WACHTELL, LIPTON, ROSEN & KATZ September 20, 1976

To Our Clients

Discussions With Securities Analysts;
The Bausch & Lomb Decision.

Last week's Bausch & Lomb decision (SEC v. Bausch & Lomb, Inc., 73 Civ. 2458, S.D.N.Y. September 16, 1976), has great significance for securities analysts and public companies. It is the first case that sanctions specifically the role of the securities analyst in the financial community. In addition, Bausch & Lomb approved the "mosaic" theory (a company may talk to an individual analyst about the general business of the company and out of such general discussion the analyst may extract bits which would not be significant to the ordinary investor but from which the analyst builds a mosaic on which he bases an investment decision); rejected the negligence standard for establishing a Rule 10b-5 violation in an SEC injunction action and applied the scienter (intent to defraud) requirement; limited Rule 10b-5 tipping violations to cases where the tippee uses the inside information in his trading decision rather than merely possesses the inside information at the time he trades; held that materiality must be determined in light of the total mix of information generally available and followed the growing weight of authority that the SEC is not entitled to an injunction unless it has proved not only the past violation, but also that it is likely that the defendant will commit future violations.

Perhaps the most significant aspect of Bausch & Lomb is that it demonstrates that it is possible to defend successfully an SEC Rule 10b-5 injunction action. In recent years the reach of Rule 10b-5 has been extended dramatically on the foundation of a few court decisions and a plethora of consent decrees. Embarrassment and expense have combined to induce consent decrees in the vast majority of Rule 10b-5 disclosure cases. These unlitigated consent dispositions have been viewed as precedents and have formed the bases for even more expansive interpretations of Rule 10b-5 -- all without judicial sanction.

The most pernicious expansion of Rule 10b-5 was the concept that mere negligence was sufficient to establish a fraud violation -- that someone who was careless could be found guilty of fraud. Indeed, the Second Circuit expressly adopted the negligence standard in SEC v. Spectrum, Ltd., 489 F.2d 535 (2d Cir. 1973), although the facts of the case showed far more than negligence. The equation of fraud

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and negligence has resulted in undue embarrassment -- indeed terror -- for many accountants, lawyers, investment bankers and corporate officers who in the honest and well meaning performance of their daily routines slipped unintentionally and found that they were charged by the SEC with fraud. The essence of Judge Ward's decision in Bausch & Lomb is his perceptive recognition that the Chairman of the Board of Bausch & Lomb, in reacting to the intense analyst interest in the company and erroneous estimates of earnings, was not tipping but responding in what he thought to be an honest and fair manner -- albeit in retrospect far from perfect.

Judge Ward's well reasoned and well written opinion builds on the Supreme Court decisions earlier this year in Ernst & Ernst v. Hochfelder, 96 S. Ct. 1375 (1976), and TSC Indus., Inc. v. Northway, Inc., 96 S. Ct. 2126 (1976). Before Hochfelder and Northway, the negligence standard for fraud and the concept that a fact which might influence an investor was material threatened the very sinews of our corporate and financial system. Fear of liability and embarrassment had a tremendous adverse impact on the desire to be innovative and venturesome in business and financial matters. Accountants, lawyers and investment bankers often found themselves more concerned with questions of their own liabilities than the vindication of their clients interests. Fortunately, the Supreme Court recognized the problem. In Hochfelder the Court showed the way back from negligence to real intent to defraud. In Northway the Court made it clear that to be material a fact must have actual significance in the investment decision of a reasonable investor: "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information available."

In early 1972 Bausch & Lomb was a hot institutional stock based on the 1971 introduction of Softlens. Bausch & Lomb was closely followed by a large number of analysts. Bausch & Lomb did not play the analyst game and was generally not forthcoming in conversations with analysts. Bausch & Lomb did not issue earnings projections.

In March 1972 there was intense analyst interest in Bausch & Lomb. There had been a number of stories in the press about Softlens quality control problems, possible adverse FDA action and the possibility of competition from other manufacturers. At the end of February a major brokerage house withdrew its buy recommendation on the basis of such concerns.

In mid-March, Schuman, Chairman of the Board of Bausch & Lomb, met separately over a period of two to three days with the analysts who followed Bausch & Lomb. Schuman discussed the Softlens problems and indicated that Bausch & Lomb had revised downward its sales and earnings projections. In these interviews Schuman did not give any specific earnings estimate for the first quarter or the year, but did indicate that certain previously published estimates by analysts were too high.

Late in the afternoon of March 15, there was a public announcement by a major company that it would compete with Bausch & Lomb in the Softlens business. This announcement caused one institutional investor to sell 100,000 shares early in the morning on March 16.

Prior to March 16, MacCallum, a leading analyst, had concluded that Bausch & Lomb sales would not be as large as previously expected and had been revising downward his estimate of Bausch & Lomb first quarter earnings. MacCallum had decided to withdraw his buy recommendation, but determined to not do so until after a meeting with Schuman on March 16. The court described the meeting as follows:

> "The SEC asserts that Schuman violated §10(b) and Rule 10b-5 during his March 16 interview with MacCallum through disclosures substantially similar to those alleged in regard to [an earlier analyst] meeting; delays in the introduction of the aphakic lens and the minikit, a reduction of Softlens sales, and earnings estimates. A review of the testimony of both participants gives the impression of a very knowledgeable analyst having undertaken considerable research and having subsequently formulated certain opinions which he sought to verify in his discussion with Schuman. On the other hand, Schuman appears to have attempted to candidly discuss that which was general knowledge among those in the investment community who followed BOL stock while parrying efforts to lure him into forbidden territory. Evidence that Schuman overstepped the bounds of proper disclosure in his March 16 interview with MacCallum was not conclusive.
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> "As in the [analyst] meeting of the previous day, the materiality of a delay in the introduction of the aphakic lens and the minikit was not established. MacCallum testified that the time of their introduction was not significant to him in his analysis of the company. The Commission did not prove that any

> earnings estimates for BOL's traditional lines were released but even had they been, their materiality, in light of investor fixation on Softlens, would be doubtful. It was apparent from the testimony of both participants that Schuman did not reveal earnings figures the morning of March 16."

After leaving Schuman, MacCallum called his firm and said that he was reducing his first quarter earnings estimate from $.90 to $.60-.70 and his full year earnings estimate from $6 to $4 and that he was withdrawing his buy recommendation. This information was disseminated to the firm's customers and sales were made as a result thereof.

There was intense reaction in the street to the MacCallum buy withdrawal and first quarter estimate. Schuman was deluged with calls. After checking with the financial officers of Bausch & Lomb, Schuman called MacCallum and told him that Bausch & Lomb was estimating $.65-.75 for the first quarter. Shortly thereafter, Schuman gave the same information to a number of other analysts and then to a columnist for the Wall Street Journal. No press release was issued. One investor, Campbell, sold 3,000 shares after sepaking to MacCallum on March 16 after Schuman told MacCallum of the Bausch & Lomb estimate of $.65-.75. No evidence was introduced as to the reason for Campbell's sale. "Campbell himself did not testify although listed among plaintiff's witnesses; nor was his deposition introduced. It would not be unreasonable to infer that Campbell sold on the strength of MacCallum's appraisal independent of Schuman's disclosure or, quite as likely, that his sale was motivated by the entire mix of factors then present."

Neither Schuman nor any other Bausch & Lomb officer sold any shares during the period in question. The court found that Schuman acted in good faith and in what Schuman thought to be a proper manner on the afternoon of March 16 when he issued the earnings estimate in response to the reaction to the MacCallum's estimate and buy withdrawal.

Judge Ward recognized that the case was crucial to the everyday functions of securities analysts. Acknowledging the utility of the profession, he set forth general principles which will be cited as the legal charter of the analysts profession:

"At the heart of this controversy is a question of the permissible scope of communications between a corporate officer and securities analysts. Analysts provide a needed service in culling and sifting available data, viewing it in light of their own knowledge of a particular industry and ultimately furnishing a distilled product in the form of reports. These analyses can then be used by both the ordinary investor and by the professional investment adviser as a basis for the decision to buy or sell a given stock. The data available to the analyst - his raw material - comes in part from published sources but must also come from communication with management."

Thus, after summarizing the general understanding as to the permissible scope of analyst activities based on statements by SEC officials, Judge Ward rejected the SEC argument that such statements could not be relied upon and restated the understanding as follows:

". . . In the absence of official pronouncements on a topic of considerable concern, however, it ill behooves the Commission which often rightly seeks to impose liability on agency principles, to assert that remarks made by its 'insiders' will not bear on how individuals attempt to conform their conduct to the law.

"The available guidance, scanty as it was, suggested that corporate officials should conduct themselves reasonably and that this standard would permit general discussion out of which a skilled analyst could extract pieces of a jigsaw puzzle which would not be significant to the ordinary investor by which the analyst could add to his own fund of knowledge and use toward constructing his ultimate judgment. Discussions with analysts regarding earnings prospects, trends in products, operating conditions, and the implications on earnings of a particular volume of business were approved. Responses to 'ball park' estimates were deemed proper. This, of course, assumed management was, 'not trying to give their stock a little jiggle,' and did not 'go overboard'."

Bausch & Lomb does hold that a specific earnings estimate is material. Thus, the Schuman conversation with MacCallum, followed by the MacCallum conversation with Campbell, followed by the Campbell sale of 3,000 shares would have violated Rule 10b-5 if it had been shown that the Schuman disclosure caused the sale. The court rejected the possession theory advanced by the SEC and held that the disclosure must have been used in making the trading decision.

> "For purposes of an SEC enforcement proceeding seeking injunctive relief, the elements of a Rule 10b-5 violation include disclosure of material, nonpublic corporate information and a connection between this disclosure and the purchase or sale of a security. See SEC v. Lum's, Inc., 365 F. Supp. 1046, 1060-61 (S.D.N.Y. 1973). . . ."

With respect to the basic issue of materiality and the permissible scope of an analyst interview, Bausch & Lomb may be said to hold that short of specific earnings estimates or specific information as to mineral discoveries, major write-offs and similar matters, there is no limitation on a good faith interview. The court said:

> ". . . MacCallum's decision to withdraw his 'buy' recommendation, according to his testimony, was formulated prior to his trip to Rochester. No fact relayed to him by Schuman changed his opinion of the stock. In sum, the purported tippee reaction following the . . . interviews does not lead to a finding of materiality.
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> "Viewing the 'total mix' of available information, this Court finds that the SEC has not established that Schuman violated §10(b) and Rule 10b-5 in the course of the interviews of March 15 and 16. What information he did convey did not constitute anything beyond 'link[s] in a chain of analytical information'. . . ."

The Bausch & Lomb decision returns the law applicable to corporate disclosure and investment research and analysis to where it was thought to be prior to its recent unwarranted and unsubstantiated expansion. The extreme precautions adopted by some corporations and securities firms have been shown to be unnecessary and the decision should have a very salutary effect on corporate disclosure.

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