elements of these present, but on the prevention of deception. Therefore, neither the holding nor the implications of *Santa Fe* precludes establishing the duty or using the shingle theory and trust and confidence doctrine as rationales.

The legislative history of the 1934 Act reveals that Congress did not directly address the question of prompt disclosure. The history strongly suggests, however, that Congress intended investors to have all the information necessary for investment decisionmaking. Although Congress believed...

---

44. See *Wall St. J.*, Jan. 29, 1979, at 16, col. 3 (management should provide better information to investors to achieve higher share price); *Bus. Week*, Jan. 22, 1979, at 47 (public relations campaign may strengthen corporation's position).
46. Id. at 478, 479 (without clear Congressional intent to the contrary court should be reluctant to federalize substantial portion of state corporate securities laws if established state policies would be overridden). Similarly, in *Cort v. Ash*, 422 U.S. 66 (1975), the Court refused to imply a private cause of action for damages against corporate directors in favor of a stockholder under a criminal statute regulating corporate contributions to federal presidential election funds. The Court noted that "the internal affairs of a corporation should be regulated by state law "except where federal law expressly requires certain responsibilities of directors with respect to stockholders . . . ." Id. at 84. The Court relied in part on the fact that Congress passed the legislation at issue to dull corporate impact on federal elections, and not to regulate corporations as such. Id. at 85. Imposing a private cause of action "would not aid the primary Congressional goal . . . and cure the influence which the use of corporate funds in the first instance may have had on a federal election." Id. at 84.
47. 430 U.S. at 474.
48. Id. at 475 & n.15.
49. Cf. Goldberg v. Meridor, 567 F.2d 209, 217-18 (2d Cir. 1977) (Friendly, J.) (*Santa Fe* does not preclude 10b-5 action, and deception of the corporation is present when controlling shareholders influence corporation to engage in transaction adverse to its interests and there is nondisclosure or misleading disclosure about material facts of the transaction), cert. denied, 434 U.S. 1069 (1978). There may be elements of fairness, fiduciary duty, and deception in 10b-5 nondisclosure cases. See id.
50. See H.R. REP. NO. 1383, 73d Cong., 2d Sess. 13 (1934), reprinted in 5 LEGISLATIVE HISTORY OF
that the reporting requirements of the 1934 Act were adequate to begin to provide such information, it gave the SEC rulemaking authority to require additional reporting if necessary. Because there is usually a substantial time lag between the occurrence of an event and its disclosure in a statutory filing and because there is no requirement that the corporation disseminate its statutory filings, the duty to disclose would provide a necessary supplement to statutory filings and would be consistent with the original congressional intent.

**THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (1973)** (reporting requirements are modest beginning to aid investor in obtaining information); **S. Rep. No. 792, 73d Cong., 2d Sess. 11 (1934), reprinted in 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (1973)** (reporting requirements are minimum necessary to protect investors). The House Report on the House version of what are now the reporting requirements of the 1934 Act stated that "no investor . . . can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. . . . [T]he hiding and secreting of important information obstructs the operation of the markets as indices of real value." H.R. Rep. No. 1383, 73d Cong., 2d Sess. 11 (1934), reprinted in 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (1973).


This legislative history suggests that the SEC has the authority to adopt a prompt disclosure rule pursuant to section 13 rather than section 10(b). Nevertheless, it is consistent to utilize rule 10b-5 in the absence of a rule under section 13; a duty under either section can be inferred from the congressional intent. Indeed, rule 10b-5, although originally designed to prevent fraudulent schemes, now compels disclosure to prevent deception. See 2 A. Bromberg, supra note 4, § 12.3, at 275 (although 10b-5 originally developed to combat devious schemes, it now serves to compel disclosure).

52. Generally, Form 8-K must be filed within 15 days after the occurrence of the earliest event required to be reported. Form 8-K General Instruction B. This timing requirement is generally shorter than that which had existed for many years prior to the recent amendment of Form 8-K. Securities Exchange Act of 1934 Release No. 13156, 5 FED. SEC. L. REP. (CCH) ¶ 72,228, at 62,558 (Jan. 13, 1977) (amendments adopted to provide more timely filing of reports on Form 8-K). Form 10-Q is to be filed within 45 days after the end of each of the first three fiscal quarters of each fiscal year; filing of Form 10-K is generally required within 90 days of the end of the fiscal year. Form 10-Q, § A(b) Form 10-K, General Instruction A(b).


The application of economic theory to the duty to disclose has not been discussed in this article, but is worthy of further study. Among other issues, such a study could consider the efficient market hypothesis and its implications for the development of future securities regulation. See generally J. LORIE & M. HAMILTON, THE STOCK MARKET—THEORIES AND EVIDENCE (1973); Kripke, A Search for a Meaningful Securities Disclosure Policy, 31 BUS. LAW. 293 (1975) (citing sources); Note, The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry, 29 STAN. L. REV. 1031 (1977); R. Kaplan, supra.

53. The only report that a corporation must publicly disseminate is an annual report to security holders, which is not filed with the SEC. See 1934 Act § 14, 15 U.S.C. § 78m(c) (1976); 17 C.F.R. §§ 240.14c-1,-101 (1976).
Finally, the duty to disclose is consistent with the policies underlying the 1934 Act and rule 10b-5 because the additional disclosure may enhance investor confidence in the securities markets, which is arguably the principal purpose of all the securities laws. Individual investors are less likely to have confidence in the market and to invest if they believe that corporations are withholding material information. Indeed, investors now expect more from corporations and corporate insiders than simply restraint from deceit and fraud; they expect full and prompt disclosure of material information. They have come to rely, "consciously or unconsciously, on the completeness and adequacy of the information about the issuer afloat in the market." To the extent that this reliance may not be shared, they believe, correctly or not, that those who do have this information will benefit from it to the detriment of those investors who do not.

III. DUTY TO DISCLOSE

Compliance with the duty to disclose involves more than mere preparation and distribution of a press release to the media. The corporation must disclose the information in a form that is designed to reduce the possibility of omission or distortion of material facts upon publication. It must also attempt to disseminate the information in a manner calculated to convey its substance adequately to all interested investors. And, unless valid business reasons warrant delay, the corporation must disclose the information promptly after collection and evaluation of the relevant facts.

54. See 5 A. Jacobs, supra note 5, § 88.04[a], at 4-3 (listing policies behind 10b-5).
57. See Fleischer, supra note 11, at 1279; Leavell, The Texas Gulf Sulphur Opinion: An Open Door to Federal Control of Corporations, 3 Ga. L. Rev. 141, 158 (1965); Lipton, Liability of Buyers and Sellers in Market Transactions in the 10b-5 Series of Rules 75, 85 (R. Bialkin, Chairman 1974); cf. 5 A. Jacobs, supra note 5, § 88.04[a].
58. Because there is little empirical data about what investors actually expect, this conclusion is open to debate. Absent a clear duty to disclose, investors only expect that they will have equal access to material information. See Talesnick, supra note 5, at 383-85.
59. 2 A. Bromberg, supra note 4, § 7.1.
60. "People won't play poker when they think the cards are marked and one of the players knows the code." Address by A.A. Sommer, Jr., Commissioner, SEC, Another Look at Insider Trading, Southwestern Legal Foundation Symposium on Securities Regulation, in Dallas, Texas (April 4, 1975). See Georgeson & Co. and Lind Brothers, Inc., The Reluctant Marriage 3, 4 (Jan. 1, 1978) (survey of individual investors reveals general belief that corporations fail to communicate sufficiently with them and favor institutional investors).
The uncertainties inherent in each of these requirements make it difficult to establish firm rules for a corporation to follow. For example, complex information cannot always be easily summarized; the corporation cannot always control the dissemination of the information; and the time at which disclosure is required will vary depending upon the corporation's need for silence and investors' need for the information. It is possible, however, to establish guidelines within which a corporation should act that can be used by a court to decide whether, in view of the totality of the circumstances, a corporation has made a good faith effort to comply with its duty to disclose.

**FORM OF DISCLOSURE**

The corporation must prepare its press release to convey fully and accurately the information to investors. Even then, full disclosure can be accomplished only if the information is published accurately. Although there will always be some risk that the media will omit or distort material facts, a corporation should be required to disclose facts in a form calculated to reduce that risk. When the material facts are reasonably simple, a corporation can issue a short release setting out the facts in a form that will require little or no alteration by the media. The problem is substantially more difficult, however, when the information is complex, highly technical, or not susceptible to easy summary by the media. In such a case the corporation has two choices, each of which raises other problems. It may prepare its own summary of the facts in a release that can be easily used by the media. If that summary is materially misleading, however, the corporation will be held liable for issuing a false and misleading press release. Alternatively, it may issue a full and accurate release, however lengthy and complex; although the corporation knows that the media will not usually publish such a release in its entirety, it can argue that the disclosure obligation is satisfied and that any omissions are the fault of the media. This argument, however, fails to recognize that investors are likely to assume that the published information accurately reflects what the corporation believes to be all the material facts.

62. In other contexts courts have suggested that disclosure, although complete, may be materially misleading if it is placed in the disclosure document in such a manner that its significance to investors is obscured. Gould v. American-Hawaiian Steamship Co., 535 F.2d 761, 774 (3d Cir. 1976) (proxy materials held materially deficient when conflict of interest information scattered and buried in lengthy proxy statement); Mills v. Electric Autolite Co., 403 F.2d 429, 434 (7th Cir. 1968) (proxy statement held misleading because directors failed to emphasize possible conflict of interest while strongly recommending merger), vacated and rem. on other grounds, 396 U.S. 375 (1970); see Richland v. Crandell, 262 F. Supp. 538, 554 (S.D.N.Y. 1967) (material information about directors' conflict of interest not clearly stated, not emphasized as was other information in prospectus, and not positioned so as to be noticeable).

63. See COMPANY GUIDE, supra note 8, § 404 (keep release simple and avoid irrelevant facts and overly technical jargon).


65. Corporations should be aware that the media will not always publish a corporate release in its entirety. See Haft, Corporate "News" Dissemination—An Introduction, in CORPORATE NEWS DISSEMINATION, supra note 5, at 9, 21, 24. Many corporations either retain financial public relations firms that specialize in preparing press releases for publication, or utilize their own internal personnel for these purposes. See id. at 24.

66. In establishing a basis for regulation, the premise that investors believe that the media accurately
Accordingly, a corporation should be required to issue complex information in a form and manner calculated to meet the needs of investors and to reduce the likelihood that material facts will be omitted from the published story. The corporation can accomplish this by placing the most important facts at the beginning of the release, timing the release to allow media representatives sufficient time to familiarize themselves with and to make inquiries about the release, and making corporate personnel available to answer questions.67

Nevertheless, there will be situations in which the corporation will not be able to comply with these requirements. For example, the SEC staff exerts informal pressure on oil and gas exploration companies to use highly technical terms in their releases and discourages the use of lay terminology on the ground that such terminology will mislead investors.68 Under these circumstances, although use of technical terms makes it difficult for anyone other than an expert in the industry to understand the information, the corporation should be held to have satisfied its duty with respect to the form of disclosure if it accedes to the SEC staff's position.

Once the corporation has taken appropriate steps to prepare and to issue a press release, questions remain regarding its duty to correct inaccurately published information and its liability if the media distort material facts. When assessing the corporation's duty to correct and to update information, a distinction must be drawn between errors and omissions in news articles and misinformation conveyed in so-called interpretative articles. A corporation that issues a press release expects that the media will publish a news article based on that release and that investors will rely on the information in that article. Investor reliance on interpretative articles, on the other hand, results from the reputation of either the publication or the author.

The case law provides little guidance in delineating the scope of the duty. In the Texas Gulf Sulphur litigation,69 the corporation (TGS) argued in the lower court that its liability should be based on the accuracy of its entire press release rather than on what actually was published by the media.70 Because the court found that the release itself was materially false and misleading, it did not pass directly on the merits of that argument.71 The court did suggest, however, that TGS might have been liable had the media materially distorted
an accurate release.\textsuperscript{72} In \textit{Mills v. Sarjem Corp.},\textsuperscript{73} however, although the court refused to hold the corporation liable for several newspapers’ erroneous reports of the terms of a transaction, it did so on the ground that there was no allegation that the corporation was \textit{responsible for}, or \textit{knew of} those reports.\textsuperscript{74} More recently in \textit{Zucker v. Sable},\textsuperscript{75} although the corporation’s release was accurate, several major publications omitted an allegedly material word from the published story.\textsuperscript{76} When the mistake was brought to the attention of the corporation it corrected the error.\textsuperscript{77} Nevertheless, the court held that the corporation had no legal duty to make such a correction because it would be unreasonable to require a corporation to search out and correct errors resulting from editing. The court stated that “[t]o require the defendants to examine every financial publication to ascertain whether the reports of its admittedly accurate press release have misinterpreted the information so as to mislead members of the public would place them under an insurmountable burden not required by the law.”\textsuperscript{78}

This language is overbroad. A corporation should not have to search out “every financial publication.” As the source of the information, however, the corporation is best able to determine the accuracy of a published news story. Because of the potential harm to investors from material omissions or inaccuracies, the corporation should have a duty to review the information in certain publications and request a correction if published information derived from a corporation’s press release is materially misleading.\textsuperscript{79} This duty should be limited, however, to a review of those publications on which the corporation reasonably believes investors are most likely to rely,\textsuperscript{80} and to situations in which the corporation reasonably believes a substantial number of investors will be misled by the misstatement.\textsuperscript{81} The duty should also be

\textsuperscript{72} See id. at 86 (TGS could not expect media to publish entire release; if important to present entire release, TGS should have mailed copy to each shareholder).
\textsuperscript{73} 133 F. Supp. 753 (D.N.J. 1955).
\textsuperscript{74} Id. at 767. This finding was made possible because after the erroneous press release the corporation had individually notified the plaintiffs of the correct terms of the transaction. Id. On this basis the court found that any reliance by the plaintiffs on the newspaper articles would have been misplaced. Id.
\textsuperscript{76} Id. at 662-63.
\textsuperscript{77} Id.
\textsuperscript{78} Id. at 663 (emphasis added). In reaching this conclusion the court erroneously relied on Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937 (2d Cir. 1969). There, misstatements had appeared in the press for which the corporation was held not liable because they were not attributable to the corporation. Id. at 949; see notes 160-90 infra and accompanying text.
\textsuperscript{79} The \textit{Wall Street Journal}, for example, publishes a regular column entitled “Corrections and Amplifications,” which identifies and corrects erroneous information that has been previously published. The author has been advised by a representative of the \textit{Wall Street Journal} that it will include information in this column upon request.
\textsuperscript{80} Both the New York and American Stock Exchanges recommend disclosure to major news services and financial publications. See \textit{COMPANY GUIDE}, supra note 8, § 403 (2), at 105-08; \textit{COMPANY MANUAL}, supra note 8, at A-23, A-24. Each corporation’s obligation, however, should depend on the nature of the market for its securities and the location of substantial numbers of its stockholders. See note 88 infra and accompanying text.
\textsuperscript{81} Even this limited duty can be difficult to apply. For example, suppose a medium-size corporation located in Houston, Texas issues a short press release containing material information. The corporation believes that most investors are likely to read and rely on information published on the Dow Jones Wire Service and in the \textit{Wall Street Journal}. In addition, however, there are many investors who will read and
limited to a period of time within which such information is usually published.\textsuperscript{82} The corporation should not be burdened with the duty to continually search for inaccuracies in news stories.

By contrast, the corporation should have no duty to correct distortions or inaccuracies that appear in interpretative articles. The corporation has not directly induced or encouraged investor reliance, and unless the corporation has spoken to the author of the article concerning the facts, it should not have a duty to seek a correction; nor should it be liable for the author's misstatements.\textsuperscript{83}

**MANNER OF DISCLOSURE: ADEQUATE DISSEMINATION**

Even if a release is disclosed in an appropriate form, it may not be published. The major financial wire services and newspapers have criteria for inclusion of information based on the size of the corporation and the significance of the information.\textsuperscript{84} As a result, publication of information will often be precluded. Even if the criteria are met and the information is published, a corporation cannot guarantee that such publication will reach a substantial number of investors. Nevertheless, a corporation should have an obligation to make a good faith attempt to disseminate the information adequately. Dissemination will be adequate only if it is directed to the relevant securities markets in general rather than to a limited group of investors. In one case, the SEC held that the release of material information over a private wire service to a limited number of institutional subscribers does not constitute adequate dissemination of that information.\textsuperscript{85} Similarly,
in SEC v. Texas Gulf Sulphur Co., the Second Circuit found that publication of information in a Canadian newspaper of limited circulation was not sufficient public dissemination. Both situations involved the question whether there had been sufficient dissemination to permit insider trading, but the principle applies equally to the duty of a corporation in the absence of trading. The purpose of the duty to disclose is to inform investors generally, and limited dissemination does not achieve that purpose.

The extent of the obligation to disseminate will vary with the nature of the principal market for the corporation's securities. If that market is national—as would be true for large corporations whose securities are either listed on an exchange or traded in the over-the-counter market—the information should be directed to the national financial press, the major financial communities, and to any other areas in which the corporation knows there is unusual interest in its securities. If the market is largely regional, dissemination should be made to the relevant regional financial communities and where appropriate to the exchange community. Finally, if the market is essentially local, dissemination may be limited to those places where there is a demonstrable interest in the corporation's securities.

Because of the difficulties in obtaining adequate dissemination, the procedures a corporation follows should bear heavily on a determination of whether it has satisfied its obligation. These procedures might include a press release to the major financial wire services and the distribution of that release to trade publications and newspapers in cities where the corporation has its headquarters or major facilities. Should these or other similar procedures fail, the corporation should consider whether to disseminate the information in other ways. For example, it could advertise in newspapers, send a letter to its stockholders, or where appropriate, file with the SEC a Current Report.

In order to effect a meaningful public disclosure of corporate information, it must be disseminated in a manner calculated to reach the securities market place in general through recognized channels of distribution. . . . Public dissemination of information also cannot be accomplished by disclosure to or through a favorite analyst or group of analysts. . . . Proper and adequate disclosure of significant corporate developments can only be effected by public release through the appropriate public media, designed to achieve a broad dissemination to the investing public generally and without favoring any special person or group.

Id. at 83,105.

85. 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).
86. Id. at 856.
87. (i) If market interest in the issuer is nationwide, dissemination should be directed at least to the financial communities in the several major urban areas across the country; (ii) if market interest in the issuer is not nationwide but its securities are traded on one or more exchanges, dissemination should be directed at least to the financial communities in each city in which such an exchange is located and in each other geographic areas of known significant market interest; and (iii) if market interest in the issuer is essentially local or regional and its securities are not traded on an exchange, dissemination should be directed at least to financial communities in such locality or region and in any other geographic area of known significant market interest.

89. See Insider Trading: Some Questions and Some Answers, supra note 88, at 338 (listing mailings to
on Form 8-K. Whether these additional procedures must be followed will vary with the materiality of the information. In any event, liability should be based on the totality of the corporation's efforts to disseminate. If the corporation has made an adequate effort, it should be held to have satisfied its duty, whether or not the information was actually disseminated to investors in the relevant market.

TIMING OF DISCLOSURE

The time at which disclosure should be made is the most difficult determination for the corporation to make. Resolution of the problem will often require careful balancing of the investor's need for information and the corporation's need for silence. The corporation will often need time to investigate carefully, to evaluate the facts, and to utilize those facts for valid business purposes; during this time investors are trading on incomplete information. The standard by which the corporation's timing decision is to be judged should protect a corporation from liability if it acts responsibly in meeting its disclosure obligations, even if a court could conclude in retrospect that disclosure should have been made earlier. This standard of review will ensure that investors receive the information in accordance with the purpose of the duty and will protect the corporation from liability for honest errors in judgment. It is important to protect the corporation in this manner because, ultimately, innocent nontrading stockholders will bear any loss arising from the wrongful failure to disclose.

Whether a corporation has acted responsibly in the timing of its disclosure depends on the following: (1) The procedures followed when making the stockholders as most effective); Current Policy Issues Involving Inside Information in the Securities Market, 1970 Sec. L. Rev. 84, 103 (Remarks of A. Fleischer)(recommending stockholder mailings when difficult to get media to print information). At least one commentator has expressed doubts about the sufficiency of a mailing to stockholders. See generally Abrams, Insider Trading, 6 Rev. Sec. Reg. 889, 893 (1973) (buyers would not be protected).

91. Form 8-K, Item 5, permits a corporation "at its option [to] report . . . any events, with respect to which information is not otherwise called for by this form, which the registrant deems of material importance to security holders." The SEC has used this item to obtain disclosure beyond that required by its statutory reporting forms and has recognized that corporations voluntarily utilize it when no other disclosure mechanism is available.

92. [I]t is our view that the transmittal of disclosure information through the most effective means of communication available (e.g., telephoning to stock exchanges, delivery to wire services and financial journals, mailing to securityholders, delivery to trade journals, etc.) should be sufficient to satisfy any obligations of the issuer to effect timely disclosure. . . . Of course, this suggestion implicitly imposes in all instances a "good faith" standard in connection with selection of the most effective available means of dissemination, and in connection generally with expediting the process of dissemination, to the relevant financial community or communities.

Insider Trading: Some Questions and Some Answers, supra note 88, at 338. See also Abrams, supra note 90, at 894 (courts have not dealt with situation in which corporation attempted to disclose but financial services did not publish information).

93. If the corporation is not protected by this standard, it may disclose too early and either harm its business position or issue a misleading release because it has not had adequate time to investigate and to evaluate the facts. In order to avoid these problems, the corporation may disclose too late, when the information is no longer valuable to investors, and thus subject itself to liability under 10b-5. See 5 A. Jacobs, supra note 5, § 88.04[a], at 4-10.
A Corporation's Procedures

In Financial Industrial Fund, Inc. (FIF) v. McDonnell Douglas Corp., the Tenth Circuit addressed the issue of what procedures a corporation must follow with respect to the timing of disclosure. In April 1966, McDonnell Douglas made public projections of its earnings for that fiscal year. One month later, management learned that earnings would be substantially below the projections, a fact that the corporation disclosed after a prompt investigation. Two weeks later, however, quarterly profit figures revealed even larger losses than previously disclosed. This decline prompted further investigations and resulted in a large inventory write-off. The day after an investigation and evaluation of the situation was completed, the corporation issued another public statement disclosing the full extent of its financial problems. A stockholder who purchased the corporation's stock between the two public statements sued, alleging that the corporation had violated rule 10b-5 by failing to disclose the full decline in earnings before the second release was issued.

The Tenth Circuit held that the corporation had not violated rule 10b-5. With respect to the issue of timing, the court found that the duty to disclose did not arise until the corporation gathered enough information to issue an accurate release, verified the information sufficiently for management to have confidence in its accuracy, and determined that there was no valid business reason for nondisclosure. After considering the reasonableness of management's decision and the speed with which it was reached, the court found no proof of a delay with respect to the publication of the earnings forecasts. The court stated that once it was shown that management exercised due care in gathering and considering the facts, a presumption arose that the evaluation was made in the exercise of good business judgment even though subsequent events might indicate that the decision was not correct.

Under a proper timing standard, if a corporation acts diligently in investigating and evaluating the relevant facts, its failure to disclose during that period should not constitute a violation of rule 10b-5. Once the

---

94. 474 F.2d 514 (10th Cir.) (per curiam) (en banc), cert. denied, 414 U.S. 874 (1973).
95. Id. at 519 (stockholders told at annual meeting that earnings would increase for coming year).
96. Id. at 516. Delays in delivery of supplies and problems with the work force were expected to cause a reduction in earnings. Id.
97. Id. The problem was uncovered on June 14; investigation was begun three days later and was completed on June 23. Id.
98. Id. at 516-17.
99. Id. at 517.
100. Id. at 522.
101. Id. at 519; see SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 862 (2d Cir. 1968) (en banc) (dictum) (10b-5 not violated if corporate management diligent in ascertaining information's truth and releases it in good faith), cert. denied, 394 U.S. 976 (1969).
102. 474 F.2d at 518.
103. Id. at 522.
104. Id. at 521-22.
105. A corporation will often need some time to develop the information fully. Management's decision-making process, however, must be "conducted with reasonable dispatch considering the need to ascertain the details as to the particular problems, to relate them to other earnings, and to arrive at a conclusion with confidence, that the statement when issued would be correct." Id. at 518.
corporation realizes that the facts themselves are material, the accuracy of the information and the full effect of this information on the corporation's business may be uncertain. Before investigation and evaluation are complete, the corporation might have difficulty issuing a release that is sufficiently accurate and that would not require a series of subsequent releases to update the original information. In a rapidly changing situation, a series of releases might cause wide fluctuations in the price of the corporation's stock, harming rather than helping investors. Additionally, the initial release could subject a corporation to subsequent litigation, with plaintiffs alleging that the original statement was materially false because it was unduly optimistic or pessimistic in light of facts that the corporation possessed but did not disclose.

This standard would not allow a corporation to delay disclosure indefinitely pending a business decision based on the relevant facts. Disclosure would be required if the corporation's board of directors had taken some action, if senior management had acted in a manner that was likely to be approved by the board, or if management's decision would not be reviewed by the board. A more difficult question is whether disclosure is required when the corporation knows of the general problem and possible solutions but has failed to decide how to proceed. Although there is no clear answer, a corporation can delay disclosure only for a reasonable period of time while the problem "works itself out"; whether a corporation has acted in a reasonable manner will depend upon the circumstances of each situation.

106. See id. at 518 (corporation aware of labor and supply problems, but needed time to investigate, to evaluate and compare actual costs with previous cost estimates, and to determine if actual costs reflected increased inventory value); cf. Elkind v. Liggett & Myers, Inc., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,602, at 94,567 (S.D.N.Y. 1978) (reasonable for corporation to withhold information about dramatic drop in monthly earnings when followed by significant revival in following month).

107. A corporation should have a duty to update even if its initial release set forth the relevant facts and indicated that the situation was in flux. See notes 144-59 infra and accompanying text (discussing duty to update).

108. See Gilroy, Disclosure and Related Problems of Bad News, in PRACTICING LAW INSTITUTE, SEVENTH ANNUAL INSTITUTE ON SECURITIES REGULATION 71, 88 (1975) (Transcript Series) (if internal decision made by senior management to curtail some operation or write-off some assets, and only likely approval of board remains, disclosure required at that time). [hereinafter cited as SEVENTH ANNUAL INSTITUTE]

109. The complexity of this question may be illustrated by the following discussion:

Mr. Sporkin: Suppose a company has a requirements contract that it knows it is not going to be able to fulfill because to do so will cause serious financial problems. I am thinking, for example, of contracts where the company contracted to provide energy at a price of $5 a unit, but now that the cost of production has gone up to $15 per unit, it finds that it is unable to meet its commitment and will have to default. The company feels that to comply with the contract would cause serious financial problems. It seems to me that disclosure has to be made at the time when management knows it is not going to meet the contract, not later, after the company defaults.

Mr. Fleischer: Does your hypothetical assume that the company had exhausted all possible negotiating postures with the other party to the contract and cannot arrive at a satisfactory resolution?

Mr. Sporkin: I am not sure that it is necessary that the company have exhausted all settlement approaches before disclosure is required. Once management realizes that the company will have difficulty meeting that contract, I think the event becomes disclosable if the contract is material.

Mr. Fleischer: I would disagree with that. There may well be a proper business purpose in
This problem is likely to arise when a corporation is faced with a generally deteriorating situation, such as problems with collections, cash-flow, working capital, or maintenance of credit, rather than with the occurrence of a specific event. Although the prudent course of action would be to disclose the existence of serious financial problems, the precise point at which disclosure would be required is unclear. Generally, if the problem can be characterized as temporary or if it is likely to be corrected quickly, disclosure is not required. There are situations, however, in which the effect on the corporation will be permanent enough to require disclosure of the information. In such a case the corporation must disclose business problems before a major crisis is reached; during the period of deterioration, the harm to investors from total silence will outweigh both the business advantages of nondisclosure and the potential burden of updating the initial release.

After appropriate investigation and evaluation, the corporation must promptly disclose the information unless it can demonstrate a valid business reason for not doing so. The validity of a particular reason will often be at the heart of a nondisclosure case because, with hindsight, such a reason is easily constructed. The most often cited example of a valid business reason is that discussed in SEC v. Texas Gulf Sulphur Co. Although TGS completed a successful drill hole late in November 1963, the results were kept confidential and further drilling was delayed until options on the surrounding land were acquired. Two weeks after the land acquisition program was completed and the drilling resumed, the corporation issued initial press releases about the discovery. Neither the question of the timing of disclosure nor management's conduct in this regard was at issue, but the court, in dictum, suggested that the secrecy required for a successful land acquisition program was a valid business purpose justifying delayed disclosure.

not disclosing. The company is not confessing liability in connection with the settlement of litigation. A press release at too early a juncture may seriously injure the company's negotiating posture. Would it not be adequate if the company disclosed that the company is about to enter into negotiations under the existing contract which may relieve its burden somewhat?  
Mr. Gilroy: The best advice is to disclose as much as possible as early as possible, but not to injure the company or its shareholders through an excess of caution.

Id. at 90-91.  
110. See Elkind v. Liggett & Myers, Inc., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,602, at 94,567 (S.D.N.Y. 1978) (no duty to disclose dramatic drop in monthly earnings when followed by significant revival in following month; reasonable to assume drop temporary and not significant).  
111. See id. at 94,567.  
112. W.T. Grant initially made public disclosure of its decision to close its stores and of its overall financial problems at the time that it was notifying its vendors. Gilroy, in SEVENTH ANNUAL INSTITUTE, supra note 108, at 89; id. app. A, at 425-26.  
114. Id. at 843.  
115. Id. at 843-44.  
116. Id. at 845-47.  
117. Id. at 850 n.12. In Astor v. Texas Gulf Sulphur Co., 306 F. Supp. 1333 (S.D.N.Y. 1969), a subsequent private action for damages, the court held that the corporation had a valid business reason for nondisclosure until March 27, 1964, when the land acquisition program was substantially completed and the decision was made to resume drilling. Id. at 1338-39. The court refused to determine on the motions for summary judgment whether the corporation had a valid business purpose to withhold disclosure after that
There are other situations in which nondisclosure may be justified. If a troubled corporation loses a major supplier, customer, or creditor, it is reasonable for the corporation to believe that disclosure of this fact might lead to a loss of other suppliers, customers, or creditors and impede a corporation's ability to find substitutes. Similarly, premature disclosure might jeopardize the acquisition of another corporation or impede the ability to liquidate a portion of a corporation's business.

Nevertheless, some reasons given to justify nondisclosure are clearly unacceptable. For example, a corporation cannot refuse to disclose information because it fears a decline in the price of its stock. By admitting that this was its reason for nondisclosure, the corporation would be evidencing an intent to artificially maintain the price of its stock. Silence based on a general fear of losing a competitive advantage should also be greeted with skepticism. This argument is easy to put forth and difficult to prove. Corporations often admit that they know a great deal about what their competitors are doing, yet claim that their own disclosure would disadvantage them. In the absence of affirmative evidence of substantial competitive harm, disclosure should be required.

A more difficult question is whether the corporation can justify silence on the ground that investors have access to the information from other sources. For example, if a corporation's new product has difficulties that are materially reducing sales, this information will be known by distributors who sell the product and securities analysts who follow the industry. Investors still need corporate disclosure in such a situation, however, because the corporation is in the best position to give the most complete and accurate information. On the other hand, if the ability to determine a fact and to evaluate its significance is as available to investors as it is to the corporation, the corporation's silence may be justified.

The facts in the Texas Gulf Sulphur litigation illustrate that the duty owed by corporate insiders to trading stockholders is different from that owed by the corporation to others. The insiders who traded while the information was undisclosed were held to have violated rule 10b-5. 401 F.2d at 852. At the same time, the corporation was allowed to purchase the adjoining land without disclosing the information to the landowners. See id. at 850 n.12. As Jennings and Marsh point out: "[T]he legitimate corporate purpose which exculpated Texas Gulf Sulphur was the wish to do to the adjoining landowners what the individual defendants were excoriated for doing to their adjoining shareholders." R. JENNINGS & H. MARSH, JR., SECURITIES REGULATION: CASES AND MATERIALS 950 (4th ed. 1977). To demonstrate this concept further, it is clear that had the corporation purchased the land for stock rather than for cash, it would have violated rule 10b-5.


120. See Segal v. Coburn Corp., [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,002, at 94,019 (E.D.N.Y. 1973) (disclosure of decision to liquidate installment finance business might have impaired "collectibility of the paper, disturbed credit relations, and forced a precipitous liquidation of the business").

121. This would constitute manipulation under rule 10b-5. The Court has called the word manipulation "virtually a term of art." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976). Manipulation refers "generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 476 (1977).

122. An example of this would be a refusal to disclose the earnings of a division of a company because it would permit a competitor to discern profit margins.

A Court's Standard of Review  Courts have suggested that the timing of disclosure is a matter of business judgment with which they will not interfere without evidence of bad faith. This suggestion is rooted in the business judgment rule, which is traditionally employed by courts to determine the liability of corporate officers and directors and which provides that directors and officers generally will not be held liable for errors of judgment if they act in good faith. The business judgment rule permits corporate managers to take business risks without incurring liability for good faith mistakes in judgment and relieves a court of the burden of deciding whether a particular business decision is in the corporation's best interest.

procedures and processing time for "investigational" applications filed with government agency because information equally available to public); cf. Haftner v. Forest Laboratories, Inc., 345 F.2d 167, 168 (2d Cir. 1965) (over-the-counter price of corporation's stock readily available and need not be disclosed before redemption even if requested); Kaplan v. Vornado, Inc., 341 F. Supp. 212, 213-16 (N.D. Ill. 1971) (corporation not liable for failure to define in debenture terms such as "convertible," "redeemable," and "callable" because reasonable investor should know terms or ask broker for definition).

124. See Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 518-19, 521-22 (10th Cir.) (per curiam) (en banc) (because decision to release earnings statement on other than customary date discretionary, and record showed defendant exercised good faith, no proof of delay shown for 10b-5 action), cert. denied, 414 U.S. 874 (1973); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 850 n.12, 862 (2d Cir. 1968) (en banc) (timing of disclosure discretionary; if information released in good faith 10b-5 not violated), cert. denied, 394 U.S. 976 (1969).

125. See Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 518 (10th Cir.) (per curiam) (en banc), cert. denied, 414 U.S. 874 (1973); Otis & Co. v. Pennsylvania Ry., 61 F. Supp. 905, 911 (E.D. Pa. 1945) (directors' good faith decision to negotiate with only one investment house for refunding of debt not basis for liability in light of previous dealings with company and desire to avoid public bidding that would adversely affect market of bonds to be called), aff'd per curiam, 155 F.2d 522 (3d Cir. 1946); Casey v. Woodruff, 49 N.Y.S.2d 625, 642-44 (Sup. Ct. 1944) (directors not liable for expenses incurred in good faith to refinance debt that ICC later denied). See generally Uhlman, The Duty of Corporate Directors to Exercise Business Judgment, 20 B.U. L. REV. 488, 489-91, 495-98 (1940).

126. The director of a business corporation is given a wide latitude of action. The law does not seek to deprive him of initiative and daring and vision. Business has its adventures, its bold adventures; and those who in good faith, and in the interests of the corporation they serve, embark upon them, are not to be penalized if failure, rather than success, results from their efforts.

Bayer v. Beran, 49 N.Y.S.2d 2, 5-6 (Sup. Ct. 1944).

127. Such a decision is generally beyond the courts' expertise.

The court might be called upon to balance probabilities of profitable results to arise from the carrying out of the one or the other of different plans proposed by or on behalf of different shareholders in a corporation, and to decree the adoption of that line of policy which seemed to it to promise the best results, or at least to enjoin the carrying out of the opposite policy. This is no business for any court to follow.


An additional justification for the rule is that in the absence of extreme circumstances such as fraud, illegality, or waste, minority stockholders should not be able to set aside business decisions made by directors elected by a majority of the stockholders. Cf. id. (majority stockholders decision to buy waterworks extension at high price not voidable by minority holders absent bad faith on part of majority).

Professor Manne has stated that the rule was the logical synthesis of the growth of corporate operations in a competitive free enterprise system and the nineteenth century suspicion of excessive governmental regulation. The desire to protect directors against liability was incidental to the greater need to erect a barrier to prevent courts from regulating the activities of corporate managers. Manne, Our Two Corporation Systems: Law and Economics, 53 Va. L. Rev. 259, 270-71 (1967).
The Tenth Circuit in *FIF*, conceding that the business judgment rule was not directly applicable to the corporation, nevertheless concluded without analysis that the reasons for the rule should be “considered as extended to the corporate entity.”128 In a duty to disclose case, this conclusion will not withstand close scrutiny. The business judgment rule was not intended to protect the corporation itself in a suit by its stockholders. Rather, it was designed to encourage corporate officers to take risks when making business decisions knowing that the courts will defer to their good faith determinations. If this rule is applied to the corporation’s decision to disclose, however, great latitude afforded timing decisions will encourage corporations to delay or even forgo disclosure. This will frustrate one of the basic purposes of the federal securities laws, which is to “substitute a philosophy of full disclosure for the philosophy of *caveat emptor.*”129

Moreover, there is no compelling justification for such judicial deference in a duty-to-disclose case. In determining whether a corporation has made timely disclosure, a court is deciding whether a particular business decision not to disclose constitutes a breach of an affirmative statutory duty. The task of interpreting and applying a statutory rule is within the traditional expertise of a court,130 and the court should not refrain from exercising that expertise simply because the conduct giving rise to the need to disclose involves the business judgment of corporate management. The plaintiff must satisfy the burden of going forward with evidence by showing that the corporation had a duty to disclose at a particular point and that it acted recklessly or intentionally in failing to do so. At that point, the corporation may come forward with evidence showing its lack of recklessness or intent with respect to its timing decision. A court or jury should give weight to management’s judgment with regard to timing, but should not defer completely as it would if the business judgment rule were applicable. Whether or not the corporation comes forward with evidence supporting its good faith defense, the plaintiff has the burden of persuading the court that the corporation’s decision was reckless or intentional. This allocation of the burden of proof protects the corporation while partial rather than complete deference to management’s judgment on the issue of timing prevents imposition of an almost insuperable burden on the plaintiff.

Management’s Standard of Conduct

To recover damages for a breach of the duty to disclose under rule 10b-5, a plaintiff must prove that scienter can be inferred from the defendant’s conduct.131 In *Ernst & Ernst v. Hochfelder*,132 the Supreme Court defined scienter as “a mental state embracing intent to deceive, manipulate, or defraud.”133 Thus if a corporation

128. See 474 F.2d at 518 (business judgment rule not directly applicable because plaintiffs challenging corporation’s, not officers’, conduct).
131. See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976) (§ 10(b) speaks of manipulation and deception; court unwilling to extend statute to negligent conduct); note 16 supra.
133. Id. at 194 n.12.
intentionally breaches its duty to disclose, its conduct will satisfy the Court's test.\textsuperscript{134}

In \textit{Hochfelder}, however, the Court seemed to use the term "knowingly" interchangeably with "intentional" when describing conduct proscribed by section 10(b) of the 1934 Act.\textsuperscript{135} The Court thus implied that scienter can be inferred if the defendant actually knew of an omission or of the falsity of the statements made. Subsequently, lower courts have followed this interpretation and have held that actual knowledge permits the inference of scienter.\textsuperscript{136} In addition, the \textit{Hochfelder} Court left open the question whether intent can be inferred from reckless conduct;\textsuperscript{137} subsequent lower court cases have applied the recklessness standard.\textsuperscript{138}

In a duty to disclose case, the plaintiff would argue that scienter should be inferred because the corporation had actual knowledge of the materiality of the information and the nondisclosure. The corporation would argue, however, that its exercise of due care and good faith with respect to its duty to disclose should negate the inference of scienter. Because of the complex nature of the duty to disclose, a court should examine all aspects of the corporation's conduct before determining liability. If the court finds that the conduct was reckless, it should infer that the corporation acted with the requisite intent to deceive and that the scienter requirement was satisfied.

\textsuperscript{134} The Court made it clear, however, that negligence will not result in liability in private damage suits. \textit{Id.} at 214.

\textsuperscript{135} "The words 'manipulative or deceptive' used in conjunction with 'device or contrivance' [in § 10(b)] strongly suggest that 10(b) was intended to proscribe knowing or intentional misconduct." \textit{Id.} at 197 (emphasis added).


\textsuperscript{137} "In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5." 425 U.S. at 194 n.12.

By leaving open this question, the Court may have suggested a narrowing of the definition of scienter under both common law fraud and section 10(b). For the common law tort of misrepresentation or deceit, "reckless disregard whether [a statement] be true or false" satisfied the requisite intent to deceive or mislead. \textit{W. PROSSER, LAW OF TORTS} § 107, at 701 (4th ed. 1971). See \textit{generally Haimoff, Holmes Looks at Hochfelder and 10b-5}, 32 Bus. LAW. 147, 151, 154 (1976). Additionally, prior to the decision in \textit{Hochfelder}, scienter under rule 10b-5 could be inferred from reckless disregard for the truth. See \textit{Lanza v. Drexel & Co.}, 479 F.2d 1277, 1305-06 (2d Cir. 1973) (en banc) (no liability because willful or reckless disregard for truth necessary to establish liability under 10b-5).

Courts should use this method of analysis with respect to each segment of the corporation’s timing decision—its investigation and evaluation of the facts and the validity of its claim that there was a business reason for nondisclosure or delay. As to the investigation and evaluation of the facts, a court should examine the procedures the corporation followed in deciding whether disclosure was warranted. Scienter should be inferred from the corporation’s behavior only if the corporation acted either willfully with intent to deceive or recklessly with respect to its investigation and evaluation of the facts.

This analysis can be illustrated by considering a corporation that is faced with the loss of a major customer. Its investigation and evaluation of the facts have two related purposes: determining the impact on its business operations and determining the need for disclosure. In a duty-to-disclose case the court will be concerned only with the latter. If the corporation investigates and evaluates its disclosure obligations promptly, it will not have acted with scienter. If, however, it intentionally decides not to disclose or fails to consider its disclosure obligation, the requisite scienter can be found or inferred through recklessness.

Whether the corporation’s timing decision was reckless is a more difficult question when the corporation defends its decision on the ground that it had a valid business reason for nondisclosure or delay. In such a case, in order to infer scienter from reckless conduct, a court should determine both that the reason was invalid and that the corporation was reckless in its belief that the reason was valid. In some cases any such belief will be reckless. A corporation should always be found to have acted recklessly, for example, if it asserts as a valid business reason for nondisclosure or delay the fear that disclosure would result in a decline in its stock price. This reason will never be a valid business reason justifying nondisclosure or delay, and it is reckless to believe that it would be valid. There will be other situations, however, in which the corporation’s belief that the business reason was valid will not have been reckless, even though the reason is found to be invalid.

If a court applying this test finds that the corporation acted recklessly with respect to any one step, the corporation should be found to have acted recklessly with respect to its reliance on counsel. In such a case, the court should infer the requisite “intent to deceive” necessary for a finding of scienter notwithstanding the corporation’s efforts to seek advice of counsel. See Hawes & Sherrard, Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases, 62 Va. L. Rev. 19 (1976). See also Floor, The Scienter Requirement Under Rule 10b-5 and Reliance on Advice of Counsel After Hochfelder, 12 Nw. Eng. L. Rev. 191, 217 (1976) (listing four steps for reliance on counsel).

139. Obviously, if the business reason is valid, the question of recklessness need not be addressed.

140. A corporation will often seek and rely on advice of counsel when determining whether and when disclosure must be made. If either of the decisions of the corporation with respect to materiality and timing are challenged, the corporation will argue that reliance on counsel should prevent any finding of recklessness. It has been suggested that a corporation may rely successfully on the advice of counsel to protect it from liability if it takes the following steps: (1) It must select counsel which it reasonably believes competent; (2) it must disclose all material facts to counsel; (3) it must receive erroneous advice from counsel on a question of law (as contrasted with a question of fact, on which counsel has no expertise); and (4) it must act in accordance with counsel’s advice. See Hawes & Sherrard, Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases, 62 Va. L. Rev. 19 (1976). See also Floor, The Scienter Requirement Under Rule 10b-5 and Reliance on Advice of Counsel After Hochfelder, 12 Nw. Eng. L. Rev. 191, 217 (1976) (listing four steps for reliance on counsel).
IV. SPECIAL DISCLOSURE PROBLEMS

Thus far, this article has discussed only the duty to disclose information concerning matters on which the corporation has not previously spoken. A corporation may also have an obligation to update previously disclosed information that is no longer accurate and to correct material misstatements made by corporate officials or people outside the corporation. Finally, some information, such as financial projections, is sufficiently unique to warrant separate treatment.

DUTY TO UPDATE

The reason for requiring a corporation to update its prior statements is clear; previously disclosed information may leave a false and misleading impression with investors if not updated.\textsuperscript{141} Taken to its extreme, this position would compel a corporation to disclose whenever there was a material change in any of its previous statements, regardless of the materiality of the previous statement at the time of the change or the length of time since the original statement. Although this extreme is not now\textsuperscript{142} and should not become the law, a corporation should have an obligation to update previously disclosed material information if an investor could reasonably rely on the continuing accuracy of that information.\textsuperscript{143}

See \textit{Floor}, supra, at 218-19. Whatever standard is used, however, \textit{Floor} concludes that \textit{Hochfelder} is likely to enhance the effectiveness of the advice of counsel defense because it would seem impossible to impute reckless or willful conduct to a defendant who took the positive step of consulting counsel in good faith, but negligently failed to comply with one of the four steps. \textit{Id.} at 221-22.

The principal problem posed by the reliance on counsel analysis is whether the validity of the business reason is a question of law or fact. If it is a question of law, the corporation may rely on counsel's advice. If it is a question of fact, reliance would be unjustified and the defense could not rebut a finding of recklessness.

In most situations counsel's advice will have been rendered only after complex legal and factual questions have been answered. Hawes & Sherrard, supra, at 30. Thus it will be difficult if not impossible for corporations to determine whether the existence of a valid business reason is a question of law or fact, and therefore, whether it can justifiably rely on counsel's advice.

Because corporations should be encouraged to seek advice on how to comply with newly developing legal standards such as the duty to disclose, counsel's advice should not be limited to legal areas but should include mixed questions of fact and law. In a mixed-question situation, the corporation should be permitted to rely on counsel's advice only if the corporation could have reached in good faith the same decision with respect to the validity of the business decision. A corporation should not be able to interpose the defense of reliance on counsel if it would have been reckless for the corporation to have reached the same decision on its own.

\textsuperscript{141} Cf. \textit{Cochran} v. \textit{Channing Corp.}, 211 F. Supp. 239, 243 (S.D.N.Y. 1962) (dictum) (failure to correct misleading statements and to disclose when duty to do so exists may mislead investors and constitute fraud).

\textsuperscript{142} See \textit{Ross} v. A.H. \textit{Robins Co.}, [1979] \textit{Fed. Sec. L. Rep.} (CCH) ¶ 96,737, at 94,895 (S.D.N.Y. Jan. 8, 1979) (duty exists only when investors' continued reliance on original statement is reasonable). \textit{See also} Schneider, \textit{Developments in 1934 Act Reporting}, in \textit{Practicing Law Institute, Third Annual Institute on Securities Regulation} 89, 91-92 (1972) (Transcript Series) (duty exists only in special circumstances, including insider trading and tipping).

\textsuperscript{143} See \textit{Ross} v. A.H. \textit{Robins Co.}, [1979] \textit{Fed. Sec. L. Rep.} (CCH) ¶ 96,737, at 94,895 (S.D.N.Y. Jan. 8, 1979). The \textit{Robins} court's willingness to recognize the duty to update indicates that a lower court may
There is very little case law dealing with the duty to update. In one early case a court indicated that a corporation would not be liable under rule 10b-5 for its failure to update unless it had benefited from its failure to do so, or had sought to affect the market price of its stock for the benefit of itself or its insiders. It is unclear, however, in light of dicta in SEC v. Texas Gulf Sulphur Co. whether courts today will require a finding of benefit.

In a recent case—Ross v. A.H. Robins Co., Inc.—the United States District Court for the Southern District of New York held that there is a duty to update prior accurate statements that have become misleading due to subsequent events. In this case the corporation had stated in its 1970 annual stockholder report that its product, the Dalkon Shield intrauterine contraceptive device, was safer and more effective than other similar devices on the market. In its 1971 annual stockholder report the shield was described as "highly successful," and in a 1972 prospectus the corporation described its plans to introduce the device to international markets. Plaintiffs alleged that these statements had been rendered misleading by a subsequent undisclosed report indicating that the device was not as safe or effective as Robins claimed, and that several product liability suits had been filed against the company. The court held that the plaintiffs' claim was cognizable under rule 10b-5, but that they had failed to state the facts supporting an allegation of fraud with particularity as required by the Federal Rules of Civil Procedure. Noting that the passage of time eventually would render prior statements immaterial, the court stated that the duty to revise exists as long as an investor can reasonably rely on the continuing accuracy of the prior statement. The court also stated that the duration of the duty will vary with the circumstances of each case, and will depend on the importance of the initially released information and the nature of later information.

147. Id. at 94,899. The second part of the court's holding, that section 18 of the 1934 Act provides the sole remedy for failure to update documents filed with the SEC, appears to be incorrect; section 18 imposes liability only if the document was misleading at the time of filing. Id. at 94,896-99; see 1934 Act § 18, 15 U.S.C. § 78r (1976).
148. Id. at 94,899.
149. Id.
150. Id. at 94,894. The report was completed in April 1972, and Robins did not correct its earlier statements until 1974. Id. The plaintiffs had purchased Robins stock in 1973. Id.
151. Id.
152. Id. at 94,899. The court dismissed for failure to comply with rule 9(b) of the Federal Rules of Civil Procedure, which requires that all averments of mistake or fraud be pleaded with particularity. Id. at 94,895-96.
153. Id. at 94,895.
154. Id.
facts before it, the court suggested that the defendant would have had a duty to update its initial disclosure.\textsuperscript{155}

Although the Robins case suggests a duty to update based on a standard of reasonable reliance, the decision does not elaborate adequately the factors a court must consider when deciding whether an investor's expectations that the prior statement is still accurate are reasonable. Such a determination requires examination of the type of information in the original statement, the predictive nature of the statement, and the length of time between the original statement and the current information. Predictiveness describes the extent to which the statement permits inferences to be drawn about the corporation's future conduct.\textsuperscript{156} The duty to update will extend for a longer period of time if the initial statement is highly predictive, because a reasonable investor would expect such a statement, as opposed to one that is less predictive, to remain accurate for a longer period unless corrected. For the same reasons, there is more likely to be a duty to update a recent statement than one issued in the distant past.

This analysis raises the question of what knowledge a reasonable investor should be presumed to possess. For example, investors should realize that a corporation's financial position is constantly fluctuating.\textsuperscript{157} Earnings and sales will vary with general economic conditions and, in some situations, with political developments. In addition, investors should be presumed to know that some industries, by their very nature, are unpredictable due to rapid technological change or other developments. Finally, investors should be held to have constructive knowledge of some information that has been widely disseminated by sources other than the corporation.\textsuperscript{158} Although these considerations do not provide a clear test for determining when to update in a particular case, they do establish a framework for addressing the issue, as the following examples illustrate.

If a corporation announces an agreement in principle to merge and a material change occurs shortly thereafter, the parties have three courses of action: They may materially alter the terms of the merger, obtain approval of the respective boards of directors, or terminate the agreement. Whichever course is chosen, the corporation should be required to update its initial announcement by disclosing this new material information.\textsuperscript{159} Although the initial disclosure is not expressly predictive, the nature of the information—an agreement in principle only, and thus subject to change—creates an expectation that material changes will be disclosed promptly. In addition, the time

\textsuperscript{155} Id.

\textsuperscript{156} Every statement is predictive insofar as it permits inferences and assumptions about the future, even if it purports to refer only to the point in time at which it was made. For example, a statement that “it is the policy of the corporation not to make questionable or illegal payments,” although speaking of present policy, is predictive insofar as it permits inferences about the corporation's future conduct. Nevertheless, some statements are more clearly predictive than others, either because they make explicit predictions (“the corporation will earn $5.00 per share next year”) or because they relate to events that will happen in the future (“the corporation will spend $10 million on research and development next year”).


\textsuperscript{158} See note 123 supra and accompanying text.

between the disclosure of the agreement in principle and any change will generally be short enough to warrant disclosure.

A more difficult problem arises if a corporation engaged in mineral exploration makes a material discovery shortly after issuing a routine press announcement of drilling results for the previous year stating that "no commercial ore body" had been discovered and that "drilling is continuing." The corporation may be assumed to have a valid business reason for not disclosing the material discovery. An investor in such a case would argue that the prior disclosure, although not expressly predictive, implied that any discovery affecting the "no commercial ore body" statement would be disclosed. The investor could further argue that having disclosed the status of the drilling, reliance on the valid business reason would no longer be warranted because to do so would knowingly leave false information outstanding in the market. These arguments, however, should not prevail. The statement that no commercial ore body was found is not predictive; it simply reports past results. The statement that "drilling is continuing" is predictive only if it refers to explorations at a specific location; it does not suggest that specific results are anticipated. Even if the statement is considered predictive, the nature of the business of exploring for minerals is so unpredictable that a reasonable investor should be presumed to know that announced results may quickly become outdated and that there will often be a legitimate need for nondisclosure even though investors may be harmed.

Two variations of the facts in the *Robins* case will further illustrate the interplay of the various factors courts should consider when determining the reasonableness of the investors' expectations. First, assume that shortly after Robins announces that the Dalkon Shield is safer and more effective than other similar contraceptives on the market the corporation learns of an unpublished study finding that the shield is unsafe. Although the statement is not directly predictive, it is reasonable for investors to believe that the product has been tested and proven safe, and that disclosure will be made if this finding is contradicted. If the contents of the study are within the peculiar knowledge of the corporation or are otherwise not generally available to investors, updating should be required. Similarly, even if the unpublished study receives extensive coverage in the financial media, such as the *Wall Street Journal*, the corporation should have a duty to confirm or to deny the contents of the study because investors could not adequately evaluate the accuracy of the report.

On the other hand, there would be no duty to update if, one week after Robins' initial disclosure, a competitor introduces a safer and more effective device. Although the original statement was indirectly predictive and the time lapse short, Robins should not have to update; the investor should be presumed to know that competition often results in the introduction of new and potentially better products into the market. Moreover, this new information will undoubtedly have been disclosed by its competitors and no confirmation should be required of Robins.

**THE DUTY TO CORRECT**

The duty to update applies to a corporation's statements that have become misleading as a result of subsequent events. There is no question about the reasonableness of investor belief that the statements were accurate when
released; the concern is with continued investor reliance on these statements. The duty to correct applies to material misstatements made by corporate officials or persons outside the corporation rather than to misstatements made by the corporation itself. Although it would be unreasonable to hold a corporation responsible for the accuracy of all statements made by such persons, a duty to correct is appropriate in certain circumstances.

One test for determining whether the corporation has a duty to correct was suggested by the decision in Electronic Specialty Co. v. International Controls Corp. In seeking to enjoin a tender offer by International Controls Corp. (ICC), Electronic Specialty (ELS) alleged that ICC had failed to correct certain misstatements that had appeared in a Wall Street Journal article concerning the amount of ELS stock owned by ICC and the possible price at which a tender offer for ELS stock might be made. ELS also alleged that Robert Vesco, the president of ICC, had made other misrepresentations in an effort to force down the price of ELS stock and had used the story, knowing its inaccuracies, as a negotiating device to mislead ELS into a merger between the two companies. The district court held ICC liable and granted a preliminary injunction. It found that ICC, acting through Vesco—"its chief executive officer and dominating personality"—had misled both ELS and public investors about its intention to make a tender offer, and had at least permitted the publication of what it knew to be false statements about the number of shares of ELS stock that it owned. Although the court failed to articulate its reasoning, it appears that ICC was held liable either because Vesco had apparent authority to speak for the corporation or because he was acting on behalf of the corporation.

161. 295 F. Supp. at 1075. On July 31, 1968, shortly before the offer, an article in the Wall Street Journal reported that ICC might make a tender offer for ELS at $45-50 per share and that "according to brokerage house reports" ICC owned approximately five percent of the stock of ELS. Neither of these statements was true; ICC owned only two and one-half percent and as of that date the Board of Directors of ICC had not authorized any offer. Id.
162. Id. at 1075-76.
163. Id. at 1082-83.
164. Id. at 1076.
165. Cf. SEC v. Management Dynamics, Inc., 515 F.2d 801, 813 (2d Cir. 1975) (broker-dealer liable for violations of 10b-5 by its vice-president because he acted with apparent authority). Apparent authority exists when a person (the investor), as a result of manifestations made to him by a principal (the corporation), reasonably believes that a third party (the corporate employee) is the principal's agent. See RESTATEMENT (SECOND) OF AGENCY § 8 & Comments a and c (1957). Therefore, an investor who knows that someone is a corporate employee will be justified in believing that the employee has authority to do those things that employees of his type customarily do. See id. § 27, Comment d. Under agency principles, a corporation is liable for the fraudulent activities of an employee who acted with apparent authority, even if the employee commits the fraud solely for his own benefit. Id. §§ 261, 262 & Illustration 1. The rationale for holding the corporation liable is that the employee's position facilitates commission of the fraud because the victim cannot normally ascertain that the employee is acting fraudulently and for his own benefit. See id. § 261, Comment a; id. § 262, Comment a.

Several decisions imply that the duty to correct depends on whether the corporation benefits from its silence or from a misstatement. Compare Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937 (2d Cir. 1969) (statement detrimental to corporation; no duty to correct) with Green v. Jonhop, Inc., 358 F. Supp. 413 (D. Ore. 1973) (corporation benefited from failure to correct misstatements because stock price rose; liable for failure to correct). The more demonstrable and direct the benefit, the greater the argument supporting the duty. See Peacock, Correcting Rumors, 6 Rev. Sec. Reg. 901, 905 (1973) (agency principles indicate that allegation of a benefit is not necessary when agency principles are applied).

166. When an officer speaks on behalf of the corporation, the statement is not his, but that of the
The Second Circuit reversed the finding of liability, however, on the ground that the record did not support the finding that Vesco's actions were, in effect, those of ICC. The court also found that neither ICC nor Vesco was the source of the erroneous story; the court reasoned that the story was detrimental to ICC because it forced the price of ELS stock to a level that temporarily aborted the tender offer. The court held that "while a company may choose to correct a misstatement not attributable to it . . . we find nothing in the securities legislation requiring it to do so." It is possible to interpret this holding, as one court has done, to mean that a corporation does not have a duty to correct when the misstatement is not made by the corporation itself. A better reading of the decision, however, is that the Second Circuit implied that a corporation will have a duty to correct if there is an agency relationship between the maker of the misstatement and the corporation and the statement is within the scope of the maker's employment. Although the federal courts have divided sharply on the applicability of common law agency principles to actions brought under rule 10b-5, it is appropriate to apply these principles in the case of the duty to corporation. It will often be difficult to distinguish an officer's personal statements from those made for the corporation, and the bases for drawing such a distinction are beyond the scope of this article. This difficulty is itself a reason for holding a corporation liable for the misstatements of employees who speak with apparent authority. Cf. Restatement (Second) of Agency § 262, Comment a (1957) (because one cannot normally ascertain whether agent is in fact acting for principal's benefit, it is rational to hold principal liable for agent who commits fraud for his own benefit while acting with apparent authority).

167. 409 F.2d at 951.
168. Id. at 949. The Second Circuit also reversed the district court's finding of fact that Vesco had misled ELS and the public about ICC's intention to make a tender offer. Id. at 949-51. Judge Feinberg dissented on this point: "No matter how phrased, these are findings of fact which are supported by the record and should not be overturned. . . . The effect of . . . the majority opinion is not only to minimize the whole episode . . . but to preempt the trial court's function in this significant area." Id. at 954 (Feinberg, J., concurring and dissenting).
169. Id. at 949.
170. Id. (emphasis added).
172. It should be noted that the Third Circuit has refused to hold a corporation liable under agency principles for false statements made by its president to a shareholder who knew that the president was acting in his own interests rather than those of the corporation. Thomas v. Duralite Co., 524 F.2d 577, 586 (3d Cir. 1975). This result is clearly not inconsistent with the duty to correct, because the duty is premised in part on the average investor's inability to distinguish an officer's personal statements from his statements on behalf of the corporation. See note 166 supra.
173. Compare SEC v. Management Dynamics, Inc., 515 F.2d 801, 813 (2d Cir. 1975) (legislative history of 1933 and 1934 Acts contains no clear evidence that agency principles should not apply; broker-dealer liable for manipulations by vice-president because vice-president acted with apparent authority) and Kerbs v. Fall River Indus., Inc., 302 F.2d 731, 741 (10th Cir. 1962) (corporation liable for sale of fraudulent stock certificate by president who acted with apparent authority) and SEC v. Lum's, Inc., 365 F. Supp. 1046, 1061 (S.D.N.Y. 1973) (corporation-issuer generally liable "for what can be deemed the corporate acts of its principal agents") with Rochez Bros., Inc. v. Rhodes, 527 F.2d 880, 884-86 (3d Cir. 1975) (legislative history indicates that § 20(a) of 1934 Act preempts common law agency principles; corporation not liable for fraudulent acts of president because he traded for his own account and because victim knew that president was not acting for corporation) and Zweig v. Hearst Corp., 521 F.2d 1129, 1132-33 (9th Cir. 1975) (newspaper corporation not liable under respondeat superior theory for fraudulent act of its financial columnist because § 20(a) sole remedy). See generally Annot., 32 A.L.R. Fed. 714 (1977) (collecting cases). Section 20(a) of the 1934 Act provides:

Every person who, directly or indirectly, controls any person liable under any provision of
correct in order to protect investors from trading on the basis of misinformation.174

Respondeat superior liability, however, should exist only for statements attributable to the corporation. In deciding whether an erroneous statement is attributable to a corporation, a court should consider the position of the person who made the misstatement. There should be no duty to correct statements made by low-level employees whose positions within the corporation would not normally authorize them to disclose information.175 Reasonable investors would not believe that such persons have authority to speak for the corporation, and it would be unduly harsh to impose liability on the corporation for such statements176 because, as a practical matter, a corporation cannot police the actions of all its employees.

When the person who made the statement is a middle or high-level employee, the duty to correct should turn primarily on whether the corporation has adopted procedures for disclosure that are designed to reduce the risk that misinformation will be disseminated.177 If the corporation has such procedures and enforces them, it would be inappropriate to use agency principles to impose liability on the corporation; in such a case, the person

---

this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.


Courts that take the position that section 20(a) preempts common law agency principles argue that the “good faith” defense of section 20(a) would be negated by the strict application of agency principles. See Rochez Bros. v. Rhoades, 527 F.2d 880, 885 (3d Cir. 1975); Jackson v. Bache & Co., 381 F. Supp. 71, 95 (N.D. Cal. 1974).

174. Cf. text accompanying note 141 supra (duty to correct imposed because investors might otherwise be misled by misinformation). One court has suggested that use of agency principles may be appropriate only when it will further the policies of the securities laws. See SEC v. Geon Indus., 531 F.2d 39, 54 (2d Cir. 1976). In the case of the duty to correct, use of agency principles will further the policy embodied in rule 10b-5 of minimizing the amount of misinformation in securities markets.

In contrast, application of section 20(a) of the 1934 Act would provide less protection for investors because the corporation is liable only if it fails to act in good faith or induces the misstatements. See 1934 Act § 20a, 15 U.S.C. § 78t(a) (1976). In addition, one court has limited the applicability of section 20(a) to suits brought by private parties. See SEC v. Coffey, 493 F.2d 1304, 1318 (6th Cir. 1974) (§ 20(a) may not be relied upon by the SEC in an injunction enforcement action), cert. denied, 420 U.S. 908 (1975).

175. See RESTATEMENT (SECOND) OF AGENCY § 245(1) (1957) (principal liable only for agent's statements made within scope of agent's authority).


177. In order to make clear who can speak for the corporation, procedures should be adopted for the public disclosure of information that will reduce the risk that misinformation will be publicly disseminated. Examples of such procedures include the following: Designation of certain officials as the only authorized spokesmen for the corporation; the appointment of special personnel to monitor corporate developments and to review press releases for completeness and accuracy; and the employment of financial public relations firms to promulgate information widely and promptly.

making the statement should be held to have acted outside the scope of his authority.\textsuperscript{178} If the corporation has no such procedures, however, it is more equitable to require the corporation to correct the misstatement than for investors to bear the risk of trading on the basis of misinformation.

In some situations, however, even these procedures should not relieve the corporation of its duty to correct. For example, a corporation should be obligated to correct when its president, knowing that his statement is materially false and in violation of the corporation's procedures, publicly announces that "the corporation has ceased making questionable payments." The authority of the president is such that he must be presumed to be speaking on behalf of the corporation.\textsuperscript{179} Similarly, depending on the materiality of a misstatement and the extent of its dissemination, a corporation may be required to correct a misstatement made in violation of the corporation's procedures if those responsible for enforcing the procedures learn of the misstatement. In the latter case, the harm to investors outweighs the burden on the corporation to correct the misstatements.

The duty to correct also may be based on the relationship between the corporation and a person not employed by the corporation who has made the misstatements. This basis for liability underlies the decision in Green v. Jonhop, Inc.,\textsuperscript{180} in which a corporation (Jonhop) and one of its officers were held to have aided and abetted violations of rule 10b-5; they failed to correct certain misstatements made by a broker-dealer, which also served as the corporation's investment banker and principal market-maker for its securities.\textsuperscript{181} The broker-dealer, American Western Securities, Inc. (American Western), issued two market letters containing projected sales and earnings for the corporation that Jonhop's executive vice-president\textsuperscript{182} knew to be materially inaccurate.\textsuperscript{183} The executive said nothing to American Western about the first letter, advised an officer of American Western of the inaccuracies in the second, but made no public correction of either, and failed to correct the misstatements in sales meetings during which the letters were discussed.\textsuperscript{184}

The court found that the corporation's silence encouraged public reliance on the misrepresentations because "it was well known that American Western was the underwriter and principal dealer in Jonhop stock."\textsuperscript{185} Thus, silence

\textsuperscript{178} Cf. SEC v. Geon Indus., 531 F.2d 39, 54-55 (2d Cir. 1976) (inappropriate to apply agency principles to enjoin brokerage house that exercised reasonable supervision over employee who violated 10b-5).


\textsuperscript{181} \textit{Id.} at 419-20.

\textsuperscript{182} The officer was also a director and principal stockholder. \textit{Id.} at 416.

\textsuperscript{183} \textit{Id.} at 416-18.

\textsuperscript{184} \textit{Id.} at 416, 418.

\textsuperscript{185} \textit{Id.} at 419. In support of this point the court relied on Brennan v. Midwestern United Life Ins. Co., 417 F.2d 147 (7th Cir. 1969),\textit{cert. denied,} 397 U.S. 989 (1970). In that case the defendant corporation knew that a broker who dealt extensively in its securities was evidently using his customers' money as working capital, in violation of the securities laws. \textit{Id.} at 150-51. Although the corporation threatened to report the
"amounted to a tacit agreement with American Western to encourage investors to buy and hold Jonhop stock."186 The court recognized the close relationship between the corporation and American Western and acknowledged that a corporation could not be responsible for every misstatement made by a broker-dealer or securities salesman.187 Nevertheless, the court concluded that a corporation was "obligated to take some action when it learns of such misstatements or omissions and is aware that their publication or nonpublication will be misleading to members of the investing public."188

On its facts, Jonhop was correctly decided. It would be reasonable for investors to rely on the report of a broker-dealer that has such a close relationship with a corporation. Similarly, a corporation should be required to correct when a representative of the broker-dealer is a member of the corporation's board of directors. In this latter situation, an investor could reasonably conclude that the corporation knew the contents of the broker-dealer's report or that the broker-dealer had obtained information from the director.189

The Jonhop courts articulation of a corporation's duty is too broad, however; it would require correction whenever a corporation knew of the contents of a market letter, regardless of the extent of its participation in the preparation of that letter. In many cases, a corporation will give factual information to a securities analyst preparing a market letter but will not comment on the conclusions the analyst draws from that information even if

activity to the State Securities Commissioner, it never did so; indeed, when customers inquired why their stock had not been delivered, Midwestern referred them back to the broker. Id. at 152-53. The court relied on a "silence theory" to find the corporation liable for aiding and abetting the broker's violation of rule 10b-5. The court stated that "by failing to report [the broker's] activities to the SEC or the Indiana Securities Commission, [Midwestern] knowingly and purposefully encouraged an artificial build-up in the market for its stock so that it would be in a more favorable position. . . . Midwestern's acquiescence through silence in the fraudulent conduct. . . . combined with its affirmative acts was a form of aiding and abetting cognizable under Section 10(b) and Rule 10b-5." Id. at 154.


186. 358 F. Supp. at 420.
187. Id.
188. Id.

In the case of the duty to correct, however, the issue is the corporation's duty to disclose, not the broker-dealer's duty to construct a "Chinese Wall" to isolate those of its employees with inside information. The corporation's duty to correct would exist regardless of the presence of a "Chinese Wall" because investors expect accurate reporting.
the corporation knows those conclusions are materially incorrect. In such cases, if the analyst has no special relationship with the corporation, there should be no duty to correct. Investors should not assume that the conclusions in a report, even when based on data furnished by the corporation, represent the views of the corporation. Similarly, absent evidence of special relationship, a corporation should not be obligated to correct a material misstatement in a report whose conclusions it did not review. Conversely, there should be a duty to correct if the corporation has commented on the conclusion.

Perhaps the most difficult situation under this analysis occurs when a report based on data, but not conclusions, obtained from the corporation is prepared by a securities analyst acknowledged to be an expert in the corporation's industry. Because investors will probably rely on that person's views, and because the corporation should know about this reliance, it arguably should have a duty to correct material misstatements in the expert's report. On the other hand, if that analyst has no special relationship with the corporation, it would be unfair to impose a duty on a corporation that did not solicit the report and refused to comment on its conclusions, because investors are relying on the status of the analyst rather than the corporation's duty to make accurate disclosure.

PROJECTIONS

The difficulty in establishing firm general rules for the duty to disclose can be illustrated by analyzing a corporation's obligation to disclose its internal projections of sales and earnings. Projections are material information; hence, under the duty to disclose set forth in this article, a corporation would have to disclose its projections, as well as update them whenever there is a material change. Because projections differ from other material facts, however, it is the position of this article that the general duty to disclose and to update should not apply to them.

Projections differ from other facts, such as dividend declarations or potential mergers, and are intrinsically more uncertain because they are based on numerous facts and assumptions that are subject to frequent change and


reinterpretation. Indeed, it could be argued that by their very nature projections are almost never "ripe" for disclosure as that term was used by the Tenth Circuit in *FIF* in discussing when the duty to disclose arises.

Many corporations have resisted making their internal projections public either because they believe that projections are so inherently unreliable that they are misleading, or because they fear liability if actual results vary materially from the projections. Additionally, recognizing that projections often fluctuate, corporations are unwilling to assume the duty to determine the materiality of each change in their projections and to update previous estimates each time there is such a change.

A corporation could raise these arguments of uncertainty and flux whenever it did not wish to disclose particular information. This article rejects these arguments as generally unpersuasive. When dealing with projections, however, courts should recognize that the inherently uncertain nature of projections, together with the burdens that a duty to disclose projections would impose on corporations, outweigh any potential benefits that disclosure of projections would provide.

If a court is unwilling to accept this argument, however, it could adopt the position suggested by the SEC that corporations should be required to disclose projections publicly only if they have been disclosed on a selective basis to persons outside the corporation. The rationale behind this alterna-


196. See note 107 supra and accompanying text.

197. Securities Act of 1933 Release No. 5581, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,167, at 85,299 (Apr. 28, 1975). Prior to 1973 the SEC prohibited projections in statutory filings. The Commission believed that projections were inherently unreliable and that investors would give them too much credence if they were included. WHEAT REPORT, supra note 52, at 96. The SEC's prohibition, however, was not absolute. For example, it required disclosure in Securities Act registration statements of future costs of labor and materials as a risk factor. See Schneider, supra note 41, at 260 (arguing that more "soft" information may be beneficial to investors). The Commission also took the position as amicus curiae that appraisals of future value might have to be disclosed in a proxy statement. Gentile v. Gamble-Skogomo, Inc., 298 F. Supp. 66, 92 (S.D.N.Y. 1969), *modified and aff'd*, 478 F.2d 1281, 1291-94 (2d Cir. 1973). But see Sunray DX Oil Co. v. Helmerich & Payne, Inc., 398 F.2d 447, 451-52 (10th Cir. 1968) (omission from proxy statement of information about unproved oil reserves not misleading). The SEC reversed its traditional position on projections in 1973 and proposed to allow them in statutory filings. The SEC also proposed to subject corporations to additional filing requirements when they made projections
itive is that those investors to whom the projections are disclosed have an informational advantage over other investors. The corporation should not be permitted to create this informational inequality; thus projections become material for purposes of triggering a disclosure obligation that will minimize the inequality.

The duty to correct an outside projection should apply only when the projection is clearly attributable to the corporation, as is the case when the source of the projection has a special relationship with the corporation. Because the duty to correct projections places such a heavy burden on a corporation, a court should be careful to apply the attribution test narrowly when projections are involved. Analysts often base their projections on information obtained from many sources, including both publicly available statutory filings and private interviews with corporate personnel. Because virtually all of the information obtained in this manner can be attributed to


In addition, corporate trading in its own securities with knowledge of its own projections must be distinguished from the selective disclosure situation. In the former situation, liability under 10b-5 should be imposed if the scienter requirement is met, that is, if the corporation makes its trading decision on the basis of the projections. In the latter situation, 10b-5 liability should be imposed because the information that is selectively disclosed inevitably will be used for trading purposes, and thus the scienter requirement will be met.

The conceptual difficulties that arise from attempting to place projections within the general duty to disclose has led various commentators to attempt to limit those situations in which projections must be disclosed. At least one commentator has argued that a corporation must disclose its projections when trading in its own securities. See Schneider, in FIFTH ANNUAL INSTITUTE, supra note 191, at 52-53. There are problems, however, if a corporation has to disclose its projections when trading. For example, this requirement could extend to corporations that are considered to be trading because they have outstanding options, warrants, or convertible securities. See Schneider, supra, at 52-53. Contrary to the position taken in this article that projections are per se material, this approach assumes that projections are material information for the purpose of triggering a disclosure obligation only when they differ significantly from the estimates of a corporation's future performance that are generally available in the market and relied upon by investors. See Ruder, in FIFTH ANNUAL INSTITUTE, supra note 191, at 14-15, 18-19 (Remarks of David S. Ruder and Carl W. Schneider). Under this suggested approach, corporate insiders and the corporation could have to ascertain, before trading in the corporation's securities, what every available estimate is, and whether each differs materially from the corporation's own internal projections. See id. (projections that deal with "what the market expects" not material); Mann, in SEVENTH ANNUAL INSTITUTE, supra note 191, at 117-18 (Remarks of Carl W. Schneider) (same); Fleischer, Mundheim & Murphy, supra note 55, at 842 (same); cf. Mann, supra, at 116 (discussing "materiality" of projection in light of investor expectations). In this situation it would be unreasonable to subject a corporation to potential liability for failing to determine the accuracy of outside estimates or for concluding that its own projections did not vary materially from such estimates, particularly because the corporation did not seek the outside estimates it had failed to correct.

200. See notes 160-50 supra and accompanying text.
the corporation, even if the projection itself cannot, the duty to correct would always arise. By limiting the application of the attribution analysis, the corporation can be protected from this danger.\textsuperscript{202} On the other hand, when the projection is not issued by or attributable to the corporation, a more limited duty to correct should apply. This more limited duty would be similar to the requirement now imposed by the American Stock Exchange, which has relaxed its strict duty to correct rumors when projections are involved,\textsuperscript{203} and which does not ordinarily require a corporation to respond to outside projections.\textsuperscript{204} Only when a projection “is manifestly based on erroneous information, or is wrongly attributed to a company source” must a corporation respond.\textsuperscript{205} Even then, the corporation need not disclose its own projections; it can limit its response to an announcement “to the effect that the company itself has made no such prediction and currently knows of no facts that would justify making such prediction.”\textsuperscript{206}

Finally, if there has been a material change in either the projections or their underlying assumptions, a corporation should be required to correct its own public projections and any public comments it may make on outside projections. This duty will arise because the corporation’s own previous disclosure is clearly predictive and will reasonably induce investor reliability on its accuracy until corrected.

Although no case has decided how such a correction should be made, an actual situation that did not result in litigation demonstrates a clearly inadequate approach. In 1973 a large corporation, listed on the New York Stock Exchange, publicly projected its earnings for the following fiscal year.\textsuperscript{207} The projection exceeded actual results by about twenty percent, yet the corporation did not publicly update its original projection.\textsuperscript{208} After the actual earnings were published, the corporation claimed that it had no duty to correct because securities analysts who had followed the corporation closely knew that the corporation’s projections were inaccurate, and had corrected the inaccuracies in their own subsequent projections.\textsuperscript{209} The corporation argued, in effect, that investor reliance on its initial projection was no longer reasonable once the outside analysts’ projections were publicized.\textsuperscript{210}

On these facts, the corporation did not satisfy the duty to correct its original projection. It could not reasonably assume that investors who had

\textsuperscript{202} The SEC, while declining to impose on corporations the duty to correct outside projections, proposed that corporations be permitted to dissociate themselves from such projections. See Securities Act of 1933 Release No. 5581, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,167, at 85,299 (Apr. 28, 1975).

\textsuperscript{203} See COMPANY GUIDE, supra note 8, § 403, at 108-09 (requiring corporation to deny affirmatively erroneous rumors or reports and to disclose facts to explain situation).

\textsuperscript{204} Id. at 109. The NYSE does not expressly distinguish between the duty to correct rumors of projections and the general duty to correct rumors. See COMPANY MANUAL, supra note 8, at A-23. It appears from the context of the rule, however, that the requirement of a “frank and explicit announcement” does not apply to projection rumors. Id. But see Schneider, in FIFTH ANNUAL INSTITUTE, supra note 191, at 51.

\textsuperscript{205} COMPANY GUIDE, supra note 8, § 403, at 109.

\textsuperscript{206} Id.

\textsuperscript{207} Wall St. J., Jan. 18, 1974, at 17, col. 3.

\textsuperscript{208} Id.

\textsuperscript{209} Id.

\textsuperscript{210} Id.
seen and relied on the original projection also had seen the analysts' revised projections. Furthermore, even if investors were aware of the analysts' projections, they could not have evaluated the accuracy of those revisions without a statement by the corporation. The corporation need not have made its original projection public but, once it did it created a reasonable expectation on the part of investors that the projections would remain accurate. It could not then rely on outsiders to satisfy that expectation. The corporation should have corrected its projection as it would have revised any other statement.

V. ALTERNATIVE SOURCES OF THE DUTY TO DISCLOSE AND LIABILITY UNDER THE EXCHANGE RULES

STOCK EXCHANGE REQUIREMENTS

The timely disclosure policies of the New York and American Stock Exchanges provide the clearest expression of the duty to disclose. Both exchanges require listed corporations to make prompt disclosure of material information, which the exchanges define as information likely to have a significant effect on the market price of the corporation's securities. The New York Stock Exchange (NYSE) does not make the duty a specific part of the listing agreement, but its Company Manual states that timely disclosure is considered "one of the most important and fundamental purposes of the agreement." The American Stock Exchange (AMEX) includes the disclosure requirement in both its listing agreement and Company Guide.

Both exchanges recognize certain exceptions to the duty to disclose. Exceptions to the NYSE disclosure requirements are based on the relationship between the materiality of the information and the need for confidentiality. A company need not disclose highly material information as long as that information is kept confidential within the corporation and its advisers. When confidentiality cannot be maintained, however, or when it is necessary to discuss the information with persons outside the corporation, disclosure must be made on an "immediate release" basis. The Company Manual also provides that disclosure may be delayed when the information is less significant, although still material, or when an immediate announcement would endanger the corporation's goals or provide information helpful to competitors. It is unclear, however, whether these exceptions permit nondisclosure when the information is of the type subject to "immediate release" and the corporation has a valid business reason for silence but cannot keep the information confidential.

211. COMPANY MANUAL, supra note 8, at A-18; COMPANY GUIDE, supra note 8, § 40.3. The AMEX further defines "material information" as information that a reasonable investor might consider important in making his investment decision. COMPANY GUIDE, supra, § 40.3.

212. COMPANY MANUAL, supra note 8, at A-18. According to the Manual the Exchange recognizes that "factors bearing upon the public interest, or the exigencies of the market, may necessitate deviation from even the most explicitly stated policy or requirement." Id. at iii.

213. COMPANY GUIDE, supra note 8, § 40.1 & app. 1, at 299.

214. COMPANY MANUAL, supra note 8, at A-19.

215. Id.

216. Id. at A-22.

217. This issue may be more academic than real because corporations often are able to resolve
The AMEX sets out its exceptions to the timely disclosure requirement with greater specificity. Disclosure may be deferred when immediate disclosure would prejudice the corporation's ability to pursue its valid business objectives or when the facts are changing and confusion would be avoided by delaying announcement until the information is more definite. The Exchange points out that, in the latter case, successive releases might mislead rather than enlighten investors.

The AMEX requirements also suggest the appropriate form for a corporation's press release. The Exchange stresses that such announcements should be balanced, fair, and complete, and that they should be written in clear and succinct language that is comprehensible to an investor. The Exchange suggests that releases be prepared or reviewed by corporate officials familiar with the information and with the requirements of both the securities laws and the Exchange rules, and that a corporation establish a permanent group to prepare all public releases. The Exchange also suggests that legal counsel review releases.

Both exchanges are concerned with adequate dissemination of information. Although they differ in detail, both require a corporation to deliver its releases to national financial and general wire services and to major New York City newspapers. In addition, the AMEX suggests that the corporation send its releases to trade publications and newspapers that circulate in areas where the corporation's plants or offices are located. It also recommends that the corporation consider paid advertisements or a letter to stockholders if information is extremely material or dissemination is unusually difficult.

THEORIES OF LIABILITY UNDER THE EXCHANGE RULES

Two alternative theories of liability premise recovery against listed corporations on breach of stock exchange disclosure requirements. Although the 1934 Act does not expressly provide a right of action to investors for a breach of exchange disclosure rules, liability could be implied in accordance with tort principles governing private rights of action based on statutory violations.

informally their disclosure problems with Exchange representatives. Indeed, the Exchange recognizes that literal compliance with its formal policy will not always be possible, and it urges corporations to work with it in resolving their disclosure problems within the spirit of the listing agreement. Id. at iii.

218. COMPANY GUIDE, supra note 8, § 403(1), at 104.
219. Id.
220. Id. § 404(a).
221. Id. § 404(c)(1), (2).
222. Id. § 404(c)(3).
223. Id. § 403(2), at 106, 107; COMPANY MANUAL, supra note 8, at A-24.
224. COMPANY GUIDE, supra note 8, § 403(2), at 107.
225. Id.
226. See Restatement (Second) of Torts § 286 (1965). The Restatement provides:

The court may adopt as the standard of conduct of a reasonable man the requirements of a legislative enactment or an administrative regulation whose purpose is found to be exclusively or in part

(a) to protect a class of persons which includes the one whose interest is invaded, and
(b) to protect the particular interest which is invaded, and
An investor will argue that the duty to disclose is contained in rules of the exchanges adopted pursuant to the 1934 Act, and that a breach of those rules constitutes a tort for which a private right of action can be implied. Alternatively, if an investor can establish that he is a third party beneficiary of an exchange's prompt disclosure requirements, relief could be grounded on traditional state third party beneficiary contract principles.

**Federal Tort Liability** The principal case dealing with implied liability for breach of a stock exchange rule is *Colonial Realty Corporation v. Bache & Co.*, in which the Second Circuit stated that in certain cases a federal cause of action could be implied for the breach of a stock exchange rule by a stock exchange member. The court acknowledged that a right of action could be implied under tort principles for violations of explicit statutory duties established by the 1934 Act; it found, however, that the Act's concept of "supervised self-regulation" applicable to the exchanges made it difficult to apply such principles on an "all-or-nothing basis" to breaches of stock exchange rules. In explaining the nature of this difficulty, the court pointed out that because the 1934 Act grants broad discretion to the exchanges under section 6(b) to establish standards and principles for exchange markets, the "significance and effect of particular rules may vary with the manner of their adoption and their relationship to provisions and purposes of the statute and SEC regulations thereunder." The Second Circuit, relying on the explicit disciplinary function of the exchanges as a means of protecting investors and on the absence of any mention of exchange rules in the language of the grant

See *Wyandotte Transp. Co. v. United States*, 389 U.S. 191, 202 (1967) (citing Restatement (Second) of Torts § 286) (implying a civil right of action for violation of § 15 of the Rivers and Harbors Act of 1899 Is in accordance with general rule of torts); *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946) (citing Restatement, Torts) (implying federal right of action for violation of § 10(b) and rule 10b-5 of the 1934 Act); cf. *Brown v. Bullock*, 194 F. Supp. 207, 246 (S.D.N.Y.) (implying that private right of action for alleged violations of Investment Company Act of 1940 is consistent with the doctrine that courts construe statutes to extend that meaning of the words fairly permits them to effectuate generally expressed legislative purpose), aff'd, 294 F.2d 415 (2d Cir. 1961).

227. Imposing a private right of action for a breach of the broker-dealers' duty to disclose imposed by the National Association of Securities Dealers, Inc. (NASD) is based on the same analysis. For a discussion of arguments in support of private rights of action under NASD rules, see generally Lowenfels, *Private Enforcement in the Over-the-Counter Markets: Implied Liabilities Based on NASD Rules*, 51 CORNELL L.Q. 633 (1966).

228. See notes 293-95 infra and accompanying text.

229. 358 F.2d 178 (2d Cir.), cert. denied, 385 U.S. 817 (1966). In this case, Colonial Realty Corporation was a customer of Bache & Co., a member of the NYSE. Id. at 179. Bache sold securities in Colonial's margin account, claiming authority to do so under a clause in the standard form margin agreement that Colonial Realty had signed. Id. Colonial Realty alleged that these sales breached its oral agreement with Bache not to require margin in excess of the NYSE's margin requirements, and thereby violated, *inter alia*, article XIV of the Constitution of the NYSE. Id. at 179-80.

230. Id. at 182.

231. The court cited as examples of such duties sections 10 and 14 of the 1934 Act. Id. at 181.

232. Id. at 181-82.

233. Id. at 181; see 1934 Act § 6(b), 15 U.S.C. § 78f(b) (1976).

In *Colonial Realty* the plaintiffs also alleged a violation of the NASD rules under section 15A(b)(3) of the 1934 Act. 358 F.2d at 180. This article, however, is only concerned with alleged violations of exchange rules.
of jurisdiction in the 1934 Act, concluded that Congress did not intend that violations of all rules adopted under the 1934 Act should give rise to an implied federal right of action.\textsuperscript{234} The court also noted that some exchange rules discipline members for unethical behavior "which Congress could well not have intended to give rise to a legal claim."\textsuperscript{235}

At the same time, the court recognized that the concept of "supervised self-regulation" under the Act is broad enough to encompass those exchange rules that do provide a basis for implying a private right of action.\textsuperscript{236} The court articulated various criteria for determining whether a private right of action could be implied; these criteria focus on the nature of a rule and its place in the regulatory scheme.\textsuperscript{237} A right of action can be implied when an exchange rule "provides what amounts to a substitute for regulation by the SEC itself."\textsuperscript{238} The court recognized that "notwithstanding the commission's decision to take a back seat role" in a particular rule's promulgation and enforcement, such a rule may play an integral part in SEC regulation.\textsuperscript{239} The court provided further guidance by stating that "the case for implication would be strongest when the rule imposes an explicit duty unknown to the common law."\textsuperscript{240} This standard was designed to ensure that rights of action implied from violations of exchange rules would not be used to impose new legal requirements on exchange members conflicting with those standards long recognized by state law.\textsuperscript{241}

In \textit{Buttrey v. Merrill Lynch, Pierce, Fenner, & Smith, Inc.}\textsuperscript{242} the Seventh Circuit, although acknowledging the \textit{Colonial Realty} approach,\textsuperscript{243} adopted a different test. Under the \textit{Buttrey} test, a private right of action can be implied for a breach of a stock exchange rule if the rule violated is designed "for the

\textsuperscript{234} 358 F.2d at 182.

\textsuperscript{235} Id. See also \textit{Silver v. New York Stock Exchange, Inc.}, 373 U.S. 341, 371 (1963) (Stewart, J., dissenting).

\textsuperscript{236} 358 F.2d at 182.

\textsuperscript{237} Id.

\textsuperscript{238} Id.

\textsuperscript{239} Id.

\textsuperscript{240} Id.

\textsuperscript{241} Id.

\textsuperscript{242} 410 F.2d 135 (7th Cir.), cert. denied, 396 U.S. 838 (1969). In this case, plaintiff was the trustee in bankruptcy for Dobich Securities Corporation (the bankrupt), which had engaged as a dealer in the sale of securities. \textit{Id.} at 136, 141. Michael Dobich, allegedly a financially unstable broker-dealer and speculator in securities and commodities, organized the bankrupt and was its sole shareholder and principal officer. \textit{Id.} at 136, 141. Defendant, Merrill Lynch, Pierce, Fenner & Smith, Inc. (Merrill Lynch) granted Michael Dobich's request to open a cash account in the name of the bankrupt without having received any financial statements, bank references, or credit reports about the bankrupt, and without ascertaining whether the securities transactions would be for the bankrupt as principal or agent. \textit{Id.} at 141. At a later date, Merrill Lynch changed the bankrupt's account to a margin account without investigating the bankrupt's financial ability, and permitted the defendant Michael Dobich to engage in large speculative stock transactions for the bankrupt. These transactions resulted in substantial losses and ultimately insolvency. \textit{Id.} The plaintiff alleged that Merrill Lynch knew that the money used by Michael Dobich in these transactions belonged to its customers, and that the money was fraudulently converted. \textit{Id.}

The Seventh Circuit upheld a private right of action based on an alleged violation of NYSE rule 405, the "know your customer rule," which requires a member to use due diligence "to learn the essential facts relative to every customer." \textit{Id.} at 137, 143.

\textsuperscript{243} Id. at 142. The court noted the "plays an integral part in SEC regulation" standard but did not make mention of the "unknown to the common law" prong. \textit{Id.}
direct protection” of investors and if the conduct by the exchange member giving rise to the violation was “tantamount to fraud.”

This test does not improve upon the criteria set forth in Colonial Realty. First, the “direct protection of investors” standard offers little limitation; arguably every exchange rule is designed to provide such protection. Further, the “tantamount to fraud” requirement does not provide a logical limitation. Under this test it can be determined whether an action should be implied only after a case has been tried. To determine whether fraud exists, the court must examine the conduct under attack rather than the rule itself. If the breach of an exchange rule gives rise to an implied right of action, it should do so in all cases regardless of the nature of the conduct; the nature of the conduct is more appropriately an element of the offense and not a jurisdictional basis for the cause of action. For these reasons the Buttrey test is not as useful as the test set forth in Colonial Realty for determining which exchange rules, when violated, should give rise to a private right of action.

244. Id.
245. Id. at 143.
246. The standard does not provide guidance “for determining whether or not the violation of a particular rule is actionable.” Id. at 142; see Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 181 (2d Cir.) (Congress did not intend violations of all rules to give rise to civil claims), cert. denied, 385 U.S. 817 (1966); notes 229-41 infra and accompanying text.

247. See 410 F.2d at 143 (acknowledging that determination whether violations of rule 405 justify imposition of liability cannot be made until the case is actually tried); Nelson v. Hench, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) § 96,085, at 91,907 (D. Minn. 1977) (because determination of fraud required before subject matter jurisdiction could be determined, Buttrey standard would result in excessive litigation); Zagari v. Dean Witter & Co., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) § 95,777, at 90,809 (N.D. Cal. 1976) (tantamount to fraud approach promotes excessive federal actions because courts forced to hear a case on merits before it can decide motion to dismiss).

248. See Nelson v. Hench, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) § 96,085, at 91,907 (D. Minn. 1977) (if private right of action depends upon individual conduct rather than nature of rule in question, result may be that violation of same rule may not consistently give rise to cause of action); Zagari v. Dean Witter & Co., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) § 95,777, at 90,809 (N.D. Cal. 1976) (if private right of action exists, it exists for all violations of rule, regardless of specific conduct).


Since Judge Friendly’s opinion in Colonial Realty, the Supreme Court has twice addressed the issue of implied rights of action under federal statutes. In Cort v. Ash, 422 U.S. 66 (1975), a unanimous Court enunciated four criteria that must be considered before implying a right of action: 1) whether plaintiff is a member of a class for whose special benefit Congress enacted the statute; 2) whether there is any explicit or implicit legislative intent implying or denying a private remedy; 3) whether a private right is consistent with the legislative scheme; and 4) whether the cause of action is one traditionally relegated to state laws such that it would be inappropriate to infer a cause of action based exclusively on federal law. Id. at 78. In Piper v. Chris-Craft Indus., 430 U.S. 1 (1970), the Supreme Court applied the four criteria articulated in Cort. 430 U.S. at 37-41. The Court in dicta, however, went beyond the holding in Cort in suggesting that unless it can be shown that an implied right of action is necessary to accomplish the legislative intent of the statute in question a right will not be implied. Id. at 38, 41. The Supreme Court has not yet decided whether the criteria developed in Cort and followed in Piper apply in determining whether there is an implied federal right of action under the exchange rules.

To the extent Colonial Realty may conflict with Cort and Piper, it can be distinguished on the ground that the implied right was based on the exchange rules, whereas in both Cort and Piper the claims were based directly on violations of federal statutes. See Piper v. Chris-Craft Indus., Inc., 430 U.S. at 4 (claim under the Williams Act); Cort v. Ash, 422 U.S. at 68 (claim under 18 U.S.C. § 610). Even if Cort and Piper
Colonial Realty and Buttrey establish that a private right of action may be implied against a member of a stock exchange for violation of some stock exchange rules. To impose liability for the breach of a corporation's duty to disclose under exchange rules, however, this principle would have to be extended to the corporation whose securities are listed on the exchange. To do so, it would be necessary to establish that the duty to disclose was imposed by a rule of the exchange and that the rule was one of those covered by the Colonial Realty test.

The question of a corporation's liability for violation of a stock exchange rule was raised recently in Van Gemert v. Boeing Co. In that case, the plaintiffs, debenture holders who had failed to convert their debentures prior to redemption, alleged that Boeing had failed to give adequate notice of the redemption as required under its listing agreement with the NYSE. Plaintiffs further claimed that Boeing was civilly liable under federal law for violation of the NYSE listing agreement because the agreement requirements "are an extension of the Securities Exchange Act of 1934 and an integral part of the statutory scheme under which exchanges are required to adopt rules... the violation of which may give rise to a civil action under federal laws." The court acknowledged that it had previously held that a violation of an exchange rule did not give rise to a federal cause of action against a listed company. The court stated, however, are applicable, two courts have held that the Colonial Realty test is consistent with the criteria set forth in Cort, See Nelson v. Hench, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,085, at 91,907 (D. Minn. 1977) (Cort implicitly confirms Colonial Reality); Zagari v. Dean Witter & Co., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,777, at 90,809 (N.D. Cal. 1976) (Colonial Reality test encompasses first Cort factor and deals directly with remaining three).

In reversing the district court's dismissal of the plaintiffs' complaint for failure to state a federal cause of action, the Second Circuit held that the listing agreement and the Company Manual were "instruments corresponding to a rule" of the NYSE within section 6 of the 1934 Act, even though the Exchange had not so designated. The court acknowledged that it had previously held that a violation of an exchange rule did not give rise to a federal cause of action against a listed company. The court stated, however, the Corporation will publish immediately to the holders of any of its securities listed on the Exchange any action taken by the Corporation with respect to dividends or to the allotment of rights to subscribe or to any rights or benefits pertaining to the ownership of its securities listed on the Exchange; and will give prompt notice to the Exchange of any such action; and will afford the holders of its securities listed on the Exchange a proper period within which to record their interests and to exercise their rights.

Id. (citing NYSE listing agreement Part III, Paragraph 4).

250. 520 F.2d 1373 (2d Cir.), cert. denied, 423 U.S. 947 (1975). 251. Id. at 1374-75. The listing agreement had been incorporated by reference into the listing application filed by Boeing in connection with the debenture issue. Id. at 1396. The pertinent part of the listing agreement provided:

The Corporation will publish immediately to the holders of any of its securities listed on the Exchange any action taken by the Corporation with respect to dividends or to the allotment of rights to subscribe or to any rights or benefits pertaining to the ownership of its securities listed on the Exchange; and will give prompt notice to the Exchange of any such action; and will afford the holders of its securities listed on the Exchange a proper period within which to record their interests and to exercise their rights.

Id. (citing NYSE listing agreement Part III, Paragraph 4).

250. Id. at 1379.

253. Id. at 1380 (citing 1934 Act, § 6(a)(3), 15 U.S.C. § 78f(a)(3) (1970)) (Exchange's articles of incorporation, bylaws, rules, or instruments corresponding thereto to be referred to as "rules of the exchange"). The Second Circuit defined what was required by the listing agreement by referring to section A-10 of the Company Manual, which sets forth specifically the requirements necessary to ensure adequate notice in the event of a redemption. Id. at 1376.

254. Id. at 1380. In O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964), plaintiffs filed a derivative suit alleging violation of the 1934 Act and the Federal Aviation Act. After the complaint was dismissed, plaintiffs sought leave to amend their complaint to allege that the transaction violated the rules of the
that its own most recent statements and developing case law had recognized that a private right of action might be appropriate in some circumstances,\textsuperscript{255} and suggested that its prior holding had been implicitly overruled. The court also found that the legislative history of the 1934 Act was at best ambiguous whether Congress intended to insulate corporations from liability for violations of a stock exchange rule.\textsuperscript{256} The Second Circuit, however, rejected the argument that delisting was the exclusive remedy for corporate breaches of exchange rules and held that the plaintiff's claim was sufficient to invoke federal jurisdiction.\textsuperscript{257}

Although the court in \textit{Van Gemert} found Boeing liable for having failed to provide adequate notice of redemption, the court based its finding of liability on the contract between the debenture holders and Boeing,\textsuperscript{258} and used the claim of an implied federal private right of action only to support pendent jurisdiction.\textsuperscript{259} As a result, the court's analysis has little utility in determining whether a breach of the exchanges' duty to disclose gives rise to an implied private right of action.\textsuperscript{260} Thus, even if \textit{Van Gemert} establishes that a claim based on an alleged violation of an exchange rule by a listed corporation is sufficient to invoke federal jurisdiction, it is still necessary to apply the \textit{Colonial Realty} test to determine whether a cause of action should be implied in any particular case.

Applying the test to the exchanges' duty to disclose, it is apparent that the first prong—that the rule imposes an explicit duty unknown to the common law—is satisfied. At common law, there was no duty to disclose even to persons engaged in securities transactions;\textsuperscript{261} a duty to disclose arose only if "special facts" surrounding the transaction dictated disclosure.\textsuperscript{262}


\textsuperscript{256} Id. at 1382.

\textsuperscript{257} Id.

\textsuperscript{258} Id. at 1383.

\textsuperscript{259} Id. at 1382 & n.19 (citing \textit{United Mine Workers v. Gibbs}, 383 U.S. 715, 725 (1966)).

\textsuperscript{260} Although the court suggests that an action should not be implied for the breach of every provision of the listing agreement, the court did not provide any clear guidance on how to determine which provisions would give rise to a cause of action. See id. at 1382 n.18 (provision requiring prompt notification to Exchange of changes of officers or directors would not give rise to liability).


Although courts have not yet applied the "unknown to the common law" test to violations of exchange disclosure requirements, courts have applied this prong to other exchange rules. In \textit{Zagari v. Dean Witter & Co.}, \textit{Fed. Sec. L. Rep. (CCH)} \textsuperscript{95,777}, at 90,809 (N.D. Cal. 1976), the court refused to imply a private right of action of an alleged violation of the "know your customer" rule of the AMEX. \textit{Id.} at 90,811-12. The court held that the standard of due diligence imposed by the rule was part of the common law concept of negligence and that the duty imposed on a member firm to supervise the activities of its salesmen existed under the common law doctrine of respondeat superior. \textit{Id.} The court concluded that the exchange rule further defined common law principles and did not impose duties unknown to the common law. \textit{Id.} at 90,812. \textit{See also Nelson v. Hench}, \textit{Fed. Sec. L. Rep. (CCH)} \textsuperscript{96,085}, at 91,908 (D. Minn. 1977) (refusing to imply private right of action for violation of "know your customer" rule of NYSE and NASD).

\textsuperscript{262} \textit{See}, \textit{eg.}, \textit{Strong v. Repide}, 213 U.S. 419, 431 (1909) (duty to disclose exists when director's agent...
The second prong of the test—the substitute for SEC regulation requirement—is more difficult to apply. In Colonial Realty the court cited as an example of a substitute regulation an instance in which the SEC terminated its own rulemaking proceeding upon the adoption of an exchange rule. The court, however, did not suggest that to meet this requirement the exchange rule must be identical to or coextensive with what the SEC would have required in a rule of its own. All that need be shown is that the SEC considers the exchange rule to be a satisfactory substitute for its own rule.

Difficulties still exist in applying this latter test. There is some evidence that the SEC views the exchanges’ disclosure requirements as a substitute for its own rule. The SEC, in statements concerning the duty to make prompt disclosure, has emphasized the significance of the exchanges’ requirements. Additionally, that the SEC has not adopted a rule requiring prompt disclosure, although it has the authority to do so under sections 10(b) and 13(a) of the Act, § 19(c), 15 U.S.C. § 78s(c) (1976). The effect of the amendments on the second prong of the test is unclear because the statute specifically states that any amendment to the rules of a self-regulatory organization made by the Commission shall not be considered a rule of the Commission.

1979] AFFIRMATIVE DUTY TO DISCLOSE 983

263. Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 182 n.4 (2d Cir.), cert. denied, 385 U.S. 817 (1966). A more recent example of an exchange rule that would presumably meet the second prong is the amendment to the NYSE listing agreement requiring all listed corporations to establish an audit committee. See Order Approving Proposed Rule Change, Securities Exchange Act of 1934 Release No. 13346, (March 9, 1977) (approving rule change). Although the SEC had not yet commenced its own rulemaking proceeding, the Exchange adopted the amendment at the SEC’s urging, presumably to foretell a similar SEC rule. See id. at 4 n.9 (SEC urged formation of audit committees).

In Colonial Realty the court suggested that those provisions of former section 19 of the 1934 Act that explicitly authorized the SEC to modify exchange rules might provide a basis for implying a private right of action for violations of those rules. 358 F.2d at 182; see 1934 Act, § 19(b), 15 U.S.C. § 78s(b) (1970) (delineating specific areas of SEC power to modify exchange rules). In 1975, however, the Securities Acts Amendments repealed section 19(b) and gave the SEC plenary power to modify any exchange rule. 1934 Act, § 19(c), 15 U.S.C. § 78s(c) (1976). The effect of the amendments on the second prong of the test is unclear because the statute specifically states that any amendment to the rules of a self-regulatory organization made by the Commission shall not be considered a rule of the Commission. Id. § 78s(c)(4)(C).

264. Because any SEC rule would apply to all corporations rather than just those whose securities are listed on a national securities exchange, the exchange’s requirements clearly are not a complete substitute for SEC regulation. It is possible that the SEC has not adopted a rule because it believes that its own standards, together with the requirements of the exchanges, adequately govern the conduct of most corporations.

265. It has been argued that the criteria governing whether an exchange rule can be considered a substitute for SEC regulation should be whether the rule is either specifically required by SEC rules or is traceable to particular statutory provisions. See Wolfson & Russo, The Stock Exchange Member: Liability for Violation of Stock Exchange Rules, 58 Calif. L. Rev. 1120, 1136-39 (1970). Under this standard, because neither section 10(b) of the 1934 Act nor rule 10b-5 specifically impose the duty to disclose, the exchanges’ timely disclosure requirement would fail the second prong of the Colonial Realty test.

of the 1934 Act, lends further support to the conclusion that the second prong could be met.\textsuperscript{267}

The exchanges' own view of their prompt disclosure requirements, however, is somewhat different. A representative of the NYSE has stated that its disclosure requirements are "more of a common sense guideline to ethical behavior than a legal document" because they are intended to help corporations solve disclosure problems to which there is no one correct answer.\textsuperscript{268}

The AMEX, moreover, acknowledges that the disclosures it requires frequently "must be more prompt and comprehensive than is required by the securities laws."\textsuperscript{269} The AMEX, however, also acknowledges that its disclosure policy has been "refined and expanded to meet changing circumstances," and "reflects recent interpretations of the federal securities laws."\textsuperscript{270} The latter language may indicate that the Exchange views its policy as an integral part of the regulatory scheme. Furthermore, the former language can be read as referring only to the relationship between the Exchange's policy and the SEC's statutory reporting requirements. If this interpretation is correct, the Exchange's policy would satisfy the second prong of the \textit{Colonial Realty} test. Absent clearer language from either the SEC or the exchanges, however, it is difficult to draw a firm conclusion about whether the substitution prong of the test is met.

Even if the exchanges' duty to disclose satisfies the \textit{Colonial Realty} test, there still may not be civil liability for a breach of that duty.\textsuperscript{271}

\begin{footnotesize}
\begin{itemize}
\item[267.] The \textit{Wheat Report} rejected such a rule because it would be "unduly burdensome for the timely disclosure policies of the self-regulatory organizations to be duplicated." \textit{Wheat Report}, supra note 52, at 329. The \textit{Wheat Report} also concluded that the SEC's statutory reporting requirements play a different role in the overall regulatory scheme than that of a timely disclosure policy.


\item[269.] \textit{Company Guide}, supra note 8, § 401.

\item[270.] Id.

\item[271.] Even if civil liability does not exist, a corporation is still subject to sanctions imposed by the exchanges for breach of their duty to disclose. Both exchanges have the discretionary power to suspend trading. See \textit{Company Guide}, supra note 8, § 1002 (policies with respect to continued listing); \textit{Company Manual}, supra note 8, at A-291-294 (numerical and other criteria with respect to continued listing). Suspensions, however, are used only occasionally to compel disclosure from a recalcitrant corporation; they are more commonly used to give investors adequate time to evaluate the significance of a corporation's unexpected, though voluntary, disclosure. Both exchanges can also delist a corporation's securities if the corporation fails to comply with the listing agreement. \textit{Id.} The exchanges have used this power sparingly, however. Only one case exists in which an exchange delisted a corporation's securities because the corporation failed to comply with the exchange's timely disclosure policy, and in that case the Exchange apparently based its delisting on the dissemination of false information rather than on complete nondisclosure. \textit{Intercontinental Indus., Inc. v. American Stock Exchange}, 452 F.2d 935, 937, 938 n.3 (5th Cir. 1971), cert. denied, 409 U.S. 842 (1972); see
\end{itemize}
\end{footnotesize}
such liability would be premised on the fact that the duty was imposed by the listing agreement, which is itself a rule or an “instrument corresponding to a rule” of the exchange pursuant to the 1934 Act.272 In the case of the AMEX, this premise is correct; its timely disclosure policy is specifically incorporated in its listing agreements.273

On the other hand, although the NYSE has characterized its timely disclosure requirement as “one of the most important and fundamental purposes of the listing agreement,”274 the requirement is not in the agreement itself. Rather, it is contained in the Company Manual,275 the guide for listed corporations published by the Exchange. The Company Manual does not purport to establish firm rules; indeed, the manual notes that in all but routine matters, deviation from its requirements may be necessary.276 Although the Exchange urges compliance with the Company Manual because its provisions are “indicative of current concepts of good practice,”277 neither the listing agreement nor the manual itself requires listed corporations to comply with the Company Manual. Thus, the Exchange appears to have carefully created a structure whereby the duty to disclose is neither a part of an Exchange rule nor an “instrument corresponding to a rule,”278 and whereby a breach of the duty may result in Exchange sanctions but not civil liability.

This difficulty may have been eliminated by the Securities Acts Amendments of 1975.279 Under these amendments, a rule of the exchange is defined to include such stated policies, practices, and interpretations as the Commission, by rule, determines in the public interest to be deemed rules.280 Rule 19b-4, which establishes the procedures to be followed in connection with changes in exchange rules, defines “stated policies, practices and interpretations” to include “any statement made generally available to . . . persons having or seeking access . . . to facilities” of the exchange.281 The SEC has stated that,

---


272. See Van Gemert v. Boeing Co., 520 F.2d 1373, 1380-82 (2d Cir.) (listing agreement is an instrument corresponding to rules of exchange within § 6(a)(3) of the 1934 Act; claim under listing agreement sufficient for jurisdictional purposes), cert. denied, 423 U.S. 947 (1975).

273. COMPANY GUIDE, supra note 8, app., at 299 (listing agreement Form L requiring prompt public disclosure of material information).

274. COMPANY MANUAL, supra note 8, at A-18.

275. See id. at A-18-21 (Timely Disclosure section).

276. Id. at iii.

277. Id. at A-33. The SEC has described the Company Manual as “a guide for listed companies,” the enforcement of which stems “from the power of the board of governors to suspend or delist securities.” SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. Doc. No. 95, 88th Cong., 1st Sess., part 4, at 566 (1963).

278. But see Van Gemert v. Boeing Co., 520 F.2d 1373, 1380 (2d Cir.) (Company Manual is an “instrument corresponding to a rule”), cert. denied, 423 U.S. 947 (1975). In Van Gemert, however, the relevant provisions of the Company Manual related directly to a specific obligation in the listing agreement. See id. at 1376 (Company Manual specifically defines what constitutes adequate notice). Thus the court was able to read the Company Manual as being part of that obligation. Id. The timely disclosure policy, by contrast, does not relate to a specific provision in the listing agreement; hence, it may be more difficult to link the Company Manual and the listing agreement to establish jurisdiction.


in the case of an exchange, the term "persons" includes issuers of securities listed on the exchange.282 Under rule 19b-4, however, an exchange can notify the Commission that a particular stated policy, practice, or interpretation is not a rule of the exchange.283 Thus, under the existing statutory scheme, it appears that the SEC could deem the Company Manual to be a rule of the NYSE, while the Exchange could notify the Commission that the Company Manual is not a rule.

To date, it appears that neither the SEC nor the NYSE has taken any action with respect to the status of the Company Manual. In its review of existing exchange rules to determine whether they comply with the 1975 Amendments, the SEC did not refer to the Company Manual.284 It cautioned, however, that its comments on some exchange rules did not imply that all other such rules were in compliance, and expressed no opinion on the status under the Act of documents such as the Company Manual.285

An additional problem with implying this right of action for breach of the NYSE's duty to disclose is that some parts of that duty impose a greater obligation on the corporation than would rule 10b-5. For example, the NYSE requires a corporation to confirm an accurate rumor "despite the business inconvenience which may be caused and even though the matter may not yet have been presented to the company's Board of Directors for consideration."286 Thus, under the facts in SEC v. Texas Gulf Sulphur Co.,287 had a rumor concerning the initial drill hole been circulated, the NYSE would have required confirmation even though there was a valid business reason for silence.288 In such a case, the failure to correct would not give rise to liability under rule 10b-5 but could result in liability if a cause of action were to be implied for breach of the Exchange's requirement. This would be an undesirable result because it undercuts the balance that rule 10b-5 strikes between the needs of investors and those of the corporation, and it forces the corporation to choose between civil liability for failure to correct the rumor and economic loss resulting from disclosure. It is precisely the type of situation in which exchange action against the corporation might be appropriate but civil liability would not.

State Third Party Beneficiary Contract Liability  An alternative theory of liability for violating the exchanges' duty to disclose is based on state law third party beneficiary contract principles. Under this theory, an investor would allege that he is the beneficiary of the corporation's promise to the exchange to disclose material information. Support for this theory might be found in Weinberger v. New York Stock Exchange,289 in which an investor

285. Id. at 87,141.
286. COMPANY MANUAL, supra note 8, at A-23.
288. This conclusion assumes that the corporation had been unable to convince the Exchange of its need for silence.
sought to hold the exchange liable to him on the grounds that he was a third party beneficiary of a contract between the Exchange and the SEC. The court held in Weinberger that the investor was more than an incidental beneficiary of this contract and on this basis denied the Exchange's motion to dismiss the complaint. Thus, an independent basis for relief was found in state contract law. Although the relevant contract in Weinberger was between an exchange and a government agency, the same reasoning should apply to a private agreement between a corporation and an exchange if the third party can demonstrate that the exchange's disclosure requirements were intended to benefit investors.

To recover as a third party beneficiary, an investor must establish that a promise to make timely disclosure of material information exists; that he is an intended, rather than an incidental, beneficiary of the promise; that recognition of the right to performance in the beneficiary is appropriate to effect the intent of the parties; and that the promise—the exchange—intended to give the investor the benefit of the promised performance.

In seeking to establish these elements, an investor faces problems similar to those that arise in attempting to imply a federal private right of action for a violation of the exchanges' timely disclosure requirement. For example, because the NYSE's listing agreement contains no direct promise to disclose, an investor would have to prove that the listing agreement should be reformed to include the timely disclosure provisions of the Company Manual. An investor would also have considerable difficulty in demonstrating that he was the intended beneficiary of the promise to disclose because the NYSE has

---

290. Id. at 140. The investor relied on an agreement filed by the Exchange pursuant to section 6(a)(1) of the 1934 Act by which the exchange undertook to comply and to enforce compliance by its members with the provisions and rules of the 1934 Act. Id. at 141. The court rejected the Exchange's argument that the agreement was "nothing more than a condition precedent to a license to engage in a particular business," and held that the agreement was a contract. Id. at 144-45.

291. Id. at 144, 146. The court applied the general rule that permits third party recovery under a government contract if the parties to the contract intended that the promisor would compensate members of the public for injurious consequences. Id. at 143 (quoting RESTATEMENT OF CONTRACTS § 145 (1932)).

292. In Van Gemert v. Boeing Co., 520 F.2d 1373 (2d Cir.), cert. denied, 423 U.S. 947 (1975), plaintiffs alleged that they were third party beneficiaries to the listing agreement between the NYSE and Boeing. Id. at 1380. Judge Oakes alone found merit in this claim, stating that under the third party beneficiary theory the result would be "essentially coterminous" with that reached by implying a federal cause of action. Id. at 1382 n.19 (Oakes, J., writing for the majority, but noting his individual view on this issue). But see 89 HARV. L. REV. 1016, 1024 (1976) (exchange's apparent acceptance of Boeing's notice presumably terminated any contractual rights of debenture holders).

293. See RESTATEMENT (SECOND) OF CONTRACTS § 133 (1973). The Restatement suggests that the intent of the parties may be disregarded in some cases when the statute embodies an "overriding policy" requiring recognition of the rights of third party beneficiaries. Id. § 133, Comment (d). An example given in the Comment is that of a collective bargaining agreement between a labor union and an employer in which the employer promises not to discriminate against any employee because of his membership in the labor union. Id. § 133, Comment (d), Illustration 12. Of course the statutory basis for the union members' rights and their relationship to the contracting parties is more direct than that of investors as third party beneficiaries of the contract between the corporation and the exchange.

294. See note 275 supra and accompanying text.
specifically indicated that its timely disclosure requirement is not intended to give rise to legal liability.295
On balance, then, it will be difficult for an investor to recover if the corporation breaches the stock exchanges' timely disclosure requirements. Such requirements may not satisfy the criteria required to imply a private right of action under the federal securities laws. Additionally, it will be hard for an investor to establish that he is an intended beneficiary of the corporation's promise to disclose, as would be required under state common law third party beneficiary principles.

CONCLUSION

This article has argued that rule 10b-5 is an appropriate vehicle for the imposition of new disclosure obligations. Existing restrictions on insider trading provide some incentive for disclosure of material information, but are insufficient to promote the full disclosure that investors need. These restrictions apply to insiders only; they do not obligate a corporation to speak. Only a disclosure duty that applies irrespective of trading will fully meet the informational needs of investors.

At the same time, the duty to disclose will constitute only part of a carefully constructed disclosure system consisting of statutory requirements, rules, forms, and interpretations administered by the SEC and the self-regulatory organizations. To be effective, the duty must be synchronized with the system so as to provide a meaningful benefit to investors without imposing an unfair burden on corporations.

The skeleton of the duty is simple: A corporation must promptly disclose all material information. Putting flesh on the skeleton is a more complex task, and one that requires balancing a corporation's need for silence against investors' need for disclosure. In essence, the duty to disclose demands that a

---

295. See note 268 supra and accompanying text.

Apparently, the only reported state case dealing with the application of third party beneficiary principles to a breach of the listing agreement is Mackubin v. Curtiss-Wright Corp., 190 Md. 52, 57 A.2d 318 (1948). In that case, the corporation had allegedly breached its listing agreement by failing to promptly publish news of the omission of its quarterly dividend. Id. at 54, 57 A.2d at 319. Plaintiff, an existing stockholder, had placed an order to buy additional shares that was executed at a price higher than that which the stock actually traded after there had been full dissemination of the news. Id. at 55, 57 A.2d at 320. The plaintiff alleged that she would have cancelled her order if the corporation had announced the dividend omission before the opening of the market. Id. The court held, however, that the listing agreement was intended only for the benefit of actual stockholders and that plaintiff could not recover because her loss arose in her capacity as an investor rather than as a stockholder. Id. at 58, 57 A.2d at 321. In reaching this conclusion, the court stated:

In order to recover, it is essential that the beneficiary shall be the real promisee; i.e., that the promise shall be made to him in fact, though not in form. It is not enough that the contract may operate to his benefit. It must clearly appear that the parties intended to recognize him as the primary party in interest and as privy to the promise.

Id.

The Mackubin holding is questionable because the court failed to analyze the statutory background of the listing agreement. In addition, its narrow interpretation of third party beneficiary principles is not generally accepted. See RESTATEMENT (SECOND) OF CONTRACTS § 133 (1973) (generally accepted standard).
corporation attempt to communicate clearly and quickly with investors. Thus, a corporation must act promptly in gathering and evaluating material information. It must also use its best efforts to prepare its disclosure in an understandable fashion and to disseminate the information where needed. To date, no court has held that a corporation has a legal obligation to communicate clearly or to disseminate accurately. These are significant aspects of the full disclosure process, however, and it is appropriate to embody them in the duty imposed by rule 10b-5.

Because of the complexities involved in achieving full and prompt disclosure the duty must be reasonably interpreted. When information is too uncertain for meaningful disclosure, when a corporation has a valid business reason for nondisclosure, or when the media fail to publish a release issued by a corporation, it would be unreasonable to impose liability on a corporation for its failure to make prompt disclosure. Therefore, the standard for measuring whether a corporation has breached its duty must focus on the corporation's good faith efforts to satisfy its disclosure obligations, even if those efforts do not always meet with success. The corporation that has made such an effort should be protected from liability.

As part of the general duty to disclose, a special disclosure obligation arises when previously disclosed material information has become inaccurate because of subsequent events. This duty to update arises if both the original and the revised information are material and the investors' continued reliance on the accuracy of the original statement is reasonable. In order to make this latter determination, courts must consider how predictive the initial disclosure is, the time lapse between the original disclosure and the subsequent event, and the availability of the new information to the investing public.

Similarly, in some situations a corporation will have an obligation to correct public misstatements made by others. Because a corporation cannot reasonably guarantee the accuracy of all publicly available information, the duty to correct must also be circumscribed. The duty arises only when a misstatement is made by an outsider who has a special relationship with the corporation, or by a corporate officer who speaks on behalf of the corporation or with apparent authority to do so. With respect to the latter case, however, the duty will turn on the position of the person who made the misstatement, the existence of corporate procedures designed to guard against such misstatements, and the extent of its dissemination.

In order to secure redress for injury due to nondisclosure, an investor might attempt to proceed against listed corporations for breach of stock exchange disclosure requirements. Establishing liability under this theory, however, requires overcoming a number of substantial obstacles. The 1934 Act provides no express remedy for such a breach and the exchange requirements alone may not sustain an implied cause of action. An investor also would have difficulty proving that he was the intended third party beneficiary of the corporation's promise to disclose, as would be required under state contract law principles. Because of these barriers, rule 10b-5 provides a preferable basis for the duty to disclose. To recover for breach of the duty under rule 10b-5, a plaintiff would have to meet several strict

296. See notes 226-95 supra and accompanying text.
requirements. An injured investor is more likely to meet these established tests under rule 10b-5, however, than to convince a court to accept a new cause of action under the stock exchange rules.

The SEC, the stock exchanges, the courts, and commentators have all discussed the duty to disclose. This discussion, however, has generated strikingly little litigation. Perhaps because of the absence of litigation, many difficult questions that corporations frequently encounter and that this article has addressed remain unanswered. It would be appropriate, therefore, for the SEC to express its views on these disclosure issues through rules or guidelines, rather than to leave the answers entirely to the courts. The drafting of an appropriate rule or guideline is a particularly difficult task, however, because it involves defining a valid business purpose for nondisclosure. Nevertheless, the SEC has the responsibility of interpreting duties imposed by the securities laws and can provide more guidance and notice to businesses regarding proper conduct by establishing rules and guidelines than by instituting enforcement actions.

The duty to disclose will not be a panacea for investors. It will not produce large amounts of previously undisclosed information. By making disclosure more timely and the disclosed information more comprehensible, however, it will improve the process of providing material information to investors. Finally, this duty to disclose is consistent with the efforts of those concerned with improving the present disclosure system, and is consonant with the underlying policies of the federal securities laws.

---

297. See notes 16 & 18 supra.

298. The SEC has traditionally shied away from defining certain types of frauds in a manner that would specify the full range of prohibited conduct without encompassing legitimate activity. Cohen, Book Review, 35 U. Chi. L. Rev. 399, 406 (1968). In SEC v. Texas Gulf Sulphur Co., the court suggested that the SEC adopt a rule dealing with the permissible timing of insider transactions after disclosure, a suggestion upon which the SEC has not acted. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854 n.18 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969). But see ALI, FED. SEC. CODE § 265 (Proposed Official Draft, Mar. 15, 1978) (definition of "generally available"—fact that has been publicly disclosed for at least one week).