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Private Rule 10b-5 Recovery for Open Market Insider Trading: The Propriety of Privity and Reliance Requirements

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PRIVATE RULE 10b-5 RECOVERY FOR OPEN MARKET INSIDER TRADING: THE PROPRIETY OF PRIVITY AND RELIANCE REQUIREMENTS

A split of authority has developed regarding the necessity of imposing privity and reliance as prerequisites to private recovery for insider trading in the anonymous markets under rule 10b-5. Elimination of these requirements gives rise to a threat of exorbitant damages; imposition of privity and reliance requirements solves the damages problem but results in the abolition of the plaintiff’s right to recover under the rule. This Comment takes the position that the defendant's rule 10b-5 liability can be limited without eliminating the plaintiff's recovery. Therefore, imposition of privity and reliance requirements is far too drastic a solution and represents an unjustifiable violation of the policy underlying rule 10b-5.

INTRODUCTION

Rule 10b-5\(^1\) was prescribed pursuant to section 10(b) of the Securities Exchange Act of 1934 (1934 Act).\(^2\) By this Act, Congress hoped to prevent unfair, fraudulent securities transactions in open market and face-to-face transactions.\(^3\) By judicial implication, a private right of action for recovery of damages resulting from insider trad-

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1. 17 C.F.R. § 240.10b-5 (1977). The rule states:
   
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
   
   (a) To employ any device, scheme, or artifice to defraud,
   
   (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of 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.


ing⁴ exists under rule 10b-5.⁵

This private right of action is generally preferred over suit under state law where the rigid restrictions of common law fraud thwart recovery in most open market situations.⁶ Today, the rule 10b-5 action is the most widely used theory of recovery for securities fraud.⁷

Because the private rule 10b-5 action is judicially implied, there is little legislative history to define the scope of the action or the limits intended by Congress when enacting the 1934 Act. Because of this uncertainty, a danger now exists that the substantive advantages of the rule 10b-5 action will be eliminated in open market, nondisclosure situations. A split of authority currently exists as to whether privity and reliance⁸ are prerequisites to recovery under rule 10b-5.

The Second Circuit has eliminated the privity requirement and has substantially relaxed the causation requirement in nondisclosure cases.⁹ The Sixth Circuit rejects the Second Circuit's position and requires proof of direct causation in fact and privity in open market, nondisclosure situations.¹⁰

Either view creates problems which inhibit the efficient administration of the civil remedy implied under rule 10b-5. Elimination of privity and reliance generates a large number of plaintiffs and

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⁴ *Insider trading* as used in this Comment means trading a security without first disclosing material inside information.

⁵ Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). In *Kardon*, the court found support for implication of a civil remedy under rule 10b-5 in *Texas & Pac. Ry. v. Rigsby*, 241 U.S. 33, 39 (1916), in which the Supreme Court recognized an implied right of action for violation of a federal regulatory statute. In *Texas*, the Court held that "disregard of the command of the statute is a wrongful act, and where it results in damage to one of the class for whose especial benefit the statute was enacted, the right to recover the damages from the party in default is implied." *Id.*


⁸ This Comment will consider the terms *reliance* and *causation* as synonymous. Generally, the courts have dealt with them as such.

⁹ Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974). This Comment deals primarily with insider trading in the nondisclosure, impersonal market situation and with resulting rule 10b-5 recovery. However, the Second Circuit has all but eliminated the reliance requirement in "fraud-on-the-market" and "comprehensive scheme" cases. *E.g.*, Competitive Assoc. v. Laventhal, Krehekstein, Horwath & Horwath, 516 F.2d 811, 814 (2d Cir. 1975); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380 (2d Cir.), *cert. denied*, 421 U.S. 976 (1974); Lober v. Beebe, 407 F. Supp. 279, 280-89 (S.D.N.Y. 1975).

threatens such enormous damages that the defendant may well be bankrupted by the award. Imposition of privity and reliance as requisites to recovery resolves these problems, but in so doing, denies the injured plaintiff a right to recover under rule 10b-5 in the impersonal market, nondisclosure transaction. The view which prevails in the future will determine whether those participating in the impersonal securities markets must return to the limited-recovery world of common law fraud.  

THE SECOND CIRCUIT'S VIEW

Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc. represents the Second Circuit's approach to the privity and reliance requirements. The defendant, Merrill Lynch, had knowledge of material inside information regarding a poor future earnings forecast for Douglas Aircraft. This information was disseminated only to certain Merrill Lynch clients, the majority of whom were institutional investors (the selling defendants). Prior to public disclosure of the revised earnings forecast, these defendants sold a total of 165,000 shares of Douglas stock. On public disclosure of the revised earnings forecast, Douglas stock plummeted. Shapiro and the other plaintiff investors had purchased Douglas stock during the period of nondisclosure and without knowledge of the material inside information.

The plaintiffs brought a rule 10b-5 action alleging trading on inside information. The district court held that both the tipper, Merrill Lynch, and the tippees, the selling defendants, had violated rule 10b-5 by failing to disclose material inside information prior to the time the trading took place. In affirming the district court's decision, Judge Timbers announced the policy considerations underlying rule 10b-5: "As we have stated time and again, the purpose behind section 10(b) and Rule 10b-5 is to protect the investing public and to secure fair dealing in the securities markets by promoting full disclosure of inside information . . . ." In furtherance of this policy, the

12. 495 F.2d 228 (2d Cir. 1974).
14. 495 F.2d at 235. For the other "times," see Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 793 (2d Cir. 1969), cert. denied, 400 U.S. 822 (1970); SEC
Second Circuit has developed what is commonly known as the “abstain or disclose rule.”

This rule, which requires that anyone in possession of material inside information must either disclose such information or refrain from trading, applies to open market as well as to face-to-face transactions. Violation of this rule exposes the inside trader to liability under rule 10b-5. Judge Timbers, speaking for the majority in Shapiro, stated that the abstain or disclose rule is based on the “justifiable expectation of the securities market place that all investors trading on impersonal exchanges have relatively equal access to material information.” Hence, a showing of a violation of the abstain or disclose rule was and is today a prerequisite to recovery in the Second Circuit.

Originally, the Court of Appeals for the Second Circuit held that a “semblance of privity” was also a prerequisite to recovery in a private cause of action under rule 10b-5. However, in Heit v. Wetzen, the Second Circuit permitted private rule 10b-5 recovery in the absence of privity between the parties. The Shapiro court reiterated that privity between the plaintiff and the defendant was “not a requisite element of a Rule 10b-5 cause of action for damages.”

The Second Circuit’s rationale for the elimination of the privity requirement lies in the policy considerations announced “time and again.” This policy requires the maintenance of fair dealing in the open markets as well as in face-to-face transactions. Requiring privity would limit recovery to face-to-face transactions, thereby frustrating this protective policy.

The elimination of the privity requirement did not solve the dif-

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16. Judge Timbers stated: “To hold that Section 10(b) and Rule 10b-5 impose a duty to disclose material inside information only in face-to-face transactions or to the actual purchasers or sellers on an anonymous public exchange, would be to frustrate a major purpose of the antifraud provisions of the securities laws . . . .” 495 F.2d at 237.
17. Id. at 236 (quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969)).
19. 402 F.2d 909 (2d Cir. 1968).
20. 495 F.2d at 239.
21. Id. at 240.
22. Id. at 236. Judge Timbers stated that “these transactions occurred on an anonymous national securities exchange where as a practical matter it would be impossible to identify a particular defendant's sale with a particular plaintiff's purchase.” Id. Therefore, imposition of a privity requirement would all but eliminate recovery under rule 10b-5.
difficult problem of proving reliance in open market transactions. Initially, the Second Circuit insisted on retaining this requirement. However, in *Affiliated Ute Citizens v. United States* the United States Supreme Court arguably opened the door to eliminating the reliance requirement in open market situations. Certainly the Second Circuit in *Shapiro* seized upon *Affiliated Ute* as an opportunity to do so itself, stating that:

*Affiliated Ute* surely warrants our conclusion that the requisite element of causation in fact has been established by the admitted withholding by defendants of material inside information which they were under an obligation to disclose, such information being clearly material in the sense that plaintiffs as reasonable investors might have considered it important in making their decision to purchase . . .

In short, a showing of materiality dispenses with the reliance requirement under *Shapiro*, with the result that reliance is no longer a prerequisite to rule 10b-5 recovery in the Second Circuit.

The *Shapiro* court recognized that eliminating privity and reliance requirements had the potential to generate a large plaintiff class which would threaten the defendant with "Draconian liability." The court found this potential liability to be an "additional reason" for remanding the case to the district court where the "appropriate form of relief" could be granted.

The Second Circuit has long been acknowledged as the leading court in securities regulation. Under the Second Circuit’s well-established *Shapiro* rule, the private plaintiff attempting to recover under rule 10b-5 need only show trading by the defendant on material inside information, scienter, standing to sue under the *Birnbaum* doctrine, and damages. These limited substantive requirements,
coupled with the vast procedural advantages of the rule 10b-5 cause of action, make this remedy far superior to any other currently available under state law.\textsuperscript{31}

**The Sixth Circuit's View**

In *Fridrich v. Bradford*,\textsuperscript{33} the Sixth Circuit dealt with a private cause of action brought under rule 10b-5 to recover damages for insider trading in the over-the-counter market.\textsuperscript{34} One defendant was a director of the Old Line Life Insurance Company and a member of a syndicate which owned a controlling block of Old Line stock. He was also a managing partner in J.C. Bradford & Co., the market maker in Old Line stock.\textsuperscript{35} He negotiated a proposed merger with the U.S. Life Corporation, the terms of which were quite favorable to Old Line. The defendant relayed this inside information to his son, who purchased 1225 shares of Old Line stock at a price of thirty–seven dollars per share. Thereafter, the agreement to merge Old Line with U.S. Life was publicly disclosed and the value of Old Line stock appreciated significantly. The defendant's son sold at a $13,000 profit. Others who had purchased Old Line stock without first disclosing material inside information traded in a similar fashion.

misrepresentation may bring a rule 10b-5 private action. Id. at 464. The doctrine bars three classes of potential plaintiffs: (1) potential purchasers who allege that they decided not to buy because of the omission or misrepresentation, (2) actual shareholders who did not sell because of the omission or misrepresentation, and (3) actual shareholders who allege that the value of their holdings was diminished because of the defendant's rule 10b-5 violations. The Supreme Court has approved the Birnbaum doctrine. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). See also Note, *Securities Law—Rule 10b-5—The Birnbaum Doctrine is Affirmed: Only a Purchaser or Seller of Securities May Maintain a Private Action for Damages Under Rule 10b-5*, 25 Cath. U.L. Rev. 402 (1976).


34. 542 F.2d at 311.

35. Id. at 309-12.
The Securities and Exchange Commission (SEC) commenced an investigation of the trading which occurred prior to the public disclosure of the merger. The defendants admitted violations of rule 10b-5 under an SEC consent decree which required the disgorgement of the son's $13,000 profit and enjoined future violations of rule 10b-5.36

Fridrich and the other plaintiffs who had sold Old Line stock during the period of nondisclosure filed a rule 10b-5 civil action charging insider trading and market manipulation. The district court held the defendants liable for violating rule 10b-5 and fixed damages at $361,186.75 irrespective of the fact that the plaintiffs had made no showing of privity or of direct causation in fact.37

The Court of Appeals for the Sixth Circuit did not agree with this result.38 Judge Engel questioned the propriety of extending recovery under rule 10b-5 to open market situations when neither privity nor reliance was shown.39 The court discussed the various policies underlying rule 10b-5 recovery in the open market and acknowledged that the "proscriptions of § 10(b) and Rule 10b-5 should encompass open market transactions."40 In addition, the court stated that "Congress certainly never intended § 10(b) to be limited in its scope solely to face-to-face transactions."41 It concluded that inasmuch as the "Securities Exchange Act of 1934 is aimed at nationwide practices, . . . it would be idle to exclude from its operation those over-the-counter and national stock exchange transactions which are most characteristic of the national market."42

In striking contrast to the policy espoused and to the admitted congressional intent underlying the 1934 Act, the Fridrich court refused to extend the civil remedy under rule 10b-5 to impersonal-market situations involving material nondisclosure: "[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

36. Id. at 308.
38. 542 F.2d at 323.
39. Id. at 318-20.
40. Id. at 320.
41. Id.
42. Id.
dealing with face-to-face transactions.”43 Thus, in direct opposition to the Second Circuit, the Sixth Circuit requires both privity44 and direct causation in fact as prerequisites to recovery under rule 10b-5.

In an earlier case, Chelsea Associates v. Rapanos,45 the Sixth Circuit held that a showing of trading on material inside information presumptively disposed of the reliance requirement.46 In Fridrich, Judge Engel reinstated the reliance requirement with relative ease and with no mention of Chelsea.47 The Fridrich court rejected the Second Circuit’s view that any trading without disclosing material inside information constitutes a violation of rule 10b-5,48 noting that the abstain or disclose rule is illogical49 because it presumes that the duty to disclose is absolute.50 Under the Sixth Circuit’s view, it is the

43. Id. at 321 (emphasis added).
44. Most commentators to date have not mentioned the imposition of a privity requirement by the Fridrich court. Rather, they have spoken only in terms of reliance-causation. See Comment, Securities—Rule 10b-5—Traders with Inside Information on the Impersonal Market Are Not Liable to Those Persons Trading After the Insider Has Ceased Trading but Before Public Disclosure, 8 TEX. TECH. L. REV. 742 (1977); Comment, Securities Law—Securities Fraud—Proof of Causation in 10b-5 Nondisclosure Cases Involving Trading on Impersonal Markets, 30 VAND. L. REV. 122 (1977). However, Fridrich arguably stands for the imposition of a privity requirement. Fridrich declined to allow a private, civil action “where plaintiffs have neither dealt with defendants nor been influenced in their trading decisions by any act of the defendants.” 542 F.2d at 321. If the plaintiff must have “dealt” with the defendant in order to recover, then he must demonstrate that he was in privity with the defendant. Because the Fridrich court had previously imposed an absolute reliance requirement, id. at 319, this language is not susceptible to the interpretation that a showing of either privity or reliance is sufficient. In other words, privity alone could not be sufficient where reliance is required. The only rational reason for discussing privity in conjunction with the reliance requirement would be for the purpose of requiring it. Judge Celebrezze’s concurring opinion supports this contention. He stated that “without at least a ‘semblance of privity’ defendants’ liability could extend to complete strangers.” Id. at 325. One commentator suggests that “[the Fridrich court’s] strict causation requirement appears to reinstate, albeit in different verbal garb, a requirement of privity in private 10b-5 actions in that, in the court’s view, trading will ‘cause’ damage only to the person on the other end of the transaction, someone impossible to identify in the impersonal securities market.

45. 527 F.2d 1266 (6th Cir. 1975).
46. In Chelsea, the Sixth Circuit interpreted Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972), as holding that a showing of materiality gives rise to a presumption of reliance by the plaintiff. 527 F.2d at 1271. For a discussion of this “presumption,” see note 113 infra.
47. Judge Celebrezze did refer to Chelsea in a footnote. 542 F.2d at 325 n.8.
48. Id. at 318.
49. Id.
50. This statement seriously misrepresents Shapiro. District Court Judge Tenney explicitly stated that the duty to disclose material inside information arises only “when one in possession of material inside information decides to trade.” Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 353 F. Supp. 264, 278 (S.D.N.Y. 1972). In other words, there is a duty to disclose before trading can
act of trading which alone constitutes the violation of rule 10b-5, and
this act itself must alter the plaintiff's expectations. The defendant's
act of trading must be the direct cause of a plaintiff's injurious
purchase or sale.\textsuperscript{51} Rule 10b-5 recovery for injury sustained in an
open market, nondisclosure transaction was thus severely limited, if
not entirely eliminated.

The Sixth Circuit had to reconcile its harsh decision with \textit{Affiliated
Ute Citizens v. United States}.\textsuperscript{52} In \textit{Affiliated Ute}, the Supreme Court
held that reliance was not a prerequisite to recovery in a private
cause of action brought under 10b-5.\textsuperscript{53} The \textit{Fridrich} court interpreted the \textit{Affiliated Ute} opinion as having eliminated the reliance
requirement only in face-to-face transactions and not in impersonal-
market situations. Therefore, the court ruled that \textit{Affiliated Ute} did
not apply to the facts in \textit{Fridrich}.\textsuperscript{54}

The \textit{Fridrich} court justified the rejection of the Second Circuit's
view and the resulting imposition of the privity and direct causation
requirements on several grounds. First, the court felt that failure to
impose these requirements would lead to an "unjust and unworkable
result"\textsuperscript{55} by generating numerous plaintiffs who would be compens-
able at the expense of a defendant whose trading had not caused
their losses. Furthermore, the court reasoned that although its deci-
sion would arguably decrease the deterrent impact of rule 10b-5,
SEC sanctions authorized by the 1934 Act, coupled with available
remedies at state law, would have a "significant impact" on insider
misconduct.\textsuperscript{56} However, the \textit{Fridrich} court refused to decide whether
this "significant impact" would sufficiently deter insider trading,\textsuperscript{57}
noting that a "similar" deterrence argument was held "unpersuasive
by the Supreme Court in \textit{Bangor Punta Operations v. Bangor & A.R.
Co.}"\textsuperscript{58}

\textsuperscript{51} 542 F.2d at 319-20. For further discussion of differing interpretations of
\textit{Affiliated Ute}, see notes 104-18 and accompanying text infra.
\textsuperscript{52} 406 U.S. 128 (1972).
\textsuperscript{53} Id. at 153.
\textsuperscript{54} Id. at 319-20.
\textsuperscript{55} Id. at 321-22.
\textsuperscript{56} Id. at 322.
Elimination of the threat of "Draconian liability" in the open market situation was also cited as justification for narrowing the civil remedy under rule 10b-5. Exorbitant damages, the court held, would "create a windfall for those fortuitous enough to be aware of their nebulous legal rights, and impose what essentially must be considered punitive damages almost unlimited in their potential scope."60

At the outset of the opinion, Judge Engel announced the primary issue before the court. "In the final analysis, the question is how far the courts are to extend the private civil right of action under Section 10(b) and Rule 10b-5 when the alleged violation is the unlawful use of inside information and the stock involved is traded upon an impersonal market."61 The court held that recovery would not be extended to those situations where privity and reliance were not proven.62 Yet, Judge Engel refused to hold that the civil remedy under rule 10b-5 would be extended to impersonal market situations even where direct causation in fact was established.63

AN ANALYSIS OF FRIDRICH

The Fridrich approach to the private right of action under rule 10b-5 is the antithesis of the Second Circuit's approach. The latter view concededly creates difficulties in administering the rule 10b-5 action in the impersonal market arena. The size of the plaintiff class generated by the elimination of privity and reliance requirements, and the defendant's corresponding liability, may well be enormous. Fridrich dealt with these problems in an interesting manner. Rather than preserve rule 10b-5 recovery and minimize the defendant's liability by fashioning appropriate relief, the Sixth Circuit chose to eliminate the plaintiff's right of recovery altogether.

This approach seems too simplistic. Although there is no problem with excessive damages when there is no right of recovery, the

Operations v. Bangor & Aroostook Rwy. Co., 417 U.S. 703 (1974), did not deal with insider trading. The decision involved a rule 10b-5 private damage action alleging corporate mismanagement. The plaintiff sought to recover the $5,000,000 it had paid for the stock of the subsidiary and additionally sought to keep this stock. The Supreme Court refused to extend 10b-5 liability to this extreme. Hence, the Court had no reason to pass on the deterrent effect of a rule 10b-5 action for insider trading, and therefore it did not rule on this issue.

59. 542 F.2d at 309.
60. Id. at 321. Judge Celebrezze offered the identical justification in his concurring opinion. Id. at 323 (Celebrezze, J., concurring).
61. Id. at 314.
62. Id. at 320.
63. Id. at 320 n.27. The court stated that "we specifically do not reach 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." Id.
plaintiff is left in the unfortunate position of having no redress for the injury incurred by reason of the defendant's insider trading on the open market. The *Fridrich* court justified the eradication of the plaintiff's right of recovery on several grounds. The validity of the *Fridrich* decision can be tested only on the strength of those justifications proffered by the court.

**SEC Enforcement Activities and Recovery Under State Law**

One justification for the abolition of the plaintiff's right of rule 10b-5 recovery in open market situations was the court's belief that SEC proceedings coupled with state remedies would significantly deter insider misconduct occurring in the anonymous markets. However, it is doubtful that the SEC has the ability to litigate the number of private rule 10b-5 actions currently on the court's dockets. The SEC is understaffed and operates on a limited budget. For example, the SEC's New York Regional Office is manned by a staff of fewer than 185 people and operates on a budget of less than $3,000,000. Mr. Moran, the supervisor of the New York office in 1974, was not optimistic about curbing securities frauds: "The ingenuity and crookedness of mankind never ceases. . . . I never know what mankind is going to do next." Furthermore, the SEC is not a private collection agency. The SEC functions more effectively under rule 10b-5 by placing emphasis on disciplinary and investigatory proceedings "unaccompanied by novel claims for restitutionary relief."

The SEC has no power to levy fines or to force people or commercial entities to surrender profits obtained in violation of rule 10b-5. However, disgorgement of profits has been granted by the federal

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64. *Id.* at 321-22.
67. *Id.*, at 239.
courts in the form of ancillary relief. 70 Although the SEC continually increases its enforcement activities, the number of securities frauds rises at an astounding rate. 71 The net result is that those investors actually injured by insider trading when dealing on the impersonal markets cannot be adequately compensated by SEC anti-fraud activity.

State law is of little more assistance in curbing fraud in the open markets. 72 Those jurisdictions enforcing the rigid requirements of common law fraud essentially eliminate recovery in impersonal market situations to the same extent as has Fridrich. 73 Furthermore, although the "special circumstances rule," which some jurisdictions apply, eliminates the requirement of a material, affirmative misrepresentation, it nonetheless retains the requirements of privity and reliance. 74

The most liberal state law approach was taken by the New York Court of Appeals in Diamond v. Oreamuno. 75 This case involved a shareholder's derivative suit alleging breach of fiduciary duty by the President and Chairman of the Board. The defendants had used inside information to reap short-swing profits. The court in essence applied section 16(b) of the 1934 Act. 76 Under section 16(b), if a ten-percent shareholder, a director, or an officer of a company makes a profit on the purchase and sale or sale and purchase of the company's securities within a six-month period, the profit must be returned to the issuing company. Because the defendants in Diamond were either directors or officers, the New York Court of Appeals required the return of their profits to the corporation. However, the validity of Diamond is certain only in New York. 77 Furthermore, the section

72. See Ratner, Federal and State Roles in the Regulation of Insider Trading, 31 Bus. Law. 947 (1976) ("If there is an appropriate place for state law in [the area of insider trading] it should apply to those cases of essentially local concern . . .") Id. at 948.
73. E.g., Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659 (1933). Commentators have frequently recognized the necessity of departure from the rigid requirements of common law fraud if the ultimate goals of the securities laws are to be accomplished. See, e.g., 3 A. Bromberg, SECURITIES LAW REGULATION § 8.4(513), at 204.115 (1977).
77. See Schein v. Chasen, 313 So. 2d 739, 746 (Fla. 1975), where the Florida Supreme Court rejected the "innovative ruling of the New York Court of Appeals" in Diamond.
16(b) theory of recovery returns profits to the corporation and is of no benefit to the private plaintiff who seeks to recover personally for injuries occasioned by the defendant's inside trading.

The impact of state law remedies coupled with SEC activities is not so "significant" as to warrant abolition of the private right of action under rule 10b-5. Even if state substantive law were to develop judicially implied actions similar to those under rule 10b-5, the Fridrich contention would still be only partially correct because the procedural advantages of rule 10b-5 are far greater than those existing under state law.

If securities frauds are to be minimized, the use and deterrent effect of the private right of action under rule 10b-5 must be maximized. In Blue Chip Stamps v. Manor Drug Stores,78 Justice Rehnquist, writing for the majority, stated that "[p]rivate enforcement' of Commission rules may [provide] a 'necessary supplement' to SEC action."79 Such "private enforcement" relating to activities on national markets should be vested in a single, nationwide judiciary to preserve uniformity in securities law as well as in the availability of recovery. The federal courts, enforcing federal securities law, are far better equipped to handle this task than are the various state courts.80

Elimination of Excessive Damages

The Sixth Circuit also justified the imposition of privity and causation requirements as a necessary measure to avoid effectively the threat of "Draconian" damages.81 However, in the process, rule 10b-5 recovery in open market situations was eliminated. As discussed above, the Second Circuit's deletion of privity and reliance as requisites to recovery under rule 10b-5 brought this "threat" into existence.82 The Shapiro court dealt with this damages problem by remanding the case to the district court for "appropriate relief."83 Neither method of dealing with the damages issue is really sufficient,

78. 421 U.S. 723 (1975).
79. Id. at 730 (quoting J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964)).
80. See Ratner, Federal and State Roles in the Regulation of Insider Trading, 31 Bus. Law. 947 (1976). ("Federal law should become the exclusive source of sanctions against insider trading in publicly held corporations, not by formal preemption of state law, but by providing a rational and workable system of sanctions that makes state remedies superfluous." Id. at 948.).
82. See notes 27-28 and accompanying text supra.
83. 495 F.2d at 242.
although the Shapiro rule does not include the elimination of all recovery, as does Fridrich’s novel approach.

Throughout the development of civil remedies under rule 10b-5 the federal courts have used three different measures of damages: the “rescission” measure, which restores to the plaintiff the difference between the price at which he bought or sold and the value of the stock at the time of suit; the “out-of-pocket” measure, which returns to the plaintiff the difference between the price paid and the real value at the time of purchase had disclosure been made; and the “expedient out-of-pocket” measure, defined as the difference between the purchase price and the actual market price a reasonable time after the nondisclosure has been cured.

The application of any one of these measures to the large plaintiff class generated by the elimination of privity and reliance requirements could result in potentially enormous damages. For example, the damages under rule 10b-5 following the collapse of Equity Funding were estimated to have been in the vicinity of $800,000,000. Damages in SEC v. Texas Gulf Sulphur Co. were thought to be as high as $75,000,000, not all of which was attributable to insider trading. Although the tendency toward settlement has been great, and therefore, relatively few cases have reached the relief stage, still the threat of enormous liability exists. Neither Shapiro nor Fridrich dealt with this threat in a satisfactory manner. The question is whether this “threat” can be eliminated without denying rule 10b-5 recovery in open market, nondisclosure situations.

The American Law Institute (ALI) has proposed a measure of

85. E.g., Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968); Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965); All States Investors, Inc. v. Bankers Bond Co., 343 F.2d 618 (5th Cir. 1965).
damages specifically for private 10b-5 insider trading actions. This proposed measure would fix the defendant's maximum liability at the greater of the plaintiff's out-of-pocket damages per share multiplied by the number of shares purchased or sold by the defendant or the defendant's profit on his sale or purchase. The ALI has also proposed a measure of damages applicable to cases involving the filing of false registration statements under section 11 of the 1933 Act, which appears to be a viable—if not superior—measure for rule 10b-5 insider trading actions. This provision would limit the defendant's liability to the greater of $100,000, one percent (to a maximum of $1,000,000) of gross income in the defendant's last fiscal year, or the defendant's profit on the trade. In either case, the ALI proposed code provides that whenever a second action is filed against the defendant for the same violation, every court in which such action is pending shall stay the proceeding and submit the record or records before it to the judicial panel on multi-district litigation.

By employing measures similar to those proposed by the ALI, the threat of "Draconian liability" can be eliminated by imposition of a ceiling on the defendant's liability. In fact, the plaintiff in Fridrich suggested that an ALI measure of damages be applied in that case to avoid unlimited liability. Judge Engel rejected this suggestion on the grounds that the "courts are ill-fitted to the task of rulemaking which would be required." However, there appears to be little or no judicial support for Judge Engel's contention.

The Supreme Court on several occasions has acknowledged the power of the federal courts to fashion the right of recovery as well as the necessary relief for violation of a federal regulatory statute. In Affiliated Ute, the Court stressed that Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed "not technically and restrictively, but flexibly to effectuate its reme-

93. Id.
94. Id. § 1403(g).
95. Id. § 1409(c).
96. Id. § 1402(f)(B).
97. 542 F.2d at 322.
98. Id.
99. Judge Engel cited no authority in support of this contention. Id.
dial purposes.”101 In *J.I. Case Co. v. Borak*,102 the Court held that “[i]t is for the federal courts ‘to adjust their remedies so as to grant the necessary relief, where federally secured rights are invaded.’ ”103 The *Fridrich* court either ignored or was unaware of the above Supreme Court authority in declining to serve in a “rulemaking” capacity.

The reasoning set forth in *Fridrich* as justification for imposing both privity and reliance as prerequisites to recovery under rule 10b-5 is suspect. The SEC and state courts are not adequately equipped to curb fraud in the securities markets. The threat of “Draconian liability” can be eliminated by fashioning an appropriate measure of damages without denying a right of recovery under rule 10b-5 in impersonal market situations. Finally, the federal courts have both the ability and the Supreme Court’s authorization to fashion this relief.

**Affiliated Ute: The Source of Confusion?**

The imposition of the reliance requirement by the *Fridrich* court was not only unjustified but was also contrary to the weight of authority. Both *Shapiro*104 and *Fridrich*105 cited the Supreme Court’s decision in *Affiliated Ute* as controlling. Yet, each court reached an entirely different result as to whether a showing of reliance was a prerequisite to recovery under rule 10b-5.

*Affiliated Ute* involved a deliberate scheme on the part of the defendant bank employees to induce the plaintiff Indians to sell their stock. The resulting sales were made without the benefit of material inside information which the defendants had failed to disclose. The Court ruled that the defendants were properly held liable under rule 10b-5 even though reliance had not been proven.

One portion of the holding has been a source of confusion in rule 10b-5 suits: “Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery.”106 The Sixth Circuit in *Fridrich* interpreted this passage as requiring positive proof of reliance in impersonal-market transactions while dispensing with that requirement in face-to-face transactions.107 Under this interpretation, the phrase “under the cir-

103. Id. at 433 (quoting Bell v. Hood, 327 U.S. 678, 684 (1946)).
104. 495 F.2d at 240.
105. 542 F.2d at 319-20.
106. 406 U.S. at 153.
107. 542 F.2d at 319-20. Judge Engel stated that “[t]he type of relationship existing between the plaintiffs and defendants in *Affiliated Ute* is totally absent here.” Id. at 320.
cumstances of this case" limits the Affiliated Ute holding solely to the face-to-face transactions which were involved in the case.

The Shapiro court, on the other hand, cited the holding in Affiliated Ute as warranting the conclusion that "causation in fact has been established" by a showing of trading on material inside information. Thus, in the Second Circuit reliance is no longer a prerequisite to recovery under rule 10b-5 in face-to-face or in impersonal market transactions.

An objective analysis of the disputed passage weighs heavily in favor of the Shapiro approach. Immediately following this passage, the Supreme Court cited Bromberg's treatise on securities fraud, where Bromberg stated: "Alternatively, reliance may be presumed from materiality . . . , and it makes sense; once the latter is shown, the reasonably prudent investor would be expected to rely." The Court also referred to Chasins v. Smith, Barney & Co., where the Second Circuit held that "[c]ausation in fact or adequate reliance was sufficiently shown" by proof of the defendant broker's recommendation to purchase without disclosure of a material fact.

The fact that the above authorities were cited following the disputed passage in Affiliated Ute, coupled with the reasonable interpretation that the "circumstances of this case" referred to a case involving "primarily a failure to disclose," indicates that the Shapiro interpretation is the most accurate. Furthermore, in Mills v. Electric Auto Lite Co., the Supreme Court held that "[w]here there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress." Thus, definite support exists for the Shapiro view.

Since Affiliated Ute was decided, the vast majority of lower courts

108. 495 F.2d at 240.
110. 3 A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10b-5, § 8.6(2), at 212 (1977).
111. 438 F.2d 1167 (2d Cir. 1970).
112. Id. at 1172.
113. Affiliated Ute Citizens v. United States, 406 U.S. at 153. Judge Timbers so interpreted Affiliated Ute in Shapiro. He stated that "[t]he rule [in Affiliated Ute] is dependent not upon the character of the transaction—face-to-face versus national securities exchange—but rather upon whether the defendant is obligated to disclose the inside information." 495 F.2d at 240.
115. Id. at 385.
have followed the Shapiro view either by adopting a presumption that causation in fact is established on a showing of trading without disclosure of material inside information\(^{116}\) or by eliminating the causation requirement altogether.\(^ {117}\) The Sixth Circuit, by requiring proof of reliance, decided contrary to the great weight of judicial authority.\(^ {118}\)

**POLICY CONSIDERATIONS**

The soundness and value of both Shapiro and Fridrich should also be judged in terms of the policy underlying the private right of action under rule 10b-5.\(^ {119}\) The Supreme Court on a number of occasions has attempted to define the parameters of this policy, which was set forth most vividly in *Superintendent of Insurance v. Banker's Life & Casualty Co.*\(^ {120}\) Justice Douglas stated:

Hence we do not read § 10(b) as narrowly as the Court of Appeals; it is not 'limited to preserving the integrity of the securities markets ... \(^ {121}\) though that purpose is included.

... [W]e read § 10(b) to mean that Congress meant to bar deceptive devices and contrivances in the purchase or sale of securities whether conducted in the organized markets or face to face.\(^ {122}\)

The Supreme Court's position on the policy underlying the private

\(^{116}\) *E.g.*, Chelsea Assocs. v. Rapanos, 527 F.2d 1266 (6th Cir. 1975); Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975); Rochez Bros. v. Rhoades, 491 F.2d 402 (3d Cir. 1974); Reeder v. Mastercraft Elec. Corp., 363 F. Supp. 574 (S.D.N.Y. 1973); Taylor v. Smith, Barney & Co., 358 F. Supp. 892 (N.D. Utah 1973). These courts have interpreted the *Affiliated Ute* decision as setting forth a "presumption" that positive proof of reliance is not a prerequisite to recovery. However, the word "presumption" does not appear in *Affiliated Ute*, as was noted in Chris-Craft Indus. v. Piper Aircraft Corp., 480 F.2d 341, 400 (2d Cir.), cert. denied, 414 U.S. 910 (1973).


\(^{118}\) One other court has held, without mentioning *Affiliated Ute*, that the reliance requirement still exists. Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514 (10th Cir.), cert. denied, 414 U.S. 874 (1973).

\(^{119}\) *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), in which Justice Rehnquist stated:

> When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn. Such growth may be quite consistent with the congressional enactment and with the role of the federal judiciary in interpreting it ..., but it would be disingenuous to suggest that either Congress in 1934 or the Securities and Exchange Commission in 1942 foreordained the present state of the law with respect to Rule 10b-5. It is therefore proper that we consider ... what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither congressional enactment nor the administrative regulations offer conclusive guidance.

*Id.* at 737 (emphasis added).

\(^{120}\) 404 U.S. 6 (1971).

\(^{121}\) Justice Douglas was quoting from the court of appeals opinion. 430 F.2d 355, 361 (2d Cir. 1971).

\(^{122}\) 404 U.S. at 12 (emphasis added).
right of action under rule 10b-5 is quite clear: The private right of action under rule 10b-5 is to function as a "necessary supplement to Commission action" while simultaneously encouraging enforcement of the securities exchange provisions in the "organized markets or face-to-face." The primary purpose of the private right of action is to compensate plaintiffs for damages caused by the defendant's illegal acts. The Fridrich approach to rule 10b-5 in open market, nondisclosure situations is so restrictive that in most cases an injured plaintiff is denied any right of recovery under the rule. The results of the imposition of privity and reliance requirements are diametrically opposed to the policy considerations set forth by the Supreme Court. The Court never chose to eliminate recovery under rule 10b-5 in open market situations while administering relief in face-to-face transactions. Yet, the holding in Fridrich has accomplished this result. The Sixth Circuit has been unable to justify adequately this departure from the policy considerations and from the judicial authority supporting rule 10b-5.

Shapiro does not differentiate between open market and face-to-face transactions but grants relief to any injured plaintiff. Thus, Shapiro is far more conducive to achieving the policy underlying rule 10b-5 and its implied private right of action. Liability extends to any purchase or sale of securities involving material nondisclosure. The elimination of privity and reliance poses a potential threat of "Draconian liability." However, the federal courts can avoid this threat in the future by following those measures set forth by the ALI.

CONCLUSION

Prior to Fridrich an investor was no less worthy of protection under rule 10b-5 because he had dealt on an impersonal exchange than he would have been had he conducted a face-to-face transaction. Following the Fridrich holding, the plaintiff is denied a right of recovery in impersonal market situations on the ground that the defendant, who has admittedly violated rule 10b-5, must be protect-
ed from excessive liability. However, the reasoning of *Fridrich* is fallacious in two respects. First, the law ought not protect the wrongdoer at the expense of the injured party; rather, the reverse should be true. Second, the defendant's liability can easily be limited without denying the plaintiff's private recovery under the rule.

As a practical matter, proof of the existence of privity between plaintiff and defendant in the impersonal market transaction is virtually impossible. Reliance is even more difficult to establish. If these requirements are imposed, the private remedy under rule 10b-5 is effectively eliminated in the anonymous market situation. No longer could private enforcement of rule 10b-5 serve as a "necessary supplement" to SEC enforcement activities. The deterrent effect of rule 10b-5 would be diminished to a state of debilitation, and securities frauds could with impunity increase in geometric proportions rather than at the current "astounding rate."

If the defendant is to be held liable for violation of rule 10b-5 in the open market transaction, and if the plaintiff is to be protected from securities frauds, recovery under the rule must not be conditioned upon privity and reliance. The Second Circuit wisely discards the privity requirement and significantly relaxes the causation element. To do otherwise returns the investor to the limited-recovery world of common law fraud, immunizes the defendant from civil liability, and seriously frustrates the policy underlying section 10(b) of the 1934 Act, rule 10b-5, and the concomitant implied right of action.

**Clyde C. Greco, Jr.**

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