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RULE 10b-5: THE RECODIFICATION THICKET

WILLIAM H. PAINTER*

A few years ago there appeared an article on a somewhat esoteric aspect of federal income taxation partially entitled "Draining the Serbonian Bog."¹ The title impressed me as being singularly apposite not only to a backwater of the Internal Revenue Code but to that fascinating morass of federal common law² which has grown up under that benevolent umbrella with the innocuous title of rule 10b-5.³ The rule needs no introduction; it is now part of the very air that corporation lawyers must breathe daily. Despite its seeming simplicity, thousands of words have been written in an attempt to explain its true meaning.⁴ It has been compared to a "dark horse, of dubious pedigree but very fleet of foot"⁵ and to an "unfolding chrysalis,"⁶ but such metaphors, as Cardozo once said, are suspect and should be "narrowly watched" lest they end by enslaving our thoughts.⁷ Fortunately, much of the judicial development which has been taking place in the 10b-5 area has been cautious and exploratory in what might be described as the best common-law tradition.⁸ With few exceptions, most of the opinions reflect judicial awareness of the importance of maintaining a balance between the legitimate roles of the federal and state courts in resolving disputes in the corporate area, recognizing the necessity of establishing

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¹ Whitman, Draining the Serbonian Bog: A New Approach to Corporate Separations under the 1954 Code, 81 HArv. L. Rxv. 1194 (1968). For a description see J. MILToN, PARADISE LOST Book II, lines 592-94:

A gulf profound as that Serbonian bog
Betwixt Damiata and Mount Casius old,
Where armies whole have sunk . . .


⁶ W. Painter, Federal Regulation of Insider Trading viii (1968) [hereinafter W. Painter].


⁸ See Loss, supra note 5, at 51, quoting P. Devlin, Samples of Law-Making 10 (1962):
It is not in accordance with traditional methods of judicial law-making to begin by saying how far you will go. Some cases are allowed and then others are disallowed as going too far, and the formulation of principles has to wait until that process is well advanced; and during the process the common lawyer will stop, logic or no logic, when something tells him that he has gone far enough.
some workable parameters to the 10b-5 expansion process, lest the rule, which says very little in itself, be so interpreted as to swallow up the whole field of shareholder litigation.

If it be assumed that the rule should have parameters, the controversial issues may be not only the question of where those parameters should be, i.e., whether the scope of the rule should be relatively broad or narrow, but also the question of who is to set them, i.e., whether the contours of the law in this area are best set by statutory reform, further rule-making on the administrative level, or whether we should be content with the present approach, which can only be described as judicial development on a more or less ad hoc basis, aided by the pragmatic effect of precedent as it reflects the wisdom which comes from experience.

Before discussing the possible parameters, let us then turn briefly to the question of how those parameters should be established.

**CODIFICATION, RULE-MAKING OR JUDICIAL DEVELOPMENT**

If there be a resolution to this question, it may primarily depend upon the extent to which a particular branch of the government, i.e., Congress, the SEC or the courts, can realistically be expected to exert itself to clarify the law, and the degree to which it is able to do so in an informed and dispassionate manner. To be sure, each approach has its potential difficulties. Despite whatever may be said about congressional intent, it seems fairly clear that the contours of legislation in the securities field, as well as many other less esoteric areas, are primarily set in committee meetings. Although I do not have a wealth of experience along these lines, I suspect that a bill, if it is not to be still-born, must have the enthusiastic support of the committee chairman and such other committee members as may be expected to have the expertise to understand the bill and its implications, as well as sufficient interest to attend the hearings which must be held before the bill makes its debut on the floor of either house. Perhaps of equal importance, however, is the influence of respected interested parties or groups. In the securities area, although one might hope that this would include law professors, realism dictates that primary recognition be given to the roles of the various stock exchanges, the NASD and, above all, the

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9 See, e.g., Hearings on S. 510 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency, 90th Cong., 1st Sess. (1967) (dealing with the Williams Bill, which provides for disclosure in cash tender offers and certain open market acquisitions of shares). The hearings lasted three days. Of the nine-member subcommittee only five senators attended any of the three meetings. Although Senator Williams, the subcommittee chairman, attended all three, no other senator attended more than one meeting except for Senator Bennett, who attended two meetings.
Indeed, without the latter's imprimatur, if not enthusiastic endorsement, the chances are slim that a piece of securities legislation will ever see the light of day. Thus, at the risk of some oversimplification, we might think of the congressional process as having as its principal focus the meetings and hearings of the appropriate committees, aided and abetted, as it were, by the SEC and other interested parties. This means that the major policy decisions and much of the drafting may take place outside of Congress and that general understandings, although not of course guarantees of passage, may be informally achieved even before a bill is submitted.

If this be so, then why legislate? Could not the same overall objectives be sustained by administrative rule-making, where interested parties are invited to express their views on proposed regulations which are given the requisite publicity under the safeguards of the Administrative Procedure Act? To some extent this may be true, and yet there are obviously things which Congress may do that an administrative agency such as the SEC cannot do. Without exploring the matter too deeply, it may suffice to say that the SEC cannot create civil liabilities or criminal sanctions which are not provided for in a statute. There is also considerable doubt about the SEC's power to negate or extend implied private rights, aside from exercising a legislatively delegated power to articulate a preexistent legislative intent or, in the context of section 10(b) of the Exchange Act, to define further the meaning of the phrase "manipulative or deceptive device or contrivance." Beyond this, it may of course exercise its prerogative to bring enforcement proceedings, such as the recent SEC v. Texas Gulf Sulphur Co. affair or file briefs amicus curiae in private proceedings in an attempt to elucidate for the court the proper meaning of the statute or its own rules.

Finally, there are some things which a court can do which neither

10 Id. Three law professors and a practicing attorney were invited to testify en masse and were given approximately thirty minutes for a panel-type presentation. Many of the fundamental issues, as well as some more technical suggestions, raised by the witnesses appeared to have received short shrift from the subcommittee. See 6 L. Loss, SECURITIES REGULATION 3664-65 (2d ed. 1961, Supp. 1969) [hereinafter Loss]. The testimony of representatives of the various stock exchanges and the SEC appeared to have made a greater impression.
an administrative agency nor Congress can do, at least with any measure of success. By and large these consist of settling disputes between private parties concerning their rights and liabilities in given fact situations and, to that extent, deciding what the law is as applied to a particular case. Without getting into jurisprudential niceties concerning whether judges can or do legislate, it may be enough to say that judges do play a vital role, to fill in statutory interstices and to interpret the meaning of statutes or rules in accordance with how they view the purpose or function of those statutes or rules. As far as section 10(b) of the Exchange Act or rule 10b-5 is concerned, this has turned out in practice to involve no inconsiderable amount of judicial creativity, whether viewed as mere extrapolation of the original intent of Cong-

18 See Iroquois Indus., Inc. v. Syracuse China Corp., 417 F.2d 963, 969 (2d Cir. 1969), cert. denied, 399 U.S. 909 (1970), dealing with the standing of a corporation making a tender offer to sue management of the target corporation for alleged violations of rule 10b-5. In denying standing, the court stated that it refused to overrule Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952), observing:

The Birnbaum rule recognizes the policy of Congress in enacting Section 10(b) and of the Commission in adopting Rule 10b-5, namely, the protection of defrauded purchasers and sellers. It is not the province of the courts to extend Section 10(b) to apply to transactions not intended to be covered by Congress. We do well to heed the words of Mr. Justice Black, writing for the Court in a case about another section of the 1934 Act, Blau v. Lehman, 368 U.S. 403, 413 (1962) . . . .

"Congress can and might amend [the Act] if the Commission would present to it the policy arguments it has presented to us, but we think that Congress is the proper agency to change an interpretation of the Act unbroken since its passage, if the change is to be made."

That the conduct averred in any given case may be reprehensible does not mean that a federal remedy must be furnished by judges.

Whether the above accurately characterizes the prevailing attitude of the judiciary towards rule 10b-5 is best left for the reader to determine. It should suffice to say that there is a respectable difference of opinion on the matter even among the judges of the Court of Appeals for the Second Circuit. See, e.g., SEC v. Great Am. Indus., Inc., 407 F.2d 453, 464 (2d Cir. 1969), cert. denied, 395 U.S. 920 (1969) (Moore, J., dissenting); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 870 (Moore, J., dissenting); see also Address of Mr. Justice Harlan before the Federal Bar Association, reprinted in N.Y.L.J., May 15, 1967, at 4, col. 1:

[There is an] increasing tendency to look to the federal courts to set right things which, under our governmental system, should be left for solution elsewhere. This tendency is, of course, a phenomenon of the spirit for change generated by the great social, political and economic upheavals that have followed in the wake of the two world wars. At bottom, it evinces impatience with the slowness of reform when sought through the political process and, what to many is more disturbing, skepticism as to whether our historic federal system is any longer adequate to meet the problems confronting modern American society . . . . To many this use of the federal judicial process is disquieting, for reasons that cut much deeper than mere disagreement with particular controversial decisions . . . . They wonder whether the current fast pace of constitutional change being effected through the medium of the judiciary is not making lasting inroads into the two great principles that underlie our system of government—the dividing lines between federal and state authority, and, within the federal system, the separation of governmental powers among the executive, legislative and judicial branches.

Although the above is directed primarily to judicial developments in constitutional controversies, it has been thought apposite to the 10b-5 area. See Entel v. Allen, 270 F. Supp. 60, 70 n.2 (S.D.N.Y. 1967).
gress or judicial activism of a more pronounced sort. Whatever one's philosophy concerning the desirability of judges making as well as interpreting law, it seems fairly obvious that, since neither statutes nor rules can possibly provide for all possible contingencies, courts must inevitably play a vital role in dealing with the new and unexpected. In doing so, they can hardly be passive in the sense of blindly applying black letter law to grind out results which are correct only because they supposedly reflect congressional or administrative intent. In reality the intent is only sparsely evident if evident at all. Hence judges must interpolate, extrapolate or even innovate since they must, above all, decide the case at hand one way or another and give plausible reasons for the results they reach.

This points up both the merits and the deficiencies of the case-by-case approach to problems of securities law. The greatest value, perhaps, is its flexibility and resiliency. Congress was well aware that fraud may come in an infinite variety of forms. Consequently, it made the wise policy decision of not attempting to define fraud with any degree of exclusivity, leaving that task to the Commission and, at least by implication, also to the courts. The Commission responded only in the most general terms by its promulgation of rule 10b-5, again presumably making a determination that the proper meaning of "device, scheme or artifice to defraud" could only be determined ad hoc, i.e., case-by-case. The courts have, by and large, adopted the same approach, although they have attempted, from time to time, to set a few parameters to the permissible scope of the rule.

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17 See, e.g., the remarks of Mr. Milton Freeman, one of the draftsmen of rule 10b-5, on its subsequent development, in Conference on Codification of Federal Securities Laws, 22 Bus. Law. 793, 922 (1967):

Louis [Loss] is absolutely right that I never thought that twenty-odd years later it [rule 10b-5] would be the biggest thing that had ever happened. It was intended to give the Commission power to deal with ... [fraudulent purchases of shares]. It had no relation in the Commission's contemplation to private proceedings. How it got into private proceedings was by the ingenuity of members of the private bar starting with the Kardon case [Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947)]. It has been developed by the private lawyers, the members of the Bar with the assistance or, if you don't like it, connivance of the federal judiciary, who thought this was a very fine fundamental idea and that it should be extended.

18 See Hearings Before the House Comm. on Interstate and Foreign Commerce, 79d Cong., 2d Sess. 115 (1934), wherein Mr. Thomas G. Corcoran, one of the draftsmen of the Exchange Act, described the function of section 10(b) as being in the nature of a catchall clause which says, in effect, "Thou shalt not devise any other cunning devices."

19 See Ruder, Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?, 57 NW. U.L. REV. 627 (1963) (perhaps the best investigation of the legislative history of section 10(b) and rule 10b-5).

20 See note 18 supra.

21 Perhaps the most successful parameter has been the Birnbaum rule, restricting civil actions for damages to those who have either purchased or sold securities, with the terms
A conspicuous defect of the judicial approach is its retroactivity and, to some extent, its lack of predictability. Judges commonly deal with situations which have already transpired or violations of the law which have allegedly taken place at some time in the past, although this is by no means always the case. Their decisions must, again with few exceptions, be retroactive in effect. This is also true with administrative enforcement proceedings, and yet the Commission has power to promulgate rules and regulations to clarify its interpretation of the law for future guidance. If enforcement proceedings are brought at the judicial level, such as an action for injunctive or other relief, then a court is free to adjust the remedy it gives to suit the exigencies of the particular situation. Thus, a court may decide not to grant injunctive relief or impose a similarly severe penalty if it believes that the various parties acted in good faith and in ignorance of what the law was if the case happens to be one of first impression.

From the foregoing discussion it should be apparent that a useful approach to the problem of clarifying the 10b-5 area would be to avoid a simplistic assumption that the job would best be performed only by Congress, only by the SEC or only by the courts. For one thing, the problem is too complex for such easy solutions. For another, any acceptable solution is likely to emerge only from the fullest possible use of the advantages of all three approaches — legislation, rule-making and judicial interpretation. Thus, to the extent that the area can and should be codified, new legislation is desirable; to the extent that such codification should be supplemented by administrative interpretations in the form of rules, guidelines or rulings, both of a formal and informal nature, this too should be done; and, finally, to the extent that purchase and sale being defined in a relatively broad sense. Birnbaum v. Newport Steel Co., 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952). See generally W. PAINTER 278-98; notes 92-106 and accompanying text infra. Less successful attempts have been the requirements of privity, reliance and scienter, all of which have at one time or another, been discredited as necessary ingredients to a 10b-5 action. See W. PAINTER 103-18 (privity and reliance), 154-65, 229-36 (scienter).

22 Declaratory judgments may be a good example of the exceptional case.
23 E.g., the practice of prospective overruling of prior decisions. For a collection of the authorities, see Rogers, Perspectives on Prospective Overruling, 36 U. Mo. K.C.L. Rev. 35, 36 n.5 (1967).
25 See, e.g., SEC v. Texas Gulf Sulphur Co., 312 F. Supp. 77 (S.D.N.Y. 1970), where the district court, in the proceeding on remand in the Texas Gulf case, decided not to grant injunctive relief against all but two of the individual defendants since the decision by the Court of Appeals represented "a considerable extension of the meaning of 'materiality' into new areas" and also because the court did not think that there was a reasonable likelihood of further violations. Id. at 90.
26 See W. PAINTER 395 n.20.
the area cannot or should not be closed in by a more or less rigid statutory or regulatory format, it should be left for judicial interpretation and development in the common-law tradition.

The problem then becomes one of determining which areas should be handled legislatively, which administratively and which should be left for the courts. Here, there is no easy solution, although a few things should be readily apparent. As already mentioned, certain reforms can be made only through legislation. One of the best examples of this might be the need to reconcile the statutes of limitations of the various provisions expressly imposing civil liability with the 10b-5 area, where the traditional rule has been that the courts are to follow the state statute of limitations prevailing in the forum for a similar action if it had been brought in the state courts, although the federal courts are free to apply the equitable doctrine of laches in appropriate cases. It seems to be well recognized that this aspect of rule 10b-5 has been particularly effective in subverting the more articulated scheme set forth in the Securities Act of 1933 with the undesirable result of permitting actions to be brought under rule 10b-5 when they would clearly be barred under the 1933 Act. Several approaches to the problem are possible. One of the best might be a by-product of the project now being conducted under the auspices of the American Law Institute to recodify the entire pattern of securities laws, and hopefully bring the statutory scheme under a single roof. This suggests that a single antifraud provision might be desirable, to cover the areas now dealt with in sections 11, 12(2) and 17 of the 1933 Act and sections 10(b), 15(c)(1), 18 and 29(b) of the 1934 Act. If this is done, then such a provision could have a statute of limitations which would apply to all actions based on fraud or negligent misstatements, although the period within which various types of actions could be brought might differ with the circumstances, e.g., a longer period of limitation could be prescribed for actions based on wilful misrepresentation; a shorter one for actions based on simple negligence.

Similar distinctions might also be made as to when the statute of limitations should commence to run, e.g., wilful suppression of the facts might justify an indefinite tolling of the statute or at least a rela-

27 See 3 Loss 1771.
28 Id. 1772.
29 See id. 1778; 6 Loss 3907.
31 15 U.S.C. §§ 77k, 77l(2) & 77q (1964).
32 15 U.S.C. §§ 78j(b), 78o(c)(1), 78r & 78cc(b) (1964).
tively long maximum period within which actions might be brought. This would also provide an opportunity to iron out or at least justify other differences, some slight and others not so slight now existing in the statutory pattern.

Aside from procedural problems such as statutes of limitations, jurisdiction and venue, the most baffling problems are likely to arise in various substantive areas and generally will involve the question of how wide the scope of federal regulation in the corporate area should be. In the context of the current statutory and regulatory pattern, the question has been one of setting parameters to the expansion of rule 10b-5, but recodification or reform of the regulatory framework might well extend beyond this to deal with the fundamental problem of which types of regulation and civil sanctions should be imposed federally and which areas should be left for regulation by the states. Using the experience under rule 10b-5 as a point of departure, we might consider at least three important areas: (1) insider trading, (2) liability for false or misleading press releases and other related problems of disclosure, and (3) liability for breaches of fiduciary duty. The list is probably not exhaustive but it is likely to include most of the significant problems which are now arising in the 10b-5 area.

For example, section 9(e) of the Exchange Act, 15 U.S.C. § 78i (1964), restricts actions to one year after discovery of the "facts constituting the violation" and three years "after such violation"; section 18(c) speaks of "one year after the discovery of the facts constituting the cause of action" and three years "after such cause of action accrued." 15 U.S.C. § 78r (1964). Cf. Securities Act of 1933, § 15, 15 U.S.C. § 77m (1964), which refers to "one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence." Query: whether the differences in language were intended by the draftsmen and whether they are more than distinctions without a difference? Similar variations exist in the antifraud language of the various provisions. For example, is there any appreciable difference between the meaning of "manipulative or deceptive device or contrivance" in section 10(b) and "fraudulent, deceptive, or manipulative acts or practices" in section 14(e) of the Exchange Act? 15 U.S.C. §§ 78j, 78n(e) (1964, Supp. V, 1970). See also §§ 15(c)(1) & 18(a), 15 U.S.C. §§ 78o & 78r(a) (1964). Are any of these different from rule 10b-5, which speaks of a "device, scheme or artifice to defraud" or "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"? At one point in the hearings on the Williams Bill, it was suggested that this matter should be clarified or at least that Congress should not compound the confusion by adding still further variations in language to the statute, but the suggestion was apparently thought unimportant or academic. See Hearings, supra note 9, at 140-41 (statement of Professor Painter).

Section 22(a) of the 1939 Act, 15 U.S.C. § 77v (1964), gives the federal courts concurrent jurisdiction with the state courts over civil suits based on violations of the Act. Section 27 of the 1934 Act, 15 U.S.C. § 78aa (1964), gives the federal courts exclusive jurisdiction over suits based on Exchange Act violations. In order to promote uniformity, it would seem desirable to give the federal courts exclusive jurisdiction over all antifraud type actions, regardless of whether they are based on the sale of securities, e.g., sections 12(2) and 17 of the Securities Act, or the purchase or sale of securities, e.g., section 10(b) of the Exchange Act.
INSIDER TRADING

Although there is at least one state statute which attempts to deal with this problem, most of the development in this area has taken place in the federal courts under rule 10b-5 or under the considerably narrower provisions of section 16 of the Exchange Act.\(^3\) Despite the fact that most states could be expected to follow the statutory, regulatory and case-law development which has been taking place on the federal level if they choose to handle this problem, it seems desirable, as already suggested, to continue the exclusive jurisdiction of the federal courts to deal with insider trading to the extent that it constitutes a violation of federal law. In certain respects, such as insider trading in securities of companies whose shares are listed on a national securities exchange or companies whose shares are dealt in over-the-counter but who fall within the reporting provisions of the Exchange Act, because their assets exceed $1,000,000 and they are issuers of a class of equity security held of record by 500 or more persons,\(^3\) it might be well to consider whether the federal law should make an attempt to preempt the field so that individual actions or class suits based on insider trading could not be brought on the state level even if authorized by state statutes. The question of preemption may resolve itself into more of a political issue than a legal one and yet, from a strictly legal standpoint, it seems advisable to avoid multiplicity of litigation and excessive forum shopping by restricting insider suits to the federal courts if they relate to companies whose shares are relatively widely held. The existing federal regulation of trading on the exchanges and over-the-counter as well as the obvious effect of such insider trading on interstate commerce in securities would seem to satisfy any constitutional qualms one might have about the constitutionality of preemption in this area. Other forms of insider trading, \(i.e.,\) in shares of companies which are closely held or whose securities are not widely traded, would be left for regulation by the states, although that would not prevent the same area from being regulated by the federal law as well. As previously indicated, the federal courts might be given exclusive jurisdiction of all

\(^3\) See CAL. CORPS. CODE § 25402 (West 1968). As a result of some prodding by the 1964 securities acts amendments, which extended the provisions of section 16 of the 1934 Act to include insurance companies unless trading in the securities of such companies was regulated by the states "substantially in the manner provided in section 16," all the states have adopted versions of the short-swing liability and reporting provisions prevailing on the federal level. See Securities Exchange Act of 1934, §§ 12(g)(2)(G)(iii) 15 U.S.C. §§ 78f(g)(2)(iii), (1964). The state provisions, however, are applicable only to insurance companies. For a collection of the various provisions, see 2 CCH FED. SEC. L. REP. ¶ 22,510.05, at 17,138 (1969). For background discussion, see W. CARY, POLITICS AND THE REGULATORY AGENCIES 112-17 (1967).

actions based on antifraud provisions of the federal securities laws although, except for the preempted area of listed or widely traded over-the-counter securities, this would not prevent state courts from entertaining actions based on violations of state law.

Turning now to what may be the primary problem in this area, how are we to define insider trading and what should be its consequences? This resolves itself into several component problems, i.e., the definition of the term insider, the definition of inside information or materiality and the problem of whether there should be civil liability, criminal liability or administrative sanctions of one form or another for various types of insider trading. The civil liability area in turn suggests the question of liability to whom? To supposedly injured parties, either individually or by class actions? To the company whose shares are being traded? To some other interested person, such as the SEC?

The Definition of Insider

To begin with, it can be safely assumed that the term insider should extend at least to directors, officers, major shareholders, i.e., those owning more than 10 percent of the outstanding shares, and to the issuer itself as well as to subsidiaries under its control. Any person in control of the issuer should likewise be termed an insider. Beyond this area the situation becomes unclear. Essentially the problem resolves itself into the extent to which so-called tippees should be subject to the same duties as those imposed on insiders of the more conventional variety. The strictest approach has been to declare that anyone in possession of undisclosed confidential information is subject to the same duties as any other insider regardless of the manner in which he acquired the information provided only that he knows or should know that the information has not been disclosed to the investing public. A more lenient approach is the access test, i.e., whether the person in question has a relationship to the company which amounts to “access,

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37 See rule 405, 17 C.F.R. § 230.405 (1970) for a useful definition of control: “Possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.” For further discussion, see Sommer, Who’s “In Control?”—S.E.C., 21 Bus. Law. 559 (1966).


directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone. . . "40 To illustrate the difference, suppose that a person having no relationship with a company either through share ownership or as an employee or independent contractor (such as accountant, attorney or management consultant) overhears a conversation in which sharply higher projected earnings are mentioned. Suppose, in addition, that this inadvertent tippee does not know the identity of the parties to the conversation he overhears but he assumes that the information may be accurate because the parties speak with an air of authority. May he use the information in his trading activities if he is willing to take the risk that the information may prove to be unreliable? Since he has no access to the company or to an insider, does his mere possession of inside information impose a duty not to trade? It is sometimes said that the stock market thrives on tips. If someone is willing to rely on a rumor should he be penalized if the rumor proves to be correct? To extend the prohibition against insider trading to such limits would pose a serious threat to the credibility of the rule for the very simple reason that it would at best be only selectively enforceable. Thus, despite the simplicity of the possession test, it would be better if something akin to "possession plus" were required, i.e., possession plus knowledge, actual or constructive, of company source, or knowledge that the information comes from someone in an "access" relationship to a company source, such as an officer, director, other employee, or consultant, including attorney, accountant, management consultant, investment advisor, underwriter or securities analyst. Under such a "possession plus" approach individuals falling within the foregoing categories, i.e., those with access, and their tippees would be covered by the prohibition against insider trading. The same would apply to "second-level" tippees if they have knowledge of the origin of the information, i.e., if they have "possession plus." This seems to be the widest reach which the rule should be given as a practical matter. For the most part, insider trading cases will probably continue as before to involve primarily people falling within the narrower access category, i.e., officers, directors, employees and other persons having a relationship with the company.

40 See Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961). The Texas Gulf case endorses the access approach and refers to Cady with approval and yet supplements this by the possession test. Since the latter is broader in scope this seems to make the access test redundant.
What Is Inside Information?

The resolution of this question depends upon the test which is applied to determine materiality. If facts are not material, then there is no duty to disclose before trading. As with the problem of determining who is an insider, there are several possible definitions of inside information. The two principal approaches to the question have been the reasonable investor test and the substantial market effect test. The former concerns itself with information which would be relevant to a hypothetical reasonable investor in making a decision to purchase, sell or hold securities. The latter concerns itself with the hypothetical effect which the public disclosure of the information might have on the market price of the company's securities. At first glance, the two tests do not appear to differ widely or at least there is a considerable area of overlap. Thus, information which would be relevant to a reasonable investor would be likely on disclosure to have a substantial market effect if we assume that the market price is determined by the net effect of market decisions by a multitude of investors who are, for the most part, acting fairly reasonably. Even though there may be other factors at work, e.g., general economic conditions, international uncertainties, and even though the precise effect of a particular news item may never be completely predictable, either qualitatively or quantitatively, we may yet assume that there is, more often than not, a general correspondence between what investors know (or think they know) and the way in which the market behaves.

But when it comes to choosing between the reasonable investor and substantial market effect tests for the purpose of defining materiality, there are some further difficulties. For example, if the reasonable investor test is chosen, how are we to define reasonability? The appellate court in the Texas Gulf case defined this exceedingly broadly, stating that "[t]he speculators and chartists of Wall and Bay Streets are also 'reasonable' investors entitled to the same legal protection afforded conservative traders."41 If this is to be taken literally, the reasonable investor test becomes so broad as to be nearly unworkable. Rumors and guesses, educated42 or otherwise, motivate the speculator, as well as what could only be described as the mood of the moment and crowd psychology. To impose an affirmative duty to disclose all that might be relevant to speculators, chartists and others would seem to condone if

41 401 F.2d at 849.
not encourage the type of premature release of unreliable or unripe facts which it would be wiser to withhold. In all fairness, however, the appellate court in *Texas Gulf* did go on to suggest that the test may involve what was termed a balancing, i.e., "a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity." The balancing approach may help but then again it may but further compound the confusion. Thus, we are told that we must have the *reasonable speculative investor* in mind, that we must estimate whether the news if disclosed *might* have a substantial effect on the market price of the company's securities and, finally, it is suggested that we should *balance* the indicated probability that the *event* will occur in the light of its *anticipated magnitude* when compared to the totality of the company *activity*. All of this seems highly conceptual if not impossible for the average insider to use as any sort of a practical guideline. In the final analysis, it may come down to little more than saying that materiality depends upon the facts of each case, retroactively determined by the particular court in which you happen to be sued, acting with the benefit of hindsight. Although it may be possible to develop more workable tests, such as "Would this information prompt me to risk my own funds?" this seems an even less satisfactory and highly subjective approach — something akin to "I may not know why it's material, but at least I know it when I see it!" or "You will know it in your heart if you are violating the law."

Considering all the possibilities, the most workable test may be that which emphasizes substantial market effect. This at least avoids the hypothetical and subjective problems of ascertaining what a reason-

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401 F.2d at 849.
46 See, e.g., the suggestion of former Commission Chairman Cohen:
A certain amount of uncertainty, of lack of rules, means that people have to continuously examine their own positions and make their own decisions about whether what they want to do is legal. If, in the insider area, that means that businessmen decide not to buy in borderline cases, I have to think that's all to the good.

able investor might consider relevant under the circumstances. None-
theless, the substantial market effect test itself involves problems of
prediction, i.e., how the market would be likely to behave if news were
disclosed. Even further uncertainties arise if the test is phrased in terms
of how the market might behave, as was the approach in the Texas Gulf
appellate opinion. Finally, who is to determine when a market effect
is substantial enough to justify a finding of materiality? The truth of
the matter may be that, no matter what the criterion for determining
materiality, the question is bound to involve several variables and its
resolution must depend upon value judgments about those variables,
i.e., what is substantial? What is the probability of market reaction?
But this does not mean that a workable test of materiality in terms of
market effect is of no utility. Inevitably there will be problems of
degree which can only be determined by a finder of fact. A suitable
formulation might be as follows: Information is material if its dis-
closure to the public would be reasonably likely to have a substantial
effect on the market price of the company's securities.

Some might argue that a materiality test should go beyond this
and consider evidence of the defendants' probable estimate of the im-
portance of the information as possibly reflected in their trading activi-
ties. For example, the appellate court in the Texas Gulf decision
placed considerable stress on the timing and amount of the defendants' 
purchases, including the purchase of short-term calls by those who, in
some instances, had never previously purchased calls on stock. This,
the court concluded, "virtually compels the inference that the insiders
were influenced by the drilling results." 47 The argument, sometimes
referred to as the "Cut Your Own Throat" test of materiality, 48 is
not without a certain appeal. Certainly, in an appropriate case such
as Texas Gulf, a court should be free to consider the pattern of trading
and draw its own conclusions. It might even be said that an unusual in-
flux of buy or sell orders originating from insiders or their tippees
shortly before the public disclosure of important information might
present a prima facie case of a securities law violation, subject to rebut-
tal by a convincing showing by one or more defendants that his pur-
chases were motivated by other factors. 49 On the other hand, the "Cut
Your Own Throat" approach should be restricted to situations such
as Texas Gulf where there has been an unusual trading pattern. One

47 401 F.2d at 851.
48 See A. Bromberg, supra note 4, at § 7.4(3)(h).
49 Many of the defendants in the Texas Gulf litigation introduced evidence that their
purchases were motivated by factors extrinsic to the ore discovery. See W. Painter 178-79.
The evidence was given little weight if not rejected by both the trial and appellate courts.
should not generalize that any trading by an insider prior to public disclosure of material information amounts to a violation, nor should such trading even raise a presumption of illegality if it is relatively modest in amount and is justified by good business or investment reasons. This is another instance in which only the court which decides the particular case can draw the line, i.e., between usual or permissible trading and that which is unusual and therefore suspect.

Sanctions for Insider Trading

Assuming that someone is an insider and that he makes unlawful use of inside information in his trading activities, or in tipping to others who trade, what then? Should he be civilly liable? If so to whom and for how much? Should he be held criminally responsible in some way? Or should there be some form of administrative sanction, such as an order to cease and desist or injunctive relief?

First, it may be wise to inquire why we wish to make insider trading unlawful. Is it because insider trading harms others?, i.e., Do an insider's purchases in some way injure those who wish to sell? Or is it that insider trading lessens public confidence in the

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50 See H. MANNE, INSIDER TRADING AND THE STOCK MARKET 61 (1969). For an earlier analysis, see Whitney, Section 10b-5: From Cady, Roberts to Texas Gulf: Matters of Disclosure, 21 BUS. LAW. 193 (1965); see also Comment, SEC Enforcement of Rule 10b-5 Duty to Disclose Material Information—Remedies and the Texas Gulf Sulphur Case, 65 MICH. L. REV. 944, 960 (1967). For discussion of the point, see W. PAINTER 333-55. After some painful soul searching, the author must express some doubts as to whether any harm in a strict economic sense results from insider trading in the essentially faceless context of exchange transactions or in an active over-the-counter market. Thus, there seems to be some validity to the argument that an insider's purchasing tends to drive up the market price and gives the seller a better price than he would have received if the insider had not been purchasing (with the converse benefit going to the purchaser if the insider happens to be on the selling side of the market). Although it would obviously be better for the non-insider to know what the insider knows, in which case he might not sell or buy at all at the prevailing market price, this merely indicates the desirability of disclosing material information as promptly as possible in order that the prevailing market price may reflect the facts as accurately as possible. If this could be done with 100 percent efficiency there would be no information gap between insiders and outsiders and hence little opportunity for insider trading. Obviously, however, all the relevant information cannot be publicly disclosed. See Manne, Insider Trading and the Law Professors, 23 VAND. L. REV. 547, 569-75 (1970). Furthermore, it has been recognized by both the SEC and the courts that a company may delay or withhold disclosure of material information if it has a legitimate business reason for doing so. Astor v. Texas Gulf Sulphur Co., 306 F. Supp. 1333 (S.D.N.Y. 1969) (no duty to disclose drilling results until the company had completed its program of acquiring options on surrounding land). Thus, it is arguable that since the investing public is not necessarily entitled to all the material facts at any given moment, and since the insider's trading tends, if anything, to equalize the disparity between the prevailing price and what the price would be if the information were disclosed, insider trading is, if anything, beneficial from an economic standpoint and certainly harms no one. Despite the cogency of the argument, it proceeds on a questionable assumption that an activity should be permitted unless it results in positive economic harm. Thus, it falls victim to the fallacy of focusing exclusively on economic effects and
integrity of the securities markets? Or does it perhaps tarnish the corporate image? The debate on matters such as these seems virtually endless but the argument has a way of resolving into a general (by no means universal) agreement that insider trading, whether or not it actually harms others, should be discouraged. It is simply not right although we may not be precisely sure why this is so.

If we can safely assume that insider trading should be discouraged even when it may not harm others, this may be a key to the approach which should be taken to the matter of sanctions against insider trading. More precisely, the prohibition should take the form of a deterrent and should only secondarily seek to compensate injured parties for their losses. In open market transactions where shares are actively and even heavily traded, and where, as on national securities exchanges, the actual purchasers and sellers may be unknown to one another (dealing through brokers including, in many instances, specialists or

overlooks other factors which are equally if not more important, i.e., prevailing public distaste for insiders' exploiting their privileged position to achieve personal gains and the widely held belief that executives or government officials who indulge in such activities lack integrity and are unworthy of public trust. Added to this is the possibility that, if insiders are permitted to exploit confidential information in the market place, disclosure of material information might be delayed for other than legitimate business reasons to enable the insiders to maximize their profits.

51 For a critique of this argument, see Manne, Insider Trading and the Law Professors, supra note 50, at 577. Without agreeing with Professor Manne, who characterizes the argument as the "SEC's Confidence Game," presumably because it has been popular with some SEC staff members, it might be better to state that insider trading lessens public confidence in the insiders, if not in the securities markets. And if there is loss of public confidence in the integrity of management, this is likely to lessen public enthusiasm for investing; in that sense there is likely to be a loss of confidence in the securities markets. To pursue the point further, if the investing public consisted exclusively of individuals who, like Professor Manne, were preoccupied solely with economic effects and made their investment decisions accordingly, public enthusiasm for investment would increase if it were widely known that insider trading was exerting a beneficial economic effect. The problem with this is that investors do not concern themselves exclusively with economic effects and are motivated by a wide variety of factors, many of which can only be described as irrational. Thus, a recent analyst, perhaps with tongue in cheek, has pointed out that stock market behavior tends to be more irrational than the behavior of (1) a woman, or (2) an insane woman, and can only be described as similar to the behavior of (3) a group of insane women. See generally 'A. Smith,' The Money Game 47-49 (1967). Without agreeing with the latter analysis, it is still possible to surmise that many investors will be decidedly disenthused to learn of widespread insider trading, as in the Texas Gulf Sulphur affair, and will react by saying, "[I]f that's the way they're playing it, I'll take my money elsewhere." Even if such a reaction should seem irrational to a coldly economic man, it is not without a certain wisdom of its own, i.e., "If there is insider trading then what else is going on that I don't know about? Are they rigging the market? Just what can I believe?"


53 Professor Manne characterizes this argument as little more than foot stamping. See H. MANNE, supra note 50, at 15 n.42. He overlooks the possibility that, if enough investors are upset enough to stamp their feet, i.e., to say "[I]t's just not right," such a reaction, although admittedly emotional (see note 51 supra) can nonetheless have very real economic effects.
odd-lot brokers) compensatory relief seems highly impractical even if it be assumed that someone is being injured, which itself may be a matter of considerable doubt. Thus, the emphasis here should be on deterrence. In sharp contrast, where insider trading takes place in a face-to-face context it is highly appropriate to grant compensatory relief if the damages can be measured in some suitable fashion. Such compensatory relief will in turn provide a form of deterrence against further violations. All of this is merely to say that no adequate generalizations can be made to cover all the cases. The sanction should depend on the type of trading and who, if anyone, is harmed.

Despite the infinite variations in possible fact situations, it is still possible to formulate a general approach which would be workable in most cases. If a company's shares are listed on one of the national securities exchanges or, being dealt in over-the-counter, are held of record by 500 or more persons and so are registered under section 12(g) of the Exchange Act (assuming that the company also meets the requirement of having over $1,000,000 in total assets), then the appropriate remedy in most insider trading situations would seem to be corporate recoupment of any profits realized by the violator, whether he be insider or tippee. An appropriate statutory provision to achieve this result might resemble section 16(b) of the existing statute except that liability would depend on a showing that inside information was in fact used in either a purchase or a sale (in sharp contrast to the section 16(b) approach which requires both a purchase and a sale but dispenses with any need to show the actual use of inside information).

Aside from these structural differences, the procedural approach would be similar, i.e., the corporation would have the right to sue for the profit realized by the insider or tippee and any shareholder could bring such an action on behalf of the corporation if the latter failed or refused to do so within a designated period after receipt of a demand from the shareholder. As in the section 16(b) situation, such a shareholder's suit would not be classified as derivative, despite its being brought on behalf of the corporation, and hence it would not

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54 See note 50 supra.

be subject to local impediments such as security for costs. So-called subsequent shareholders, i.e., those who acquired their shares after the transaction complained of, might also be allowed to sue, as is currently permitted in the section 16(b) area, and reasonable attorney's fees could be awarded as an added inducement. Although such purchasing of lawsuits and its tendency to perpetuate a specialized group of professional plaintiffs has been criticized, it must be admitted that, however distasteful the scheme may be, it is also a powerful deterrent to insider trading and other related abuses arising under the securities laws. This is particularly so in cases involving large, publicly held corporations whose shares are relatively widely distributed and where the vast majority of shareholders tends to be passive if not completely lethargic. Although an occasional mutual fund or other institutional investor might be expected to bring an action, many, if not most funds would hesitate to do so, perhaps in the fear that the adverse publicity might be a greater detriment to the company and the price of the shares than the potential gain the company might realize from recoupment of the profits from the insider. If the fund were thoroughly disenthused with the situation it would be more likely to dispose of its investment entirely. Thus, expediency may require that the insider trading prohibition be enforced through what the Supreme Court has recently characterized as "corporate therapeutics," i.e., by private individuals whose real interest is in receiving reimbursement for attorney's fees. As has been said, the scheme is distasteful, if not degrading, but it is nonetheless an effective deterrent.

A further question remains, however. Is it enough merely for the profits to be recouped from the insider or his tippee? If the defendant receives a tax deduction for the amount he is required to pay over, he suffers no real monetary loss, being merely deprived of his unlawful winnings. There is, of course, the unfavorable publicity which is bound to result from litigation. Several of the individual

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56 See 2 Loss 1046 n.39.
57 Id. 1051-55. For a recent holding, see Blau v. Rayette-Faberge, Inc., 389 F.2d 469 (2d Cir. 1968).
58 Professor Loss has been perhaps the most outspoken critic. See 2 Loss 1053. He suggests that the Commission might be given some enforcement powers under section 16 as an alternative solution to the problem. Id. 1053-55; see also 3 Loss 1828-29. For a contrary opinion by an equally well-informed commentator, see Cary, Book Review, 75 HARV. L. REV. 856, 861 (1962).
60 See Mitchell v. Commissioner, 428 F.2d 259 (6th Cir. 1970), restricting the deduction to a short-term capital loss where the profit was originally reported as short-term capital gain. For further discussion, see Lokken, Tax Aspects of Section 16(b) Payments, 4 GA. L. REV. 298 (1970).
defendants in the Texas Gulf Sulphur case could no doubt confirm the fact that the publicity may have been the most damaging feature of the entire affair. Nonetheless, publicity can usually be avoided by early settlement of a case. Thus, an insider might well be inclined to take his chances. If he is caught, he can voluntarily restore his winnings; if he is not caught, so much the better. There is always the very real possibility that restoration of his winnings may not be the end of the matter; he may lose his job as well if his conduct violates company policy. But this will depend upon the particular company and the insider’s relationship to it. If he is a controlling shareholder, his job is likely to be fairly secure. This suggests that recoupment of the profits may not be an adequate deterrent. It might be well then, to explore the possibility of a treble damage clause, similar to the approach used in the antitrust area. Such relief could be granted in the discretion of the court, taking into account the severity of the infraction and whether the defendant’s behavior indicated that such a deterrent was advisable to prevent similar violations in the future.61

The treble damage approach seems far more preferable to open-ended civil liability, which seems to be implicit in the current interpretations of rule 10b-5, since the potential recovery far outweighs the gravity of the offense.62 Although no case has yet to reach an open-ended liability result, the very possibility of such relief might lead to a judicial hesitancy to face the issue with candor, with a further proliferation of the already complex pattern of narrow distinctions present in the 10b-5 theology.63 This can lead only to further confusion and uncertainty. No law, whether it involves possession of drugs or

61 Cf. SEC v. Texas Gulf Sulphur Co., 312 F. Supp. 77, 90 (S.D.N.Y. 1970), where the district court, after finding (on remand of the case) that the various defendants had violated rule 10b-5, exercised its discretion not to grant injunctive relief against the company or five individual defendants since the defendants could not have anticipated the relatively wide interpretation which the Second Circuit gave to the concept of materiality, as well as the unlikelihood of further violations in view of the wide publicity which had been given to the case.


63 As one court has remarked, “the laws governing the securities market become more intricate and finely spun daily. Some engaged in the business of securities trading believe themselves to be characters from Victorian novels wandering aimlessly on treacherous moors.” H. Kook & Co. v. Scheinman, Hochstin & Trotta, Inc., 414 F.2d 93, 98 (2d Cir. 1969).
the more esoteric and perhaps more socially respectable violations involved in the securities markets, is entitled to much respect if the potential penalty far exceeds the gravity of the offense. If the law is not ignored it will only be selectively enforced. Such lack of predictability can hardly create a suitable environment in which qualified people can be persuaded to become or to remain directors. The primary point should be clear enough: the emphasis should be on deterrence rather than on compensation where insider trading takes place on the national securities exchanges or in any active over-the-counter market. The deterrence must be both commensurate with the offense and sufficient to prevent its occurrence. In short, it must be both realistic and credible. Treble damages seem to meet these requirements.

If the foregoing analysis is correct, then a useful approach to that part of the insider trading problem which concerns purchases or sales by individuals64 on the basis of inside information65 in shares of listed securities or a security registered under section 12(g) of the Exchange Act would be to provide for corporate recovery of insider trading profits, with treble damages to be granted in appropriate cases at the discretion of the court. Such relief would be the exclusive remedy for insider trading of the type described and the federal law would in this respect preempt the field,66 thereby preventing similar suits in the state courts or other actions of a compensatory nature on the federal level. The existing powers of the SEC to seek injunctive or other appropriate relief in suitable cases67 would remain unaffected.

If this type of insider trading is subjected to special statutory provisions preempting the field and restricting the remedy to corporate recovery, what should be done with other forms of insider trading? The non-preempted area would consist primarily of (1) insider trading by a corporation in its own shares, and (2) insider trading in shares of corporations held of record by 500 or fewer individuals.68

As far as the first category is concerned, corporate recovery of profits is obviously ridiculous as a deterrent since the corporation by

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64 Insiders as previously defined, see notes 37-40 and accompanying text supra.
65 See notes 41-49 and accompanying text supra.
66 See note 36 and accompanying text supra.
67 The Commission's current powers are set forth in section 21(e) of the Exchange Act, 15 U.S.C. § 78u(e) (1964). Texas Gulf Sulphur was an enforcement proceeding brought under section 21(e), seeking injunctive and other appropriate relief. The Commission should also retain administrative powers to revoke or suspend the licenses of broker-dealers for insider trading violations as well as other fraudulent or manipulative practices. See §§ 15(b)(6) & 15(c)(1), 15 U.S.C. §§ 78o(b)(5) & 78o(c)(1) (1964).
68 Or, the relatively rare case of a corporation having more than 500 shareholders but less than $1,000,000 in assets.
hypothesis has already received the profits. A more realistic approach might be to require the corporation to disgorge its profits to shareholders with whom it dealt, i.e., to those who could show privity with the corporation in its insider purchases or sales. If there are fewer than 500 shareholders such a privity requirement is not likely to be a serious obstacle since in most instances the transaction will have been negotiated on a more or less face-to-face basis. The privity requirement, as well as reliance and such other traditional 10b-5 concepts, is more troublesome where the shares are listed or actively traded. Privity in the contractual sense is unsuitable as a prerequisite for recovery in such situations, due to the difficulty of tracing buy and sell orders and the windfall character of the recovery when received by someone who did not know (or care) with whom he was dealing. The reliance concept is open to similar objections, since only by a strained interpretation of the term could it be adapted to insider trading on an exchange or active over-the-counter market. Since the purchaser or seller does not know with whom he is trading he cannot be said to rely in any realistic sense upon the other party to disclose. And, as already suggested, it may well be that he is not really harmed in an economic sense. Hence the concept of compensatory relief also seems inappropriate. Accordingly, the most effective deterrent would seem to be an action for injunctive relief which could be brought by any shareholder (regardless of privity, reliance or a showing that he held shares at the time of the transaction complained of) wherein the court could exercise its equitable powers to order any other appropriate relief, such as the assessment of punitive damages, including

69 See SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 2, at 355-56 (1963) [hereinafter SEC SPECIAL STUDY REPORT]; see also Reynolds v. Texas Gulf Sulphur Co., 309 F. Supp. 566, 569 (C.D. Utah 1970), recounting how counsel in one instance of attempted tracing, procured from the New York Stock Exchange Stock Clearing Corporation sixty-nine computer print-outs, recording approximately 3900 separate transactions, all involving lots of 100 or more shares, for a period covering only four trading days. This was only the beginning of the tracing process, however, since the records of more than 225 brokerage houses would have to be examined to determine, if possible, the identity of the actual purchasers or sellers. A final complication was introduced by the fact that many of the transactions were by odd-lot dealers, who represented more than one purchaser or seller in a single transaction involving 100 or more shares.


71 See note 50 supra.

72 See notes 56-59 and accompanying text supra.
a reasonable allowance for counsel fees, against any corporate officers responsible for the trading. Such recovery might be paid into an escrow fund, in a manner similar to that adopted by the district court in the Texas Gulf case on remand, to be held subject to claims of interested persons (including the SEC) and for disposition in such manner as the court might direct. Even if the fund were eventually to revert to the company, the main objective of deterring future violations would have been achieved. Deterrence rather than compensation of supposedly injured parties should be the keynote in these situations, as already pointed out.

If this approach were adopted, the final category, namely insider trading in shares of corporations held of record by 500 or fewer individuals, would be left as a residual area in which, it is submitted, the compensatory approach could be followed with relatively little difficulty. Transactions would tend to be face-to-face or a person would at least be likely to know with whom he was dealing. The overall approach could be more or less along the lines presently being followed by courts now operating under the aegis of rule 10b-5, although the parameters of the law could be made more specific. Thus, as already suggested, the terms insider and inside information could be defined with greater particularity. And perhaps some effort might be made to spell out the necessary qualifications of plaintiffs entitled to recover. Privity in the contractual sense might be required, since this would be relatively easy to show where the dealings were face-to-face or on a negotiated basis. It is more doubtful whether reliance or causation should be required as well. The problem here, as in the other areas discussed, is whether the insider trading rules should have as their primary objective the compensation of supposedly injured victims or whether the emphasis should be upon deterrence. It has been suggested that the latter should have the primary role and, if this is so, then it makes less sense to insist on such tort-oriented concepts as reliance and causation, especially if they might interfere with the major objective, namely, deterring insider trading in any form, whether or not others rely or are harmed in any economic sense.

When May Insiders Trade?

This is the problem of the waiting period after public disclosure of material developments during which it is supposedly unsafe for

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73 312 F. Supp. at 98-94.
74 For a good argument that rule 10b-5 may have outlived its usefulness as a compensatory device, at least in some respects, and that the tort-oriented concepts of reliance, causation, materiality and scienter should be subjected to reevaluation, see Bahlman, supra note 55, at 761-69.
insiders to purchase or sell. Although the Commission attempted to persuade the court in the Texas Gulf case to determine the length of such a period, the court declined to do so and stated that the permissible timing of insider transactions after disclosures of various sorts is one of the many areas of expertise for appropriate exercise of the SEC's rule-making power, which we hope will be utilized in the future to provide some predictability of certainty [sic] for the business community.75

The court did suggest, however, that the waiting period might be longer "where the news is of a sort which is not readily translatable into investment action."76 In other words, complex data relating to a mineral discovery might take some time for absorption and dissemination to investors whereas a simple announcement of higher earnings might justify a relatively short waiting period. Notwithstanding the soundness of this approach, it would seem to be an excessively complex task to draft a rule which would specify differing waiting periods for differing types of information in view of the wide diversity of possible items of disclosure. The predictability and certainty which the court in Texas Gulf thought to be desirable as a matter of policy can be achieved in practice only by a rule which would set forth the same waiting period for most types of information. The waiting period should therefore be long enough for the more complex forms of disclosure. Failure to meet the waiting period requirement would establish a prima facie case which could be overcome only by the insider defendant's submission of enough evidence to overcome a presumption of nondissemination. Such an approach would seem to impose little hardship on the insider. Although insiders should be encouraged to invest in their companies there is no such policy in favor of encouraging them to trade the shares, i.e., to try to beat the market. In the case of unfavorable news there is a more appealing argument in favor of permitting the insider to dispose of his investment at the earliest possible opportunity consistent with the policy of maintaining equality of treatment for him and for the investing public. This is particularly so when we include as insiders, family members, close associates and trusts to which the insider may stand in a fiduciary relationship.77

75 401 F.2d at 854 n.18.
76 Id.
It may thus seem to be unduly harsh to require the insider to "go to the rear of the line," so to speak, when most of the other investors are disposing of their shares when the bad news breaks. Since most of the situations in which this problem has been presented have involved lower earnings reports, a matter which, as the court in the Texas Gulf Sulphur case implied, is likely to be rapidly disseminated and absorbed by the investing public, it might be possible to specify a relatively short waiting period for earnings reports and a lengthier one for all other forms of material information. This would lead to relative certainty without undue complexity. If the insider considered that the waiting period was unrealistic he could assume the burden of establishing that the news had been adequately disseminated and absorbed at an earlier time, but his failure to meet the waiting period requirement would create a presumption against him.

How long should the waiting period be? For relatively complex matters, such as the drilling results in the Texas Gulf Sulphur affair, the very minimum should be one day and very possibly the period should be longer. Thus, the American Stock Exchange has suggested a period of from twenty-four to forty-eight hours after general publication of the news in a national medium. One court has even taken the view that twenty trading days should be required as a reasonable time within which all investors could be expected to evaluate fully the April 16, 1964 press release in the Texas Gulf situation. Although the latter seems to be extreme, it does point to the very real possibility that twenty-four hours may not be enough. To a large degree one must inevitably be somewhat arbitrary in these matters but it might be well to establish a waiting period of at least twenty-four hours after the information has been disclosed in a newspaper of national circulation (not the Dow Jones News Service but, for example, the New York Times or Wall Street Journal). If the news relates solely to corporate earnings, and is reported by the Dow Jones News Service, then the waiting period might be shortened to twenty-four hours after the report has appeared on the tape. In extraordinary situations extensive amounts of Penn Central shares shortly before the news of sharply lower earnings became public and prior to its filing for reorganization under section 77 of the Bankruptcy Act, 11 U.S.C. § 207 (1964). See Wall St. J., Sept. 25, 1970, at 6, cols. 2-3 (Midwest ed.).


81 It is interesting to note that in a 1966 survey by a New York public relations firm, Burson-Marsteller Associates, roughly twice as many companies considered that corporate news had been made public when it was delivered to a news service, such as Dow Jones,
where a longer period is necessary for public evaluation of the news, or where the news is itself unclear and should be particularized further, trading in the shares can always be suspended for a suitable period of time.82

**LIABILITY FOR FALSE OR MISLEADING PRESS RELEASES**

Rule 10b-5 has been used not only as an insider trading rule but also as a means of insuring an adequate and accurate flow of information to investors. In this respect, it has served as a potent supplement to the various provisions of the securities acts which expressly require disclosure or filing.83 The decisions in this area can be grouped into two general categories: (1) those which, like Texas Gulf, involve an enforcement proceeding by the Commission based on a false or misleading press release or other report and (2) an increasing number of private actions for damages brought by investors who allege that they suffered harm as a result of false or misleading press releases, reports or corporate failure to disclose material information.84 Although the outlines of rule 10b-5 are particularly unclear in this area, it appears that the developing judicial standards have been strictest in administrative enforcement proceedings. As the Texas Gulf case admirably illustrates, no scienter is required in such a proceeding to establish a violation of the rule, and lack of due diligence in preparing (or failing to issue) a press release is enough to support a cause of action.85 Similarly, since an enforcement proceeding is brought to protect the investing public generally it is not necessary to show that any particular investor has relied on the allegedly misleading press release or that economic harm has been inflicted to any appreciable extent.86 The essence of the cause of action is the failure to

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85 Rule 10b-5 is violated whenever assertions are made . . . in a manner
inform investors adequately whether or not particular investors have been adversely affected.

In private actions for damages the prerequisites for a cause of action may be more extensive, although this too is at the moment unclear from the decisions. Several courts appear to be following the suggestion in the various concurring and dissenting opinions in the *Texas Gulf* case (particularly the views of Judge Friendly) that something more than simple negligence may be required to support a private action for damages. Interestingly enough, the SEC's *Special Study of Securities Markets*, although recognizing the difficulty of regulating the wide area of corporate publicity, recommended that consideration be given to the enactment of a statute providing criminal sanctions and civil liability for

intentional or reckless dissemination by issuers or their agents, of false and misleading statements, including forecasts unwarranted by existing circumstances, which may reasonably be expected to affect investment decisions, loans, or other transactions involving the issuer’s securities.

Thus, both the decisions to date and the suggestions of the Special Study group point in the direction of imposing civil liability only for intentional or reckless behavior, gross negligence or at least something more than simple negligence, preserving the right of the SEC to bring enforcement proceedings even in simple negligence cases and without a showing of harm to particular investors.

This approach seems to be a sound one and might well form the framework for statutory codification. The primary problem in codification would seem to relate not to making explicit the SEC's existing enforcement powers but to spelling out the contours of a civil action for damages. Although the concepts of gross negligence or intentional or reckless behavior may be fairly satisfactory, difficult as they may be to apply in occasional close cases, the more troublesome problems arise in connection with determining who should be entitled to sue and the extent of potential liability.

*reasonably calculated* to influence the investing public, e.g., by means of the financial media . . . if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes.


88 SEC SPECIAL STUDY REPORT pt. 5, at 156.
First, who should be able to sue for damages based on a false or misleading press release? Although at first glance it would seem that only those who have read or at least heard of the release, i.e., those who may have relied, should be permitted to sue, it would seem that other investors might be just as severely harmed by a false or misleading press release even though they were unaware of its existence. Suppose, for example, that a company issues an unjustifiably bleak earnings report. As a result, the price of the company’s shares falls from 50 to 40. To those who bought at 50 or sold at 40 it makes little difference whether they read the release or not; the economic harm they suffer is the same. The truth of the matter is that the market has read the release and, reacting adversely, has harmed investors irrespective of whether they knew of the release or not. There are of course situations where reliance on a press release may create additional harm. Suppose, for example, that an investor alleges that he sold his shares at 40 because he was disappointed by the earnings report and that he would not otherwise have sold. If the price should later rise to 50 after the earnings have been correctly restated the investor has lost money which he would not otherwise have lost if he had not read the press release and become discouraged. However, it may be questioned whether civil recovery should be restricted to investors who can show that their buying or selling was induced by the press release. Other investors are equally harmed although they may have sold for other reasons. The critical factor is that the press release has adversely affected the market price and this would not have happened if it had not been for the defendant’s wrong. Harm to all those who sell is just as foreseeable as harm to those who have read the release. To give a further example, suppose that shares have been purchased on margin and that the fall in price leads to a margin call which the investor cannot meet because of his personal financial circumstances. His account will be sold out at the artificially low price even though he may not have read the release which caused the market to fall. Accordingly, unless we are to circumvent the cause of action with artificial limitations which are unrelated to the economic harm on which the action is presumably based, the class of eligible plaintiffs should include all investors who can show damage which is causally related to the false or misleading press release, using cause in the broad sense of effect on the market price.

The potential liability under this theory is of course considerable. However, unlike the insider trading situation, where there is some doubt as to whether investors are economically harmed by the defendant’s unlawful activities, there is, in the press release situation, the
clear possibility, if not probability, that investors will suffer economi-
cally as a result of a false or misleading release whether or not they
specifically rely on it. Even those who do not purchase or sell securities
may be harmed, although the harm is likely to be rectified once proper
disclosure has been made. Thus, civil liability should be confined to
purchasers or sellers unless the misleading situation is never clarified.
In any case, the plaintiff should be able to recover only for such loss
in value as is directly attributable to the false or misleading press re-
lease. This is on the principle that one who issues false information
should not thereby be made an insurer of any or all market declines.

The question of who is to prove causation, namely the burden
of proof in press release cases, is likely to be a decisive factor in much
of the litigation. Here, there are two possibilities. First, one could
follow the approach taken by section 11(e) of the Securities Act of 1933
and place the burden of proving lack of causation on the defendant.89
Secondly, one could place the burden of proving causation on the
plaintiff, as is done under sections 9(e) and 19(a) of the Securities Ex-
change Act of 1934.90 In view of the difficulties of proof, which may
account for the rarity of recoveries under the Exchange Act provi-
sions,91 one might be inclined to follow the 1933 Act format and place
the burden on the defendant. On the other hand, doing so might well
involve exposure to overwhelming liability, particularly if we permit
all purchasers or sellers (as the case may be) to sue rather than confine
suits merely to those who relied on the false or misleading press release.
At the risk of some complexity, a compromise between the two ap-
proaches is possible. Initially, the burden of proof could be placed
on the plaintiff. If the latter could show that he relied on the false or
misleading press release, i.e., that the press release was at least a sig-
nificant factor in bringing about his purchase or sale, then we might shift
the burden of proving lack of causation to the defendant. In effect this
would mean that those who relied would not have to show causation;

90 Id. §§ 78i(e) & 78s(a) (Supp. V, 1970).
91 See 3 Loss 1747-54. Note that section 18(a), dealing with civil liability for false or
misleading statements in applications, reports or documents filed with the SEC, limits
recovery to those who relied on the statement "not knowing that such statement was false
or misleading." As Professor Loss indicates, the SEC proposed in 1941 to delete the
requirement of proving causation in view of the difficulty of proof and the Commission's
belief that, where "a plaintiff has relied upon a false or misleading statement and has
been damaged thereby . . . it is extremely unfair to require him to prove the totally
irrelevant factor that the price was affected by the statement." Id. at 1754-55, citing SEC,
REPORT ON PROPOSALS FOR AMENDMENTS TO THE SECURITIES ACT OF 1933 AND THE SECURITIES
EXCHANGE ACT OF 1934, 77th Cong., 1st Sess. 38 (Comm. Print 1941). Although the Act
expressly requires reliance, is causation more relevant than reliance in this area?
those who did not rely but were economically harmed would have to establish that the harm resulted from the defendant's acts. Since, as has been said, harm is likely to be suffered by both categories of investors, the compromise would be justified on purely pragmatic grounds — alleviating the risk of overwhelming and disproportionate liability, rather than theoretical considerations.

It may be argued that, despite placing the burden of proof on the plaintiff in non-reliance situations, permitting all injured investors to sue regardless of their reliance might be unduly burdensome to those who may be held responsible for faulty publicity even if something more than simple negligence, e.g., gross negligence or reckless behavior which indicates indifference to the outcome, is required. On the other hand, there seems to be no legitimate policy reason for preventing injured persons from recovering damages merely because of their numbers. If anything, the social interest lies in assuring that acts which are likely to entail a risk of injury to large numbers of persons are not undertaken without at least a normal degree of care and, arguably, the standard of diligence should be higher as the risk of injury increases. Although an alternative approach to the problem might be to dispense with civil liability, except perhaps in instances of wilful misconduct, and confine relief to administrative or criminal proceedings, there seems to be no clear policy reason for preventing injured parties from recouping losses causally related to a defendant's conduct if the latter is clearly in violation of a federal statute intended to protect investors and also transcends the limits of simple negligence. No reported judicial decision under rule 10b-5 has taken the view that civil liability should not be imposed for gross negligence in connection with press releases. To delimit the scope of recovery already available under rule 10b-5 because of a fear of overwhelming liability seems to be unjustified in the absence of one or more judicial decisions which are shown to have a manifestly unfair result. Thus, the proposed recodification, with the possible exception of providing rights for persons who are injured and yet who have not expressly relied on press releases, merely restates existing principles which have been developing in the case law.

**Liability for Breaches of Fiduciary Duty**

Perhaps the most perplexing of the three major areas of rule 10b-5 jurisprudence is the extent to which the rule covers breaches of fiduciary duty. Breach of fiduciary duty is a phrase covering a multitude of sins, but at least two types have been among the most frequently litigated areas: (1) the extent to which a controlling shareholder should
be held liable for selling a controlling block of shares at a premium, and (2) the rights of a corporation which is led to sell shares to a controlling shareholder, director, officer or other insider at a grossly inadequate price, or the converse case of a purchase from any of such persons at a grossly excessive price. Before considering the two areas in greater detail, it might be well to point out the general direction in which rule 10b-5 has been developing in breach of fiduciary duty situations.

The key case continues to be *Birnbaum v. Newport Steel Corp.*, an action by a minority shareholder against a controlling shareholder for selling a controlling block of shares in Newport Steel Corporation to one of the defendants, Wilport Steel Company, which happened to be an end user of steel sold by Newport. As a result of the sale of control, Newport was thereafter unable to take advantage of certain opportunities which it otherwise would have had to improve its geographical market position and to sell steel on favorable terms to customers at a time when steel was in short supply due to the Korean War. Although in a separate proceeding the sale of control was held a breach of fiduciary duty under applicable state law, the *Birnbaum* case held that there was no right to recover under rule 10b-5, since the court construed section 10(b) of the Exchange Act as being directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs, and ... Rule X-10B-5 extended protection only to the defrauded purchaser or seller.

What the court was saying, here, was that 10b-5 covers only fraud or similar offenses "in connection with the purchase or sale of any security" and that the latter phrase restricted civil liability under the rule to those who had either purchased or sold. Although securities were of course sold in the *Birnbaum* case, neither the plaintiff minority shareholder nor the corporation on whose behalf he brought the action had purchased or sold shares. Thus, according to the court's construction of the rule and the legislative intent of section 10(b), there was no liability.

It is not necessary for our purposes to trace the subsequent history of the *Birnbaum* rule except to observe that it continues to retain a

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92 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952).
94 Id.
95 193 F.2d at 464.
remarkable degree of vitality, despite fears, or hopes of those who favor further expansion of rule 10b-5, that it had been repudiated by some of the more liberal judicial decisions towards the close of the 1960's. Although Birnbaum has been narrowed somewhat in scope it is still respectable authority with regard to private actions for damages. Thus, unless the action is one for injunctive or other equitable relief, it must be shown that the individual plaintiff has purchased or sold shares or that the corporation on whose behalf he sues was a purchaser or seller. The court's observation in Birnbaum that rule 10b-5 does not extend to actions based primarily on mismanagement of corporate affairs continues to be correct if this is thought to refer to damage actions. On the other hand, if it can be shown that the plaintiff purchased or sold shares or that the corporation on whose behalf he sues was a purchaser or seller, and that the purchase or sale was somehow related to the transaction which gave rise to the harm then there is a cause of action under 10b-5 even though there may also be a cause of action under applicable state law.

The Birnbaum case is still good authority as well on the specific question which the court dealt with, namely whether there is a cause of action under 10b-5 for a mere sale of controlling shares at a premium. Whatever may be the result under applicable state law there

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97 One of the major exceptions is where the plaintiff sues for injunctive or other equitable relief. Here, there are several holdings to the effect that neither the plaintiff nor the company on whose behalf he sues need meet the purchase or sale requirement because the action is a private enforcement proceeding. See, e.g., Britt v. The Cyril Bath Co., 417 F.2d 433 (6th Cir. 1969); Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540 (2d Cir. 1967); Federal Savs. & Loan Ins. Corp. v. Fielding, 309 F. Supp. 1146 (D. Nev. 1969). But see Berne St. Enterprises, Inc. v. American Export Isbrandtsen Co., [1969-1970 Transfer Binder] CCH Fed. Sec. L. REP. ¶ 92,711 (S.D.N.Y. July 8, 1970). The concept that a private enforcement proceeding need not meet the requirements of a damage action seems to have developed by way of analogy to enforcement proceedings brought by the SEC, such as in Texas Gulf Sulphur.


99 See note 97 supra.

100 See, e.g., Bluestein v. Friedman, [1969-1970 Transfer Binder] CCH Fed. Sec. L. REP. ¶ 92,558 (S.D.N.Y. Jan. 9, 1970) holding that there was no 10b-5 cause of action where the fraud occurred after the plaintiff had acquired his shares; see also Cooper v. Garza, 431 F.2d 578 (5th Cir. 1970); Simmons v. Wolfson, 423 F.2d 455 (6th Cir. 1970).

101 See note 98 supra.

is no cause of action for damages under the rule. This is so even if it is alleged that the seller knew or should have known that the purchaser of control intended to loot the corporation, to waste its assets or to mismanage its affairs. Some exceptions to the general rule of no recovery have been suggested where it is alleged that the controlling shareholder invited some friends and associates to participate in the opportunity to sell their shares at a premium and did not extend a similar invitation to all the shareholders or where it is alleged that the purchase of control was financed in whole or in part out of corporate funds, through a transaction whereby the corporation was led to acquire its own shares or the shares of some other entity at a grossly excessive price. This latter situation, namely the bootstrap acquisition of control, illustrates how the sale of control cases may overlap with other cases dealing with derivative suits on behalf of a corporation which has been led to acquire shares at an excessive price or to issue or sell them to controlling shareholders, officers, directors or other insiders for a grossly inadequate price.

There was a time when it was being argued that there would be no liability under rule 10b-5 in the latter situation because, it was suggested, the rule-making authority of the Commission under section 10(b) of the Exchange Act is confined to prescribing only such rules as are “necessary or appropriate in the public interest or for the protection of investors” and that the corporation, when it sells its shares, or even when it purchases them, is not an investor in the usual sense of the term. This argument was repudiated in Hooper v. Mountain States Securities Corp., and it is now well recognized that there is a derivative cause of action for either a purchase or for a sale. One


106 Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970) (purchasers of control may be liable); Herpich v. Wilder, 430 F.2d 818 (5th Cir. 1970) (sellers of control may be liable); Shell v. Hensley, 430 F.2d 819 (5th Cir. 1970).


108 E.g., Shell v. Hensley, 430 F.2d 819 (5th Cir. 1970); Rekant v. Desser, 425 F.2d 872
case suggested that there may be no cause of action unless it is shown that there is some deceit on the corporation, apparently referring to a requirement that at least some of the directors who authorized the transaction must have been misled by others, such as their fellow directors or the purchaser who failed to disclose material facts.\footnote{109} However, it now seems fairly clear that a corporation may be deceived by \textit{all} of its directors in this respect and, at least where the shares are sold to a controlling party or some other insider, there may be a cause of action if the transaction is basically unfair and its terms are not disclosed to the minority shareholders.\footnote{110} This does not mean, however, that all corporate sales or purchases of shares may give rise to 10b-5 liability merely because they are unfair. For example, where the shares are sold to or purchased from an unrelated third party who is neither an insider nor exerts any control over the board of directors, there is no cause of action under rule 10b-5,\footnote{111} although the directors may be liable under state law principles if there has been a gross abuse of business judgment.

It might be possible to codify this area to some extent. For example, it could be expressly provided that a prerequisite to bringing an action for any relief other than equitable relief would be a showing that either the plaintiff or the corporation on whose behalf he sues was a purchaser or seller of shares. Although this might be a necessary condition, it would not be sufficient in some cases, for, as we have seen, it may not be enough to show merely that a corporation has purchased or sold shares at an unfair price. It must be shown that the transaction was with a controlling shareholder or some other interested party, such as a director, officer or other insider.\footnote{112}

Since the area is obviously complex and is likely to involve a relatively more diverse pattern of fact situations than either the insider trading or press release liability areas, it might be well to forego codification in the interests of permitting the courts to develop their own guidelines. There is a definite value in what has been called the


112 Id.}
“neo-federal-common-law tradition,” particularly where it is uncertain how much of a given area the federal courts should attempt to regulate and how much should be left for the state courts. Something can be said for a greater judicial reluctance to take cognizance as a federal matter of actions based solely on breaches of fiduciary duty where there is at least a considerable body of precedent available on the state law level, unlike the situation which prevails with regard to insider trading in shares of publicly held corporations or the problem of press release liability as it affects national securities markets. Although some may argue that an attempt should be made to preempt the field in the breach of fiduciary duty area and even to consider the adoption of a Federal Corporation Law under which publicly held corporations doing a substantial amount of interstate business might incorporate, such an attempt, at least in the writer's opinion, seems to be overly ambitious if not premature. The breach of fiduciary duty field is simply too complex and diverse to lend itself readily to codification. It seems better to permit the further judicial development of the parameters of liability both at the state and the federal levels on a case-by-case basis. Where it is both uncertain what the courts should regulate and how the matter should be dealt with it is well to let the outlines of the law develop gradually through experience. This is the greatest contribution which can be made by the common law.

113 Loss, supra note 30, at 34. Although Professor Loss' remarks were directed towards a specific problem, namely the effect on corporate elections of violation of the proxy rules, his overall approach appears to indicate concern lest overcodification in the rule 10b-5 area lead to an inadequate and artificially frozen format for future regulation of the complexities which may develop and which may not be entirely foreseeable. He also agrees with Judge Friendly in his assessment of the value of case-by-case development of the law. See Friendly, supra note 2.

114 For a good discussion of the various proposals which have been made along these lines, see 1 Loss 107.