St. John's Law Review

Volume 49, Winter 1975, Number 2 Article 19

Rule 10b-5--Expanding Insider Liability (Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.)

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RULE 10b-5 — EXPANDING INSIDER LIABILITY

Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.

The liability of corporate insiders[1] for violations of federal securities laws has recently come under close scrutiny by the Second Circuit. In a decision of far-reaching importance, *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[2] the court held that recipients of inside information (tippees) who buy or sell securities without disclosure of the information can be held liable under rule 10b-5[3] in a private action for damages brought by persons trading in the stock over a national securities exchange. Judge Timbers, writing for the unanimous panel, also ruled that the tippers of the information can be held accountable even though they themselves did not trade in the security. Moreover, the *Shapiro* court made fundamental changes in the elements necessary to establish a private cause of action for securities fraud. *Shapiro* substantially eliminates the requirement of privity[4] and provides that the requisite showing of causation may be satisfied by proof of the materiality of the inside information.

Historically, insider trading in the public securities markets has been viewed with disapproval.[5] The insider, with his unique possession

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1 The term "insider" has been defined as anyone who has a "relationship giving access" to inside information. Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961). In Ross v. Licht, 263 F. Supp. 395, 410 (S.D.N.Y. 1967), this definition was held to include outside "tippees." This view of the corporate insider gained recognition by the Second Circuit in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), when it imposed the insider's duty upon "anyone in possession of material inside information." *Id.*

2 495 F.2d 228 (2d Cir. 1974).

3 Rule 10b-5, 17 C.F.R. § 240.10b-5 (1974), was promulgated by the Securities and Exchange Commission pursuant to authority granted in section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1974). 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 a 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.

17 C.F.R. § 240.10b-5 (1974).

4 *See* notes 30 & 33 and accompanying text *infra*.

5 *See* 2 L. LOSS, SECURITIES REGULATIONS 1037 (2d ed. 1961), where special mention is made of the 1934 report of the Senate Banking and Currency Committee, which condemned the practice of insider trading:

> Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential

of confidential information, is able to trade with foreknowledge of such corporate developments as pending mergers, technological breakthroughs, or earnings forecasts. Such conduct threatens investor confidence in the integrity of the securities marketplace by permitting a privileged few to profit at the expense of the uninformed public.[6]

Section 10(b) of the Securities Exchange Act of 1934[7] was enacted by Congress in an attempt to curb these unscrupulous practices. The section confers upon the SEC broad power to regulate the purchase and sale of securities.[8] Rule 10b-5, adopted in pursuance of this authority, makes it unlawful (1) to employ a scheme to defraud; (2) to make false statements of, or fail to disclose, material facts; or (3) to engage in any other act which would operate as a fraud in connection with the purchase or sale of a security.[9] Judicial recognition of the remedial intent underlying both section 10(b) and rule 10b-5 has resulted in a broadening of the scope of these provisions, making them effective weapons against insider trading.[10]

> information which came to them in such positions, to aid them in their market activities.

Id., citing COMMITTEE ON BANKING & CURRENCY, STOCK EXCHANGE PRACTICES, S. REP. No. 1455, 73d Cong., 2d Sess. 55 (1934). The Second Circuit has recognized that "Congress was concerned about the plight of the average public investor who is at serious disadvantage in dealing with persons possessing superior knowledge, skill and resources." Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341, 357 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973).

6 The deterrence of such insider trading has been recognized by the Second Circuit as a primary aim of rule 10b-5: "The essential purpose of rule 10b-5, as we have stated time and again, is to prevent corporate insiders and their tippees from taking unfair advantage of the uninformed outsiders." Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876, 890 (2d Cir. 1972). If 10b-5 performs its intended function, "all investors trading on impersonal exchanges [will] have relatively equal access to material information. . . ." SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). *See generally* Comment, *Fashioning a Lid for Pandora's Box: A Legitimate Role for Rule 10b-5 in Private Actions Against Insider Trading on a National Stock Exchange*, 16 U.C.L.A.L. REV. 404 (1969). *See also* Comment, *Insider Trading Without Disclosure — Theory of Liability*, 28 OHIO ST. L.J. 472, 477-79 (1967).

7 15 U.S.C. § 78j(b) (1970):

> 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 —
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> . . . .
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> (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.

8 *See id.*

9 *See* note 3 *supra*.

10 In *Shapiro* the Second Circuit noted that

> it is important to bear in mind that "Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed 'not technically and restrictively, but flexibly to effectuate its remedial purposes.'"

495 F.2d at 235, *quoting* Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972). For an excellent discussion of current developments in the area of rule 10b-5, see Note,

Although neither section 10(b) nor rule 10b-5 explicitly provides a private remedy, the courts have long recognized a private cause of action to enforce the provisions.[11] Because the private 10b-5 action is a creature of the courts, there has been considerable confusion as to requisite elements of the action. Courts have at various times incorporated the tests employed in common law fraud, including privity, misrepresentation, materiality, scienter, reliance, and causation.[12] The *Shapiro* court was thus confronted with the task of defining the nature and the scope of the cause of action.

In 1966, Merrill Lynch, in its posture as prospective managing underwriter of a Douglas Aircraft debenture issue, became privy to material inside information concerning Douglas' projected earnings.[13] This information indicated a significant downward adjustment in Douglas' estimated future profits. Merrill Lynch divulged this information to several of its major clients, the majority of whom were institutional investors.[14] The Merrill Lynch customers sold over 165,000 Douglas shares on the New York Stock Exchange within a four-day period preceding public disclosure of the information. As a result, the selling tippees were able to minimize their losses on the Douglas stock, and Merrill Lynch received brokerage commissions on the transactions.[15] The uninformed investing public sustained substantial losses.[16]

SEC Rule 10b-5: A Recent Profile, 13 WM. & MARY L. REV. 860 (1972) [hereinafter cited as *Recent Profile*]. *See also* Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?* 57 NW. U.L. REV. 627 (1963).

11 *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971), wherein Justice Douglas commented that "[i]t is now established that a private right of action is implied under 10b." The cause of action was first recognized in Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946). The court in Astor v. Texas Gulf Sulphur Co., 306 F. Supp. 1333 (S.D.N.Y. 1969), summarized the rationale for judicial recognition of a private action as follows:

> This private right of action is predicated on the grounds (1) that a person injured by a violation of a statute enacted for his benefit is entitled to sue on his own behalf and recover his damages . . . (2) that the aims of the 1934 Act require that the investing public be completely and effectively protected . . . and "it is for the federal courts 'to adjust their remedies so as to grant the necessary relief' where federally secured rights are invaded."

Id. at 1340, *quoting* J.I. Case Co. v. Borak, 377 U.S. 426, 433 (1964).

12 *See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 353 F. Supp. 264, 270 (S.D.N.Y. 1972) (Tenney, J.), *aff'd,* 495 F.2d 228 (2d Cir. 1974); *Recent Profile, supra* note 10, at 860. *Cf.* Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1291 (2d Cir. 1969) (Kaufman, J.), *cert. denied,* 397 U.S. 913 (1970).

13 495 F.2d at 231-32. The information disclosed that Douglas would report substantially lower income for the first six months of 1966 than it had for that year's first five months and that Douglas had sharply reduced its estimate of earnings for the full 1966 and 1967 fiscal years. *Id.* at 232.

14 *Id.*

15 *Id.* In addition to its commissions, Merrill Lynch also received "give-ups," shares of the commissions of other brokers who executed orders for the defendants. *Id.*

16 495 F.2d at 233. In SEC administrative proceedings precipitated by these transac-

The plaintiffs, five individuals who had purchased Douglas stock in the open market during the period of nondisclosure, brought an action for damages against both Merrill Lynch and the beneficiaries of the Merrill Lynch tip.[17] The district court denied defendants' motion to dismiss for failure to state a claim[18] and an appeal was taken to the Second Circuit.[19]

In affirming the district court's decision, the Second Circuit applied the "disclose or abstain" rule announced in *SEC v. Texas Gulf Sulphur Co.*[20] In *Texas Gulf Sulphur,* an SEC-enforcement action,[21] it was held that an insider must either abstain from trading in the securi-

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tions, Merrill Lynch's New York institutional sales office was suspended for 15 days and the tippees were ordered censured by the SEC. *Id.* at n.9.

17 *Id.* at 232-33. Only one of the five plaintiffs had actually purchased Douglas stock before the information was made public. Nonetheless, the defendants' motion to dismiss as to the other four plaintiffs was denied by the district court on the ground that the record did not establish at what time full disclosure was effected. The district court indicated that conceivably the press release could have been issued one minute prior to the opening of the Exchange and the plaintiffs could have placed their orders one minute after the opening. In such case, reasoned the court, full disclosure would not have been achieved. 353 F. Supp. at 279-80.

18 353 F. Supp. 264 (S.D.N.Y. 1972). In the district court, Judge Tenney denied the defendants' motion for judgment on the pleadings. He held that Merrill Lynch violated a duty owed the plaintiffs by furtively disclosing material information to its customers, the selling defendants. The selling defendants, in turn, violated their duty to the plaintiffs by selling the Douglas stock without disclosing the material inside information. *Id.* at 275-79. It was ruled that the conduct of all the defendants, as pleaded in the complaint, stated a claim for which relief could be granted under section 10(b) and rule 10b-5. *Id.* at 280.

19 Appeal was taken pursuant to 28 U.S.C. § 1292(b) (1970), despite the interlocutory nature of the district court's order. Section 1292(b) permits a district judge to certify to the court of appeals interlocutory orders involving controlling issues of law. The appellate court may then, in its discretion, accept the appeal. Judge Tenney amended his original order to provide for the requisite certification. 495 F.2d at 234.

20 401 F.2d 833 (2d Cir. 1968) (en banc) (Waterman, J.), *cert. denied,* 394 U.S. 976 (1969). The court held that

> anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it . . . must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.

Id. at 848.

21 The SEC brought an action in the district court against Texas Gulf Sulphur Co. and a number of its officers, directors and employees, seeking to enjoin the allegedly violative conduct and to compel rescission by individual defendants of their illegal securities transactions. *Id.* at 839. Having determined the issue of liability, the Second Circuit remanded to the district court to decide the appropriate relief. The SEC sought to divest each of the individual defendants of profits realized on the illegal transactions. SEC v. Texas Gulf Sulphur Co., 312 F. Supp. 77, 93, *aff'd in part and rev'd in part,* 446 F.2d 1301 (2d Cir.), *cert. denied,* 404 U.S. 1005 (1971). The court granted the requested relief and held that funds thus accruing would be held in escrow for a three-year period, subject to disposition by the court upon application of the SEC or other interested party. Upon the expiration of such period, the remaining funds would inure to Texas Gulf Sulphur. *Id.* at 93. The other defendants were enjoined from exercising illegally obtained stock options. *Id.* at 98.

ties concerned while the inside information remains undisclosed, or must himself disclose it to the investing public.[22]

The *Shapiro* court held that a violation of this "disclose or abstain" rule can subject the insiders to a private action for damages.[23] Moreover, the definition of insider was expanded to include tippees, *i.e.*, the recipients of inside information.[24] In reaching this decision, the court relied heavily upon dicta in the *Texas Gulf Sulphur* opinion. In that case, Judge Waterman declared the tippee's conduct "equally reprehensible"[25] and indicated that liability for 10b-5 violations could be imposed upon "anyone in possession of material inside information."[26] *Shapiro* rejected the argument that the tippees would be unable to make an effective public disclosure of information regarding a cor-

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[22] *See* note 20 *supra*.

[23] 495 F.2d at 236:

> Although *Texas Gulf* was an SEC injunction action, the strong public policy considerations behind our "disclose or abstain" rule are equally applicable here.

Extension of the *Texas Gulf Sulphur* "disclose or abstain" rule to private actions seems appropriate in view of the purposes of the Securities Exchange Act and section 10(b) in particular. On several occasions, the Second Circuit has noted that the congressional intent in enacting section 10(b) was to protect the investing public and to secure fair dealings in securities markets by promoting full disclosure of inside information. Presumably, if material facts are made available to all, investors can make informed judgments as to their prospective transactions. *See, e.g.*, Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 793 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). The general purpose behind the Act was stated by the House Committee as follows:

> Manipulation and dishonest practices of the market place thrive upon mystery and secrecy. The disclosure of information materially important to the investors may not instantaneously be reflected in market value, but despite the intricacies of security values truth does find relatively quick acceptance on the market. That is why in many cases it is so carefully guarded. Delayed, inaccurate and misleading reports are the tools of the unconscionable market operator and recreant corporate official who speculate on inside information.

H.R. Rep. No. 1383, 73d Cong., 2d Sess. 12 (1934).

The Supreme Court has declared its intention to enforce this legislation flexibly and creatively. For example, in J. I. Case Co. v. Borak, 377 U.S. 426 (1964), the Court recognized a private remedy for violation of the SEC proxy rules promulgated pursuant to § 14a of the Securities Exchange Act, 15 U.S.C. § 78n (1970). Writing for a unanimous Court, Justice Clark stated, "[I]t is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose." *Id.* at 433. The Court has found this flexible standard appropriate in 10b-5 actions as well. *See, e.g.*, Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972); Superintendent of Ins. v. Bankers Life Cas. Co., 404 U.S. 6, 12 (1971). *See also* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963) (securities antifraud legislation to be construed "flexibly to effectuate its remedial purposes").

[24] 495 F.2d at 237-38.

[25] SEC v. Texas Gulf Sulphur Co., 401 F.2d at 833, 852-53 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). However, the tippees in *Texas Gulf* were not named as defendants in the action.

[26] *Id.* at 848.

poration with which they were not associated.[27] Judge Timbers stated that the duty is not "a naked one to disclose, but a duty to abstain from trading unless they do disclose."[28] Since the tippees knew or should have known that the information came from nonpublic sources within the corporation, their failure to refrain from trading rendered them liable in damages.[29] Moreover, this liability could be enforced by persons not in privity with the tippees. The court held that the duty to disclose or abstain ran to the benefit of all uninformed purchasers of Douglas stock during the critical time period during which the defendants alone had access to the inside information.[30]

Having determined that tippees as well as tippers can be liable in a 10b-5 action, the court was compelled to consider whether these plaintiffs were so damaged by the activities of the defendants as to entitle them to relief. The defendants argued that a lack of privity would bar recovery. It was contended that the plaintiffs could not establish that their damages were caused by acts of the defendants, since plaintiffs were not in privity with either the tippers or tippees.[31] The complainants had bought their shares of Douglas stock on the New York Stock Exchange and were unable to establish that they had purchased the actual securities that the tippers were selling.[32] While conceding that the plaintiffs must establish the existence of a causal relationship between their losses and defendants' acts, the court nevertheless held that the causation element could be satisfied without a showing of privity.[33] Plaintiffs were relieved of the duty to trace their purchases, a

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27 495 F.2d at 237-38.

28 *Id.* at 238.

29 *Id.*

30 *Id.* at 237. The court reasoned that in the context of trading on a national securities exchange, limiting the defendants' duty to disclose to those who actually purchased the shares from them would frustrate the purposes of the securities laws:

> To hold that Section 10(b) and Rule 10b-5 impose a duty to disclose material inside information only in face-to-face transactions or to the actual purchasers or sellers on an anonymous public stock exchange, would be to frustrate a major purpose of the securities laws: to insure the integrity and efficiency of the securities markets.

Id. Any attempt at matching buyers and sellers in an effort to establish privity would be virtually futile. *See* 2 BROMBERG, SECURITIES LAW: FRAUD SEC RULE 10b-5 ¶ 8.6(1) (1973). Thus, the court concluded that disclosure was a duty owed to all members of that class of stockholders who purchased the concerned stock in the open market during the period of nondisclosure. 495 F.2d at 237. *See* Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 COLUM. L. REV. 1361, 1378 (1965) [hereinafter cited as Painter].

31 495 F.2d at 239.

32 *Id.* at 236.

33 *Id.* at 239. The court indicated that the privity requirement had already been substantially weakened by other courts. *Id.* at 239, *quoting* Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 101-02 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971). *See* Astor v. Texas Gulf Sulphur Co., 306 F. Supp. 1333, 1341 (S.D.N.Y. 1969).

task that would be impossible where the trading occurred on "anonymous public stock exchanges."[34]

The court next considered whether there was a sufficient causal connection between the defendants' actions and the plaintiffs' damages. The defendants maintained that it was Douglas' poor financial condition, not the extensive insider trading, which was responsible for the drop in the price of Douglas stock.[35] Furthermore, since the plaintiffs were unaware of defendants' actions, it was argued they would have purchased their stock regardless of the 10b-5 violations.[36] Rejecting these contentions, the court ruled that the requisite element of causation was established by the mere fact that the insiders acted without disclosing "material . . . information which plaintiffs as reasonable investors might have considered important in making their decision to purchase Douglas stock."[37]

The causation requirement has had a confused and rather muddled history in the Second Circuit. This confusion has resulted in part from the fact that causation and reliance have been spoken of interchangeably.[38] The traditional test for reliance was expounded by the Second Circuit in *List v. Fashion Park, Inc.*[39]: "[T]he test of 'reliance' is whether the 'misrepresentation is a substantial factor in determining the course of conduct which results in [the] . . . loss.' "[40] The *List* court also distinguished between reliance and "materiality," both of which were held necessary elements of the plaintiff's cause of action.[41] In de-

[34] 495 F.2d at 236, 239.

[35] *Id.* at 238.

[36] *Id.* The district court in *Shapiro* commented upon the weakness of this argument:

> Plaintiffs had no knowledge of defendants' transaction and it logically follows that plaintiffs' decision to purchase Douglas stock would have been unaffected had defendants abstained from any transactions. But therein lies the fallacy of defendants' reasoning; it is not the act of trading which causes plaintiffs' injury, *it is the act of trading without disclosing material inside information which causes plaintiffs' injury.*

353 F. Supp. at 278 (emphasis in original).

[37] 495 F.2d at 238.

[38] *See, e.g.*, List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965), where the Second Circuit held that "[t]he reason for this [reliance] requirement, . . . is to certify that the conduct of the defendant actually *caused* the plaintiff's injury." *Id.* at 462 (emphasis added). *See also* Chasins v. Smith, Barney & Co., 438 F.2d. 1167, 1172 (2d Cir. 1970); Astor v. Texas Gulf Sulphur Co., 306 F. Supp. 1333, 1341 (S.D.N.Y. 1969). Professor Painter has criticized the judicial fusion of the two concepts. He argues that "[a]lthough causation and reliance are closely related, they are analytically distinct, and analysis of these problems is easier if the terms are not used interchangeably." Painter, *supra* note 30, at 1369.

[39] 340 F.2d 457 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

[40] *Id.* at 462, *quoting* RESTATEMENT OF TORTS § 546 (1938).

[41] *Id.*

The court expressly refused to discard the reliance requirement merely to facilitate the maintenance of private 10b-5 damage actions. Judge Waterman, author of the *List* opinion, commented:

termining materiality, the issue is whether " 'a reasonable man would attach importance [to the fact misrepresented] in determining his choice of action in the transaction in question.' "[42] Thus, the reliance test focuses upon the subjective considerations of the particular plaintiff, whereas the materiality determination employs the objective standards of a reasonable man. In a nondisclosure case, these "parallel" requirements will be satisfied by a showing that the plaintiff would have been induced to act differently than he did had the withheld information been made known to him.[43]

It appears that the *Shapiro* plaintiffs could have established a cause of action under the *List* test.[44] However, the *Shapiro* court went beyond *List* and, by applying the rationale of *Affiliated Ute Citizens v. United States*,[45] abandoned completely the distinction between reliance and materiality. In *Affiliated Ute*, the Supreme Court held that reliance need not be established in order to recover:

> All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.[46]

Affiliated Ute, however, involved direct transactions in which it was alleged that a class of stockholders was defrauded in a series of direct, face-to-face transactions.[47] The defendants in *Shapiro* contended that *Affiliated Ute* should be restricted to its facts. Judge Timbers, in rejecting this contention, ruled that the test of causation does not vary according to the nature of the transaction involved. Section 10(b) and

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> Assuredly, to abandon the requirement of reliance would be to facilitate outsiders' proof of insiders' fraud, and to that extent the interpretation for which plaintiff contends might advance the purposes of Rule 10b-5. But this strikes us as an inadequate reason for reading out of the rule so basic an element of tort law as the principle of causation in fact.

Id. at 463.

[42] *Id.*, *quoting* RESTATEMENT OF TORTS § 538(2)(a) (1938).

[43] *Id.* at 463. *See* Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1172 (2d Cir. 1970).

[44] Judge Timbers declared that the "causation in fact requirement is satisfied by plaintiffs' allegation that they would not have purchased Douglas stock if they had known of the information withheld by defendants." 495 F.2d at 240.

[45] 406 U.S. 128 (1972). In *Affiliated Ute*, a large number of stockholders were defrauded by the employees of a bank which was acting as their broker. The bank employees had arranged the sale of stocks without informing the shareholders of either the bank's position as market maker or the true value of the stock. *Id.* at 145-47.

[46] *Id.* at 153-54. The Supreme Court applied the rationale of Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970), to the 10b-5 situation. In *Mills*, an action arising under rule 14(a), 17 C.F.R. § 240.14(a) (1974), the Court held that a material omission from a proxy statement was sufficient to warrant inferring the existence of a relationship between the violation and injury. 396 U.S. at 384.

[47] *See* 406 U.S. at 145-47.

rule 10b-5 embody a general policy to prohibit disreputable securities practices and to maintain an honest and fair marketplace for securities, whether the transactions are "conducted face-to-face, over the counter, or on the exchanges."[48]

In sum, *Shapiro* imposes upon nontrading tippers of corporate inside information and their trading tippees a duty to disclose their secrets to the investing public if they wish to make use of the information. Absent full disclosure, insiders must abstain both from trading in the securities and from recommending that others do so. Violation of this rule is grounds for a private action for damages by all uninformed persons who purchased the stock in the open market during the period of nondisclosure. Moreover, the requirement of causation will be satisfied by proof of materiality.

Shapiro contains few novel ideas in the substantive law of 10b-5 liability. Application of the "disclose and abstain" rule to tippees was implicitly recognized by the Second Circuit in *Texas Gulf Sulphur.*[49] The abandonment of the privity requirement is in accordance with the tenor of prior case law.[50] Similarly, the modification of the causation-in-fact test is consonant with the approach taken by the Supreme Court in *Affiliated Ute.*[51] The significance of the *Shapiro* decision lies in the court's pulling together the common threads running through *Texas Gulf Sulphur, Affiliated Ute,* and other Second Circuit decisions[52] in an attempt to insure that the investing public will be able to effectively protect itself from the machinations of corporate insiders.[53] *Shapiro*

48 495 F.2d at 240, *quoting* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 847-48 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969).

49 SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969). *See* notes 20-22 *supra.* The imposition of tippee liability was foreshadowed as early as Ross v. Licht, 263 F. Supp. 395 (S.D.N.Y. 1967), where the court indicated that if defendants "were not insiders, they would seem to be 'tippees' . . . and subject to the same duty as insiders." *Id.* at 410. Thus, the imposition of tippee liability by the *Shapiro* court is no cause for surprise.

50 *See, e.g.,* Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 101 (10th Cir.), *cert. denied,* 404 U.S. 1004 (1971) ("the common law requirement of privity has all but vanished from 10b-5 proceedings"); Heit v. Weitzen, 402 F.2d 909, 913 (2d Cir. 1968), *cert. denied,* 395 U.S. 903 (1969) ("there is no necessity for contemporaneous trading in securities by insiders or by the corporation itself"); *cf.* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 860-61 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969).

51 Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972). The Court indicated that where a case involves a failure to disclose material information, "positive proof of reliance is not a prerequisite to recovery." *Id.* at 153.

52 *See, e.g.,* Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341, 354, 356-57 (2d Cir.), *cert. denied,* 414 U.S. 910 (1973); Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1171-72 (2d Cir. 1970); Globus v. Law Research Serv. Inc., 418 F.2d 1276, 1291 (2d Cir. 1969), *cert. denied,* 397 U.S. 913 (1970).

53 The Second Circuit previously indicated the need for private actions to enforce the antifraud provisions of the federal securities law in Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341, 356 (2d Cir.), *cert. denied,* 414 U.S. 910 (1973):

represents an important judicial step in the development of strong, all-inclusive protection against securities fraud.

Regrettably, the *Shapiro* court avoided venturing an opinion on the issue of damages.[54] In view of the number of potential investor-plaintiffs in a *Shapiro* situation, the holding of the court brings with it an almost boundless scope of potential liability — a liability which might well prove ruinous to even the most financially sound defendant.[55] Additionally, the 10b-5 liability in *Shapiro* is not exclusive. The same defendants might be held accountable by disgruntled stockholders in derivative suits based on common law fraud.[56] The expansion of insider liability could well prove to be a pyrrhic victory, especially in times of economic difficulty. A reasonable means for controlling the total liability of insiders must be found in order to protect both the securities industry and its clientele, the general investing public.[57]

Christopher M. McCarthy

[T]he Supreme Court, as well as other federal courts including our own, have recognized that vigorous enforcement of the federal securities laws, particularly the antifraud provisions, can be accomplished effectively only when implemented by private damage actions.

54 *See* 495 F.2d at 234, 241. The interlocutory nature of the appeal, *see* note 19 *supra*, enabled the court to avoid ruling on the issue of damages. On remand, the district court was left with the task of ascertaining the proper measure of damages. *Id.* at 241. It is unfortunate that the Second Circuit failed to provide the district court with guidance.

Professor Ruder criticizes the practice of deciding liability without fixing damages in the context of a 10b-5 action. He argues that the potential for immense damage awards should be an important factor in deciding whether to impose liability at all. Ruder, *Texas Gulf Sulphur the Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 Nw. U.L. Rev. 423, 427 (1968) [hereinafter cited as Ruder].

55 In Ruder, *supra* note 56, the author estimates the amount of damages accruing in the *Texas Gulf Sulphur* litigation. *See* text accompanying notes 20-22. If liability were imposed upon Texas Gulf Sulphur for every share traded during the period of nondisclosure, its liability, computed at the rate of $130 per share multiplied by the 3 million shares traded in this period, would be over $390 million. That total is approximately $150 million more than Texas Gulf Sulphur's then net worth. The damages in *Shapiro* would not be as extreme if calculated by the same method. Douglas stock was at a high of 90 when the defendants started selling and bottomed out about ten days later at a low of 61. 495 F.2d at 233 n.8. Thus losses to purchasers of the stock during that period could range as high as $29 per share. Since there were approximately 400,000 shares traded during this period, strict compensatory damages would be somewhere in the range of $10,000,000.

56 *See* Schein v. Chasen, 478 F.2d 817, 823 (2d Cir. 1973), *remanded on other grounds sub nom.* Lehman Bros. v. Schein, 416 U.S. 386 (1974) (tippee-broker held to be in "common enterprise" with tipper corporate director); Diamond v. Oreamuno, 24 N.Y.2d 494, 503, 248 N.E.2d 910, 915, 301 N.Y.S.2d 78, 85 (1969) (directors' breach of fiduciary duty). The *Shapiro* defendants argued that, in light of decisions authorizing derivative actions for misuse of corporate information, it was unnecessary to sustain plaintiffs' complaint in order to effectuate the congressional purpose behind section 10(b). 495 F.2d at 241 n.18. The court met this argument by noting that derivative actions are a product of state law, and therefore not uniformly available throughout the country. *Id.* Furthermore, a derivative action would do nothing to compensate defrauded investors such as the *Shapiro* plaintiffs.

57 It has been suggested that damages be measured not by traders' losses, but by the

amount that the insiders made as profits or avoided as losses. The money would be placed in a fund and distributed pro rata among the plaintiffs. These relatively small recoveries would be supplemented by awards of attorneys' fees. It is believed that this procedure would both compensate injured parties and provide an adequate deterrent against insider trading. Note, *Damages to Uninformed Traders For Insider Trading on Impersonal Exchanges,* 74 COLUM. L. REV. 299, 313 (1974). It has been further suggested that damages from the various types of actions, *e.g.*, stockholders derivative actions and private 10b-5 actions, be limited to such a fund. The private awards would be satisfied first and the balance, if any, would inure to the benefit of the corporation. *Second Circuit Note,* 48 ST. JOHN'S L. REV. 415, 424 (1973).

A more radical solution to the problem of excessive damage awards is elimination of a private cause of action under 10b-5. The goals of compensation and deterrence underlying 10b-5 might be met equally well through alternative methods of curbing insider misconduct. The SEC alone could seek injunctive and restitutory relief on behalf of defrauded traders, *see, e.g.*, SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301 (2d Cir.), *cert. denied,* 404 U.S. 1005 (1971), and compensatory relief could be limited to *Diamond* and *Schein* derivative actions, *see* note 59 *supra,* and suits based on common law fraud for direct, face-to-face transactions. Such an approach, it has been argued, might be more appropriate than permitting a plethora of compensatory suits that result in arguably haphazard, economically wasteful results. *See* Note, *Limiting the Plaintiff Class: Rule 10b-5 and the Federal Securities Code,* 72 MICH. L. REV. 1398, 1429-31 (1974).