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Rule 10b-5: Notes for Legislation

A. A. Sommer, Jr.

SEC Rule 10b-5, which authorizes a judicial remedy for fraud in certain sales of securities, without providing specific guidelines for the judiciary, has become the subject of much controversy. After delineating the background and development of Rule 10b-5, Mr. Sommer addresses himself to the judicially unsolved problem of defining the scope of "insider" liability for complete non-disclosure of material facts pertaining to impersonal transactions in the organized securities markets, on the exchanges, or in the over-the-counter market. The author suggests some guidelines for uniform federal legislation that would accomplish the following: limit both the persons who shall be liable in such transactions and the extent of their liability, reduce the probability that potential plaintiffs in non-face-to-face transactions will remain unaware of and hence fail to pursue their remedy against the "insider," and, finally, a rational disposition of the recovery.

NO ISSUES in the realm of securities law are more afire today than those which pertain to Rule 10b-5¹ promulgated by the Securities and Exchange Commission in 1942 under section 10 of the Securities Exchange Act of 1934.² *Cady, Roberts & Co.*,³ with its clear indications of Commission conviction that it extended to complete non-disclosure and transactions on a securities exchange, coupled with the broadening of the concept of "insider," provoked considerable comment, much of it adverse.⁴ The severe implications of that case were quickly perceived. Then came

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¹ 17 C.F.R. § 240.10b-5 (1964).

² 48 Stat. 891, 15 U.S.C. § 78j (1964).

³ *Cady, Roberts & Co.*, SEC Securities Act Release No. 6668, CCH FED. SEC. L. REP. ¶ 76803 (Nov. 8, 1961). The facts of the *Cady, Roberts* case are fairly simple. One J. Cheever Cowdin, a registered representative of *Cady, Roberts & Co.*, a registered broker-dealer, was a director of Curtiss-Wright Corporation. On the morning of November 25, 1959, the directors of Curtiss-Wright met, among other purposes, to consider and take action upon a quarterly dividend declaration. At the meeting they decided to cut the quarterly dividend rate from the \$0.625 paid during the preceding three quarters of 1959 to \$0.375 per share. At approximately 11 a.m., the board authorized transmission of the information by telegram to the New York Stock Exchange. Through what appeared to be clerical difficulties, the telegram did not reach the Exchange until 12:29 p.m. Similarly, though the company's practice had been to advise the Dow Jones News Ticker Service of dividend action promptly, through "mistake or inadvertence" (the Commission's language) the information was not given to *The Wall Street Journal* until 11:45 a.m. and it did not go on the "broad tape" until 11:48 a.m. Meanwhile, during a recess in the directors' meeting, Cowdin called the *Cady, Roberts* office and left a message for Gintel, one of the partners, that the dividend had been cut. Upon receiving this information Gintel sold 2,000 shares of Curtiss-Wright for ten discretionary ac-

the filing of a complaint by the Commission which seemed to justify the worst fears of those who viewed *Cady, Roberts* with alarm: *SEC v. Texas Gulf Sulphur Co.*⁵

The allegations in the *Texas Gulf Sulphur* case have become too well known to require extensive recital.⁶ Suffice to say that it poses a number of unique issues for judicial — as distinguished from administrative, as in *Cady, Roberts* — determination. Among the issues are these: (1) Is complete non-disclosure actionable under rule 10b-5?⁷ (2) May the Commission assume the role of “public defender” and bring an action for the benefit of a number of would-be plaintiffs who probably had no awareness that they had a cause of action and would not have sought a remedy?⁸ (3) Assuming liability on the part of the defendants, who is to be compensated when their purchases on the New York Stock Exchange occurred on days when the number of shares sold vastly exceeded the number purchased by insiders and “tippees”?⁹ (4) May “insiders” be held liable for the gain realized by those to whom they transmitted “inside” information? (5) How shall any recovery be allocated? (6) How shall the recovery be measured?

These questions by no means exhaust the issues before the court in *Texas Gulf Sulphur*, but they indicate the huge uncharted sea upon which the Commission has asked the District Court for the Southern District of New York to embark.

counts and sold 5,000 shares short for eleven accounts. These orders were at 11:15 and 11:18 a.m., at prices in excess of \$40 a share. When the news of the dividend cut became known, trading was temporarily suspended on the Exchange. When it resumed some two hours later, the price was 36½ a share and during the remainder of the day it ranged from 34⅞ to 37 and closed at 34⅞. On these facts the Commission determined that the firm and the individuals involved had violated Rule 10b-5 under the Securities Exchange Act of 1934 and § 17 (a) of the Securities Act of 1933.

⁴ Daum & Phillips, *The Implications of Cady, Roberts*, 17 BUS. LAW. 939 (1962); Whitney, *Section 10b-5: From Cady, Roberts to Texas Gulf: Matters of Disclosure*, 21 BUS. LAW. 193 (1965); Case Note, *SEC Rule 10b-5 Invoked to Suspend Broker Who Failed to Disclose Inside Information When Selling on National Exchange*, 62 COLUM. L. REV. 735 (1962); Case Note, *New Concept of Fraud on the Securities Exchange*, 15 S.C.L.Q. 557 (1963).

⁵ CCH FED. SEC. L. REP. ¶ 91520 (S.D.N.Y. April 19, 1965).

⁶ See Kennedy & Wander, *Texas Gulf Sulphur, A Most Unusual Case*, 20 BUS. LAW. 1057 (1965).

⁷ Comment, *Civil Liability Under Section 10b and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658, 676 (1965).

⁸ Note, *Ancillary Relief in SEC Injunction Suits for Violation of Rule 10b-5*, 79 HARV. L. REV. 656 (1966).

⁹ See Whitney, *supra* note 4, at 202, where the author notes that on a day when a defendant named in the *Texas Gulf Sulphur* case bought 100 shares, 27,500 shares of that stock were traded on the New York Stock Exchange.

I. THE ORIGIN OF RULE 10b-5

It is indeed interesting, and perhaps anomalous, how rule 10b-5 has pervaded the federal securities laws as it has and driven older remedies into retreat.

The principal penalties in the Securities Act of 1933¹⁰ related to securities for which no exemption from registration and use of the statutory prospectus under section 5¹¹ was available, and which hence had to be registered and sold with appropriate use of the prospectus. Section 11 of that act¹² performed this chore, a chore it was predicted would have as one consequence the drying up of private venture capital.¹³ Section 11 introduced innovations. Where most common law actions demanded privity, section 11 did not: it extended liability to all purchasers of the registered security, namely, it permitted suit by an ultimate purchaser against an issuer even though sales by an underwriter and a dealer may have intervened; and it permitted suit against many not sellers at all. Where common law fraud demanded reliance, section 11 did not, except in a limited situation added by amendment in 1934.¹⁴ Where common law fraud demanded some element of *scienter*, section 11 surely did not as to the issuer, who became in effect an insurer of the accuracy and completeness of its registration statement. Section 11 also placed the burden of proving lack of knowledge and use of appropriate care upon other possible defendants (directors, officers who signed the registration statement, experts, underwriters, and, via section 15,¹⁵ controlling persons). Where common law fraud generally required that there be some false statement, section 11 made a complete non-disclosure — albeit only a non-disclosure of a fact “required” to be included in the registration statement — actionable. Where common law fraud was triable in federal court upon a proper showing of diversity — but in every instance after *Erie R.R. v. Tompkins*¹⁶ in accordance with the applicable state law — section 11 and section 22¹⁷ made violations of section 11

¹⁰ 48 Stat. 74 (1933), as amended, 15 U.S.C. §§ 77a-aa (1964).

¹¹ 48 Stat. 77 (1933), as amended, 15 U.S.C. § 77e (1964).

¹² 48 Stat. 82 (1933), as amended, 15 U.S.C. § 77k (1964).

¹³ DE BEDTS, *THE NEW DEAL'S SEC: THE FORMATIVE YEARS* 38, 50-52 (1964); Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 40 (1959).

¹⁴ 48 Stat. 82 (1933), as amended, 15 U.S.C. § 77k (1964).

¹⁵ 48 Stat. 84 (1933), as amended, 15 U.S.C. § 77o (1964).

¹⁶ 304 U.S. 64 (1938).

¹⁷ 48 Stat. 86 (1933), as amended, 15 U.S.C. § 77v (1964).

matters within the jurisdiction of federal courts, regardless of diversity. Section 11 established a new rule of damages for violations which departed from common law concepts.

In short, section 11 defined with reasonable exactness the nature and limits of liability of fraudulent or negligent issuers, "insiders," and experts, the identity of those liable, and many other specifics, such as security for costs, as to *registered* securities. Section 13 of the Act¹⁸ stated a relatively short statute of limitations for actions under section 11: suit had to be brought within one year after discovery of the untrue statement or omission, or after discovery should have been made by the exercise of reasonable diligence, but in any event not later than three years after the security was bona fide offered to the public. The departures from common law fraud concepts were ill-received by many and much criticized.¹⁹

The Securities Act of 1933 did more: through the medium of section 12(2)²⁰ it established liability in connection with the *sale* of *any* security (whether registered or required to be registered or not) through the use of the mails or other instrument of transportation or communication in interstate commerce. The elements of the cause of action under section 12(2) were as follows: (1) a use of the mails or other means of interstate transportation or communication in connection with the transaction (litigation has clearly established that such means need not be used to transmit the material misstatement or misleading communication itself);²¹ (2) a misstatement of a material fact or an omission to state a material fact "necessary in order to make the statements in the light of the circumstances under which they were made not misleading"; (3) the bringing of the action within the prescribed limitation period; and (4) lack of knowledge on the part of the plaintiff of the actionable untruth or omission.

Section 13 also established a statute of limitations for section 12(2) offenses — the same one year after discovery of the untrue statement or omission or after discovery should have been made by the exercise of reasonable diligence as applied to section 11 violations; but in the case of section 12(2) the final cut-off was three

¹⁸ 48 Stat. 84 (1933), as amended, 15 U.S.C. § 77m (1964).

¹⁹ DE BEDTS, *op. cit. supra* note 13; Landis, *supra* note 13.

²⁰ 48 Stat. 84 (1933), as amended, 15 U.S.C. § 77l(2) (1964).

²¹ MacClain v. Bules, 275 F.2d 431 (8th Cir. 1960); Blackwell v. Bentsen, 203 F.2d 690 (5th Cir.), *cert. granted*, 346 U.S. 908 (1953), *cert. dismissed per curiam*, 347 U.S. 925 (1954).

years after the sale. Section 15 made controlling persons of a violator of section 12(2) jointly and severally liable with the violator, as it did with respect to violators of section 11.

Section 17 of the 1933 Act²² made it "unlawful" *in the offer or sale* of securities by mail or interstate means:

- (1) to employ any device, scheme, or artifice to defraud, or
- (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Be it noted that, unlike sections 11 and 12(2), section 17(a) does not have built-in rules related to civil liability, and it is explicit that section 15 establishing controlling person liability does not apply to section 17.

Through these means Congress established the first federal statutory scheme with respect to the offering and sale of securities in general. It made decisions with respect to the need for privity; it dealt with the problem of scienter; it established statutes of limitation; it established in the case of sections 11 and 12(2) measures of recovery; and it determined in section 11 cases rules for requiring security for costs.

In 1942, against this background of detailed legislation pertaining to fraud and fraud-like offerings and sales of securities, the Securities and Exchange Commission adopted Rule 10b-5 under the authority given it under section 10 of the Securities Exchange Act²³ which said:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5, with minor changes and one major change, simply repeated section 17(a) of the 1933 Act. The major change, and

²² 48 Stat. 84 (1933), as amended, 15 U.S.C. § 77q (1964).

²³ 48 Stat. 891 (1934), as amended, 15 U.S.C. § 78j (1964).

the one which motivated the adoption of the rule,²⁴ was the application of those protections to *sellers* of securities as well as to buyers. All of the prior statutory strictures had been designed to protect buyers of securities — and, clearly, buyers were historically the most aggrieved. Obviously, however, fraud and fraudlike conduct could as readily harm those who were impelled to dispose of securities because of such means as those who were induced to purchase securities.

Significantly, prior to 1942 and the adoption of Rule 10b-5, its prototype, section 17(a) of the 1933 Act, had not been construed as giving a private right of action to persons defrauded in the purchase of securities;²⁵ it had unvaryingly been regarded only as the basis for criminal and injunctive proceedings under section 20²⁶ of the 1933 Act and administrative proceedings against broker-dealers under section 15²⁷ of the 1934 Act.

The problem of "insider" trading was dealt with by Congress through the medium of section 16²⁸ of the 1934 Act. Congress specifically considered means which might be used to prohibit the use by insiders of inside information. It rejected creation of a cause of action based on the actual use of such information because of the difficulties of proving such use,²⁹ and instead adopted the very mechanical tests incorporated in section 16(b): beneficial owners of more than ten per cent of a class of equity security listed on an exchange and the officers and directors of the issuer of any such listed security (in 1964 the 16(b) limitations were extended to many companies traded over-the-counter)³⁰ were liable for "profits" realized through the purchase and sale, or sale and purchase, of any

²⁴ SEC Securities Exchange Act Release No. 3230 (1942); 3 LOSS, *SECURITIES REGULATION* 1426 (2d ed. 1961).

²⁵ The suggestion has been made on occasion that civil liabilities arise also from violation of Section 17 [of the Securities Act of 1933], the first subsection of which makes unlawful the circulation of falsehoods and untruths in connection with the sale of a security in interstate commerce or through the mails. But a reading of this section in the light of the entire Act leaves no doubt but that violations of its provisions give rise only to a liability to be restrained by injunctive action or, if wilfully done, to a liability to be punished criminally. Landis, *Liability Sections of Securities Act*, 18 *AMERICAN ACCOUNTANT* 330 (1933); 3 LOSS, *op. cit. supra* note 24, at 1785.

²⁶ 48 Stat. 86 (1933), as amended, 15 U.S.C. § 77t (1964).

²⁷ 48 Stat. 895 (1934), as amended, 15 U.S.C. § 78o (1964).

²⁸ 48 Stat. 896 (1934), 15 U.S.C. § 78p (1964).

²⁹ *Hearings on S. Res. 84* (72d Cong.) and *S. Res. 56 & S. Res. 97* (73d Cong.) *Before the Senate Committee on Banking and Currency*, 73d Cong., 2d Sess., pt. 5, at 6557 (1934); *Blau v. Lehman*, 368 U.S. 403, 411 (1962).

³⁰ 78 Stat. 565 (1964).

equity security (with very limited exceptions) of the issuer within a period of six months. Actual use of inside information was not made a part of a cause of action under section 16(b).

Despite assertions to the contrary by members of the Commission's staff, it is highly uncertain whether the Commission intended when it adopted Rule 10b-5 to establish a private right of action.³¹ Four years after adoption of the rule, a court first determined that the rule did indeed create a private right of action³² — and at that moment the Pandora's box was opened.

This first case involved face-to-face dealings by two shareholders with two other shareholders, and apparently a fraudulent representation that no negotiations were pending for sale of the business when in fact such negotiations were being conducted.³³ From the time of *Kardon v. National Gypsum Co.*,³⁴ there has been, despite the absence of a Supreme Court determination and despite the doubts of Professor Loss and Professor Ruder and others,³⁵ little doubt that rule 10b-5 created a private cause of action. With a single exception,³⁶ courts which have considered the matter have so held. Any lingering doubts were probably dispelled by *J. I. Case Co. v. Borak*,³⁷ which found an implied cause of action under the proxy rules, and *Surowitz v. Hilton Hotels Corp.*,³⁸ in which a claim under Rule 10b-5 (and under other provisions of the federal securities laws) was treated sympathetically by the Supreme Court, although the issue before the Court was a technical one related to pleadings.

³¹ Joseph, *Civil Liability Under Rule 10b-5 — A Reply*, 59 NW. U.L. REV. 171 (1964); Brief for the SEC, *Pratt v. Robinson*, 203 F.2d 627 (9th Cir. 1953), cited in Ruder, *Civil Liability under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. U.L. REV. 627, 637 & n.53 (1963).

³² *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947).

³³ In the *Kardon* case the evidence was conflicting concerning whether there had been an express denial of the pendency of the merger or simply a non-disclosure; the court held in effect that it made no difference in its decision. *Id.* at 801 & n.1.

³⁴ 73 F. Supp. 798 (E.D. Pa. 1947).

³⁵ Professor Loss' misgivings are generally confined to the question of whether the *buyer* has a remedy under Rule 10b-5. 3 LOSS, *op. cit. supra* note 24, at 1787-90; Ruder, *supra* note 31.

³⁶ *Goldsmith v. Western & So. Life Ins. Co.*, 5 S.E.C. Jud. Dec. 795 (N.D. Ohio 1948).

³⁷ 377 U.S. 426 (1964).

³⁸ 383 U.S. 363 (1966). *Certiorari* has been denied by the Supreme Court in cases in which Rule 10b-5 liability was found, *e.g.*, *Janigan v. Taylor*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965), lending support to the belief that when the rule does finally come before the Supreme Court it will be upheld.

II. ELEMENTS AND UNCERTAINTIES OF THE RULE

As case after case has been determined under rule 10b-5, certain dimensions and characteristics of a cause of action under the rule have emerged, although with regard to virtually each one there is some authority which casts doubt on the certainty of the proposition. If anything seems clearly established, it is that state statutes of limitations apply,³⁹ although there is some uncertainty as to the specific statute which is applicable; in most instances it is the statute of limitations with respect to fraud actions.⁴⁰

After *Cady, Roberts*, it seems reasonably certain that rule 10b-5 applies to transactions executed on an exchange or in the organized over-the-counter market and not only to face-to-face transactions. It is also evident that the jurisdictional requirement of use of the mails or other means of interstate communication poses no serious problem or obstacle to a plaintiff. Similarly, it seems now clearly established that a cause of action may be asserted derivatively on behalf of a corporation which has been caused to issue securities through fraudulent means,⁴¹ and that a corporation may be sued for improprieties with respect to the issuance and sale of securities.⁴² It seems fairly sure that the plaintiff in a rule 10b-5 action must be a buyer or a seller,⁴³ although at least one case appears to have stretched this concept to the breaking point.⁴⁴

³⁹ Ruder, *supra* note 31, at 680-81.

⁴⁰ *Id.* at 681.

⁴¹ *Ruckle v. Roto Am. Corp.*, 339 F.2d 24 (2d Cir. 1964); *McClure v. Borne Chem. Co.*, 292 F.2d 824 (3d Cir.), *cert. denied*, 368 U.S. 939 (1961).

⁴² *Trussell v. United Underwriters, Ltd.*, 228 F. Supp. 757 (D. Colo.), *modified*, 236 F. Supp. 801 (D. Colo. 1964).

⁴³ *Vine v. Beneficial Fin. Co.*, CCH FED. SEC. L. RBP. ¶ 91634 (S.D.N.Y. Feb. 23, 1966).

⁴⁴ See *Voegel v. American Sumatra Tobacco Corp.*, 241 F. Supp. 369 (D. Del. 1965). In this case, it was alleged that "A" Corporation had obtained a substantial interest in "B" Corporation through fraudulent means and without disclosing material information concerning the prospects of "B" Corporation. After securing more than 90% of the stock of "B" Corporation, "A" Corporation caused "B" Corporation to be merged into a newly formed "C" Corporation. Plaintiff, a shareholder of "B" Corporation, filed for dissenters' rights which at the time of the instant action had not been determined. Plaintiff brought this action based on Rule 10b-5. Upon motion for dismissal the defendants contended that the plaintiff was not a purchaser or seller of securities and hence could not maintain an action under Rule 10b-5. The court concluded that plaintiff fitted the statutory definition of seller on these grounds: § 3(a)(14) of the Securities Exchange Act of 1934 defines "sale" or "sell" as including any contract to sell or otherwise dispose of "a security." It then held that the charter of a Delaware corporation constituted a contract between the corporation and its shareholders and the shareholders *inter sese* and that the provisions of the Delaware corporation law are a part of the charter of every corporation. The court then concluded that when the plaintiff bought her shares she contracted that if the corporation ever merged

Whether scienter — some sort of knowingly improper conduct, whether it be regarded as knowing dishonesty or simply recklessness or even perhaps just negligence⁴⁵ — is a necessary element of the cause of action is disputed.⁴⁶ To some extent, the issue may turn upon which subsection of the rule is relied upon; subsection (2) appears to be concerned only with untrue statements of material facts or omissions of material facts, regardless of scienter, while subsections (1) and (3) speak in terms of “defraud,” “fraud,” and “deceit,” which at common law implied some element of scienter. A respectable body of opinion is developing to the effect that rule 10b-5 will support a cause of action based simply on negligence.⁴⁷

It seems evident that for a cause of action to lie under rule 10b-5, the misstatement or the omission must relate to a material fact which is defined by the Commission as a fact “as to which an average prudent investor ought reasonably to be informed before purchasing the security”⁴⁸ and which has been defined in one 10b-5 case as a fact to which “a reasonable man would attach importance . . . in determining his choice of action in the transaction in question.”⁴⁹

Whether complete non-disclosure is actionable is less than certain. *Cady, Roberts* surely indicated as much, but that was an administrative action. Recently, the court in *List v. Fashion Park, Inc.*,⁵⁰ indicated there had been no clear holding on the question whether there would be a cause of action in the event of complete non-disclosure. Subsection (2) of the rule speaks not of complete non-disclosure, but rather of the omission “of a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading,” clearly

she would surrender the shares for whatever amount of cash or securities the merger agreement provided or accept the appraisal value of them. The court then dismissed, somewhat ingeniously, the significance of the plaintiff's appraisal rights and concluded that she had a right of action as a seller of securities under Rule 10b-5.

⁴⁵ Note, *Proof of Scienter Necessary in a Private Suit Under SEC Anti-Fraud Rule 10b-5*, 63 MICH. L. REV. 1070, 1075-76, 1079 (1965).

⁴⁶ JENNINGS & MARSH, SECURITIES REGULATION — CASES AND MATERIALS 791 (1963).

⁴⁷ Comment, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. CHI. L. REV. 824, 839 (1965); Comment, *supra* note 7, at 682.

⁴⁸ Rule 405 under the Securities Act of 1933, 17 C.F.R. § 230.405(k) (1) (1964).

⁴⁹ *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965), quoting RESTATEMENT, TORTS § 538(2) (a) (1938).

⁵⁰ *Supra* note 49, at 461; Comment, *Recent Judicial Extensions of SEC Rule 10b-5*, 63 COLUM. L. REV. 934, 942 (1963); “no court has squarely decided whether a private individual has a judicial remedy for violation of the rule [10b-5] when the purchaser remains silent.” *Id.* at 937.

implying that complete omission must find remedy under subsections (1) and (3), the subsections requiring more plainly an element of scienter; without determining that complete non-disclosure would not be within the scope of subsections (1) and (2), the Commission in *Cady, Roberts* specifically found that it violated subsection (3). Similarly, while the rule speaks of it being "unlawful for *any person*," there is by no means assurance that if complete non-disclosure does constitute a cause of action "any person" means more than "any 'insider'" — whatever that means.⁵¹

Then there is the subtle and perplexing problem of privity. Despite some suggestion that the term is ambiguous,⁵² it would appear that in most rule 10b-5 contexts the courts have used the term in the sense of privity of contract, namely, the relationship between buyer and seller. Early in the history of rule 10b-5 in *Joseph v. Farnsworth Radio & Television Corp.*,⁵³ the District Court for the Southern District of New York, a respected and perceptive one, spoke of the necessity of there being a "semblance of privity" to sustain a rule 10b-5 action; more recent cases have abandoned this concept.⁵⁴ The suggestion has been made that privity may no longer be a requisite for an action based on a misstatement or an omission which makes the statements made misleading but that it should be retained as an element of a non-disclosure action to provide a means of keeping liabilities for non-disclosure within reasonable limits.⁵⁵ The Commission in *Cady, Roberts* appeared to imply that in a *private action* based on non-disclosure there would have to be a showing of privity, but that in an administrative proceeding, like *Cady, Roberts*, such a showing was not a necessary element.⁵⁶ To some commentators, the notion of privity has appeared

⁵¹ Comment, *Insider Liability under Securities Exchange Act Rule 10b-5: The Cady, Roberts Doctrine*, 30 U. CHI. L. REV. 121, 136 (1962).

⁵² 4 CORBIN, CONTRACTS § 778, at 28 (1951).

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

⁵⁴ *Miller v. Bargain City U.S.A., Inc.*, 229 F. Supp. 33 (E.D. Pa. 1964); *Freed v. Szabo Food Serv., Inc.*, CCH FED. SEC. L. REP. § 91317 (N.D. Ill. 1964).

⁵⁵ Comment, *supra* note 50, at 942.

⁵⁶ Cases cited by respondents in which relief was denied to purchasers or sellers of securities in exchange transactions are distinguishable. The action here was instituted by the Commission, not by individuals. The cited cases concern private suits brought against insiders for violation of the anti-fraud rules. They suggest that the plaintiffs may not recover because there was lacking a "semblance of privity" since it was not shown that the buyers or sellers bought from or sold to the insiders. These cases have no relevance here as they concern the remedy of the buyer or seller *vis-a-vis* the insider. The absence of a remedy by the private litigant because of lack of privity does not

too confining. Thus, attempting to give some substance to the court's language in the *Farnsworth* case concerning "semblance of privity," they have asserted that mere presence in the market at approximately the same time as the insider's allegedly wrongful transaction should be sufficient without establishing a conventional privity relationship.⁵⁷

Reliance, historically, has been a part of the common law conception of fraud or deceit.⁵⁸ Is it a part of a rule 10b-5 action? Some recent cases have specifically so held.⁵⁹ However, scholarly discussion has suggested that the broader concept, causation, is the more appropriate consideration and category,⁶⁰ and some question has been raised concerning the relevance of reliance in the context of complete non-disclosure.⁶¹ It is obviously more difficult to show reliance when there has been a failure to disclose than when there has been a misstatement. The concept of "causation," of course, opens up alluring vistas for those who specialize in plaintiff's actions in this field, for if the crux is a showing of causation of the loss suffered by the plaintiff, liability of the insider can readily be expanded beyond simply those who had transactions with the insiders or those who "relied" on the misstatement or omission, even if they did not deal with the insider. As reliance and privity sink into irrelevance, the problem of identifying the seller or purchaser who has the cause of action becomes involved and uncertain.

And there is the question of damages: What is the victim of a violation of rule 10b-5 entitled to recover? It has been suggested that the so-called federal "out of pocket" rule is the appropriate one,⁶² and it appears to have gained some acceptance in cases. It should be noted, however, that many of the reported rule 10b-5

absolve the insider from responsibility for fraudulent conduct. Cady, Roberts & Co., SEC Securities Act Release No. 6668, CCH FED. SEC. L. REP. ¶ 76808 (Nov. 8, 1961). (Footnotes omitted.)

⁵⁷ Comment, *supra* note 51, at 153-55; Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 COLUM. L. REV. 1361, 1370 (1965).

⁵⁸ PROSSER, TORTS § 86 at 523, § 91 at 566 (2d ed. 1955).

⁵⁹ *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965); *Janigan v. Taylor*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

⁶⁰ Comment, *Civil Liability Under Section 10b and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658, 672, 675 (1965).

⁶¹ Painter, *supra* note 57, at 1370.

⁶² Ruder, *supra* note 31, at 680 & n.240; See *Janigan v. Taylor*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965).

cases thus far have been on rulings on motions for summary judgment; relatively few detail the final outcome.

III. THE TEXAS GULF SULPHUR CASE

All of the uncertainties and ambiguities are reaching their acme (or perhaps it is their nadir!) in the case of *SEC v. Texas Gulf Sulphur Corp.*⁶³ In this case, the Securities and Exchange Commission, on its own initiative, is seeking rescission on behalf of those who sold to "insiders" during a period when material information was allegedly concealed, and is seeking restitution from the insiders on behalf of those who sold to "tippees" of such insiders, namely, those to whom the insiders passed information concerning the purported material mineral discovery during the period of its concealment.

While with respect to some transactions there may be a basis for action in the allegedly material misstatements contained in an April 12, 1964 press release which was contradicted in large measure by another release four days later, for the most part the allegations relate to complete non-disclosure. The transactions, other than the grant of options to "insiders," occurred on the New York Stock Exchange. The action is apparently the first in which the Commission has appeared in the role of representative of a class under Rule 10b-5 seeking damages for the benefit of all members of the class, namely, those who sold to the insiders and their tippees.⁶⁴

Obviously the propriety of this role for the Commission will be at issue. Likewise the question of reliance will loom large, as will the question whether complete non-disclosure states a cause of action. Since the Commission purportedly seeks recovery only for the benefit of those who sold to "insiders" or their "tippees," it would appear there is a tacit acknowledgement that privity of contract has continuing relevance.

The problems associated with the case have been repeatedly and knowledgeably discussed.⁶⁵ How should those who sold to "insiders" be identified when the transactions were accomplished through the impersonal mechanism of the New York Stock Exchange?⁶⁶ Even if those who sold to insiders can be identified, why

⁶³ CCH FED. SEC. L. REP. § 91520 (S.D.N.Y. April 19, 1965).

⁶⁴ Note, *Ancillary Relief in SEC Injunction Suits for Violation of Rule 10b-5*, 79 HARV. L. REV. 656 (1966).

⁶⁵ Painter, *supra* note 57, at 1362-65; Whitney, *Section 10b-5: From Cady, Roberts to Texas Gulf: Matters of Disclosure*, 21 BUS. LAW. 193 (1965).

⁶⁶ Painter, *supra* note 57, at 1372.

should they enjoy a bonanza in the form of recovery, while others who sold at about the same time for substantially the same price and whose conduct was perhaps influenced to an equal or perhaps greater degree by the non-disclosure be denied the same recovery? How far should the liability of an indiscreet insider who discloses inside information extend — only to transactions by his tippee, to those of his tippee's tippee and on down the line? To what extent must the Commission show some causative relationship between the sale by a shareholder of Texas Gulf Sulphur and his loss, and the failure of the corporation to disclose the mineral strike? How should the seller's loss be measured? To what extent must reliance be shown? To what extent must scienter — whatever its dimensions — be proven? If all of these issues are determined in a manner unfavorable to the Commission, it is evident that its job of proving its claims will be a difficult one.

The *Texas Gulf Sulphur* case will probably be *sub judice* when this article appears. Unquestionably this case will be appealed regardless of outcome, and it is not improbable that it will be the first Supreme Court determination of what Rule 10b-5 really means.

Despite this, it is most unlikely that all areas of uncertainty under rule 10b-5 will be removed and that clear-cut rules will resolve the difficulties only briefly alluded to above.

The steady extension of Rule 10b-5, among other developments, has given rise to extensive discussion of the emergence of a new "federal corporation law."⁶⁷ There has been suggestion that the principles thus far expressed in Rule 10b-5 cases, especially the erosion of the privity and the reliance concepts, may result in fantastic liabilities for insiders.⁶⁸ For instance, if privity is not a requisite and if simple causation is all that is required, an officer or director responsible for concealing a material fact or making a material misrepresentation might be liable for fantastic damages even though he neither bought nor sold a share during the critical period.

IV. THE PROBLEM

Common law fraud classically involved the misstatement of a material fact.⁶⁹ Since most of the Rule 10b-5 cases, to date have in-

⁶⁷ McClure v. Borne Chem. Co., 292 F.2d 824 (3d Cir.), *cert. denied*, 368 U.S. 939 (1961); Fleischer, "Federal Corporation Law": An Assessment, 78 HARV. L. REV. 1146 (1965); BAKER & CARY, CASES ON CORPORATIONS 564 (3d ed. 1958).

⁶⁸ Painter, *supra* note 57, at 1371; Ruder, *supra* note 31, at 674.

⁶⁹ PROSSER, *op. cit. supra* note 58, § 86 at 523, § 89 at 554.

volved misstatements rather than, like *Cady, Roberts* and *Texas Gulf Sulphur*, complete silence, and since the origins of the theory that Rule 10b-5 constitutes the basis for a private action lie principally in tort theory,⁷⁰ it is not surprising that most of the cases under Rule 10b-5 have utilized terms and concepts related to common law fraud — reliance, privity, causation, scienter. Common law fraud theory and concepts were not limited to the conduct of those involved with corporations, but applied to relations among men generally.

Complete non-disclosure did not constitute common law fraud or deceit unless a party intentionally prevented a person from securing material information or unless there was some special fiduciary relationship between the parties.⁷¹ As for purchases and sales of securities by officers and directors (insiders) from or to non-insider shareholders, there developed three approaches: the majority rule, the minority rule, and the "special circumstances" rule. The majority rule held that an "insider" had a fiduciary duty only to the corporation and not to its shareholders, and hence that he might purchase from or sell to a shareholder securities of the corporation without disclosing material facts as long as there was no misrepresentation, half-truth, or active concealment by word or deed.⁷² The minority rule stated in effect that the insider owes a fiduciary duty to the shareholders and hence must disclose material facts.⁷³ And the "special circumstances" rule held that where special circumstances, for example, inequality of bargaining position or trust by the shareholder in the insider, existed, then the insider had a duty

⁷⁰ *McClure v. Borne Chem. Co.*, 292 F.2d 824, 836 (3d Cir.), *cert. denied*, 368 U.S. 939 (1961); *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961), *dismissal on merits aff'd on remand*, 328 F.2d 573 (9th Cir. 1964); *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961); *Ruder*, *supra* note 31, at 635-36. While the tort theory has been the principal source of implied liability under Rule 10b-5, § 29(b) of the Securities Exchange Act of 1934 has also been invoked to sustain such an implication. Section 29(b) makes void contracts made in violation of the act or any rule or regulation thereunder as to the party who violates or any person who acquires rights under the contract knowing of the facts which would make it void as to a party. If recourse is had to this "contract" theory of liability, then, of course, significant consequences follow: privity becomes important, the measure of damages is basically a rescission measure, reliance is not a matter of consequence, scienter as to the violating party is probably not an element (though it clearly is as to a third person who acquires rights under the contract) and different statutes of limitation apply. The principal line of development of liability under Rule 10b-5, however, has been the tort theory, with occasional references to § 29(b), and the discussion in this paper is within that framework.

⁷¹ *PROSSER*, *op. cit. supra* note 58, § 87, at 534; *Ruder*, *supra* note 31, at 661-62.

⁷² 3 *LOSS*, *op. cit. supra* note 24, at 1446-48; *Comment*, *supra* note 48, at 123.

⁷³ 3 *LOSS*, *op. cit. supra* note 24, at 1446-48.

to disclose.⁷⁴ The three rules have tended to meld toward the strict standard of the minority rule, which appears to be the standard taking form in Rule 10b-5, when "insiders," who are considered to have fiduciary responsibilities toward shareholders, are guilty of non-disclosure.

Obviously, it would appear that, at least in some measure, the concepts that are useful in defining liability for common law fraud pose unique problems when the subject is complete non-disclosure, and historically it appears that common law non-disclosure has developed in a somewhat different framework, that of *fiduciary* duty. For instance, it is much more difficult to make meaningful use of the concept of "reliance" in the non-disclosure situation. What does a purchaser rely upon when nothing has been said? And especially what does he rely upon when the transaction is over an exchange or in the over-the-counter market? The suggestion has been made that in such a circumstance a person may be considered as relying on the expectation that the insider will deal fairly with shareholders or that all material information has been disclosed.⁷⁵ This theory smacks of another day in the law characterized by fictions and represents an effort to construct a theory so that the symmetry is preserved. It is much easier to say simply that reliance is no longer an element in a non-disclosure case.

Of course, even in misstatement cases, when the transaction occurs on an exchange or over-the-counter, there may be considerable difficulty in showing reliance. For this reason, it has been suggested that causation should be the necessary element instead of reliance, but some commentators have recoiled from this because of the vast potential for liability it opens up.⁷⁶

As attention and discussion have turned increasingly to the problems of non-disclosure with respect to transactions in the public markets since the decision in the *Cady, Roberts* case and the filing of the complaint in the *Texas Gulf Sulphur* case, commentators have been increasingly concerned with the means of limiting the potential scope of "insider" liability for failure to disclose. Suggestions have ranged from simple non-liability in the non-disclosure case⁷⁷ to suggestions that concepts of privity,⁷⁸ reliance,⁷⁹ scienter,⁸⁰

⁷⁴ *Ibid.*

⁷⁵ *Voegel v. American Sumatra Tobacco Corp.*, 241 F. Supp. 369 (D. Del. 1965); *Painter*, *supra* note 57, at 1370-71.

⁷⁶ *Painter*, *supra* note 57, at 1371.

⁷⁷ *Id.* at 1391-92.

⁷⁸ *Trussell v. United Underwriters, Ltd.*, 228 F. Supp. 757 (D. Colo.), *modified*,

foreseeability,⁸¹ proximity in time of the insider transactions to purchases or sales by outside holders,⁸² and motivation resulting in expected economic benefits,⁸³ may be the means of keeping "insider" liability within practicable and reasonable limits.

Amid all this theorizing, courts must confront cases and decide them. The simple question is whether, in an area so fraught with concern, so involved with the fundamentals of corporate conduct, the concepts should continue to be elaborated and made more precise only through the means of administrative and judicial decision, or whether this process should be assisted by creative legislation.

Both approaches have their advocates.⁸⁴ It is submitted that the latter is the more feasible course.

All of the substantive rule 10b-5 litigation to date has been in the district courts and the courts of appeals. To date, twenty-four years after adoption of the rule, a score of years after the rule was found to be a source of civil liability, only one case involving the rule has reached the Supreme Court, and that on a pleading point.⁸⁵ Numerous conflicts and sharply varying conclusions have been expressed by the Commission and appellate courts. Is it not time the effort was made to eliminate not all uncertainties and occasions for disagreement — for no legislation can do that as long as it must be couched in human language — but at least those which are evident and susceptible of some definition?

More and more corporate activity is national in scope. If a "federal corporation law" is to emerge,⁸⁶ it is absurd that it be

236 F. Supp. 801 (D. Colo. 1964); Comment, *supra* note 50, at 942; Comment, *supra* note 51, at 153, 170.

⁷⁹ Painter, *supra* note 57, at 1374; Ruder, *supra* note 31, at 679; Comment, *supra* note 47, at 841-42.

⁸⁰ Trussell v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Colo.), *modified*, 236 F. Supp. 801 (D. Colo. 1964); Note, *supra* note 45.

⁸¹ Comment *supra* note 47, at 842-43; Comment, 74 YALE L.J. 658, 667, 674 (1965).

⁸² Painter, *supra* note 57, at 1373.

⁸³ Comment, *supra* note 81, at 686.

⁸⁴ Pro-judicial development: *Recent Developments in Securities Regulation*, 63 COLUM. L. REV. 856, 861 (1963) (opinion expressed by Professor Loss); Fleischer, *supra* note 67, at 1178-79. Pro-legislative development: Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. U.L. REV. 627 (1963); Comment, *supra* note 50, at 943-44; Comment, *supra* note 7, at 679.

⁸⁵ Surowitz v. Hilton Hotels Corp., 383 U.S. 363 (1966).

⁸⁶ At various times in the past, proposals for a federal licensing law for corporations have been urged and some suggestions have been made that there should be a federal incorporation law so that, as in Canada, a corporation might choose a national incorporation or a local one. 1 LOSS, SECURITIES REGULATION 107-11 (2d ed. 1961). An interesting variation on the theme of the federal corporation has been the incorporation

not one federal corporation law, but in effect eleven — one for each court of appeals.⁸⁷ The necessity of scienter as an element of a Rule 10b-5 cause of action should not depend upon whether one is in the Ninth Circuit⁸⁸ or the Second Circuit;⁸⁹ similarly, the statute of limitations should not depend upon the circumstance of where the wrong occurred. Furthermore, it is desirable for corporate officers and directors to know with more certainty than they can now what type of conduct is permissible and what type is forbidden; it is dubious jurisprudence to suggest that public policy is best served if they are maintained in an *in terrorem* state of uncertainty.

It is not intended in this article to suggest definitive answers to the many problems posed by a suggestion for legislative action. It is intended, however, to suggest — tentatively and diffidently — some guidelines for discussion and some possible means of threading the strands which have developed in Rule 10b-5 litigation through the existing structure of federal securities law and to select from among alternatives the strands to be integrated.

V. A LEGISLATIVE PROPOSAL

The problems of codifying anew against fraud and fraud-like transactions reflecting the developments of law, the changes in mores, and the conceptions of corporate fairness which have emerged since the last effort of Congress at such regulation may be variously categorized. Two primary categories suggest themselves. First, transactions may be divided between those which are in some measure face-to-face and those which are executed through the more impersonal instrumentalities of the organized securities markets, the exchanges, and the over-the-counter market — a cate-

and public offering of the securities of Communications Satellite Corporation. This corporation, organized under a special act of Congress, is governed by a law unto itself, although in offering its securities to the public like other corporations less exalted as to origins, it conformed to the provisions of the Securities Act of 1933 in detail. Whether this is the beginning of a new trend or not remains to be seen. Since the organization of "Comsat," proposals for other specially organized federal corporations for special functions have been made.

⁸⁷ "[T]he introduction of federal law into the area of securities transactions was designed to provide uniform, nationwide regulation over a matter of national concern, a goal which the diverse state laws by their very nature could not achieve. Viewed in this light, one goal of the federal securities law should be to allow similarly situated plaintiffs to recover no matter what their residence or the situs of their transaction." Comment, *supra* note 81, at 670.

⁸⁸ *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961), *dismissal on merits aff'd on remand*, 328 F.2d 573 (9th Cir. 1964); *Texas Continental Life Ins. Co. v. Bankers Bond Co.*, 187 F. Supp. 14 (D. Ky. 1960).

⁸⁹ *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951).

gorization which, of course, relates closely to privity. Second, transactions may be divided between those which involve some statement, either a misstatement or the omission of a fact necessary to make the statements made not misleading, and those which involve complete non-disclosure.

It is submitted that relatively simple surgery on section 12(2) should be sufficient to remedy the shortcomings in the category of face-to-face transactions. First, of course, the section should be broadened to cover purchases accomplished through improper means as well as sales. Second, it should be changed to embrace not only misstatements and omissions of facts necessary to make the statements made not misleading, but complete non-disclosures as well. After such amendments, section 12(2) would permit recovery by a defrauded person for misstatements *or* omissions, complete as well as partial and by anyone, insider or not. There would remain the need to establish privity,⁹⁰ there would be no need to show reliance,⁹¹ and the defendant would have available the defense now in section 12(2) — lack of knowledge and inability to know through exercise of reasonable care of the untruth or omission.

It is in dealing with the non-face-to-face transactions that all the ogres facing the District Court in the *Texas Gulf Sulphur* case and described by the various writers who have contemplated the potential of rule 10b-5 are confronted.

It is suggested that there must be found legislative means of accomplishing the following results. First, there must be a means of limiting those liable. The casual tippee who learns third or fourth hand through casual conversation, with no knowledge of the origin of the information, that a material event is about to be disclosed concerning the fortunes of an issuer should not in all probability be held responsible; the advertising agency vice-president who learns this in the course of his work with the officers of the company probably should be. Second, there should be a means of limiting the extent of liability. To contend that the insider who buys a hundred shares of stock on the eve of the announcement of a materially important event should be liable to everyone who sold at a lower price than they might have received had they, too, known of the event is to state a rule that has little to recommend it except its capacity to terrorize. Third, means must be found to eliminate

⁹⁰ *Barlas v. Bear, Stearns & Co.*, CCH FED. SEC. L. REP., § 91674 (N.D. Ill. 1966).

⁹¹ *Woodward v. Wright*, 266 F.2d 108 (10th Cir. 1959); 3 LOSS, *op. cit. supra* note 86, at 1702-04.

the expectations and hopes of insiders that the precise person on the other side of a transaction on an exchange or in the over-the-counter market will never know of his cause of action and hence will not pursue it. Finally, some rational basis for the disposition of recoveries must be found. It is hardly rational that on a day when a hundred thousand shares of a security are traded the person whose sell order happened to cross the insider's buy order should recover damages while the seller whose order preceded or followed that order by an instant is able to recover nothing even though he is equally harmed by the non-disclosure. Not only does this make the entire matter into some sort of a huge lottery, but, if the recovery must be secured by that person, it is unlikely that he will even know of his right to recover. Even if he suspects it, ascertaining whether he is the "winner" will require considerable expense, not to mention the inconvenience and expense incurred by the "losers" who find, after considerable digging, that their orders were not those matched against the insider's purchase.

The problems themselves suggest the answers. Since most of the problems of non-face-to-face transactions arise in the context of organized markets, it is suggested that there be adopted, perhaps as an additional subsection of section 12 of the Securities Act of 1933, a separate remedy for transactions which occur in the organized securities markets, the exchange or the over-the-counter market, or in which privity is absent. The following might be the elements of the action. The plaintiff who might, as under section 16(b) of the 1934 Act, be either the issuer or, if the issuer refuses to bring the action, any shareholder, would have to show that either the insider bought during a time when favorable information was concealed or the market might reasonably be expected to be affected by a "bearish" misstatement, or that he sold during a time when unfavorable information was concealed or the market might reasonably be expected to be affected by a "bullish" misstatement. The insider would be given a defense somewhat along the lines of that afforded by section 12(2): he did not know of the concealment or misstatement. It is suggested that in this context the defendant should not be required to show that he could not have learned of the concealed fact or of the misstatement by exercise of reasonable care.

The problem of the measure of damages in the non-privity, non-face-to-face situation is a difficult one. It is suggested that, recognizing the difficulties discussed above inherent in matching an

insider's purchase or sale with a particular transaction at the specialist's post or through a market-making dealer, the approach of and experience with section 16(b) be utilized. The amount of liability of the insider would be the difference between the price he paid or received for his securities and the following prices: (a) in the case of a concealment of a favorable fact, the highest, and in the case of a concealment of an unfavorable fact, the lowest, market price (or if there were no public market for the security, the fair market value) of the security at any time during the period — perhaps three or six months — following the disclosure, or (b) in the case of a favorable misstatement, the lowest price, and in the case of an unfavorable misstatement, the highest price, of the security during the designated period following publication of the correct information, but in no event could his liability be more than his profit if he sold before the expiration of the period following accurate disclosure. In no event would the statute of limitations commence running until either the concealed information had been disclosed or the corrected information published; this, too, has its analogy in case law under section 16(b) where the statute of limitations does not commence running until a report of the transaction has been filed under section 16(a).⁹²

It is evident that, while the foregoing proposal does not contain the perils to the insider latent within some suggestions, such as that he should, if his conduct were negligent, be liable for all losses suffered by outsiders to the extent such losses were "foreseeable,"⁹³ nonetheless, it does contain enough danger to constitute a considerable deterrent. The insider might well have a liability affected by events and circumstances other than the concealment or misstatement; for example, during the period of concealment of favorable information, the market price might rise with a market trend or in response to generally higher earnings of the issuer. However, any effort to isolate the price change attributable to the misstatement or concealment would make the remedy like that in section 18 of the Securities Exchange Act of 1934⁹⁴ — sterile and seldom used.

What should be done with the recovery? If the proceeds were to be divided among those who sold or bought in a market affected by the concealment or misstatement, each case would entail an involved proceeding before a master much after the fashion of

⁹² Grossman v. Young, 72 F. Supp. 375 (S.D.N.Y. 1947).

⁹³ Comment, *supra* note 47, at 842-43.

⁹⁴ 48 Stat. 897, as amended, 15 U.S.C. § 78r (1964).

Cherner v. Transitron Electronics Corp.,⁹⁵ and in many instances the amount of the recovery would be so small for individual claimants as to make pursuit of it prohibitive. It is suggested, therefore, that the approach taken in section 16(b) be followed, and that any recovery be for the benefit of the corporation, with the plaintiff's counsel entitled to fees out of the recovery.⁹⁶

Obviously this approach to damages would cause any would-be plaintiff to seek first his relief under amended section 12(2), since a successful proceeding there would yield benefits directly to the plaintiff. Probably it would be well, if the statutory parts are to link properly, to exclude from amended section 12(2) claims based upon transactions over exchanges or in the over-the-counter market with respect to a security actively traded there (of course this concept would need definition).

This approach with respect to damages is obviously less than conceptually consistent. Those who buy or sell securities otherwise than through an exchange or in the organized over-the-counter market enjoy the benefits of the recovery; those who buy or sell through the organized markets do not get benefits, even though their injury may be one as indisputable and harmful to them as the injury suffered by their brethren who dealt face-to-face. However, the considerations discussed above suggest this as a feasible means of balancing the equities as among wrongdoers and those harmed, while at the same time providing a penalty severe enough to make insiders extremely cautious in their purchases and sales of securities.

Finally, who should be subject to suit? It is suggested that the standard be twofold. First, the definition of "insider" in *Cady, Roberts* is a useful one: an "insider" is anyone who has "a relationship [to the issuer] giving access, directly or indirectly, to information intended to be available for a corporate purpose and not for

⁹⁵ 221 F. Supp. 55 (D. Mass. 1963) (attorney's fees allowed).

⁹⁶ It has been suggested that the Securities and Exchange Commission, by seeking damages on behalf of sellers or purchasers who are victims of Rule 10b-5 violations by insiders in transactions on an exchange or in the organized over-the-counter market as relief ancillary to an action for injunction or other equitable relief, might, as in *Texas Gulf Sulphur*, perform the recovery function for the small, anonymous, shareholder. Note, *Ancillary Relief in SEC Injunction Suits for Violation of Rule 10b-5*, 79 HARV. L. REV. 656, 663 (1965). This would obviously enlarge substantially the function of the Commission, and considering the extent of its present responsibilities and its limited resources it is doubtful whether this is a responsibility it would welcome, even though in some instances, e.g., *Texas Gulf Sulphur*, considerations, including the desirability of clarifying the law or of remedying a particularly obvious and substantial wrong, may cause it to assume the role.

the personal benefit of anyone."⁹⁷ Second, it has been suggested that the common law rule which has developed in connection with trade secrets has relevance in defining the "tippees" who should be liable:

Where a fiduciary [here read one with a relationship to the issuer giving access to information intended to be available for a corporate purpose and not for the personal benefit of anyone] in violation of his duty to the beneficiary [here read issuer] communicates confidential information to a third person, the third person, if he had notice of the violation of duty, holds upon a constructive trust for the beneficiary any profit which he makes through the use of such information.⁹⁸

Under such a rule the tippee could be held liable for his profits if he received and acted on inside information — undisclosed information or information that there had been material misstatements uncorrected which might affect the price of the security — with knowledge that it was being improperly disclosed and if he profited therefrom. Should the insider be held liable for the wrongful use of inside information by his "tippee"? This is what the Commission is seeking in *Texas Gulf Sulphur*. If the "tippee" can be held liable it is submitted that the additional extension of the insider's liability is not necessary.

Of course, if the statutory approach suggested above is to be taken, Rule 10b-5 would have to be repealed, or at least it should be modified to make clear that it does not afford a private remedy. Section 17(a) of the 1933 Act⁹⁹ should be amended to apply to misconduct in the purchase of securities as well as in the sale of them, and it should also be made clear that it is not intended to afford a private remedy.

The foregoing presupposes a basic determination — that liabilities of insiders for non-disclosures or misstatements when they are not involved in purchasing or selling securities should not, at least now, be extended beyond those already existing, for example, the liability of directors and others under section 11 of the 1933 Act¹⁰⁰ even if they are not selling securities themselves. If the contrary is concluded, then, of course, entirely new areas are opened up with

⁹⁷ Cady, Roberts & Co., Securities Act Release No. 6668, CCH FED. SEC. L. REP. ¶ 76803, at 81017 (Nov. 8, 1961).

⁹⁸ RESTATEMENT, RESTITUTION § 201(2) (1937).

⁹⁹ 48 Stat. 84 (1933), as amended, 15 U.S.C. § 77q (1964).

¹⁰⁰ 48 Stat. 82 (1933), as amended, 15 U.S.C. § 77k (1964).

even more difficult problems of limiting the extent of liabilities, identifying "insiders" subject to liability, and the like.

This approach to transactions in the organized securities markets has evident shortcomings. It does not permit the injured party to secure relief. It permits the recovery to redound theoretically to the benefit of all shareholders through the medium of the corporation, even though most of the shareholders did not suffer as a consequence of the insider's misuse of information. However, it does recognize the fiduciary relationship of the insider to the corporation, and that the information he secures as an insider properly belongs to the corporation and may not be used for personal benefit; to this extent it is in the mainstream of common law theory. And it does provide a powerful deterrent.¹⁰¹

Basically, it resolves the problem of limiting an insider's liability by allowing recovery only of an amount presumably bearing some crude relationship to his profit from the use of the inside information, as contrasted with the theories which would measure liability by the amount of damage "caused" by the insider's misconduct.¹⁰² The relationship is not precise; it is doubtful if it can ever be made precise. Unlike the approach suggested by the Ontario Committee in Canada,¹⁰³ and similar to the approach taken by the Jenkins Committee in England,¹⁰⁴ it permits but a single recovery, and that one on behalf of the corporation. By the same token, the extension of section 12(2) to embrace the face-to-face situation involving non-disclosure at least recognizes the desirability where feasible of directing the recovery to the benefit of the one harmed.

This quasi-section 16(b) approach, of course, does create some danger of a double liability on the part of an officer, director, or ten per cent shareholder: if he were to make a purchase or sale in circumstances which constituted a violation of Rule 10b-5, and the transaction were capable of being coupled with another occurring within a six-month period, thus attaching section 16(b) liability, there might be a double recovery. While there is some merit to preserving both dangers as additional deterrents, probably some consideration should be given to reconciling the potential liabilities in a manner which would result in only a single recovery.

¹⁰¹ It has been suggested that the compensatory aspect of Rule 10b-5 has been over-emphasized: Painter, *supra* note 57, at 1393.

¹⁰² Comment, *supra* note 81, at 672, 675.

¹⁰³ Discussed in Whitney, *supra* note 65, at 205-08.

¹⁰⁴ *Ibid.*

The approach here suggested by-passes many of the problems extensively discussed in law review literature, for instance, reliance, causation, foreseeability, and harm. It is suggested that these concepts, developed through the common law process in a simpler society, are extremely difficult to transport into the complexities of modern security transactions, even if they are substantially reshaped. The approach suggested does seek to recognize that there is an essential difference between gains realized by insiders through the impersonal medium of the securities markets and those accomplished through transactions of the kinds out of which the common law concepts grew.

VI. CONCLUSION

Where is the necessity for action at this time to provide legislative rationalization and ordering of trends? Simply in this. One of these days — and as things are heading, in the not-distant future — a court will be confronted with the case of an insider who engaged in a transaction on an exchange or in the over-the-counter market while he wittingly had possession of inside information. The court will consider the difficulty and the inherent irrationality of matching his purchase or sale with a particular transaction by an outside shareholder, and it will question why one individual whose shares, quite by chance and without anything to differentiate him from the multitude of other shareholders who engaged in transactions at about the same time, were the shares involved in the transaction with the insider, should reap benefits, while the others who sold or bought at or about the same time, engaging in the same kind of assumed and generalized reliance upon there having been full disclosure, should be denied recovery. With these considerations in mind, the court will contemplate the inequity of permitting an insider to enjoy the fruits of his misconduct simply because of the difficulties of determining who should be the beneficiary or beneficiaries of the recovery. Out of these considerations may come difficult law to live with — a liability on the insider vastly in excess of the amount of any gain secured, a liability to all those who at or about the time of his transaction were on the opposite side of the market from him and sold or bought at too low or too high a price. When that decision occurs, it will surely frighten everyone who might be labeled an insider; and, especially if the facts of the case involve a close question on the matter of materiality, there

will be considerable alarm among those who serve on the boards of companies and considerable reluctance to assume, for the usually inadequate compensation paid directors, the vastly expanded risks that would accompany serving on a board.

When that case — or one as awesome — is reached, there may then be more stirring suggestions that something should be done in the halls of Congress to place effective limits on the liability potentials of insiders. Will the effort then restore the confidence of honest men that they can safely serve on boards of publicly held companies? Will the conclusion be that serving on a board effectively precludes being a shareholder — or at least entering into any transaction in the stock of the company while on its board — since it is difficult to define a time when a director is not in possession of some information which might in the light of hindsight be considered material when it is dramatically exposed to a court? Men of substance serve on boards from a variety of motives, among them out of the conviction that the company is one of worth, future, and prosperity. Must the penalty of being a director of such a company be the practical impossibility of participating other than through directors' fees in the future prosperity of the company? For a long time it has been considered a good sign if the directors had built substantial positions in the securities of the company; is this notion now to be made obsolete as it will surely be if the feared extensions of Rule 10b-5 come to life?

The above discussion is not intended to explore all of the problems involved in legislating in place of permitting the implications of Rule 10b-5 to be worked out through the courts. It is suggested that ultimately better law, better *national* law, can be developed if the effort is made through legislative means, with the opportunity it affords for a more sweeping study of the problems than is possible in the courts. As the law in this area develops, each district judge and each appellate judge confronting 10b-5 must become a legislator. Granted, judges often perform quasi-legislative functions, but it is suggested that the present state of the law permits and invites too great an admixture of legislation with adjudication.¹⁰⁵

¹⁰⁵ "It is apparent from what has been said that Texas Gulf presents to the court a number of different decisions. *One or more of the decisions will take on the character of legislation.*" Whitney, *supra* note 65, at 205. (Emphasis added.)