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The Contemporaneous Traders Who Can Sue an Inside Trader

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In *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, the Second Circuit held that an inside trading defendant was civilly liable for damages to all persons who purchased the security involved in the open market during the same period as the inside sale. On remand, the district court held that “during the same period” meant the period between the inside trade and dissemination of the nonpublic information. According to the district court, “during the same period” was a term of art adopted in the district court’s initial opinion, which the Second Circuit affirmed. Under this interpretation, “during the same period” could be as long as one year if a year elapsed between the inside trade and dissemination.

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1. 495 F.2d 228 (2d Cir. 1974).
2. In this Article, the terms “inside trading,” “inside trade,” “inside purchase,” and “inside sale” refer 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. To avoid confusion, the term “insider trading” will not be used.
5. *But cf.* Wilson v. Comtech Telecommunications Corp., 648 F.2d 88, 94 (2d Cir. 1981) (“[T]he [Shapiro] district court on remand construed this language [“during the same period”] to refer to the period of time from the defendants’ trades to the public disclosure of the insider information . . . but the entire period in that case was only four days.”).

The American Law Institute’s Federal Securities Code allows a class of plaintiffs similar to that allowed by the district court in *Shapiro*. Section 1603 of the A.L.I. Federal Securities Code prohibits certain forms of inside trading. *ALI FEDERAL SECURITIES CODE* § 1603 (Supp. 1981). If a defendant violates § 1603 “in a manner that would make the matching of
In a single paragraph, however, a later Second Circuit opinion redefined the proper class of civil plaintiffs in inside trading cases. In *Wilson v. Comtech Telecommunications Corp.*, the plaintiff bought 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:

[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. This court 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.]

The *Wilson* court cited Judge Celebrezze's Sixth Circuit concurring opinion in *Fridrich v. Bradford*. Judge Celebrezze was the first circuit court judge to state that inside traders should be civilly liable to “contemporaneous” traders:

It is only when the insider enters the market and creates an informational imbalance that a duty to disclose is imposed to protect the anonymous investors trading with the insider. . . . The duty of disclosure is owed to the class of investors trading contemporaneously with the insider . . . .

Although Judge Celebrezze’s opinion has influenced courts in other circuits, his opinion is not the law of the Sixth Circuit. Judge Engel,
joined by Judge Peck, wrote the majority opinion for the Fridrich panel. Judge Engel did not endorse Judge Celebrezze's contemporaneous class of plaintiffs. On the other hand, Wilson is the law of the Second Circuit, the most important circuit in securities litigation. Dictum in an Eighth Circuit opinion, Laventhall v. General Dynamics Corp., may also endorse Wilson's contemporaneous class of plaintiffs. At least two district courts in the Eighth Circuit have so interpreted Laventhall. A few district courts outside the Second and Eighth Circuits have also endorsed the contemporaneous class of plaintiffs.

The Wilson court did not explain the meaning of “contemporaneous.” Trading one month after the inside trade is too long; unclear is whether a day or even an hour also would be too long. Among the unanswered questions are the following:

I. When does the class of “contemporaneous” traders open?

II. When does the class of “contemporaneous” traders close?

III. Must “contemporaneous” traders transact in the same place as the inside trader?

IV. Must “contemporaneous” traders buy or sell the same class of security of the issuer as that bought or sold by the inside trader?

V. Must “contemporaneous” traders buy or sell a security with the same issuer as the security bought or sold by the inside trader?

The definition of “contemporaneous” may be important in both private civil actions and in SEC civil actions for disgorgement of profits to possible victims of inside trading. This Article will discuss each of the above questions left unanswered by the Wilson court.

10. See 542 F.2d 307, 318-23 (6th Cir. 1976). Judge Engel held that the gravamen of the rule 10b-5 offense of inside trading is the trade, not the nondisclosure. In order to recover from an inside trader, the plaintiff must demonstrate injury from the trade. Id. The opinion is not clear whether privity is an alternative basis for recovery. See id. at 321. For discussion of Fridrich, see Wang, supra note 3, at 1262-67, 1284.


13. Two such opinions in the First Circuit are Abelson v. Strong, 644 F. Supp. 524, 527 (D. Mass. 1986) and Backman v. Polaroid Corp., 540 F. Supp. 667, 670 (D. Mass. 1982). In another case, In re Equity Funding Corp. of Am. Sec. Litig., 416 F. Supp. 161, 183-85 (C.D. Cal. 1976), a district court in the Ninth Circuit also dealt with the issue of which plaintiffs can sue an inside trader for damages under rule 10b-5. This case arose before the Second Circuit decision in Wilson but after the Second Circuit decision in Shapiro. The Equity Funding district court agreed with Shapiro that an inside trader should be liable not only to the parties on the other side of the inside trade but to all persons who “during the same period” engaged in transactions opposite in type to the inside trade. 416 F. Supp. at 185.

14. See Wilson, 648 F.2d at 94-95.
I. When Does the Class of “Contemporaneous” Traders Open?

Several district courts have held that the class of contemporaneous traders opens with the first inside trade. In other words, contemporaneous trades exclude those before the inside trade. One district court excluded from the class of contemporaneous traders “a plaintiff whose trades were completed prior to those of the defendant [inside trader]. . . .” In dictum, the court explained that a tipper would be liable only to those plaintiffs who traded after the tippee’s trade. Similarly, after endorsing the “contemporaneous” trader class, another district court barred plaintiffs who bought stock before the alleged inside trade.


In 1976, a district court in the Ninth Circuit also confronted the issue of who can sue inside trading defendants under rule 10b-5; see In re Equity Funding Corp. of Am. Sec. Litig., 416 F. Supp. 161, 183-85 (C.D. Cal. 1976). This case arose before the Second Circuit decision in Wilson but after the Second Circuit decision in Shapiro. The California district court agreed with Shapiro that an inside trader should be liable to all persons who “during the same period” engaged in transactions opposite in type to the inside trade. Id. at 185. The court held: “Aside from plaintiff’s aiding and abetting theory of recovery, . . . [inside trading] defendants will not be held liable to prior purchasers . . . simply because they [the defendants] sold shares . . . without disclosure . . . at a later date.” Id. at 184 (emphasis added). In other words, the class of plaintiffs opens with the inside trade.

Surprisingly, a district court in the Third Circuit held that a plaintiff’s purchase on December 18, 1985 was “unquestionably contemporaneous with defendants’ December 9, 18, and 19 sales.” Froid v. Berner, 649 F. Supp. 1418, 1421 n.2 (D.N.J. 1986). Apparently, the court assumed that transactions on the same day must be contemporaneous. The court did not discuss whether the plaintiff’s purchase on December 18 preceded or followed the defendant’s sale on the same day. If the class of plaintiffs opens with the defendant’s trade and if the plaintiff’s purchase preceded the defendant’s sale, the two transactions on December 18 would not be contemporaneous. The court either overlooked this possibility or rejected any requirement that the defendant’s trade precede the plaintiff’s transaction.

In at least one case, the SEC brought a civil action against alleged inside traders and obtained a consent decree ordering the defendants to disgorge their profits; subsequently, the Commission submitted for judicial approval the following plan of disbursement: disgorgement of profits to those purchasing anytime on the same day as the defendant’s sale. The SEC did not limit disgorgement to those purchasing after the defendant sold. The district court approved this approach: “The SEC’s decision to define purchasers ‘during the period of’ defendants’ sales as purchasers on the six dates on which defendant’s sales took place seems to be
Logically, someone cannot be a victim of fraud until the fraudulent behavior occurs. Outside the context of inside trading, a number of federal courts have said that a plaintiff cannot sue under rule 10b-5 or section 10 (b) if the plaintiff's trade took place before the alleged fraudulent activity.  

II. When Does the Class of “Contemporaneous” Traders Close?

In his concurrence in Fridrich, Judge Celebrezze suggested that “contemporaneous” traders would be those who might have been on the other side of the inside trade. He concurred in the denial of the plaintiffs' standing to sue because “they entered the market weeks after Appellants [the defendants] had ceased trading, [and] none of the shares they [the plaintiffs] sold could possibly have been purchased by Appellants.”

Earlier in his concurring opinion, Judge Celebrezze explained that he would allow contemporaneous traders to sue because of the perceived difficulty of identifying the party on the other side of the inside trade.


20. 542 F.2d at 324 (Celebrezze, J., concurring) (“Since the mechanics of the marketplace make it virtually impossible to identify the actual investors with whom an insider is trading, the duty of disclosure is owed to investors as a class who trade on the market during the period of insider trading.”) (footnote omitted). Later in his opinion, Judge Celebrezze noted that “to accomplish the deterrent and compensatory purposes of 10b-5, it is better to be overinclusive in the definition of the plaintiff class than underinclusive. Id. at 326 n.11 (Celebrezze, J., concurring) (emphasis added).

Judge Celebrezze is vague on what he means by the party “on the other side” of the inside trade. Apparently, Judge Celebrezze believed that the victims of a stock market inside trade are those “on the other side” of the transaction, disregarding any “intermediary.” See
Under Judge Celebrezze's approach, the contemporaneous period would

*Fridrich*, 542 F.2d at 324 & nn.3-4, 325 & n.7, 326 & n.11. In any event, Judge Celebrezze's definition of "on the other side" is unusual. The normal definition of someone "on the other side" of a trade is a party in contractual privity. *See R. Jennings & H. Marsh, Securities Regulation: Cases and Materials* 1126-27 (6th ed. 1987) ("[T]he plaintiff executes a transaction on the other side of the market contemporaneously with the defendant's, but their transactions are not with each other (i.e., there is no 'privity').").

Other courts and commentators have emphasized the difficulty of identifying the party in contractual privity with a stock market inside trader. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 236 (2d Cir. 1974) ("[O]n an anonymous national securities exchange . . . as a practical matter it would be impossible to identify a particular defendant's sale with a particular plaintiff's purchase."); Backman v. Polaroid Corp., 540 F. Supp. 667, 669 (D. Mass. 1982) (quoting the above language in Shapiro); *see* 5C A. Jacobs, Litigation and Practice Under Rule 10b-5, § 260.03[c][viii][C], 11-110 to 11-111 (2d ed. rev. 1987). Citing SEC v. Courtois, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,000 (S.D.N.Y. 1985) (defendant faced both criminal charges brought by U.S. Attorney and civil complaint brought by SEC; pursuant to a plea agreement, the court initially ordered disgorgement of inside trading profits into a fund to be distributed to parties in contractual privity with inside traders or, if that was not feasible, to the U.S. Treasury; the court agreed with the Special Escrow Agent Report that it was not feasible or practicable to distribute the disgorgement fund to parties in privity with inside traders).

Identifying the party in contractual privity may not be as difficult as Judge Celebrezze believed. The task is easier if the inside trade is small, and the volume of the security traded is also small. *See* Note, Damages to Uninformed Traders for Insider Trading on Impersonal Exchanges, 74 Colum. L. Rev. 299, 312 n.120 (1974) ("The problem of tracing transactions through the exchange so as to determine with whom the insider traded has probably been overstated. Brokers do have records of their transactions. . . . Of course, as the volume on the exchange increases, the problem of tracing becomes more difficult."). Cf. *SEC v. Golconda Mining Co.*, 327 F. Supp. 257, 258-59 (S.D.N.Y. 1971) (pursuant to consent decree, inside trading defendants deposited profits with a trustee, who used his best efforts to locate the persons with whom the defendants traded; trustee was able to locate some, but not all, of those who transacted with defendants).

Apparantly, the automation of the parts of the over-the-counter market has made it somewhat easier to recreate transactions there. *See* The SEC's Spy System: Monitoring Computers—and Fielding Tips, Bus. Wk., April 23, 1984, at 29, 30 ("The NASD . . . can now recreate stock trades by identifying the serial numbers of terminals where they originated."). But cf. Sowell v. Butcher & Singer, Inc., No. 84-0714, slip op. (E.D. Pa. May 13, 1987) (LEXIS, Genfed library) (plaintiff traded over-the-counter on a different date than the defendant; while discussing liability under section 12 of the 1933 Act, the court mentions: "Since plaintiff purchased his shares . . . in the over-the-counter market through his broker on January 19, 1981, and defendants did not sell those shares on that date, plaintiff cannot identify who his seller was and lacks strict privity with the defendants." The statement that the plaintiff could not identify his seller may have been an unwarranted assumption by the court; it noted "the strict privity [requirement for § 12] adopted by this circuit". Because plaintiff and defendant were clearly not in privity, the actual party in the privity with the plaintiff was irrelevant).

In the landmark state law case of Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659 (1933), the plaintiff purchased 700 shares of a company on the Boston Stock Exchange through a broker. After the transaction, the plaintiff was able to discover that he was in privity with the president and a director of the issuer. 283 Mass. at 363, 186 N.E. at 660.

In Feldman v. Simkins Indus., Inc., 679 F.2d 1299, 1305-06 (9th Cir. 1982), one of the plaintiff's claims was under section 12 of the Securities Act of 1933. The plaintiff had bought
close soon after the inside trade. The plaintiffs would have to trade almost simultaneously with the inside trade or perhaps within a few minutes after the inside trade.\(^{21}\) As noted earlier,\(^ {22}\) however, Judge

500 shares of Fibreboard common stock and attempted to demonstrate contractual privity with the defendant. *Id.* at 1302, 1305. During the relevant period, the defendant's massive sales constituted nearly one half of the shares traded. *Id.* at 1306. Nevertheless, the defendant used only one brokerage firm and was able to offer evidence which matched the purchase by the plaintiff’s broker against a sale of an equal number of shares at the same time and price from a brokerage firm different than the defendant’s. The court held that the plaintiff had failed to demonstrate contractual privity with the defendant. *Id.* at 1305-06. Suppose the sale of an equal number of shares at the same time and price had been from the brokerage firm the defendant used. An interesting question is whether the court would have ruled that the plaintiff had made a sufficient showing of contractual privity.

When institutions buy or sell large blocks of stock, the transactions are often handled by so-called block positioning brokerage firms which specialize in handling such blocks. For a discussion of the activity of block positioning firms, see S. MITTRA & C. GASSEN, INVESTMENT ANALYSIS AND PORTFOLIO MANAGEMENT 59-61 (1981); W. SHARPE, INVESTMENTS 34, 48 (3d ed. 1985); N. WOLFSON, R. PHILLIPS & T. RUSSO, REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS § 11.02, at 11-5 n.16 (1977). With such block transactions, tracing the party in privity may be feasible.

In State Teachers Retirement Bd. v. Fluor Corp., 500 F. Supp. 278 (S.D.N.Y. 1980), one of the defendants was Manufacturers Hanover Trust Co. The fund had sold 150,000 shares of Fluor Corporation to Manufacturers allegedly after Manufacturers had received bullish non-public material information from executives of Fluor. The fund apparently had no trouble locating the purchaser of the huge block. *See id.* at 284. For subsequent developments in State Teachers, see 654 F.2d 843 (2d Cir. 1981), 576 F. Supp. 1116 (S.D.N.Y. 1983), and 589 F. Supp. 1268 (S.D.N.Y. 1984). Large block trades (10,000 or more shares per trade) constituted 49.9% of all New York Stock Exchange reported volume in 1986. This percentage was a slight decrease from the previous year's all-time high of 51.7%. NEW YORK STOCK EXCHANGE, FACT BOOK 12 (1987).

In 1986, *TIME* reported: “Even though they control only about 33% of the equity on U.S. exchanges, institutional investors currently make about eight out of every ten stock trades each day.” *Manic Market, TIME*, Nov. 10, 1986, at 64, 65.

A 1984 article stated:

> The best estimate is that institutional trading accounts for at least 70 percent, and probably close to 80 percent of the daily trading volume of companies listed on the New York Stock Exchange. Block trades, all but a minor fraction of which can be presumed to represent institutional trading, now account for over 50 percent of volume.


At year end 1980, major institutional investors held about 35.4% of the stock listed on the New York Exchange. During the fourth quarter of that year these investors accounted for about 65% of the trading volume in unit terms, and nearly 72% in dollar value terms. NEW YORK STOCK EXCHANGE, FACT BOOK 1984, at 57, 59. In the same year, 1980, block trades accounted for about 31% of the total volume on the New York Stock Exchange. Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 300 (1983). For additional discussion of the growth in institutional trading, see S. MITTRA & C. GASSEN, *supra* note 20, at 57-59.

Celebrezze's concurring opinion is not the law in the Sixth Circuit.

In Wilson itself, the Second Circuit affirmed the dismissal of a claim by a plaintiff who sold about one month after the defendant's purchase. In Wilson itself, the Second Circuit affirmed the dismissal of a claim by a plaintiff who sold about one month after the defendant's purchase.23 A few subsequent district court decisions have confronted the issue of when the contemporaneous class closes. In one extreme case, the defendant bought between 1979 and 1983, and the plaintiff sold his stock on April 3, 1984; naturally, the court held that the plaintiff's trade was not contemporaneous with the defendant's transactions.24 In another extreme case, the plaintiff did not sell her shares until after commencing the lawsuit, four to five months after the defendant's last purchase of stock allegedly based on nonpublic information.25 Not surprisingly, the court held that the plaintiff was not a contemporaneous trader.26

Another opinion held that the purchase of stock seven trading days after the insider's sale was not sufficiently contemporaneous to confer standing to sue.27 The decision stated that the inside sale on December 8, 1977 took place "some seven trading days" before the plaintiff's purchase on December 16, 1977.28 The court probably meant six trading days. Language in the opinion also implies that the period of "contemporaneousness" in a heavily traded stock would be shorter than in a lightly traded stock.29

In Backman v. Polaroid Corp.,30 one of the defendants allegedly sold stock on nonpublic information on January 18, 1979. The court held that a plaintiff who exercised a call option on January 22, two trading days later, and a plaintiff who bought stock on January 29, seven trading days after the insider's sale was not sufficiently contemporaneous to confer standing to sue.27 The decision stated that the inside sale on December 8, 1977 took place "some seven trading days" before the plaintiff's purchase on December 16, 1977.28 The court probably meant six trading days. Language in the opinion also implies that the period of "contemporaneousness" in a heavily traded stock would be shorter than in a lightly traded stock.29

1361, 1378 (1965): "[A]ll those who sold while the defendant was purchasing should be accorded equal rights of recovery." 542 F.2d at 324 n.5 (emphasis added).

22. See supra text accompanying note 10.

23. Wilson v. Comtech Telecommunications Corp., 648 F.2d 88, 94-95 (2d Cir. 1981). The court did mention: "[T]he [Shapiro] district court on remand interpreted this language ['during the same period'] to refer to the period of time from the defendants' trades to the public disclosure of the insider information, but the entire period in that case was only four days." Id. at 94. (citation omitted). This dictum is too vague to be interpreted as a definition of "contemporaneous" as "within four days." Contra Pietrzak & Ray, Private Litigation Involving Insider Trading, 20 REV. OF SEC. & COMMODITIES REG. 43, 37 n.36 (1987) (summarizing Wilson as follows: "recovery only allowed on trades contemporaneous with those of insider, i.e. within approximately four days after those trades").


26. Id. at 963.


28. Id.

29. Id. at 91,962.

days later, both traded "outside of the period of insider trading."\(^{31}\) in other words, not contemporaneously.

Another district court, however, has held that a plaintiff’s purchase on December 18, 1985 was "unquestionably contemporaneous with defendants’ December 9, 18 and 19 sales."\(^ {32}\) Apparently, the court assumed that transactions on the same day must be contemporaneous.\(^ {33}\)

An indirect definition of "contemporaneous" appears in *State Teachers Retirement Board v. Fluor Corporation.*\(^ {34}\) Allegedly on the basis of material, nonpublic information, one defendant purchased Fluor stock during two periods in 1975: March 4 through March 6 and March 10 through April 11. The plaintiff class sold Fluor stock during the period March 3 through March 6.\(^ {35}\) Relying on both *Wilson* and *Elkind v. Liggett & Myers, Inc.*,\(^ {36}\) the defendant argued that the ceiling on liability should *not* be the defendant’s total profit; instead, the ceiling should be only the profit the defendant realized during March 4 through March 6, the only time when the defendant traded "contemporaneously" with the plaintiff class. Although the court ultimately rejected the defendant’s interpretation of *Elkind*, the court did assume that the defendant’s trades from March 10 through April 11 were not contemporaneous with the plaintiff’s trades from March 3 through March 6.\(^ {37}\) In other words, a trade on March 10 is not "contemporaneous" with a trade on March 6.

Another district court opinion is ambiguous on the meaning of the term "contemporaneous." In *O'Connor & Associates v. Dean Witter Reynolds, Inc.*,\(^ {38}\) the various defendants allegedly traded within an eight calendar (six trading) day period (February 27, 1981 to March 6, 1981). The proposed plaintiff class consisted of those who traded during a *seven* calendar (five trading) day period (February 27, 1981 to March 5, 1981).\(^ {39}\) The court ruled: "[The defendants’] trades clearly were suffi-
ciently contemporaneous with those of the class members to permit a finding of liability under Wilson.”

This language has two, alternative interpretations. On the one hand, the court may have felt that a defendant’s trade on February 27, the beginning of the seven day period, was contemporaneous with a plaintiff’s trade on March 5, the end of the seven day period. On the other hand, the class representative, O’Connor & Associates, apparently traded throughout the period during which the defendants traded.41 Thus, O’Connor’s trades may have been close in time to those of all of the defendants. Therefore, under virtually any definition of “contemporaneous,” O’Connor was an adequate class representative. If a defendant who traded on February 27, for example, felt that she should not be liable to the entire plaintiff class, that defendant could move to divide the plaintiff class into subclasses at a later stage.42 This second interpretation of the ambiguous language seems the more likely. Therefore, O’Connor sheds little light on the time limits on “contemporaneousness.”

III. Must “Contemporaneous” Traders Transact in the Same Place As the Inside Trader?

If the defendant buys IBM stock on the New York Stock Exchange

40. Id. at 805 n.5 (emphasis added).
41. See id. at 802.
42. Cf. id. at 806 n.8 (certain defendants argued that they should only be liable to certain members of the proposed class; the court replied that this argument was relevant to the issue of whether subclasses would be appropriate); Elkind v. Ligget & Myers, Inc., 66 F.R.D. 36, 39 (S.D.N.Y. 1975) (“As there are numerous defendants in Class II it is necessary to define the class of plaintiffs to whom each defendant may prove liable.”) (emphasis added).
43. In the course of denying a motion to dismiss an inside trading suit as premature, a district court, in In re McDonnell Douglas Corp. Sec. Litig., refused preliminarily to impose a “contemporaneous” requirement of four days. [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,838, at 94,317 (E.D. Mo. 1982). Indeed, at such a preliminary stage of litigation, the court seemed unwilling even to decide whether to endorse the Wilson “contemporaneous” limitation. Id. The opinion does not indicate whether the “four days” involved were trading or calendar days. (For a report of an earlier opinion in the same case, see In re McDonnell Douglas Corp. Sec. Litig., 98 F.R.D. 613, 618-19 (E.D. Mo. 1982) (refusing to decide whether to endorse the Wilson “contemporaneous” limitation). Subsequently, the same district court interpreted Laventhal v. General Dynamics Corp., 704 F.2d 407, 412 (8th Cir.), cert. denied, 464 U.S. 846 (1983), as recognizing that the “causal nexus requirement goes at least as far as the ‘contemporaneous trading rule.’”). In re McDonnell Douglas Corp. Sec. Litig., 587 F. Supp. 625, 630 (E.D. Mo. 1983).

A very old opinion, predating Wilson and even Shapiro, refused to allow rule 10b-5 recovery to a plaintiff who bought on November 12, thirteen calendar days after October 30, the date on which the defendants allegedly sold based on nonpublic information. Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701, 705-06 (S.D.N.Y. 1951), aff’d per curiam, 198 F.2d 883 (2d Cir. 1952).
based on nonpublic information, the question arises whether the defendant is liable to "contemporaneous" sellers of IBM in all markets, including the regional stock exchanges, the over-the-counter market, or even foreign stock exchanges. One leading commentator has answered this question in the affirmative.

Dictum in the Eighth Circuit decision of Laventhall v. General Dynamics Corp. may suggest a contrary conclusion. In this case, the issue was whether a defendant who bought common stock was liable to sellers of call options on the stock. The plaintiff brought a class action on behalf of all persons who sold call options of General Dynamics between December 6, 1978 and January 4, 1979, the period during which General Dynamics allegedly had been buying its own stock on the open market knowing of a pending cash dividend and stock split.

The court denied standing to the plaintiffs:

[i]he sine qua non in every private action under section 10(b) is unauthorized trading of securities in the same market as the persons damaged. . . . Here defendant's purchase of stock, if done wrongfully as claimed, could not in any way be asserted as the basis for plaintiff's alleged loss because the parties were not dealing in the same market.

The Eighth Circuit found support for this statement in Wilson's contemporaneous trading requirement. Nevertheless, the court's principal rationale was that Chiarella v. United States requires a "special rela-

44. Cf. Gordon v. Hunt, 98 F.R.D. 573 (S.D.N.Y. 1983). An action was brought against various individuals and the commodities exchanges on which they traded alleging manipulation of silver market. Class certification was only appropriate as to those who, like class representative, traded on Comex under rule 23. The plaintiff (who traded on the Comex) was not typical of traders on other exchanges, such as CBOT and MidAmerica, because separate defenses might be available to the different exchanges and because of the factual difficulty of proving that action in one exchange injured traders on another.) Id. at 580.
45. 5A A. Jacobs, supra note 20, § 62, at 3-257 n.39 (2d ed. rev. 1986) ("If a plaintiff traded in one market and would have been within the class protected if he traded on the same market as the defendants, then he should nevertheless be protected.").
47. Id. at 410. An option is the right to purchase or sell a particular security at a specific price within a set period of time. A "call" option gives the owner the right to buy. A "put" option gives the owner the right to sell. In 1982, section 3(a)(10) of the Securities Exchange Act of 1934 was amended to include expressly any put, call, or option in the definition of "security." Pub. L. No. 97-303, § 1, 96 Stat. 1409 (codified as amended at 15 U.S.C. § 78c(a)(10) (1982)). For a general discussion of options, see L. Loss, FUNDAMENTALS OF SECURITIES REGULATION 251 & n.6 (1983) and Wang, supra note 3, at 1238 n.60.
48. Laventhall, 704 F.2d at 412 (emphasis added).
49. Id. at 414. The opinion also quotes from Judge Celebrezze's concurrence in Fridrich v. Bradford, 542 F.2d 307, 327 (6th Cir. 1976). 704 F.2d at 414.
tionship” between the plaintiff and the defendant. This relationship was absent because the plaintiff's option-sellers and the defendant stock-purchaser traded on different markets.

*Laventhall* did not involve a plaintiff who traded the same security on a different market than did the defendant (e.g., the Pacific Stock Exchange versus the New York Stock Exchange). The plaintiff in *Laventhall* traded a different security with a different issuer on a different market. The opinion's requirement that a plaintiff trade in the “same market” is ambiguous. The phrase “same market” may mean the worldwide market for a given security, for example, the worldwide market for IBM common stock. Alternatively, the phrase may mean a particular place of trading, in other words, a particular specialist or market-maker. Under the latter interpretation, the dictum would preclude a plaintiff from suing an inside trader even when the plaintiff trades the same security (as the defendant) around the same time but at a place different than that of the defendant's trade.

IV. Must “Contemporaneous” Traders Buy or Sell the Same Class of Security of the Issuer as That Bought or Sold by the Inside Trader?

Closely related to the “same market” issue is the question whether a defendant who trades one class of security of an issuer is liable to contemporaneous traders of another security or class of security of the same issuer. Apparently, no reported decision has addressed this issue.


53. *See infra* text accompanying notes 56-69.

54. At one point, the court seems to so define “same market”: “[h]ad plaintiff been contemporaneously trading in the same market, that is, buying and selling common stock at the same time defendant was trading . . . .” *Laventhall*, 704 F.2d at 412.

55. *In re Equity Funding Corp. of Am. Sec. Litig.*, 416 F. Supp. 161 (C.D. Cal.1976), contains ambiguous language on the issue of whether a plaintiff who trades one class of security can sue an inside trader of another class of security of the same issuer. The case arose before the Second Circuit decision in *Wilson*, but after the Second Circuit decision in *Shapiro*.

In *Equity Funding*, the inside trading defendants allegedly sold various classes of Equity Funding securities (including both stock and bonds) based on material nonpublic adverse information passed to them by Raymond Dirks. *Id.* at 174-75. Subsequently, the Supreme Court exonerated Dirks of rule 10b-5 liability. *Dirks v. SEC*, 463 U.S. 646 (1983).

The *Equity Funding* district court agreed with *Shapiro* that inside traders should “be liable for breach of the duty they owed to all persons who during the same period purchased [EFCA securities] on the open market without knowledge of the material information which
The next subsection discusses a related issue, whether a plaintiff who trades an option can sue an inside trader of stock. A few district courts have allowed such suits. These courts might be receptive to allowing a plaintiff who trades one class of security (for example, a convertible preferred or convertible debenture) to sue an insider trader of stock of the same issuer.

V. Must "Contemporaneous" Traders Buy or Sell a Security With the Same Issuer as the Security Bought or Sold by the Inside Trader?

Clearly, someone who sells the stock of Apple Computer cannot sue an inside purchaser of IBM common stock. Nevertheless, a seller of a call option on IBM stock may attempt to sue someone who buys IBM common stock based on material, nonpublic information. The call option is issued not by IBM, but by an independent party (generally the Options Clearing Corporation). Thus, the common stock and the option have different issuers. As discussed above, the Eighth Circuit has held that option-sellers cannot sue a defendant who sells common stock based on material, nonpublic information. Earlier, a district court in the Eighth Circuit had taken a different approach but then reversed its position after the Eighth Circuit opinion in Laventhall.

was in the possession of defendants." 416 F. Supp. at 185 (quoting Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 238 (2d Cir. 1974)) (material in brackets in original). The Equity Funding district court's bracketed reference to all classes of Equity Funding securities is ambiguous. The court probably meant that inside traders of bonds were liable to plaintiff traders of bonds and that inside traders of stock were liable to plaintiff traders of stock. It seems unlikely that the court meant that an inside trader of any security of Equity Funding was liable to those trading any Equity Funding security around the same time as the inside trade.

57. See supra text accompanying notes 46-54.
58. Laventhall, 704 F.2d at 414-15. See generally In re McDonnell Douglas Corp. Sec. Litig., 567 F. Supp. 126 (E.D. Mo. 1983) (the plaintiff sold options and sued some defendants for selling stock on nonpublic information and other defendants, including the corporation, for failure to disclose material adverse information; the plaintiff conceded that the inside trading claims were foreclosed by Laventhall, but the court extended Laventhall to preclude the non-disclosure claims as well).
59. Compare In re McDonnell Douglas Corp. Securities Litigation, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,838, at 94,317-18 (E.D. Mo. 1982) (The court allowed two classes of plaintiffs to sue defendants who allegedly sold stock based on inside information. The two classes of plaintiffs were (1) purchasers of common stock, and (2) purchasers of options. According to the court, "[t]he action for improper insider trading protects security holders under the 1934 Act, and both option and stock purchasers have here alleged the same core of operative facts to pose liability." Id. at 94,318 (emphasis original.),) with In re McDonnell
Another district court gave an option-trader standing to sue an inside trader of stock. One of the plaintiffs in that case purchased call options on Polaroid stock, and two of the defendants sold Polaroid stock. The court refused to dismiss the option-buyer’s complaint against the alleged inside traders of stock:

[c]all options are 'securities' within the meaning of section 10(b) and Rule 10b-5. . . . Although . . . [the plaintiff option-buyer] may have difficulty in establishing that he was damaged by the [inside stock] trading . . . , he does state a claim upon which relief can be granted and the motion to dismiss must be denied . . . .60

The Insider Trading Sanctions Act of 1984 added the following section to section 20(d) the Securities Exchange Act of 1934:

Wherever communicating, or purchasing or selling a security while in possession of, material nonpublic information would violate, or result in liability to any purchaser or seller of the security under any provision of this title, or any rule or regulation thereunder, such conduct in connection with a purchase or sale of a put, call, straddle, option, or privilege with respect to such security or with respect to a group or index of securities including such security, shall also violate and result in comparable liability to any purchaser or seller of that security under such provision, rule, or regulation.61

In short, section 20(d) makes unlawful the trading of options while in possession of material, nonpublic information where trading in the underlying security would be unlawful.62 Nevertheless, the private civil liability of such an unlawful option trader is unclear.

The next to the last line of the provision contains the ambiguous phrase “that security.” This term could mean either the underlying stock or the option. If “that security” means the stock, the provision would have the following meaning:

Wherever an inside trader of stock would be civilly liable to purchasers or sellers of stock, an inside trader of options on the stock shall be liable to the same purchasers and sellers of the stock (to which the insider trader of stock would be civilly liable).

Under this first interpretation, an inside trade of an option (on common stock) would result in the identical private civil liability as an inside trade

Douglas Corp. Secs. Litig., 567 F. Supp. 126, 127 (E.D. Mo. 1983) ("[T]he option purchaser has no standing to sue with respect to insider transactions in shares.").


of the *stock*. In the Second Circuit, the inside trade of the stock would result in civil liability to "contemporaneous" traders. According to section 20(d), an inside trader of an *option* would be liable to contemporaneous traders of the *stock*.64

If the phrase "that security" (in the next to the last line of section 20(d)) means the option, the provision would have the following meaning:

Wherever an inside trader of stock would be civilly liable to purchasers or sellers of stock, an inside trader of *options* on the stock shall have liability to purchasers and sellers of *options* comparable to the liability an inside trader of stock has to purchasers or sellers of stock. Under the second interpretation, if the inside trader of stock would be liable to contemporaneous traders of stock, the inside trader of options would be liable to contemporaneous traders of *options*.65

Section 20(d)'s earlier references to "security," however, all mean the underlying security, not the option. Therefore, the text strongly suggests the first interpretation of the phrase "that security" (as the stock).

Nevertheless, the second interpretation of the phrase "that security" (as the option) has the more sensible result. The legislative history of the Insider Trading Sanctions Act of 1984 clearly supports this interpretation of the phrase "that security" (as the option). In 1984, Senator Alfonse D'Amato was chair of the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs. When the Insider Trading Sanctions Act was introduced on the floor on the Senate, Senator D'Amato's remarks in support of the bill included the following illustration of the effect of section 20(d):

For example, if, in a given set of circumstances, a corporate officer would violate the antifraud provisions by purchasing any securities issued by his employer, subjecting himself to liability to selling shareholders, then he would violate the antifraud provisions to the same extent by purchasing options with respect to these securities, and sub-

63. *See supra* text accompanying notes 6-7.

64. Conceivably, however, the Supreme Court might ultimately hold that an inside trader of stock is liable not to contemporaneous traders but only to the party in contractual privity with the inside trader. For an argument that the Supreme Court opinion of Chiarella v. United States, 445 U.S. 222, 230-33 (1980), suggests that an inside trader is civilly liable only to the party in contractual privity with the inside trader, see *Wang, supra* note 3, at 1270-71, 1281, 1284, 1316-17. If the Supreme Court were to so hold, the ironic result of this first interpretation of § 20(d) would be that an inside trader of an option would not be civilly liable for damages to anyone. The option trader would not be in privity with any purchaser or seller of the stock.

65. If the inside trader of stock would be liable solely to the party in contractual privity (*see supra* note 64), the inside trader of an option would be liable solely to the party in privity also.
ject himself to comparable liability to selling option holders and other similarly situated persons in the derivative market.66

Section 20(d) was added by the Senate to a House-passed bill.67 In 1984, Congressman John Dingell was chair of the House Committee on Energy and Commerce. When Congressman Dingell introduced the final version of the Insider Trading Sanctions Act of 1984 on the floor of the House, he included in his remarks an attached explanation of various Senate amendments (in the absence of a report by the Senate Banking Committee or a House-Senate conference report). Included in this attached explanation was the example (verbatim) given by Senator D'Amato and quoted above.68

In summary, the text of section 20(d) suggests the first interpretation of “that security” (as the stock), but the legislative history clearly indicates the second interpretation: “that security” (as the option). Because of the clear legislative history and the more sensible result, Congress must have intended the second interpretation of “that security,” which results in an inside trader of options having liability to buyers and sellers of options comparable to the liability an inside trader of stock has to buyers and sellers of stock.

An interesting question is whether section 20(d) preempts other civil liability. If not, an inside trader of options might be liable for damages to private plaintiffs under the “common law” of rule 10b-5.69 Unfortu-


69. One issue in Bianco v. Texas Instruments, Inc., 627 F. Supp. 154, 163-64 (N.D. Ill. 1985), was whether the plaintiff option-traders could sue inside traders of options who traded contemporaneously with the plaintiffs. Although the case was decided after the passage of the Inside Trading Sanctions Act of 1984, the court did not mention the statute. Instead, based on the “common law” of rule 10b-5 after Chiarella v. United States, 445 U.S. 222 (1980), the district court refused to dismiss the complaint and held that a plaintiff option-trader can sue a contemporaneous inside trader of the same type of option. 627 F. Supp. at 163-64 (citing O'Connor & Assoc. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179, 1187 (S.D.N.Y. 1981) and Laventhal v. General Dynamics Corp., 704 F.2d 407, 412 (8th Cir. 1983)). Bianco involved an issue different than that discussed in this section. The issue in this section (and in Laventhal and Backman) is whether an option trader can sue a defendant trader of stock. Bianco involved option traders suing other option traders.

See generally In re Warner Communications Sec. Litig., 618 F. Supp. 735, 743 (S.D.N.Y. 1985) (in the course of approving a settlement, discussing general issue of whether options traders have standing to maintain a § 10(b) claim); In re Digital Equip. Corp. Sec. Litig., 601
nately, the "common law" rule of 10b-5 liability of inside traders of options remains largely undeveloped.

Conclusion

Although identifying the party in contractual privity with an inside trader may not be as difficult as many commentators believe, one rationale for permitting contemporaneous traders to sue is that the use of this criterion avoids this potential problem. Judge Celebrezze's concurrence in Fridrich endorsed the contemporaneous trader class of plaintiffs in part because of the problem of identifying who was "on the other side" of the inside trade. If the rationale underlying the "contemporaneous" class of plaintiffs is the difficulty of ascertaining the party in privity, all those who might have been in privity would be allowed to sue. The "contemporaneous" period would be quite short, perhaps within one hour or even a few minutes after the inside trade. Furthermore, contemporaneous traders would include only those trading the same class of security in the same place as the inside trader. For consistency, these plaintiffs could be allowed to sue a stock market inside trader even when the party in privity is identifiable. Unfortunately, the pivotal Second Circuit decision, Wilson, does not mention as a rationale the possible difficulty of identifying the party in contractual privity.

70. See supra note 20.
71. See supra note 20 and accompanying text.
72. See supra notes 19 & 20 and accompanying text.
73. See Wilson, 648 F.2d at 94-95.

In O'Connor & Assocs. v. Dean Witter Reynolds, Inc., 559 F. Supp. 800, 805 (S.D.N.Y. 1983), the defendant argued that an inside trader of options should be liable only to the party in privity. The reason was that, unlike a stock trade, the party on the other side of an option trade can be readily identified. The court rejected the defendant's argument and held that an inside trader of options should be liable to contemporaneous traders of options: Although the Court of Appeals did note in Shapiro the practical difficulties of match-
The meaning of “contemporaneous” is important in actions against an inside trader by both private plaintiffs and the Securities and Exchange Commission. In private suits for damages, the Second Circuit has limited a defendant’s liability for damages to the inside trading profit. The plaintiffs share these profits pro rata. Because each plaintiff is not entitled to actual damages, the exact contours of the plaintiff class does not affect the liability of the defendant in the Second Circuit. The definition of the class, however, does determine who may recover.

When the SEC sues an inside trader, the Commission sometimes requests disgorgement of profits to “contemporaneous” traders. In particular sales with particular purchases, the Court’s decision was based primarily not on that rationale but rather on the conclusion that “it would make a mockery of the ‘disclose or abstain’ rule if we were to permit the fortuitous matching of buy and sell orders to determine whether a duty to disclose had been violated.

O’Connor, 559 F. Supp. at 805 (quoting Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 236 (2d Cir. 1974)).

In 1976, a district court in the Ninth Circuit also confronted an argument by inside trading defendants that they should be liable only to the parties in privity. Apparently, the parties in privity were identifiable. Indeed, certain plaintiffs claimed to be the actual purchasers of certain blocks sold by the defendants. In re Equity Funding Corp. of Am. Sec. Litig., 416 F. Supp. 161, 174-75 (C.D. Cal. 1976). This case arose before the Second Circuit decision in Wilson but after the Second Circuit decision in Shapiro. The California district court agreed with Shapiro that an inside trader should be liable not only to the parties on the other side of the inside trade but to all persons who “during the same period” engaged in transactions opposite in type to the inside trade. Consequently, the district court held: “Even if these transactions [block trades to identifiable plaintiffs] turn out to be the only sales by these defendants . . . they can also be liable for breach of the duty they owed ‘to all persons who during the same period purchased . . . on the open market without knowledge of the material information which was in the possession of defendants.’”). 416 F. Supp. at 185 (quoting Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237 (2d Cir. 1974)).


75. See, e.g., SEC v. Certain Unknown Purchasers of the Common Stock of and Call Options for the Common Stock of Santa Fe Int’l Corp., [1985-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,484, at 92,929 (S.D.N.Y. 1986) (consent decree providing for disgorgement to “persons who traded directly with the defendants as well as persons trading contemporaneously with the defendants” who can show they suffered a “loss” as a result of the transactions), aff’d, [Current] Fed. Sec. L. Rep. (CCH) 93,250 (2d Cir. 1987); SEC v. Voigt (S.D. Ind. 1982), SEC Litig. Release No. 9613 (March 12, 1982), 24 SEC Docket 1657, 1658 (consent decree pursuant to which inside trading defendants disgorged profits to those “who sold the target securities at the time when the defendants were purchasing such securities . . . .”). Cf. SEC v. Andes, No. 82-1659, slip op. (E.D. Pa. Jan. 23, 1986) (LEXIS, Genfed library) (consent decree with “a plan of disbursement which would allocate pro rata the disgorged funds among those identifiable individuals who purchased Franklin Mint common stock on the dates when the defendants were alleged to have sold their common stock while in possession of material insider information.”); the court noted: “Although compensation of injured investors is not the primary purpose of disgorgement, it is a valid secondary purpose, and in fact most courts do order that disgorged proceeds be distributed among injured investors.”); SEC v. Reed, 97 F.R.D. 746, 747-48 (S.D.N.Y. 1983) (describing consent decree providing for
such cases, the meaning of "contemporaneous" is important in determining the precise decree requested by the SEC and issued by the court.

disgorgement of inside trading profits into escrow account for satisfaction of any judgment or settlement in pending class action on behalf of those who traded contemporaneously with defendant; any residue would be used to satisfy any other action against defendant; the summary of this opinion in United States v. Reed, 601 F. Supp. 685, 691 n.8 (S.D.N.Y. 1985), rev'd on other grounds, 773 F.2d 477 (2d Cir. 1985), states that, according to Reed, he deposited funds into the escrow account with the understanding that any ultimate residue would go to charity; SEC v. Shapiro, 349 F. Supp. 46, 55-56 (S.D.N.Y. 1972) (court held that inside trading defendants violated rule 10b-5; SEC sought disgorgement of profits to "defrauded public investors"; court ordered that "[t]he trustee [of the disgorgement fund] shall use his best efforts to locate those members of the public who sold Harvey's shares during the period from January 6, 1971 [date of the first inside trade] to February 18, 1971 [date of last inside trade] and pay each person so located . . . an amount to be determined by the trustee to be equitable and fair."); aff'd, 494 F.2d 1301 (2d Cir. 1974); D. Langevoort, INSIDER TRADING HANDBOOK 299 (1987) ("While the SEC has long maintained that its disgorgement actions are enforcement actions designed to deter unlawful trading and not simply collection efforts on behalf of injured investors, as a practical matter the disgorgement funds are almost always used to compensate investors who claim injury resulting from the violation (presumably in a collateral private action.") (footnote omitted); Report of the Task Force on Regulation of Insider Trading—Part I: Regulation Under the Anti-Fraud Provisions of the Securities Exchange Act of 1934, 41 BUS. LAW. 223, 245 (1985) (Committee on Federal Regulation of Securities, Section of Corporation, Banking and Business Law, A.B.A.) ("The SEC typically requests that disgorgement be made to a fund from which those persons who can prove that they were damaged by the violations may recover . . . ."). But cf SEC v. Commonwealth Chem. Sec., Inc., 574 F.2d 90, 102 (2d Cir. 1978) ("[T]he primary purpose of disgorgement is not to compensate investors. Unlike damages, it is a method of forcing a defendant to give up the amount by which he was unjustly enriched . . . ."); SEC v. Materia, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99, 583 at 97, 287 (S.D.N.Y. 1983) ("[T]he purpose of the disgorgement is not to take care of anybody's damages but rather to insure that no one profits by willful violations.") (footnote omitted); SEC v. Courtois, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,000 (S.D.N.Y. 1985) (Defendant faced both criminal charges brought by U. S. Attorney and civil complaint brought by SEC. Pursuant to a plea agreement, the court initially ordered disgorgement of inside trading profits into a fund to be distributed to parties in contractual privity with the inside trader. For examples, see SEC v. Griffith (N.D. Ga. 1983), SEC Litig. Release No. 10,072 (July 20, 1983), 28 SEC Docket 608; SEC v. Baranowicz (C.D. Cal. 1982), SEC Litig. Release No. 9704 (June 29, 1982), 25 SEC Docket 1051; SEC v. Acki (S.D.N.Y. 1980), SEC Litig. Release No. 9139 (July 23, 1980), 20 SEC Docket 831; SEC v. National Kinney Corp. (S.D.N.Y. 1980), SEC Litig. Release No. 9118 (June 30, 1980), 20 SEC Docket 595. But cf. SEC v. Courtois, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,000 (S.D.N.Y. 1985) (Defendant faced both criminal charges brought by U. S. Attorney and civil complaint brought by SEC. Pursuant to a plea agreement, the court initially ordered disgorgement of inside trading profits into a fund to be distributed to parties in contractual privity with inside traders or, if that was not feasible, to the U.S. Treasury. The Special Escrow Agent reported that it was not feasible or practicable to distribute the disgorgement fund to parties in privity with inside traders; the court agreed with this finding and ordered disgorgement fund paid to U.S. Treasury). In some other instances, consent decrees have provided for disgorgement to the "sellers" or "buyers" without indicating which sellers of buyers; apparently, the terms "sellers" and "buyers" meant those in contractual privity with the inside trading defendant. For examples, see SEC v. Spiker (E.D. Wa. 1984), SEC Litig. Release No. 10444 (July 2,
Unfortunately, only a few opinions have addressed the meaning of "contemporaneous," and almost all of these decisions were reached by district courts. A clearer definition would aid the courts, the SEC, and private plaintiffs.