Trading on Material Non-Public Information on Impersonal Stock Markets: Who is Harmed, and Who can Sue Whom Under SEC Rule 10b-5?

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TRADING ON MATERIAL NONPUBLIC INFORMATION ON IMPERSONAL STOCK MARKETS: WHO IS HARMED, AND WHO CAN SUE WHOM UNDER SEC RULE 10b-5?

WILLIAM K.S. WANG*

TABLE OF CONTENTS

I. INTRODUCTION ............................................. 1219
   A. WHO IS HARMED BY STOCK MARKET INSIDE TRADING ................................ 1221
   B. PROPER PLAINTIFFS AND DEFENDANTS UNDER SEC RULE 10b-5 ...................... 1224
   C. SOLUTION PROPOSED BY THE ALI FEDERAL SECURITIES CODE ...................... 1225

II. THE ALLEGED BENEFICIAL AND HARMFUL EFFECTS OF INSIDE TRADING ON SOCIETY ...... 1225
   A. ALLEGED BENEFITS ................................ 1225
   B. ALLEGED DETRIMENTS .............................. 1227

III. INDIVIDUAL HARM FROM INSIDE TRADING ON THE IMPERSONAL STOCK MARKET ........... 1230
   A. ADVERSE EFFECT ON THE ISSUER .................... 1230

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B. Harm to Specific Individuals Caused by a Stock Trade on Nonpublic Information

1. How the Stock Market Functions ............................................. 1230
2. Who Might Be in Privity With an Inside Trader ....................... 1232
3. Why the Party in Privity Is Not Necessarily Harmed by an Inside Trade ................................................................. 1233
4. The Law of Conservation of Securities .................................... 1234
5. Who Bears the Net Loss Caused by an Inside Trade
   a. Induced adverse trades ...................................................... 1235
   b. Preempted traders ............................................................ 1236
   c. The practical difficulty of identifying those harmed by an inside trade ......................................................... 1236
6. Price Change Effects on Those Trading About the Same Time as the Inside Trade ......................................................... 1239

C. Harm to Specific Individuals Caused by the Nondisclosure ................................................................................................. 1240

1. Moral or Legal Causation ......................................................... 1240
2. Causation Anomaly ................................................................. 1241

D. Why Businessmen Might Not Consider Inside Trading Immoral .......................................................................................... 1245

E. Why Members of the Public Might Consider Inside Trading Immoral .................................................................................. 1247

IV. Application of SEC Rule 10b-5 to Inside Trading on Impersonal Stock Markets ................................................................. 1248

A. Preliminary Consideration—To Whom Is the Duty To Disclose Owed?

1. Duty To Disclose to the Party in Privity ...................................... 1248
2. Duty To Disclose to the Individual to Whom the Party in Privity May Transmit the Harm of Nondisclosure ......................................................... 1250
3. Duty To Disclose to the Victims of the Inside Trade Itself .......... 1251
4. Duty To Disclose to the World .................................................. 1255

B. Defining the Class of Rule 10b-5 Plaintiffs Who Can Demonstrate Causation When Suing a Stock Market Inside Trader for Damages ................................................................. 1255

1. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc. ............... 1256
2. Fridrich v. Bradford ................................................................. 1262
3. Chiarella v. United States ......................................................... 1269
I. INTRODUCTION

This Article analyzes stock market 1 inside trading on the basis of material nonpublic information. 2 Part II of the Article considers inside

1. The term "stock market" refers to both organized stock exchanges and the over-the-counter market. For a brief discussion of how these markets function, see notes 49-52 and accompanying text infra. The distinction between exchanges and the over-the-counter market is eroding. See note 52 infra. Whether on a stock exchange or in the over-the-counter market, trading on nonpublic information poses the same issues. In the over-the-counter market, however, the party in privity with the insider can be identified more frequently.

2. In this Article, the term "inside trading" refers to trading by anyone (corporate insider or outsider) on any type of material nonpublic information about the issuer's profits or about the market for the security. For more precise definitions of such terms as "market" information and "outside" information, see text accompanying notes 293-97 infra. The term "insider" will refer to employees of a corporation or those in an equivalent position. See note 270 and accompanying text infra. To avoid confusion, the term "inside trading" will not be used, and insider will always be italicized.

Discussion of the measure of damages and of definitions of "nonpublic," "material," and
trading's supposed beneficial and harmful effects on society as a whole. Part III attempts to identify who specifically is harmed by stock market inside trading — i.e., those who would have an implied cause of action available under a hypothetical statute reading: "Thou shalt not trade on the stock market based on material nonpublic information." Part IV of the Article considers the identity of proper plaintiffs and defendants under section 10(b) of the Securities Exchange Act

"dissemination" is beyond the scope of this Article. For discussion of the definition of "nonpublic," see Jennings & Smith, Insider Trading and the Analyst, in FIFTH ANNUAL INSTITUTE ON SECURITIES REGULATION 262-67 (R. Mundheim, A. Fleischer, Jr., & J. Schupper eds., transcript ser., 1974) [hereinafter cited as FIFTH ANNUAL INSTITUTE].


This Article does address whether the civil liability of an inside trader should be limited to his profits. See text accompanying notes 219-32 infra.

This Article does not discuss an inside trader's possible liability under § 17(a) of the Securities Act of 1933.

3. See text accompanying notes 20-44 infra.

4. This Article frequently uses the terms "harm," "causation," and "victim." Almost always, "harm" and "causation" mean "but for" causation. When such concepts as legal or moral causation are discussed, specific reference will be made to these principles. See, e.g., text accompanying notes 65-67 infra.

5. See text accompanying notes 45-72 infra.

of 1934 and SEC rule 10b-5 when inside trading has taken place, and discusses the solution proposed by the American Law Institute's Federal Securities Code. The Article does not address the issue of whether inside trading should be prohibited or discouraged.

A. WHO IS HARMED BY STOCK MARKET INSIDE TRADING

An inside trade has two aspects: the trade itself and the nondisclosure of the inside information that prompted the trade. Part III of this Article identifies those harmed by stock market inside trading and by nondisclosure. These victims could be private plaintiffs for damages under a hypothetical statute that explicitly prohibits stock market inside trading without indicating whether the gravamen of the offense is the trade or the nondisclosure. This distinction is usually unimportant when an inside trader engages in a face to face transaction in the stock of a closely held corporation. In such transactions, the victim of both the trade and the nondisclosure is almost always the party in privity with the defendant. Had the inside trader abstained from the transaction, the other party could not have traded because no other buyer or seller would have been available. If the defendant had a duty to disclose to the party in privity, the latter would be the victim of the nondisclosure. This Article will not discuss causation problems in face to face transactions. Nevertheless, examination of some transactions in closely held shares will illustrate similar causation problems in stock market transactions.

In rare situations, even in the closely held context, the trade and the nondisclosure may have different victims. Possibly the person in privity would have traded with a third party had the defendant not traded. Under these circumstances, the party in privity is not harmed by the trade; the real victim is the third party whose transaction was preempted by the defendant's trade. The party in privity remains the victim of the nondisclosure, however, if the defendant had an absolute

7. 17 C.F.R. § 240.10b-5 (1980). The rule states:
   (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 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.

Rule 10b-5 was promulgated pursuant to § 10(b) of the Securities Exchange Act of 1934.

8. But see text accompanying notes 64-72 infra.
duty to disclose to the person with whom he transacted. If the party in privity resells or repurchases before disclosure, however, he may have no damages.

For example, suppose a corporation has ten shareholders, one of whom, the president, knows secret, material, adverse news about the corporation. X, an existing shareholder, is interested in buying 100 more shares in the corporation, and contacts both the president and A, another shareholder. A offers to sell 100 shares for $11 per share, but the president offers to sell for $10 per share. X buys from the president. One week later X sells the 100 shares to Y, a nonshareholder, for $12 per share. When the adverse news becomes public, Y is still holding the shares, which are worth only $8 per share. The following diagram illustrates these transactions:

```
sells to
President -------> X -------> Y
```

The victim of the president's trade is A, whose transaction with X was preempted. Had the president not sold, A would have 100 fewer shares. X would have purchased A's shares and then resold to Y. The victim of the president's nondisclosure, however, is X, who passed the harm along, and possibly Y, if the president had a duty to disclose to X and Y. The president may have a higher duty to X because, unlike Y, X is an existing shareholder.

In practice, the president might be forced to disclose to the world to avoid any liability. If the president were to disclose only to X, and X in turn were to sell his own shares to an ignorant purchaser, the president might be liable as an aider and abettor of X's misconduct. Thus, an officer of a closely held corporation might face a hopeless dilemma. If he sells without disclosing to the buyer, he commits fraud. If he discloses and his buyer trades on the basis of the information, the officer is liable as a tipper. This dilemma is compounded when full disclosure to the world is infeasible, unless outsiders are to be held to constructive notice or to a standard of due care.

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9. See generally 5 A. Jacobs, supra note 2, § 64.01[b][ii], at 3-246 to -252.
10. For discussions of the plaintiff's duty of care under rule 10b-5, see Mallis v. Bankers Trust Co., 615 F.2d 68 (2d Cir. 1980), cert. denied, 101 S. Ct. 938 (1981); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033 (7th Cir.), cert. denied, 434 U.S. 875 (1977); Hirsch v. du Pont, 553 F.2d 750, 762-63 (2d Cir. 1977); Dupuy v. Dupuy, 551 F.2d 1005, 1013-24 (5th Cir.), cert. denied, 434 U.S. 911 (1977); Holdsworth v. Strong, 545 F.2d 687, 692-97 (10th Cir. 1976); Straub v. Vaisman, 540 F.2d 591, 596-98 (D.C. Cir. 1976), noted in 50 Tempo L.Q. 124 (1976); Dura-Bilt v. Chase Manhattan, 89 F.R.D. 87, 95-96 & n.7 (S.D.N.Y. 1981); 3A H. Bloomenthal, supra note 2, § 9.21[6]; 5 A. Jacobs, supra note 2, § 64.01[b][ii], at 3-248 to -252; W. Painter, supra note 2,
Although it might be wise for the president, if possible, to disclose to the world, he would not be liable to the world if he sold to $X$ without disclosing his information to anyone. At most he would be liable to $Y$, and possibly to $A$, if $A$ had standing. Thus, if the president does not disclose his information to anyone, he may be liable to both $Y$ and $A$, but he will not be liable to an outsider, $Z$, who purchased shares from some other shareholder, $B$, during the period between the president's sale and public dissemination of the material information.

Similar results can occur when, instead of seeking to sell on non-public adverse information, the president of the ten-shareholder corporation wishes to buy 100 shares based on secret good news. An outsider, $X$, is also interested in purchasing 100 shares at $10 per share. An existing shareholder, $A$, is willing to sell. The president outbids $X$ by offering $11, so $A$ sells his 100 shares to the president. One week later, $A$ fortuitously decides that it was a mistake to sell the 100 shares and purchases 100 shares at $11 from $B$, another shareholder. When the good news is disclosed, $B$ holds 100 fewer shares, and $X$ still holds no shares. The stock is now worth $14 per share. The following diagram illustrates these transactions:

\[
\text{President} \quad \leftarrow \quad A \quad \leftarrow \quad B
\]

(preampting $X$)

The victim of the president's trade is $X$, whose purchase was preempted. Had the president not bought, $X$ would have purchased from $A$, who in turn would still have repurchased from $B$. The victim of the president's nondisclosure is $A$, who unknowingly transmitted the harm to $B$.

Disclosure by the president to $A$ alone might itself be misconduct if $A$ trades on the information disclosed. If the president purchased from $A$ without disclosure, however, he might be liable for damages to $B$, and possibly to $X$, if $X$ has standing. The president might also be liable to $A$ for rescission. Thus, the president could theoretically be liable to $A$, $B$, and $X$, although his trade harmed only $X$. The president would not be liable to some other shareholder, $C$, who sold shares after the president's sale and before public dissemination.

The closely held corporation example illustrates causation.
problems that also arise in stock market transactions. When inside trading takes place on a stock market, the victims of the nondisclosure and the victims of the trade are almost always different and are usually impossible to identify. Those injured by the trade are investors whose transactions were either preempted or induced, in accordance with the Law of Conservation of Securities. These victims are generally not in privity with the defendant. Those harmed by the nondisclosure are those who can demonstrate the two elements of moral or legal causation: a duty to disclose owed to them, and a breach of that duty.

B. PROPER PLAINTIFFS AND DEFENDANTS UNDER SEC RULE 10b-5

No federal provision expressly prohibits the general practice of trading on nonpublic information; therefore, the federal judiciary has relied on section 10(b) and rule 10b-5, discussed in Part IV of this Article. Rule 10b-5 is an imperfect weapon against stock market inside trading because of the restrictive deceit and standing requirements. Four circuit court opinions have attempted to define the class of rule 10b-5 plaintiffs able to demonstrate that damages were caused by a stock market inside trade: Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.; Fridrich v. Bradford; Elkind v. Liggett & Myers, Inc.; and Wilson v. Comtech Telecommunications Corp. All four decisions are overshadowed by contrary dicta in the recent Supreme Court decision of Chiarella v. United States. Surprisingly, Elkind and Wilson are contrary to Chiarella even though these two circuit court opinions came after it. All four circuit court opinions seem to have been frustrated and possibly confused by the fact that the victims of a stock market inside trade are different from the victims of the nondisclosure.

Chiarella reversed the criminal conviction of an individual who had purchased shares on the stock market based on nonpublic information. The issue before the Supreme Court was the class of inside trading defendants subject to rule 10b-5. The Court held that a special

11. See text accompanying notes 56-57 infra.
12. See text accompanying notes 64-67 infra; cf. text accompanying notes 98-262 infra (discussing the class of plaintiffs who can demonstrate causation when suing a stock market inside trader for damages).
15. 495 F.2d 228 (2d Cir. 1974).
17. 635 F.2d 156 (2d Cir. 1980).
relationship of trust and confidence must exist between the defendant and the party in privity for criminal liability to be imposed. Justice Powell seemed to extrapolate from face to face deals to stock market transactions. The Supreme Court apparently intended to employ the same rationale to impose liability on insiders of both closely held and publicly traded corporations. Although Powell's special relationship test satisfies the deceit requirement of rule 10b-5, his approach is inadequate to deal with the complex realities of the stock market.

C. Solution Proposed by the ALI Federal Securities Code

This Article concludes with a discussion of the American Law Institute's Federal Securities Code, which codifies the civil liability of corporate insiders and their tippees. These provisions avoid the limitations of rule 10b-5 and provide an expedient and practical solution to the problems of causation and definition of proper parties. The Federal Securities Code, however, deliberately leaves other areas of inside trading in limbo.

II. The Alleged Beneficial and Harmful Effects of Inside Trading on Society

A. Alleged Benefits

Professor Henry Manne contends that inside trading by top management is an essential incentive for entrepreneurs.20 This thesis has been extensively criticized.21 It is unlikely that inside trading is an incentive, much less an essential one, for top corporate executives.

In an article on unilateral mistakes and nondisclosure in contract law,22 Professor Kronman argues that the law should encourage the deliberate search for information that reveals a change in circumstances affecting relative values, because expediting such information

to the market promotes allocative efficiency. Therefore, Kronman argues, in cases of unilateral mistake, disclosure should not be required when the information was acquired by a deliberate and costly search. On the other hand, when the information has been acquired casually, disclosure should be required. Kronman's theory has certain weaknesses. Because he assumes that unilateral mistakes are socially wasteful, he starts with a presumption against unilateral mistake contracts, which is overcome by the need for an incentive to discover information and thereby correct mistakes. However, many unilateral mistakes only enrich the knowledgeable party at the cost of the mistaken party without affecting production or resource allocation. Furthermore, Kronman himself concedes that his standard is difficult to apply in practice. Instead of a case-by-case application of the standard, he suggests a blanket rule of disclosure or nondisclosure for each class of cases involving the same type of information. The choice of rule would be based on the likelihood that the information would be discovered by chance or by deliberate searching.

It is uncertain whether most material information regarding securities is discovered casually or by deliberate search, or whether the search for material information is socially useful. Those who discover the information may trade and then passively wait for the information to be disclosed. Even then, inside trading may enhance the efficiency of the market by making prices more accurate. Under classical theory, this would benefit the market by improving capital allocation and dampening price fluctuations. This decreased volatility would enhance the overall appeal of stocks to risk-averse investors. Moreover, undeserved windfall gains and losses would decrease. Some commentators have suggested, however, that inside trading would not have a significant effect on stock prices. They argue that even if prices are

24. Id. at 15-16.
25. Id. at 12-13.
26. Id. at 17.
27. Id. at 17-18.
30. Lorie, supra note 28, at 819.
31. See text accompanying note 63 infra.
32. Mendelson, supra note 21, at 474 (arguing that those who sell to an insider will use the proceeds to purchase other securities, so that the price of the stock bought by the insider "will not be relatively higher than the price of the stock of other companies" (emphasis in original)); Schot-
affected, resource allocation is not directly affected by trades of existing securities.\textsuperscript{33} As Homer Kripke has noted: "The influence of the trading market on the allocation of funds is very remote and indirect."\textsuperscript{34}

\section*{B. Alleged Detriments}

Investors may be deterred from participating in the market if they know that others are trading on nonpublic information; the investing public could feel that the odds are stacked against them.\textsuperscript{35} This would decrease the liquidity of the stock market and also make it harder for firms to raise capital. On the other hand, investors already disregard a large body of evidence indicating that it is difficult for even the most sophisticated institutions to outperform the stock market averages.\textsuperscript{36} Greed may be the primary motive for stock market investment. Investors may be convinced that certain stocks will make them rich; the occurrence of inside trading may have little effect on investment so motivated.\textsuperscript{37}

\begin{footnotesize}
\begin{enumerate}
\item The rationale for the prohibition of inside trading seems to be not economic efficiency but moral or equitable principles, such as the principle that a person should not profit from undeserved information advantages. In an excellent article, Professor Victor Brudney utilized both efficiency and fairness principles to determine what forms of inside trading should be permitted. \textit{Brudney, supra}. See note 331 infra.
\item Herman, \textit{Equity Funding, Inside Information and the Regulators}, 21 U.C.L.A. L. REV. 1, 17 (1973). \textit{Cf.} Manne, \textit{supra} note 21, at 577 (pointing out that the public's percentage participa-
\end{enumerate}
\end{footnotesize}
Assuming the corporate issuer has no affirmative duty to disclose material developments, permitting inside trading might cause members of corporate management to delay public announcements until after trading. This would extend the period during which public traders incur beneficial or adverse windfalls. Even assuming that society should concern itself with minimizing such windfalls, inside trading may not actually cause delay in publication. One survey of all the reported inside trading cases concluded that, with one possible exception, inside trading did not have an effect on the timing of publication of the information.


A footnote in the recent decision of Elkind v. Liggett & Myers, Inc., cited with approval the Financial Industrial Fund case and then suggested that whether the issuer should disclose material developments is a matter for its “business judgment.” 635 F.2d at 169 n.26. Elkind’s earlier discussion of Liggett’s obligation to correct investment community expectations also seemed to assume no affirmative duty to disclose. Id. at 162-64. Citing Elkind, another Second Circuit opinion also seemed to assume no affirmative duty to disclose. The court held that “[a] company has no duty to correct or verify [accurate] rumors in the marketplace unless those rumors can be attributed to the company.” State Teachers Retirement Bd. v. Fluor Corp., [Current] FED. SEC. L. REP. (CCH) ¶ 98,005, at 91,204 (2d Cir. 1981). The plaintiff in State Teachers also argued that once an issuer decides to withhold material information, the corporation must try to halt trading in its stock. The court did not reach this issue because the defendant lacked scienter and because the plaintiff could not possibly demonstrate causation. Id. at 91,204-05.


39. Dooley, Enforcement of Insider Trading Restrictions, 66 VA. L. REV. 1, 34 (1980); Cf. Scott, Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy, 9 J. LEGAL STUD. 801, 810-11 (1980) (admitting the plausibility of the proposition that insiders might release favorable information more promptly if they could not profit from it, but arguing that insiders would be less likely to release unfavorable news if they could not trade upon it).
One commentator has advanced an ingenious argument that the cost of capital of a corporation with a management that trades on inside information will be higher than that of a corporation with a management that does not engage in such trading. In his example, corporations A and B are identical in all respects except that A's management trades on nonpublic information and B's does not. The outside shareholders of A gain less than B's outside shareholders because the management of A collects a disproportionate share of the earnings stream of A. If the behavior of A's management becomes known, A's stock price will fall relative to B's. Because A and B are identical economic units, the relative rise in A's cost of capital would result in a misallocation of resources. Professor Brudney argues that if outside investors do not know which corporations have managers who trade on inside information, some members of the public will refrain from investing altogether, while others will incur costs to avoid dealing with executives with nonpublic information. This would raise the cost of capital for public corporations generally.

Although these theories seem plausible, another commentator points out that ethical managers do not publicize their abstention from inside trading. Moreover, companies do not vigorously monitor employee trading on nonpublic information, much less publicize such efforts. If the above theories are correct, it seems curious that companies are not using these methods to decrease their relative cost of capital. A possible explanation is that public investors are really not so averse to dealing with inside traders.

In summary, the supposed beneficial and harmful effects of inside trading on society are quite speculative. Therefore, the controversy has shifted to its effect on individuals. If stock market inside trading does harm individuals, that may be sufficient reason for prohibiting such trading, and the debate over the indirect societal effects is less important.

40. Mendelson, supra note 21, at 477-78.
41. Id.
42. Brudney, supra note 34, at 355-56.
43. Dooley, supra note 39, at 48.
44. See note 73 and accompanying text infra.
III. INDIVIDUAL HARM FROM INSIDE TRADING ON THE IMPERSONAL STOCK MARKET

A. ADVERSE EFFECT ON THE ISSUER

Although the New York Court of Appeals in *Diamond v. Oreamuno* suggested that trading by corporate executives harmed the reputation of the corporation,45 this harm is highly speculative.46 It is unclear why customers or suppliers would be less willing to deal with a firm whose executives have traded on nonpublic information. Stock transactions take place between outside parties, with no effect on the business operations of the issuer of the security being traded.47

Nevertheless, as previously mentioned,48 if corporate executives acquired a reputation for inside trading, public investors might feel that management was collecting more than its share of the earnings (or capital gains) of the stock. The price of the stock would tend to fall, and the firm’s cost of capital would rise relative to that of other companies. The corporation would be worse off if it issued new shares. In short, the issuer may be adversely affected by inside trading in its stock.

B. HARM TO SPECIFIC INDIVIDUALS CAUSED BY A STOCK TRADE ON NONPUBLIC INFORMATION

This section briefly describes how the stock market functions; discusses who might be in privity with an inside trader; explains why the party in privity is not necessarily harmed; and analyzes who is damaged by an inside trade.


47. But cf. *Scott*, supra note 39, at 814-15 (Employee trading on nonpublic information may sometimes harm the issuer by feeding the rumor mill at a time when the issuer’s purposes require secrecy.).

48. *See* text accompanying notes 40-41 supra.
1. How the Stock Market Functions

An organized stock exchange is not really a continuous auction market. When a member of the public gives his broker an order to buy or sell "at the market," that order may be executed with a specialist dealing for his own account. Specialists and their over-the-counter counterparts, market-makers, make a living by dealing in certain stocks, much like dealers in used cars, rare coins, or art. If a public investor wants to buy, the specialist or market-maker sells at his "ask" price quotation; if a public investor wants to sell, the specialist or market-maker buys at his "bid" price quotation, which is lower than his ask price. With both over-the-counter and exchange-listed stocks, usually more than one market-maker or specialist trades in a given stock. For example, stocks listed on the New York Stock Exchange are traded by specialists on regional exchanges as well as market-makers in the over-the-counter market.


50. For a description of the over-the-counter market, see 11A E. GADSBY, supra note 49, §§ 2.01[2], 04[1]; 3B H. BLOOMENTHAL, supra note 2, § 12.03; D. VAGTS, supra note 49, at 550-57.


In his pathbreaking discussion of the market effects of inside trading, Professor Henry Manne ignored the role of specialists and market-makers, presumably for simplicity. See H. MANNE, supra note 20, at 77-110.

In addition, a specialist frequently trades not for his own account but on behalf of some public customer who has entered a limit order to buy or sell at a certain price. Finally, floor brokers with public orders to “buy at the market” sometimes trade with each other around the specialist’s booth rather than with the specialist himself. This phenomenon is known as “trading in the crowd.”

2. Who Might Be in Privity With an Inside Trader

When an inside trader telephones his stockbroker with an order to buy a New York or American Stock Exchange listed stock “at the market,” the party in privity could be:

1. A member of the public who has left a limit order with a New York or American Stock Exchange specialist to buy or sell at a certain price;

2. A member of the public who gave a market order and whose floor broker traded with the inside trader’s floor broker around the New York or American Stock Exchange specialist’s booth;

3. The New York or American Stock Exchange specialist for his own account;

4. A specialist on a regional stock exchange for his own account;

or

5. An over-the-counter market-maker who buys and sells stock listed on the New York or American Stock Exchange (a so-called third market-maker).

If the inside trader gives his broker a market order to purchase a stock listed only on a regional exchange, the party in privity might be a member of the public, the regional specialist, or an over-the-counter market-maker. With an inside trade in a stock traded only over-the-counter, the party in privity would be a market-maker.

53. See note 49 supra.
54. See note 52 supra.
3. Why the Party in Privity Is Not Necessarily Harmed by an Inside Trade

Whether the party in privity with an inside trader is a member of the public or a specialist/market-maker, the party in privity may not be damaged by an inside trade. If the inside trade is executed over-the-counter, the party in privity is a market-maker. If the trade is on a stock exchange, the party in privity will be in one of the first four classes listed above. The public investor with a market order (class two) would definitely have traded with someone else—probably the specialist—in the absence of the inside trade. The public investor with a limit order (class one) might also have traded with someone else absent the inside trade, depending on how prices moved subsequently.\(^{55}\)

If the party in privity is a specialist or market-maker, his damage is determined by comparing his actual inventory at the time of disclosure with the inventory he would have had in the absence of the inside trade. Unfortunately, the second figure is impossible to determine. Unlike a public investor, a specialist/market-maker does not have complete control over his inventory. Because more public investors will sell and fewer will buy when there is an increase in the bid and ask prices quoted by the intermediary, the specialist/market-maker’s inventory will be increased. Similarly, because fewer investors will sell and more will buy, a decrease in the specialist/market-maker’s prices will tend to decrease his inventory. Nevertheless, the intermediary does not know exactly what effect a price change will have.

The following example demonstrates the difficulty of determining

55. After transacting with an inside trader, a public investor may reinstate his original position by selling the shares he purchased or buying back the same type of shares he sold. If so, a fallback argument can be made that the party in privity was not damaged. Assuming that the inside trader induced the party in privity to trade, the latter has transferred the harm to someone else. This argument assumes that the party in privity’s first transaction was a but for cause of the second transaction. With a publicly traded security, this possibility is overwhelmingly likely. For example, someone with no previous holdings may buy 100 shares from the inside trader and then sell at a slight profit. The second sale is obviously connected to the first.

Even if the party in privity already owned 1000 shares prior to buying 100 shares from the inside trader, a subsequent decision to sell 100 shares is logically linked to the earlier purchase. A rational investor has a certain inventory with which he feels comfortable. The second transaction indicates that the party in privity felt comfortable with 1000 shares. Had he not purchased the 100 shares from the inside trader, increasing his inventory to 1100, he would not have sold, since he would already hold his desired number of shares.

Similarly, if the party in privity had prior holdings of 1000 shares, bought 100 shares (from the inside trader), and then sold 300 shares, the sale would indicate that the party in privity felt comfortable with 800 shares. Had he not bought the 100 shares (increasing his inventory to 1100), he would have sold only 200 shares, to reduce his inventory to the 800-share level at which he felt comfortable.
whether an inside trade has helped or harmed a specialist/market-maker. Suppose that the inside trader bought 100 shares from a specialist, thereby reducing the latter’s inventory from 1100 shares to 1000, and that the specialist kept his prices absolutely stable. Purchases and sales cancel each other, so that at the time of disclosure of the good news the specialist’s inventory was 1000 shares.

The following are two scenarios that might have happened absent the inside trade. Because the specialist wanted to decrease his inventory to 1000 and because there was no inside trade resulting in that reduction, the specialist lowered his prices. His inventory could have been 800 at the time of disclosure of the good news. Alternatively, after the specialist lowered his prices, his inventory could have initially decreased to 800; but before disclosure he could have compensated for the excess decrease by raising his prices, and his inventory could have unexpectedly risen to 1300 by the time of disclosure.

In the first case, the inside trade has made the specialist considerably worse off. Indeed, the harm to the specialist exceeds the gain to the inside trader. In the second case, the inside trade has made the specialist better off. This hypothetical situation is quite simple; in reality the specialist will have altered his prices many times between the time of the inside trade and the time of the public disclosure.

The problem is that the inside trade changes the specialist/market-maker’s inventory. This change in inventory may create a pattern of price quotations different from the one that would have existed absent the trade. Such an altered pattern will create different reactions by the public and by competing specialists and market-makers. To determine the effect of this new price pattern on the intermediary in privity with an inside trader, it is necessary to recreate the pattern that would have prevailed absent the inside trade and to ascertain the consequence of that pattern on the intermediary’s inventory. Unfortunately, this is impossible. Therefore, a specialist/market-maker cannot demonstrate harm from an inside trade.

4. *The Law of Conservation of Securities*

Despite the suggestions of some commentators that market participants are generally not harmed by inside trading, each act of inside trading

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does in fact harm other individuals. With a purchase of an existing issue of securities, someone has less of that issue; with a sale of an existing issue, someone ultimately acquires more of that issue. This phenomenon is labeled "The Law of Conservation of Securities." This law has three corollaries:

1. When someone trades on nonpublic information, the group of all other investors suffers a net loss. (Some members of this group gain, others lose; but the losses will exceed gains.)

2. The group's net loss is equivalent to the inside trader's gain.

3. To the extent that some outside investors gain from an inside trade, those harmed by the trade will lose more than the inside trader's gain.

5. Who Bears the Net Loss Caused by an Inside Trade

The Law of Conservation of Securities could work in one or both of two ways. The inside trade could induce opposite trade transactions that otherwise would not have occurred, or preempt trades of the same type that otherwise would have occurred. Thus, there are at least two categories of people harmed by an inside trade: those who would not have made bad purchases or sales but for the inside trade; and those who would have made good purchases or sales but for the inside trade.58

a. Induced adverse trades: An inside purchase could be a but for cause of many different transactions. Sellers in these induced transac-

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58. See H. Manne, supra note 20, at 103; Whitney, Section 10b-5: From Cady, Roberts to Texas Gulf: Matters of Disclosure, 21 Bus. Law. 193, 201 (1965); Note, supra note 57, at 872 n.45.
tions are adversely affected because they miss the increase in value after the public announcement of good news. Similarly, an inside sale could be a but for cause of transactions in which buyers suffer a windfall loss when the bad news is announced.

There are many ways by which an inside trade could directly or indirectly induce transactions that otherwise would not have occurred. If the party in privity had a limit order, there is a remote possibility that the order would not have been executed but for the inside trade. The most common way by which an inside trade induces transactions, however, is by altering the behavior of a specialist or market-maker. Whether or not the party in privity is a specialist/market-maker, the inside trade probably affects an intermediary’s inventory. If the inside trader is in privity with the specialist/market-maker, the intermediary’s inventory is directly affected. Even if the inside trader deals with a public investor, a trade has probably been diverted from a specialist or market-maker. This direct or indirect change in the intermediary’s inventory may precipitate a different pattern of price quotations and transactions by him. In transactions that otherwise would not have occurred, either the buyer or seller is harmed—depending upon whether the nonpublic information is good or bad.

Although it is unlikely, the additional volume or price movement caused by a large inside trade conceivably might attract trend-riding speculators and create an avalanche effect that would harm all those who sold into good news or bought into bad news.

b. Preempted traders: Instead of inducing opposite trade transactions, an inside trade may preempt trades of the same type. When an inside trade directly or indirectly changes a specialist/market-maker’s inventory, the new pattern of quotations may either induce new transactions or deter ones that would otherwise have occurred. For example, if an inside trade increases a market-maker’s inventory, he may lower his price quotations to encourage purchases from him and deter sales to him. If an inside trade decreases the market-maker’s inventory, he may increase his prices to encourage sales to him and deter purchases from him.

c. The practical difficulty of identifying those harmed by an inside trade: The foregoing analysis demonstrates that after an inside trade,

59. H. MANNE, supra note 20, at 103; Whitney, supra note 58, at 201; Note, supra note 57, at 872 n.45.
the universe is different than it would have been in the absence of the trade. In practice, however, it is virtually impossible to recreate the universe that would have existed had there been no inside trade.

If the party in privity, \( P \), is a specialist/market-maker, \( S/M \), his inventory is directly affected by the trade. If \( P \) is a member of the public, a \( S/M \)'s inventory is indirectly affected by the trade for one of the following reasons: (1) \( P \) would otherwise have traded with a \( S/M \); (2) \( P \) would have traded with \( X \), who instead traded with a \( S/M \); (3) \( P \) would have traded with \( X \), who instead traded with \( Y \), who would have traded with a \( S/M \), and so on.

It is impossible to determine how the inside trade's direct or indirect effect on an intermediary's inventory altered the intermediary's price quotations, and how these in turn affected the behavior of public investors. The following diagram illustrates the problem (the arrows indicate the direction of the stock transfers):

1. \( T \) (an inside trader) \( \xrightarrow{\text{(directly or indirectly affecting the inventory of } S/M)} \) \( P \)

2. \( S/M \) alters his price quotations and either:
   a. \( S/M \) (sells) \( \xrightarrow{(\text{preempting } X_1, X_2, \ldots \text{ who otherwise would have sold})} B_1, B_2, \ldots \) (who otherwise would not have bought)
   
   OR
   
   b. \( S/M \) (buys) \( \xrightarrow{(\text{preempting } Y_1, Y_2, \ldots \text{ who otherwise would have bought})} S_1, S_2, \ldots \) (who otherwise would not have sold)

It is therefore extremely difficult to allocate an inside trade's harm between intermediaries, outside marginal buyers or sellers, and outside marginal nonbuyers and nonsellers.

Such difficulty is not confined to securities markets. Suppose \( A \) owns a small car rental agency and secretly learns that a certain make of car has a serious defect. \( A \) owns five cars of this make and sells all of them to a large used car dealer, who still owns these cars at the time the defect is made public and prices drop. It is possible that in both the universe in which \( A \) sold the five cars and the one in which he did not, the dealer would have the same inventory at the time of the public
announcement of the defect. In the first universe, prior to the announcement, the dealer may have lowered his prices or raised them less than he otherwise would have. These lower prices may have attracted purchasers or deterred sellers or both. Thus, in the first universe, some members of the public may find themselves owning defective cars who would not have owned them in the second universe.

Recreating the hypothetical second universe, however, is almost impossible. Both the used car dealer and his purchasers will give self-serving testimony. Regardless how low the level of his inventory was at the time of the announcement, the dealer will claim that his inventory would have been even lower had A not sold him the five cars. Regardless how high the prices actually charged by the dealer were during the period between A's sale and the public announcement, outside buyers will claim that A's sale caused the dealer to charge lower prices than otherwise, and that but for these lower prices, the outsiders would not have bought. Outside nonsellers will claim that A's sale caused the dealer to charge lower prices than otherwise, and that but for these lower prices, the nonsellers would have sold. In summary, the Law of Conservation of Securities indicates that although an inside trade does harm specific individuals, identifying them is almost impossible.60

60. In unusual situations, it may be possible to identify the probable victims of an inside transaction in a publicly traded stock. When the stock is very thinly traded, transactions may be so isolated that a plaintiff could argue persuasively that, but for defendant's trade, plaintiff would have had a smaller (or larger) holding of the stock. In addition, institutions and block-trading firms dealing in large amounts of shares occasionally may operate in what is in effect a separate market with isolated transactions. In this block-trading market, a plaintiff might be able to demonstrate that but for the defendant's trade the plaintiff would have had a smaller (or larger) holding of stock. Cf. ALI CODE, supra note 2, § 1702(b), Comment (4) (observing that many institutional trades are negotiated "offboard" and "crossed" on the floor, and that such trades would fall within the Federal Securities Code provision covering nonfortuitous transactions not effected in a stock market).

Calls are options to buy stock; puts are options to sell. Both types of options are issued or written by private individuals who obligate themselves to buy or sell at a certain price. An option trade based on nonpublic information also harms specific individuals. If a person buys a call based on inside information, the purchase either preempts another purchase or elicits the writing of a new call by someone (not necessarily the party in privity) who would not have done so otherwise.

In the first case, the person whose purchase is preempted is harmed. In the second case, the person who writes the additional call is worse off unless he purchases additional shares to "cover" the call. If the writer's call is "covered," the option buyer (on inside information) in effect has bought shares with the option writer acting as intermediary. The option writer is not harmed, but the inside trader's de facto purchase is subject to the Law of Conservation of Securities. Either the stock purchase preempts another buyer or it attracts a seller of the stock.

The analysis of puts is similar. When a person buys a put based on inside information, the
6. Price Change Effects on Those Trading About the Same Time as the Inside Trade

If a substantial purchase or sale based on nonpublic information causes the specialist or market-maker to change his price quotations, those engaging in the same type of transaction at approximately the same time as the inside trade (the "same type" class) will either pay more or receive less than they otherwise would. For example, after selling to an inside trader, a specialist or market-maker might increase price quotations; after buying from an inside trader, a specialist or market-maker might decrease his prices. On organized stock exchanges, changes in specialist price quotations would affect the prices of brokers "trading in the crowd" around the specialist's booth. In short, if an inside purchase increases the market price, those purchasing at about the same time will pay more. If an inside sale decreases the market price, those selling at about the same time will receive less.\footnote{This phenomenon is sometimes called loss causation, as distinguished from transaction causation. Cf. Falls v. Fickling, 621 F.2d 1362 (5th Cir. 1980) (Public announcement of material information prior to sheriff's sale would have brought substantially higher bids than those actually received absent the disclosure; therefore, nondisclosure by bidders in actual sheriff's sale harmed plaintiff.). See also Shores v. Sklar, 647 F.2d 462 (5th Cir. 1981) (en banc) (bond purchaser has cause of action if he can prove that he reasonably relied on integrity of market to protect him from bonds not entitled to be marketed); Blackie v. Barrack, 524 F.2d 891, 906-08 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380-81 (2d Cir. 1974), cert. denied, 421 U.S. 976 (1975); 3A H. BLOOMETHAL, supra note 2, § 9.21[5][b]; 3 A. BROMBERG & L. LOWENFELS, supra note 2, § 8.7(1), at 216; 5 A. JACOBS, supra note 2, § 64.03, at 3-226 to -227; R. JENNINGS & H. MARSH, supra note 51, at 1066; W. PAINTER, supra note 2, at 187, 206-07; Note, The Reliance Requirement in Private Actions Under SEC Rule 10b-5, 88 HARV. L. REV. 584, 592-96 (1975).}

Although the members of the same type class are unquestionably worse off, those with whom they transact (the "opposite type" class) are purchase either preempts another option purchase or causes a new put to be written by someone. The writer of the new put may or may not cover himself by short selling the stock.

When a person trades in puts or calls based on nonpublic information, the harm is especially difficult to trace. It may fall on: (1) a person who has been induced to write an option, (2) a preempted would-be option purchaser, (3) someone who would not have traded the stock but for a stock trade by the option writer, or (4) someone who would have traded the stock but for a stock trade by the option writer. For a simpler discussion of insider purchases of calls omitting the "crowding out" complication, see H. MANNE, supra note 20, at 90-91.

better off. Members of the same type class, however, are unsympathetic figures. Along with the inside trader, they are either buying into a windfall gain or selling into a windfall avoidance of loss. On the other hand, members of the opposite type class are selling into a fortuitous avoidance of gain or buying into a fortuitous loss. The price change induced by the inside trade decreases the extent of these various undeserved fortuities. Arguably, this is beneficial.

C. HARM TO SPECIFIC INDIVIDUALS CAUSED BY THE NONDISCLOSURE

1. Moral or Legal Causation

A stock market inside trader fails to disclose the nonpublic information to both the party in privity and the world. As noted in Part III(B) above, the typical inside trade harms neither the party in privity nor the overwhelming majority of investors. Normally, the inside trader is a total stranger to the party in privity and other investors. If the inside trader were to disclose to a stranger who would be unharmed by the trade, the inside trader would be acting like a Good Samaritan. If the inside trader had disclosed to the party in privity, the latter would have traded at a different price or not at all. Had the inside trader decided to be a quasi-Samaritan and disseminated the secret information to the investing public, the universe would have been dramatically different. In the case of favorable information, the price would have been higher. Sellers would have benefited, and buyers would have been harmed. Many individuals would have abstained from selling once they knew the good news. With adverse news, the price would have dropped. Buyers would have been better off, and sellers would have been harmed. Many investors would have abstained from buying once they knew the bad news.

If the inside trader does not engage in any quasi-Samaritan disclosure, the question is whether he has morally or legally harmed all those who would have been better off had he disclosed. This is the issue of


63. See text accompanying notes 28-31 supra. But see note 32 and accompanying text supra (suggesting that inside trading would not have a significant effect on stock prices).

64. Henceforth, such an obligation to disclose will be referred to as a "quasi-Samaritan" duty.
moral or legal causation. An individual's inaction can be said to cause harm to another if there is a preexisting duty to act. 65 For example, because a parent has a duty to care for his child, if he does not feed his child he is said to have morally or legally caused the infant's subsequent death. A next door neighbor who knows of the starvation may or may not have caused the death, depending upon whether he owes a duty to the child. An affluent American may be said to have caused the death of starving children in developing nations only if it is determined that he has a duty to save them. 66 Thus, whether an inside trader morally or legally causes harm to those who would have been better off with earlier disclosure depends upon whether it can be said that the inside trader has a quasi-Samaritan duty to rescue total strangers. 67

2. Causation Anomaly

If the quasi-Samaritan duty to disclose or to rescue is not absolute, but is contingent on some act by the information possessor, a causation anomaly arises. The information possessor may claim that his choice was between two courses of conduct, one illegal and one legal, both of which would result in the same harm to the plaintiff. Indeed, the illegal course of conduct might result in less harm. Arguably then, choosing the illegal course of conduct did not cause harm to the plaintiff.

The following hypothetical illustrates this causation problem. Suppose a physician sees an injured person on the street. He has three alternatives:


67. This analysis is analogous to the distinction between but for cause and proximate cause. Out of the vast array of but for causes of an injury, liability is imposed only where there is proximate cause, which could be described as existing in those situations where the defendant owes a legal duty of care to the plaintiff. W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 42, at 244 (4th ed. 1971); Mack, supra note 65, at 244-45.

Mack rejects the notion that a failure to rescue causes harm when the harm would have occurred without the rescue. He defines as the but for causes of an event all those conditions jointly and individually necessary to it. If A, B, and C are sufficient and necessary to cause Y, Mack argues that it is meaningless to say that failure to prevent B is a cause of Y. Mack, supra note 65, at 257-59. Similarly, in the criminal law, inaction alone is not sufficient to impose liability "unless: (a) the omission is expressly made sufficient by the law defining the offense [e.g. failing to register for the draft]; or (b) a duty to perform the omitted act is otherwise imposed by law." MODEL PENAL CODE § 2.01(3), Illustrations (1962).
1. Stop and give adequate medical care;  
2. Stop and give inadequate medical care;  
3. Not stop.

In Anglo-American jurisprudence, options one and three are permissible, but option two is not.\(^6\) Suppose the physician chooses option two, and the injured person is permanently handicapped. Had the physician chosen option one, the injured person would have fully recovered. Had he chosen option three, the injured person would have died.

It is not clear, then, that he caused the harm to the injured person. The physician could claim that had he not chosen option two, he would have chosen option three over option one. The actual choice was between options two and three; by choosing option two, he made the injured person better off. The victim could still demonstrate but for causation if he could prove that the physician would have chosen option one over option three despite his allegation to the contrary. The victim could demonstrate moral or legal causation if it were conclusively presumed that the physician would have chosen option one over option three, or that the physician's stopping triggered a duty to choose option one. Although the law could create bootstrap causation by either a conclusive presumption or a triggered duty approach, the claim that the injured person is no worse off and, perhaps, even better off, than if the physician had failed to act at all, would still be troubling.\(^6\)\(^9\)

Similarly, suppose that someone with nonpublic information about a security has no absolute duty to disclose the news to anyone,\(^7\) just as the doctor had no duty to rescue. If he trades, however, he must disclose, just as the physician must be diligent if he renders assistance. An information possessor who trades without disclosing might argue

\(^{68}\) W. Prosser, supra note 67, § 56, at 343-48; Restatement (Second) of Torts §§ 323, 324 (1965).

\(^{69}\) For discussions of the tort liability of Good Samaritans, see Restatement (Second) of Torts § 323, Illustrations (1965); Note, Good Samaritans and Liability for Medical Malpractice, 64 Colum. L. Rev. 1301, 1301-15 (1964) [hereinafter cited as Good Samaritans and Liability]; Comment, Good Samaritan Laws—Good or Bad?, 15 Mercer L. Rev. 477 (1964); Comment, Criticism of Existing Good Samaritan Statutes, 42 Ore. L. Rev. 328 (1963); Note, Good Samaritans and Hospital Emergencies, 54 S. Cal. L. Rev. 417, 419-23 (1981); Note, The Good Samaritan and the Law, 32 Tenn. L. Rev. 287, 288 (1965); Note, Florida's Proposed Good Samaritan Statute—It Does Not Meet the Problem, 17 U. Fla. L. Rev. 586, 588-90 (1965); Comment, Pennsylvania's Good Samaritan Statute—An Answer to the Medical Profession's Dilemma, 10 Vill. L. Rev. 130 (1964); Note, Good Samaritan Statutes: Time for Uniformity, 27 Wayne L. Rev. 217 (1980); Comment, Physicians—Civil Liability for Treatment Rendered at the Scene of Emergency, 1964 Wis. L. Rev. 494 (1964).

\(^{70}\) For discussions of an issuing corporation's possible affirmative duty to disclose material corporate developments, see sources cited in note 38 supra.
that had he not utilized the information he would have done nothing, and the various plaintiffs would have been harmed to the same extent anyway, just as the injured person in the street would have been no better off had the physician not stopped. The law could answer such a contention by asserting either that there is a conclusive presumption that the information possessor would have disclosed rather than do nothing, or that the trade triggered an absolute duty to rescue some or all of those who would be better off with disclosure. This bootstrap causation would still not eliminate the anomaly.

This causation anomaly may be more readily understood in the close corporation context. Suppose the president and majority shareholder of a farming corporation knows that oil is likely to lie under the property owned by the company. Coincidentally, $F$, who owns five percent of the company, announces that all his stock is for sale. Several neighboring farmers offer to pay $F$'s asking price. $F$ is about to accept one of the neighbor's offers, when the president $X$ offers more than the asking price. Although the two are enemies, $F$ sells to $X$. Arguably, $F$ is benefited rather than harmed by $X$'s purchase because otherwise $F$ would have sold at a lower price.

$X$ had three choices upon learning about the oil:

1. Buy the shares without disclosure, thereby enriching himself at the cost of either $F$ or one of the neighbors;

2. Do nothing and allow one of the neighbors to buy the shares, thereby enriching one of the neighbors at the cost of either $X$ or $F$;

3. Disclose the oil potential to $F$, thereby enriching $F$ at the cost of either $X$ or one of the neighbors.

Options two and three are clearly permissible. By choosing the first option rather than the second or third, $X$ has harmed either $F$ or one of the neighbors. If option one were eliminated, and $X$ had chosen option two, the harm would have fallen on one of the neighbors rather than on $F$. $X$ has an incentive so to testify, because he can then advance a harmless error defense against $F$ by claiming that option two would have produced the same loss to $F$. The neighbors lack standing to sue under rule 10b-5, but even without the standing problem, it is impossible to know which of the neighbors was harmed unless $F$ can specify the neighbor to whom he would have sold. If $F$'s decision depended on which neighbor was willing to sweeten terms, the answer

would depend on the self-serving testimony of the neighbors as to what they would have done had $X$ not preempted them. The analysis becomes even more complicated if after $X$ bought, one or more of the neighbors purchased shares in a nearby incorporated farm on which oil was subsequently discovered.

All these problems are avoided if it is conclusively presumed that $X$ would have chosen option three over option two (were option one eliminated); or if $X$'s choice of option one triggered a quasi-Samaritan duty to have already performed option three (disclosure to $F$). In either event, $F$ could recover.

The same anomaly occurs with sales on adverse nonpublic information. Suppose $A$ is one of ten shareholders in a corporation that owns one resort hotel. The other shareholders are all $A$’s good friends. $A$ is the only person who knows there is a landslide problem on the site of the hotel. $B$ is seriously considering buying shares from either of two of $A$’s fellow shareholders. Without revealing the landslide problem, $A$ offers to sell at a lower price. $B$ buys $A$’s shares.\(^{72}\) After the deal is closed, a heavy rain causes major landslide damage to the hotel.

$A$ had three choices:

1. Sell his shares, thereby enriching himself at the cost of either the buyer or one of the two fellow shareholders;

2. Do nothing to interfere with the buyer’s purchase from one of the two fellow shareholders, thereby enriching one of the two fellow shareholders at the cost of either the buyer or himself; or

3. Disclose the landslide problem to the prospective buyer, thereby enriching the prospective buyer at the cost of either himself or one of the two fellow shareholders.

As before, options two and three are clearly permissible. By choosing the first option rather than the second or third, $A$ harmed either the buyer or one of the two fellow shareholders, but it is difficult to identify which. $A$ has an incentive to state that if option one were precluded, he would have chosen option two over three. Then the victim of option one would be one of the two fellow shareholders, both of

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\(^{72}\) This hypothetical assumes that the sale is covered by the federal securities laws. *See* Mifflin Energy Sources, Inc. v. Brooks, 501 F. Supp. 334 (W.D. Pa. 1980). *But cf.* Frederiksen v. Poloway, 637 F.2d 1147 (7th Cir.), *cert. denied*, 101 S. Ct. 3006 (1981) (When purchaser of stock obtains control of a company, the stock purchased is not a “security” under the federal securities laws.). To bring the hypothetical more clearly within the federal securities laws, the percentage of the corporation sold could be lowered further.
IMPERSONAL STOCK MARKETS

whom lack standing to sue under rule 10b-5. Again, $B$ would have difficulty demonstrating causation unless it were conclusively presumed that $A$ would have chosen option three over option two (if option one were precluded); or unless $A$'s choice of option one triggered a quasi-Samaritan duty already to have performed option three (disclosure to $B$).

The farm and resort hotel hypotheticals demonstrate that a causation anomaly can arise in face to face transactions as well as in impersonal stock market trading. With the latter, however, the problem is more serious and more likely to occur. A publicly traded security has more potential buyers and sellers than the farm or resort hotel of the previous hypotheticals. Also, it is far more likely that if there were no inside trade, the defendant would have pursued the perfectly legal course of remaining silent. There is a difference of degree and not of kind between the occasional causation anomaly in face to face transactions and the inevitable anomaly in stock market trades.

D. WHY BUSINESSMEN MIGHT NOT CONSIDER INSIDE TRADING IMMORAL

A 1961 survey of 1700 American corporate executives indicated that a large number of these executives do not consider inside trading to be particularly immoral. There are two principal reasons why a busi-

73. Baumhart, How Ethical are Businessmen?, 39 HARV. BUS. REV. 6, 16 (July-Aug. 1961). When asked what they would do if given material inside information, the response was: 42% would buy securities themselves, 2% would inform their broker, 14% would tell a friend, 56% would do nothing. Id. When asked what they thought their colleagues would do in the same position, those polled felt that: 61% would buy for themselves, 11% would inform their broker, 46% would tell a friend, 29% would do nothing. Id.


Studies of public filings indicate that corporate insiders consistently out-perform the market. See Finnerty, Insiders and Market Efficiency, 31 J. FINANCE 1141, 1148 (1976) ("Insiders can and do identify profitable as well as unprofitable situations within their corporations."); Jaffe, The Effect of Regulation Changes on Insider Trading, 5 BELL J. ECON. & MANAGEMENT SCI. 93, 101-15 (1974); Pratt & DeVere, Relationship Between Insider Trading and Rates of Return for NYSE Com-
nessman might not consider inside trading unethical. First, since several commentators have erroneously concluded that such trading causes no harm to other traders,\textsuperscript{74} businessmen may be subject to the same illusion. Second, even if a businessman is vaguely aware that someone is harmed, the stock market is so impersonal that it is easy to ignore any harm or to persuade oneself that no one is harmed. If the victim is someone whose transaction was preempted, the inside trader could also rationalize that the victim has only been deprived of an undeserved windfall gain or avoidance of loss.

To illustrate, suppose $X$ contracts to purchase a house in a new development. Subsequently, $X$ learns the secret information that a volcano may erupt nearby and decrease real estate values. $X$ offers the developer a small amount of cash to rescind the purchase. Because of a strong demand for units, the developer accepts $X$'s offer. $X$'s unit is allocated by lottery together with 1000 other remaining units. Only one out of four prospective home purchasers is able to buy. While $X$'s rescission resulted in someone else owning $X$'s unit, $X$ might rationalize that the new owner would have bought another unit had $X$'s unit not been available. If someone pointed out to $X$ that his rescission must have resulted in one more person's being able to purchase a unit and losing money when the volcano erupts, $X$ might rationalize that the lottery is really responsible for the loss or that the homes will eventually go up in price after a delay. Because $X$ never meets any of the homeowners in the development, and because $X$ cannot know which of them he actually harmed, $X$ may not feel as unethical as he would if he were the face to face seller of an older home in the same area.

Moreover, inconsistent ethical standards are often followed in impersonal as opposed to personal dealings. For example, some persons take improper deductions on income tax returns,\textsuperscript{75} while others scrupulously avoid doing so. If a bank credit card company makes an error in one's favor, some will report the error, while others will remain silent and feel no guilt. Although it is clear that someone must be worse off because of the error, the customer who takes advantage of it may rationalize that the bank is rich, that it expects to lose money on errors, or that it passes the costs on to all customers. Because dealing with a large

\textsuperscript{74} See note 56 supra.

\textsuperscript{75} Indeed, many Americans fail to report income. See How Tax Evasion Has Grown, N.Y. Times, Mar. 15, 1980, § 3, at 1, col. 2.
bank or the Internal Revenue Service is so impersonal, some individuals feel less guilt or no guilt about cheating these entities.

E. Why Members of the Public Might Consider Inside Trading Immoral

The lack of uniformity in the ethics of Americans can be illustrated by the following hypotheticals, which are listed in increasing order of reprehensibility:

1. A large bank’s credit card division underbills a customer. The customer does not volunteer to pay the extra amount.

2. A bank teller gives a customer too much change. Even though the customer knows the loss will fall on the teller, the customer does not correct the error.

3. A bank teller embezzles a small amount of cash from the bank.

Almost all Americans would condemn the conduct in hypotheticals two and three. The second involves cheating another individual, and the third involves a breach of trust or fiduciary duty. By contrast, the first hypothetical involves an arm’s length relationship rather than a fiduciary one, and the victim is a large institution rather than an individual. American attitudes toward the conduct in hypothetical one are surprisingly divergent.\footnote{See note 75 and accompanying text supra.}

Inside trading seems closer to hypotheticals two and three than to hypothetical one. Although a businessman might rationalize that inside trading causes no harm, he would be wrong. If a corporation’s management has a reputation for inside trading, the company’s cost of capital will rise.\footnote{See note 40 and accompanying text supra.} Furthermore, at dissemination, under the Law of Conservation of Securities, someone has more of a security if an inside trader has sold, and someone has less of a security if an inside trader has bought.\footnote{See text accompanying notes 56-59 supra.} That person is harmed by the inside trade.\footnote{The particular victims of inside trading would be harmed even if the presence of inside trading caused the overall price of equity securities to fall or the price of a specific issue to decline.} The victim may be a large institution or a small investor. Thus, even people who tolerate the conduct in the first hypothetical might disapprove of inside trading.

Analogously, suppose $A$ is an employee of a whiskey bottler. If he
sneaks several bottles of whiskey home and covers the shortage by short-filling each bottle in one case, A is better off and some consumers are worse off, even if they do not realize it, and even if overall retail whiskey prices are somewhat lower because of the possibility of short-filling. A has more whiskey, and someone else has less. The person harmed may be a huge hotel chain or an ordinary consumer. Because A’s conduct is more like hypotheticals two and three than hypothetical one, his behavior would be unanimously condemned.

Although the average American may not think in terms of the cost of capital or the Law of Conservation of Securities, he probably has a visceral reaction that inside trading definitely harms someone else in the market and may harm the issuer. This reaction is absolutely correct. In short, any public antipathy toward inside trading has a valid foundation.

Even if inside trading were unanimously considered unethical, a separate question is the extent of an inside trader’s civil liability. The next part of this Article considers the application of SEC rule 10b-5 to stock market trading on material nonpublic information.

IV. APPLICATION OF SEC RULE 10b-5 TO INSIDE TRADING ON IMPERSONAL STOCK MARKETS

A. PRELIMINARY CONSIDERATION: TO WHOM IS THE DUTY TO DISCLOSE OWED?

SEC rule 10b-5 applies only to fraud. Although an act of stock market inside trading unquestionably harms someone, the inside trader has no contact with the victim. For an inside trader to violate rule 10b-5, he must have a duty to disclose before trading. The duty to disclose could be owed to: the party in privity with the inside trader; the individual to whom the party in privity transmits the harm, if the party in privity reinstates his original position by repurchasing or reselling; the victims of the inside trade itself; or the entire world. If an inside trader cannot identify in advance the potential party in privity or the potential

80. Sante Fe Indus., Inc. v. Green, 430 U.S. 462 (1977). Actually, this case held that rule 10b-5 requires either manipulation or deceit. Id. at 473-74. Manipulation, however, is a term of art used to refer to practices intended to mislead investors by artificially affecting market activity (e.g., wash sales, matched orders, and rigged prices). Id. at 476-77; Hundahl v. United Benefit Life Ins. Co., 465 F. Supp. 1349, 1359-62 (N.D. Tex. 1979). The typical trade would not involve market manipulation in this sense. Therefore, under Sante Fe Industries, an inside trader must be deceitful in order to violate rule 10b-5. See notes 57-59 supra; notes 178-81, 191-92, and accompanying text infra. See generally Note, Suits for Breach of Fiduciary Duty Under Rule 10b-5 After Sante Fe Industries, Inc. v. Green, 91 HARV. L. REV. 1874 (1978).
victims of his trade, the duties to the first three possible parties may in practice require a potential inside trader to disclose to the world first. If the inside trader does not disclose, however, duties to any of the first three parties would create a much smaller group of plaintiffs than would a duty to the world.

1. **Duty To Disclose to the Party in Privity**

If the potential inside trader is able in advance to identify and disclose to the potential party in privity, the other individual either would not trade or would demand a more attractive price. This would eliminate the advantage of dealing with this particular party. The inside trader would encounter the same problem if he turned to another potential buyer or seller. In each case, disclosure would eliminate the benefit of trading on nonpublic information. Ironically, each revelation to a potential party in privity might itself be grounds for rule 10b-5 liability, if the recipient of the information traded on the basis of the revelation. By attempting to avoid liability, the initial information possessor would have incurred it. If the selective revelation is a per se violation even in the absence of a trade by the tippee, the initial information possessor is in violation of the rule whether or not he discloses the information. Even if the selective revelation is a violation only if the tippee trades, the initial information possessor risks liability by disclosing to a potential party in privity. On the other hand, selective revelation in the course of a bona fide attempt to purchase or sell may not violate rule 10b-5, even if the information recipient trades on the basis of the information.

If the potential party in privity cannot be identified in advance, the potential inside trader must disclose to the world before trading. Again, this eliminates the advantage of trading on the information. If the inside trader transacts without disclosing, however, he will be liable only to the party on the other side of the transaction.

Part III(B)(3) of this Article demonstrates that the party in privity is not necessarily harmed by the inside trade itself. For example, if an inside trader, T, transacts with A, the party harmed by the trade might be X, a preempted trader. The Law of Conservation of Securities does not preclude harm to both A and X. In fact, X is the only victim of the

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81. See notes 125-26, 207 and accompanying text infra.
82. See text accompanying notes 9-10 supra.
83. This assumes that the plaintiff can demonstrate causation. For a discussion of a causation anomaly, see text accompanying notes 68-72 supra.
transaction, and $A$ is the victim of $T$'s nondisclosure. Had $T$ disclosed, $A$ would not have traded. By trading without disclosing, $T$ engaged in both action and inaction. His action was the trade. His inaction was the failure to disclose. Both the action and the inaction influenced the universe, which was changed by the trade and would have been different had $T$ disclosed to $A$.

Two hypotheticals illustrate this point. Suppose that after watching a blackjack dealer, $A$ realizes that the remaining deck is disproportionately rich in high cards, which is advantageous to the player. There is only one vacant seat at the table, and $A$ takes it just before another individual is about to sit down. The dealer busts (goes over twenty-one) four times in a row and then runs out of cards. Everyone at the table wins all four times. $A$'s playing harmed the gambler whom $A$ preempted. $A$'s nondisclosure harmed the casino. Had $A$ disclosed to the dealer that the deck was rich in high cards, he would have reshuffled, and the casino would not have lost repeatedly.

Suppose $B$ has secret information that in one day Rolls Royce Ltd. will announce it is discontinuing production forever. $B$ goes to a Rolls Royce dealer and buys a car off the floor. His purchase preempts that of another customer who was eyeing the same floor model and would have bought had $B$ not acted first. Because the other floor models do not interest him, the other customer goes home. The next day, Rolls Royce Ltd. makes its public announcement, and the prices of all its cars rise dramatically. $B$'s purchase harmed the other customer; $B$'s nondisclosure harmed the dealer.

These two hypotheticals raise another difficult issue. Had $A$ disclosed to the blackjack dealer, the casino would have avoided losses to all those sitting at the table. Had $B$ disclosed to the Rolls Royce dealer, he would have raised all his prices or refused to sell to anyone until the announcement. In either case, the nondisclosure was a but for cause of losses far in excess of the gains. Whether it should create liability for all these losses is an intriguing question. The same situation could easily develop in the stock market when the inside trader deals with a specialist, market-maker, or other active trader.

2. Duty To Disclose to the Individual to Whom the Party in Privity May Transmit the Harm of Nondisclosure

Suppose a stock market inside trader deals with someone who, before public disclosure, regains his original position by reselling or repurchasing. It is extremely likely that the first transaction of the party in
privity was a but for cause of the second reverse trade.\footnote{84. See note 55 and text accompanying notes 9-10 \textit{supra}.} In other words, the individual in privity with the inside trader has transmitted the harm of nondisclosure to someone else, who in turn may retransmit the harm. Because this transmission of the harm is reasonably foreseeable, the inside trader might owe a duty to disclose to the person to whom the harm has been transmitted at the time of public dissemination. For example, suppose an inside trader, $T$, trades with $A$, who then engages in a reverse transaction with $B$. $T$ might owe a duty to disclose to $B$. Had $B$ known the nonpublic information, he would not have traded with $A$, or he would have demanded a more attractive price.

Even if $T$'s duty to disclose were owed only to $A$, initially one might think that $B$ could recover as an indirect but foreseeable victim of $T$'s nondisclosure. $B$ is not necessarily harmed by the nondisclosure to $A$, however. Although disclosure to $A$ might have precluded $A$'s trades with both $T$ and $B$, $B$ might have traded with someone else. Under the Law of Conservation of Securities, someone must be harmed by $A$'s repurchase or resale, but it is difficult to identify who. In other words, $A$'s repurchase or resale creates its own trade victim, who is different from the victim of the inside trade itself. This phenomenon is illustrated in the following diagram:

\begin{center}
\begin{tikzcd}
T \arrow[r] & A \arrow[r] & B \\
\text{trades with} \quad & \text{trades with} \quad & \\
\text{(preempting or} \quad & \text{(preempting or} \quad & \\
\text{inducing } X) \quad & \text{inducing } Y) \quad & \\
\end{tikzcd}
\end{center}

Again, the Law of Conservation of Securities does not preclude there being two victims of $T$'s conduct. $X$ is the victim of $T$'s transaction. $Y$ is the victim of $T$'s nondisclosure to $A$. Had $T$ disclosed to $A$, the latter would not have traded with $T$, traded with $B$, and preempted $Y$. $Y$ would have held more of a good security or less of a bad security.

3. \textit{Duty To Disclose to the Victims of the Inside Trade Itself}

If it were possible to disclose only to the potential victim of the inside trade itself, there would be some curious results. The inside trade could either induce or preempt a transaction by the potential victim (Trade Victim One). If Trade Victim One were an induced trader, as opposed to a preempted trader, he would abstain from trading if the inside trader disclosed the information to him alone. This in turn might transfer the potential harm to another victim (Trade Victim
Two). Disclosure to Trade Victim Two would transfer the potential harm to a third victim, and so on. At first, this chain might seem to go on indefinitely. Complications would arise, however, if any potential trade victim in the chain, including Trade Victim One, were a preempted trader, rather than an induced trader. Such a potential victim probably would himself violate rule 10b-5 by utilizing any information selectively revealed to him by the inside trader. Therefore, individual disclosure would not make this potential victim better off. There is no way that an inside trader can save a potential preempted trade victim through individual disclosure—although the inside trader can save this potential victim from harm by abstaining from trading.

This discussion is academic, however, because the inside trader usually cannot identify his potential victim and therefore cannot disclose only to him. If the potential inside trader were to disclose to the world, he would help any potential trade victim whose trade would have been induced by the inside trade. After disclosure, this potential victim either would not trade or would trade at a better price. On the other hand, public disclosure would not improve the position of a potential trade victim whose transaction would have been preempted, because this potential victim's transaction still could be eliminated by the new transactions precipitated by disclosure. Even if the potential victim is able to trade, the price he pays or receives will be accurate. The potential harm of the inside trade was the loss of opportunity to trade at an advantageous but inaccurate price. In short, public disclosure improves the position of one type of potential victim but not the other.

The following analogy illustrates this point. Suppose A has non-public information that a company has made a major mineral discovery. On behalf of an undisclosed principal, a block of the company's shares is to be sold at an auction by sealed bid. The seller reserves the right to reject any bid not higher than an undisclosed minimum—$100 per share. A's bid of $110 is the highest, and he buys the shares. An hour after his purchase, the mineral discovery is made public, and the market price of the stock climbs to $120. If the second highest bid was $99, and if this bid would have been rejected, A's trade victim was the seller of the block, an induced trader. Had A not bid $110, no bid would have met the secret minimum. When the news was announced, the seller of the block would still own the shares.

85. See text accompanying notes 104-26 infra; notes 277, 288-89 and accompanying text infra. But see notes 275-76 and accompanying text infra (uncertain impact of Chiarella on tippee liability).
Suppose prior to submitting the bid, A tried to disclose the non-public information to the undisclosed principal of the auctioneer, but was told that the only way A could disclose to this undisclosed principal was to disclose to the world. A's disclosure to the world would have benefited the potential seller, because he presumably would have stopped the auction or increased the minimum bid. Even if he did neither, the seller still would have benefited because A's disclosure would have generated much higher bids from third parties. 86

On the other hand, if the second highest bid was $105 per share, A's trade victim would be the second highest bidder, a preempted trader. Had A not bid $110, the second highest bidder would have bought the stock and reaped the windfall gain. A did not know the identity of the second highest bidder, so he could not have disclosed his information only to him. Had A disclosed his information to the world, another group of bids and bidders would have been attracted. The winning bidder in this hypothetical auction may not even have been a bidder in the auction without disclosure. Even if the winning bidder in the auction after public disclosure happened to be the second highest bidder in the actual auction (for $105), his bid in the hypothetical auction would be so high that he would be deprived of the very windfall gain of which A deprived him by submitting a higher bid in the actual auction.

Although the stock market is not an auction, an inside trade induces or preempts transactions. 87 To the extent that an inside trade fulfills the Law of Conservation of Securities by preempting a trade, the inside trade substitutes a knowing undeserved windfall gain (or windfall avoidance of loss) for an unknowing undeserved windfall gain (or windfall avoidance of loss). With a publicly traded security, individual disclosure to this type of potential victim is impossible, and public disclosure is not helpful. Even if individual disclosure were possible, this type of potential victim would not be better off because he probably could not utilize the information without violating rule 10b-5 himself. 88 In either event, the inside trade would be objectionable not because of any harmful fraud, but because of the harmful effects of the act itself.

86. See note 61 supra. See generally Falls v. Fickling, 621 F.2d 1362 (5th Cir. 1980).
87. See text accompanying notes 58-60 supra.
88. See text accompanying notes 104-26 infra; notes 277, 288-89 and accompanying text infra. But see notes 275-76 and accompanying text infra (uncertain impact of Chiarella on tippee liability).
Under *Santa Fe Industries, Inc. v. Green*, the gravamen of an inside trader's 10b-5 violation must be fraud. If nondisclosure does not harm a civil plaintiff, he can recover only if the causation requirement is waived. The current status of the causation requirement in private 10b-5 actions for nondisclosure is unclear. Even if the harmful fraud requirement could be avoided, a preempted potential trader would lack standing to sue civilly. It is unclear whether there can be a criminal violation of rule 10b-5 when no one has civil standing. In his concurring opinion in *Chiarella v. United States*, Justice Stevens raised this issue without resolving it.

As mentioned earlier, in practice there is no way of identifying the victims of a stock market inside trade. Thus, it is impossible to know whether the victims are induced or preempted traders. The victims of a large inside trade need not include some induced traders. A large inside trade may only preempt another single large inside trade.

If the type of victim of an inside trade cannot be identified, and if rule 10b-5 is not violated when the victim is a preempted trader, it is impossible to know whether a rule 10b-5 violation has occurred. In other words, because of the limitations placed on rule 10b-5 by *Santa Fe Industries, Inc. v. Green* (requiring fraud) and *Blue Chip Stamps v. Manor Drug Stores* (limiting civil standing), it is difficult to apply

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This discussion ignores another causation anomaly faced by both induced and preempted traders. For a discussion of this causation anomaly, see text accompanying notes 68-71 supra.
92. 445 U.S. at 237-38 (Stevens, J., concurring); see note 194 and accompanying text infra.
For a discussion of this case, see text accompanying notes 170-344 infra.
93. See note 60 and accompanying text supra.
94. 430 U.S. at 473-74. See note 80 supra.
95. 421 U.S. at 736-41 (1975).
rule 10b-5 to stock market inside trading if the duty to disclose is owed to the victims of the trade itself.

4. *Duty To Disclose to the World*

If the potential inside trader on the stock market has a duty to disclose to the world before transacting, his liability for breaching the duty may be enormous, because several classes of plaintiffs could claim harm from the nondisclosure: those who would not have traded to their disadvantage; those who would have traded to their advantage; and actual traders who would have traded at a more attractive price. Plaintiffs in the second class lack standing to sue under *Blue Chip Stamps v. Manor Drug Stores*. Nevertheless, if trading in the security is active, and if there is a significant delay between the commencement of the defendant’s duty to disclose and public dissemination of the information, the potential number of plaintiffs in the other two classes is large and the potential liability enormous.

Anomalies, practical difficulties, and theoretical problems in finding harmful deceit exist in a stock market inside trade. Nevertheless, the courts have been willing to hold that such trading violates rule 10b-5. Parts IV (B) and (C) of the Article will explore how the courts have dealt with the issues of defining plaintiffs and defendants.

B. *Defining the Class of Rule 10b-5 Plaintiffs Who Can Demonstrate Causation When Suing a Stock Market Inside Trader for Damages*

Fridrich v. Bradford; Elkind v. Liggett & Myers, Inc., and Wilson v. Comtech Telecommunications Corp. All four of these decisions have been overshadowed by contrary dicta in the recent Supreme Court decision of Chiarella v. United States. Although Elkind and Wilson were decided subsequently to Chiarella, both are inconsistent with the rationale of the Supreme Court opinion. This Article discusses these five decisions in chronological order. The proper class of plaintiffs depends upon whether the gravamen of the offense is a trade or a duty to disclose; and, if the latter, to whom the duty to disclose is owed.


In the Shapiro case, Merrill Lynch was the managing underwriter of a proposed offering of Douglas Aircraft debentures. Because of Merrill Lynch’s position, it received certain material adverse nonpublic information about Douglas’ earnings prospects from its management. Merrill Lynch disclosed this confidential information to certain of its customers, most of which were institutional investors. Prior to the public announcement of the adverse news, these tippees sold their holdings of Douglas Aircraft, made short sales, or both. Once the adverse news became public, the stock price dropped sharply.

The plaintiffs brought a class action in the Southern District of New York against Merrill Lynch and its tippees on behalf of them-
selves and all others similarly situated who bought Douglas common shares during the period between the first trade by a Merrill Lynch tippee and public dissemination of the adverse news. After the pleadings, the plaintiffs moved for an order declaring that the action could be maintained as a class action. The defendants moved for judgment on the pleadings. The trial judge denied both motions but granted the plaintiffs leave to renew their motion when sufficient facts could be presented.

The only issue before the Second Circuit was whether the trial court had properly denied the defendants' motion for judgment on the pleadings. In an opinion by Judge Timbers, the Second Circuit affirmed the trial court ruling that, based on the pleadings, the defendants had violated section 10(b) and rule 10b-5 and were liable for damages to the plaintiffs. The Second Circuit quoted its earlier decision in SEC v. Texas Gulf Sulphur Co.: "[A]nyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it... , must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed." Thus, an individual with material nonpublic information has no per se duty to disclose. His trade while in possession of the information triggers a duty to have already disclosed.

Judge Timbers held that the duty to disclose (triggered by the trade) runs not only to the purchasers of the actual shares sold by the defendants (in the unlikely event they can be identified) but to all persons who during the same period purchased Douglas stock in the open market without knowledge of the material inside information which was in the possession of the defendants.

In other words, the defendants' trade triggers a quasi-Samaritan duty to all investors throughout the world.

Because no class had yet been certified, the Second Circuit did not precisely define the class of plaintiffs, but held the defendants liable to

106. Id. at 231.
107. Id.
109. 495 F.2d at 236 (quoting Texas Gulf Sulphur, 401 F.2d at 848).
110. 495 F.2d at 237.
111. The district court judge actually mentioned Good Samaritan duties and analogized an inside trader to one who negligently comes to the aid of a drowning man. Shapiro v. Merrill Lynch, 353 F. Supp. at 278.
"all persons who during the same period purchased Douglas stock in
the open market." On remand, the district court sustained
plaintiffs' request that the class be certified to include all persons who
purchased Douglas stock in the open market without benefit of inside
information from the time of the first allegedly illegal sale by a de-
fendant, June 21, 1966, through June 24, 1966, the day of Douglas'
public announcement of the information. Liability begins at the time
10b-5 is violated . . . and continues until the non-public material
information is effectively publicly disseminated. The defendants claimed that their conduct had not caused harm to
the plaintiffs. Judge Timbers rejected this argument because the de-
fendants had a duty to disclose the adverse news and the plaintiffs al-
leged that they would not have purchased Douglas stock had they
known of the adverse developments. The Second Circuit had to ac-
cept the plaintiffs' allegations as true. Therefore, Judge Timbers stated
that the complaint could not be dismissed even on the basis of the law
before Affiliated Ute Citizens v. United States. The court interpreted
Affiliated Ute as having created a presumption of reliance and causa-
tion in fact in material nondisclosure cases. This interpretation of
Affiliated Ute would be relevant at trial if the defendants questioned
the plaintiffs' allegations that they would not have bought had they
known the adverse information. However, Affiliated Ute deals not with
the issue of moral or legal causation but with whether the plaintiff must
demonstrate reliance or causation after it has been found that the de-
fendant breached a duty to disclose. Therefore, Affiliated Ute was
not relevant to defendants' motion to dismiss on the pleadings. It is

112. 495 F.2d at 237.
The Shapiro case was eventually settled for $2,012,250, with $1,500,000 contributed by Mer-
rill Lynch. Dooley, supra note 39, at 22 n.106 (citing Affidavit in Support of Proposed Settlement
April 11, 1979) (final judgment)).
A subsequent opinion in the Southern District of New York held a tipper liable to all those
who traded between the time "when inside information was tipped . . . [and the time] when this
situation was cured by public release of the same information." Elkind v. Liggett & Myers, Inc.,
See notes 201-11 and accompanying text infra.
A recent Second Circuit decision interpreted the Second Circuit Shapiro phrase "during the
same period" to mean "contemporaneous." Wilson v. Contech Telecommunications Corp., 648
F.2d at 94-95. See text accompanying notes 233-49 infra.
114. 495 F.2d at 240.
116. 495 F.2d at 240. See Zweig v. Hearst, 594 F.2d 1261, 1271 (9th Cir. 1979); Note, supra
note 61, at 591 & n.37. See also W. Painter, supra note 2, at 203-04 & n.141.
117. See note 90 supra.
difficult to understand why the court regarded "Affiliated Ute . . . as controlling on the issue of causation in the instant case," unless the court was anticipating issues that would arise at trial.

The Shapiro defendant tippees resisted the imposition of an obligation to "disclose or abstain," alleging that they would not have been able to make effective public disclosure of information about a company with which they were not associated. The defendants may have been attempting to suggest the previously discussed causation anomaly. The defendants had to choose from among three courses of conduct: (1) disclosure to the world (assuming this were possible); (2) nondisclosure, without trading; and (3) nondisclosure, with trading. The first two courses were legal, the third illegal. The tippees claimed that option one was impossible. Had they called a press conference, no one would have come. Therefore, the actual choice was between options two and three, both of which would have caused equal harm to the defendants. Although he could have simply refused to accept this allegation and left the issue for the trial judge, Judge Timbers chose to address the issue directly, and concluded that if tippees are unable to disclose, they must abstain from trading.

In answer to the tippee's claim that disclosure was impossible, the court might instead have responded that each Merrill Lynch tippee was affluent enough to have purchased, for example, a Wall Street Journal advertisement disclosing the adverse news. A more satisfactory answer is that the defendants could have disclosed to the New York Stock Exchange, on which Douglas Aircraft was listed. To avoid rule 10b-5 tippee/tipper liability, the Exchange actually might have been forced to suspend trading; to issue a press release; and to notify the regional exchange specialists and over-the-counter broker-dealers who made a market in Douglas securities.

A troubling issue arises if an information possessor actually makes a good faith and "reasonable," but unsuccessful effort to disclose, e.g., (1) by purchasing a regional newspaper advertisement, which goes unnoticed; (2) by sending out press releases which are ignored; or (3) by

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118. 495 F.2d at 240.
119. Id. at 238. See generally 5 A. Jacobs, supra note 2, § 66.02[e], at 3-321 to -322.
120. See text accompanying notes 68-72 supra.
121. 495 F.2d at 238.
122. In its release accompanying rule 14e-3, the SEC expressly approved the following form of public disclosure: "notice to the exchange on which the security is listed or to the National Association of Securities Dealers if the security is traded through NASDAQ." 45 Fed. Reg. 60410, 60414 (Sept. 12, 1980). See note 322 infra; Pitt, supra note 2, at 695.
calling a press conference which no one attends. The commentators are split on whether insider and tippee trading should be permitted after reasonable but unsuccessful attempts to publicize.\textsuperscript{123} This question was not reached in \textit{Shapiro}.

Other questions are left unanswered by the \textit{Shapiro} series of decisions, including whether the class of plaintiffs against a tipper should open when the tipper tips rather than when the first tippee trades,\textsuperscript{124} and whether a tipper is liable even when his tippee does not trade.\textsuperscript{125} The answers to these questions may depend upon whether the tipper’s duty to disclose is triggered by the tip or the tippee’s trade. If the former, the class of plaintiffs would open earlier and a tipper could incur enormous liability even if no use was ever made of the nonpublic information. For example, in the \textit{Shapiro} fact situation, even if none of its tippees had traded, Merrill Lynch would have been liable to all those who bought Douglas aircraft shares from the time of its first tip to the time of dissemination of the news. Actually, these two questions do not necessarily involve the same issue. Conceivably, the class of plaintiffs could open at the time of the tip rather than at the time of the tippee’s trade, but only if in fact the tippee traded.\textsuperscript{126}

Despite the many questions \textit{Shapiro} left open, including the issue of damages, the opinion was far reaching. An analogy will illustrate its broad scope. Suppose \textit{A} is a typist for a professor who has secretly developed a winning blackjack system and plans to publish it in a book. \textit{A} divulges the system to \textit{B}. The strategy is so simple that any reasonable player would probably adopt it. \textit{B} has no duty to disseminate the blackjack system. If he goes to Las Vegas, however, and plays even a few rounds of blackjack using the system, this triggers a quasi-Samaritan duty to rescue blackjack players throughout the world from their current suboptimal strategy. \textit{B} would be liable for all blackjack player losses until the strategy is published. It would make no difference that \textit{B} could not possibly have disclosed the strategy to the entire world. \textit{B}’s liability would be enormous. He might win $10 playing blackjack and be liable to tens of thousands of blackjack players for hundreds of millions of dollars of losses. In addition, \textit{A}, who gave \textit{B} the system, might be liable jointly and severally.

\textsuperscript{123} 5 A. \textit{Jacobs}, supra note 2, § 66.02[g], at 3-328 & n.38.
\textsuperscript{124} See notes 204-07 and accompanying text \textit{infra}.
\textsuperscript{126} See notes 204-08 and accompanying text \textit{infra}.
Judge Timbers realized that his decision might create "Draconian liability," and intimated that the trial court might limit the extent of defendants' liability. This approach does not make sense. The liability is "Draconian" because the quasi-Samaritan duty is so broad. If someone owes a legal duty, he is responsible for the consequences of the breach. If one has a duty to rescue a stranger from danger, and does not, his liability may be enormous. If this seems unfair, the logical solution is to limit the extent of the moral duty rather than the damages for which one is liable.

By analogy, if \( B \) owes a quasi-Samaritan duty to rescue blackjack players throughout the world from their suboptimal strategies, \( B \) is liable for all their losses. There is no logical reason to limit his liability to his paltry winnings, which have no relationship whatsoever to the harm which resulted from the breach of his duty to rescue.

The Shapiro court's obligation to disclose to a huge class of total strangers seems contrary to normal moral principles. Imposition of moral obligation to a stranger is usually predicated, in large part, upon one's proximity to the stranger. Because of the total absence of contact in the stock market context, it is difficult to understand why one investor should ever have a moral obligation to other investors who are total strangers.

Even if at times a moral obligation to aid other investors generally did exist, it would violate American legal norms to impose a legal obligation to rescue absent some special relationship between the parties. Indeed, in American legal tradition, there is generally no civil or criminal liability for failure to save the life of a stranger in obvious peril.

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127. 495 F.2d at 242. See generally W. Painter, supra note 2, at 187-88 & n.105.
128. 495 F.2d at 242.
129. See Damages to Uninformed Traders, supra note 56, at 315 ("In effect, the courts would be allowing recovery but stopping the dollar flow when the figures become too large."). See Parts III(C)(1) and IV(A)(4) supra; notes 229-32 and accompanying text infra. For a discussion of the proposed ALI Federal Securities Code solution, see Part IV(D) infra.
130. See note 67 and accompanying text supra. See also ALI Code, supra note 2, § 202(19), Comment 5 (distinguishing between but for and legal cause).

Similarly, in the criminal law, inaction alone is not sufficient to impose liability "unless: (a) the omission is expressly made sufficient by the law defining the offense [e.g., failure to register for possible induction into military service]; or (b) a duty to perform the omitted act is otherwise imposed by law." Model Penal Code § 2.01(3) (1962). See generally J. Hall, General Principles of Criminal Law 190-205, 208-11 (2d ed. 1960); S. Kadish & M. Paulsen, Criminal Law and Its Processes: Cases and Materials 83-85 (1975); W. LA Fave & A. Scott, Jr., Criminal Law § 26 (1972); Frankel, Criminal Omissions: A Legal Microcosm, 11 WAYNE L. REV. 367 (1965); Hughes, Criminal Omissions, 67 YALE L. J. 590 (1980).
131. Jones v. United States, 308 F.2d 307 (D.C. Cir. 1962) (no criminal liability for allowing...
If Americans have no duty to rescue strangers from death, it is incongruous to create a duty to rescue investors from trading on imperfect information.

Furthermore, if someone with nonpublic information were to disclose the news to the world, he would rescue some investors from a fortuitous loss or avoidance of gain at the cost of preventing other investors from realizing a windfall gain or avoidance of loss. The individual benefits would be almost entirely cancelled by the individual harms. It is illogical to create a duty to rescue at the cost of possible injury to another stranger.

Another major problem with Shapiro is that there is no logical reason why a trade by the defendant should create such an immense quasi-Samaritan obligation. The trade does not create any relationship with all other investors. 132

2. Fridrich v. Bradford

In Fridrich v. Bradford,133 the Sixth Circuit dealt with trading on non-

infant in the house to die of starvation and neglect in the absence of some independent legal duty to supply food and necessities to baby); People v. Lilly, 71 A.D.2d 393, 422 N.Y.S.2d 976 (1979) (no criminal liability for failure to provide medical assistance to an infant in the house in the absence of showing that the individual intended to assume all the obligations of parenthood). See generally The Good Samaritan and the Law (J. Ratcliffe ed. 1966); 2 F. Harper & F. James, The Law of Torts § 18.6, at 1044 (1956); W. LaFave & A. Scott, Jr., supra note 130, § 26; W. Prosser, supra note 68, § 56, at 340-43; Ames, Law and Morals, 22 Harv. L. Rev. 97 (1908); Bohlen, The Moral Duty To Aid Others as a Basis of Tort Liability, 56 U. Pa. L. Rev. 217 (1908); Epstein, A Theory of Strict Liability, 2 J. Legal Stud. 151, 189-90 (1973); Gregory, supra note 66, at 34-36; Landes & Posner, Saviors, Finders, Good Samaritans, and Other Rescuers: An Economic Analysis of Altruism, 7 J. Legal Stud. 83, 89 (1978); Mack, supra note 65, at 230; Minor, Moral Obligation as a Basis of Liability, 9 Va. L. Rev. 420, 422-23 (1923); Rudolph, The Duty To Act: A Proposed Rule, 44 Neb. L. Rev. 499 (1965); Legislation, Good Samaritan Protection, 18 Vand. L. Rev. 323, 323-24 (1964); sources cited in note 69 supra.


public information, but interpreted rule 10b-5 differently than did the Second Circuit in Shapiro.

In April 1972, the defendants bought stock in Old Line Life Insurance Company based on favorable material nonpublic information. The plaintiffs sold Old Line stock in June, prior to the public announcement of the news on June 29, 1972. One of the defendants, Mr. James C. Bradford, was a director of Old Line; the other defendants were his relatives or firms directly or indirectly controlled by him.134

Ironically, the defendants purchased shares from J.C. Bradford & Co., a brokerage firm controlled by the Bradford family. J.C. Bradford & Co. was the principal market-maker in Old Line stock, which was traded over the counter. As Judge Celebrezze noted in his concurrence, the defendants were in effect trading with themselves.135 There was no proof that the defendants' purchases affected the price of Old Line. Although the court noted that throughout 1972, J.C. Bradford and Co. bought 169,054 shares and sold 170,685 shares of Old Line, the brokerage firm's May and June inventory was not discussed. The plaintiffs' transactions did not involve Mr. Bradford or any of his firms. Presumably, the plaintiffs dealt with another market-maker.

Although the district court had awarded damages to the plaintiffs, the Sixth Circuit reversed, in an opinion by Judge Engel. Rejecting the rationale of Shapiro, Judge Engel held that a retroactive duty to disclose is not triggered by a trade on nonpublic information.136 Instead, the trade itself constitutes the violation of rule 10b-5 when a condition precedent is fulfilled—the trader has not disclosed.137 In effect, Judge Engel held that a trade based on nonpublic information violates rule 10b-5. If either the inside trader or someone else has already disclosed the information, it is no longer nonpublic.
Contrary to Shapiro, Judge Engel read the Affiliated Ute holding as narrowly limited to its facts, which involved prior business dealings between the plaintiffs and defendants and a deliberate scheme by the defendants to induce the plaintiffs to sell their stock.\textsuperscript{138} According to Judge Engel, because the trade constitutes the violation, the plaintiff must demonstrate it has been harmed by the defendant's transaction.\textsuperscript{139} Thus, in order to prove harm from the defendants' trades, the plaintiffs in Fridrich would have had to demonstrate: (1) that the purchases by the defendants from the market-maker, J.C. Bradford & Co., induced J.C. Bradford & Co. to increase its inventory above what it would otherwise have been (or decrease it to less than otherwise); (2) that these extra J.C. Bradford & Co. purchases preempted purchases by the market-maker with which the plaintiffs dealt; (3) that these lost purchases caused the plaintiffs' market-maker to increase its bid price for Old Line Life Insurance Company; and (4) that this increase in bid price was a but for cause of the plaintiffs' decision to sell.\textsuperscript{140}

Judge Engel noted: "It is undisputed ... that defendants' acts of trading in no way affected plaintiffs' decision to sell."\textsuperscript{141} Therefore, the court held, the defendants' violation did not cause harm to the plaintiffs. Judge Engel reserved the "question of availability of the remedy to open market situations where the insider trading with resultant price changes has in fact induced the plaintiffs to buy or sell to their injury."\textsuperscript{142}

Finally, the court buttressed its holding with policy considerations. In Judge Engel's opinion, the primary rationale for rule 10b-5 private causes of action is compensation, not deterrence. When the individual who deserves compensation cannot be identified, criminal prosecution and SEC actions are available. If these alternatives do not deter inside trading, Judge Engel would leave the solution to Congress or to the SEC rather than create civil "punitive damages almost unlimited in their potential scope."\textsuperscript{143}

In an open market transaction, it is almost impossible for a plaintiff to demonstrate that the defendant's trade harmed him. Even the party in privity with the defendant probably would have traded any-
If the plaintiff is a market-maker in privity with the defendant, the market-maker will have difficulty demonstrating that its inventory would have been smaller or larger at the time of public disclosure than it would have been absent the defendant's trade. At one point Judge Engel stated:

[E]xtension of the private remedy to impersonal market cases where plaintiffs have neither dealt with defendants nor been influenced in their trading decisions by any act of the defendants would present a situation wholly lacking in the natural limitations on damages present in cases dealing with face-to-face transactions.46

At least one commentator has interpreted this casual reference to privity to mean that the Sixth Circuit has adopted both privity and causation as de jure requirements for recovery. Other writers have concluded that although Judge Engel imposed a de jure requirement of causation only, this has the effect of requiring privity. Other commentators have concluded that causation is a necessary and sufficient condition; that either causation or privity is necessary; or that the opinion is ambiguous. It is most probable that the Sixth Circuit believed that, for stock market transactions, causation is both a necessary and sufficient condi-

144. See Part III(B)(3) supra.
145. Id.
146. 542 F.2d at 321 (emphasis added).
148. 11A E. GADSBY, supra note 49, § 5.04[3], at 5-77 ("Implicit in the Sixth Circuit's holding on 'causation' is the assumption that a person purchasing or selling stock on the open market need not disclose material inside information to other open market purchasers or sellers of the same stock if he has not traded with them."); id. § 5.04[2], at 5-57 n.107; Rapp, supra note 132, at 86 ("Reintroduction of an element tantamount to traditional common-law privity . . . is clear in Fridrich."); Private 10b-5 Action, supra note 133, at 97 (The Fridrich "causation requirement appears to reinstate, albeit in different verbal garb, a requirement of privity . . . .").
149. 46 U. CINN. L. REV. 303, 311 (1977) ("[T]he mere existence of privity . . . probably would not be sufficient to support recovery . . . [T]he strongest kind of evidence . . . would be evidence that the defendant insider's trading activity affected stock prices sufficiently to induce the plaintiff to trade."). See Brooks, supra note 91, at 416 n.65 ("[The] Sixth Circuit . . . require[s] a plaintiff to establish actual causation even in impersonal transactions . . . It may be impossible for any plaintiff to establish causation unless he or she purchased or sold in a limited market.").
150. 8 TEX. TECH. L. REV. 742, 745 (1977) ("This standard required the plaintiff to show that either the insider purchased shares of stock from the plaintiff, or that the insider's act of trading affected the plaintiff's decision to sell . . ."). See 11 SUFFOLK U. L. REV. 1129, 1141 (1977) ("[P]laintiff must at least be able to show either that there was a transactional relationship between the defendant and the plaintiff—as in Affiliated Ute—or that the trading of the defendant in an impersonal market influenced the plaintiff's decision to trade.").
151. W. PAINTER, supra note 2, at 193-94.
tion for recovery. In other words, if the plaintiff can demonstrate harm caused by the defendant’s conduct, the plaintiff should recover. Conversely, even the party in privity should not recover if he cannot demonstrate causation. Otherwise, the defendant could be subject to double liability. Additionally, in many open market transactions, privity is fortuitous; allowing the party in privity to recover would give him an undeserved windfall. On the basis of expediency rather than logic, however, the Sixth Circuit might give the party in privity the benefit of a rebuttable or conclusive presumption of causation, thereby allowing at least someone to recover damages.

Ironically, although the party in privity may not be able to recover under rule 10b-5 in the Sixth Circuit, he may have an action for rescission or damages under section 29(b) of the Securities Exchange Act, which renders voidable any contract made in violation of the Act or any rule promulgated thereunder. Because the Sixth Circuit treats the inside trade as a violation of rule 10b-5, the contract between the inside trader and the party in privity is arguably made in violation of rule 10b-5. Therefore, in the Sixth Circuit an inside trader might be liable in damages to one plaintiff and liable for rescission to the party in privity. This double liability is theoretical, however, because the person harmed will generally be unidentifiable, and the party in privity will often be unascertainable as well.

Some anomalous situations could arise, however. Suppose an institution with material nonpublic information, A, had indicated an interest in purchasing a large block from a block-trading firm, which had

152. See Damages to Uninformed Traders, supra note 56, at 312.
subsequently persuaded another institution, $B$, to sell an equivalent block to it for resale to $A$. The party in privity with $A$, the inside trader, would be the block trader; however, the party damaged would be $B$, which sold to the block trader. $B$ could sue for damages and the block-trading firm could sue for rescission. This problem was created not by Judge Engel, but by the overlap between section 29(b) and the implied private cause of action for damages under rule 10b-5.

As a matter of logic, Judge Engel's opinion in *Fridrich* is superior to the *Shapiro* opinion. There is no reason why a trade should trigger a duty to disclose to the world. There is a practical problem with Judge Engel's holding, however. Because it is usually impossible to identify the victims of a stock market inside trade,\(^{155}\) under Judge Engel's decision, a civil plaintiff could almost never successfully sue such an inside trader for damages. If the party in privity is identifiable, he might be able to obtain rescission under section 29(b). If the party in privity is not identifiable,\(^{156}\) one solution would be to impose on the defendant the burden of proving nonprivity, thereby allowing duplicate "rescission."

The major problem with Judge Engel's opinion is the Supreme Court's subsequent holding\(^{157}\) that fraud is an essential element for 10b-5 liability.\(^ {158}\) The trade itself would not be deceitful, so unless the trade triggered a duty to disclose, rule 10b-5 may not have been violated at all.\(^ {159}\)

In his concurrence, Judge Celebrezze took a middle course between Judge Engel's position and that of Judge Timbers in *Shapiro*.\(^ {160}\) Apparently, Judge Celebrezze agreed with Judge Engel that "[t]rading is the gravamen of the offense."\(^ {161}\) He apparently also believed that those harmed by the *trade* must be among those engaging in the opposite type transaction "contemporaneously" with the defendant's trade.\(^ {162}\) Because it is impossible to identify who among that class is actually harmed by the defendant's trade, Judge Celebrezze decided to

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155. See text accompanying notes 59-60 supra.

156. For a discussion of the difficulty of identifying the party in privity, see Damages to Uninformed Traders, supra note 56, at 312 n.120 (1974).


158. See notes 178-81, 191-92, 310 and accompanying text infra.

159. See note 80 and accompanying text supra.


162. Id. at 326 & n.11.
accept partially the Second Circuit's "disclose or abstain" rule.\textsuperscript{163} The inside trade triggers a duty to have disclosed to those trading "contemporaneously" with the defendant.\textsuperscript{164} Furthermore, this class would receive the benefit of the relaxed causation standard of \textit{Affiliated Ute},\textsuperscript{165} which Judge Celebrezze interpreted as a rebuttable presumption of causation.\textsuperscript{166}

The logical problem with Judge Celebrezze's compromise is that those harmed by the defendant's trade are not necessarily among those trading contemporaneously. First, a defendant's purchase may preempt another purchase, so that the person harmed is not even a trader. Second, a defendant's purchase may directly or indirectly lower the inventory of a market-maker or specialist, who might decide to compensate for this decrease at a time much later than the defendant's transaction. For example, a week later the market-maker might react to the small size of his inventory. To dissuade buyers, the market-maker might increase the price at which he is willing to sell to them; to encourage sellers, he might increase the price at which he is willing to buy from them. Of course, such upward adjustments may have occurred somewhat later anyway. In fact, one possible result is that throughout the period between the defendant's trade and the dissemination of the news, the bid and ask prices of the market-maker may be somewhat higher than otherwise. Those harmed would be almost impossible to identify but they would not be among those trading contemporaneously with the inside trader.

In dictum, Judge Celebrezze noted that a person who tips rather than trades "has set off a chain of events which perhaps may only be remedied by full public disclosure."\textsuperscript{167} He suggested that when the gravamen of the offense is a tip rather than a trade, the tipper may be liable to all those in the market up to the point of effective disclosure. Judge Celebrezze did not address the issues of whether the class should commence with the tip and whether a tipper should be liable even if no

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{163} Id. at 323.
\item \textsuperscript{164} Id. at 326-27.
\item Recently, a Second Circuit panel endorsed Judge Celebrezze's class of plaintiffs (those trading contemporaneously with the inside trader), and interpreted Shapiro as adopting the same class of plaintiffs as had Judge Celebrezze. Wilson v. Comtech Telecommunications Corp., 648 F.2d at 94-95. See text accompanying notes 233-43 infra.
\item \textsuperscript{165} 542 F.2d at 326 (Celebrezze, J., concurring).
\item \textsuperscript{166} Id. at 325 n.8.
\item \textsuperscript{167} Id. at 327.
\end{itemize}
\end{footnotesize}
Tippee trades. Judge Celebrezze's treatment of tippers suffers from the same defects as the court's decision in Shapiro. There is no reason why a tip should trigger a quasi-Samaritan duty to rescue an unknown and potentially immense number of total strangers.

3. Chiarella v. United States

a. Special relationship: In Chiarella v. United States, the United States Supreme Court addressed the application of rule 10b-5 to stock market inside trading for the first time.

Chiarella worked for a financial printer. Among the documents he handled were five announcements of takeover bids. Although the identities of the targets were concealed, Chiarella was able to deduce the names from other information in the documents. Without disclosing his knowledge, Chiarella bought stock in the targets and sold the shares at a profit immediately after the tender offers were announced.

Chiarella was convicted of violating section 10(b) and rule 10b-5, and the Second Circuit affirmed. In an opinion by Justice Powell, the Supreme Court reversed the conviction. A trade per se does not trigger a duty of prior disclosure. There must have been "an affirmative duty to disclose . . . before trading," based on a "relationship of trust and confidence between parties to a transaction."

168. See notes 124-25 and accompanying text supra; notes 204-10, 277 and accompanying text infra.

169. See text accompanying notes 130-32 supra.


171. Chiarella realized a gain of approximately $30,000 from his dealings. He returned his profits to the sellers of the shares pursuant to a consent agreement with the SEC. Id. at 112-13.


Prior to the Supreme Court's decision, several commentators had argued that rule 10b-5 imposes a disclose or abstain rule only in a fiduciary context or where a fiduciary relationship is present. Fleischer, Mundheim & Murphy, An Initial Inquiry Into the Responsibility to Disclose
Chiarella had no such relationship with the people from whom he bought, he had not violated section 10(b) or rule 10b-5.\textsuperscript{176}

Although Chiarella’s conviction was reversed, the Court stated for the first time that rule 10b-5 prohibits inside trading on an impersonal stock market if there is a special relationship between the contracting parties.\textsuperscript{177} Nevertheless, \textit{Chiarella} limits both \textit{Fridrich} and \textit{Shapiro}. \textit{Fridrich} is limited because Powell regarded the \textit{nondisclosure} rather than the \textit{trade} as the gravamen of any 10b-5 violation. Citing \textit{Santa Fe Industries, Inc. v. Green},\textsuperscript{178} he emphasized that “not every instance of financial unfairness constitutes fraudulent activity under § 10(b) . . . [T]he element required to make silence fraudulent [is] a duty to disclose . . .”\textsuperscript{179} Later in his opinion, he reiterated: “Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud.”\textsuperscript{180} Although a trade may cause harm, it does not constitute fraud. To Justice Powell, an inside trade involves fraud only when there is non-disclosure plus a duty to speak.\textsuperscript{181}

\textit{Shapiro} also does not fare well under the \textit{Chiarella} holding. Powell extrapolated from face to face transactions to impersonal stock market trading. If the president of a closely held corporation cannot purchase stock from a shareholder based on material nonpublic information,\textsuperscript{182} the president of a publicly traded corporation cannot do so \textit{for the same reason}. In both cases, the gravamen of the offense is the nondisclosure, and the president has a fiduciary duty to disclose to the shareholder. Thus, Powell’s decision strongly suggests that, in stock market inside trades as well as face to face transactions, the duty to


176. Justice Powell did not reach another possible basis for Chiarella’s conviction, the misappropriation theory, which is discussed in text accompanying notes 185-96, 309-22 \textit{infra}. Powell concluded that the misappropriation theory had not been included in the jury instructions. 445 U.S. at 236-37. \textit{See} notes 185-87 \textit{infra}.

177. 445 U.S. at 230. \textit{See} note 267 and accompanying text \textit{infra}.

178. 430 U.S. 462. \textit{See} note 80 and accompanying text \textit{supra}.

179. 445 U.S. at 232.

180. \textit{Id.} at 234-35.

181. \textit{Id}.

182. \textit{See} text accompanying notes 8-11 \textit{supra}.
 disclosed is owed only to the party in privity with the inside trader. In exonerating Chiarella, Powell repeatedly emphasized that Chiarella had no special relationship with his sellers. Even if the Court were to relax its emphasis on privity, it seems unlikely that it would have embraced the Shapiro solution of allowing an enormous class of plaintiffs to sue.

b. Misappropriation: In its brief to the Supreme Court, the United States advanced an alternative theory to justify Chiarella's conviction. The brief argued that, by trading, Chiarella breached his duty to the acquiring corporations (the takeover bidders). The Court reserved judgment on this theory because it had not been submitted to the jury. Both Justice Brennan's concurrence and Chief Justice Burger's dissent openly embraced this misappropriation theory, although the two differed on whether the theory had been presented to the jury.

183. Harvey L. Pitt, Esq. has independently arrived at the same conclusion. Pitt, supra note 2, at 643, 662-63.

184. See, e.g., 445 U.S. at 231-32 ("The Court of Appeals, like the trial court, failed to identify a relationship between the petitioner and the sellers . . . ." [emphasis added]); id. at 232-33 ("No duty could arise from petitioner's relationship with the sellers of the target company's securities . . . . [H]e was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions." [emphasis added]); id. at 230 ("[A]dministrative and judicial interpretations have established that silence . . . may operate as a fraud actionable under § 10(b) . . . . But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction." [emphasis added]). Contra, Elkind v. Liggett & Myers, Inc., 635 F.2d at 173; Stromfeld v. Great Atl. & Pac. Tea Co., 496 F. Supp. 1084, 1088 (S.D.N.Y. 1980).

185. 445 U.S. at 235-36.

186. See generally Koeltl & Longstreth, supra note 175, at 848 (commenting that the Second Circuit opinion in Chiarella was justified on a misappropriation theory, but that a disclose or abstain duty to the investing public was unjustified). One commentator has also suggested that 10b-5 insider trading liability is based on misappropriation from the corporation. W. Painter, supra note 2, at 197.


188. 445 U.S. at 238-39 (Brennan, J., concurring).

189. Id. at 239-45 (Burger, C.J., dissenting).

190. Mr. Justice Brennan found "no instruction suggesting that one element of the offense was the improper conversion or misappropriation of . . . nonpublic information." Id. at 239 (Brennan, J., concurring). The Chief Justice, however, found that the jury was charged on the misappropriation theory. Id. at 243-45 (Burger, C.J., dissenting).

For a general discussion of the Court's treatment of the misappropriation theory, see
In the typical misappropriation situation, an employee, perhaps a corporate or government official, improperly utilizes information gained from his direct or indirect employer. In all or almost all cases, however, the employer itself could not be a rule 10b-5 plaintiff. First, rule 10b-5 applies only to fraud. Although misappropriation would be a breach of fiduciary duty to the employer, it might not constitute fraud. Second, in almost all cases, an employer would be neither a purchaser nor a seller and, therefore, could not sue for damages because it would lack standing under Blue Chip Stamps v. Manor Drug Stores. In his Chiarella concurrence, Justice Stevens reserved the question of whether there can be any rule 10b-5 liability when no one


191. Sante Fe Indus., Inc. v. Green, 430 U.S. at 471-74. See notes 80, 157-59, 178-81 and accompanying text supra; note 310 and accompanying text infra.


193. 421 U.S. 723.
has civil standing. Nevertheless, Chief Justice Burger's dissent contains language which suggests a way to circumvent both the fraud requirement and the standing barrier. The Chief Justice would hold that "an absolute duty to disclose or refrain from trading arises from the very act of misappropriating nonpublic information." In other words, the trade based on misappropriated information would trigger a duty to have disclosed, presumably to the other party to the transaction. The party in privity would have standing to sue for nondisclosure. This approach is strained and anomalous. The misappropriation theory would forbid employees either to use or to disclose the nonpublic information. A rule 10b-5 duty to disclose to the party in privity before trading would compound the misappropriation or breach of duty to the employer. Despite this irony, the duty-triggering approach does manage to create a civil plaintiff. The problem of identifying the party in privity remains, however.

Of course, the majority did not reach the issue of Chiarella's criminal liability under the misappropriation theory, much less his civil lia-

194. 445 U.S. at 238. See Deutsch, supra note 190, at 1295-96 & n.26. One reason why a district court dismissed a rule 10b-5 criminal indictment against an alleged tippee of a misappropriator was that the misappropriator's employer was not a purchaser or seller. United States v. Courtois, [Current] FED. SEC. L. REP. (CCH) ¶ 98,024, at 91,926 (S.D.N.Y. 1981). But see 3 W. NEW ENG. L. REV. 99, 118 n.133 ("Contrary to Justice Steven's assessment, . . . the actual purchaser or seller requirement would not preclude an actionable violation of rule 10b-5 in a suit initiated by the SEC.").


196. Contra, Deutsch, supra note 190:
The theory contained in the Chief Justice's dissent—"that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading"—leaves unclear the identity of the person to whom the duty of disclosure is owed. The words of section 10(b) identify the acquiring corporation—a purchaser of securities—as such a person. Id. at 1295. See Duty to Disclose, supra note 73, at 115 n.128 ("Burger's dissent is silent [on the question of to whom the duty is owed] . . . ."). But see United States v. Courtois, [Current] FED. SEC. L. REP. (CCH) ¶ 98,024, at 91,295-96 (S.D.N.Y. 1981) (assuming that a misappropriator's duty is not to the party in privity).

Professor Dooley observes that the misappropriation theory "seems squarely inconsistent with the majority's opinion" and that not every instance of financial unfairness constitutes fraudulent activity under section 10(b). Dooley, supra note 39, at 70 n.294. Dooley either neglects or rejects the possibility of creating bootstrap fraud by holding that the trade on misappropriated information triggers a duty to disclose to the other party to the transaction. See also Koeltl & Kubek, supra note 175, at 906-08 (recognizing but rejecting the possibility of creating bootstrap fraud; stating that the misappropriator's duty was not to disclose the information but to obtain permission from the employer/source before trading; concluding that traders with the misappropriator could not demonstrate causation); Morrison, supra note 172, at 224 (treating misappropriation as a fraud on the information source; because the source typically is not a purchaser or seller, "it could be argued that there is no damage and, therefore, no actionable violation." Morrison also either neglects or rejects the possibility of bootstrap fraud.).
bility. Even if the full Court eventually endorsed the misappropriation theory, however, the majority almost certainly would not hold that the misappropriation triggers a duty to disclose to the entire world, given Justice Powell's emphasis on a special relationship between the inside trader and the party in privity.

c. **Concluding comments on Chiarella:** *Chiarella* involved the reversal of a criminal conviction. Therefore, Justice Powell did not reach the practical and theoretical problems of allowing civil recovery to the party in privity. The special relationship requirement does not eliminate the numerous difficulties discussed earlier, including the causation anomaly created when the defendant had the choice of two courses of conduct, one illegal (trading without disclosure) and one legal (no trading, without disclosure), both of which would have resulted in the same harm to the plaintiff. Even without demonstrating causation, however, the party in privity might be able to rescind under Exchange Act section 29(b).

By focusing on the nondisclosure rather than the trade, and by requiring a preexisting and independent duty to disclose, Powell was able to bring inside trading within the deceit requirement of *Santa Fe Industries, Inc. v. Green*. He did not define the class of civil plaintiffs who can demonstrate causation when suing an inside trader under rule 10b-5. However, his opinion strongly suggests that only the party in privity can sue, and then only if a special relationship existed between the plaintiff and defendant. The Supreme Court has yet to address the practical and theoretical problems of allowing civil recovery only to the party in privity.

4. **Elkind v. Liggett & Myers, Inc.**

After the Supreme Court's decision in *Chiarella*, the Second Circuit, in *Elkind v. Liggett & Myers, Inc.*, addressed the two following significant issues: (1) The proper class of plaintiffs in an action against a tipping issuer; (2) the ceiling on damages awarded to plaintiffs.

Judge Mansfield found that the chief financial officer of Liggett & Myers, Inc., with scienter, had disclosed material adverse nonpublic in-

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197. *See* text accompanying notes 67-71, 81-84 *supra*.
198. *See* text accompanying notes 67-71 *supra*.
199. *See* notes 153-54 and accompanying text *supra*.
200. 430 U.S. 462.
201. 635 F.2d 156. *See* notes 280-82 and accompanying text *infra*.
202. Among the other issues in the case was whether tipping by an insider violates rule 10b-5. *See* notes 280-87 and accompanying text *infra*.
formation on July 17, 1972 to an analyst at Loeb Rhoades & Co., a stockbrokerage firm. The analyst relayed that information to his firm, and to a stockbroker who promptly sold 1800 shares of Liggett stock on behalf of his customers. The district court held that the proper class of plaintiffs consisted of uninformed buyers between the time of the tip and the subsequent public disclosure. On appeal, the Second Circuit mentioned this same class, and did not expressly deny that the class opened with the tip. Nevertheless, Judge Mansfield's later discussion of damages clearly indicated that the class should open not at the time of the tip, but at the time the tippee trades. At one point Judge Mansfield stated: "[N]o injury occurs until the information is used by the tippee." Elsewhere, he stated that there is no liability for damages unless a tippee trades. Most important, at the end of the opinion, the court allowed recovery to those "who bought Liggett shares during the period from the afternoon of July 17 to the close of the market on July 18." The tippee traded between 2:00 and 3:00 p.m. on July 17. The tip took place in the late morning of July 17. By opening the class of plaintiffs in the afternoon, the court commenced the class with the tippee's trade rather than with the tip.

Under the Second Circuit's opinion, the class does not close until there has been public dissemination of the information. Thus, the court apparently endorsed Shapiro's broad class of plaintiffs, and disregarded Chiarella's indication that only the party in privity can recover. Justice Powell's "special relationship" approach suggests that

203. 635 F.2d at 161.
205. 635 F.2d at 158.
206. Id. at 169.
207. Id. at 165. The court reserved the question whether the SEC could seek injunctive relief against tipping that cannot be shown to have resulted in trading. Id.
208. Id. at 173 (emphasis added).
211. See notes 124-25 and accompanying text supra.
213. But see Wilson v. Comtech Telecommunications Corp., 648 F.2d at 94-95 (narrowly construing both the Shapiro and Elkind class of plaintiffs as those trading "contemporaneously" with the inside trader). See text accompanying notes 233-49 infra.
214. See notes 112-13 and accompanying text supra. Indeed, Elkind largely ignored Chiarella.
if an officer of a closely held or publicly held corporation tips an outsider who subsequently trades, the proper plaintiff is the person in privity with the tippee. In both the closely held and publicly held contexts, the tippee's trade would not trigger a duty to rescue all shareholders, much less all investors. Indeed, Liggett or its officers may not even have had a special relationship with the buyer in privity with the tippee. This buyer might not have held any shares previously. Chiarella did not resolve the issue of whether a special relationship could be created simultaneously with the purchase. Even if the Supreme Court were to endorse the misappropriation theory, the majority would not be likely to hold that the misappropriation triggers a duty to disclose to the entire world. In short, Elkind's broad class of plaintiffs is inconsistent with the spirit, if not the letter, of Chiarella.

After erroneously creating a huge class of plaintiffs, the Second Circuit limited recoverable damages to the amount of defendant's profits. The court could have held Liggett liable to this large class of plaintiffs under either of two theories:

1. The gravamen of the violation is the tippee's trade. Liggett is liable to the few individuals harmed by that trade. Because these victims cannot be identified, however, damages should be prorated among a larger group, each member of which might be an actual victim.

2. The tippee's trade triggered Liggett's duty to disclose to the world. Therefore, Liggett is liable to those who bought its stock between the time it had a duty to disclose and the time of public dissemination of the information.

The Second Circuit's only reference to the Supreme Court's opinion is in a three-sentence footnote:

The Supreme Court ruled in Chiarella that there can be no violation of § 10(b) unless the party so charged has violated a duty arising out of a relationship of trust. A corporate insider who tips confidential information clearly violates a fiduciary obligation, see Chiarella, supra, 445 U.S. at 229 & n.12, 100 S. Ct. at 1115 & n.12. This obligation is breached by insider selling, e.g., Shapiro, supra; cf. Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir.) (L. Hand, J.), cert. denied, 341 U.S. 920, 71 S. Ct. 741, 95 L. Ed. 1353 (1951), as well as buying, e.g., SEC v. Texas Gulf Sulphur Co., supra.

635 F.2d at 165 n.14.

215. See text accompanying note 183 supra.
216. See text accompanying note 286 infra.
217. See notes 273, 286 and accompanying text infra.
218. See text accompanying notes 195-96 supra.
219. 635 F.2d at 173.
220. See Part III(B)(5)(c) supra.
The first theory has several defects. First, as mentioned earlier, the trade cannot be the gravamen of the offense because the trade itself is not deceitful, an essential element of a rule 10b-5 violation. Second, prorating damages among a larger group of individuals, some of whom might be actual victims, is contrary to the winner-take-all tradition in American law. Liggett either did or did not harm a particular plaintiff. If Liggett did not harm the plaintiff, there should be no recovery. If, on the other hand, Liggett did harm the plaintiff, the corporation is liable for the plaintiff's actual damages.

At least one commentator has criticized the winner-take-all principle and has urged court imposed compromise. It is sometimes impossible to determine which of several defendants injured a single plaintiff, although one of the defendants must be the culprit. On rare occasions, the courts have solved this problem by prorating liability among defendants. With stock market inside trading, the defendant is known, but it may be difficult or impossible to identify who, among a large group of plaintiffs, has actually been harmed. In this situation, a court might be willing to break with tradition by prorating damages among a large group of plaintiffs. Judge Mansfield rejected this ap-

221. See text accompanying note 159 supra.
222. See notes 80, 157-59, 178-81 and accompanying text supra; note 310 and accompanying text infra.
223. See Coons, Compromise as Precise Justice, 68 CALIF. L. REV. 250, 259-60 (1980) [hereinafter cited as Compromise]; Coons, Approaches to Court Imposed Compromise—The Uses of Doubt and Reason, 58 NW. U. L. REV. 750, 751, 758, 778 (1964) [hereinafter cited as Court Imposed Compromise]. Cf. Wetzl v. Eaton Corp., 62 F.R.D. 22, 24-25, 28-31 (D. Minn. 1973) (involving a defective tractor part that injured the plaintiff, with no record of whether the part was made by the tractor manufacturer or an independent supplier); Garcia v. Joseph Vince Co., 84 Cal. App. 3d 868, 872-75, 148 Cal. Rptr. 843, 845-47 (1978) (involving an allegedly defective fencing blade which was returned to a bag containing blades manufactured by two different companies; the identify of the particular blade was thereby lost). These two cases involved a situation opposite to stock market inside trading. When someone trades on nonpublic information, the defendant is known, but it is difficult or impossible to know which of several parties is the proper defendant. No one was found liable in either case. See Note, Market Share Liability: An Answer to the DES Causation Problem, 94 HARV. L. REV. 668, 678 n.51 (1981).
224. Compromise, supra note 223; Court Imposed Compromise, supra note 223, at 752-64.
225. Sindell v. Abbott Laboratories, 26 Cal. 3d 588, 607 P.2d 924, 163 Cal. Rptr. 132 (1980), cert. denied, 101 S. Ct. 285 (1980); Summers v. Tice, 33 Cal. 2d 80, 199 P.2d 1 (1948) (en banc) (Two hunters negligently fired toward the plaintiff and were held jointly liable because it was impossible to determine which hunter's bullet had hit the plaintiff.). In Sindell, the plaintiff could not identify which of several companies manufactured the particular pills that injured the plaintiff. The California Supreme Court held that each defendant had the burden of demonstrating that it could not have made the harmful pills. If a defendant could not meet that burden, it would be liable for a portion of the judgment. The percentage of liability would be equivalent to the defendant's share of the market for the drug.
proach's underlying assumption that the proper plaintiff is the victim of the trade.\textsuperscript{226} One reason is that the plaintiff would find it difficult or impossible to prove any harm from the defendant's trade.\textsuperscript{227} Another reason is that: "This causation-in-fact approach . . . allows no recovery for the tippee's violation of his duty to disclose the inside information before trading. Had he fulfilled his duty, others, including holders of the stock, could then have traded on an equal informational basis."\textsuperscript{228} In other words, the tippee's trade triggered a duty to disclose to the world. Under this theory, liability should not be limited to the tippee's profits. Rather, Liggett should be held liable for the actual damages of all those harmed by the nondisclosure.\textsuperscript{229} If Liggett owes a legal duty, it is responsible for the consequences of the breach. Earlier in the opinion, Judge Mansfield expressed concern about Draconian liability, which he described as "out of all proportion to the wrong committed . . . and grossly unfair."\textsuperscript{230} The liability is Draconian, however, because the Second Circuit has created such a broad quasi-Samaritan duty. If Liggett has the duty to rescue investors throughout the world from buying Liggett shares, its liability inevitably will be enormous. If this is unfair, the logical solution is to limit the extent of Liggett's moral duty, not the damages for which it is liable.\textsuperscript{231} Limiting the "damages" all plaintiffs can recover to the profits of the tippee does an injustice to the concept of damages. Damages are generally mea-

\textsuperscript{226} 635 F.2d at 171.

\textsuperscript{227} Id.

In his discussion of limiting recovery to those who can demonstrate damage from the tippee's trade, Judge Mansfield referred only to those who bought "at or after a tippee sold." Id. The court assumed such buyers are harmed by the general price decline caused by a tippee's trade; in fact, this temporary decline benefits those who purchase during the decline. See Manne, supra note 62, at 115 (Buying on inside information increases the price during the interval before disclosure; sellers during this interval may actually benefit); text accompanying notes 62-63 supra. At another point, Judge Mansfield referred to "victims" who bought Liggett stock prior to a general decline caused by tippee selling. 635 F.2d at 171-72. Such buyers are not harmed, because the price will fall anyway once the adverse news becomes public. Judge Mansfield ignored the real victims of the tippee's trade: induced and preempted traders. See text accompanying notes 58-60 supra.

\textsuperscript{228} 635 F.2d at 171 (emphasis added).

\textsuperscript{229} See Elkind v. Liggett & Myers, Inc., 472 F. Supp. at 129, 133-35, rev'd, 635 F.2d at 168-72. In the words of one commentator:

[If all traders can recover, there is no theoretical reason to limit the recovery to the amount of profits earned by the insider. In effect, the courts would be allowing recovery but stopping the dollar flow when the figures become too large. Such a result abandons any pretense of particular damages to injured plaintiffs.

\textit{Damages to Uninformed Traders, supra} note 56, at 315.

\textsuperscript{230} 635 F.2d at 170.

\textsuperscript{231} See notes 127-29 and accompanying text supra.
Impersonal stock markets

secured by the extent of the harm to the plaintiff, not by the benefit accruing to the defendant as a result of his wrongful conduct.

An analogy illustrates these points. Suppose A throws a beer can onto the road and it causes some flat tires. Further assume that on the road there are fifty other beer cans indistinguishable from A's. The fifty-one beer cans cause 1000 flat tires. If it is impossible to determine which flat tires were caused by A's can, the court might hold A liable to all 1000 flat-tire owners under either of two theories:

1. A's throwing one can made A liable only for the damage caused by that particular can, but because it is impossible to identify the actual victims, the damage caused by A's can will be estimated and prorated among all 1000 flat-tire owners. 232

2. A's throwing one beer can triggered a Good Samaritan duty to pick up all fifty-one cans.

If the court adopts the second theory, A should be liable for the actual damages of all 1000 flat-tire owners. If A owes a legal duty to rescue numerous strangers from danger, A is responsible for all the consequences of the breach. It would not make sense to estimate the damage caused by one beer can and spread that among all 1000 flat-tire owners.


In one paragraph, a recent Second Circuit panel redefined the proper class of civil plaintiffs in inside trading cases. In Wilson v. Comtech Telecommunications Corp., 233 the plaintiff had purchased shares about a month after the inside traders' sales but before disclosure of the non-public information. The court held that the plaintiff lacked standing because:

To extend the period of liability well beyond the time of the insider's trading simply because disclosure was never made could make the insider liable to all the world. . . . Any duty of disclosure is owed only to those investors trading contemporaneously with the insider; non-contemporaneous traders do not require the protection of the "disclose or abstain" rule because they do not suffer the disadvantage of trading with someone who has superior access to information. See Fridrich v. Bradford, 542 F.2d 307, 326 (6th Cir. 1976) (Celebrezze, J., concurring), cert. denied, 429 U.S. 1053 (1977). This court re-

232. In fact, the Elkind group of buyer plaintiffs may not include the victim of Liggett's tippee's sale. The injured party may be a preempted seller. See text accompanying note 59 supra.

233. 648 F.2d 88.
recently reiterated such a limitation on the scope of liability under rule 10b-5 for insiders trading in the open market:

The knowing use by corporate insiders of non-public information for their own benefit or that of "tippees" by trading in corporate securities amounts to a violation of Rule 10b-5... which may give rise to a suit for damages by uninformed outsiders who trade during a period of tippee trading.

*Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 165 (2d Cir. 1980) (emphasis added) (citations omitted). 234

This opinion does not specify the meaning of "contemporaneous." Trading one month after the inside trade is too long; it is unclear whether a day or even an hour also would be too long. Regardless of the meaning of "contemporaneous," however, the opinion is contrary to both precedent and logic.

*Wilson*’s holding is inconsistent with prior cases in the same circuit. Although the *Elkind* opinion is confusing, it clearly does not make an inside trading defendant liable to contemporaneous traders. Indeed, the word "contemporaneous" does not appear in *Elkind*. Nor does *Elkind* cite Celebrezze’s concurrence in *Fridrich*. *Wilson* cites *Elkind*’s casual reference to "outsiders who trade during a period of tippee trading." 235 This passage is from a section of *Elkind* entitled "Tipping Liability," which deals with the class of defendants, not plaintiffs. As noted earlier, 236 Judge Mansfield’s *Elkind* decision never expressly discussed when the class of plaintiffs opens and closes. Nevertheless, some comments in the opinion indicate that the class opened with the tippee’s trade and closed upon dissemination of the information. The district court had held Liggett liable to all purchasers of Liggett stock from “July 11, 1972, when inside information was tipped, to July 18, 1972, when this situation was cured by public release of the same information.” 237 The circuit court narrowed this class, not be-

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234. *Id.* at 94-95.

Indeed, *Wilson* may go further even than Judge Celebrezze's *Fridrich* concurrence. In dictum, Judge Celebrezze suggested that, unlike an inside trader, a tipper may be liable to all those in the market up to the point of effective disclosure (a class much broader than "contemporaneous" traders). *Fridrich v. Bradford*, 542 F.2d at 327 (Celebrezze, J., concurring). See text accompanying note 167 *supra*. *Wilson* contains no such qualifying dictum.

235. *Id.*

236. *See* notes 204-10 and accompanying text *supra*.

cause only "contemporaneous" traders had a cause of action, but because the first tip, on July 10, was not material.\textsuperscript{238} The second and only other tip did not occur until July 17.\textsuperscript{239}

The \textit{Wilson} class is also inconsistent with the Second Circuit's earlier \textit{Shapiro} opinion, which affirmed the district court opinion. The lower court opinion in \textit{Shapiro} clearly indicates that the class of plaintiffs would not close until public dissemination.\textsuperscript{240} Indeed, Judge Tenney had this broad \textit{non} contemporaneous-trader class in mind when in his appeal he referred to certification: "all persons who \textit{during the same period} purchased securities in the same company."\textsuperscript{241} The Second Circuit expressed no disagreement with the trial judge's broad class of plaintiffs. In Judge Tenney's cogent words, "Had the circuit court intended . . . a grave qualification [of Judge Tenney's plaintiff class], surely it would have expressed that intent explicitly and unequivocally."\textsuperscript{242}

\textit{Wilson}'s compatibility with earlier Second Circuit decisions is largely academic, however, because \textit{Wilson}'s class of contemporaneously trading plaintiffs is not consistent with the privity requirement strongly suggested by the Supreme Court in \textit{Chiarella}.\textsuperscript{243} \textit{Wilson} nowhere mentioned the Supreme Court's opinion.\textsuperscript{244}

Not only is \textit{Wilson} contrary to Supreme Court and Second Circuit precedent, the contemporaneous-traders class of plaintiffs makes no sense whether the gravamen of an inside trading offense is the trade or the nondisclosure. As indicated in the preceding discussion of Judge Celebrezze's concurrence in \textit{Fridrich}, the victims of the inside trade are not necessarily among those trading contemporaneously.\textsuperscript{245} In any event, \textit{Wilson} seems to assume that nondisclosure constitutes the violation.\textsuperscript{246} If the defendant's trade triggers a quasi-Samaritan duty to dis-
close to the entire investing public, the harm of the nondisclosure continues until public dissemination of the news.247 Under Wilson, the trade triggers a disclosure obligation not to the world, but only to those trading contemporaneously. The court's only justification for this narrowed obligation is that "non-contemporaneous traders do not require the protection of the 'disclose or abstain' rule because they do not suffer the disadvantage of trading with someone who has superior access to information."248 This explanation is a 'non sequitur. Not every non-privity plaintiff, including contemporaneous traders, transacts with someone with nonpublic information. A purchaser one minute after the inside trade is no different from a buyer one month later (like Wilson). Neither purchaser dealt with or had contact with the inside trader. If the defendant had a quasi-Samaritan duty to rescue one buyer, he should have the same obligation to the other.

One possible judicial solution would be to hold that the party in privity is the only proper plaintiff but, if that party is not identifiable, recovery should be spread pro rata among all those who might have been in privity. Such a compromise would solve many practical problems, but would be contrary to the winner-take-all Anglo-American legal tradition.249 In any event, Wilson does not mention this rationale.

In summary, Wilson's restriction of standing to contemporaneous traders is both illogical and contrary to precedent. The Second Circuit's muddled paragraph provides no satisfactory explanation for the ruling.

6. Reflections on the Proper Class of Plaintiffs

Although the landmark decisions of In re Cady, Roberts & Co.250 and SEC v. Texas Gulf Sulphur Co.251 paved the way for the application of rule 10b-5 to stock market inside trading, it is surprisingly difficult to so apply the rule.252 Following are several possible classes of plaintiffs that might be allowed to sue an inside trader.

1. All those who traded to their disadvantage between the time of the inside trade and public dissemination of the information (the Sha-
The inside trade triggers a quasi-Samaritan duty to have disclosed to the entire world. This broad duty creates the requisite moral and legal causation.\textsuperscript{253} The absurdity of this approach is demonstrated by the resulting possibility of Draconian liability. In addition, the \textit{Shapiro/Elkind} class is contrary to the privity requirement suggested by \textit{Chiarella}.

A variation would allow recovery to the \textit{Shapiro} class, but limit liability to the amount of the defendant's profit. This is the \textit{Elkind} solution. One practical problem with it is that, unless the defendant's profit is large, an attorney has little incentive to bring a class action.\textsuperscript{254} A legal problem with \textit{Elkind} is that the defendant's profit is equal to the \textit{direct} harm resulting from the \textit{trade},\textsuperscript{255} which cannot be the gravamen of a rule 10b-5 offense.\textsuperscript{256} If the defendant had a duty to disclose to the world, the harm of the \textit{nondisclosure} would far exceed the inside trader's profits.

Even if the trade were the gravamen of the offense, the \textit{Elkind} approach of pro rata disgorgement would be contrary to the all-or-nothing Anglo-American legal tradition. Most, if not all, members of the \textit{Shapiro/Elkind} class of plaintiffs are not harmed by the trade.

2. Only those trading contemporaneously with the inside trade (the Judge Celebrezze\textsuperscript{257}/\textit{Wilson} class). Once "contemporaneous" is defined, this class is easily identified, but it is not a logical one. If the gravamen of the offense is nondisclosure, no reason exists why the defendant should owe a quasi-Samaritan obligation to disclose to a plaintiff trading one minute after the inside trade but not to a plaintiff trading one month after the trade. Neither plaintiff dealt with or had any contact with the inside trader. Even assuming (incorrectly) that the \textit{trade} is the gravamen of the offense, the victims of the trade are not necessarily among those trading contemporaneously. \textsuperscript{1}Finally, the

\textsuperscript{253} See notes 64-67 and accompanying text supra.

\textsuperscript{254} Another practical problem occurs when some of the parties in privity with the defendant are identifiable and sue for either damages or rescission under Exchange Act section 29(b). See notes 153-54 and accompanying text supra. For a discussion of this and other practical problems with the \textit{Elkind} approach, see \textit{Damages to Uninformed Traders}, supra note 56, at 314 n.130.

By itself, the disgorgement remedy provides little deterrence to inside trading. The defendant loses only his gains and is no worse off than if he had not traded. The inside trader, however, may be subject to criminal prosecution and to civil liability under state law or other provisions of federal securities law. See 5B A. Jacob, supra note 2, § 260.03(h).

\textsuperscript{255} See notes 56-58 and accompanying text supra.

\textsuperscript{256} See note 80 supra.

Judge Celebrezze/Wilson class is inconsistent with the privity requirement suggested by Chiarella.

3. All those injured by the inside trade itself. This is the Fridrich class. As discussed earlier, by preempting or inducing other transactions, an inside trade definitely harms specific individuals. Ironically, few if any members of the enormous Shapiro/Elkind class of plaintiffs are injured by the inside trade itself. The major practical problem with the Fridrich approach is the impossibility of identifying the victims of the trade. The legal problem is that the act of trading is not deceitful and so cannot be the graveness of a rule 10b-5 offense.

4. Only the party in privity, and only when there is special relationship of trust and confidence between the parties. This narrow class of plaintiffs is suggested by Chiarella. A serious practical problem is identifying the party in privity. Legally, however, the approach appears sound. The graveness of the offense is nondisclosure (not the trade). No artificial quasi-Samaritan obligation is created.

All four alternatives have formidable practical or legal flaws, which result from two fundamental problems. First, the offensive part of stock market inside trading does not fit easily within the deceit requirement of rule 10b-5. The inside trade has two aspects: the trade and the nondisclosure of inside information. Generally the trade, not the nondisclosure, is the offensive feature; the victims of the trade are the ones who evoke sympathy, not the victims of the nondisclosure. Only in rare instances is the nondisclosure aspect offensive—e.g., when the inside trader has a special relationship with the party in privity. Second, the victims of an inside trade who evoke sympathy (the trade victims and at times the parties in privity) are in practice difficult to identify.

The best solution is simply to recognize that rule 10b-5 civil liability cannot be legally and practically applied to stock market inside trading. To create a workable civil remedy, Congress would have to enact a specific statutory provision.

258. 542 F.2d 307 (Engel, J.). See text accompanying notes 36-59 supra.
259. See notes 56-59 and accompanying text supra.
260. See note 80 supra.
261. The Chiarella special relationship test also drastically narrows the class of inside trading defendants who violate rule 10b-5. See text accompanying notes 266-308 infra.
262. See Damages to Uninformed Traders, supra note 56, at 316-17. Cf. Dooley, supra note 39, at 62, 71 (The SEC should have sought Congressional authority to regulate inside trading.). For a discussion of the solution in the proposed ALI Federal Securities Code, see text accompanying notes 350-91 infra.
C. Defendants

Several SEC administrative decisions and circuit court opinions have discussed who is subject to the rule 10b-5 stricture against inside trading. These opinions have been extensively discussed by commentators. This Article confines itself to a discussion of the Supreme Court decision of Chiarella v. United States, in which the precise issue was the class of inside traders subject to rule 10b-5. Chiarella was a criminal case, but except for “willfulness” and the burden of proof required for a verdict, the elements necessary to impose rule 10b-5 civil and criminal liability are the same.

1. Requirement of a Relationship of Trust and Confidence

As mentioned in the previous section, Justice Powell held for the Court that trading on material nonpublic information is not a per se violation of rule 10b-5. There must be a duty to disclose based on a “relationship of trust and confidence between parties to a transaction.” Although Justice Powell did not elaborate on what he meant by a relationship of trust and confidence, he did state that a corporate insider could not purchase shares based on material nonpublic information because the insider owed an obligation to each shareholder. Powell paraphrased the SEC’s definition of “insider” in In re Cady, Roberts & Co.: “The Commission emphasized that the duty arose from

263. See note 98 supra.
266. See note 174 and accompanying text supra.
268. A recent Second Circuit panel endorsed in dictum the Texas Gulf Sulphur rule that “[A]nyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it . . . or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.” Wilson v. Contech Telecommunications Corp., 648 F.2d at 94 (quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969)) (emphasis added). See text accompanying notes 233-49 supra. Texas Gulf Sulphur’s broad prohibition was clearly repudiated by the Supreme Court in Chiarella; however, Wilson does not even mention the Supreme Court’s decision.
269. This Article uses the term “insider” to refer to employees of a corporation or those in an equivalent relationship. To avoid confusion insider is italicized. See note 2 supra.
269. 445 U.S. at 230.
the existence of a relationship affording access to inside information intended to be available only for a corporate purpose . . . "

Because of the complexity of anonymous market transactions, Justice Powell's test may allow many *insiders* to escape liability. An *insider* can utilize nonpublic information without trading with an existing shareholder. For example, if an *insider* purchases stock from a short seller (someone who has borrowed the shares and then sold), does the *insider* owe a fiduciary duty to someone who has borrowed stock and sold it in the hope that the price of the stock will decline? Suppose the *insider* buys a call\(^\text{270}\) and the writer of the call holds no stock. Presumably the *insider* owes no duty to the writer of the call and, therefore, does not violate rule 10b-5. This would be true even if the writer subsequently purchased stock in the company. On the other hand, if the writer of the call already held at least one share of stock of the corporation, the *insider's* purchase of the call would expose him to civil

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\(^{270}\) *Id.* at 227 (citing *In re* Cady, Roberts & Co., 40 S.E.C. at 912 & n.15). In order to define "insider," a post-Chiarella district court opinion recast Powell's paraphrase: "[I]nsider status results from being an officer, director or controlling shareholder or from standing in a special relationship affording access to inside information intended to be available only for a corporate purpose." Feldman v. Simkins Industries, Inc., 492 F. Supp. 839, 844 (N.D. Ca. 1980) (citing Chiarella and Cady, Roberts). *Feldman* held that although one corporation, Simkins, owned more than 14% of the shares of Fibreboard (the largest single block), it was not an "insider" for the purposes of rule 10b-5 because Simkins was not a controlling shareholder and was not even represented on the board of Fibreboard, and the plaintiff did not contend that Simkins had access to any nonpublic corporate information. *Id.* For another variation of the *Cady, Roberts* definition of *insider*, see Xaphes v. Shearson, Hayden, Stone, 508 F. Supp. 882, 884 n.3 (S.D. Fla. 1981) ("those persons who by reason of their positions and special relationships with the corporation have access to information not available to those with whom they are dealing"). A recent SEC administrative opinion refused to distinguish between tips by lower level employees and top executives. *In re Dirks*, SEC Exchange Act Release No. 17480, [Current] FED. SEC. L. REP. (CCH) 182,812, at 83,948 (Jan. 22, 1981) ("The purposes served by the insider trading provisions are just as compelling when the corporate informant is not of the highest rank . . . ").

For a post-Chiarella discussion of the definition of *insider*, see 71 J. CRIM. L.C. & P.S. 474, 479 n.59 (1979). For a pre-Chiarella analysis of the definition of *insider*, see 2 A. BROMBERG & L. LOWENFELS, supra note 2, § 7.4(6)(b); 5 A. JACOBS, supra note 2, § 66.02[a]; W. PAINTER, supra note 2, § 5.02. For the American Law Institute's definition of *insider*, see note 347 infra. For another post-Chiarella decision involving nondisclosure by a money-market broker in the "short-term repurchase agreement" market, see SEC v. Miller, [1980] FED. SEC. L. REP. (CCH) ¶ 82,812, at 83,948 (Jan. 22, 1981) ("The purposes served by the insider trading provisions are just as compelling when the corporate informant is not of the highest rank . . . ").

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and criminal liability.\footnote{272}

If an \textit{insider} sells stock based on material adverse nonpublic information, the buyer may not have held any stock previously. In a footnote, Justice Powell mentioned the possibility that "the director or officer assumed a fiduciary relation to the buyer by the very sale."\footnote{273} This analysis is strained.

When an \textit{insider} with nonpublic adverse news buys a put, there is no fiduciary relationship between the \textit{insider} and the writer, unless the writer fortuitously held at least one share of the company's stock already. To minimize his risk, a put writer is likely to hold cash equivalents\footnote{274} or even to short sell the stock which he is obligating himself to buy. Therefore, he probably would not hold any shares outright.

The liability of tippees is even more problematic.\footnote{275} A tippee has no fiduciary relationship with the corporation or its shareholders.\footnote{276} In a footnote in \textit{Chiarella}, Justice Powell mentioned that a tippee conceivably could be held liable as a participant after the fact in the \textit{insider}'s breach of fiduciary duty by tipping.\footnote{277} How the \textit{insider} tipper breaches

\begin{footnotes}
\footnote{272}{For a general discussion of option trading, see sources cited at note 60 \textit{supra}.}
\footnote{273}{445 U.S. at 227 n.8. \textit{See} Morrison, \textit{supra} note 172, at 217. \textit{But see} Dooley, \textit{supra} note 39, at 70-71 (concluding that when an \textit{insider} sells to an outside party, the requisite fiduciary relationship is absent).}
\footnote{274}{Gordon, \textit{Clothing the Naked Put,"} 14 REV. SEC. REG. 997 (1981).}
\footnote{275}{Justice Blackmun's dissent noted: "The Court fails to specify whether the obligations of a special relationship must fall directly upon the person engaging in an allegedly fraudulent transaction, or whether the derivative obligations of 'tippees,' that lower courts long have recognized, are encompassed by its rule." 445 U.S. at 246 n.1 (Blackmun, J., dissenting).}
\footnote{276}{Cann, \textit{supra} note 98, at 262 & n.77.}
\footnote{278}{Citing, inter alia, footnote 12 of Powell's opinion, a recent SEC administrative opinion stated that tippees of corporate insiders are liable for utilizing or tipping nonpublic information. \textit{In re Dirks}, SEC Exchange Act Release No. 17480, [Current] FED. SEC. L. REP. (CCH) ¶ 82,812, at 83,945, 83,948 n.42 (Jan. 22, 1981). Justice Powell's footnote 12, however, only suggested that tippees are liable. " 'Tippees' of corporate insiders have been held liable . . . . The tippee's obligation has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty." 445 U.S. at 230 n.12 (emphasis added). See note 275 \textit{supra}.}
\end{footnotes}
rule 10b-5 is not clear. After Santa Fe Industries, Inc. v. Green and Chiarella itself, the insider tipper must breach a duty to disclose to someone with whom he has a special relationship. Presumably, Powell is suggesting that the duty is owed to the shareholder who will subsequently sell to the tippee. If the tippee does not trade, there apparently is no rule 10b-5 violation by anyone because there was never any person to whom the tipper owed a duty to disclose.

Even with tippers of good news, this analysis is strained. When an inside tipper transmits bad news, however, the theory breaks down completely. The tippee may sell his shares to someone who previously held none. At the time of the tip, the tippee’s buyer was not a shareholder and was not owed a duty by the tipper. Because neither the tipper nor the tippee has transacted with anyone to whom either owed a fiduciary duty, there has been no rule 10b-5 violation. The only escape from this conclusion is to hold that an insider owes a fiduciary duty to both existing shareholders and those who will subsequently become shareholders. The tippee then becomes a participant after the fact in the tipper’s past breach of fiduciary duty to the investor who will become a shareholder as a result of the tippee’s trade. The artificiality of this theory is obvious.

When the insider tips a nontrading tippee, who in turn tips someone else who trades, the “participant after the fact” analysis becomes even more cumbersome. The first generation tippee is a participant after the fact in the insider’s breach of fiduciary duty either to the existing shareholders who will sell to the second generation tippee (good news), or to those who will subsequently become shareholders when they buy from the second generation tippee (bad news).

Despite all these difficulties, in a post-Chiarella opinion, the Second Circuit applied rule 10b-5 to the defendant tipper in Elkind v. Liggett & Myers, Inc., a case discussed earlier in a different context. The opinion largely ignored Chiarella, not only in determining the

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278. In In re Dirks, the SEC held that a nontrading tipper is liable as an aider and abettor of the trading tippee. In re Dirks, SEC Exchange Act Release No. 17480, [Current] Fed. Sec. L. Rep. (CCH) ¶ 82,812, at 83,945 (Jan. 22, 1981). This analysis is circular. Earlier in the same paragraph, the SEC cited footnote 12 of Justice Powell’s opinion, which suggested that a trading tippee might be liable as a participant after the fact in the insider tipper’s breach of fiduciary duty. See note 271 and accompanying text supra. The tipper and the trading tippee cannot both be secondarily liable; someone must be a primary violator.

279. See generally B. Rider & H. Ffrench, supra note 21, at 76.

280. 635 F.2d at 165-68.

281. See text accompanying notes 201-32 supra (discussing Elkind’s views on the proper class of plaintiffs and on limiting damages).
proper class of plaintiffs, but also in imposing liability on a particular defendant (Liggett & Myers). As indicated earlier, Liggett tipped adverse news to an analyst, who in turn passed the information along to a stockbroker. The stockbroker sold 1800 shares on behalf of a client. The court's application of Chiarella consisted of a vague threesentence footnote, which did not discuss any special relationship between Liggett and the buyer(s) of the 1800 shares. The buyer(s) may have held no Liggett shares previously. The Second Circuit did not even cite the footnote in Chiarella which mentioned the possibility that an insider selling directly to a nonshareholder might assume a fiduciary relation to the buyer by the very sale. One might infer from Powell's suggestion in this footnote that a special relationship between Liggett and the buyer(s) of the 1800 shares arose simultaneously with the 1800 share transaction. Liggett's tip would breach a fiduciary duty to the buyer(s) of the 1800 shares with whom Liggett would later have a special relationship. The Second Circuit did not even engage in this cumbersome analysis, much less attempt to defend it. Citing Elkind, another recent Second Circuit decision simply assumed that both trading tippees and their tippers violate rule 10b-5. The court's brief discussion did not mention or cite Chiarella.

To return to Chiarella, two kinds of tippees apparently would escape liability entirely under Justice Powell's fiduciary duty theory. The first is the so-called accidental tippee, who inadvertently overhears a private conversation between insiders through no fault of the insiders. The second type is the surreptitious tippee, who uses eavesdropping devices to gain valuable information, again through no fault of the insiders. Because the insiders were not negligent, there has been no breach of fiduciary duty in which the tippee can participate after the fact. If the insiders were negligent, perhaps in talking too loudly, it is unclear whether this negligence could be the basis of a breach of fiduciary duty on which a tippee's 10b-5 violation could be based. The

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282. See text accompanying notes 211-18 supra.
283. See text accompanying note 203 supra.
284. 635 F.2d at 161.
287. 445 U.S. at 227 n.8.
289. Id.
290. See generally B. RIDER & H. FFRENCH, supra note 21, at 75.
291. For a reference to accidental and surreptitious tippees, see Investors Management Co., Inc., 44 S.E.C. 633, 641 n.18 (1971).
ers themselves would lack scienter and would not be liable. 292

The Powell test would also fail to reach much of the trading on “outside” information, 293 i.e., information not derived directly or indirectly from the issuer or any of its employees or agents. 294 If someone not associated with the issuer traded on the basis of nonpublic outside information, both the trader and his information source would lack the requisite special relationship with the party in privity.

“Outside” information includes both “market” and “corporate” information. “Market” information is “information about events or circumstances which affect the market for a company’s securities but which do not affect the company’s assets or earning power.” 295 Examples of market information include information about a pending tender offer or a favorable recommendation by a brokerage firm or journalist. 296 “Corporate information” is information about events or circum-

292. See Aaron v. SEC, 446 U.S. 680, 689-95 (1980) (holding that scienter is a necessary element of a violation of rule 10b-5 regardless of the identity of the plaintiff or the nature of the relief sought); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194-214 (1976) (holding that scienter is a prerequisite to rule 10b-5 liability in a private civil action for damages); Note, supra note 154, at 270-79 (discussing Aaron).

293. See Pitt, supra note 2, at 656-67. Cf. [1980] SEC. REG. & L. REP. (BNA) #579 A-4, at A-5 (November 11, 1980) (“If one reads the words in Chiarella, it is certainly possible to construct a number of theories under which outsiders in possession of outside information could conceivably be held liable under Rule 10b-5. If one reads the music of Chiarella, it appears that this is not an acceptable category of liability unless there exists a specific, concrete, and affirmative duty to disclose.”) (remarks of Harvey L. Pitt, Esq. at PLI Twelfth Annual Institute on Securities Regulation).

294. See Koeltl & Kubek, supra note 175, at 904; ABA Letter, supra note 98, at 348-49. This terminology is not universal. For a different classification of nonpublic information see 5 A. Jacobs, supra note 2, § 66.02[b], at 3-338. See also Koeltl & Longstreth, supra note 175, at 844 (describing the ambiguous use of the term “market information” to refer to either information which affects the market for a company’s securities but not the company’s assets or earning power, or information emanating from a source other than the issuer). For examples of “outsiders” who might trade on nonpublic information, see text accompanying note 363 infra.

295. Fleischer, Mundheim, & Murphy, supra note 175, at 799; Koeltl & Kubek, supra note 175, at 904. See also 5 A. Jacobs, supra note 2, § 66.02[b], at 3-336 n.11; Koeltl & Longstreth, supra note 175, at 844; Pitt, supra note 2, at 652-54.

In reversing Chiarella’s conviction, Justice Powell noted that “the ‘market information’ upon which [Chiarella] . . . relied did not concern the earning power or operations of the target company, but only the plans of the acquiring company.” 445 U.S. at 231. This statement could be viewed as disdain for liability based even on inside market information, e.g., a president purchasing stock of his own company in advance of a tender offer by the issuer itself. Pitt, supra note 2, at 652. Nevertheless, Justice Powell later emphasized the “special relationship” test. Presumably, he would impose liability on an insider trading on inside, market information. See id. at 642.

296. Zweig v. Hearst Corp., 594 F.2d 1261 (9th Cir. 1979), noted in 29 De Paul L. Rev. 287 (1979); 19 Washburn L.J. 382 (1980); 26 Wayne L. Rev. 1021 (1980). Zweig involved a financial columnist’s duty to disclose conflicts of interest to his readers. That duty was triggered by the publication of the column, not by his purchase of stock prior to its recommendation through his
stances which affect the company's assets or earning power.\textsuperscript{297} "Outside corporate information" is information about the company's assets or earning power not derived directly or indirectly from the issuer or any of its employees or agents.

One example of outside corporate information is a government official's knowledge that a major federal suit will be settled favorably to a corporate defendant.\textsuperscript{298} Conceivably, a government official or an individual with some other special status has a fiduciary duty to the world, but this seems contrary to the spirit of Justice Powell's requirement that there be a special relationship of trust and confidence between plaintiff and defendant.\textsuperscript{299} Significantly, no Justice endorsed the Second Cir-

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\textsuperscript{297} \textit{FIFTH ANNUAL INSTITUTE}, supra note 2, at 287-88 (remarks of Martin Lipton).

\textsuperscript{298} For a discussion of the use of inside information by government officials, see H. MANNE, \textit{supra} note 20, at 171-89 (opposing such trading); Fleischer, Mundheim, & Murphy, \textit{supra} note 175, at 821-24; Note, \textit{The Government Insider and Rule 10b-5: A New Application for an Expanding Doctrine}, 47 S. CAL. L. REV. 1491 (1974).

\textsuperscript{299} \textit{But see Morrison, supra} note 172, at 221, quoting the following passage from Powell's opinion in \textit{Chiarella}: "[T]he Second Circuit held Chiarella liable \textit{although} \ldots \textit{Ie received no confidential information from the target company [and] moreover, the 'market information' \ldots did not concern the earning power or operations of the target company, \textit{but only} the plans of the acquiring company." 445 U.S. at 231 (emphasis added). In Morrison's opinion, this language "suggests a difference where the nonpublic information is corporate in nature." Morrison, \textit{supra} note 172, at 221. It is not clear whether Morrison is referring only to inside corporate information or to both inside and outside corporate information. Powell probably would not distinguish between inside corporate and inside noncorporate (market) information, or between outside corporate and outside noncorporate (market) information. His special relationship test is affected not by the type of information but by the duty of the trader to the other party to the transaction. The
cuit's holding that Chiarella owed a duty to disclose to all investors because of his status as someone who regularly received material non-public information.\(^{300}\)

Another example of trading on outside corporate information would be the purchase by Sears Roebuck of the stock of a supplier prior to awarding it a large contract. Although some pre-Chiarella commentators have suggested that an issuer's major or sole supplier or customer may be considered an insider for the purposes of rule 10b-5,\(^{301}\) such inside traders might not meet Chiarella's requirement of a special relationship to the issuer's shareholders.

On the other hand, certain securities professionals, like broker-dealers, may be precluded from trading on "outside corporate information" or "outside market" information because they owe a fiduciary duty to all those with whom they deal in securities.\(^ {302} \) Specialists and market-makers have a special status that may create conflicting obliga-

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\(^{300}\) SEC is also of the opinion that the Chiarella decision did not distinguish between corporate and market information:

The Court in Chiarella did not distinguish between corporate and market information where there exists a duty to disclose such information or abstain from trading. Nor does the Commission believe that any such distinction is appropriate, since both corporate and market information may be material to an investment decision. Moreover, Section 10(b) and Rule 10b-5 by their terms do not distinguish between corporate and market information.


300. Justice Powell, however, believed that Blackmun's dissent expressed a "view . . . not substantially different from the [Second Circuit] Court of Appeals' theory." 445 U.S. at 235 n.20.

301. 2 A. BROMBERG & L. LOWENFELS, supra note 2, § 7.4(6)(b), at 181 & n.171; 5 A. JACOBS, supra note 2, § 66.02[a], at 3-286 & n.60; Solomon & Wilke, Securities Professionals and Rule 10b-5: Legal Standards, Industry Practices, Preventative Guidelines and Proposals for Reform, 43 FORDHAM L. REV. 505, 528-29 (1975).

302. Brudney, supra note 34, at 349; Solomon and Wilke, supra note 301. See 3A H. BLOOMENTHAL, supra note 2, § 9.20[5]; Fleischer, Mundheim, & Murphy, supra note 175, at 847. See generally SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963) (registered investment adviser has duty to disclose relevant trading facts regarding his own account); Rolf v. Blyth Eastman Dillon & Co., 570 F.2d 38, 44 (2d Cir. 1978) (stockbroker owes a fiduciary duty to customer); Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1943) (fraud and overreaching found for selling securities at prices above the market value); M.S. Wein & Co., 23 S.E.C. 735 (1946) (manipulation of the over-the-counter securities market and fraud in the repurchase of securities); 3 L. LOSS, supra note 49, at 1482-93 (shingle theory: fraud for a dealer to sell securities to a customer at a price not reasonably related to the current market); 1 S. GOLDBERG, FRAUDULENT BROKER-DEALER PRACTICES ch. 8 (1978); Cohen and Rabin, Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in Their Development, 29 LAW & CONTEMP. PROB. 691, 694-710 (1964); Knauss, A Reappraisal of the Role of Disclosure, 62 MICH. L. REV. 607, 635-43 (1964) (disclosure duties of broker-dealers and investment advisers); Note, Conflicting Duties of Brokerage Firms, 88 HARV. L. REV. 396 (1974); Comment, Current Problems
tions. One duty is to treat customers fairly and possibly to disclose material nonpublic information to them. Another responsibility, however, is to maintain an orderly and efficient market. In order to perform the latter function, these intermediaries may be allowed to exploit market information, subject to restrictions imposed by the SEC and self-regulatory bodies. A footnote in Justice Powell's opinion in Chiarella hints that under certain circumstances securities professionals who "contribute to a fair and orderly marketplace" might be allowed some latitude to utilize outside market information.

In short, the disclosure obligations of market-makers and specialists are unclear. Suppose that a brokerage firm like Merrill Lynch buys for its own investment account a security in which it does not make a market. Merrill Lynch may owe a fiduciary duty to its own clients, but not to strangers (e.g., other securities firms). If that were so, there would conceivably be situations in which Merrill Lynch could trade on nonpublic outside information with strangers, but not with someone who was coincidentally a client.

This example raises the interesting issue of inadvertent violations of rule 10b-5. Suppose, for example, government officials do not owe a fiduciary duty to the world. Further suppose that when trading in a security in which it does not make a market, Merrill Lynch owes a

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303. See sources cited in note 49 supra.
304. Brudney, supra note 34, at 363-64; Fleischer, Mundheim, & Murphy, supra note 175, at 847-51; ABA Letter, supra note 98, at 350; Morrison, supra note 172, at 218-19; Pitt, supra note 2, at 656. See Bunch, supra note 98, at 754-56.
305. 445 U.S. at 233 n.16.
306. Justice Powell noted that a broad rule of insider trading liability would contrast with Congress' careful action in an area such as

Section 11 of the 1934 Act [which] generally forbids a member of a national securities exchange from effecting any transaction on the exchange for its own account. . . . Congress has specifically exempted specialists from this prohibition. . . . The exception is based upon Congress' recognition that specialists contribute to a fair and orderly marketplace at the same time they exploit the informational advantage that comes from their possession of buy and sell orders. Similar concerns with the functioning of the market prompted Congress to exempt market makers, block positioners, registered odd-lot dealers, bona fide arbitrageurs, and risk arbitrageurs from § 11's prohibition on member trading.

445 U.S. at 233-34 n.16 (citations omitted).

On the basis of this language, one commentator concluded: "The Court's analysis . . . leaves the impression that it created an 'implied' exception to Rule 10b-5 for market professionals." Morrison, supra note 172, at 221.

307. When trading on nonpublic "outside information," Merrill Lynch should also avoid trading with someone in a special relationship with the source of the outside information. Otherwise, Merrill Lynch might be a participant after the fact in the source's breach of fiduciary duty.
fiduciary duty only to its clients. Assume that a government official reveals nonpublic outside information about Acme Corporation to Merrill Lynch. Merrill Lynch does not make a market in Acme. On the basis of the information, Merrill Lynch attempts to locate an institution which is not a Merrill Lynch client and is willing to sell a block of Acme. Amherst College fits both categories, and it sells Acme stock to Merrill Lynch. Unbeknownst to the trading department of Merrill Lynch, however, Amherst has an old inactive account with the Springfield, Massachusetts branch of Merrill Lynch. Assuming that this account qualifies Amherst as a client of Merrill Lynch and that Amherst has the requisite special relationship with Merrill Lynch, the question is whether Merrill Lynch should be exonerated because it believed that it had no special relationship with Amherst and thus lacked the requisite element of scienter. 308

In summary, before imposing rule 10b-5 liability, Justice Powell required a relationship of trust and confidence between the inside trader and the plaintiff. The latter must apparently be the other party to the transaction. Powell noted that a corporate insider would have the requisite special relationship with each corporate shareholder. If a corporate insider buys shares from an existing shareholder, a special relationship between the parties unquestionably exists. If an insider sells to a new shareholder, a special relationship can be found, but the analysis is strained. If the insider buys shares from a short seller, or if the insider purchases puts or calls, the insider may not have a relationship of trust and confidence with the party in privity. The special relationship requirement may also allow tippees, particularly inadvertent and surreptitious tippees, to escape liability altogether. Finally, the Powell test would fail to reach much, if not all, trading on outside information.

2. The Misappropriation Theory

As mentioned earlier in this Article,309 the Court did not reach the issue of Chiarella’s liability for trading in breach of his duty to his indirect employers, the takeover bidders. Justice Powell expressly reserved comment on the misappropriation theory, which would impose rule 10b-5 liability on those who trade on material nonpublic information in breach of a duty to the information source, and possibly on those who trade on information obtained through a tort against the information

308. See note 292 supra.
309. See text accompanying notes 185-96 supra.
source. For those who oppose trading by corporate *insiders* on non-public information, one advantage of the misappropriation theory, is that it could be used to impose criminal and civil liability not only on an *insider* who trades in stock but also on one who buys puts or calls based on nonpublic information. The *insider's* purchase of an option based on misappropriated information could trigger a duty to have disclosed to the option writer. The *insider* would be liable both criminally and civilly for the nondisclosure.

When the *inside* or outside misappropriator tips rather than trades, both the tipper and the tippee may be liable under rule 10b-5. The tippee could be liable on the following basis. If a tippee receives and trades on information whose ultimate source is a misappropriator, a duty to have disclosed to the other party to the transaction is imposed. The tipper might be *indirectly* liable as a co-conspirator of the tippee, a participant before the fact.

Imposing *direct* liability on the misappropriator/tipper is more difficult. As mentioned earlier, the misappropriator's tip is a breach of fiduciary duty to his employer, but rule 10b-5 liability requires deceit.\(^{310}\) For deceit to be present, the tip must have triggered a duty to disclose. The tipper's duty to disclose might run to the party with whom the tippee will trade in the future. Under this theory, if the tippee does not trade, the tipper has not violated 10b-5, because there was never any person to whom the tipper owed a duty to disclose.

A misappropriator, however, could tip someone who does not trade but tips someone else who does trade. The nontrading tippee may have no relationship to the employer of the misappropriator, but may be jointly liable with his own trading tippee and/or the misappropriator. The possible theories are conspiracy, co-venture, or aiding and abetting.\(^{311}\)

The above discussion assumes that the tippee received the information as a result of a deliberate tip from the tipper. Tippees may also gain information surreptitiously or inadvertently.\(^{312}\) Chief Justice Burger broadly defined misappropriation as obtaining an informational

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\(^{310}\) *See* notes 80, 157-59, 178-81 and accompanying text *supra*.

When a misappropriator trades (rather than tips), deceit can be created by a holding that the trade based on misappropriated information triggered a duty to have disclosed to the party in privity. See notes 192, 195-96 and accompanying text *supra*.


\(^{312}\) *See* notes 290-91 and accompanying text *supra*.
advantage "by some unlawful means." Therefore, even a surreptitious tippee's trade based on unlawfully obtained information would trigger a duty to disclose to the other party. On the other hand, an inadvertent tippee does not acquire information illegally and has no fiduciary relationship with the information source. The inadvertent tippee thus may not be covered by the misappropriation theory. In short, the misappropriation theory may be used to impose liability on most tippers and tippees, but in many instances only with great difficulty—although applying the misappropriation theory is no harder than applying the special relationship rule.

Another problem with the misappropriation theory is its dependence on employer prohibition of trading on nonpublic information. If the employer permits such trading, no misappropriation occurs. If, however, the employer bans such transactions, the misappropriation turns a violation of a company rule into a federal crime. Employers might choose to rescind their personnel rules against inside trading to avoid such drastic sanctions.

The misappropriation theory would fail to reach a great deal of trading on information not derived from a corporate source. An example of trading on such outside information discussed earlier was the purchase by Sears of common stock of a supplier before awarding it a large contract. If the corporate source of outside information (i.e., Sears) itself trades, there can be no misappropriation of the information. Moreover, if an employee of the outside corporate source purchases stock, there is no improper conversion of information unless the employer itself planned to purchase and the employee usurped a corporate opportunity, or the employer had prohibited such transactions. Therefore, if the employer plans to trade on inside information

313. 445 U.S. at 240 (Burger, C.J., dissenting).
314. But cf. Koeltl & Kubek, supra note 175, at 906 (Chief Justice's standard is too broad if it covers all information obtained by unlawful means; under majority's opinion, rule 10b-5 forbids only trading on fraudulently obtained information, not on information obtained through, say, theft.). This focus may be erroneous. The fraud may not be the acquisition of the information but the breach of the duty to disclose triggered by the use of the misappropriated information. See notes 195-96 and accompanying text supra.
315. But see Ross, Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory, in ISSUES IN FINANCIAL REGULATION 177, 184 (F. Edwards ed. 1979) (arguing that stockholders will not permit managers to trade on inside information, not because of any moralistic attitudes, but to avoid overcompensation that would frustrate the incentive system). Cf. Lehman Bros. Issues Warning to Traders, Syndicate Personnel, Wall St. J., Feb. 26, 1981, at 48, col. 4 (Lehman Brothers gave employees stern warning against trading on inside information from firm's investment banking activities.).
316. See text accompanying note 301 supra.
and bans competing trades by employees, the misappropriation theory aids the firm in taking advantage of less informed investors. If, however, the employer has a policy of not trading on nonpublic information, it is not harmed by employee trades in the stock of third parties. Nevertheless, an employer might still choose to forbid such transactions for public relations or other reasons.317

Prior to prohibition by the SEC, many takeover bidders had selectively tipped institutions so that the target's stock would be in friendly hands at the time of the tender offer. This is the "warehousing"318 mentioned in the opinions of Justice Powell and Chief Justice Burger.319 Had Chiarella planned to tender his stock, the takeover bidders probably would have been pleased by his advance purchases.320 Even though Chiarella sold immediately after the tender offers were announced, his shares were probably ultimately held by risk arbitrageurs who subsequently tendered.321 Indeed, even if both Powell's fiduciary duty and Burger's misappropriation theories were adopted, it would be possible under rule 10b-5 for a tender offeror to compensate its printer, attorneys, depository, or other agents by allowing them to purchase in advance of the takeover bid.

The depository accepts tendered shares and holds them on behalf of the offeror. Even if the depository does not make use of advance notice of the offer, it could use information about the amount of stock tendered to outguess the risk arbitrageurs as to whether and to what extent the tender offer will succeed. Because the tender offeror does not care whose shares it buys and because it is foreclosed by rule 10b-13 from making market purchases during the offer, it might give the depository permission to trade on the basis of this information.322

317. To the extent that the Federal Government prohibited inside trading by its employees, the misappropriation theory would forbid the inside trading by federal officials that might be permitted by the special relationship theory. See note 298 and accompanying text supra.

318. See B. Rider & H. FFrench, supra note 21, at 87-88; Dooley, supra note 39, at 53-54 & n.229; Fleischer, Mundheim & Murphy, supra note 175, at 811-15; 92 Harv. L. Rev. 1538, 1546-48 (1979); 1980 Wis. L. Rev. 162, 191 & nn.113 & 116. Warehousing is now prohibited by SEC rule 14e-3. See note 322 infra.

319. 445 U.S. at 234 (Powell, J., for the Court); id. at 242-43 (Burger, C.J., dissenting).

320. See Dooley, supra note 39, at 53-54 & n.228. But cf. id. at 52 (offeror may be concerned about maintaining secrecy so as not to forewarn target).


3. Blackmun's Chiarella Dissent

Justice Blackmun did not rely on the misappropriation theory in his dissent. Instead, he stated he would impose liability on Chiarella "even if he had obtained the blessing of his employer's principals before embarking on his profiteering scheme." Blackmun twice quoted with approval the SEC opinion in In re Cady, Roberts & Co., which based the "disclose or abstain" obligation in part on whether the information utilized was "intended to be available only for a corporate purpose and not for the personal benefit of anyone." By referring to corporate intent, Blackmun undercut slightly his earlier refusal to rely on the misappropriation theory.

The thrust of his dissent, however, is "that persons having access to confidential material information that is not legally available to others generally are prohibited by rule 10b-5 from engaging in schemes to exploit their structural informational advantage through trading in affected securities." Blackmun further explained that he would permit advantages resulting from diligence or acumen, but forbid those

individuals from trading on the basis of material information about an impending tender offer if they know or have reason to know the information is nonpublic and comes from the target company, the acquiring company, or the agents of either. The rule also forbids tipping when it is foreseeable that the tip is likely to result in a violation of the rule. There are specific exceptions to the prohibitions against both trading and tipping. The rule was announced in SEC Release Nos. 33-6239; 34-17120; and IC-11336 (Sept. 4, 1980), 45 Fed. Reg. 60,410 (1980). The rule and release are reprinted in [1980] SEC. REG. & L. REP. (BNA) #569, at L-1. Rule 14e-3 is also reprinted in 3 FED. SEC. L. REP. (CCH) 24,297, and the release in [1980] FED. SEC. L. REP. (CCH) #82,646. See Pitt, supra note 2, at 692-701; 3 WHITMER L. REV. 129, 148-51 (1981).

Although the release emphasizes that rule 14e-3 is a "disclose or abstain" rule, the text of the rule suggests that the gravamen of the offense may be the trade itself. Clause (a) provides: "[I]t shall constitute a fraudulent, deceptive or manipulative act or practice... to purchase or sell... unless within a reasonable time prior to any purchase or sale such information and its sources are publicly disclosed by press release or otherwise." (emphasis added).

If the gravamen of a rule 14e-3 violation is the trade itself, and the meanings of fraud, deception, and manipulation in section 14(e) are the same as in section 10(b) and rule 10b-5, rule 14e-3 may exceed the Commission's authority. For the somewhat similar problem in rule 10b-5, see notes 80, 157-59, 178-86, 191-92, 310 and accompanying text supra. Cf. Peloso & Krause, supra note 98, at 947-48 (discussing rule 14e-3's inconsistency with Chiarella). According to one commentator, however,

section 14(e) is somewhat broader than section 10(b) of the 1934 Act. It [section 14(e)] empowers the Commission not only to adopt rules designed to prevent deceptive, manipulative or fraudulent acts or practices in connection with tender offers, but also to define a "manipulative or deceptive device or contrivance."

3 WHITMER L. REV. 129, 150 (1981) (emphasis in original). In any event, rule 14e-3 does not broaden liability under rule 10b-5, the subject of this Article.

323. 445 U.S. at 246 (Blackmun, J., dissenting).
324. 445 U.S. at 249, 252 (Blackmun, J., dissenting) (emphasis added).
326. Id. at 251 (emphasis added).
resulting from "manipulation of confidential connections or resort to stealth." 327

One problem with Justice Blackmun’s test is the difficulty of differentiating between permitted and prohibited trading. An enormous gray area exists between information obtained through superior ability or effort and that which is obtained through stealth or confidential connections. 328 If an analyst or journalist is the first to discover a conspiracy like Equity Funding, 329 luck, diligence, and employment status may all have played a role in the discovery. 330 Are either or both of the first two factors tainted by the third? 331

327. 445 U.S. at 252 n.2.

328. Justice Blackmun attempted to distinguish between parity of information and parity of access. Id. This is analogous to the elusive distinction between equality and equality of opportunity. Cf. 4 A. Bromberg & L. Lowenfels, supra note 2, § 12.2, at 267-68 (discussing rule 10b-5 in terms of egalitarian theory).


In the SEC administrative opinion of In re Dirks, the Commission commented: “Despite the utility of the analyst’s role, such professionals have no special license to ignore the insider trading proscriptions of the federal securities laws.” In re Dirks, supra, at 83,945.


330. Cf. Lorie, supra note 28, at 820-22 (A skillful analyst may be able to deduce from a collection of facts important conclusions which could not be drawn by a less skillful analyst. Also, discovery may be a result of either private initiative or abuse of privileged position.).

331. Blackmun’s standard is similar to one advanced recently by Professor Brudney, whose article Blackmun cited. 445 U.S. at 251-52 (citing Brudney, supra note 34). See Bloomenthal, Introductory Survey to Sec. L. Rev.—1980, at xxxiv (“Justice Blackmun’s opinion . . . in some respects comes close to the Brudney view. . . .”). The Brudney article utilized efficiency and fairness principles to determine what forms of inside trading should be permitted. In Brudney’s opinion, the search for relevant corporate and economic information is a valuable service to society because it enables the market to function efficiently in the allocation of savings to more profitable enterprises. Brudney, supra note 34, at 341. This valuable search should be encouraged by allowing at least certain types of outsiders to trade on nonpublic information, as long as such trading does not violate other overriding principles. Id. at 341-43.

Professor Brudney divided inside traders into three categories: (1) those who owe a fiduciary duty to those with whom they trade, such as the issuer, issuer’s management, issuer tippees, and investment advisers and broker-dealers, id. at 343-53; (2) those not in class one who gain information through an unerodable informational advantage, one that public investors may not lawfully overcome regardless of their diligence or resources, id. at 353-67; and (3) those in neither class one nor class two, id. at 368-76. In his view, by legislative history and traditional law, inside trading by class one violates the antifraud provisions of the federal securities laws. Id. at 343-53. Inside trading by those in class two should be prohibited because of the inherent unfairness of such trading. Id. at 353-67. Members of class three should be permitted to trade on nonpublic information.
4. Reflections on the Proper Class of Defendants

Following are several possible classes of inside traders who might violate rule 10b-5:

1. No one.

2. Those who trade with someone with whom they have a fiduciary relationship based on some other body of law. This is the Powell special relationship test, and is based on the relationship with the other party.

3. Those who trade on information in breach of a duty to the information source, or trade on information obtained through a tort against the source. This is the Burger/Brennan misappropriation test and is based on the relationship of the trader to the source of the information.

4. Class three, plus tippees of those in class three.

5. Those who trade on information obtained through a structural informational advantage, the Blackmun test, or an unerodable information advantage, the Brudney test. These tests are based on how the information was obtained.

6. Class five, plus tippees of those in class five.

7. Those who regularly receive material nonpublic information, the Second Circuit Chiarella test. This test is based on status.

8. Class seven, plus tippees of those in class seven.

9. All corporate insiders, including those directly or indirectly employed by the issuer. This test is also based on status, and differs from class two. An insider who purchases puts and calls, for example, would fall into this class, but not necessarily into class two—unless a fiduciary relationship was found between the option-writer and the insider. This class also does not fit wholly within class three—some issuers might not prohibit inside trading by employees.

10. Class nine, plus tippees of class nine.

11. Those who trade on the basis of corporate information (information that will affect the issuer's earning power or assets). This

332. See note 331 supra.
333. United States v. Chiarella, 588 F.2d at 1365.
334. See 4 A. Bromberg & L. Lowenfels, supra note 2, § 12.4; Pitt, supra note 2, at 624-25, 646-47.
335. See text accompanying notes 297-98 supra.
class is based on the type of information and excludes "market" information (information that will affect the market for a security). 336

12. Some combination of the above classes, for example, class ten (all corporate insiders and their tippees) plus class eleven (all those who trade on corporate information). This combined class is based on both status and type of information. Insiders would be liable regardless of whether they traded on corporate or market information. Outsiders would be liable only if they traded on corporate information, rather than market information.

13. Everyone. 337

This Article discusses the individual harm brought about by stock market inside trading. 338 As illustrated below, the inside trade enriches the inside trader, $T$, at the expense of a victim, $V$, in the course of a dealing with a party in privity, $P$. The victim, $V$, is a preempted or induced trader.

\[
\begin{array}{c}
T \text{ (possibly breaching a duty to } S) \quad \text{trades with}
\\[3ex]
\text{(preempting or inducing } V) \quad \rightarrow \quad P \text{ (who may have a special relationship to } T) \\
\end{array}
\]

There may be a special relationship between $T$ and $P$. The use of the nonpublic information may be a breach of a fiduciary duty to, or a tort against, a source, $S$. Neither $S$ nor $V$ necessarily falls into the category of those protected by rule 10b-5. Typically, $S$ would not even be an investor. Although $V$ would be an investor, he might not be a trader and would probably not be the party in privity.

The offensive features of inside trading are the harm to $V$, and the intended, undeserved, and possibly improper windfall received by $T$. Rule 10b-5, however, requires more than outrageous conduct; it requires fraud. 339 Classes three through thirteen above focus on these offensive features, and use various aspects of them to trigger a duty to disclose—presumably to $P$, but perhaps to a larger class. The deceit is the breach of the triggered duty to disclose.

The argument in favor of class thirteen (imposing liability on all

336. See text accompanying notes 295-96 supra.
337. Cf. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d at 236 ("[A]nyone in possession of material inside information must either disclose it to the investing public, or . . . abstain from trading . . .") (quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d at 848 (en banc)) (emphasis added); Pitt, supra note 2, at 625-26, 649.
338. See notes 55-63 and accompanying text supra.
339. See note 80 supra; notes 178-81 and accompanying text supra.
inside traders) is the inherent unfairness of unequal access to information. The same argument applies to the other smaller classes, although trading by many of these classes is more offensive because the members probably are able to trade on a steady stream of inside information. Transactions by classes five and six seem especially unfair because the investing public could not discover the information through diligent search.

The counterargument to imposing liability on classes five through thirteen is that taking unfair advantage does not constitute deceit. A similar counterargument can be made against class three liability. Misappropriation may be a breach of fiduciary duty to S, the source; however, it does not constitute fraud, especially against P, the party in privity, or V, the victim of the trade. In fact, the triggering of a quasi-Samaritan duty on members of classes three through thirteen is an artificial means of creating deceit in situations where it is absent.

Justice Powell escaped this criticism by expressly rejecting defendant classes thirteen and five through eight, implicitly rejecting classes nine through twelve, and taking no position on class three. By imposing liability when there is a special relationship between T and P (class two), he held a stock market inside trader liable for the same reason that the defendant would be liable had he dealt face to face. The duty to disclose is grounded not on an artificial quasi-Samaritan obligation but on an independent fiduciary relationship between the parties, presumably based on state common law. If the president of a closely held company violates rule 10b-5 by trading with a shareholder without disclosing material information, the president of a publicly held

340. See SEC v. Texas Gulf Sulphur Co., 401 F.2d at 847-48; 4 A. Bromberg & L. Lowenfels, supra note 2, §§ 12.2, 12.5; 5 A. Jacobs, supra note 2, §§ 6.03, 6.04, 6.07; Dooley, supra note 39, at 30; Koeltl & Kubek, supra note 175, at 905; Pitt, supra note 2, at 623; Scott, supra note 39, at 804 ("The . . . common view . . . that the rule is principally intended to serve the ends of fairness and equity . . . [is] the Fair Play or 'fair game' concept of the rule."); id. at 805-06. Cf. Morrison, supra note 172, at 212, 225 (In Chiarella "[t]he Court rejects the idea that all traders are equal, refusing a proffered parity-of-information rule.").

341. See Pitt, supra note 2, at 640-41. For a discussion of the state common law of inside trading, see H. Henn, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 239 (2d ed. 1970); Brooks, supra note 91, at 405-10; Duty to Disclose, supra note 73, at 96-100; Re-Evaluation, supra note 45, at 916-20; 58 WASH. U.L.Q. 1013, 1015 (1980).


Rule 10b-5's adoption was prompted by the story of a corporate president who acquired the stock of his company at a low price by telling potential sellers that the company was doing poorly when in fact it was doing extremely well. 22 BUS. LAW. 922 (1967) (remarks of Milton V. Free-
IMPERSONAL STOCK MARKETS

corporation also violates the rule when purchasing on the stock exchange without disclosing to the shareholder with whom he deals. In both cases, the parties in privity are harmed by the president's breach of a duty to disclose. With the stock market inside trade, however, to determine whether the party in privity is really harmed, the causation anomaly discussed earlier must be addressed. Powell might use a bootstrap conclusive presumption or triggered duty to overcome the causation problem. Given the special relationship between the parties, however, such a solution involves only minor difficulty.

If a prospective stock market inside trader had a special relationship with the party in privity, the prospective trader would be forced to disclose to the world before trading, for two reasons. First, the party in privity is usually not identifiable in advance. Second, selective revelation to a potential party in privity might itself violate rule 10b-5, especially if the tippee subsequently traded on the information.

Powell's approach could still be a subterfuge to circumvent the deceit requirement. If his real concern is T's enrichment and V's loss, Powell can be criticized for fabricating a duty to disclose to P in order to bring the stock market inside trade within rule 10b-5. On the other hand, Powell's opinion is not a subterfuge if his motive for imposing liability on T is concern for P, to whom T owes a fiduciary duty. If Powell's concern is for P, however, the decision is an extremely narrow one; unequal access to information is irrelevant in this case.

This Article notes that Powell's test would fail to reach much stock market inside trading. His reply presumably would be that such trading may be immoral and unfair, but it is not deceitful and therefore does not violate rule 10b-5. The conflicting principles in defining the proper class of defendants are the supposed unfairness or impropriety of inside trading, and the deceit requirement of rule 10b-5. The stricter the adherence to the deceit requirement, the lower the amount of unfair or improper inside trading prohibited. The greater the amount of unfair or improper inside trading forbidden, the greater the disregard of the fraud requirement. Chiarella indicates that the Court has decided

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343. See notes 68-72 and accompanying text supra.
344. Id.
345. See notes 81-82 and accompanying text supra. See also notes 108-09, 278, 280-89 and accompanying text supra.
346. See text accompanying notes 271-79, 290-308 supra.
to adhere closely to the fraud requirement at the cost of allowing much inside trading to escape liability.

D. THE APPROACH OF THE AMERICAN LAW INSTITUTE'S FEDERAL SECURITIES CODE

1. Defendants: Insiders, Outsiders, and Their Tippees

The American Law Institute's Federal Securities Code section 1603 codifies the substantive application of rule 10b-5 to insider trading, defining the liability of corporate insiders and their tippees.

INSIDERS' DUTY TO DISCLOSE WHEN TRADING

For purposes of section 1603, "insider" means (1) the issuer, (2) a director or officer of, or a person controlling, controlled by, or under common control with, the issuer, (3) a person who, by virtue of his relationship or former relationship to the issuer, knows a fact of special significance about the issuer or the security in question that is not generally available, or (4) a person who learns such a fact from a person within section 1603(b) (including a person within section 1603(b)(4)) with knowledge that the person from whom he learns the fact is such a person, unless the Commission or a court finds that it would be inequitable, on consideration of the circumstances and the purposes of this Code (including the deterrent effect of liability), to treat the person within section 1603(b)(4) as if he were within section 1603(b)(1), (2), or (3).

ALI CODE supra, note 2, § 1603 (1980).

For general discussions of § 1603, see 11A E. GADSBY, supra note 49, § 10.06[3]; Note, The Codification of Rule 10b-5 Private Actions in the Proposed Federal Securities Code, 33 U. MIAMI L. REV. 1615, 1623-29 (1979). The Reporter notes that § 1603(b)(4) is broad enough to cover surreptitious tippees, who learn information from wiretapping, industrial espionage, or other methods without the insider's knowledge. ALI CODE, supra note 2, § 1603, Comment (7).

"Fact of special significance" is defined in § 202(56). The concept of materiality is defined "somewhat more strictly" here than the general "reasonable person" materiality definition of § 202(92). ALI CODE, supra note 2, § 202(56), Comment (1).

To win SEC endorsement, the Code was amended in September 1980. See note 379 and accompanying text infra. Sections 1603(a) and (b) were amended as follows:

§ 1603 (Insiders' Duty to Disclose When Trading)

Substitute:

Sec. 1603 (a) GENERAL.—It is unlawful for an insider to sell or buy a security of the issuer, if he knows a fact of special significance with respect to the issuer or the security that is not generally available, unless—

(1) the insider reasonably believes that the fact is generally available;

(2) the identity of the other party to the transaction (or his agent) is known to the insider and (A) the insider reasonably believes that that party (or his agent) knows the fact, or (B) that party (or his agent) knows the fact from the insider or otherwise;

(3) the insider proves that the fact is not a fact of special significance, except that this defense is not available in an action or proceeding by the Commission under section 1809, 1810, 1811, 1812, 1815, or 1819(a).

COMMENT: (1) In the introductory portion "material fact" has been substituted for "fact of special significance." But new § 1603(a)(3) affords a defense, except in SEC injunctive and disciplinary actions, in terms of the Official Draft's language. That is to say the plaintiff need allege and prove only materiality, after
The provisions proscribe insider buying or selling;\textsuperscript{348} in addition, the prohibition is waived under certain enumerated circumstances.\textsuperscript{349} Nowhere in section 1603(a) is there a reference to fraud, deceit, nondisclosure, or disclosure. Apparently, the provision makes the trade itself, rather than nondisclosure, the gravamen of the violation. This apparently eliminates the effect of \textit{Santa Fe Industries, Inc. v. Green},\textsuperscript{350} which held that only conduct involving manipulation or deceit is reached by section 10(b) or rule 10b-5. Nevertheless, the Reporter's comments to section 1603 are replete with references to "duty to disclose,"\textsuperscript{351} "misrepresentations or fraudulent acts,"\textsuperscript{352} and "'fraud' or 'deception.'"\textsuperscript{353} Indeed, the comment referring to fraud or deception specifically states: "[T]he Code is not overruling \textit{Santa Fe Industries} . . . by specifically endorsing the reading that a number of commentators gave \textit{Schoenbaum v. Firstbook} . . . ."\textsuperscript{354} \textit{Schoenbaum}\textsuperscript{355} concerned "new fraud," the application of rule 10b-5 to management's liability to the corporation for unfair self-dealing securities transactions.\textsuperscript{356} In short, the language of section 1603(a) suggests that the trade itself is the gravamen of a violation, but the comments suggest that nondisclosure is actually the gravamen.

Section 1603 does not prohibit tipping,\textsuperscript{357} although it clearly covers tippees.\textsuperscript{358} Another provision, section 1724(c), creates liability for a
tipper to the same extent as a tippee unless the tipper discloses for a proper purpose and in a proper manner and reasonably believes that the tippee will not use the fact in a manner that would create liability.\textsuperscript{359} The Reporter also noted that section 1603(b)(3) is broad enough to cover surreptitious tippees and their subtippees.\textsuperscript{360} Section 1603 does not cover quasi-insiders with nonpublic outside information,\textsuperscript{361} i.e., information not derived from the issuer.\textsuperscript{362} Examples of quasi-insiders would include:

(i) judges' clerks who trade on information in unpublished opinions,
(ii) Federal Reserve Bank employees who trade with knowledge of an imminent change in the margin rate . . . , (iii) printers of tender offer literature who buy the target company's stock . . . , [and] (iv) [independent] persons who are about to give profitable supply contracts to [the issuer].\textsuperscript{363}

The Reporter noted that "a sufficiently egregious or shocking or offensive case"\textsuperscript{364} of trading on outside information might be covered by Federal Securities Code Section 1602(a)(1).\textsuperscript{365}

\textbf{SEC. 1602(a) GENERAL.}—It is unlawful for any person to engage in a fraudulent act or to make a misrepresentation in connection with (1) a sale or purchase of a security, an offer to sell or buy a security, or an inducement not to buy or sell a security.\textsuperscript{366}

The Reporter concluded that "this area must be left to further judicial development."\textsuperscript{367} In short, the Federal Securities Code leaves trading on outside information in a state of uncertainty.\textsuperscript{368} In possible contrast to section 1603, the gravamen of an inside trading section 1602 violation would be nondisclosure, rather than the trade itself.

2. \textit{Defining the Class of Plaintiffs}

\hspace{1em} a. The distinction between fortuitous/market transactions and nonfortuitous/nonmarket transactions: The civil liability provisions of

\textsuperscript{359} ALI Code, supra note 2, § 1724(c); see note 68 supra.

\textsuperscript{360} ALI Code, supra note 2, § 1603, Comment (7) (stating that § 1603(b)(3) is broad enough to cover tippees who learn information from wiretapping, industrial espionage, or other methods, or who merely find an insider's papers).

\textsuperscript{361} Id. Comment (3)(d).

\textsuperscript{362} See notes 293-94, 301 and accompanying text supra.

\textsuperscript{363} ALI Code, supra note 2, § 1603, Comment (3)(d).

\textsuperscript{364} Id.

\textsuperscript{365} Id. The Reporter commented that § 1602 "is as broad as Rule 10b-5 is today," and that "§ 1602(a)(1) is as broad as anything in existing law . . . ." Id.

\textsuperscript{366} Id., § 1602(a). For a discussion of this section, see Note, supra note 347, at 1617-23.

\textsuperscript{367} ALI Code, supra note 2, § 1603, Comment (3)(d).

\textsuperscript{368} See Brudney, supra note 34, at 353 n.102.
the American Law Institute's Federal Securities Code distinguish between so-called "market" and "nonmarket" transactions. 369 Market transactions are those "effected in a manner that would make the matching of buyers and sellers substantially fortuitous." 370 A person who violates either Code section 1602(a)(1) (the broad antifraud provision equivalent to the present rule 10b-5) 371 or Code section 1603(a) (the codification of corporate insider liability for trading on nonpublic information) 372 in a fortuitous/market transaction is not liable for rescission 373 but is liable for damages to all those who buy or sell "during the period beginning at the start of the day when the defendant first unlawfully sells or buys, and ending at the end of the day" when the information becomes "generally available." 374

This classification is roughly equivalent to the Shapiro or Elkind class of plaintiffs. 375 The defendant has the burden of demonstrating lack of causation. 376 Damages are reduced to the extent that the defendant proves that the violation did not cause the plaintiff's loss. 377

369. ALI CODE, supra note 2, § 1703. See E. GADSBY, supra note 49, § 10.07, at 10-126; W. PAINTER, supra note 2, at 212.
370. ALI CODE, supra note 2, § 1603(a).
371. See notes 365-66 and accompanying text supra.
372. See note 347 and accompanying text supra.
373. Compare ALI Code § 1703(a) (in a transaction not effected in the markets, violator is liable to his buyer or seller for rescission or damages) with § 1703(b) (in a transaction effected in the markets, violator is liable for damages). ALI CODE, supra note 2, § 1703(a), (b).
374. Id. § 1703(b).
377. ALI CODE, supra note 2, § 1708(b)(2).

The ALI Code defines causation generally in § 202(19): "A loss is 'caused' by specified conduct to the extent that (A) the conduct was a substantial factor in producing the loss, and (B) the loss was of a kind that might reasonably have been expected to occur as a result of the conduct." The Reporter states that this definition requires both causation in fact (or but for cause) and legal cause (based on policy considerations). ALI CODE, supra note 2, § 1603, Comment (2)(p); id. § 202(19), Comment 5. See W. PAINTER, supra note 2, at 207-08; Note, supra note 376, at 1426. This Article almost always discusses causation in terms of but for cause. See note 4 supra.

This Article discusses ALI Code §§ 1603(a) and 1602(a) and suggests that the gravamen of an inside trading § 1602(a) violation apparently is nondisclosure, while the gravamen of a § 1603(a) violation is either the nondisclosure or the trade. See notes 348-54, 364-68 and accompanying text supra. If the gravamen of § 1603 is the trade, and of an inside trading § 1602 violation is nondisclosure, a stock market inside trading defendant might be liable for damages under § 1602 but not § 1603. To illustrate, suppose that the president of a mining company calls a press conference and announces a major mineral discovery. Immediately after the announcement, the president gives his broker a market order to buy 1000 shares. The order is transmitted to the New York Stock Exchange. When the president's broker reaches the specialist's booth, the specialist is asking 10% to
The potential harshness of these provisions is mitigated by a ceiling on the defendant's liability. The Official Draft approved by the American Law Institute limited the defendant's liability to the damages which would be imposed if "all the members of the class . . . had bought (or sold) only the amount of securities that the defendant had sold (or bought)." At the request of the SEC, the Code has been amended to give courts the discretion to raise the ceiling to 150% of the amount of the inside trader's profits. The court's decision is to be based on the circumstances of the case and the purposes of the Code, including the deterrent effect of liability. Section 1711 of the Code provides a procedure for bringing all the claimants into a single forum and prorating or otherwise disposing of the amount recovered.

In short, the Code distinguishes between "substantially nonfor-
tuitously matched" ("nonmarket") and "substantially fortuitously matched" ("market") transactions. With the latter, compensation may be abandoned if impracticable. Deterrence and avoidance of unjust enrichment are then the principal purposes of damages. 381 The de-emphasis on compensation permits the Code to (1) grant recovery to a class of plaintiffs, all or most of whom are not harmed by the defendant's trade, and (2) limit and prorate damages in such a way that those actually harmed by an inside trade will recover only a small fraction of their actual damages.

b. Practical problems of distinguishing between fortuitous and nonfortuitous transactions: In practice, the fortuitous/nonfortuitous distinction will sometimes be difficult to apply. The line-drawing problems result from three factors: (1) significant fortuity exists in many face to face transactions; (2) many impersonal market transactions might not be considered particularly fortuitous; (3) fortuity is a matter of degree and not of kind. The Code's comments provide little assistance in defining fortuitousness. Section 1703's fortuitous/nonfortuitous distinction is also made in section 1702, which deals with illegal sales and purchases. Section 1702(a) concerns nonfortuitous transactions and section 1702(b) deals with fortuitous trades. 382 In the comment to section 1702(b), the Reporter explains the difference:

[O]ver-the-counter transactions fall on both sides of the line; and, of course, the technology and practice are rapidly evolving. Indeed, even with respect to stock exchange transactions, many institutional trades are negotiated offboard and "crossed" on the floor. Those will fall within [§ 1702(a)] rather than [§ 1702(b)]. Contrariwise, a transaction with a marketmaker will normally fall within § 1702(b) even though his identity becomes known before the transaction is completed. 383

This explanation is puzzling. The phrase "even though his identity becomes known" suggests that the distinction is between face to face and impersonal transactions. This impression is reinforced by the titles of sections 1702(a) and (b): "Transactions Not Effected in the Markets" and "Transactions Effected in the Markets." 384 Yet some face to face transactions could be "effected in a manner that would

381. ALI CODE, supra note 2, § 1711, Comment (7)(a).
382. Id. § 1702(a), (b).
383. Id. § 1702(b), Comment (4).
384. Id. § 1702(a), (b).
make the matching of buyers and sellers substantially fortuitous.\textsuperscript{385}

Suppose a firm lets it be known that it has a 10,000 share block to sell, and one buyer immediately snaps up the block. Within a half hour, ten other prospective buyers telephone the seller. It might be considered fortuitous that one particular buyer found out about the block first and decided to call immediately. Similarly, if $A$ wishes to sell his house and gives his realtor written instructions to wait in an open house and accept the first bid equal to or greater than the asking price, it might be considered "substantially fortuitous" that one buyer got to the house before another.\textsuperscript{386}

On the other hand, impersonal transactions might not be considered substantially fortuitous. Suppose an inside trader gives his broker a "market order\textsuperscript{387}" to buy 1000 shares of stock listed on the Boston Stock Exchange. If the stock is inactively traded, and the 1000-share order is executed with the specialist, that trade might \textit{not} be considered "effected in a manner that would make the matching of buyers and sellers substantially fortuitous." Suppose the trade was the only one that hour, day, or week. Suppose that the stock is active only infrequently. Is it fortuitous that the stock is quiet during the hour, day, or week when the inside trade is executed with the specialist? Does it make any difference whether the inside trader \textit{knows} whether trading in the stock is active or inactive at the particular time when he trades?\textsuperscript{388}

The problem is that fortuity is a matter of degree and not of kind. Suppose $A$ owns a toy store and suspects that a certain toy is dangerous. No one else has this knowledge. If $A$ is the only retailer in town selling this toy, he cannot argue that any particular purchase was fortuitous. The more stores that sell the toy, however, the stronger $A$’s claim that a purchase of the toy \textit{from $A$} was fortuitous. Even if only a few stores sell the toy, $A$ could argue that it was substantially fortuitous that the buyer transacted with him rather than with another retailer.

Despite the problem of demarcating the border between fortuitous and nonfortuitous transactions, most stock market transactions will be

\textsuperscript{385} See note 370 and accompanying text \textit{supra}.

\textsuperscript{386} For similar examples, see text accompanying notes 71-72, 74-75 \textit{supra}.

\textsuperscript{387} For a discussion of how the stock market functions, see text accompanying notes 49-54 \textit{supra}.

\textsuperscript{388} In the landmark state law case of Goodwin \textit{v.} Agassiz, 282 Mass. 358, 186 N.E.2d 659 (1933), the plaintiff was able to match his 700 share sale of Cliff Mining Company stock with the purchase of the defendant, the president of the company, even though the transaction took place on the Boston Stock Exchange. Presumably, trading in Cliff stock was relatively inactive.
clearly fortuitous. Although it is not perfect, the Code’s fortuitous/nonfortuitous distinction is workable.

3. Reflections on the Approach Proposed by the Code
Section 1603 specifies the obligation of insiders to abstain from trading on nonpublic information. This provision is nonexclusive, however, and the general issue of who are proper defendants is not resolved.

The American Law Institute’s Federal Securities Code does provide a definite solution to the legal problem of determining the proper class of plaintiffs and maximum liability of defendants. The Code does not compensate the victims of the inside trade, but they were not identifiable anyway.\textsuperscript{389} Although the fortuitous/nonfortuitous distinction may sometimes be difficult to apply, the Code’s approach successfully accomplishes a number of objectives. It eliminates the problem of identifying the party in privity. It avoids bestowing a large windfall on the party in privity by spreading the windfall among numerous plaintiffs; in fact, the attorney bringing the class action may get the bulk of the recovery. The Code deprives the defendant of his unjust profit. It deters inside trading by threatening potential liability equal to 150% of profit. It encourages civil suits against inside traders by private attorneys general. Unless the defendant’s profits are large, however, lawyers still may not find it worthwhile to bring a class action. Perhaps in inside trading suits the Code should permit the court to order the defendant to pay the plaintiff’s legal costs.

V. SUMMARY\textsuperscript{390}
A stock market inside trade\textsuperscript{391} has two aspects: the trade and the non-disclosure of information inducing the trade. Each aspect has different victims who would have been better off but for the trade or the non-disclosure. The trade harms specific investors, but not necessarily the party in privity. If there has been a purchase of an existing issue of securities, someone has less of that issue; if there has been a sale of an existing issue, someone ends up with more of that issue. This Article labels this phenomenon “The Law of Conservation of Securities.” With an inside trade, this law can work in two ways. The inside trade could induce opposite-type transactions which otherwise would not have occurred, or it could preempt same-type trades which otherwise

\textsuperscript{389} See text accompanying note 60 supra.
\textsuperscript{390} Summaries and reflections appear throughout the Article. See Table of Contents; text accompanying notes 250-62, 332-46, 389.
\textsuperscript{391} For this Article’s definition of “inside trade,” see note 2 supra.
would have occurred. Those harmed by an inside trade fall into at least two categories: those who would not have made disadvantageous purchases or sales but for the inside trade, and those who would have made advantageous purchases or sales but for the inside trade. In addition, an inside trade may induce changes in the prices of transactions in the same security. Both sellers who receive less and buyers who pay more are worse off. In practice, it is impossible to recreate the hypothetical universe that would have existed had there been no inside trade. The inside trade directly or indirectly changes the inventory of a specialist or market-maker. There is no way of knowing how this change alters the intermediary's price quotations, and how these quotations affect the behavior of public investors. Therefore, the victims of a stock market inside trade cannot be identified.

As opposed to an inside trade, the nondisclosure of material beneficial nonpublic information harms sellers who would not have sold had the beneficial information been disclosed, and sellers who would have received higher prices had the beneficial information been disclosed. The nondisclosure of material adverse information harms buyers who would not have bought had the adverse information been disclosed, and buyers who would have bought at a lower price had the adverse information been disclosed. Whether someone with material nonpublic information can be said to have morally or legally caused harm to these investors depends on whether the information possessor has a quasi-Samaritan duty to rescue total strangers. Even assuming such a duty exists, if the duty is contingent on some act by the information possessor, a causation anomaly may arise. The information possessor may claim that his relevant choice was between two courses of conduct, one illegal and one permissible, both of which would result in the same harm to the plaintiff. Therefore, the illegal course of conduct arguably did not cause harm to the plaintiff.

Rule 10b-5 liability requires fraud or manipulation. The latter is a term of art not relevant to inside trading. Therefore, to violate rule 10b-5, inside trading must be fraudulent. A stock market inside trader has no contact with the other party to the transaction. For an inside trader to violate rule 10b-5, he must have a duty to disclose. This duty could be owed to: (1) the party in privity, (2) the individual to whom the party in privity sometimes transmits the harm of nondisclosure when the party in privity regains his original position, (3) the victims of the trade itself, or (4) the world. All four alternatives create practical and theoretical problems. If the potential inside trader were to dis-
close only to a potential party in privity or a potential victim of a contemplated trade, the potential inside trader might have violated rule 10b-5 if the recipient traded on the information. Ironically, by seeking to comply with the rule, the potential inside trader could run afoul of it. If the inside trader trades without disclosing, he is potentially liable to those to whom he had a duty to disclose. If the duty is owed to the party in privity, that party might be able to recover even if it was not damaged by the trade itself. This recovery is arguably an undeserved windfall.

The above discussion assumes that it is possible to identify: (1) the actual or potential party in privity with a stock market inside trader, (2) the individual to whom the party in privity sometimes transmits the harm of nondisclosure, and (3) the actual or potential victim of a stock market inside trade. In practice, such identification generally is impossible. Even if the victims of an inside trade were identifiable, and even if a duty to disclose were owed to them, many victims would have difficulty recovering. The victims of an inside trade are either induced or preempted traders. Preempted traders lack standing to sue under Blue Chip Stamps v. Manor Drug Stores. Even if the Blue Chip civil standing problem were ignored, a preempted trader, E, would not be able to demonstrate harm from the nondisclosure. If the information was revealed only to E, he probably could not trade without violating rule 10b-5. If the information was publicly announced, a wave of new buyers or sellers would be attracted, and E might still be preempted. Even if E were able to trade, the price would accurately reflect the new information. Since the harm of the inside trade was the loss of opportunity to trade at an advantageous inaccurate price, neither individual nor public disclosure would have made E better off; the nondisclosure did not cause harm to E. E could recover damages only if both the Blue Chip standing and the causation requirements were waived.

An unresolved issue is whether a defendant can be liable criminally when there is no one with standing to sue civilly. If the duty to disclose is owed to victims of the trade itself, and if rule 10b-5 is not violated when the victims are preempted traders, and if it is impossible to identify the type of victim, then it is impossible to know whether a rule 10b-5 violation has occurred.

The duty to disclose may be owed to the world, rather than to the

392. 421 U.S. 723.
party in privity or the potential victims of the trade. If an inside trader breaches a duty to disclose to the world, both the potential number of plaintiffs and the potential liability are gigantic.

All four alternative duties are subject to criticism. Despite the theoretical and practical obstacles, however, courts have been willing to apply rule 10b-5 to inside trading on the stock market. Four circuit court decisions have dealt with the class of plaintiffs who can demonstrate causation when suing for damages from a stock market inside trader: Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 393 Fridrich v. Bradford, 394 Elkind v. Liggett & Myers Inc., 395 and Wilson v. Comtech Telecommunications Corp. 396 All four opinions are overshadowed by contrary dictum in the Supreme Court's recent decision in the criminal case of Chiarella v. United States. 397 The outline below analyzes the positions of these five cases on the proper class of plaintiffs.

1. Shapiro/Elkind

Gravamen of the offense: Nondisclosure.

Class of plaintiffs allowed: All those who traded to their disadvantage between the time of the inside trade and dissemination of the information. The inside trade (in these two cases the tippee's trade) triggers a quasi-Samaritan duty on the part of both tipper and tippee to disclose to the entire investing public. Once this broad duty is created, the requisite moral and legal causation automatically follows. The defendant's breach of his duty to disclose "caused" moral or legal harm to all actual traders who would have transacted at a better price or not at all had they known the information.

Theoretical problems: The Shapiro/Elkind obligation is not in accord with general moral principles, which base duties to rescue on proximity. The inside trader has no contact with other investors. The broad quasi-Samaritan duty is also contrary to American legal norms, which impose no civil or criminal liability for failure to save the life of a stranger in obvious peril. Furthermore, there is no logical reason why such an immense quasi-Samaritan duty should depend on the existence of a trade by the defendant. The trade does not create any relationship

393. 495 F.2d 228.
395. 635 F.2d 156.
396. 648 F.2d 88.
397. 445 U.S. 222.
with the investing public. The absurdity of the approach is demonstrated by the Draconian liability that it logically compels.

Legal problems: This approach is incompatible with the privity requirement strongly suggested by Chiarella. Surprisingly, although the Second Circuit decided Elkind more than one year after the Supreme Court handed down Chiarella, Elkind almost completely ignored the Supreme Court decision.

Elkind's ceiling on liability: To avoid Draconian liability, Elkind limited all plaintiffs' recovery to the defendant's profits. This ceiling is illogical. If the defendant had a duty to disclose to the world, the harm of the nondisclosure far exceeds the inside trader's profit. A legal problem is that defendant's profit is equal to the direct harm resulting from the trade, which is not deceitful and cannot be the gravamen of a rule 10b-5 offense. Even if the trade were the gravamen of the offense, the Elkind approach of pro rata disgorgement would still be contrary to the winner-take-all Anglo-American legal tradition. Most, if not all, members of the Shapiro/Elkind class of plaintiffs are unharmed by the trade.

2. Celebrezze/Wilson

Gravamen of the offense (Wilson): Nondisclosure. (Celebrezze): In theory, the trade; as an expedient, the nondisclosure.

Class of plaintiffs allowed: Those trading contemporaneously with the inside trader.

Theoretical problems: If the gravamen of the offense is nondisclosure, a plaintiff trading one minute after the inside trade cannot be distinguished logically from a plaintiff trading one month later. Both plaintiffs neither dealt with nor had any contact with the inside trader. If the defendant had a quasi-Samaritan duty to rescue one plaintiff, the defendant should have the same obligation to the other.

Even assuming, incorrectly, that the gravamen of the offense were the trade, the contemporaneous trader class of plaintiffs does not make sense, because the victims of the trade are not necessarily those trading

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398. See text accompanying notes 56-58 supra.
399. See notes 157, 159, 178-81 and accompanying text supra.
400. See note 223 and accompanying text supra. But see notes 224-25 and accompanying text supra.
402. 542 F.2d at 326. See notes 161-63 supra and accompanying text, note 246 supra.
contemporaneously. 403

Legal problems: The contemporaneous trader class is inconsistent with the broader class of plaintiffs allowed by the earlier Second Circuit decisions Shapiro and Elkind. More important, it is incompatible with the privity requirement strongly suggested by Chiarella.

3. Fridrich 404

Gravamen of the offense: The inside trade itself, rather than the nondisclosure.

Class of plaintiffs allowed: All those injured by the act of inside trading; i.e., those investors whose transactions were preempted or induced by the inside trade.

Practical problem: It is impossible to identify the victims of the trade. Fridrich did not reach the issue whether the party in privity might be able to rescind under Exchange Act section 29(b), which makes voidable any contract made in violation of the Securities Exchange Act of 1934, or a rule promulgated thereunder, including rule 10b-5.

Legal problems: This rationale is incompatible with Santa Fe Industries, Inc. v. Green, 405 which requires deceit for rule 10b-5 liability. As mentioned above, a stock market inside trade is not itself deceitful and cannot be the gravamen of a rule 10b-5 violation. In addition, Fridrich apparently does not impose the privity requirement 406 strongly suggested by Chiarella.

4. Chiarella (relationship of trust and confidence)

Gravamen of the offense: Nondisclosure.

Class of plaintiffs allowed: Party in privity (strongly suggested in dictum). Chiarella was a criminal proceeding in which the defendant's conviction was reversed. Nevertheless, the Court stated that a stock market inside trader would violate rule 10b-5 when he lied a relationship of trust and confidence with the party on the other side of the transaction. This statement indicates that the proper plaintiff in a civil suit would be the party in privity with the inside trader.

403. See text accompanying notes 166-67, 245 supra.
406. See text accompanying notes 146-52 supra.
Practical problem: Identifying the party in privity will often be impossible.

Legal problem: With regard to the class of plaintiffs, Chiarella’s legal position is difficult to attack. The gravamen of the offense is nondisclosure, yet no artificial quasi-Samaritan obligation is created.

5. Chiarella (misappropriation)

Chiarella reserved judgment on the issue of whether the defendant violated rule 10b-5 by misappropriating information from his indirect employers, the takeover bidders. This theory was not submitted to the jury. Because the Court did not reach the misappropriation theory, the analysis below is speculative.

Gravamen of the offense: Nondisclosure.

Class of plaintiffs allowed: Possibly the party in privity. The trade based on misappropriated information would trigger a duty to have disclosed to the other party to the transaction. The majority almost certainly would not hold that the misappropriation triggers a duty to disclose to the entire world.

The inside trader’s employer would not be a proper civil plaintiff. First, the employer usually would not have bought or sold and therefore would lack standing to sue for damages under rule 10b-5. Second, the inside trader’s breach of fiduciary duty to his employer would not involve deceit.

Theoretical problem: Generally, the employer would forbid both utilizing and disclosing the information. Ironically, a rule 10b-5 duty to disclose (before trading) would compound the employee’s breach of duty to his employer.

All five approaches have practical, theoretical, and legal flaws. Two fundamental factors create this predicament. First, the trade, not the nondisclosure, is usually the offensive feature of stock market inside trading, and the trade generally does not meet the deceit requirement of rule 10b-5. (One rare instance in which the nondisclosure is offensive is when the inside trader has a special relationship with the party in privity.) Second, the victims who evoke sympathy, the trade victims and sometimes the party in privity, are difficult to identify in practice. These basic problems can be solved only legislatively, not judicially.

In Chiarella, the actual issue before the Court was not the class of
private plaintiffs who can sue an inside trader, but the proper class of criminal (or civil) defendants, i.e., those inside traders subject to rule 10b-5. Except for the requirement of willfulness and the burden of proof, however, the elements necessary to impose rule 10b-5 civil and criminal liability are the same.\textsuperscript{408} As discussed above, the Court required a relationship of trust and confidence between the inside trader and the other party to the transaction to impose liability. Speaking for the majority, Justice Powell noted that a corporate insider\textsuperscript{409} would have the requisite special relationship with each corporate shareholder. If a corporate insider purchases shares from an existing shareholder, a special relationship unquestionably exists. If an insider sells to a new shareholder, a special relationship can be found only with difficulty. If an insider buys puts or calls, or purchases shares from a short seller, the insider may lack the requisite relationship with the party in privity, who may own no shares. This special relationship requirement may also permit tippees, especially accidental and surreptitious tippees, to escape liability.\textsuperscript{410} The Powell test also fails to reach most or all trading on outside information—information not derived directly or indirectly from the issuer.

The Court reserved judgment on whether misappropriation of information could violate rule 10b-5. Although the misappropriation approach can impose liability on corporate insiders who buy puts or calls, the principle cannot easily be applied to tippers and tippees. Another weakness of the theory is that it depends on employer prohibition of trading on the nonpublic information. Finally, the principle would fail to reach a great deal of trading on outside information.

The class of stock market inside traders who violate rule 10b-5 can be legally defined narrowly or broadly. Following is a partial list of possible classes of violators:\textsuperscript{411}

A. No one.

\textsuperscript{408} See note 265 and accompanying text supra.

\textsuperscript{409} For this Article's definition of insider, see note 2 supra.

\textsuperscript{410} The post-Chiarella opinion of Elkind v. Liggett & Myers imposed rule 10b-5 liability on an issuer for tipping adverse news to an analyst, who in turn passed the information on to a stockbroker. 635 F.2d at 165 n.14. The stockbroker sold 1800 shares on behalf of a client. The Second Circuit ignored the numerous problems of finding a special relationship between the defendant issuer and the buyers of the 1800 shares. A special relationship is especially difficult to find if these particular buyers had held no shares previously. See text accompanying notes 280-87 supra.

\textsuperscript{411} For a comprehensive list of thirteen possible classes, see text accompanying notes 332-37 supra.
B. Those who trade with someone with whom they have a fiduciary relationship based on some other body of law.

C. Those who trade on information in breach of a duty to the information source (or trade on information obtained through a tort against the information source).

D. Those who trade on information based on information obtained through a structural and/or unerodable informational advantage.

E. Those who regularly receive material nonpublic information.

F. All corporate insiders (those directly or indirectly employed by the issuer).

G. Those who trade on the basis of “corporate” information (information that will affect the issuer’s earning power or assets), as opposed to “market” information (information that will affect the market for a security).

H. Everyone.

The various classes are defined by the defendant’s special relationship with the party in privity, how the defendant obtained the information, his special status, or the type of information he utilized.

The offensive aspect of the inside trade is the unfair or improper enrichment of the trader, $T$, at the expense of a victim, $V$, in the course of a transaction with a party in privity, $P$. The persistent problem is that this misconduct does not constitute deceit. Most of the tests defining the defendant use certain improper or unfair conduct by the inside trader to trigger a duty to disclose, presumably to $P$, but possibly to a larger class. This is an artificial means of circumventing the rule 10b-5 deceit requirement in situations where it is absent. In Chiarella, Justice Powell escaped this criticism by expressly rejecting defendant classes D, E, and H; implicitly rejecting classes F and G; taking no position on class C; and endorsing only class B. Justice Powell definitely would find a violation only when there is a special relationship between $T$ and $P$ based on some other body of law. He would impose liability on a corporate president buying through the stock exchange for the same reason that the corporate president would be liable if he had dealt face to face.\textsuperscript{412}

\textsuperscript{412} A certain causation anomaly is more likely with a stock market inside trade, however, than with a face to face trade. The stock market inside trader could argue that had he done nothing, the party in privity would have traded with someone else anyway. In other words, the inside trader could contend that his relevant choice was between two courses of conduct, one legal (doing nothing) and one illegal (inside trading), both of which would have resulted in the same harm to the party in privity. This harmless error defense could be overcome through a bootstrap conclusive presumption or triggered duty. \textit{See} text accompanying notes 68-72, 343-44 \textit{supra}.\textit{}}
The two conflicting principles in defining the proper class of defendants are (1) the supposed unfairness or impropriety of inside trading, and (2) the deceit requirement of rule 10b-5. The stricter the adherence to the fraud requirement, the lower the amount of unfair or improper inside trading prohibited. The greater the amount of unfair or improper inside trading prohibited, the greater is the disregard of the deceit requirement. Chiarella indicates that the Court has decided to adhere closely to the fraud requirement at the cost of allowing some or most inside trading to escape liability.

The American Law Institute's proposed Federal Securities Code provides a statutory solution to the stock market inside trading problem. Section 1603 codifies the liability of corporate insiders and their tippees. Left in a kind of limbo is the liability of "quasi-insiders," such as those with nonpublic "outside" information. If sufficiently offensive, such quasi-insider trading might violate section 1602(a)(1), a broad antifraud provision equivalent to the present rule 10b-5. To define the class of plaintiffs who can sue an inside trader under either section 1603 or section 1602(a)(1), section 1703 of the Code distinguishes between "substantially nonfortuitously matched" ("nonmarket") and "substantially fortuitously matched" ("market") transactions. With the latter, the Code expediently abandons compensation as a goal, and adopts instead deterrence and deprivation of unjust enrichment. The class of allowable plaintiffs is all those who buy or sell during the period beginning at the start of the day when the defendant unlawfully trades and ending at the end of the day when the information becomes generally available. The defendant is permitted to demonstrate lack of causation. The harshness of the enormous plaintiff class is mitigated by a ceiling on liability of 150% of the inside trader's profits.\footnote{As originally approved by the American Law Institute, the Code's ceiling was 100% of the inside trader's profits. To win SEC endorsement of the Code, New Code § 1708(b)(4)(c) was added. This provision gives courts the discretion to raise the ceiling to 150% of the inside trader's profits. See notes 378-79 and accompanying text supra.}

The practical problem with the Code's approach is in drawing the line between fortuitous and nonfortuitous transactions. Many nonmarket face to face transactions are significantly fortuitous, and market transactions are often nonfortuitous. Despite this minor problem, the Code's approach of prorated and limited damages is a satisfactory statutory solution to the problem of providing a workable civil remedy for stock market inside trading.
CONCLUSION

Legally determining the proper classes of inside trading plaintiffs and defendants is difficult. The problem is created by the tension between the deceit requirement of rule 10b-5 and the desire to use the rule to combat unfair and unethical stock market transactions. A stock market inside trade has two aspects: the trade and the nondisclosure. The trade always benefits the inside trader and harms other specific investors. This result is offensive, but involves no deceit. Occasionally, an inside trade may also be a breach of fiduciary duty to the trader’s employer. Only with a strained analysis can this breach be considered fraudulent. The nondisclosure aspect of an inside trade clearly involves deceit but is offensive only if the inside trader has a relationship of trust and confidence with the other party to the transaction. With much inside trading, especially option transactions and outsider or tippee trading, no such special relationship exists. Holding that an inside trader has a duty to disclose to the world is absurd, as illustrated by the logically compelled Draconian liability that would result from such a duty.

The Supreme Court’s recent Chiarella decision severely restricts the class of inside trading defendants and suggests a drastic restriction of the class of civil plaintiffs. This narrowing is the inevitable consequence of the Court’s correct decision to adhere closely to the deceit requirement of rule 10b-5. Fraud is no longer in the eyes of the beholder.414 In the cogent words of the majority, “Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud.”415

Under the Law of Conservation of Securities any particular inside trade clearly harms other investors. For this reason alone, an inside trader should be forced to disgorge his gains, and this type of misconduct should be deterred. Only Congressional action, however, can provide the necessary weapon to eliminate stock market inside trading.