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SEC Enforcement of the Rule I0b-5 Duty to Disclose Material Information-Remedies and the Texas Gulf Sulphur Case

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SEC Enforcement of the Rule 10b-5 Duty To Disclose Material Information—Remedies and the Texas Gulf Sulphur Case

On April 16, 1964, the Texas Gulf Sulphur Company announced one of the most significant mineral discoveries of the twentieth century—a major copper and zinc deposit near Timmins, Ontario, found by means of geophysical exploration and exploratory drilling.[1] Unusual market activity prior to this announcement prompted a Securities Exchange Commission (SEC) investigation of insider stock transactions.[2] In April 1965, the SEC brought suit against a group of Texas Gulf insiders, alleging that their purchase of stock on national exchanges before the disclosure of the information concerning the Timmins strike constituted a violation of section 10(b) of the Securities Exchange Act of 1934, as implemented by rule 10b-5.[3] The SEC sought relief under section 21(e) of the act, which provides for the issuance of an injunction against future violation,[4]

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1. Wall Street Journal, April 17, 1964, p. 2, col. 2; see Sheehan, *Great Day in the Morning for Texas Gulf Sulphur,* Fortune, July 1964, p. 137.

2. Post-trial Memorandum of Law of Plaintiff, pp. 3-4, SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262 (S.D.N.Y. 1966).

3. Securities Exchange Act of 1934, § 10, 48 Stat. 891 (1934), 15 U.S.C. § 78j (1964), provides in part:

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

Rule 10b-5, 17 CFR 240.10b-5 (1964) provides:

> It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
> (a) To employ any device, scheme, or artifice to defraud,
> (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (c) to engage in any act, practice, or course of business which operates, or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

All of the individual defendants had made purchases of Texas Gulf shares prior to any effective public disclosure of the Timmins strike. However, the district court found that, contrary to the SEC contention, the fact of the strike did not become "material" until after April 9, 1964. Thus, only two of the individual defendants were held to have violated rule 10b-5. SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 286-87 (S.D.N.Y. 1966) [hereinafter referred to as *Texas Gulf*]. Both sides have appealed. Appeal docketed, No. 30882, 2d Cir., Oct. 24, 1966. By consent of the parties, remedial questions were reserved for a later hearing. *Texas Gulf* at 266.

4. Securities and Exchange Act of 1934, § 21(e), 48 Stat. 899, as amended, 15 U.S.C. § 78u(e) (1964), provides in part:

> Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of

and, in addition, requested rescission and restitution on behalf of the private parties who had sold shares of Texas Gulf to the defendants or to parties who purchased on the advice of defendants.[5] However, the Securities Exchange Act's remedial provisions do not specifically authorize an SEC action for a monetary recovery[6] and, since this is the first time that the Commission has asserted this prerogative, it may be timely to examine the SEC's authority to seek such remedies. The first part of this Comment will focus on the two possible bases for an SEC suit for rescission and restitution or for other new enforcement measures. Assuming that the courts are authorized to give such relief, two questions remain to be discussed in the second part of the Comment: (1) What are the relevant criteria for developing a new enforcement scheme for violations of section 10(b) of the Securities Exchange Act; and (2) What specific enforcement measures should the courts create in order to further the purposes of that act?

I. Judicial Creation of Non-Statutory Enforcement Measures

A. *The Ancillary Power of an Equity Court*

The Securities Exchange Act provides a specific enforcement scheme to be implemented by the Attorney General and the SEC. The Attorney General is authorized to bring criminal suits,[7] whereas the SEC is entrusted with the responsibility for enforcing the reporting and disclosure requirements,[8] conducting investigations,[9] and obtaining injunctions to prevent future violations.[10] Although there are several other enforcement measures, including provisions

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the provisions of this chapter, or of any rule or regulation thereunder, it may in its discretion bring an action in the proper district court of the United States or the United States courts of any Territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond.

5. Complaint, pp. 33-34, *Texas Gulf.* The SEC, following *Texas Gulf*, has requested a monetary remedy in a number of cases. See SEC v. National Sec., Inc., 252 F. Supp. 623 (D. Ariz. 1966); SEC v. Wong, 252 F. Supp. 608 (D.P.R. 1966); SEC v. Gloconda Mining Co., Civil No. 1512/1965 (S.D.N.Y., filed May 19, 1965).

6. Securities and Exchange Act of 1934, § 21(e), 48 Stat. 899, as amended, 15 U.S.C. § 78u(e) (1964), which is the only provision that gives the SEC standing before the courts, authorizes only an injunction.

7. Securities Exchange Act of 1934, § 32, 48 Stat. 904, as amended, 15 U.S.C. § 78ff. (1964).

8. Securities Exchange Act of 1934, § 19, 48 Stat. 898, as amended, 15 U.S.C. § 78s (1964).

9. Securities Exchange Act of 1934, §§ 21(a)-(d), 48 Stat. 899, 15 U.S.C. §§ 78u(a)-(d) (1964).

10. Securities Exchange Act of 1934, § 21(e), 48 Stat. 899, as amended, 15 U.S.C. § 78u(e) (1964).

for the bringing of private civil suits in specified situations,[11] nowhere is the SEC given the power to seek money damages.

Congressional authorization of these specific enforcement measures might arguably imply the exclusion of others.[12] The courts, however, have not accepted the doctrine of *expressio unius est exclusio alterius* in interpreting securities legislation.[13] Rather, they have employed the concept of statutory tort to supplement the civil remedies enumerated by the act[14] and, when an injunction has been sought under section 21(e), they have used their inherent equity power to provide relief ancillary to the injunction when such relief has been necessary for the adequate protection of investors.[15] To date this theory of ancillary relief has been employed only to allow the appointment of a receiver.[16] However, in its pretrial memorandum of law, the SEC indicated that it would rely on this theory in its attempt to collect a monetary judgment in *Texas Gulf*.[17]

The development of the ancillary theory in other areas of the law indicates that the doctrine is sufficiently well established to support the SEC's claim for rescission and restitution. Indeed, support for this position can be found dating from 1946 when the Supreme Court decided *Porter v. Warner Holding Co.*[18] In *Warner*, the price administrator brought an action under section 205(a) of the Emergency Price Control Act, which provides that "upon a

11. Securities Exchange Act of 1934, §§ 19, 48 Stat. 898, as amended, 15 U.S.C. § 78s (1964) (power to stop trading on a national exchange); 15, as amended, 49 Stat. 1377 (1936), as amended, 15 U.S.C. § 78 (1964) (power to revoke the license of a noncomplying broker). Securities Exchange Act of 1934, §§ 9(e), 16(b), 18, 48 Stat. 889, 896, 897, as amended, 15 U.S.C. §§ 78i(e), p(b), r (1964), authorize private civil suits in specific and limited circumstances.

12. This is a general rule of statutory construction. See, *e.g.*, Botany Worsted Mills v. United States, 278 U.S. 282, 289 (1929); United States v. Parkinson, 240 F.2d 918, 921-22 (9th Cir. 1956).

13. See SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344, 350-51 (1943); Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946).

14. See Kardon v. National Gypsum Co., *supra* note 13.

15. See 3 LOSS, SECURITIES REGULATION 1824-28 (2d ed. 1961) [hereinafter cited as Loss].

16. See Los Angeles Trust Deed & Mortgage Exchange v. SEC, 285 F.2d 162, 180-81 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961); Aldred Inv. Trust v. SEC, 151 F.2d 254 (1st Cir. 1945), *cert. denied*, 326 U.S. 795 (1946); SEC v. H. S. Simmons & Co., 190 F. Supp. 432 (S.D.N.Y. 1961). For a case which has extended the ancillary theory so as to allow restitution in the area of securities regulation, see SEC v. Wong, 252 F. Supp. 608 (D.P.R. 1966). In *Wong* the district court approved an award of restitution to injured investors as a remedy ancillary to an injunction under § 42(e) of the Investment Company Act of 1940, 54 Stat. 842, 15 U.S.C. § 80a-41(e) (1964), which has language similar to that of § 21(e) of the Securities Exchange Act of 1934. This case, however, cannot be considered authority for the restitutionary remedies requested in the present case. Section 42(e), unlike 21(e), indicates a specific congressional intent that the SEC should have a more direct role in the regulation of investment companies, since it specifically authorizes the appointment of a trustee, in addition to the conventional injunction.

17. Pretrial Memorandum of Law of Plaintiff, pp. 48-53, *Texas Gulf*.

18. 328 U.S. 395 (1946).

showing by the Administrator that such person has engaged or is about to engage in any such acts or practices a permanent or temporary injunction, restraining order, or *other order* shall be granted without bond."[19] In addition to an injunction, the administrator sought an "other order," one that would compel the defendant to make restitution of amounts collected in excess of the established maximum price. The Supreme Court, affirming the granting of the order, noted that the authority to grant an award for restitution was within the traditional power of a court with equitable jurisdiction and that the award was authorized by the "other order" language in the statute.[20] Originally, there was some uncertainty as to the basis of the holding and at least one court has interpreted the decision as sanctioning equitable relief ancillary to an injunction only if the language in the grant of jurisdiction is as broad as the "other order" language of the Emergency Price Control Act.[21] However, the more persuasive, and recently accepted, interpretation is that *Warner* stands for the proposition that, whenever an act authorizes equitable jurisdiction, ancillary relief which is necessary to protect the public interest and which effectuates the purposes of the act is within the court's traditional power whether or not the statute contains "other order" language.

This latter approach is best demonstrated by a series of cases arising under the Fair Labor Standards Act. Section 17 of the act, as originally enacted, provided only that the courts have "jurisdiction for cause shown to restrain violations of section 15 of this title . . . ."[22] Despite the absence of a broad grant of equitable jurisdiction, the Second Circuit held, as early as 1944, that section 17 entitled the Secretary of Labor to obtain from equity not only an

19. Emergency Price Control Act ch. 26, § 205(a), 56 Stat. 33 (1942). (Emphasis added.)

20. 328 U.S. at 398-400.

21. See United States v. Parkinson, 240 F.2d 918 (9th Cir. 1956). One commentator has suggested that

> the SEC also has some general statutory language that, like the term "other order" in *Warner*, might be found to provide an "explicit" basis for a rescission order: section 21(f) of the 1934 act gives the Commission power to apply to the courts for an injunction "commanding any person to comply with the provisions of this title. . . ."

Note, 79 HARV. L. REV. 656, 660 (1966). This argument is untenable, however, because § 21(f) of the 1934 act, 48 Stat. 900, as amended, 15 U.S.C. § 78u(f) (1964), makes provision for "writs of mandamus commanding any person to comply with the provisions of this chapter . . . ," not equitable injunctions. The purpose of a writ of mandamus is to compel the future performance of ministerial or official duties, but not discretionary or remedial acts. See, *e.g.*, United States *ex rel.* Roughton v. Ickes, 101 F.2d 248, 252 (D.C. Cir. 1938). Thus § 21(f) was intended to give the SEC the power to force filing or correction of required reports, and it cannot be used as a basis for remedial orders. Although writs of mandamus have been abolished in federal practice, § 21(f) can still be considered authority for the SEC to seek orders similar in scope under the new federal procedure. FED. R. CIV. P. 81(b); see SEC v. Atlas Tack Corp., 93 F. Supp. 111 (D. Mass. 1950).

22. Fair Labor Standards Act of 1938, ch. 676, § 17, 52 Stat. 1069 (1938).

injunction but also an order directing reimbursement of wages lost due to illegal dismissal.[23] In 1949, the Secretary's enforcement powers were expanded again when the Second Circuit ordered restitution of unpaid minimum wages.[24] Congressional disapproval of this expansion resulted in an amendment to section 17 to the effect

> that no court shall have jurisdiction, in any action brought by the Secretary of Labor, to order the payment of unpaid minimum wages or unpaid overtime compensation or an additional equal amount as liquidated damages in such actions.[25]

Nonetheless, the Supreme Court was willing to create non-statutory remedies. In *Mitchell v. Robert Demario Jewelry, Inc.*,[26] the Court, distinguishing between restitution of unpaid minimum wages, prohibited by the congressional proviso, and reimbursement of wages lost due to illegal dismissal, granted the Secretary of Labor's request for reimbursement. The Court, relying heavily on *Porter v. Warner*, ignored the "other order" grounds for that decision.[27]

On the basis of this approach, the SEC would not have to rely on a specific statutory authorization to support its request for rescission and restitution so long as congressional purposes would be effectuated by such an award. Indeed, section 21(e) of the Securities and Exchange Act is even more amenable to ancillary remedies than was section 17 of the Fair Labor Standards Act since the latter contained a congressional proviso condemning ancillary remedies. One problem which is presented by the Securities Exchange Act is that the statute clearly indicates that the SEC is to enforce the act through prospective means whereas the redress of past wrongs

23. Walling v. O'Grady, 146 F.2d 422 (2d Cir. 1944).

24. McComb v. Frank Scerbo & Sons, 177 F.2d 137 (2d Cir. 1949).

25. Fair Labor Standards Act Amendments of 1949, ch. 736, § 15, 63 Stat. 919.

26. 361 U.S. 288 (1960). The § 17 injunction was designed to encourage the reporting of minimum wage violations, by preventing discriminatory discharge of employees reporting such violations.

27. After noting the Court of Appeals' mistaken reliance on "the principle that to be upheld the jurisdiction here contested 'must be expressly conferred by an act of Congress or be necessarily implied from a Congressional enactment,' 260 F.2d at 933," the Court in *De Mario* quoted the following language from *Warner*:

> Thus the Administrator invoked the jurisdiction of the District Court to enjoin acts and practices made illegal by the Act and to enforce compliance with the Act. Such a jurisdiction is an equitable one. Unless otherwise provided by statute, all the inherent equitable powers of the District Court are available for the proper and complete exercise of that jurisdiction. And since the public interest is involved in a proceeding of this nature, those equitable powers assume an even broader and more flexible character than when only a private controversy is at stake . . . . [T]he court may go beyond the matters immediately underlying its equitable jurisdiction . . . and give whatever other relief may be necessary under the circumstances. . . . 328 U.S., at 397-98.

The court then continued: "The applicability of this principle is not to be denied, . . . because [the Court in *Warner*] . . . went on to find in the language of the statute affirmative confirmation of the power to order reimbursement." 361 U.S. at 290-91.

is left to private civil suits.[28] A suit by the SEC for a money judgment on behalf of private parties might therefore be construed as an unnecessary invasion of the remedial area reserved for private actions. However, the SEC has stated in its pretrial memorandum of law that it considers its action to be necessary in order to deter future illegal use of inside information and that therefore it "is not acting in this case as an instrument for particular individuals but only to enforce and apply section 10(b) and rule 10b-5 in the public interest."[29]

Whether rescission and restitution are in fact appropriate means for enforcing the act in the public interest will be discussed in the second part of this Comment. A more serious drawback to the use of the ancillary theory lies in the limitations inherent in the term "ancillary." In order for the award of money damages to be truly "ancillary," the injunction would seemingly have to be central to the suit. However, section 21(e) authorizes the SEC to seek an injunction only "whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation . . . ."[30] This language indicates that an injunctive suit may not be proper in *Texas Gulf* since the violations have already occurred and the subsequent public disclosure of the mineral discoveries has precluded further insider profits. Absent a basis for injunctive relief, the court would seemingly lack the equitable jurisdiction from which it could have proceeded to the ancillary questions. To avoid this apparent limitation on their authority to fashion remedies, the courts have generally been willing to infer the threat of a future violation from the mere fact of a past violation.[31] Furthermore, the SEC has argued that, if the injunction is sought in good faith, ancillary relief is appropriate even if no injunction is granted.[32] If this type of rationalization is accepted, the granting of the injunction itself is clearly of little importance and the characterization of the relief actually granted as "ancillary" becomes merely a fictionalized means by

28. Securities Exchange Act of 1934, § 21(e), 48 Stat. 899 (1934), as amended, 15 U.S.C. § 78u(e) (1964), gives the SEC the authority to seek an injunction only when a person "is engaged or about to engage" in a violation.

29. Pretrial Memorandum of Law of Plaintiff, p. 51, *Texas Gulf*. For a discussion of the propriety of an SEC action to obtain a remedy for injured private parties who can sue on their own, as distinguished from an SEC regulatory enforcement action, see Note, 79 HARV. L. REV. 656 (1966).

30. Securities Exchange Act of 1934, § 21(e), 48 Stat. 899, as amended, 15 U.S.C. § 78u(e) (1964).

31. See SEC v. Keller Corp., 323 F.2d 397 (7th Cir. 1963); Los Angeles Trust Deed & Mortgage Exch. v. SEC, 285 F.2d 162, 180-81 (9th Cir. 1960); SEC v. Boren, 283 F.2d 312 (2d Cir. 1960) (*per curiam*); SEC v. Culpepper, 270 F.2d 241, 249 (2d Cir. 1959). To avoid an injunction once a violation has been shown, the wrongdoer must demonstrate that there is no "reasonable expectation" of future violation, and this "burden is a heavy one." United States v. W. T. Grant Co., 345 U.S. 629, 633 (1953).

32. Pretrial Memorandum of Law of Plaintiff, pp. 53-54, *Texas Gulf*.

which the court avoids the limitations of the statute.[33] Thus, although there may be sufficient precedent for applying the ancillary theory in *Texas Gulf*, its use should be avoided in favor of an alternative theory which more accurately describes the nature of the relief sought by the SEC.

B. *Section 27 Jurisdiction and the New Federal Common Law*

The SEC is requesting the courts to exercise their inherent lawmaking power so as to fashion appropriate remedies for the more effective enforcement of the Securities Exchange Act. The decision in *Erie R.R. v. Tompkins*[34] might, at first blush, appear to be an obstacle to the court's ability to fashion such remedies, but *Erie* did not deprive the federal courts of all power to develop a federal common law.[35] Indeed, once the federal courts were no longer able to fashion a federal common law to be applied in diversity of citizenship cases involving state questions, they devoted greater attention to their role as developers of law in areas of federal interest, especially with respect to the fashioning of remedies which would effectuate various federal statutory schemes.[36]

Judicial willingness to imply new remedies in areas governed

33. Arguably, an order directing rescission might be characterized as a "mandatory injunction" and thus authorized by the express terms of § 21(e). Compare Creedon v. Randolf, 165 F.2d 918 (5th Cir. 1948), where the court held that an order directing restitution of rent overcharges was a "mandatory injunction" which would be proper under § 205(a) of the Emergency Price Control Act, ch. 26, 56 Stat. 33 (1942). This argument has been alluded to by the SEC. Pretrial Memorandum of Law of Plaintiff, pp. 53-54, *Texas Gulf.* However, unlike § 21(e), § 205(a) contains the "other order" language, which in the *Warner* case had been held to justify the restitutionary remedy. More important, § 205(a) clearly authorizes the administrator's resort to the courts in order to remedy *past* violations. Section 21(e), on the other hand, clearly contemplates "injunctions" which are prohibitory and prospective in operation, rather than remedial. *Compare* Securities Exchange Act § 21(e), 48 Stat. 899 (1934), as amended, 15 U.S.C. § 78u(e) (1964), *with* Emergency Price Control Act ch. 26, § 205(a), 56 Stat. 33 (1942).

34. 304 U.S. 64 (1938).

35. See Friendly, *In Praise of Erie—and of the New Federal Common Law*, 39 N.Y.U.L. REV. 363 (1964).

36. One year after *Erie*, the Court considered the right of an Indian to the return of taxes collected in violation of a treaty with the United States. The treaty did not mention remedies, but Mr. Justice Frankfurter, speaking for the Court, held that Congress had "left such remedial details to judicial implication." Board of County Comm'rs v. United States, 308 U.S. 343, 349-50 (1939). These remedies were derived from the federal right and did not depend upon state law. Thus *Erie* did not preclude federal courts from creating implied remedies for the protection of federal rights. *Accord*, Deitrick v. Greaney, 309 U.S. 190, 200-01 (1940). In Sola Elec. Co. v. Jefferson Elec. Co., 317 U.S. 173 (1942), a suit involving a question of patent licensee estoppel under the antitrust laws, the Court said:

> When a federal statute condemns an act as unlawful, the extent and nature of the legal consequences of the condemnation, though left by the statute to judicial determination, are nevertheless federal questions, the answers to which are to be derived from the statute and the federal policy which it has adopted.

Id. at 176.

by federal law has been expressed in a number of ways. The aforementioned cases utilizing the ancillary theory to extend administrative enforcement power under the Emergency Price Control Act and the Fair Labor Standards Act are one example.[37] In the field of investment securities, the courts have implied various civil remedies. For example, in *Kardon v. National Gypsum Co.*,[38] the district court inferred from section 10(b) of the Securities Exchange Act a cause of action for damages resulting from a sale of securities induced by the purchaser's misrepresentations. The court relied upon the theory embodied in section 286 of the *Restatement of Torts*[39] that anyone who is injured by a person acting in violation of a legislative command may sue in tort. The court concluded:

> Of course, the legislature . . . may withhold from parties injured the right to recover damages arising by reason of violation of statute but the right . . . is so fundamental and so deeply ingrained in the law that where it is not expressly denied the intention to withhold it should appear very clearly and plainly.[40]

Although the Supreme Court has not ruled on the merits of this statutory-tort doctrine, the *Kardon* decision has been cited with approval in ten of the circuits and consequently appears to be well established.[41] Admittedly, the statutory-tort doctrine is available only to those persons who have been injured by conduct which violates a federal statute—a class from which the SEC is clearly ex-

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37. See Mitchell v. Robert DeMario Jewelry, Inc., 361 U.S. 288 (1960); Porter v. Warner Holding Co., 328 U.S. 395 (1946); McComb v. Frank Scerbo & Sons, 177 F.2d 137 (2d Cir. 1949); Walling v. O'Grady, 146 F.2d 422 (2d Cir. 1944).

38. 69 F. Supp. 512 (E.D. Pa. 1946).

39. RESTATEMENT, TORTS § 286 (1934), provides:

> The violation of a legislative enactment by doing a prohibited act, or by failing to do a required act, makes the actor liable for an invasion of an interest of another if:
> (a) the intent of the enactment is exclusively or in part to protect an interest of the other as an individual; and
> (b) the interest invaded is one which the enactment is intended to protect; and,
> (c) where the enactment is intended to protect an interest from a particular hazard, the invasion of the interests results from that hazard; and,
> (d) the violation is a legal cause of the invasion, and the other has not so conducted himself as to disable himself from maintaining an action.

40. Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946). See generally 3 Loss 1421-74, 1763-97; Comment, *Civil Liability Under Section 10(b) and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658 (1965).

41. See cases cited Comment, 74 YALE L.J. 658 n.4 (1965). Some of these cases have been criticized on the ground that implication of remedies enables the circumvention of specific congressional limitations on private suits. See 3 Loss 1789-90; Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 Nw. U.L. REV. 627 (1963). However, in 1963, when Professor Loss participated in a symposium on *Recent Developments in Securities Regulation*, 63 COLUM. L. REV. 856 (1963), he said: "Do we want Kardon overruled? . . . It is almost like asking whether we would like to see the school segregation cases overruled, despite the problems they have created." *Id.* at 867.

cluded. Furthermore, as noted earlier,[42] the ancillary theory is inappropriate in a *Texas Gulf* situation. However, for the purposes of this discussion, these cases are significant in that they are evidence of the fact that the courts are willing to exercise their lawmaking power in the fashioning of extra-statutory remedies.

Moreover, in implying new federal common-law remedies, the Supreme Court has not rested solely on the ancillary and statutory tort doctrines. Rather, it has inferred the power to fashion *all* appropriate remedies for violations of a federally created duty from a general jurisdictional grant. The Court's clearest expression of this approach was in the 1957 case of *Textile Workers v. Lincoln Mills.*[43] In *Lincoln Mills,* the relevant statute was section 301(a) of the Labor Management Relations Act, which gives the courts jurisdiction over "suits for violation of contracts between an employer and a labor organization representing employees in an industry affecting commerce . . . ."[44] The Court found that this section authorized the federal courts "to fashion a federal law for the enforcement of these collective bargaining agreements,"[45] and that the law to be applied in such suits "is a federal law, which the courts must fashion from the policy of our national labor laws."[46]

Since *Lincoln Mills* arose under a statute which grants jurisdiction to the federal courts without providing a specific enforcement scheme, it is not directly applicable to a suit brought pursuant to the Securities Exchange Act which does provide specific remedies. Nevertheless, in *J. I. Case Co. v. Borak,*[47] the Supreme Court invoked the *Lincoln Mills* rationale in authorizing the courts to develop new remedies under the Securities Exchange Act. In *Borak,* a stockholder contesting a merger alleged that his proxy had been solicited by means of false and misleading statements in violation of section 14(a) of the act.[48] The Court looked to section 27 of the act which states:

> The district courts of the United States, . . . shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder.[49]

42. See text accompanying note 33 *supra.*

43. 353 U.S. 448 (1957).

44. Labor Management Relations Act, § 301(a), 61 Stat. 156 (1947), 29 U.S.C. § 185 (1964).

45. 353 U.S. at 451.

46. *Id.* at 456. Although this Comment focuses on the remedial aspects of the case, the law developed under *Lincoln Mills* is both substantive and remedial. See Bickel & Wellington, *Legislative Purpose and the Judicial Process: The Lincoln Mills Case,* 71 HARV. L. REV. 1 (1957).

47. 377 U.S. 426 (1964).

48. Securities Exchange Act of 1934, § 14(a), 48 Stat. 895, 15 U.S.C. § 78n(a) (1964).

49. Securities Exchange Act of 1934, § 27, 48 Stat. 902, 15 U.S.C. § 78aa (1964).

Although this language might be construed as merely jurisdictional in nature, the Court held that it also provides the authority for the district courts to create new remedies that will promote the congressional objectives behind the Securities Exchange Act. The Court therefore found that the plaintiff had a cause of action for either rescission of the merger or restitution. Since this was a civil remedy for an injured private litigant, it might be argued that *Borak* is simply an extension of the statutory-tort doctrine. However, the court did not invoke the statutory-tort doctrine, nor did it cite *Kardon* or any other case that has relied upon this theory. Instead, it based its decision directly on section 27 saying:

> We consider only the question of whether § 27 of the Act authorizes a federal cause of action for rescission or damages to a corporate shareholder with respect to a consummated merger which was authorized pursuant to the use of a proxy statement alleged to contain false and misleading statements . . . .[50]

In answering this question, the Court cited *Lincoln Mills* and other cases in which the courts have invoked their broad power to create new federal common law.[51] It concluded:

> It appears clear that private parties have a right under § 27 to bring suit for violation of § 14(a) of the Act. Indeed, this section specifically grants the appropriate District Courts jurisdiction over "all suits in equity and actions at law brought to enforce any liability or duty created" under the Act.[52]

In light of the Court's approach and the cases upon which it relied, it is apparent that, as in *Lincoln Mills*, the Court was inferring from a broad jurisdictional grant the authority to fashion remedies to effectuate the purposes underlying the act. *Borak*, then, can be viewed as an additional step in the judicial trend toward flexibility in the enforcement of federal duties. As such, it is clearly applicable to the *Texas Gulf* suit for rescission and restitution, a "suit . . . in equity brought to enforce . . . [a] duty created" under

50. 377 U.S. at 428.

51. In addition to *Lincoln Mills*, the Court cited Sola Elec. Co. v. Jefferson Elec. Co., 317 U.S. 173 (1942), and Deitrick v. Greaney, 309 U.S. 190 (1940). 377 U.S. at 428; see note 36 *supra*.

52. 377 U.S. at 430-31. This approach was anticipated by Deckert v. Independence Shares Corp., 311 U.S. 282 (1940), which granted implied remedies under the Securities Act of 1933 before the statutory tort doctrine became popular:

> The Securities Act does not restrict purchasers seeking relief under its provisions to a money judgment. On the contrary, the Act as a whole indicates an intention to establish a statutory right which the litigant may enforce in designated courts by such legal or equitable actions or procedures as are normally available to him . . . . Moreover, in § 22(a) (15 U.S.C. § 77v) specified courts are given jurisdiction "of all suits in equity and actions at law brought *to enforce* any liability or duty created by this subchapter." The power *to enforce* implies the power to make effective the right of recovery afforded by the Act.

311 U.S. at 287-88.

the act.[53] Therefore, the court in *Texas Gulf* has the authority to grant the requested remedies and to add whatever new measures are necessary to the enforcement scheme.

II. Proper Enforcement of the *Texas Gulf* Duty

A. *Congressional Purpose*

Judicial creation of extra-statutory remedies has been justified as necessary for the effectuation of congressional objectives,[54] and the securing of this goal must therefore be the standard by which proposed new remedies are evaluated. Consequently, before turning to a discussion of the possible means of enforcing the duty at issue in *Texas Gulf,* it is appropriate to examine the underlying philosophy of the Securities Exchange Act and to determine the scope and content of the 10b-5 duty placed upon the defendant insiders.

As stated by the SEC in its *Report of Special Study of Securities Markets,* "the keystone of the entire structure of Federal securities legislation is disclosure."[55] The disclosure philosophy is based on the assumptions that the investing public will be able to protect itself, if informed, and that potential wrongdoers will be deterred by the probability of publicity.[56] The Securities Act of 1933 requires disclosure at the time of the issuing of a security and the Securities Exchange Act of 1934 expands this practice by requiring continuous periodic disclosures of corporate information.[57]

Section 10(b) of the 1934 Act makes it illegal to "employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe . . . ."[58] The Commission has implemented this section by promulgating rule 10b-5, a general fraud rule which has become one of the provisions

53. Securities Exchange Act of 1934, § 27, 48 Stat. 902, as amended, 15 U.S.C. § 78aa (1964).

54. See J. I. Case Co. v. Borak, 377 U.S. 426, 430-31 (1964); Mitchell v. Robert DeMario Jewelry Co., 361 U.S. 288, 291 (1960).

55. SEC, *Report of Special Study of Securities Markets,* H.R. Doc. No. 95, 88th Cong., 1st Sess. pt. 3, at 1 (1963).

56. See 1 Loss 21, 121-28. See generally Knauss, *A Reappraisal of the Role of Disclosure,* 62 Mich. L. Rev. 607 (1964).

57. Securities Exchange Act of 1934, §§ 12-13, 48 Stat. 894, as amended, 15 U.S.C. §§ 78*l*-m (1964), require registration and disclosure through annual reports by companies whose stock is traded on a national exchange or over-the-counter market. Securities Exchange Act of 1934, § 14, 48 Stat. 895, as amended, 15 U.S.C. § 78n (1964), regulates the annual solicitation of proxies so as to insure full disclosure in the proxy statement or its annual equivalent. Securities Exchange Act of 1934, § 15, as amended, 49 Stat. 1377 (1936), as amended, 15 U.S.C. § 78o (1964), regulates the conduct and disclosures of broker-dealers selling on the over-the-counter market. Securities Exchange Act of 1934, § 16(a), as amended, 78 Stat. 579 (1964), 15 U.S.C. § 78p(a) (1964), requires that insiders disclose all transactions in their companies' stock.

58. 48 Stat. 891 (1934), 15 U.S.C. 78j(b) (1964).

most frequently invoked by the courts in requiring full disclosure.[59] The court in *Texas Gulf*, interpreting section 10(b) and rule 10b-5 in light of the basic disclosure philosophy of the act, concluded that insiders who possess material information which is not generally available to the investing public must disclose such information before using it to their own advantage.[60] The duty of disclosure is not absolute, for the SEC and the court admit that there may be legitimate business reasons for withholding information;[61] indeed, premature disclosure which is based on what ultimately is incomplete information may be as misleading as delayed disclosure.[62] Moreover, the insiders themselves must necessarily be the ones to determine when disclosure is appropriate. However, insiders who fail to disclose material information must forego transactions in the shares of their company. Thus, although the court in *Texas Gulf* could not say that good business judgment would have dictated an earlier disclosure of the mineral strike, it could insist that the insiders refrain from taking unfair advantage of material information and that they postpone their transactions until the disclosure of such information.

In considering the purpose underlying the duty to disclose inside information, the court in *Texas Gulf* relied heavily on the Commission's decision in *Cady, Roberts & Co.*,[63] which was the first articulation of the duty to disclose material information or forego the transaction:

> The Commission in *Cady, Roberts & Co.* . . . found that the obligation to disclose material information rests on two grounds: . . . "first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing that it is unavailable to those with whom he is dealing."[64]

It is not surprising that the court was impressed by principles of "inherent unfairness," but it is doubtful that Congress intended to regulate all questions of fairness between corporate insiders and shareholders.[65] William Cary, past chairman of the SEC, has re-

59. 17 C.F.R. 240.10b-5 (1964).

60. *Texas Gulf* at 278-79.

61. *Id.* at 280; Pretrial Memorandum of Law of Plaintiff, p. 30, *Texas Gulf.*

62. See 3 Loss 1463; Farmer, Cary, Fleischer & Halleran, *Insider Trading in Stocks*, 21 Bus. Law. 1009, 1013-14 (1966); Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 Colum. L. Rev. 1361, 1378 (1965); Whitney, *Section 10b-5: From Cady, Roberts to Texas Gulf: Matters of Disclosure*, 21 Bus. Law. 193, 202-03 (1965).

63. Cady, Roberts & Co., 40 S.E.C. 907 (1961).

64. *Texas Gulf* at 279.

65. Congress has consistently rejected proposed federal incorporation statutes designed to regulate all phases of corporate life. See 1 Loss 107-11.

cently given a more satisfactory articulation of the *Cady, Roberts-Texas Gulf* concept of fairness and its role in effecting the underlying purposes of the securities legislation: "Everyone representing management may tend to forget the underlying importance of the stockholder in the capital market. We sometimes forget that integrity in the capital markets is essential for mass capitalism."[66] He particularly emphasized "the importance of confidence, and a high standard of conduct by directors, as an essential ingredient before one can expect the private investor to begin putting his funds into public companies."[67] Thus, the *Texas Gulf* duty to disclose promotes investor confidence by assuring the public that corporate insiders serve the corporation and the investing public before serving themselves.

Texas Gulf is concerned with insider trading on the market where silence (failure to disclose material inside information) rather than a more active type of fraud is involved. In his recent book, *Insider Trading and the Stock Market,* Professor Henry G. Manne indicated that trading on inside information is widespread.[68] This conclusion is supported by a 1961 study in the *Harvard Business Review,* which reported that forty-two per cent of the insiders who returned questionnaires considered trading on inside information to be legitimate and that sixty-one per cent expressed a belief that the average executive would take advantage of inside information if he had the opportunity.[69] The SEC, therefore, is attempting to regulate the conduct of a large segment of the business community. For the most part it is not dealing with malicious or willful frauds; rather, it is concerned with the by-product of an underlying attitude which pervades the business community. The SEC's goal is to promote complete disclosure of essential information at the earliest possible time, and the means used to secure this goal must necessarily be tailored to the nature of the conduct being regulated and to the attitude with which the business community approaches such conduct. If the measures used to enforce the duty of disclosure are not sufficiently stringent, they will fail to affect prevailing attitudes and insiders will continue to trade before disclosure. On the other hand, if the remedies for a breach of the duty are too harsh, the courts will naturally be hesitant to apply them absent flagrant or abusive conduct. Furthermore, in selecting proper remedies, the courts should consider matters of efficiency; unreasonable demands on the resources of either the courts or the agency should be avoided.

66. Farmer, Cary, Fleischer & Halleran, *supra* note 62, at 1010.

67. *Ibid. But see* MANNE, INSIDER TRADING AND THE STOCK MARKET 12-15 (1966), for a criticism of Cary's arguments.

68. MANNE, *op. cit. supra* note 67, at 63, 66-68.

69. Baumhart, *How Ethical Are Businessmen?*, Harv. Bus. Rev., July-Aug. 1961, pp. 6, 16.

B. *Civil Liability as an Enforcement Measure*

Private civil suits have been frequently and successfully used in enforcing securities legislation. For example, stockholders have brought suits as "private attorneys general" pursuant to section 16(b) of the act in order to force insiders to return to the corporation illegal short swing profits.[70] Indeed, the mere threat of civil liability under sections 11 and 12 of the Securities Act of 1933 appears to have been instrumental in securing full disclosure through the registration of *new* issues under section 5 of that act.[71] The courts have also allowed private individuals to bring suit for violations of rule 10b-5 on the theory of statutory tort, without requiring them to prove the traditional common-law elements of fraud.[72] Such suits are favored by the Commission, for, in addition to their effectiveness, they require little or no agency effort.[73]

However, the use of civil remedies would not be an appropriate means of enforcing the *Texas Gulf* duty. When the stock has been actively traded on the market, the number of potential plaintiffs and the amount of potential liability will be overwhelming.[74] A footnote to the *Texas Gulf* decision indicates that, at the time the opinion was written, forty-nine private suits seeking over $77,000,000 in damages had been filed against the defendants.[75] In light of the magnitude of such claims, surely the courts would be inhibited from finding a breach of duty by any but the most obvious of violators. Since the *Texas Gulf* duty arises only where there is a failure to disclose *material* information, an essential element in establishing a breach of the duty is a finding of materiality. However, conscious of the fact that private litigants were claiming $77,000,000 in damages, the district court in *Texas Gulf* resorted to a very narrow view:

> [T]he test of materiality must necessarily be a conservative one, particularly since many actions under Section 10b are brought on the basis of hindsight. As stated by a former member of the staff of the Commission: "It is appropriate that management's duty of dis-

70. Securities Exchange Act of 1934, § 16(b), 48 Stat. 896, 15 U.S.C. § 78p(b) (1964).

71. Securities Act of 1933, § 5, 48 Stat. 77, as amended, 15 U.S.C. § 77(e) (1964), requires registration and full disclosure in connection with any new issue of a security. Securities Act of 1933, §§ 11-12, 48 Stat. 82, as amended, 15 U.S.C. §§ 77k-*l* (1964), provide civil liability for violation of § 5. Although few suits have been brought pursuant to these sections, the substantial civil liability they impose has been responsible for a high degree of compliance with § 5 of the Act. See 3 Loss 1690; Note, 65 MICH. L. REV. 795, 797-99 (1967).

72. See Stevens v. Vowell, 343 F.2d 374, 379 (10th Cir. 1965); Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961). See generally 3 Loss 1757-71.

73. See Cary, Israels & Loss, *Recent Developments in Securities Regulation*, 63 COLUM. L. REV. 856, 858-59 (1963); Cary, Book Review, 75 HARV. L. REV. 857, 860-61 (1962).

74. See Knauss, *supra* note 56, at 635 n.111; Painter, *supra* note 62, at 1379; Comment, 74 YALE L.J. 658, 678 (1965).

75. *Texas Gulf* at 267 n.1.

closure under rule 10b-5 be limited to those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if disclosed. A more rigorous standard would impose an unreasonable burden on management in its securities trading . . . ."[76]

The court concluded that information is not material if it is merely the product of an "educated guess,"[77] and therefore only the two defendants who purchased immediately before disclosure, when the existence of the mine was an absolute certainty, were held liable.[78] Thus, the magnitude of potential civil liability inhibited the court from developing a more meaningful concept of materiality and forced it to limit the *Texas Gulf* 10b-5 duty to "extraordinary cases." Such a narrow interpretation of the duty will accomplish little in the way of getting relevant information to the public at the earliest possible time. On the contrary, it may strike a serious blow to the objectives of the act by encouraging the non-flagrant use of inside information.

Consequently, if civil liability is to be a viable means of enforcing the *Texas Gulf* duty, it must be limited. However, it is doubtful that the courts can develop workable limitations. One approach might be to require privity between the defendant and the plaintiff—that is, to limit private recovery to those persons who actually sold their stock to the particular defendants. But, regardless of the method utilized for determining the sellers who are in privity with the defendants,[79] no logical justification can be presented for allowing one seller to recover while others do not, especially since the identity of the purchaser is generally totally irrelevant and un-

76. *Id.* at 280, quoting from Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 VA. L. REV. 1271, 1289 (1965).

77. *Texas Gulf* at 283-84.

78. *Id.* at 286-87. The court dismissed charges against defendant Fogarty who apparently considered the information sufficiently material to warrant the purchase of 3,100 shares during the period in question. Eight hundred of these shares were purchased for $22,000 between April 1, 1964, and April 16, 1964, when disclosure was finally made. *Id.* at 274.

79. A seller might be identified by one of two methods when transactions have been made on a national exchange. First, defendant's shares might be traced through the clearing house to the previous owner. However, time lapses in the clearing house process might result in the identification of a person who sold at a time completely removed from the defendant's purchase—even after disclosure. See LEFFLER & FARWELL, THE STOCK MARKET 282-86 (3d ed. 1962). In order to circumvent the time lapse problem, shares could be matched by focusing on the actual transactions among brokers; a seller whose broker sold at exactly the same time the defendant's broker purchased might therefore satisfy the privity requirement. Although such tracing would be impractical, it would be theoretically possible, unless the defendant's broker bought from a specialist—one who works on the market floor buying and selling from his own block of shares. The interposition of a specialist in the line of transactions would make identification of a public seller in privity with defendant buyer impossible. *Id.* at 203-11.

known to any seller. For this reason, the courts have substantially eliminated the privity requirement from other 10b-5 civil actions and it would appear that in the instant case there are no compelling policy considerations that would dictate the resurrection of privity as a prerequisite for civil liability.[80]

A second approach for limiting civil liability would be to require each plaintiff to prove reliance—that is, to establish that he would not have sold the stock had the material information been disclosed.[81] However, it is doubtful that this requirement could be effectively implemented since it is likely that every seller will contend that disclosure would have prevented his sale, thereby requiring the courts to engage in a difficult factual determination. Thus, litigation would not be diminished and there is no assurance that the amount of civil liability would in fact be limited.[82]

The above discussion suggests that the breach of the *Texas Gulf* duty should not give rise to private actions. This might appear to be inconsistent with the *Kardon* statutory-tort doctrine which recognizes an extra-statutory civil remedy for parties sustaining damages as a result of a 10-b(5) violation. On the contrary, however, such a conclusion would merely give effect to the limitations placed on civil actions by section 28 of the act, which provides that "no person permitted to maintain a suit for damages under the provisions of this title shall recover . . . a total amount in excess of his actual damages on account of the act complained of."[83] The courts have construed section 28 as establishing causation as a prerequisite to the bringing of a private civil suit.[84] Causation is also a necessary

80. See Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962); Texas Continental Life Ins. Co. v. Bankers Bond Co., 187 F. Supp. 14 (W.D. Ky. 1960), *rev'd on other grounds*, 307 F.2d 242 (6th Cir. 1962); Comment, 74 YALE L.J. 658, 661-67 (1965).

81. In List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir. 1965), the court recognized that the traditional common-law requirement of conscious reliance is inappropriate in cases involving silent non-disclosure: "Such a requirement would unduly dilute the obligation of insiders to inform outsiders of all material facts." *Id.* at 463. The court indicated that the proper test of reliance in these cases is "whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact." *Ibid.*

82. Class suits, while tending to decrease the amount of civil litigation, would not be completely effective since there must be common questions of law and fact and the plaintiff must insure adequate representation for the class. Moreover, some members of the class might withdraw to bring separate suits. See FED. R. CIV. P. 23; 3 Loss 1819; Comment, 51 CALIF. L. REV. 939 (1963). *Texas Gulf* itself indicates that the class action device will not avoid multiple suits. "At least 49 private actions are now pending in this court against TGS, defendants named in this action, and others . . . . Some 16 of these are individual actions, 31 are said to be class actions, and one is a derivative action." *Texas Gulf* at 267 n.1.

83. Securities Exchange Act of 1934, § 28, 48 Stat. 903, 15 U.S.C. § 78bb (1964).

84. See Estate Counseling Serv., Inc. v. Merrill Lynch, Pierce, Fenner, & Smith, Inc., 303 F.2d 527, 533 (10th Cir. 1962); Kohler v. Kohler Co., 208 F. Supp. 808, 825 (E.D. Wis. 1962), *aff'd*, 319 F.2d 634 (7th Cir. 1963); Mills v. Sarjem Corp., 133 F. Supp. 753, 761 (D.N.J. 1955).

element of the statutory-tort theory, upon which a majority of private parties seeking damages for 10b-5 violations must rely.[85] In the *Texas Gulf* case, if the wrong complained of is defendant's purchasing with an unfair advantage, the defendant did not *cause* harm to any seller because these sellers would have sold regardless of the defendants' unfair purchases.[86] The use of a causation test in such a situation would therefore eliminate private actions and do so on the basis of statutory construction. On the other hand, persons who sold prior to the disclosure could contend that the source of their damages is the lack of disclosure and that therefore they were damaged within the meaning of section 28. This argument must rest on the premise that an insider has a duty either to disclose *or* to forego purchasing, and that by purchasing he elects to fulfill his duty by disclosing. The fallacy in this argument, however, is that both the courts and the SEC recognize that the *Texas Gulf* duty cannot realistically be framed to compel disclosure.[87] Therefore, although the duty has been stated in the alternative, it should be construed only as requiring insiders to refrain from purchasing on the basis of undisclosed information, that is, purchasing with an unfair advantage. As indicated above, this interpretation of the duty precludes a finding of causation and thus eliminates the possibility of bringing a private action.

C. *Prospective and Preventive Enforcement Measures*

Absent private enforcement of the *Texas Gulf* duty, regulation by the SEC and the Attorney General becomes the only available means of protecting the investing public. There are several enforcement measures specifically provided by the act and several alternative measures which can be developed by the courts.

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85. RESTATEMENT, TORTS §§ 286(c)-(d) (1934). An alternative theory for private civil recovery which would not entail any express causation requirement, might be based on Securities Exchange Act of 1934, § 29(b), 48 Stat. 903 (1934), as amended, 15 U.S.C. § 78cc(b) (1964), which provides that contracts made in violation of the act shall confer no legal rights upon the violator. However, an implied civil cause of action could not be based on this section in the present case. Contractual privity would seem to be a necessary element under this theory, 3 Loss 1759, and privity would not be an effective concept for determining the right to recovery in *Texas Gulf*. See text accompanying note 80 *supra*.

86. MANNE, *op. cit. supra* note 67, at 93-110; Whitney, *supra* note 62, at 201-02; Note, 80 HARV. L. REV. 468, 475 (1966); Comment, 74 YALE L.J. 658, 675 (1965). It should be noted however that a different question is presented by Texas Gulf's granting of stock options to defendants before disclosure. See *Texas Gulf* at 290-92. The committee in charge of awarding stock options was in direct contact with the defendants and the defendants' silence could well have had a direct effect on the decision to grant the stock options. In a case so closely resembling common-law fraud, it might be completely proper to allow a private suit by the corporation, or on behalf of the corporation, to cancel the stock options. This type of suit would be limited in scope and would not be inconsistent with rejection of the broader type of civil liability to plaintiffs who sold on the market.

87. See text accompanying notes 61-62 *supra*.

(1) *Criminal Liability*

To the extent that an *in terrorem* deterrent is used to effect compliance with the *Texas Gulf* 10b-5 duty, the courts should rely upon the substantial criminal sanctions authorized by the act. Section 21(e) permits the SEC to seek an injunction and, in addition, provides that the Commission may "transmit such evidence as may be available . . . to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this chapter."[88] The language of section 21(e) thus indicates a congressional intent that when a penal sanction rather than a prospective injunction is appropriate, such a sanction should be sought by the Attorney General. Were the SEC to seek the imposition of penal sanctions, the alleged violator would be deprived of his right to a jury trial and the protection of section 32(a)'s requirement of willful violation, both of which would be available if the Attorney General were to prosecute the suit.[89] Thus, if penal sanctions are desired, the courts should not try to effect such sanctions by expanding the remedies available to the SEC.

Criminal suits under section 32 have played an important role in enforcing securities legislation, particularly insofar as they help to publicize the fact that the federal government does intend to enforce such legislation. By the end of fiscal year 1965, 1,880 defendants had been convicted of criminal violations of securities regulations.[90] However, the Attorney General cannot be the primary regulator of insider trading. Since considerations of time and money preclude prosecution except in those cases involving a more serious fraud or positive misrepresentation,[91] it is doubtful that the Attorney General could or would assume the burden of prosecuting the numerous cases involving the type of borderline violation at issue in *Texas Gulf*. Moreover, if the Attorney General were to attempt to regulate insider trading, he would be faced with the task of establishing in each case fraudulent intent and willful violation.[92] Since this would require proof that a defendant knew that

88. Securities Exchange Act of 1934, § 21(e), 48 Stat. 899, as amended, 15 U.S.C. § 78u(e) (1964).

89. Securities Exchange Act of 1934, § 32(a), 48 Stat. 904, as amended, 15 U.S.C. § 78ff(a) (1964), provides for fines up to $10,000 for individuals and jail sentences of a maximum of two years "for any person who wilfully violates any provision of this chapter."

90. 1965 SEC ANN. REP. 174. This figure should be compared with the total number of injunctions obtained by the Commission which is 3,682. *Id.* at 173.

91. See 3 Loss 1993.

92. Securities Exchange Act of 1934, § 32(a), 48 Stat. 904, as amended, 15 U.S.C. § 78ff(a) (1964), punishes only willful violations of the act. It has been held that the corresponding provision of the Securities Act, § 24, 48 Stat. 87, 15 U.S.C. § 77x (1964), does not require proof of specific intent, bad motive, and knowledge for the imposition of criminal liability. United States v. Sussman, 37 F. Supp. 294 (E.D. Pa. 1941). A recent case, however, has indicated that the requirement of willfulness will be given more substantial meaning when the duty violated lacks precision and clarity as in the *Texas*

the information he withheld was material—a difficult burden in view of the vagueness of the judicial definition of materiality—the expanded imposition of criminal liability would be extremely difficult.

(2) *Investigation and Publication*

Under section 21(a) of the act, the Commission is given the authority to:

> make such investigations as it deems necessary to determine whether any person has violated, or is about to violate, any provision of this chapter . . . . The Commission is authorized, in its discretion, to publish information concerning such violations . . . .[93]

Section 21(b) further authorizes the Commission to:

> administer oaths and affirmations, subpena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, or other records which the Commission deems relevant or material to the inquiry.[94]

It has been suggested that the sensitivity of most corporate insiders about their reputations renders the SEC's power to investigate and publish a significant deterrent.[95] Such measures have definite advantages in terms of efficiency because they do not require the courts to expend either time or effort. Moreover, since section 16(a) requires insiders to report to the Commission all transactions in their companies' stock,[96] it is relatively easy for the SEC to spot potential violations of rule 10b-5. However, it is questionable whether investigation and publication unaccompanied by other sanctions would be effective in enforcing the *Texas Gulf* duty. Opportunities for personal advantage to violators are great, and the deterrent effect of publication may in fact be minimal since the business community does not seriously condemn this type of misconduct.[97] Furthermore, investigation will not bring violators before the courts, and the *Texas Gulf* duty should, in its early stages, be developed and defined by the courts which have the final responsibility for interpreting the act.

(3) *Injunction*

The Commission will probably continue to seek from the courts the more formal injunctive remedy. It is submitted that a permanent

Gulf case. See United States v. Crosby, 294 F.2d 928, 938-43 (2d Cir. 1961). *See generally* 3 Loss 1984-87.

93. 48 Stat. 899 (1934), 15 U.S.C. § 78u(a) (1964).
94. 48 Stat. 899 (1934), 15 U.S.C. § 78u(b) (1964).
95. Painter, *supra* note 62, at 1382.
96. Securities Exchange Act of 1934, § 16(a), 48 Stat. 896, as amended, 15 U.S.C. § 78p(a) (1964).
97. See text accompanying notes 68-69 *supra*.

injunction would have a greater psychological impact on corporate insiders than would investigation and publication by the SEC. It would also prevent future violations by the particular defendant involved. As noted earlier, the injunctive remedy is available in almost all cases since the threat of future violation can usually be inferred from a past violation.[98] However, it is evident from *Texas Gulf* that the SEC believes that an injunction without more is not a sufficient remedy against a defendant who is allowed to retain the profits of his illegal conduct. The SEC has apparently concluded that the prospect of substantial profit which is immune from further legal sanctions more than counterbalances the threat of censure from either the courts or the business community.[99] Such a conclusion may be well-founded, particularly when the business community does not seriously condemn the conduct—insider trading—sought to be regulated.[100] Furthermore, an injunction would be notably ineffective against a violator who is neither attempting to build a reputation in the business community nor is in such a position that it is likely that he will again have access to important inside information.

(4) *Preventing Unjust Enrichment*

The SEC has taken the position that the most effective means of enforcing the 10b-5 duty is to deprive insiders of any profits acquired as a result of purchasing with an unfair advantage. It is submitted that this conclusion is an accurate one since only by depriving insiders of potential profits will the temptation to indulge in such activity be eliminated. In *Texas Gulf*, the SEC asked the court to order the defendants to offer their sellers an opportunity to *rescind*.[101] However, rescission is both undesirable and inappropriate when the stock has been traded on the market and has con-

98. See text accompanying note 31 *supra*.

99. See Pretrial Memorandum of Law of Plaintiff, pp. 51-52, *Texas Gulf*.

100. See text accompanying notes 68-69 *supra*.

101. Complaint, p. 33, *Texas Gulf*. The SEC in *Texas Gulf* also requested that certain defendants be ordered to offer not only rescission of their own purchases, but also restitution for the purchases made by persons to whom they disclosed the information. This order cannot be rationalized by any unjust enrichment theory, since the SEC has not alleged that these defendants profited from giving tips. Thus any order directing restitution for the "tippee's" purchases would be a penalty, and outside the SEC's power. Admittedly, the giving of inside tips may be a significant problem because insiders can take advantage of inside information indirectly by trading it to executives of other companies in exchange for a return favor at a later date. However, the solution to this problem is to deny the "tippee" his profit, rather than to penalize the person who gave the tip. If insiders were forced to make restitution for the purchases of their "tippees" there would be a danger that important sources of corporate information would dry up, for insiders would necessarily become wary of discussing corporate affairs with anyone who might later make purchases on the basis of the information they received. See Farmer, Cary, Fleischer & Halleran, *supra* note 62, at 1013-14.

tinued to climb since the initial disclosure of the inside information. Rescission would deprive the violators of the increment in the value of their stock between the time of purchase and the bringing of the suit. The SEC bases its claim for rescission on the theory of unjust enrichment,[102] but the amount taken from the defendant by rescission may considerably exceed the amount which is justified by such a rationale since it would include the increment in value from the time at which the defendant could have legitimately purchased the stock.[103] Indeed, the inclusion of this amount would appear to be penal in nature and thus an infringement upon the powers which Congress has specifically granted to the Attorney General.

This is not to suggest that the theory of unjust enrichment is not an appropriate basis for an SEC action against one who has breached the *Texas Gulf* duty. Indeed, an action for *restitution* based upon such a theory would be most appropriate since it would deprive the insider of the amount, and only the amount, by which he profited as a result of purchasing on the basis of material inside information. However, even if the order is limited to an award for restitution, two questions remain. First, the courts will have to determine precisely the measure of the amount to be recovered pursuant to a theory of unjust enrichment. Since the price of the stock will probably not change appreciably until after the disclosure of the material information, the gain obtained (or loss avoided) between defendants' transactions and the moment of disclosure will generally be substantially less than the amount by which the defendant is unjustly enriched. A more realistic measure would be the difference between the market value of the stock at the time of defendant's purchase and its value when the public reaction to the disclosure has been recorded on the market—the point at which the SEC believes insiders can legitimately begin to transact.[104] Admit-

102. Pretrial Memorandum of Law of Plaintiff, p. 51, *Texas Gulf*.

103. A different argument for rescission might be advanced on the basis of Securities Exchange Act of 1934, § 29(b), 48 Stat. 903, as amended, 15 U.S.C. § 78cc(b) (1964), which provides that contracts made in violation of the act are "void" as regards the rights of any person who, in violation of the act, has engaged in the performance of such contract. Thus, it might be said that ownership of the purchased shares never passed to defendants and that the shares still belong to the original holders. This argument, however, ignores the fact that it may be impossible to find the seller. It also disregards the fact that the defendants have rights in the stock as holders of negotiable instruments even if the contract of sale is "void." See, *e.g.*, UNIFORM COMMERCIAL CODE § 8-105. Indeed, in similar provisions of state blue sky laws, the word "void" has been interpreted to mean "voidable" since only persons in privity are allowed to rescind the sale and the holder of the stock is allowed to transfer good title to another purchaser. See 3 Loss 1632-33. It seems necessary to interpret § 29(b) in the same way since the statute clearly protects an innocent purchaser. Thus § 29(b) would justify rescission only in favor of a person in privity of contract with the defendant and would not apply to a regulatory suit by the SEC when the seller is unknown and probably cannot be found.

104. Pretrial Memorandum of Law of Plaintiff, pp. 34-35, *Texas Gulf*.

tedly, the court in *Texas Gulf* held that it was not illegal for defendants to purchase forty minutes after disclosure, which was before the information had even gone out over the Dow-Jones tape.[105] However, the court did express agreement with the Commission's position that transactions should not be sanctioned until the information has reached the market and indicated that its refusal to impose liability was based on the fact that there was no Commission rule that specifically condemned "gun jumping."[106] If the appellate court takes the same position on this issue, the Commission will probably promulgate the necessary rule for imposing liability on persons who purchase before the information has been absorbed by the market.[107]

Second, it will be necessary for the courts to determine the recipient or beneficiary of the restitutionary award. Pursuant to section 27, which gives the courts the power to fashion appropriate remedies, the selection of the recipient could be left to judicial determination. One alternative is to give the amount recovered to the corporation; this would be consistent with the congressional scheme for dealing with illegal shortswing profits under section 16(b) of the act.[108] Although it may be argued that it would be more appropriate to designate the sellers as the recipients, such an approach introduces numerous administrative difficulties. For example, assuming that the award would be given to a master to be distributed among the sellers, it would still be necessary to determine with precision the class of sellers involved.[109] Moreover, as indicated above, the

105. *Texas Gulf* at 288-90.

106. *Id.* at 288-89.

107. Due to the difficulty of pinpointing the exact moment at which the public reaction has been absorbed by the market, the courts or the SEC will have to designate a reasonable, albeit arbitrary, point of time; possible alternatives include an approximation of the point when the information has gone out over the wire and brokers have had sufficient time to call their customers, or the point when the average investor would have been able to read the newspaper and call his broker.

108. 48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1964). For the purpose of preventing the unfair use of inside information, § 16(b) makes the profits of officers, directors, and 10% shareholders resulting from the purchase and sale, or sale and purchase, of their corporation's stock within a period of six months recoverable by the corporation.

In Brophy v. Cities Serv. Co., 31 Del. Ch. 241, 70 A.2d 5 (Ch. 1949), a case relied upon in both *Cady-Roberts* and *Texas Gulf* as establishing the duty to forego transactions until after the disclosure of material information, the court ordered that the unjust enrichment from the insiders' transactions be paid over to the corporation.

109. Presumably, the class of sellers entitled to recover would be composed of those persons who sold during a period of time starting with the violation and ending at the point when disclosure became effective. If trading on the market was heavy during this period of time it would be difficult to determine exactly which sellers were in this class. It seems fair to make the determination by reference to the point of time when the sellers decided to sell and contacted their brokers, but this would involve a difficult factual inquiry. If a number of defendants were involved, the master would have to decide whether the unjust enrichment of each defendant should be treated separately or combined into a common fund to be distributed to the relevant class of sellers. In any case similar to *Texas Gulf*, the number of sellers in the class entitled to recover would be so great that their individual recovery would be insignificant. Thus identifica-

prime objective is to deprive the insiders of any benefits they might have obtained as a result of purchasing with an unfair advantage, and not to compensate the sellers.[110]

If the courts are willing to designate the corporation as the recipient of the restitutionary award obtained as the result of an SEC suit, they might consider as an alternative a shareholders' derivative suit on behalf of the corporation.[111] However, although such a suit would relieve the SEC of a significant part of its enforcement burden, it would not be an adequate substitute for an SEC action. Not only would the SEC lose control over its enforcement plan, but such an action would be difficult to justify in terms of traditional derivative suit theory since the corporation would not actually be harmed by the insider's purchases. Moreover, the appropriateness of a rule 10b-5 derivative suit cannot be as clearly ascertained as that of a similar suit for short-swing profits under section 16(b) and therefore to permit a 10b-5 derivative suit would be to put insiders in jeopardy of nuisance suits whenever they purchased or sold.[112]

III. Conclusion

Section 27 of the Securities Exchange Act permits the courts to exercise considerable discretion in the framing of remedies for violations of securities legislation. The courts must recognize, however, that this discretion carries with it the responsibility of assuring that such remedies are appropriate in light of the conduct sought to be regulated and effective in terms of achieving the policy objectives

tion of the class of sellers and distribution of the fund could be deemed a waste of administrative effort.

110. In cases where the corporation involved is small, transactions in its stock are infrequent, and defendant insiders own a large portion of the corporation's stock, it would be more appropriate and more practical for the court or a master to select a seller to receive a windfall instead of the corporation.

111. See generally Comment, 18 Stan. L. Rev. 1339 (1966); Comment, 114 U. Pa. L. Rev. 578 (1966).

112. For enforcement by means of derivative suits to be effective, it would seem necessary to encourage private suits by following the precedent set in § 16(b) suits of paying the counsel fees of the plaintiff out of any judgment obtained. See 2 Loss 1051-52. Professor Loss has condemned the practice of allowing plaintiff's counsel fees under § 16(b) because it encourages champerty; indeed, he believes that § 16(b) should be enforced by the SEC. *Id.* at 1053. Professor Cary, on the other hand, approves present practice under § 16(b) because it relieves the Commission of a significant enforcement burden. Cary, Book Review, 75 Harv. L. Rev. 857, 860-61 (1962). Professor Cary's position on the enforcement of § 16(b) may be correct, since it applies exclusively to the relatively well-defined situation where there has been a purchase and a sale by an insider within six months, and therefore presents only a limited opportunity for suits to be instigated by attorneys interested in contingent fees. However, a derivative suit for violation of the somewhat ill-defined *Texas Gulf*-rule 10b-5 duty would subject insiders to champertous nuisance suits *whenever* they bought or sold stock in their corporations. Thus, Professor Loss' condemnation of champertous suits is far more persuasive when the suit is based on rule 10b-5.

underlying the act. The preceding discussion has attempted to focus attention on various alternative remedies which may be used to enforce section 10(b) of the Securities Exchange Act. It must be remembered that the point of departure—the *Texas Gulf Sulfur* case—involves insider trading on a national exchange where silence rather than a more active type of fraud is at issue. Although most insider trading is included within this category, the courts will undoubtedly be faced with numerous situations in which the facts are not analogous to *Texas Gulf,* but a discussion of the effect of these variations on the remedies discussed herein will have to wait for another time.

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