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A Re-Evaluation of Federal and State Regulation of Insider Trading on the Open Securities Market

Anne Graff Brown
Washington University School of Law

A RE-EVALUATION OF FEDERAL AND STATE REGULATION OF INSIDER TRADING ON THE OPEN SECURITIES MARKET

Insider trading occurs when fiduciaries purchase or sell shares of their corporation and the transactions are, at least in part, motivated by insider information acquired in performance of their fiduciary duties.[1] Although authority exists to the contrary,[2] the widely accepted view is that insider trading should be deterred because it is unfair to other investors who do not enjoy access to inside information.[3] A principal goal of the Securities Exchange Act of 1934[4] is "to insure the maintenance of a fair and honest market" in securities trading.[5] One means of achieving this end is through regulation of insider trading.[6]

This Note focuses on trading on the open market by corporate officers and directors who use undisclosed material inside information. Specifically, this Note examines the lack of federal or state regulation of insider activity in impersonal market transactions. The present scheme of insider trading regulation demands renewed examination in light of recent developments in federal securities law.[7]

1. W. PAINTER, FEDERAL REGULATION OF INSIDER TRADING 2-3 (1968).

2. One commentator, Professor Henry Manne, opposes sanctions against insider trading. Professor Manne argues that insider trading is a desirable method of rewarding entrepreneurial effort. H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966); Ferber, *The Case Against Insider Trading: A Response to Professor Manne*, 23 VAND. L. REV. 621 (1970); Manne, *In Defense of Insider Trading*, 44 HARV. BUS. REV. 113 (1966); Manne, *A Rejoinder to Mr. Ferber*, 23 VAND. L. REV. 627 (1970); Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 54 (1970).

3. Freeman v. Decio, 584 F.2d 186, 189 (7th Cir. 1978). *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969); *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961). *See generally* L. LOSS, SECURITIES REGULATION 1037-38 (1961); W. PAINTER, *supra* note 1, at 1-6; Farmer, Cary, Fleischer & Halleran, *Insider Trading in Stocks*, 21 BUS. LAW. 1009, 1010 (1966).

4. 15 U.S.C. §§ 78a-78kk (1976).

5. *Id.* at § 78b.

6. The preamble of the Securities Exchange Act of 1934 specifically refers to the need to regulate and control transactions of "officers, directors, and principal security holders." *Id.* "[O]ne of the primary purposes of the Securities Exchange Act of 1934 . . . was to outlaw the use of inside information by corporate officers and principal stockholders for their own financial advantage to the detriment of uninformed public security holders." Speed v. Transamerica Corp., 99 F. Supp. 808, 829 (D. Del. 1951).

7. Aaron v. United States, 100 S. Ct. 1945 (1980); Chiarella v. United States, 445 U.S. 222 (1980); Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); Affiliated Ute Citizens

The examination begins with a survey of the common-law approach to insider trading. Part II reviews an innovative remedy fashioned by the New York Court of Appeals in *Diamond v. Oreamuno*.[8] Part III analyzes the effectiveness of federal securities regulation in addition to emphasizing recent Supreme Court mandates in rule 10b-5 actions.[9] Part IV evaluates three reform proposals for providing legal sanctions against insider trading on the open securities market.

I. COMMON-LAW APPROACHES TO INSIDER TRADING

Traditionally directors and officers of a corporation owe no duty to disclose material inside information in the purchase or sale of stock.[10] If the insider makes misrepresentations or half-truths in the purchase or sale of stock, however, he may be liable in a common-law tort action for deceit or fraud.[11] Thus, under the majority common-law approach, a director or officer is not liable to a purchaser or seller for nondisclosure of inside information providing the nondisclosure falls short of an affirmative misrepresentation or half-truth.[12]

Several jurisdictions developed the "special facts rule" as an exception to the majority rule.[13] The rule, first enunciated by the Supreme Court in *Strong v. Repide*,[14] recognizes a duty to disclose inside infor-

v. United States, 406 U.S. 128 (1972); Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974).

8. 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969).

9. 17 C.F.R. § 240.10b-5 (1980).

10. "The orthodox view was that a director or officer occupied a fiduciary relationship to the corporation and its shareholders as a body with respect to corporate business and property." H. HENN, CORPORATIONS § 239, at 471 (2d ed. 1970). Because shares are the private property of the shareholders, not the corporation, dealings in shares were not considered corporate transactions. Therefore directors and officers owed no fiduciary duties to the shareholders concerning such dealings. *Id. See* Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659 (1933); Comment, *Insider Trading Without Disclosure—Theory of Liability*, 28 OHIO ST. L.J. 472 (1967); Comment, *Insider Liabilities Examined*, 18 SYRACUSE L. REV. 808 (1967).

11. R. FROME & V. ROSENZWEIG, SALES OF SECURITIES BY CORPORATE INSIDERS § 8.101, at 233-34 (1975). The elements of a common-law action for deceit are as follows: "There must be (1) a false representation of (2) a material (3) fact; (4) the defendant must know of the falsity (scienter) but make the statement nevertheless for the purpose of inducing the plaintiff to rely on it; and (5) the plaintiff must justifiably rely on it and (6) suffer damages as a consequence." L. LOSS, *supra* note 3, at 1431.

12. R. FROME, *supra* note 11, § 8.101, at 234; H. HENN, *supra* note 10, § 239, at 471.

13. R. FROME, *supra* note 11, § 8.102, at 234-35; H. HENN, *supra* note 10, § 239, at 472; L. LOSS, *supra* note 3, at 1446-47.

14. 213 U.S. 419 (1909). A controlling stockholder and general manager of a corporation was

mation to sellers or purchasers under special facts or circumstances.[15]

Although the special facts rule marked a significant departure from the majority approach, a third view, the "minority rule," completely repudiated the traditional majority view. The minority rule requires corporate fiduciaries to disclose all material information to trading shareholders.[16] Under this approach nondisclosure, even in the absence of special facts, constitutes a breach of fiduciary duty.[17]

Organization of the common-law approach into three distinct views is easier in theory than in practice. Courts purporting to apply the majority rule instead apply the special facts doctrine.[18] In many states the expanding special facts doctrine virtually encompasses the minority rule.[19] Frequently, minority rule cases actually contain an element of fraud or a breach of fiduciary duty.[20] The case law does reveal, however, a growing sense of fiduciary responsibility to disclose inside information.[21]

Although courts are expanding the fiduciary duties of a corporate insider, common-law approaches have been unsatisfactory in deterring

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found guilty of fraud in purchasing the holdings of a minority stockholder without disclosing information concerning negotiations for the sale of the company's business at a very favorable price. On consideration of all the factors, particularly the insider's position and knowledge of the company, the Court held that "it became the duty of the defendant, acting in good faith, to state the facts before making the purchase." *Id.* at 431.

15. The special facts or circumstances that trigger a duty either to disclose material inside information to sellers or purchasers or to refrain from buying or selling stock include: Closely held shares with no readily ascertainable market value, Saville v. Sweet, 234 A.D. 236, 254 N.Y.S. 768 (1932); director or officer with insider access to information, Gratz v. Claughton, 187 F.2d 46 (2d Cir. 1951); shareholder lacking in business acumen, Jaynes v. Jaynes, 98 Cal. App. 2d 447, 220 P.2d 598 (1951); instigation of a transaction by director or officer, Strong v. Repide, 213 U.S. 419 (1909); and the use of an intermediary by a director or officer coupled with nondisclosure of the principal, Taylor v. Wright, 69 Cal. App. 2d 371, 159 P.2d 980 (1945). *See* Comment, *Insider Liability Under Securities Exchange Act Rule 10b-5: The Cady, Roberts Doctrine*, 30 U. CHI. L. REV. 121, 123-25 (1962).

16. Dawson v. National Life Ins. Co., 176 Iowa 362, 157 N.W. 929 (1916); Jacquith v. Mason, 99 Neb. 509, 156 N.W. 1041 (1916).

17. Most commentators approve this view. L. LOSS, *supra* note 3, at 1446-47. *See* Annot., 84 A.L.R. 615, 622-23 (1933).

18. *See, e.g.,* Taylor v. Wright, 69 Cal. App. 2d 371, 159 P.2d 980 (1945).

19. *See, e.g.,* Jacobson v. Yaschik, 249 S.C. 577, 155 S.E.2d 601 (1967).

20. *See, e.g.,* Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903); Stewart v. Harris, 69 Kan. 498, 77 P. 277 (1904).

21. In the last fifty years the majority rule has been applied in pure form in very few cases. H. HENN, *supra* note 10, § 239, at 472 n.4. Some authorities maintain that the "majority rule" has actually been applied in pure form in only one or two cases in the last thirty years. L. LOSS, *supra* note 3, at 1448 n.8.

insider trading on the securities exchange or in over-the-counter transactions. Even under the liberal special facts or minority rule, the successful plaintiff must demonstrate privity between the parties.[22] The burden of proving that a plaintiff bought the shares from, or sold them to, the insider presents an almost insurmountable obstacle to plaintiff when the transaction occurs on a national securities exchange.[23] Furthermore, plaintiff must demonstrate reliance on the disclosed or, worse yet, the undisclosed information.[24] Reliance, however, is virtually impossible to prove in anonymous trading transactions.[25] At common law an insider, even one with a duty to disclose inside information, can trade on the open market with impunity.[26]

II. AN INNOVATIVE APPROACH TO INSIDER TRADING: *DIAMOND V. OREAMUNO*

A. *Prelude to* Diamond

At common law, courts do not permit the corporation to recover against its officers or directors who trade on inside information.[27] The only two recognized exceptions to corporate nonrecovery occur with diversion of a corporate opportunity,[28] or loss of corporate con-

22. *See* note 11 *supra* for a list of the elements of an action for deceit.

23. For a good discussion of the time consuming and expensive steps necessary in tracing shares from the purchasers to the original sellers in open market transactions, see Reynolds v. Texas Gulf Sulphur Co., 309 F. Supp. 566, 569-70 (D. Utah 1970). *See also* SECURITIES AND EXCHANGE COMMISSION, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, 88th Cong., 1st Sess., pt. 2, at 355-56 (1963).

24. *See* note 11 *supra. See, e.g.,* Jacobson v. Yaschik, 249 S.C. 577, 155 S.E.2d 601 (1967).

25. *See, e.g.,* Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701 (S.D.N.Y. 1951); Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659 (1933).

26. Every state has some law regulating securities transactions. These statutes, known as "blue sky laws," typically protect only purchasers and are directed at deterring infirmities in the original issuance of securities, not in subsequent transactions in the stock. *See* L. Loss & E. COWETT, BLUE SKY LAW 11 (1958). "Even the Uniform [Securities] Act, now in force in nearly half the states, falls short. It has adopted all three 10b-5 clauses in its general prohibition and clause 2 in its express civil liability provision, but recovery is limited to purchasers, and implied liability is denied." 1 A. BROMBERG, SECURITIES LAW: FRAUD § 2.7(2), at 57 (1977).

27. *See* notes 10-25 *supra* and accompanying text.

28. The corporate opportunity doctrine prohibits corporate personnel from diverting to themselves opportunities in which the corporation has a right, property interest, or expectancy or which, in justice, belongs to the corporation. The following factors often point to a corporate opportunity: (1) The corporation has a present interest, a tangible expectancy in the opportunity; (2) the opportunity was discovered by the director in his capacity as director of the corporation; (3) the corporation's funds were involved in the director discovering or acquiring the opportunity; or (4) where the corporation's facilities or employees were used in developing it. H. HENN, *supra*

trol.[29] Courts that deny relief to the corporation for use of inside information by its officers and directors reason that the corporation suffers no harm in the traditional sense of measurable, monetary loss. The resulting injury, if any, is to the uninformed trader, rather than to the corporation.[30]

In *Brophy v. Cities Service*[31] a court first recognized a cause of action in the corporation for recovery of insider trading profits. The *Brophy* court held an employee liable to the corporation for profits realized in the purchase and sale of stock based on inside information.[32] The employee, a confidential secretary to an officer and director of Cities Service, learned through his position that the corporation planned a tender offer for a substantial number of shares.[33] The proposed offer was sufficient to cause a rise in the market price of the shares.[34] Acting on the basis of the inside information, the employee purchased a block of stock and subsequently sold the stock when the corporation entered the market in accordance with the planned tender offer.[35]

In ordering an accounting of the profits, the Delaware court stated that loss to the corporation need not be alleged in a suit in equity for breach of a confidential relationship by an employee.[36] The court anal-

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note 10, § 237, at 462. *See* Ashman v. Miller, 101 F.2d 85 (6th Cir. 1939); Irving Trust Co. v. Deutsch, 73 F.2d 121 (2d Cir. 1934); Steven v. Hale-Haas Corp., 249 Wis. 205, 23 N.W.2d 620 (1946).

29. *See, e.g.,* Dunnett v. Arn, 71 F.2d 912 (10th Cir. 1934); Insuranshares Corp. v. Northern Fiscal Corp., 35 F. Supp. 22 (E.D. Pa. 1940). *See generally* H. HENN, *supra* note 10, at § 241; Hill, *The Sale of Controlling Shares*, 70 HARV. L. REV. 986 (1957); Jennings, *Trading in Corporate Control*, 44 CALIF. L. REV. 1 (1956).

30. In Newman v. Baldwin, 13 Misc. 2d 898, 179 N.Y.S.2d 19 (Sup. Ct. 1958), the shareholders of the corporation brought a derivative suit against the directors of the company for profits obtained through misrepresentations made in the sale of stock. The court held:

> [D]efendants have not been paid anything for an asset of the corporation. They have made profits as a result of misrepresentations, not an asset of the corporation [sic]. No court of equity would hold the corporation is entitled to the fruits of such misrepresentations. If there were misrepresentations, those who purchased in reliance on them may have causes of action against the tortfeasors for damages they sustained, but no recovery can enure to the benefit of the corporation or its stockholders generally. As to them, such a recovery would be an unjustified windfall.

Id. at 900-01, 179 N.Y.S.2d at 22. *See generally* Conant, *Duties of Disclosure of Corporate Insiders Who Purchase Shares*, 46 CORNELL L.Q. 53, 64-65 (1960).

31. 31 Del. Ch. 241, 70 A.2d 5 (1949).

32. *Id.* at 247, 70 A.2d at 8.

33. *Id.* at 243, 70 A.2d at 7.

34. *Id.*

35. *Id.*

36. The *Brophy* court stated: "Public policy will not permit an employee occupying a posi-

ogized an employee occupying a position of trust and confidence to the corporation to a fiduciary owing a duty to the beneficiary.[37] The court held that the employee, as a fiduciary, must not use confidential information acquired in the course of employment for his own benefit.[38]

B. Diamond v. Oreamuno

The principle set forth in *Brophy* lay dormant for twenty years until the New York Court of Appeals handed down the *Diamond v. Oreamuno* decision.[39] In *Diamond* defendants Oreamuno and Gonzales were, respectively, chairman of the board of directors and president of Management Assistance, Inc. (MAI).[40] Defendants learned that the net earnings of the corporation dropped seventy-five percent between July 1966 and August 1966 because of increased corporate expenditures.[41] Before the corporation publicly announced the decrease in net earnings, defendants sold 56,500 shares of MAI stock at the prevailing market price of twenty-eight dollars per share.[42] After the corporation disclosed its net earnings, the value of the stock fell to eleven dollars per share.[43]

Plaintiff, a shareholder of MAI, brought a derivative suit to compel an accounting of the profits acquired by defendants.[44] The New York Court of Appeals held that insider trading constitutes a breach of the fiduciary duties owed to the corporation regardless of whether the cor-

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tion of trust and confidence toward his employer to abuse that relation to his own profit, regardless of whether his employer suffers a loss." *Id.* at 246, 70 A.2d at 8.

37. *Id.* at 244, 70 A.2d at 7-8.

38. *Id.*

39. 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969).

40. MAI was in the business of financing computer installations through sale and lease back arrangements with various commercial and industrial users. *Id.* at 496, 248 N.E.2d at 911, 301 N.Y.S.2d at 79-80.

41. Under the lease provisions, MAI was required to maintain and repair the computers. Because MAI lacked the capacity to perform this function it was forced to hire the manufacturer of the computers, International Business Machines (IBM), to service the machines. As a result of a sharp increase in service charges by IBM, MAI's expenses for August 1966 rose considerably and its net earnings declined approximately 75%. *Id.* at 496-97, 248 N.E.2d at 911, 301 N.Y.S.2d at 80.

42. *Id.* at 497, 248 N.E.2d at 911, 301 N.Y.S.2d at 80.

43. The plaintiff alleged that "by taking advantage of their privileged position and their access to confidential information, Oreamuno and Gonzales were able to realize $800,000 more for their securities than they would have had this inside information not been available to them." *Id.*

44. *Id.* at 496, 248 N.E.2d at 911, 301 N.Y.S.2d at 79.

poration is a party to the transaction.[45]

Relying on principles from the law of trusts, the court reasoned that one who learns of confidential information by virtue of his fiduciary relationship cannot use that information for personal benefit.[46] The court compared the corporate fiduciary to a trustee, labeled "insider information" a corporate asset, and concluded that a corporate officer or director could not appropriate that asset for personal benefit.[47] Although the *Diamond* court found that plaintiff need not allege injury to the corporation in an action founded on breach of fiduciary duty, the court reasoned that it could infer harm in loss of corporate prestige and good will from abuse of a fiduciary relationship.[48]

The court concluded that the available federal remedies were inadequate to deter insider trading in this situation.[49] Section 10(b),[50] the general antifraud provision of the 1934 Act, provides three different means of enforcement, but the court found those remedies limited in scope.[51] A Securities and Exchange Commission (SEC) injunctive proceeding, the first method of enforcement, was more effective in establishing a principle than in providing a regular method of enforcement.[52] The class action, a second method of enforcement and a potentially effective remedy, was laden with unresolved questions.[53] A third method of enforcement under section 10(b), a private right of action, only existed if the individual purchaser or seller could demon-

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45. *Id.* at 498, 248 N.E.2d at 912, 301 N.Y.S.2d at 81.

46. *Id.* at 497, 248 N.E.2d at 912, 301 N.Y.S.2d at 80.

47. Just as a trustee has no right to retain for himself the profits yielded by property placed in his possession but must account to his beneficiaries, a corporate fiduciary, who is entrusted with potentially valuable information, may not appropriate that asset for his own use, even though, in so doing, he causes no injury to the corporation.

Id. at 498, 248 N.E.2d at 912, 301 N.Y.S.2d at 81. This denomination of inside information as a corporate asset was extensively criticized by the court in Freeman v. Decio, 584 F.2d 186, 193-94 (7th Cir. 1978). *See* note 70 *infra*. *See also* the RESTATEMENT (SECOND) OF AGENCY:

> An agent who acquires confidential information in the course of his employment . . . has a duty not to use it to the disadvantage of the principal. . . . He also has a duty to account for any profits made by the use of such information, although this does not harm the principal. . . . So, if he has "inside" information . . . profits made by him in stock transactions undertaken because of his knowledge are held in constructive trust for the principal.

RESTATEMENT (SECOND) OF AGENCY § 388, Comment c (1957).

48. 24 N.Y.2d at 498-99, 248 N.E.2d at 912, 301 N.Y.S.2d at 81-82.

49. *Id.* at 502-03, 248 N.E.2d at 914-15, 301 N.Y.S.2d at 84-85.

50. 15 U.S.C. § 78j(b) (1976).

51. *See* notes 87-89 *infra* and accompanying text.

52. 24 N.Y.2d at 502-03, 248 N.E.2d at 914-15, 301 N.Y.S.2d at 84-85.

53. *Id.*

strate injury resulting from the insider trading.[54] The court could not refer to a single successful prosecution for insider trading in a public sale of securities.[55] Unless a section 16(b) "short swing profit" violation[56] was present, the court determined that an effective federal remedy did not exist.[57] The defendants fell outside the proscriptions of section 16(b), however, because defendants' purchases and sales were not within a six month period.[58]

In supporting the derivative action as a proper remedy, the *Diamond* court relied heavily on *Brophy v. Cities Service*[59] and section 16(b) of the Securities and Exchange Act of 1934.[60] Section 16(b) provides for corporate recovery of certain insider trading profits acquired in the purchase and sale (or sale and purchase) of securities within a six month period.[61] Section 16(b), the court reasoned, illustrates that the derivative action can be an effective method for dealing with insider trading and can be used to accomplish a similar purpose in situations not covered by the statute.[62] The New York court found nothing in federal law that limited the power of the states to fashion additional remedies.[63]

C. *Aftermath of* Diamond v. Oreamuno

The innovative approach fashioned by the *Diamond* court, although a significant development in state common law, met with judicial hos-

54. *Id.*
55. *Id.*
56. *See* note 61 *infra* and accompanying text.
57. 24 N.Y.2d at 502-03, 248 N.E.2d at 914-15, 301 N.Y.S.2d at 84-85.
58. *Id.* at 501, 248 N.E.2d at 914, 301 N.Y.S.2d at 84. *See* notes 178-90 *infra* and accompanying text.
59. 31 Del. Ch. 241, 70 A.2d 5 (1949). *See* 24 N.Y.2d at 500-01, 248 N.E.2d at 913-14, 301 N.Y.S.2d at 83. *See* notes 31-38 *supra* and accompanying text.
60. 15 U.S.C. § 78p(b) (1976).
61. *Id. See* notes 178-90 *infra* and accompanying text.
62. 24 N.Y.2d at 500, 248 N.E.2d at 913, 301 N.Y.S.2d at 83.
63. Congress expressly provided against such an implication, the court said, by declaring that "[t]he rights and remedies provided by this title [§ 28(a) of the Securities Exchange Act of 1934] shall be in addition to any and all rights and remedies that may exist at law or in equity." 24 N.Y.2d at 503-04, 248 N.E.2d at 914-15, 301 N.Y.S.2d at 85, (citing 15 U.S.C. § 78bb(a) (1976)).

In fashioning a derivative right in the corporation for insider trading violations, the court was undeterred by the possibility of double liability. If the defendant wished to protect himself against double liability, the court suggested that the defendant interplead all possible claimants and bind them to the judgment. 24 N.Y.2d at 504, 248 N.E.2d at 915-16, 301 N.Y.S.2d at 86.

tility in other state forums.[64] The Florida Supreme Court in *Schein v. Chasen*[65] not only refused to extend the innovative ruling of *Diamond* to trading tippees, but also refused to follow *Diamond* in holding a director-officer liable in the absence of a showing of actual damage to the corporation.[66] The *Schein* court recognized the need to maintain a free and honest securities market, but restricted consideration of this need to claims arising under federal securities law.[67]

The Seventh Circuit Court of Appeals in *Freeman v. Decio*[68] dismissed a derivative suit against corporate officers and directors to re-

64. *See* note 65 *infra* and accompanying text.

65. 313 So. 2d 739 (Fla. 1975).

In Schein v. Chasen, 478 F.2d 817 (2d Cir. 1973), *vacated and remanded sub. nom.* Lehman Bros. v. Schein, 416 U.S. 386, *on certification*, to the Fla. Sup. Ct., 313 So.2d 739 (Fla. 1975), the plaintiffs, stockholders in Lum's, Inc., a Florida corporation, brought a derivative action by invoking diversity jurisdiction. In November 1969 Chasen, president and chief operating officer at Lum's, announced to a group of securities investors that the corporation's earning prospects for the fiscal year ending July, 1970 would be approximately one dollar per share. Two months later, after learning that Lum's earnings would be significantly lower, Chasen telephoned Simon, a stockholder employed by defendant Lehman Bros., and relayed the revised earnings figure. Simon reconveyed the information to investment advisors of two mutual funds. On the morning of January 9, 1970, before any public announcement, the two mutual funds sold, in the aggregate, 83,000 shares of Lum's at $17.50 a share. After the public announcement the stock closed at fourteen dollars per share. Plaintiffs alleged that the investment advisors and the mutual funds were jointly and severally liable to the corporation under Florida law for misusing corporation information to their own advantage in violation of the duty they owed to Lum's. *Id.*

66. 313 So.2d at 746-47. In earlier *Schein* proceedings, however, the Second Circuit Court had held that Florida law was the applicable state law, but in the absence of a clearly enunciated state rule, the federal court could turn to other state law for guidance in resolving the issue. Concluding that the *Schein* issues resembled those present in *Diamond*, the court interpreted the facts in light of the New York court's decision. The Second Circuit held that *Diamond* "should extend to reach third parties, who, though not officers or directors of the injured corporation, are involved with directors in a common enterprise to misuse confidential corporate information for their own enrichment." 478 F.2d at 823. The court reasoned that the corporate image is damaged just as much by tippee trading as when the trading is by its own directors and oficers. To immunize tippees from liability to the corporation would encourage insider "leaks" to outsiders, thus defeating the policies underlying the *Diamond* decision. *Id.*

The Second Circuit decision was later vacated and remanded by the United States Supreme Court on certification to the Florida courts to determine Florida law. Lehman Bros. v. Schein, 416 U.S. 386, *on certification* to the Fla. Sup. Ct., 313 So.2d 739 (Fla. 1975).

The Second Circuit's decision is analyzed in conjunction with *Diamond v. Oreamuno* in Note, *Common Law Corporation Recovery for Trading on Non-Public Information*, 74 COLUM. L. REV. 269 (1974). *See* Note, *From Brophy to Diamond to Schein: Muddled Thinking, Excellent Result*, 1 J. CORP. L. 83 (1975).

67. 313 So.2d at 745 (citing 478 F.2d at 825 (Kaufman, J., dissenting)). The Florida Supreme Court's reasoning is compared with that of the Second Circuit's at 41 MO. L. REV. 589 (1976).

68. 584 F.2d 186 (7th Cir. 1978).

cover profits allegedly acquired through use of inside information.[69] The *Freeman* court held that Indiana law neither recognized this corporate right nor was likely to follow the lead of the New York Court of Appeals in *Diamond*.[70] Although the *Freeman* court acknowledged the general policy of deterring insider trading, it found that the expanding common law and existent federal remedies afforded sufficient relief.[71] Repeated rejection of the *Diamond* approach to insider trading regulation dictates a re-evaluation of present federal remedies to determine if they do indeed "afford sufficient relief" to deter insider trading on the open securities market.

III. FEDERAL REGULATION OF INSIDER TRADING

Before adoption of federal securities regulations, no federal remedy existed for fraudulent activities in the securities area.[72] The wake of confusion and disaster following the stock market crash of 1929, however, produced a public demand for closer supervision and investigation of securities exchange practices.[73] Congress heard considerable

69. *Id.* Plaintiffs, shareholders of Skyline Corporation, brought a derivative action against the corporation's directors to recover profits the directors allegedly acquired through use of inside information. The plaintiffs charged the defendants with creating a market for the corporate stock by overstating earnings and understating expenses and then selling a substantial number of their shares on this artificial market. *Id.* at 187.

70. *Id.* at 193-96. The *Freeman* court criticized *Diamond* for its reliance on *Brophy* and distinguished *Brophy* because potential harm to the corporation existed on the *Brophy* facts. Because the corporation was about to enter the market, the employee's acquisition of stock competed with the corporate plans. The *Freeman* court viewed this potential harm as a very persuasive factor in the *Brophy* court's decision. *Id.*

The Seventh Circuit also objected to *Diamond*'s automatic characterization of inside information as a corporate asset. Rather, the court argued, the question is whether there is any potential loss to the corporation from the use of this information. The court objected strongly to *Diamond*'s failure to insist on a showing of damages to the corporation. The court accused the *Diamond* court of instituting the corporate cause of action as a "back up" plan in the event the "real victims" were unable to bring suit. 584 F.2d at 193-96.

71. The *Freeman* court recognized that several courts had expanded significantly the requirements of privity, reliance, and misrepresentation in the 10b-5 actions decided subsequent to *Diamond.* This fact, coupled with the court's clarification of class action requirements, provided an adequate basis for relief in the opinion of the *Freeman* court. *Id.*

72. *See* notes 10-30 *supra* and accompanying text. The only possibility of federal relief prior to the enactment of securities regulations was a federal prosecution for violation of the mail fraud statute. 18 U.S.C. § 1341 (1976). This statute prohibits use of the mail service to perpetrate a fraud.

73. Prior to the enactment of the Securities Exchange Act, profits from "sure thing" speculation in the stocks of their corporations were more or less generally accepted by the financial community as part of the emolument for serving as a corporate officer or director notwithstanding the flagrantly inequitable character of such trading.

testimony concerning the evils of insider trading.[74] In response to public outcry and to prevent abuse of fiduciary duties by corporate officers and directors, Congress enacted the Securities Act of 1933[75] and the Securities Exchange Act of 1934.[76]

A. *Section 10(b) and Rule 10b-5*

Section 10(b) is the antifraud provision of the Securities Exchange Act of 1934.[77] The provision grants the Securities and Exchange Commission power to adopt rules and regulations proscribing deceptive practices in the purchase or sale of securities.[78] Rule 10b-5, promulgated by the Commission in 1942, prohibits, *inter alia*, affirmative misrepresentations and omissions of material facts in connection with the purchase or sale of any security.[79] Although section 10(b) does not ex-

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L. Loss, *supra* note 3, at 1037 (citing 10 SEC Ann. Rep. 50 (1944)). *See* W. Painter, *supra* note 1, at 1-6.

74. Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities. Closely allied to this type of abuse was the unscrupulous employment of inside information by large stockholders who, while not directors and officers, exercised sufficient control over the destinies of their companies to enable them to acquire and profit by information not available to others.

L. Loss, *supra* note 3, at 1037 (citing Stock Exchange Practices, Report of Committee on Banking and Currency, S. Doc. No. 1455, 73d Cong., 2d Sess. 55 (1934)).

75. Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1976). The purpose of the Securities Act of 1933, as stated by Congress in the preamble, was "[t]o provide for full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof . . . ." Securities Act of 1933, ch. 38, 48 Stat. 74 (1933).

76. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1976).

77. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1976) 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—

. . . .

(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.

The Securities Act of 1933 contains several antifraud provisions, but these are limited in scope and offer a private remedy only to the defrauded purchaser. Section 11 of the Securities Act of 1933 provides a private remedy when registration statements contain untrue statements or omissions of material facts at the time they became effective. 15 U.S.C. § 77l (1976).

Section 17(a) is a general antifraud provision that makes it unlawful to use any facility of interstate commerce to defraud purchasers of securities. 15 U.S.C. § 77q(a) (1976).

78. 15 U.S.C. § 78j(b) (1976).

79. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1980) states:

pressly provide a private right of action to recover damages, the courts extended an implied right of recovery to the defrauded investor.[80]

Regulation of insider trading under rule 10b-5 is premised on the theory that the "market for a security should reflect the judgments of purchasers and sellers with equal access to all relevant information."[81] Possession of material inside information alone is not prohibited under rule 10b-5.[82] An insider possessing confidential information violates rule 10b-5 if the insider subsequently trades without disclosing the in-

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> 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,
> (1) to employ any device, scheme or artifice to defraud,
> (2) 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
> (3) 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.

Rule 10b-5 was created to fill the void present in § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1976). The elements of a violation under § 17(a) include the requirements of misrepresentation or omission of a material fact that give rise to an action under rule 10b-5 of the Securities Exchange Act of 1934. Section 17(a), however, extends relief only to defrauded purchasers. After tabling a contemplated extension of § 17(a) the Commission adopted rule X-10B-5, later renamed rule 10b-5. *See* K. BIALKIN, THE 10B-5 SERIES OF RULES 4 (1975); L. LOSS, *supra* note 3, at 1426-27. *See also Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967).

80. *See* Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). The court in *Kardon* relied on the RESTATEMENT OF TORTS § 286 (1934), which implies a civil remedy in favor of any person injured by violation of a statute enacted for the protection of the class of persons of which he is a member. 69 F. Supp. at 513-14. Section 286 reads:

> 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 . . . .

RESTATEMENT OF TORTS § 286 (1934).

The rationale underlying a private cause of action is to encourage enforcement of the Act and to compensate for the SEC's inability to investigate and prosecute every violation. An implied right of action prevailed in spite of arguments by the rule's originators that no private right was intended and that where a private right was so intended, both the 1933 and 1934 Acts explicitly provided for one, *e.g.*, §§ 11 and 12 of the 1933 Act, and § 18 of the 1934 Act. K. BIALKIN, *supra* note 79, at 5.

The Supreme Court finally recognized an implied right of action under § 10(b) in Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971).

81. R. FROME, *supra* note 11, at 157.

82. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969); *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).

formation.[83] The judicially created "disclose or abstain" rule requires an insider possessing material inside information to disclose the information to the investing public or abstain from trading in the securities while the information remains undisclosed.[84]

Rule 10b-5 has existed for almost forty years. Although few would doubt the rule's broad purpose, few would agree that its purpose has been adequately effectuated.[85] One of the chief criticisms of the rule is that its proscriptive measures fail to provide relief when insider trading appears on the open securities market.[86]

Three civil remedies are available against an insider who trades without disclosing material information: The SEC can sue for injunctive relief against future violations;[87] the defrauded investor can bring a private cause of action for damages, restitution, or recission;[88] or defrauded investors may bring a class action.[89] Although the remedies appear sufficient, they fail to provide effective relief in most instances of insider trading on the open market.

1. *Injunctive Relief*

The SEC is expressly authorized to bring injunctive actions under section 21(d) of the Securities Exchange Act of 1934.[90] As "ancillary relief" the SEC can request a court order for disgorgement of profits.[91] Although disgorgement of profits could be a powerful deterrent to the insider, time, money, and manpower limitations prevent the SEC from

83. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

84. *Id.* at 848.

85. *See, e.g.*, 4 A. BROMBERG, *supra* note 26, § 12.9, at 283.

86. *See, e.g.*, Note, *Regulation of Insider Trading on the Open Market: A Re-evaluation of* Diamond v. Oreamuno, 9 GA. L. REV. 189, 200-05 (1974).

87. Section 21(d) of the Securities Exchange Act of 1934, 15 U.S.C. § 78u(d) (1976). *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969); *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).

88. *See* note 80 *supra*.

89. *See* notes 170-71 *infra* and accompanying text.

90. 15 U.S.C. § 78u(d) (1976).

91. *See, e.g.*, SEC v. Shapiro, 494 F.2d 1301 (2d Cir. 1974); SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971). Normally the defendants pay the profits into a fund for eventual distribution to persons deemed entitled to them. For a discussion of administrative remedies available to the Securities and Exchange Commission, see Jacobs, *Judicial and Administrative Remedies Available to the SEC for Breaches of Rule 10b-5*, 53 ST. JOHN'S L. REV. 397 (1979).

adequately pursuing many alleged violations of rule 10b-5.[92]

Assuming the SEC does have sufficient resources to effectively pursue rule 10b-5 violations, injunctive relief is only granted to prevent future violations.[93] In many situations inside trading is completed and material information disclosed before the rule 10b-5 violation becomes apparent. Furthermore, the SEC may prefer to bring an administrative proceeding against the alleged violator rather than to institute judicial proceedings.[94] If the SEC elects to resolve the issue administratively, however, it is powerless to require disgorgement of profits.[95] Thus, although a SEC action for injunctive relief is a potentially powerful weapon, the opportunities for successful application are limited.

2. *Private Cause of Action*

Courts imply a private cause of action under rule 10b-5[96] to aid the SEC in deterring activities proscribed under rule 10b-5[97] and to compensate the victims of fraud.[98] Judicial recognition of the broad remedial[99] and preventive[100] purposes of the rule led courts to extend the scope of rule 10b-5 beyond the confines of common-law deceit.[101] The

92. *See* note 97 *infra* and accompanying text.

93. Section 21(d) requires a reasonable likelihood that the defendant will commit the violations in the future. 15 U.S.C. § 78u(d) (1976).

94. *See, e.g.,* Investors Management Co., SEC Securities Exchange Act Release No. 9267 (July 29, 1971).

95. *See* Ratner, *Federal and State Roles in the Regulation of Insider Trading*, 31 BUS. LAW. 947, 954 (1976).

96. *See* note 80 *supra*.

97. Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1284-85 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970); Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent*, 57 NW. U.L. REV. 627, 637 n.53 (1963).

98. Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1206-07 (9th Cir. 1970); List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

99. The Supreme Court in SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963), stated: "A fundamental purpose, common to these statutes is to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus achieve a high standard of business ethics in the securities industry."

100. Rapp, Fridrich v. Bradford *and the Scope of Insider Trading Liability under SEC Rule 10b-5: A Commentary*, 38 OHIO ST. L.J. 67, 69 (1977) (prevent inequitable practices and insure fairness in securities transactions).

101. *See* note 11 *supra* for the elements of a common-law deceit action.

"The fact is that the courts have repeatedly said that the fraud provision in the SEC acts . . . are not limited to circumstances which would give rise to a common law action for deceit." L. Loss, *supra* note 3, at 1435.

"[C]ommon law fraud provides a starting point from which the courts can develop a federal lack of explicit legislative history on the scope of rule 10b-5[102] coupled with the noticeable reluctance, until recently, of the Supreme Court to entertain rule 10b-5 actions,[103] yielded major inconsistencies among the circuits in defining basic elements of a rule 10b-5 action.[104]

An increasing concern with the flood of securities litigation in the federal courts[105] finally prompted Supreme Court action. The Supreme Court responded to this concern and the need for precise delineation of the requisite elements of a rule 10b-5 action by sharply curtailing access to federal courts through strict interpretation of basic elements of a 10b-5 action.[106] In the past decade the Supreme Court delineated four basic elements of a 10b-5 action. First, rule 10b-5 extends protection only to the defrauded purchaser or seller of securities.[107] Secondly, the defrauded purchaser or seller must demonstrate "scienter" on the part of the defendant.[108] Thirdly, the 10b-5 plaintiff must prove a misrepresentation or an omission of a material fact.[109] Finally, the injured party must show resulting damage, usually established in terms of reliance or causation.[110]

A noticeable cutback in rule 10b-5 relief occurred when the Supreme

common law that will promote the broad policy goals of rule 10b-5." Note, *The Nature and Scope of the Reliance Requirement*, 24 CASE W. RES. L. REV. 363, 367 (1973).

102. *See* Proceedings, *Conference on Codification of Federal Securities Laws*, 22 BUS. LAW. 793 (1967) (Milton Freeman, Attorney and Assistant Solicitor, SEC, 1934-46):

> It [rule 10b-5] was intended to give the Commission power to deal with this problem—lack of protection for defrauded sellers of securities. It had no relation in the commission's contemplation to private proceedings. How it got into private proceedings was by the ingenuity of the private Bar starting with the *Kardon* case.

Id. at 922.

103. Although the Commission promulgated rule 10b-5 in 1942, the first rule 10b-5 case did not reach the Supreme Court until 1969. SEC v. National Sec., Inc., 393 U.S. 453 (1969).

104. *See generally* Note, *supra* note 101.

105. *See* Landy v. Federal Deposit Ins. Corp., 486 F.2d 139, 158 (3rd Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); Friendly, *Federal Appellate Justice: Averting the Flood by Lessening the Flow*, 59 CORNELL L. REV. 634 (1974).

106. *See* Chiarella v. United States, 445 U.S. 222 (1980); Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

107. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952).

108. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

109. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969); List v. Fashion Park, Inc., 340 F.2d 456 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

110. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974).

Court affirmed the *Birnbaum*[111] purchaser-seller requirement. In 1952 the Second Circuit Court of Appeals[112] in *Birnbaum v. Newport Steel Corp.*[113] held that rule 10b-5 extended protection only to a defrauded purchaser or seller of securities.[114] Dissatisfied with the arbitrariness of the rule, however, lower courts chipped away at the *Birnbaum* doctrine.[115] The courts liberally interpreted the purchaser-seller requirement to include those defrauded investors not technically connected with the sale of securities.[116] Finally in 1975 the Supreme Court in *Blue Chip Stamps v. Manor Drug Stores*,[117] attempting to discourage private actions against corporate mismanagement under section 10(b), reaffirmed the battered *Birnbaum* doctrine.[118]

Pursuant to a consent decree entered in an antitrust action, the defendant in *Blue Chip Stamps*, a company that provided trading stamps to retailers, offered a substantial number of its shares to retailers who previously used the stamp service but who were not stockholders.[119] The retailers charged that the prospectus prepared in connection with the offer was materially misleading[120] and that they failed to purchase stock in reliance on the misleading information.[121] The Supreme Court, in a decision based heavily on policy considerations,[122] reaf-

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111. Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952).

112. The eminent panel announcing the doctrine consisted of Augustus Hand, author of the opinion, Learned Hand, and Chief Judge Thomas Swan. 193 F.2d 461 (2d Cir. 1952).

113. *Id.*

114. 193 F.2d at 464. In *Birnbaum* the shareholders of a corporation brought a derivative suit charging the officers and directors of the corporation with violation of their fiduciary duties and specific acts of fraud. The court concluded that § 10(b) was directed only at fraudulent practices associated with the sale or purchase of securities and did not encompass fraudulent mismanagement of corporate affairs. Consequently the court determined that the plaintiffs lacked standing to sue under rule 10b-5 because they were neither purchasers nor sellers of the securities in question. *Id.*

115. *See, e.g.*, Eason v. General Motors Acceptance Corp., 490 F.2d 654 (7th Cir. 1973) (abolished the purchaser-seller requirement altogether); A.T. Brod & Co. v. Perlow, 375 F.2d 393 (2d Cir. 1967) (broker allowed to maintain action against customers who ordered him to purchase shares, intending to pay only if price increased); Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967) (minority shareholder in a short form merger is a forced seller); Commerce Reporting Co. v. Puretec, Inc., 290 F. Supp. 715 (S.D.N.Y. 1968) (extended *Birnbaum* requirement to protect parties to an agreement to sell securities).

116. *See* note 115 *supra*.

117. 421 U.S. 723 (1975).

118. *Id.*

119. *Id.* at 726.

120. *Id.* at 726-27.

121. *Id.*

122. Justice Rehnquist's opinion cited three policy considerations: (1) a susceptibility to "vex-

firmed the purchaser-seller requirement first enunciated in *Birnbaum* and denied relief to retailers.[123]

The *Blue Chip Stamps* ruling flatly eliminates the possibility of a 10b-5 action on behalf of the corporation to recover insider trading profits. Unless the corporation is a defrauded purchaser or seller of securities, the corporate plaintiff lacks standing to sue under rule 10b-5. By removing the possibility of a federally derived corporate right of recovery under rule 10b-5, the Court eliminated a potentially effective method of regulating insider trading on the open market.[124]

Until 1976 courts failed to consistently require "scienter" as a requisite element of a 10b-5 action.[125] In 1976, however, the Supreme Court in *Ernst & Ernst v. Hochfelder*[126] resolved this long standing conflict among the circuits[127] and held: A private cause of action for damages does not lie under section 10(b) in the absence of an allegation of "scienter."[128] The Court removed any remaining dispute on whether 10b-5 liability would lie for negligent conduct alone.[129] The *Ernst* decision narrowed the class of culpable defendants to those possessing "a mental state embracing intent to deceive, manipulate, or defraud."[130]

The third requisite element of a 10b-5 action, a showing of materiality, lies at the heart of 10b-5 litigation.[131] A synthesis of the language employed by various courts yields a definition of materiality that focuses on whether undisclosed information would affect decisions of the reasonable investor.[132] When the Supreme Court in *Affiliated Ute Citi-*

atious" litigation possibly leading to threats of large judgments and forcing settlements out of proportion to the number of suits with merit; (2) a potential for abuse of the discovery system; and (3) a disproportionate reliance on oral testimony. *Id.* at 739-45.

123. *Id.* at 731. The effect of the Court's ruling on the lower courts' expansion of the purchaser-seller requirement is uncertain. See Note, *Standing Under Rule 10b-5 After* Blue Chip Stamps, 75 MICH. L. REV. 428-44 (1976) for a discussion of the effect of *Blue Chip Stamps* on 1) the forced-seller doctrine, 2) aborted transactions, and 3) injunctive relief.

124. *See* notes 219-27 *infra* and accompanying text.

125. *See* note 127 *infra.*

126. 425 U.S. 185 (1976).

127. *See* Comment, *The Inadequacy of Rule 10b-5 as a Remedy in Securities Transactions,* 4 S.U.L. REV. 234, 236 n.10 (1978) for a list of cases requiring negligence and those requiring scienter prior to *Ernst & Ernst.*

128. 425 U.S. at 193. In Aaron v. United States, 100 S.Ct. 1945 (1980), the Court extended this requisite showing of scienter to 10b-5 injunctive proceedings brought by the SEC.

129. *See* note 127 *supra.*

130. 425 U.S. at 193 n.12.

131. *See* note 79 *supra.*

132. *See, e.g.,* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (en banc), *cert.*

zens v. United States[133] confronted the issue of materiality under 10b-5, the Court found material those facts that a reasonable investor "*might have* considered . . . important"[134] in making a decision. Five years later, however, the Court in *TSC Industries, Inc. v. Northway, Inc.*[135] narrowly defined an omitted fact as material "if there is *substantial likelihood* that a reasonable shareholder would consider it important in deciding how to vote."[136] Once again the Supreme Court sharply curtailed available relief under 10b-5 by strictly interpreting the third element of a 10b-5 action. *Blue Chip Stamps* narrowed the class of compensable plaintiffs,[137] *Ernst & Ernst* narrowed the class of culpable defendants,[138] and *TSC Industries* narrowed the definition of materiality.[139]

The 10b-5 plaintiff must prove causation of a compensable injury as the final element in a 10b-5 action.[140] Before 1972, a plaintiff satisfied the causation requirement in a 10b-5 action by showing that plaintiff detrimentally relied on the alleged material misrepresentation.[141] In 1972,[142] however, the Supreme Court in *Affiliated Ute Citizens v. United States*[143] reconstructed the requirement of reliance.

In *Affiliated Ute* a corporation formed by Ute Indians appointed a bank as transfer agent for its stock.[144] The bank and its employees

denied, 394 U.S. 976 (1969); List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

133. 406 U.S. 128 (1972).

134. *Id.* at 54 (emphasis added).

135. 426 U.S. 438 (1976).

136. *Id.* at 449 (emphasis added). Although the *TSC* case defined materiality in the context of SEC rule 14a-9, 17 C.F.R. § 240.14a-9(a) (1980), the definition is readily applicable in rule 10b-5 cases.

137. *See* notes 111-23 *supra* and accompanying text.

138. *See* notes 125-30 *supra* and accompanying text.

139. *See* notes 135-36 *supra* and accompanying text.

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

The requisite element of causation stems from the compensatory aspect of rule 10b-5 private actions. *See, e.g.,* Rochez Bros., Inc. v. Rhoades, 491 F.2d 402, 410 (3d Cir. 1973), *cert. denied*, 425 U.S. 993 (1976).

141. *See, e.g.,* List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

142. Before *Affiliated Ute Citizens*, *List* was often cited in support of the need to prove reliance in rule 10b-5 cases.

143. 406 U.S. 128 (1972).

144. 406 U.S. at 144-49. *See* Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584, 586 n.9 (1975), in which the author states:

> The 85 Indian plaintiffs were former shareholders of the Ute Development Corporation.

purchased shares from the unsophisticated shareholders without disclosing the bank's status as a market maker in the stock or the true value of the shares.[145] The Court, particularly cognizant of the fiduciary relationship between the bank and the Indian shareholders, held that positive proof of reliance was not a prerequisite to recovery under 10b-5 in situations involving primarily a failure to disclose material information.[146] The Court determined that the obligation to disclose material facts coupled with the nondisclosure of material facts established the causation element.[147] The Court's two-prong test for establishing causation—duty to disclose material information and nondisclosure of that information—has been labelled a "relaxed causation standard."[148]

The courts have been inconsistent in their application of the relaxed causation standard of *Affiliated Ute*.[149] Their treatment of reliance de-

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The corporation had been formed by the Affiliated Ute Citizens, an unincorporated association whose members were of mixed-blood Ute ancestry, under the Ute Partition Act, 25 U.S.C. §§ 677-77aa (1970), which provided for partition and distribution of Ute tribal assets between mixed-blood and full-blood Ute Indians. The Ute Development Corporation appointed the First Security Bank of Utah as transfer agent for its stock certificates. Employees of the bank encouraged Indian shareholders to sell their shares to the bank or to the employees themselves without disclosing that the price in the secondary market exceeded that paid to the Indian shareholders.

145. 406 U.S. at 144-49.

146. *Id.* at 153-54. The Court argued that the "defendants may not stand mute while they facilitate . . . sales to those seeking to profit in the . . . market the defendants had developed and encouraged and with which they were fully familiar." *Id.* at 153.

147. *Id.*

148. Judge Celebrezze described the rule enunciated in *Affiliated Ute Citizens* as a "relaxed causation standard." Fridrich v. Bradford, 542 F.2d 307, 326 (6th Cir. 1976) (concurring opinion), *cert. denied*, 429 U.S. 1053 (1977).

Although some courts speak of the *Affiliated Ute* holding as creating a presumption of reliance, the court in Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976), noted that the Supreme Court did not speak of such a presumption. The *Blackie* court recognized that "materiality directly establishes causation more likely than not, and that reliance as a separate requirement is simply a milepost on the road to causation." *Id.* at 906 n.22.

149. Some courts restrict application of *Affiliated Ute* to similar circumstances. *See, e.g.*, St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 562 F.2d 1040 (8th Cir. 1977), *cert. denied*, 435 U.S. 925 (1978); Sunstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977); Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977).

Other courts extend the "relaxed causation standard" to all nondisclosure or misrepresentation cases. *See, e.g.*, Carras v. Burns, 516 F.2d 251, 257 (4th Cir. 1975); Davis v. Avco Corp., 371 F. Supp. 782, 792 (N.D. Ohio 1974). *See generally* Note, *The Nature and Scope of the Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 24 CASE W. RES. L. REV. 363 (1973); Comment, 9 CUM. L. REV. 721 (1979).

pends on whether the material information was nondisclosed[150] or misrepresented[151] and whether the transaction occurred face-to-face or on the open market.[152] *Affiliated Ute* concerned the nondisclosure of material information in a face-to-face transaction.[153] The courts usually agree that "reliance has little if any rational role" in establishing a private action under rule 10b-5 when the alleged deception occurs through nondisclosure of material facts in a face-to-face transaction.[154] Hence, the lower courts almost uniformly adopt a presumption of reliance on a showing of materiality in nondisclosure cases.[155]

The courts refuse to apply *Affiliated Ute* when the alleged deception occurs through the misrepresentation of material facts in a face-to-face transaction;[156] requiring, instead, that plaintiff demonstrate actual reliance on the misrepresentation. The courts reason that when fraud occurs through misrepresentation in a face-to-face transaction, the plaintiff encounters no special difficulties in proving reliance.[157]

The courts are divided, however, in their treatment of reliance when

150. *See, e.g.,* Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972); Rochez Bros. v. Rhoades, 491 F.2d 402, 407-08 (3d Cir. 1974), *cert. denied,* 425 U.S. 993 (1976); Sirota v. Econo-Car Int'l Inc., 61 F.R.D. 604, 606 (S.D.N.Y. 1974); Jenkins v. Fidelity Bank, 365 F. Supp. 1391, 1398 (E.D. Pa. 1973).

151. *See, e.g.,* Allen Organ Co. v. North Am. Rockwell Corp., 363 F. Supp. 1117 (E.D. Pa. 1973).

152. *See, e.g.,* Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975), *cert. denied,* 429 U.S. 816 (1976); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); Chris-Craft Indus., Inc. v. Piper Aircraft, Inc., 480 F.2d 341 (2d Cir.), *cert. denied,* 414 U.S. 910 (1973); Kohn v. American Metal Climax, Inc., 458 F.2d 255 (3d Cir. 1972), *cert. denied,* 409 U.S. 874 (1972).

153. 406 U.S. 128 (1972).

154. 3 A. BROMBERG, *supra* note 26, § 8.6, at 209. *See* note 149 *supra.*

155. *See* Note, *supra* note 144, at 589:

> A few courts have held that a reliance requirement still exists, without even mentioning *Affiliated Ute.* One court has said, without further elaboration, that *Affiliated Ute* makes reliance "a somewhat lesser evidentiary hurdle"; and another appears to have introduced a new kind of reliance requirement, proof of "general" reliance, which must be met before *Affiliated Ute* applies.

Other courts have ameliorated the "relaxed causation standard" by allowing the defendant to rebut the "presumption of reliance." *See* Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975), *cert. denied,* 429 U.S. 816 (1976).

156. *See* note 149 *supra.* Some courts do not require a showing of reliance when both misrepresentation and omission are present in the fraudulent activities. *See* Competitive Assocs., Inc. v. Laventhol, Krekstein, Horwath & Horwath, 516 F.2d 811, 814 (2d Cir. 1975); Clark v. Cameron-Brown Co., 72 F.R.D. 48, 57 (M.D.N.C. 1976).

157. *See* 3 A. BROMBERG, *supra* note 26, § 8.6, at 209-12 (1975); Note, *supra* note 144, at 587-89.

the alleged fraud is perpetrated on the open market.[158] Some courts abandon the need to demonstrate actual reliance when insider trading occurs on the open market.[159] They argue that the reliance requirement is meaningless when the misrepresentation or nondisclosure occurs in open market trading.[160] Deception, if material, presumably affects the market in the form of inflated or deflated market prices.[161] Therefore, the trading investor, relying on general market conditions and prices is adversely affected.[162] Proof of specific reliance becomes superfluous under these circumstances.[163] Other courts, however, insist on maintaining the evidentiary hurdle and require "a direct causal relationship or connection between the insider's trading and the injury suffered."[164]

The effectiveness of rule 10b-5 in deterring insider trading on the open market turns on whether courts will apply the "relaxed causation standard" in impersonal market transactions.[165] In spite of the strict purchaser-seller requirement, the necessity of demonstrating scienter, and the limited definition of materiality, a relaxation of the reliance requirement in impersonal open market transactions could make rule 10b-5 a viable remedy for deterring insider trading on the open market.[166] Proving reliance on the misrepresented or omitted fact is virtually impossible when the transaction takes place on the open market.[167] Whether the defrauded open market trader obtains relief thus depends on the causation standard applied by the court. The Supreme Court has perpetuated this dilemma by refusing to clarify the role of reliance in open market transactions.[168] In light of recent Supreme Court decisions limiting the scope of rule 10b-5, further expansion of relief under

158. *See* notes 159-64 *infra* and accompanying text.

159. *See, e.g.,* Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975), *cert. denied,* 429 U.S. 816 (1976); Herbst v. ITT Corp., 495 F.2d 1308 (2d Cir. 1974); Chris-Craft Indus., Inc. v. Piper Aircraft Inc., 480 F.2d 341 (2d Cir.), *cert. denied,* 414 U.S. 910 (1973).

160. This is the argument of Professor Bromberg; 3 A. BROMBERG, *supra* note 26, § 8.6, at 209-12. *See* Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5,* 65 COLUM. L. REV. 1361, 1370-72 (1965).

161. *See* Note, *supra* note 157, at 587-89.

162. *Id.*

163. *Id.*

164. *See, e.g.,* Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), *cert. denied,* 429 U.S. 1053 (1977).

165. *See* notes 194-204 *infra* and accompanying text.

166. *Id.*

167. *See* note 160 *supra.*

168. *See* notes 149-52 *supra* for cases in which Supreme Court has denied *certiorari.*

rule 10b-5 is improbable.[169]

3. *Class Actions*

The third form of relief under rule 10b-5 is the class action.[170] The class action facilitates claims by small investors whose claims would be insufficient to warrant individual litigation.[171] Judicial distaste for the class action,[172] coupled with procedural, evidentiary, and administrative problems, diminishes the potential efficacy of this alternative.

The procedural obstacle erected by the Supreme Court in *Eisen v. Carlisle & Jacquelin*[173] illustrates the judicial distaste for class action suits. The *Eisen* Court required that individual notice be sent to all class members whose names and addresses could be ascertained through reasonable effort.[174] The class action is a desirable vehicle for litigation because it allows formation of a large class of investors. The requirement of individual notice, however, renders the class action unworkable as an effective enforcement alternative.

The evidentiary problems associated with proving actual reliance in impersonal transactions are compounded in the class action setting.[175] The burden of demonstrating reliance in open market transactions may be insurmountable. Different degrees of reliance among the plaintiff

169. *See* note 106 *supra.*

170. The basic requirements of a class action under Rule 23 are:

> (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.

FED. R. CIV. P. 23(a). Securities fraud cases usually fall under Rule 23(b)(3) which allows a class action where:

> [T]he court finds that the questions of law or fact common to the members and the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy.

For a thorough discussion of the class action as applied in securities litigation, see Bernfeldt, *Class Actions and Federal Securities Laws*, 55 CORNELL L. REV. 78 (1969).

171. *See* 4 A. BROMBERG, *supra* note 26, § 11.6, at 255. *See generally* W. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 16.01, at 483-85 (1978).

172. *See* Eisen v. Carlisle & Jacquelin, 391 F.2d 555, 572 (2d Cir. 1968) (Lumbard, J., dissenting), *vacated*, 417 U.S. 156 (1974), described the class action as a "Frankenstein monster."

173. 417 U.S. 156 (1974). *See* Klein, *The Effect of* Eisen v. Carlisle & Jacquelin *on Corporate Class Actions*, 4 SEC. REG. L.J. 57 (1976).

174. 417 U.S. at 173. "The plaintiff in *Eisen* had a mere $70 at stake and sought to represent a class of at least 2.25 million members. Personal notice to all of these absentees would have cost plaintiff approximately $225,000." Klein, *supra* note 173, at 59.

175. *See* notes 149-64 *supra* and accompanying text.

class may also afford defendant the means with which to challenge plaintiff's claim.[176]

Administration of relief presents the largest impasse to effective use of the class action suit. If relief is awarded to every member of the class based on actual loss incurred, total damages could reach outrageous proportions.[177] But recovery limited to the insider's profits would remove the compensatory incentive for instituting the action.

B. *Section 16(b)*

The second major provision of the Securities Exchange Act of 1934 governing insider trading is section 16(b).[178] Section 16(b), or the "short swing profit" provision, imposes strict liability on those falling within its narrow scope.[179] The section prohibits certain directors,[180] officers,[181] and beneficial owners of securities[182] from engaging in the

176. *See generally* 4 A. BROMBERG, *supra* note 26, § 11.6, at 255.

177. This is the most frequently cited reason for seeking some limitation to insider liability. In the *Texas Gulf Sulphur Co.* litigation it was estimated that damages, depending on the method of calculation used, might well range to $84 million and could possibly reach $390 million—a figure well over the company's worth. 446 F.2d at 105 n.13.

178. Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (1976).

Section 16(b) provides:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months.

179. *Id.* Section 16 applies to issuers that have securities registered under § 12 of the Securities Exchange Act. Section 12 requires registration of any equity securities listed on a national exchange and any class of equity securities of an issuer engaged in interstate commerce, or in a business affecting interstate commerce or whose securities are traded by use of the mails or any means or instrumentality of interstate commerce if that issuer's total assets exceed $1,000,000 and the class of equity security is held by 500 or more persons. 15 U.S.C. § 78l(g) (1976).

180. A director is "any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated." 15 U.S.C. § 78c(a)(7) (1976).

181. An officer is "a president, vice-president, treasurer, secretary, comptroller, and any other person who performs for an issuer . . . functions corresponding to those performed by the foregoing officers." 17 C.F.R. § 240.3b-2 (1980).

182. A beneficial owner for purposes of section 16(b) is a "person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 78l of this title . . . ." 15 U.S.C. § 78p(a) (1976).

purchase and sale (or sale and purchase) of security equities within a six month period.[183] Any profit[184] realized from short swing purchases and sales is recoverable by the corporation or by shareholders of the corporation in a derivative suit.[185]

The guidelines of section 16(b) are clearly delineated and applied in a fairly mechanical fashion. The primary problem in the application of section 16(b) concerns the definition of "insider," "sale," "purchase," and "profit."[186]

Although the purpose of section 16(b) is to prevent unfair use of information obtained by an insider through his relationship with the issuer,[187] the section is both over inclusive and under inclusive in its reach. Liability is automatically imposed under section 16(b) without a showing that the insider actually used the confidential information.[188] Conversely, a person who is not a statutorily designated insider, but trades on the basis of inside information, falls outside the confines of the section.[189] Furthermore, the director, officer, or beneficial owner who engages in transactions based on inside information but trades outside the designated six month period escapes the scope of section 16(b).[190]

IV. PROPOSALS FOR REFORM

Existing federal and state remedies are inadequate to curb insider

183. The constitutionality of section 16(b) was upheld in Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

184. The profit realized is computed by matching the highest price sales with the lowest price purchases during the six month period. Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943). This method is premised on the theory that "the statute was intended to . . . squeeze all possible profits out of stock transactions." *Id.* at 239.

185. 15 U.S.C. § 78p(b) (1976).

186. *See, e.g.*, Foremost-McKesson, Inc. v. Provident Sec. Co., 423 U.S. 232 (1976).

187. 15 U.S.C. § 78p(b) (1976). H.R. REP. No. 1383, 73d Cong., 2d Sess. (1934).

188. Thus one of the draftsman of the provision testified before the Senate Committee on Banking and Currency:

> You hold the director, irrespective of any intention or expectation to sell the security within 6 months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing.

Hearings on S. Res. 84 and S. Res. 56 and S. Res. 97 Before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess. 6554 (1934).

189. 15 U.S.C. § 78p(b) (1976).

190. For a thorough discussion on the limitations of section 16(b), see 45 NOTRE DAME LAW. 314, 316 n.16 (1969).

trading on the open securities market. Several alternative means exist that would more closely regulate insider trading. One alternative is application of the *Affiliated Ute* "relaxed causation standard" when insider trading is perpetuated on the open market.[191] Another alternative, suggested in *Diamond v. Oreamuno*,[192] is a state cause of action in the corporation to recover insider trading profits. A third alternative provides for a federally derived right of action on behalf of the corporation to recover insider trading profits.[193]

The first proposal purports to increase the efficacy of private enforcement under rule 10b-5 by removing proof of actual reliance. Although the Supreme Court in *Affiliated Ute Citizens v. United States*[194] first applied the "relaxed causation standard," any further expansion of the reliance requirement by the Supreme Court is unlikely in view of the Court's recent restrictions in private actions under 10b-5.[195] Unless the Court decides to limit the *Affiliated Ute* holding to face-to-face transactions involving the nondisclosure of material information, the individual circuits are free to adopt the so-called "relaxed causation standard."

Uniform application of this standard would foster consistency, simplicity, and predictability. A relaxation of the reliance requirement would insure the *in terrorem* effect of section 10(b).[196] Nationwide service of process[197] and a broad choice of venue[198] are additional advantages offered by this approach.

Relaxation of the reliance requirement would increase the number of plaintiffs able to bring suit under section 10(b). The large number of potential plaintiffs would make the class action device more desira-

191. *See* Rapp, Fridrich v. Bradford *and the Scope of Insider Trading Liability Under SEC Rule 10b-5: A Commentary*, 38 OHIO ST. L.J. 67 (1977); 1977 UTAH L. REV. 150.

192. 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969).

193. *See* Ratner, *supra* note 95, at 960.

194. 406 U.S. 128 (1972).

195. *See* notes 77-177 *supra* and accompanying text. Justice Blackmun described the Supreme Court's attitude as a "preternatural solicitousness for corporate well-being and a seeming callousness toward the investing public quite out of keeping . . . with our own traditions and the intent of the securities laws." Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 762 (1975) (Blackmun, J., dissenting).

196. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 877 (2d Cir. 1968) (en banc) (Moore, J., dissenting), *cert. denied*, 394 U.S. 976 (1969).

197. *See* Ratner, *supra* note 95.

198. *Id.*

ble.[199] Relaxation of the reliance requirement would also greatly increase chances for successful application of the class action. The defendant could no longer assert varying degrees of reliance by the plaintiffs as an affirmative defense.[200]

Because of the increased number of potential plaintiffs, however, and the availability of the class action, removal of the reliance safeguard risks inundation of federal courts with groundless rule 10b-5 claims.[201] Given the present concern with the flood of securities litigation in federal courts,[202] the "relaxed causation" alternative presents certain judicial problems.

The greatest infirmity of the "relaxed causation" proposal, however, is the potential for imposition of unlimited liability on the insider. In applying a liberal reliance requirement, some courts have adjudged 10b-5 defendants liable to all investors trading in stock from the time the insider began trading until effective disclosure.[203] Other courts have attempted to mitigate the possibility of unlimited liability by restricting recovery to investors trading on the market during the time the insider was actually trading.[204] Under either approach, potential liability could assume punitive proportions. The limitation of the amount of recovery to the insider's profits, however, reduces individual recovery to miniscule proportions and decreases the incentive to bring suit.

The second proposal, a state cause of action in the corporation to recover the insider's profits, was fashioned by the *Diamond* court nearly ten years ago.[205] The *Diamond* court attempted to bridge the gap in federal and state regulation of insider trading on the open market by creating a cause of action in the corporation.[206] Although the

199. The requirement that individual notice be sent to all class members whose names and addresses can be ascertained through reasonable effort, however, would hamper effective use of the class action suit. *See* notes 173-74 *supra* and accompanying text.

200. *See generally* Comment, *supra* note 149.

201. *See* note 105 *supra.*

202. *Id.*

203. This principle concern with unlimited liability led the court in *Fridrich v. Bradford* to hold: no private action for damages under rule 10b-5 will lie in favor of open market purchasers or sellers of securities against those persons having material inside information who transact in those securities without disclosing that information to the marketplace. 542 F.2d 307 (6th Cir. 1976), *cert. denied,* 429 U.S. 1053 (1977).

204. *Id.* (Celebrezze, J., concurring).

205. 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969). *See* notes 39-65 *supra* and accompanying text.

206. *Id.* at 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969).

last decade of Supreme Court activity in the 10b-5 area widened the gap,[207] state courts refuse to adopt the *Diamond* approach.[208]

The chief criticism of the *Diamond* approach is that it lacks uniformity.[209] Imposition of liability on insiders who trade in stock listed on the national securities exchange or over-the-counter exchanges will depend on the applicable law of the state of incorporation.[210] Even if the state recognizes a corporate right of recovery, the plaintiff may not be able to serve process on all defendants involved in the suit. Although a shareholder who suspects insider abuse could institute proceedings on behalf of the corporation, certain states require a derivative complainant to post security for expenses incurred by the defense.[211] These procedural obstacles hamper effective corporate recovery at the state level.

Additionally, the *Diamond* approach raises the possibility of dual liability under concurrent federal and state law.[212] The defendant could interplead all possible claimants to avoid double liability.[213] This suggestion, however, presents several problems. First, effective use of state interpleader is hindered by difficulties in obtaining jurisdiction over all traders.[214] Secondly, the addition of a section 16(b), section 10(b), or rule 10b-5 claim divests the state court of jurisdiction because federal courts exercise exclusive jurisdiction over all claims brought under the 1934 Act.[215]

In an effort to ameliorate the effect of dual liability, courts have ordered defendants to place insider trading profits in escrow.[216] After five years, any unclaimed moneys in the account are paid to the corporation.[217] This alternative, however, ignores the separate harm to the corporation[218] and places the costs of administering the fund on the

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207. *See* notes 77-139 *supra* and accompanying text.

208. *See* notes 64-71 *supra* and accompanying text.

209. *See, e.g.,* 83 HARV. L. REV. 1421 (1970).

210. *See* note 95 *supra.*

211. *See, e.g.,* N.Y. BUS. CORP. LAW § 627 (McKinney 1965).

212. *See, e.g.,* Note, *Common Law Corporate Recovery for Trading on Non-Public Information,* 74 COLUM. L. REV. 269, 289-294 (1974).

213. *See* note 63 *supra.*

214. *See* note 212 *supra.*

215. Securities and Exchange Act of 1934, § 27, 15 U.S.C. § 78aa (1976).

216. *See* SEC v. Texas Gulf Sulphur Co., 312 F. Supp. 77 (S.D.N.Y. 1970), *aff'd,* 446 F.2d 1301 (2d Cir. 1971).

217. *Id.*

218. The theoretical solution to the problem of concurrent liability is to recognize two injuries: not only on the corporation for breach of fiduciary duty, but also on the trading investors for violation of federal securities law. Under this approach, however, actual injury to the corporation

corporation. If all the money is claimed before expiration of five years, the corporation is financially penalized for bringing the suit.

The third and most feasible proposal is a federally derived cause of action in the corporation to recover the insider's profits.[219] This proposal retains many of the positive attributes of the "relaxed causation" alternative and eliminates the potential imposition of unlimited liability.[220] Nationwide service of process and wide selection of venue are available under a federally derived right of recovery in the corporation.[221] Additionally, a federally derived cause of action retains the virtues of consistency, simplicity, and predictability.

Contrary to the "relaxed causation" proposal, the theory behind the proposal for a federal cause of action in the corporation is not compensation of injured open market traders.[222] The proposal, like the *Diamond* approach, seeks to deter insider trading by placing the right of recovery in a readily available plaintiff, the corporation.[223] By placing the right of recovery in the corporation or derivatively, its stockholders, uninterested shareholders are replaced with corporate watchdogs. A shareholder who suspects insider abuse could institute proceedings on behalf of the corporation. By limiting the amount of damages to insider profits, the danger of unlimited liability is ameliorated. Sanctions are thus imposed on insiders to discourage an undesirable practice, not to compensate injured victims of open market transactions.[224]

The proposal's sanction would extend beyond the arbitrary six month period established in section 16(b).[225] Additionally, the proposal would ease the harshness of section 16(b)'s strict liability by requiring proof of actual insider abuse.

Before *Blue Chip Stamps*, gradual erosion of the *Birnbaum* doctrine revealed the possibility that courts could implant a federal cause of action in the corporation.[226] Affirmation of the purchaser-seller require-

would not necessarily be commensurate with the insider's profit. Although loss of corporate goodwill and harm to corporate reputation constitute injury to the corporation, proof of these injuries would be very difficult.

219. *See* note 95 *supra*.

220. *See* notes 196-204 *supra* and accompanying text.

221. *See* notes 197-98 *supra* and accompanying text.

222. *See* Ratner, *supra* note 95, at 956.

223. *Id.*

224. *Id.*

225. *See* notes 178-90 *supra* and accompanying text.

226. *See* notes 111-24 *supra* and accompanying text.

ment in section 10(b) actions, however, extinguished judicial implementation of this approach.[227] A federally derived right of recovery in the corporation or, derivatively, its shareholders, will thus require congressional action.

The proposal for a federal derivative cause of action is not free from infirmities. First, additional federal relief would accelerate the growth of securities litigation in federal courts.[228] Secondly, federal legislation creating a corporate right of recovery could signal encroachment of federal law into issues of corporate mismanagement and fiduciary duties of corporate officers, areas traditionally of state concern. Lastly, adoption of a federal cause of action in the corporation would place the defendant in jeopardy of multiple liability under section 16(b), section 10(b), and the proposed federal right of corporate recovery.

CONCLUSION

In spite of difficulties mentioned in connection with the federally derived cause of action, the absence of effective regulation of insider trading on the open securities market demands legislative implementation of this approach. The Supreme Court decisions in 10(b) actions have effectively diminished opportunities for judicial resolution at the federal level.[229] State courts have similarly failed to respond with effective relief in an area that is arguably of traditional state concern.[230] Federal securities laws purport to "insure the maintenance of a fair and honest market," but in actuality leave a major area of insider trading unregulated. The burden is thus on Congress to effectuate this goal.

Anne Graff Brown

227. *Id.*
228. *See* note 105 *supra.*
229. *See* notes 77-139 *supra* and accompanying text.
230. *See* notes 64-71 *supra* and accompanying text.