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# THE INSIDER TRADING AND SECURITIES FRAUD ENFORCEMENT ACT OF 1988

HOWARD M. FRIEDMAN†

*In enacting the Insider Trading and Securities Fraud Enforcement Act ("ITSFEA"), Congress added another weapon to the Securities and Exchange Commission's arsenal used to combat insider trading. The Act made a number of changes to the law, but perhaps more importantly, ITSFEA seems to have effected a number of less-than-obvious changes to insider trading law. In this Article Professor Howard Friedman summarizes the Act's major provisions. In addition, the author analyzes the pre-existing state of insider trading law and ITSFEA's legislative history to highlight the importance of the Act's hidden changes to insider trading jurisprudence.*

On November 19, 1988, the President signed the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA").<sup>1</sup> The Act made a number of obvious changes in the law. In addition, and perhaps as importantly, it may have effected a number of less-than-obvious changes through provisions whose impact lay buried in language that assumes significance only upon a close examination of the Act's legislative history and of the pre-existing state of insider trading jurisprudence. The most significant of these hidden changes in the law were provisions that arguably resulted in (1) validation of the Securities and Exchange Commission's ("SEC") rule 14e-3, which prohibits one from trading while in the possession of material undisclosed information about an upcoming tender offer; (2) solving the conundrum of "transactional causation" in insider trading cases; and (3) creating the basis for applying a uniform five-year statute of limitations to all rule 10b-5 claims.

This Article chronicles the background of ITSFEA, summarizes the Act's major provisions, and analyzes the hidden changes in law made by some of those provisions.

## I. THE CONTEXT AND BACKGROUND OF ITSFEA

### A. The New "Insider" Trading Problem

The general problem of insider trading is hardly new. Insider trading holds great potential for profit, and most often occurs when the inside information involves unexpected events crucial to assessing a company's value. In these

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1. Pub. L. No. 100-704, 102 Stat. 4677 (codified in scattered sections of 15 U.S.C. § 78 (1988 Supp.)). For a discussion of the proposals leading to the enactment of ITSFEA, see Aldave, *The Insider Trading and Securities Fraud Enforcement Act of 1988: An Analysis and Appraisal*, 52 ALB. L. REV. 893, 893-905 (1988).

cases, the market has not adjusted stock prices in anticipation of the development so that large price movements can be expected upon public disclosure.<sup>2</sup>

As early as 1914 the New York Stock Exchange (NYSE) amended its listing agreement to require prompt disclosure by listed companies of actions relating to dividends and interest.<sup>3</sup> The amendment represented the NYSE's reaction to stock price distortions and the potential for insider trading caused by Goodrich Rubber Co.'s failure to disclose the declaration of a dividend that was to be payable several months after its declaration.<sup>4</sup> Twenty years later, in Section 16 of the Securities Exchange Act of 1934,<sup>5</sup> Congress directly dealt with some of the dangers from insider trading by permitting recovery on behalf of the issuer for profits realized from a pair of transactions conducted within six months of each other by specified insiders.<sup>6</sup> As the Senate Committee Report on the 1982 Act stated:

The bill further aims to protect the interests of the public by preventing directors, officers, and principal stockholders of a corporation, the stock of which is traded in on exchanges, from speculating in the stock on the basis of information not available to others. . . . Such a provision [Section 16] will render difficult or impossible the kind of transactions which were frequently described to the committee, where directors and large stockholders participated in pools trading in the stock of their own companies, with the benefit of advance information regarding an increase or resumption of dividends in some cases, and the passing of dividends in others.<sup>7</sup>

Because much insider trading fell outside the proscription of Section 16,<sup>8</sup> however, SEC rule 10b-5<sup>9</sup> became the predominant tool for use against tradi-

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2. See generally Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984) (discussing effects of the distribution of information on market efficiency).

3. See Westwood & Howard, *Self-Government in the Securities Business*, 17 LAW & CONTEMP. PROBS. 518, 524 (1952).

4. *Id.* For the current NYSE requirements for listed companies in this regard, see NYSE LISTED COMPANY MANUAL §§ 202.05 - .06 (1983).

5. Securities Exchange Act of 1934, ch. 404 § 16, 48 Stat. 881, 886-87 (1934) (current version at 15 U.S.C. § 78p (1982)). See generally A. JACOBS, SECTION 16 OF THE SECURITIES EXCHANGE ACT (1989) (comprehensive discussion of Section 16).

6. Section 16 covers short-swing transactions by directors, officers, and persons beneficially owning more than 10% of a class of equity securities of an issuer that is registered pursuant to § 12 of the Securities Exchange Act. 15 U.S.C. § 78p (1982).

7. S. REP. NO. 792, 73rd Cong., 2d Sess. 9 (1934).

8. Much insider trading involves a span of more than six months between the purchase and sale or sale and purchase. Some insider trading is undertaken by employees and other insiders, or by tippees, who are not officers, directors or over-10% shareholders. Some insider trading involves securities of an issuer that is sufficiently small or closely held that it is not required to register under § 12 of the Securities Exchange Act.

9. Rule 10b-5 under the Securities Exchange Act of 1934 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would oper-

tional insider trading. In its decision in *In re Cady, Roberts & Co.*<sup>10</sup> the SEC held that insider trading on unreleased news of a dividend cut by persons in a special relationship with the company and privy to its internal affairs amounted to a practice that operated as a fraud or deceit on purchasers, in violation of rule 10b-5, clause (3).<sup>11</sup>

Initially, the typical insider trading case involved advance knowledge of dividend<sup>12</sup> or earnings<sup>13</sup> changes, or undisclosed information about assets<sup>14</sup> or operations<sup>15</sup> of the issuer.<sup>16</sup> However, with the rise of hostile cash tender offers made at large premiums over current market,<sup>17</sup> advance information about upcoming tender offers became a prime source of insiders' profits.<sup>18</sup> Advance information about tender offers involved two new and different elements from traditional insider trading cases that made it difficult for courts to find violations of rule 10b-5.

First, information about tender offers related not to information about business developments of the issuer; rather, it was "market information,"<sup>19</sup> that is, information about the amount that some third party was willing to pay in the market for the issuer's stock. Second, the information often came not from the issuer or its officers or directors, but rather from the third party who was contemplating the making of the tender offer. Thus, individuals were profiting from the use of material undisclosed information, but not from information that belonged to the issuer whose shares were being traded as in the case of traditional insider trading. The notion of insider trading as a kind of misappropriation of corporate assets<sup>20</sup> thus could not be superimposed on this sort of transaction.

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ate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1989).

10. 40 S.E.C. 907 (1961).

11. *Id.* at 913.

12. *Id.*

13. *E.g.*, *Elkind v. Liggett & Myers Inc.*, 635 F.2d 156, 160 (2d Cir. 1980); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* 495 F.2d 228, 231-32 (2d Cir. 1974); *In re Ward LaFrance Truck Corp.*, 13 S.E.C. 373, 374-78 (1943).

14. *E.g.*, *SEC v. MacDonald*, 699 F.2d 47, 48-49 (1st Cir. 1983); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 840-42 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

15. *E.g.*, *State Teachers Retirement Bd. v. Fluor Corp.*, 654 F.2d 843, 846-48 (2d Cir. 1981).

16. See 3 A. BROMBERG & L. LOWENFELS, *SECURITIES FRAUD & COMMODITIES FRAUD* § 7.4 (200)-(219) (1988) (discussion of numerous traditional insider trading cases). The rich, but publicly unanticipated, mineral find involved in the famous *Texas Gulf Sulphur* litigation presents a paradigm for insider trading because of the magnitude of the unanticipated inside information involved. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied sub nom. Coates v. SEC*, 394 U.S. 976 (1969); *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971).

17. See TENDER OFFERS, DEVELOPMENTS AND COMMENTARIES 10-11 (1985); M. SALTER & W. WEINHOLD, *MERGER TRENDS AND PROSPECTS FOR THE 1980's* (1980).

18. See *GAO Says More Precise Definition of Insider Trading May Be Necessary*, 20 Sec. Reg. & L. Rep. (BNA) 1475 (1988).

19. See Fleischer, Mundheim & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 810-12 (1973).

20. See, e.g., *Diamond v. Oreamuno*, 24 N.Y.2d 494, 503-04, 248 N.E.2d 910, 915-16, 301 N.Y.S.2d 78, 85-86 (1969) (common-law treatment of insider trading as misappropriation of corporate asset).

Instead, other notions of wrongfulness were required in order to bring this type of trading within the ambit of rule 10b-5.

### B. *The Supreme Court's Reshaping of the Law*

Courts facing the problem of market information originating with third parties had difficulty bringing the cases within the traditional conception of "insider trading" under rule 10b-5. Insider trading involves not affirmative misstatements or half truths; rather, it involves market participants remaining totally silent about material information. If silence amounts to an act or practice that operates as a fraud, it is because the defendant had a duty to speak.<sup>21</sup> Courts could easily find such a duty when the insider trading on nonpublic information was an officer or director of the issuer.<sup>22</sup> Courts were also willing to find that one class of outsiders—tippees of insiders—violated rule 10b-5 by aiding in the insider's breach of duty.<sup>23</sup> But courts refused to impose a duty on all outsiders to disclose material information<sup>24</sup> before they traded.<sup>25</sup> The expansion of disclosure obligations under rule 10b-5 to large classes of outsiders was accomplished only through the development of the misappropriation theory.

Theories, such as the one describing insider trading, have their own inexorable internal logic. For example, once tippees were found to be in violation of insider trading proscriptions solely by reason of their abetting an insider's breach of duty, it became clear that some traders might obtain information from insiders other than through the insider's breach of duty. In such cases, logic compelled that the trader could freely take advantage of the publicly undisclosed information in the same way as information lawfully obtained from third parties.<sup>26</sup> Justice Holmes' aphorism that "the life of the law has not been logic: it has been experience"<sup>27</sup> is as applicable, however, to the regulation of securities fraud as it is to the common law more generally. The perceived unfairness of trading, even by outsiders, on at least certain kinds of undisclosed material information led the SEC to seek an alternative theory for imposing sanctions upon those who used wrongfully obtained information for personal profit. As discussed below,<sup>28</sup> the availability of that theory—commonly called the misappropriation theory—was ultimately confirmed by judicial and legislative action, albeit without broad justification for drawing the lines where they were drawn.

The Supreme Court first faced the issue of nontippee "outsider" trading on

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21. *Chiarella v. United States*, 445 U.S. 222, 227-29 (1980).

22. *Id.*

23. *Id.* at 230 n.12.

24. *Id.* at 227-37. For a discussion of the *Chiarella* case, see *infra* text accompanying notes 29-38.

25. While this rule might lead to some financial unfairness, one theory suggests that the strong policy of encouraging the search for corporate and economic information which will make securities markets more efficient justifies the costs of the rule. Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 339-43 (1979).

26. See *Dirks v. SEC*, 463 U.S. 646, 665-67 (1983).

27. O.W. HOLMES, *THE COMMON LAW* 1 (1881).

28. For a discussion of the misappropriation theory, see *infra* notes 53-64 and accompanying text.

material, undisclosed information in *Chiarella v. United States*.<sup>29</sup> Vincent Chiarella, the defendant whom the trial court criminally convicted, worked in the composing room of a New York financial printer as a "markup man."<sup>30</sup> He obtained the names of target companies in upcoming tender offers from the bidders' announcements that he handled and purchased stock in those targets before the offers were publicly announced.<sup>31</sup> He made slightly more than \$30,000 in profits by reselling these shares upon public announcement of the tender offers.<sup>32</sup> The Supreme Court reversed his conviction, finding that Chiarella had no duty to disclose information that he knew before trading in the market.<sup>33</sup> Silence, the Court held, amounts to fraud only if there is a duty to speak.<sup>34</sup>

*Chiarella* made clear that rule 10b-5 did not apply merely because a buyer or seller obtained an unfair advantage over less informed buyers or sellers through his use of undisclosed material information.<sup>35</sup> Absent a duty to disclose, which is imposed upon corporate insiders because of their fiduciary duties to shareholders,<sup>36</sup> informational imbalances in the marketplace will be tolerated. However, one group of outsiders, tippees of corporate insiders, will violate rule 10b-5 when they trade. These outsiders participate after the fact in the insider's breach of duty when they profit by the use of inside information that they know is confidential and that they know or should know came from a corporate insider.<sup>37</sup>

*Chiarella* laid to rest once and for all the notion that rule 10b-5 requires a level playing field for all investors. The Court declared that "neither the Congress nor the Commission ever has adopted a parity-of-information rule."<sup>38</sup> Three years later the Supreme Court pursued the logic of that conclusion by holding in *Dirks v. SEC*<sup>39</sup> that outsiders may use even some undisclosed material information obtained from insiders without violating rule 10b-5.<sup>40</sup>

If ever it were true that "hard cases make bad law," *Dirks* would be the case to make the point. Raymond Dirks, an officer of a broker-dealer firm, specialized in providing investment analysis of insurance company securities.<sup>41</sup> A former officer of Equity Funding informed Dirks that Equity Funding's assets were vastly overstated as a result of massive fraud, and encouraged Dirks to verify and disclose the fraud.<sup>42</sup> Dirks' subsequent investigation led to corroboration

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29. 445 U.S. 222 (1980).

30. *Id.* at 224.

31. *Id.*

32. *Id.*

33. *Id.* at 230-35.

34. *Id.*

35. *Id.* at 231-35.

36. *Id.* at 227-30.

37. *Id.* at 230-35.

38. *Id.* at 233.

39. 463 U.S. 646 (1983).

40. *Id.* at 664.

41. *Id.* at 648.

42. *Id.* at 649.

of the charges from various employees of Equity Funding. Dirks urged a Wall Street Journal reporter to write a story about the fraud, but the reporter refused, not believing that such a massive fraud could go undetected.<sup>43</sup> Dirks continued his investigation, discussing it openly with a number of clients and investors, as well as with the SEC. Some of those clients sold off their Equity Funding holdings before the fraud was finally exposed publicly.<sup>44</sup> The SEC in administrative proceedings formally censured Dirks, claiming that he illegally tipped inside information to potential traders.<sup>45</sup> The Supreme Court reversed that determination.<sup>46</sup>

In the Supreme Court's view, *Dirks* flowed logically from *Chiarella*. In determining whether a tippee may trade on undisclosed information, it is necessary to determine whether the insider's tip constituted a breach of the insider's fiduciary duty.<sup>47</sup> An insider breaches his duty only if he will personally benefit, either directly or indirectly from his disclosure of information, that is, only if he receives a pecuniary gain or a reputational benefit that will translate into future earnings.<sup>48</sup> This may be shown by a relationship that suggests a quid pro quo from the tippee, by showing an intention to benefit the particular tippee, or by demonstrating a personal or family relationship that makes the tip and trade resemble trading by the insider followed by a gift of the profits to the recipient.<sup>49</sup> None of these elements was present in *Dirks*. The insiders' whistle blowing did not benefit the insiders personally; therefore they did not breach their duty to Equity Funding's shareholders. Absent such a breach, neither Dirks nor his tippees could have participated in a breach of duty.<sup>50</sup>

*Dirks* did concede that in addition to traditional insiders, persons such as underwriters, accountants, attorneys, or consultants may become temporary or constructive insiders when they enter into a special confidential relationship with an issuer and are given access to information solely for corporate purposes.<sup>51</sup> When such a person uses that inside information for trading, he violates rule 10b-5, and when he passes on that information, he should be treated as a tipper, not a tippee.<sup>52</sup>

One more piece is necessary to understand the state of insider trading law at the time of congressional enactment of ITSFEA. In *Chiarella*'s criminal prosecution, the United States suggested an alternative theory of liability under rule 10b-5 for outsiders—an approach known as the "misappropriation theory."<sup>53</sup>

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43. *Id.* at 649-50.

44. *Id.* at 649.

45. *Id.* at 650-52.

46. *Id.* at 667.

47. *Id.* at 661-62.

48. *Id.* at 662-63.

49. *Id.* at 664.

50. *Id.* at 661-67.

51. *Id.* at 655 n.14.

52. *Id.*

53. *Chiarella*, 445 U.S. at 235-27. See generally D. LANGEVOORT, INSIDER TRADING REGULATION 147-80 (1989 ed.) (discussing the misappropriation theory); Aldave, *The Misappropriation Theory: Carpenter and its Aftermath*, 49 OHIO ST. L.J. 373 (1988) (reviewing the misappropriation

The majority refused to examine the validity of the theory because, in its view, the trial court did not submit the theory to the jury at trial.<sup>54</sup> Chief Justice Burger, however, disagreed and explored the theory at length in his dissenting opinion.<sup>55</sup> He framed the theory succinctly:

As a general rule, neither party to an arm's length business transaction has an obligation to disclose information to the other unless the parties stand in some confidential or fiduciary relation. . . . This rule . . . provides incentive for hard work, careful analysis, and astute forecasting. But the policies that underlie the rule also should limit its scope. In particular, the rule should give way when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means. . . . [A] person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading.<sup>56</sup>

The misappropriation theory fit nicely into the language of rule 10b-5 as well. Fraud on a third person (for example, one's employer, as in *Chiarella*) may be "in connection with" the purchase or sale of securities. It need not be committed against the seller or purchaser to violate rule 10b-5.

The misappropriation theory was quickly adopted by the Second Circuit,<sup>57</sup> and the Third Circuit followed suit.<sup>58</sup> The Second Circuit cases that had adopted the misappropriation theory were not private damage actions; rather the cases involved criminal prosecutions or SEC injunctive actions. When the issue of the availability of a private action for damages based upon the misappropriation theory arose, the Second Circuit in *Moss v. Morgan Stanley, Inc.*<sup>59</sup> denied recovery on the ground that the duty which was breached was not a duty that the defendant owed to the plaintiff seller of securities, but rather a duty the defendant owed to his employer.<sup>60</sup> ITSFEA has overturned the result of *Moss*.

The Supreme Court considered the validity of the misappropriation theory in *Carpenter v. United States*.<sup>61</sup> Here, a Wall Street Journal reporter used information regarding the contents of upcoming newspaper columns for purposes of

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theory in light of Supreme Court's decision in *Carpenter v. United States*, 484 U.S. 19 (1987)); Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101 (1984) (arguing that a person commits fraud under rule 10b-5 when he misappropriates nonpublic information and uses it in purchasing and selling securities); Mitchell, *The Jurisprudence of the Misappropriation Theory and the New Insider Trading Legislation: From Fairness to Efficiency and Back*, 52 ALB. L. REV. 775 (1988) (discussing the misappropriation theory).

54. *Chiarella*, 445 U.S. at 235-37.

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

56. 445 U.S. at 239-40 (Burger, C.J., dissenting); cf. Brudney, *supra* note 25, at 353-67, 365 (rule 10b-5 should protect against "informational advantages" that cannot be legally "overcome or offset").

57. *SEC v. Materia*, 745 F.2d 197, 201 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985); *United States v. Newman*, 664 F.2d 12, 18 (2d Cir. 1981).

58. *Rothberg v. Rosenbloom*, 771 F.2d 818, 822-23 (3d Cir. 1985); see also *SEC v. Clark*, 699 F. Supp. 839, 845 (W.D. Wash. 1988) (adopting misappropriation theory in district court in Ninth Circuit).

59. 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984).

60. *Id.* at 12-13.

61. 484 U.S. 19 (1987).



tipping and trading in violation of his newspaper's confidentiality policy.<sup>62</sup> The Supreme Court affirmed by a four-to-four vote (and without discussion of the merits) the defendant's conviction under the misappropriation theory, thus postponing to another day its definitive ruling on the theory.<sup>63</sup> Congress' apparent endorsement of the misappropriation theory in ITSFEA will certainly influence that definitive ruling, if and when it comes.<sup>64</sup>

## II. THE IMPACT OF ITSFEA

Endorsement of the misappropriation theory was not the only item on the Congressional agenda. A wide array of proposals to clarify and expand the government's arsenal for combatting insider trading had been proposed in the months prior to the enactment of ITSFEA. ITSFEA adopted a number of these.

### A. Rule 14e-3

A few months after the Supreme Court's decision in *Chiarella* the SEC adopted rule 14e-3 under the Securities Exchange Act of 1934.<sup>65</sup> In the context of tender offers the rule explicitly prohibits the kind of misappropriation of material, nonpublic information in which *Chiarella* had engaged. ITSFEA appears to have clarified lingering doubts about the validity of rule 14e-3.<sup>66</sup>

Rule 14e-3 contains an "abstain or disclose" provision that applies whenever a bidder has taken substantial steps to commence, or has commenced, a tender offer.<sup>67</sup> In particular, absent public disclosure by press release or otherwise,<sup>68</sup> the rule prohibits trading by any person (other than the tender offeror) who possesses material information relating to the tender offer who knows or has reason to know both that the information is nonpublic and that it came from the bidder, the target company, or any officer, director, partner, employee, or other person acting on behalf of the bidder or the target company.<sup>69</sup> This prohibition on trading is not limited to insiders and their tippees and does not turn upon whether the information has been obtained through misappropriation.<sup>70</sup>

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62. *Id.* at 19.

63. *Id.* at 24.

64. See *infra* notes 130-37 and accompanying text.

65. 17 C.F.R. § 240.14e-3, adopted in Exchange Act Release No. 34-17120, Fed. Sec. L. Rep. (CCH) ¶ 82,646 (Sept. 4, 1980).

66. See *infra* notes 86-91 and accompanying text.

67. 17 C.F.R. § 240.14e-3(a) (1989).

68. Rule 14e-3 requires that the disclosure of the material information come within a reasonable time prior to the purchase or sale of the target company's shares and that it include the source of the information. *Id.* § 240.14e-3

69. Under rule 14e-3, no person in possession of such information may purchase or sell, or cause to be purchased or sold, any securities which are the subject of the tender offer (or securities convertible into them or options to obtain or dispose of them), unless she makes the required public disclosure first. *Id.*

70. In addition, rule 14e-3(d)(1) contains an antitipping provision which prohibits various persons from passing on information relating to a tender offer under circumstances in which it is reasonably foreseeable that the tip is likely to result in a violation of the rule's disclose or abstain provisions. *Id.* § 240.14e-3(d)(1).

Commentators have raised two major questions about the validity of rule 14e-3. First is the question whether the prohibitions of the rule which apply prior to the actual commencement of a tender offer—that is, which apply whenever a “substantial step or steps to commence”<sup>71</sup> a tender offer have been taken—are valid. Specifically, is activity undertaken prior to the actual commencement of a tender offer nevertheless “in connection with” a tender offer, as required by Section 14(e)<sup>72</sup> of the Securities Exchange Act?<sup>73</sup> Some cases suggest that Section 14(e) does not provide a cause of action for preoffer activities.<sup>74</sup> However, the one direct judicial challenge to rule 14e-3 on this ground has failed. In *O'Connor & Associates v. Dean Witter Reynolds, Inc.*<sup>75</sup> Federal district court Judge Lasker stated:

While . . . the scope of the Williams Act provisions is not infinitely expandable to apply to any acts preceding a tender offer proposal, we conclude that the conduct alleged here, insider trading on the basis of nonpublic information that a tender offer proposal was being considered by the target board and would soon be publicly announced, are [sic] among the ills at which the Williams Act is directed and that the SEC accordingly had authority to prohibit such conduct under § 14(e).<sup>76</sup>

The second major challenge to the validity of rule 14e-3 is whether, given the similarity between the language of Section 14(e) and rule 10b-5, rule 14e-3 can survive the Supreme Court's *Chiarella* analysis which requires “the existence of a [pre-existing] fiduciary duty to disclose.”<sup>77</sup> Section 14(e) contains two separate grants of authority to the SEC. The SEC may (1) define what are “fraudulent, deceptive, or manipulative acts or practices”; and (2) “prescribe means reasonably designed to prevent such acts and practices.”<sup>78</sup> This latter prophylactic rulemaking authority presumably gives the SEC broader authority than merely the power to define prohibited activity. In promulgating rules under Section 14(e), however, the SEC has distinguished carefully between defining fraud and promulgating rules to prevent fraudulent practices. While the antitipping provisions in rule 14e-3(d) were promulgated as prophylactic provisions, the basic “disclose or abstain” provisions of rule 14e-3(a) define fraudulent, deceptive, or manipulative acts or practices.<sup>79</sup>

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71. *Id.* § 240.14e-3(a).

72. 15 U.S.C. § 78n(e) (1982).

73. See Heller, *Chiarella*, *SEC Rule 14e-3 and Dirks: "Fairness" versus Economic Theory*, 37 BUS. LAW. 517, 542 (1982); American Bar Association, *Report of the Task Force on Regulation of Insider Trading*, 41 BUS. LAW. 223, 252 (1985); D. LANGEVOORT, *supra* note 53, at 193-94.

74. See *Panter v. Marshall Field & Co.*, 646 F.2d 271, 283-84 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); *Sanders v. Thrall Car Mfg. Co.*, 582 F. Supp. 945, 966-69 (S.D.N.Y. 1983), *aff'd*, 730 F.2d 910 (2d Cir. 1984).

75. 529 F. Supp. 1179 (S.D.N.Y. 1981).

76. *Id.* at 1192.

77. See Heller, *supra* note 73, at 544-45; see also American Bar Association, *supra* note 73, at 251-52 (“rule 14e-3 is inconsistent with the fraud rationale of . . . *Chiarella*”); D. LANGEVOORT, *supra* note 53, at 194-97 (the narrow *Chiarella* decision is controlled by the “common law restrictions on the affirmative duty to disclose”).

78. 15 U.S.C. § 78n(e) (1982).

79. This is made clear by the language of the rule itself. Rule 14e-3(d) prohibits tipping in

Given this framework, the issue is posed whether the SEC has exceeded its authority under Section 14(e) by defining trading on the basis of undisclosed information as fraudulent when the trader has no pre-existing duty to speak. It is clear following *Chiarella* that fraud for purposes of rule 10b-5 does not include silence when there is no pre-existing duty to speak. Does *Chiarella's* definition of fraud also apply to limit the SEC in defining fraud under its Section 14(e) authority? For example, when a trader is neither an insider nor a tippee of an insider, and has not otherwise misappropriated the information, can his failure to disclose material information—his silence—be a “fraudulent” practice within the meaning of Section 14(e)? The one court that has ruled on the issue has upheld the validity of rule 14e-3, but in a rather cryptic opinion. In *United States v. Chestman*<sup>80</sup> the court offered two rationales for upholding rule 14e-3. First, the court emphasized that Congress had given greater authority to the SEC under Section 14(e) than under Section 10(b). That greater authority, however, was primarily the power to prescribe means to prevent fraud, as well as to define it—the power which the SEC eschewed in promulgating the disclose or abstain provisions of Section 14e-3.<sup>81</sup>

The *Chestman* court's second rationale, focusing on congressional intent, is somewhat more convincing than its first. The court pointed to two pieces of legislative history. First, it pointed to the legislative history surrounding the enactment of the 1970 amendments to Section 14(e), which gave the SEC its rulemaking power under the section.<sup>82</sup> An SEC memorandum submitted to the Senate subcommittee in hearings on the bill described the types of practices that SEC rulemaking might cover. The memorandum included reference to persons who trade on undisclosed information about an upcoming tender offer, thereby giving some support to the promulgation of rule 14e-3.<sup>83</sup> Second, in the House Report on the Insider Trading Sanctions Act of 1984,<sup>84</sup> the committee recognized rule 14e-3 as one of the existing rules that prohibit insider trading and which therefore presumably would trigger civil liability under the penalty provisions of that Act.<sup>85</sup> Surprisingly, the court did not point to the most convincing piece of legislative history—the implicit approval of rule 14e-3 in ITSFEA, enacted only two months prior to the court's decision.

Section 2 of ITSFEA contains specific Congressional findings. The first of these findings states:

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various tender offer contexts “as a means reasonably designed to prevent fraudulent, deceptive or manipulative acts or practices within the meaning of section 14(e)” 17 C.F.R. § 240.14e-3(a) (1989) (emphasis added). Rule 14e-3(a) provides that “it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e)” to trade without disclosing specified information. *Id.* (emphasis added).

80. 704 F. Supp. 451 (S.D.N.Y. 1989).

81. See 17 C.F.R. § 240.14(e)-3(a) (1989).

82. Pub. L. No. 91-567, § 5, 84 Stat. 1497-98 (1970) (adding the last sentence of § 14(e)).

83. 704 F. Supp. at 456-57 (citing *Hearings on S. 3431 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency*, 91st Cong., 2d Sess. 12 (1970)).

84. For insider trading, the Act generally imposed civil penalties of up to three times profit gained or loss avoided. H.R. REP. NO. 355, 98th Cong., 1st Sess. 4 (1983).

85. 704 F. Supp. at 457 (citing H.R. REP. NO. 355, 98th Cong., 1st Sess. 13 n.20 (1983)).

(1) the rules and regulations of the Securities and Exchange Commission under the Securities Exchange Act of 1934 ("Exchange Act") governing trading while in possession of material, nonpublic information are, as required by such Act, necessary and appropriate for the Commission to carry out its responsibilities to act in the public interest and for the protection of investors.<sup>86</sup>

In discussing these findings, the House Report on ITSFEA states: "These findings are intended as an expression of congressional support for these regulations."<sup>87</sup>

It seems that this finding was designed, albeit somewhat inartfully, to validate rule 14e-3 as an exercise of SEC rulemaking authority under Section 14(e) of the Securities Exchange Act. Section 14(e) grants the SEC rulemaking power subject to the general limitation in Section 23(a)(1) that its rules be "necessary or appropriate to implement the provisions" of the Act.<sup>88</sup> Congressional language in ITSFEA, however, goes beyond a finding that the SEC's insider trading rules are merely "necessary" or "appropriate". Instead, the finding tracks the language of Section 10(b) of the Securities Exchange Act, which prohibits the use of manipulative or deceptive devices or contrivances "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."<sup>89</sup> Nevertheless, the congressional finding in ITSFEA seems designed to validate rule 14e-3. Validation of the insider trading rules promulgated under Section 10(b) was unnecessary because no question had been raised as to their validity. Rule 14e-3 was one of the few rules as to which any question of validity existed. Moreover, the language of Congress' statutory finding in ITSFEA, referring to SEC rules and regulations "governing trading while in possession of material, nonpublic information" is virtually identical to the language in rule 14e-3(a). No similar language appears in any of the insider trading rules promulgated under Section 10(b).

Thus, one important, albeit largely unnoticed, effect of ITSFEA should be to end further controversy regarding the SEC's authority to promulgate rule 14e-3. In addition, the enactment through ITSFEA of Section 20A of the Securities Exchange Act, discussed below,<sup>90</sup> makes it clear that a private right of action is available to contemporaneous purchasers or sellers against persons who have traded in violation of rule 14e-3.<sup>91</sup>

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86. H.R. REP. NO. 910, 100th Cong., 2d Sess. 35 (1988), *reprinted in* 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6072.

87. *Id.*

88. 15 U.S.C. § 78w(a)(1) (1982).

89. 15 U.S.C. § 78j(b) (1982).

90. See *infra* notes 129-211 and accompanying text.

91. See D. LANGERVOORT, *supra* note 53, at 265 (discussing the impact of § 20A on private rights of action under rule 14e-3). Prior to the enactment of ITSFEA, *O'Connor & Assocs. v. Dean Witter Reynolds, Inc.*, 529 F. Supp. 1179, 1193 (S.D.N.Y. 1981), had upheld the existence of such a cause of action.

### B. Clarification of Civil Penalty Provisions

ITSFEA has clarified pre-existing civil penalty provisions by providing that all tippers may be liable for civil penalties and specifying the penalty amounts that may be imposed upon tippers. In 1984, Congress enacted the Insider Trading Sanctions Act (ITSA)<sup>92</sup> which, for the first time, permitted the Commission to bring an action in federal district court to impose a civil penalty of up to three times profit gained or loss avoided against persons who violated the Securities Exchange Act or rules under it by trading in a security while in possession of material nonpublic information.<sup>93</sup> It similarly permitted an action for imposition of a civil penalty against any person who aided and abetted illegal trading by communicating material nonpublic information to a person who traded while in possession of such information.<sup>94</sup> ITSFEA has retained this liability,<sup>95</sup> while modifying the language of newly enacted Section 21A<sup>96</sup> to make clear that tippers may be liable for civil penalties when their tip involves a violation of law, even if they are not technically aiders and abettors.<sup>97</sup> This change was intended to insure that the civil penalty provisions were coextensive with the substantive law of insider trading which imposes independent liability under rule 10b-5 on tippers.<sup>98</sup>

ITSFEA and its legislative history also clarify the amount of civil penalties that may be imposed upon tippers. Section 21A(a)(2) caps the penalty at "three times the profit gained or loss avoided as a result of such unlawful purchase, sale, or communication." The House Report makes it clear, however, that the computation of penalties may include profit made (or loss avoided) by both the direct tippee and the remote tippees of the information as well.<sup>99</sup>

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92. Pub. L. No. 98-376, 98 Stat. 1264 (1984).

93. *Id.* § 2.

94. *Id.*

95. ITSFEA renumbered the civil penalty provision to make it § 21A of the Securities Exchange Act, Pub. L. No. 100-704, § 3, 102 Stat. 4677 (1988) (codified at 15 U.S.C. § 78u-1 (1988 Supp.)), and made the penalty provision applicable to actions occurring on or after November 19, 1988. Pub. L. No. 100-704, § 9, 102 Stat. 4684 (1988) (codified at 15 U.S.C. § 78o (1988 Supp.)). Section 21A(c) gives the SEC authority to exempt either by rule or order any person or transaction, or class of persons or transactions, from the civil penalty provisions. The exemptions may be either total or partial, and may be either unconditional or upon specific terms and conditions.

96. Section 21A was added by § 3 of ITSFEA, Pub. L. No. 100-704, § 3, 102 Stat. 4677 (1988) (codified as amended at 15 U.S.C. § 78u-1 (1988 Supp.)).

97. Section 21A(d) sets out procedures for collection of civil penalties, basically providing that the SEC may refer cases to the Department of Justice for collection when the defendant fails to pay the court-imposed penalty within the time prescribed in the court's order. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 467 (codified as amended at 15 U.S.C. § 78u-1(d) (1988 Supp.)). It also retains the statute of limitations of five years after the purchase or sale which was originally included in the Insider Trading Sanctions Act of 1984. *Id.* The potential implications of Congressional choice of a five-year statute for insider trading cases is discussed further below. See *infra* notes 185-211 and accompanying text.

98. H.R. REP. NO. 910, 100th Cong., 2d Sess. 18-19 (Sept. 9, 1988), reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6055-56 (citing Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299 (1985)). Congress saw this as merely clarifying its original intent in enacting the Insider Trading Sanctions Act of 1984. *Id.* at 19.

99. *Id.* at 20 n.16 (1988).

### C. Civil Penalties For Controlling Persons

ITSFEA generally has expanded the civil penalty provision of the 1984 Insider Trading Sanctions Act to cover not only traders and tippers, but also controlling persons who fail to take appropriate steps to prevent potential insider trading or tipping by their employees.<sup>100</sup> The House Committee described the reasons for the expansion of civil penalty liability made by ITSFEA as follows:

The Committee intends through the broadening of controlling person civil penalty liability to increase the economic incentives for such persons to supervise vigorously their employees. Effective supervision of securities firms of their employees and agents is a foundation of the federal regulatory scheme of investor protection. With respect to insider trading in particular, the necessity for appropriate supervision to prevent violations is evident in view of the special opportunities for abuse in this area.<sup>101</sup>

ITSFEA uses, but does not define, the term "controlling person." The legislative history of ITSFEA makes clear, however, that Congress intended to adopt the definition currently used under Section 20(a) of the Securities Exchange Act.<sup>102</sup> This definition was summarized as follows in the House Committee Report on ITSFEA:

"Controlling person" may include not only employers, but any person with power to influence or control the direction or the management, policies, or activities of another person. "Control" is inferred from possession of such power, whether or not it is exercised. The Committee expects the Commission and courts to continue to interpret the term "controlling person" on a case-by-case basis according to the factual circumstances.<sup>103</sup>

For broker-dealer or investment adviser firms which become potentially liable as controlling persons, ITSFEA imposes mandatory compliance programs. The firm must "establish, maintain and enforce written policies and procedures reasonably designed, taking into consideration the nature of [its business,] to prevent the illegal misuse . . . of material nonpublic information by [the firm] or by any person associated with [the firm]."<sup>104</sup> ITSFEA permits imposition of civil penalties on the firm as a controlling person if the SEC proves that it

100. ITSFEA precludes liability for the imposition of civil penalties solely because a person employs a violator, unless the employer meets the criteria in § 21A for controlling person liability. Securities Exchange Act § 21A(b)(2), 15 U.S.C. § 78u-1(b)(2) (1988 Supp.).

101. H.R. REP. NO. 910, 100th Cong., 2d Sess. 17, reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6054 (footnote omitted). See Kaswell, *An Insider's View of the Insider Trading and Securities Fraud Enforcement Act of 1988*, 45 BUS. LAW. 145, 152-64 (1989) (discussion of provision by House Committee's Minority Counsel). For a criticism of the imposition of treble damage penalties on employers, see Aldave, *supra* note 1, at 908-12.

102. 15 U.S.C. § 78t(a) (1982). Although the definition of "controlling person" is seen as identical to that in § 20(a), the substantive controlling person provisions and defenses of § 20(a) are made specifically inapplicable to the insider trading civil penalty provisions. Insider Trading and Securities Fraud Enforcement Act of 1988 § 3, Pub. L. No. 100-704, 102 Stat. 4677 (codified at 15 U.S.C. § 78u-1(b)(1)-(2) (1988 Supp.)).

103. H.R. REP. NO. 910, 100th Cong., 2d Sess. 17, reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6054 (citations omitted).

104. The required compliance programs are set out in § 15(f) of the Securities Exchange Act, 15

"knowingly or recklessly failed to establish, maintain, or enforce any policy or procedures required . . . , and such failure substantially contributed to or permitted the occurrence of the act or acts constituting the violation."<sup>105</sup>

While the Act does not set out precise compliance procedures for broker-dealer and investment advisory firms, the House committee report on ITSFEA states:

[T]he Committee expects that institutions subject to the requirements of this provision will adopt policies and procedures appropriate to restrict communication of nonpublic information and to monitor its dissemination, such as restraining access to files likely to contain such information; providing continuing education programs concerning insider trading; restricting or monitoring trading in securities relating to which the firm's employees possess nonpublic information; and vigorously monitoring and reviewing trading for the account of the firm or of individuals. . . . [T]he Committee would expect that a firm's supervisory system would include, at a minimum, employment policies such as those requiring personnel to conduct their securities trading through in-house accounts or requiring that any trading in outside accounts be reported expeditiously to the employing firm.<sup>106</sup>

In addition, ITSFEA gives the SEC authority to promulgate rules requiring specific compliance policies or procedures for broker-dealer or investment advisory firms.<sup>107</sup>

ITSFEA permits civil penalty liability to be imposed upon controlling persons who are not broker-dealers or investment advisers if the SEC establishes that they "knew or recklessly disregarded the fact that [the] controlled person was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent such act or acts before they occurred."<sup>108</sup> This provision creates special problems for employers whose firms are privy to material undisclosed information relating to issuers of securities or the market for securities. Thus, law firms, banks, accounting firms, financial publishers, and indeed issuers themselves now face the risk of civil penalties unless these firms adopt measures to control the risk of information misuse by employees.<sup>109</sup>

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U.S.C. § 78o(f) (1988), for registered broker-dealers, and in § 204A of the Investment Advisers Act, 15 U.S.C. § 80b-4a (1988 Supp.), for investment advisers.

105. Securities Exchange Act, § 21A(b)(1)(B), 15 U.S.C. § 78u-1(b)(1)(B) (1988 Supp.). The House Committee Report states that the causal connection is sufficient if the failure to maintain or enforce compliance policies or procedures "allowed the violation to occur, or . . . provided some assistance to the controlled person's violations." H.R. REP. NO. 910, 100th Cong., 2d Sess. 18, reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6055.

106. H.R. REP. NO. 910, 100th Cong. 2d Sess. 22 (1988), reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6059.

107. Securities Exchange Act, § 15(f), 15 U.S.C.A. § 78o(f) (1988 Supp.); Investment Advisers Act, § 204A, 15 U.S.C.A. § 80b-4a (1988 Supp.).

108. Securities Exchange Act § 21A(b)(1)(A), 15 U.S.C. § 78u-1(b)(1)(A) (1988 Supp.).

109. Appropriate steps to prevent misuse of inside information will vary depending upon the firm or business involved. Procedures may include a firm-wide policy statement, procedures to limit information to persons with a need to know ("Chinese Walls"), and specified prohibitions on trading activities by employees (for example, restricted lists or watch lists). See Eisenberg, *Protecting Against Insider Trading Liability*, 22 REV. SEC. & COMMODITIES REG. 87 (1989) (discussing procedures to prevent employer liability).

The potential penalties that may be imposed on controlling persons under ITSFEA differ to some extent from those penalties that may be imposed upon the controlled person. While the basic measure is still up to three times profit gained or loss avoided, in no event may the penalty exceed one million dollars.<sup>110</sup>

Furthermore, if the controlled person is a tipper and there are sub-tippees, liability of the controlling person is premised only upon profit gained or loss avoided "by the person or persons to whom the controlled person directed such communication."<sup>111</sup> The legislative history clarifies this language. When the person who has directly received a tip trades, a controlling person is liable for a penalty based upon the profit gained or loss avoided by the first level tippee. Should a first level tippee not trade and therefore receive no direct profit, but rather act as a conduit and pass on the information to others who do trade, the controlling person is not liable for a penalty based on profit gained or loss avoided by "the possibly endless chain of persons who may trade on the information before it is public."<sup>112</sup> The controlling person is liable only for a penalty based on profits made or loss avoided by the first level of tippees who do trade.

#### D. Bounty Provisions

Because of the difficulty of detecting insider trading, informants become an important resource for the government in its attempts to enforce the securities laws. The *House Report on ITSFEA* expressly notes the importance of information obtained through Ivan Boesky's cooperation with prosecutors to cases brought in 1986 and 1987.<sup>113</sup>

In order to encourage informants to come forward, Section 21A(e) permits the SEC to pay bounties to informants of up to ten percent of the civil penalties recovered.<sup>114</sup> No bounty may be paid to members, officers, or employees of federal regulatory agencies, the Department of Justice, or self-regulatory organizations.<sup>115</sup> The House Committee Report also stated that Congress expected that "bounty payments would not be made to supervisory and compliance officers of securities firms in situations in which a reward would undermine substantially the compliance programs within such firms."<sup>116</sup>

The SEC has promulgated rules governing the award of bounties under this provision.<sup>117</sup> The rules provide that the SEC has complete discretion regarding bounty awards and that such determinations are not subject to judicial re-

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110. Securities Exchange Act § 21A(a)(3), 15 U.S.C. § 78u-1(a)(3) (1988 Supp.).

111. *Id.*

112. H.R. REP. NO. 910, 100th Cong., 2d Sess. 19, reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6053.

113. *Id.* at 11-13, reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS at 6053.

114. Securities Exchange Act § 21A(e), 15 U.S.C. § 78u-1(e) (1988 Supp.). See Kaswell, *supra* note 101, at 164-66 (discussing bounty provisions).

115. *Id.*

116. H.R. REP. NO. 910, 100th Cong., 2d Sess. 23 (1988), reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6060.

117. Applications for Bounty Awards on Civil Penalties, Exchange Act Release No. 26994, FED. SEC. L. REP. (CCH) ¶ 84,423 (June 30, 1989) (adopting SEC Rules of Practice, Reg. §§ 201.61-



view.<sup>118</sup> Applicants for bounties must file a written application with the SEC within 180 days after the entry of the court order requiring payment of the penalty subject to the application.<sup>119</sup> Generally, applicants for bounties must identify themselves in their application; however, provision is made for temporary anonymity if the applicant amends his application to identify himself within the required 180 day period.<sup>120</sup> Once an applicant has identified himself in an application, no guarantees of confidentiality are given. However, absent compelling cause, the SEC normally does not disclose the identities of confidential sources, and serious consideration is given to requests for confidentiality.<sup>121</sup>

Information regarding insider trading violations may be furnished to the SEC in any form; however, the Commission encourages persons to furnish it in writing as soon as possible.<sup>122</sup> When the bounty application is not the initial means by which a person provides information, the application must contain the dates, times, and means by which the information was provided, the identity of the SEC staff member to whom it was provided, and, if it was provided anonymously, "sufficient further information to confirm that the person filing the application is the same person who provided the information to the Commission."<sup>123</sup> The SEC refuses to authorize any advance offers or promises of bounties to potential informants.<sup>124</sup>

### *E. Increases in Criminal Penalties*

ITSFEA amends Section 32(a) of the Securities Exchange Act of 1934 to increase the criminal penalties for violations of the Act or rules under it.<sup>125</sup> The amendments increase the maximum fine for natural persons from \$100,000 to \$1 million and set the maximum fine for entities other than natural persons at \$2.5 million.<sup>126</sup>

ITSFEA also increases the maximum prison sentence from five to ten years.<sup>127</sup> In making this change, the House Committee Report stated:

The Committee's interest in the maximum jail term is an explicit

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201.68, *reprinted in* 6 FED. SEC. L. REP. (CCH) ¶ 66,221-66,221G). The SEC Office of Public Affairs has also published a pamphlet entitled "Information on Bounties," SEC 2222 (6-89).

118. *Id.* at 80,205 (adopting SEC Rules of Practice, Reg. § 201.61, *reprinted in* 6 FED. SEC. L. REP. (CCH) ¶ 66,221).

119. *Id.* (adopting SEC Rules of Practice, Reg. §§ 201.62-201.63, *reprinted in* 6 FED. SEC. L. REP. (CCH) ¶ 66,221A- 66,221B).

120. *Id.* (adopting SEC Rules of Practice, Reg. §§ 201.64-201.65, *reprinted in* 6 FED. SEC. L. REP. (CCH) ¶ 66,221C- 66,221D).

121. *Id.* (*reprinted in* 6 FED. SEC. L. REP. (CCH) ¶ 84,423, at 80,206 n.5 (June 30, 1989)).

122. *Id.* ¶ 84,423, at 80,205-06.

123. Form of Application and Information Required, 43 Fed. Reg. 28,799 (1989) (to be codified at 17 C.F.R. § 201.64).

124. No Promises of Payment, 54 Fed. Reg. 28,799 (1989) (to be codified at 17 C.F.R. § 201.68).

125. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 4, 102 Stat. 4677, 4680 (1988) (codified as amended at 15 U.S.C. § 78ff(a) (1988 Supp.)). See Kaswell, *supra* note 101, at 169-70 (discussing criminal penalty provisions).

126. Under the prior version of § 32(a), enhanced fines applied only to stock exchanges.

127. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 4, 102 Stat. 4680 (codified as amended at 15 U.S.C. § 78ff(a) (1988 Supp.)).

congressional statement of the heightened seriousness with which insider trading and other securities fraud offenses should be viewed. Although the legislation does not include an explicit mandatory minimum sentence the Committee believes in the strongest possible manner that courts should impose jail terms for the commission of these crimes, and expects that raising the ceiling will increase the certainty of substantial prison sentences.<sup>128</sup>

#### F. *Private Actions for Contemporaneous Traders—Explicit and Implicit Effects*

One of the most interesting and potentially far reaching provisions of ITSFEA is new Section 20A<sup>129</sup> of the Securities Exchange Act of 1934. The new section grants a private right of action to contemporaneous purchasers or sellers of securities against those who tip or trade while in possession of inside information. The section, taken with its legislative history, has (1) effectively validated the misappropriation theory; (2) resolved the conundrum of transactional causation that plagued the courts in insider trading cases; and (3) provided a strong argument in favor of judicial application of a uniform five-year statute of limitations to all private rule 10b-5 actions.

##### 1. Validation of the Misappropriation Theory

In 1986 and 1987, particularly as the *Carpenter* case moved through the courts, substantial pressure grew for legislation that would define insider trading clearly.<sup>130</sup> The ambiguities created by *Chiarella* and *Dirks*, combined with the fear that the Supreme Court would undercut the validity of the misappropriation theory in *Carpenter*, led even the SEC to agree reluctantly that definitional legislation would be appropriate.<sup>131</sup>

In late 1987, however, when an evenly divided Supreme Court affirmed the application of the misappropriation theory in *Carpenter*, the critical need for definition diminished.<sup>132</sup> In enacting ITSFEA, Congress did not include a statu-

128. H.R. REP. NO. 910, 100th Cong., 2d Sess. 23 (1988), reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6060; cf. U.S. SENTENCING COMMISSION, FEDERAL SENTENCING GUIDELINES § 2F1.2 (1988) (insider trading provisions).

129. Section 20A was added by § 5 of ITSFEA, Pub. L. No. 100-704, § 5, 102 Stat. 4680 (codified at 15 U.S.C. § 78t-1 (1988 Supp.)). See Kaswell, *supra* note 101, at 166-69 (discussing expanded private rights of action under ITSFEA).

130. See S. Hrg. 100-155, Pts. I & II, *Definition of Insider Trading: Hearings Before the Senate Subcomm. on Securities of the Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess. (1987); see also D. LANGEVOORT, *supra* note 53, at ch. 13 (considering three legislative proposals for reform of ITSFEA); Symposium: *Defining Insider Trading*, 39 ALA. L. REV. 337 (1988) (collection of articles regarding proposed legislation).

131. Cox Says SEC to Present Own Bill With Definition of Insider Trading, 19 Sec. Reg. & L. Rep. (BNA) 939 (June 26, 1987). For discussion and text of SEC bills, see SEC *Compromise Proposal on Insider Trading Legislation: Accompanying Letter, and Analysis by Ad Hoc Legislation Committee*, 19 Sec. Reg. & L. Rep. (BNA) 1817 (Nov. 27, 1987); SEC *Submits Compromise Proposal to Define, Prohibit Insider Trading*, 19 Sec. Reg. & L. Rep. (BNA) 1783 (Nov. 27, 1987); Text of Draft "Insider Trading Act of 1987" Submitted by Securities & Exchange Commission, 19 Sec. Reg. & L. Rep. (BNA) 1284 (Aug. 14, 1987); SEC *Submits Own Proposal to Define Insider Trading*, 19 Sec. Reg. & L. Rep. (BNA) 1239 (Aug. 14, 1987).

132. See SEC to Bring More Insider Trading Cases, But Not for Several Months, Ruder Says, 19

tory definition of insider trading. The House Committee Report stated:

While cognizant of the importance of providing clear guidelines for behavior which may be subject to stiff criminal and civil penalties, the Committee nevertheless declined to include a statutory definition in this bill for several reasons. First, the Committee believed that the court-drawn parameters of insider trading have established clear guidelines for the vast majority of traditional insider trading cases, and that a statutory definition could potentially be narrowing, and in an unintended manner facilitate schemes to evade the law. Second, the Committee did not believe that the lack of consensus over the proper delineation of an insider trading definition should impede progress on the needed enforcement reforms encompassed within this legislation. Accordingly, the Committee does not intend to alter the substantive law with respect to insider trading with this legislation. The legal principles governing insider trading cases are well-established and widely-known.<sup>133</sup>

Despite this disclaimer, ITSFEA, when taken with its legislative history, did move toward a definition of insider trading. In particular, it confirmed the validity of the misappropriation theory. The House Committee Report, in discussing the *Carpenter* case, stated:

Thus the misappropriation theory clearly remains valid in the Second Circuit, . . . but is unresolved nationally. In the view of the Committee, however, this type of security fraud should be encompassed within Section 10(b) [of the Securities Exchange Act] and Rule 10b-5.<sup>134</sup>

Similarly, in explaining Section 20A, the House Committee stated:

[T]he codification of a right of action for contemporaneous traders is specifically intended to overturn court cases which have precluded recovery for plaintiffs where the defendant's violation is premised upon the misappropriation theory. See, e.g., *Moss v. Morgan Stanley*, 719 F. 2d 5 (2d Cir. 1983).<sup>135</sup>

This legislative history leaves little doubt as to the validity of the misappropriation theory which imposes rule 10b-5 liability upon outsiders who trade while in possession of information which they have wrongfully acquired.<sup>136</sup> The

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Sec. Reg. & L. Rep. (BNA) 1923, 1924 (Dec. 18, 1987) (views of Securities Industry Association President Edward I. O'Brien); see also D. LANGEVOORT, *supra* note 53, at 393 (views expressed to Senate subcommittee questioning need for legislation).

133. H.R. REP. NO. 910, 100th Cong., 2d Sess. 11, reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6048. See Kaswell, *supra* note 101, at 150-51 (discussing decision to exclude definition of insider trading).

134. *Id.* at 10, reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS at 6047.

135. *Id.* at 26, reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS at 6063. In *Moss*, the court had also dismissed plaintiff's civil RICO claim because the dismissal of the rule 10b-5 claims had undercut plaintiff's allegation of securities fraud as predicate offenses constituting a pattern of racketeering activity. *Moss*, 719 F.2d at 17-20. This holding, which was problematic even under prior law, was presumably also overturned by the enactment of Section 20A as to RICO claims by contemporaneous traders.

136. See *supra* notes 53-64 and accompanying text (discussing development of the misappropriation theory).

exact parameters of misappropriation may, however, remain open to some dispute. In particular, questions of a person's pre-existing duty not to take information for his own use may arise.<sup>137</sup>

## 2. Transactional Causation In Rule 10b-5 Cases

The judicial development of private rights of action against those trading on stock exchanges and in other impersonal markets while in possession of inside information, prior to the enactment of ITSFEA, proceeded without legislative guidance on two crucial issues: (1) which investors have standing to sue in a market in which privity between purchasers and sellers is difficult to establish;<sup>138</sup> and (2) are damages in such cases to be primarily compensatory or primarily directed toward deterrence of insider trading? In enacting Section 20A of the Securities Exchange Act to address these issues, Congress focused primarily on the law as developed in the Second Circuit and adopted the Second Circuit's general rule on private damage actions in traditional insider trading and tipping cases; as discussed above, however, Congress rejected the Second Circuit's rule that denied private rights of action in misappropriation cases. By focusing almost solely on Second Circuit precedents, Congress may not have realized that it was changing the law in traditional insider trading cases in other jurisdictions as well.<sup>139</sup>

Prior to ITSFEA, when insider trading occurred on a stock exchange or otherwise in impersonal securities markets, identifying the injury caused by the violation of law and the amount of damages suffered was difficult. The difficulty arose from both theoretical and practical considerations.

On a theoretical basis, it has generally been held that one element of a successful rule 10b-5 claim is transactional causation—the violation of law must be a substantial factor in the plaintiff's decision to enter the transaction in question.<sup>140</sup> In rule 10b-5 claims involving not insider trading, but rather affirmative misstatements or half-truths, transactional causation is satisfied by showing reliance upon the inaccurate information furnished, or at least indirect reliance upon such information through reliance upon the integrity of the price of the stock as reflected in a well-developed market.<sup>141</sup> In rule 10b-5 insider trading cases, however, the violation occurs through trading in the face of total silence; traditional reliance is absent. Plaintiff did not base the decision to purchase or

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137. See D. LANGEVOORT, *supra* note 53, at 394-96 (raising the issue and suggesting that wrongfulness be defined as "use of information directly or indirectly in violation of a reasonable expectation of confidentiality").

138. See generally Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who Is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217 (1981) (discussing which investors should have a cause of action against insiders who trade without disclosing material information).

139. The major case taking a different position was *Fridrich v. Bradford*, 542 F.2d 307 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977), discussed more fully *infra* text accompanying notes 175-77.

140. "[R]eliance is an element of a Rule 10b-5 cause of action. . . . Reliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury." *Basic, Inc. v. Levinson*, 108 S. Ct. 978, 989 (1988).

141. See *id.* at 988-92.

sell his stock upon anything that defendant did or said; rather, his decision merely might have been different if defendant had spoken. Thus, causation can be established only by showing that plaintiff would not have purchased or sold, at least not at the same price, had he known the relevant inside information.<sup>142</sup>

Yet rule 10b-5 insider trading violations do not occur by nondisclosure alone, but rather by trading coupled with nondisclosure.<sup>143</sup> Even without trading by insiders, many investors would have acted differently had they known the truth. How does one distinguish that vast group who have no right to expect market prices to reflect inside information<sup>144</sup> from those who are injured in addition by the insider trading? The most direct answer to this is that any losses which the former group suffers have been caused by perfectly legal market activity, not by the illegal conduct of an insider. Thus, investors who trade during periods of nondisclosure alone have no claim because rule 10b-5 has not been violated.

Once the insider trades without disclosing material information, however, a rule 10b-5 violation has occurred. The question then becomes: Which transactions are causally related to that trading so as to give rise to a cause of action? In the most literal sense, the insider has caused a purchase or sale by persons who accidentally are in direct privity with him as a result of their transactions in an impersonal market. The injury suffered by those in direct privity, however, is difficult to distinguish from the injury suffered by everyone else trading on an impersonal market at the same time.

Thus, three groups of injured investors may be identified when material information has not been disclosed. First are those who trade during periods of nondisclosure of inside information, but in which no trading by the insider occurs. These investors have no cause of action because no one has violated rule 10b-5. A second class includes those investors who purchase from or sell to an insider during a period in which that insider has not disclosed material information. These investors have the strongest claim for relief since a violation of rule 10b-5 has occurred and their purchase or sale was caused by the insider's illegal trading. But early on, the courts refused to limit relief under rule 10b-5 to those with actual privity.<sup>145</sup> Third are those who buy or sell during a period of nondisclosure which is coupled with insider trading, but who buy or sell from third persons equally ignorant of the undisclosed information. These investors have a

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142. In non-insider trading cases under rule 10b-5 involving primarily the breach of a duty to disclose, proof that the withheld information was material is sufficient to create at least a rebuttable presumption of reliance. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153-54 (1972).

143. "[A]n insider will be liable under Rule 10b-5 for inside trading only where he fails to disclose material nonpublic information before trading on it and thus makes 'secret profits.'" *Dirks v. SEC*, 463 U.S. 646, 654 (1983).

144. "It is the combination of the tip and the tippee's trading that poses the evil against which the open market investor must be protected . . . . If the insider chooses not to trade, . . . no injury may be claimed by the outside investor, since the public has no right to the undisclosed information." *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 169 (2d Cir. 1980).

145. "[T]he common law requirement of privity has all but vanished from 10b-5 proceedings . . . ." *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 101 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971).

more problematic claim for relief. A violation of rule 10b-5 has occurred, as it has for the second class of investors defined above. But their injuries seem no more causally related to the insider's trading than do the pre-insider trading injuries of investors in the first class.

The case law developed in the Second Circuit largely failed to address these theoretical complexities of transactional causation, and instead merely articulated a rule that contemporaneous traders—that is, all those who traded during the same period that defendants traded or recommended trading—may recover damages.<sup>146</sup> But why were the injuries of those contemporaneous traders who were not in privity with insiders caused by the insiders' illicit *trading* as opposed merely to their nondisclosure?

The best theoretical justification for a rule permitting standing for contemporaneous traders who were not in privity with the insider or his tippee was articulated not in the Second Circuit, but rather by Judge Celebrezze of the Sixth Circuit Court of Appeals in his concurring opinion in *Fridrich v. Bradford*.<sup>147</sup> According to Judge Celebrezze, contemporaneous traders are "surrogate plaintiffs" for those actually in privity.<sup>148</sup> The difficulty of post hoc matching of buyers and sellers on impersonal markets requires such stand-in plaintiffs in order to accomplish the deterrent purposes of rule 10b-5.<sup>149</sup>

This deterrent effect rationale also supports the other portion of the Second Circuit's traditional approach to private damages actions for insider trading—the limitation of damages to the profit gained or loss avoided by the defendant or his tippees.<sup>150</sup> Under this rationale, surrogate plaintiffs are granted standing not primarily to obtain compensation for their losses, but in order to impose a deterrent on insider trading that would be lost if insiders could escape liability by reason of the impossibility of finding those in privity with them. As Judge Celebrezze remarked: "[A]n insider should not escape civil liability for conduct which would clearly violate rule 10b-5 . . . by the simple expedient of restricting his trading to the open market where the mechanics of the marketplace make it difficult, if not impossible, to trace particular transactions."<sup>151</sup> Compensation is less important for stand-in plaintiffs, because they were not actually victims of insider trading in the first place.<sup>152</sup>

In addition to this theoretical justification for placing a ceiling on damage awards to surrogate plaintiffs, a practical concern in insider trading cases was

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146. *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 238 (2d Cir. 1974).

147. 542 F.2d 307, 323-27 (6th Cir. 1976) (Celebrezze, J., concurring), *cert. denied*, 429 U.S. 1053 (1977). For discussion of the majority opinion in *Fridrich*, see *infra* text accompanying notes 175-77. Judge Celebrezze concurred in the court's decision in favor of the defendants because plaintiffs here were not contemporaneous traders. *Id.* at 327 (Celebrezze, J., concurring).

148. *Id.* at 326 n.11 (Celebrezze, J., concurring).

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

150. *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 172-73 (2d Cir. 1980) (limiting plaintiff's total recovery to gain realized by tippee from inside information).

151. *Fridrich*, 542 F.2d at 323-24 (Celebrezze, J., concurring) (footnote omitted).

152. See Note, *Limiting the Plaintiff Class: Rule 10b-5 and the Federal Securities Code*, 72 MICH. L. REV. 1398, 1429-30 (1974) (suggesting remedies that focus on deterrence rather than compensation).

the potentially draconian nature of damages. Even liability limited to contemporaneous traders may be substantially out of proportion to the wrong committed by the defendant.<sup>153</sup> For this reason, the Second Circuit in *Elkind v. Liggett & Myers, Inc.*<sup>154</sup> limited damages to disgorgement of profits.<sup>155</sup>

Section 20A of the Securities Exchange Act of 1934, as added by ITSFEA, has in general codified the Second Circuit's judicial standards by creating an express cause of action, with a cap on damages, for contemporaneous traders. Under the legislation, any person who violates any provision of the 1934 Act, or rules promulgated under it, by purchasing or selling securities while in possession of material, nonpublic information is liable to persons who traded contemporaneously.<sup>156</sup> Tippers are jointly and severally liable with, and to the same extent as, the person to whom they communicated their tip, either directly or through a conduit.<sup>157</sup> That is, tippers are liable to the same extent as the first level of tippee who trades, but are not liable for the profits made by sub-tippees.<sup>158</sup> The total amount of damages imposed on traders and tippers, however, may not exceed the profit gained or loss avoided in the transactions that are the subject of the violation.<sup>159</sup> Section 20A does not define "profit gained or loss avoided,"<sup>160</sup> but presumably it was intended to have the same meaning as set out in Section 21A(f)<sup>161</sup> for purposes of civil penalty provisions and as developed in *Elkind v. Liggett & Myers, Inc.*<sup>162</sup> According to the Second Circuit, civil penalties should be assessed as the difference between the purchase or sale price of the security and the value of the security as measured by its trading price a reasonable period after public dissemination of the nonpublic information.<sup>163</sup> Furthermore, any amounts disgorged in an SEC injunction action relat-

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153. Logic would compel application of the theory to a case where a tippee sells only 10 shares of a heavily traded stock (e.g., IBM), which then drops substantially when the tipped information is publicly disclosed. To hold the tipper and tippee liable for the losses suffered by every open market buyer of the stock as a result of the later decline in value of the stock after the news became public would be grossly unfair.

*Elkind*, 635 F.2d at 170.

154. 635 F.2d 156, 172-73 (2d Cir. 1980).

155. A similar measure of damages was recommended by the American Law Institute. See AMERICAN LAW INSTITUTE, FEDERAL SECURITIES CODE § 1708 (1980).

156. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 20A(a), 102 Stat. 4677 (codified as amended at 15 U.S.C. § 78t-1 (1988 Supp.)).

157. *Id.*

158. See H.R. REP. NO. 910, 100th Cong., 2d Sess. 19-20 & n.16 (1988), reprinted in U.S. CODE CONG. & ADMIN. NEWS 6043, 6046-47 & n.16.

159. 15 U.S.C. § 78t-1(b)(1) (1988 Supp.). Controlling persons are subject to liability under the general controlling person provisions of Securities Exchange Act § 20a, 15 U.S.C. § 78t(a) (1982), but are not otherwise liable under the doctrine of *respondeat superior* if the good faith and non-inducement defense of § 20(a) is proven. *Id.*

160. This failure to define profit gained or loss avoided for purposes of § 20A again reflects Congress' focus upon adoption of the law of the Second Circuit. The measure of damages had been definitively worked out in *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980). Congress was largely satisfied with that. See *supra* text accompanying note 134. Its main focus was to reverse *Moss v. Morgan Stanley*, 719 F.2d 5 (2d Cir. 1983), cert. denied, 465 U.S. 1025 (1984), see *supra* note 134 and accompanying text, and create a private right of action in misappropriation cases.

161. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4679 (codified as amended at 15 U.S.C. § 78u-1 (1988 Supp.)).

162. 635 F.2d 156, 172 (2d Cir. 1980).

163. *Id.*

ing to the transaction are deducted from the amount that may be recovered as damages under Section 20A.<sup>164</sup>

The statutory language of ITSFEA also failed to define specifically "contemporaneous trading." The House Committee Report, however, made it clear that case law had defined the term, specifically citing three Second Circuit cases.<sup>165</sup> The first, *Shapiro v. Merrill Lynch, Pierce Fenner & Smith, Inc.*,<sup>166</sup> established the basic proposition that liability runs to plaintiffs who traded "during the same period" that defendants engaged in insider trading or tipping.<sup>167</sup> The second, *Wilson v. Comtech Telecommunications Corp.*,<sup>168</sup> held that liability does not run to everyone who traded between the time defendants began trading and the time the material information was finally disclosed.<sup>169</sup> The court distinguished *Shapiro*, noting that everyone who traded during that period was permitted to recover because only four days elapsed until disclosure.<sup>170</sup> In *Wilson*, however, when plaintiff's purchases occurred a full month after defendant's sales, the court denied recovery, stating that "[t]o 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."<sup>171</sup> The third case focused on the other end of the spectrum. *O'Connor & Associates v. Dean Witter Reynolds, Inc.*<sup>172</sup> held that liability does not run to plaintiffs who trade prior to trading by the insider or his tippees, even when only a few hours separate the trades.<sup>173</sup> Consequently, the court further held that a nontrading tipper's liability extends only to those who trade after his tippees begin to trade.<sup>174</sup>

Congress' adoption of Second Circuit law necessarily rejects alternative positions on causation developed outside of that Circuit. In particular, the Sixth Circuit in *Fridrich v. Bradford*<sup>175</sup> had taken a narrower view of standing to recover in open market insider trading cases. The majority of the court in

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164. 15 U.S.C.A. § 20A(b)(2) (1988 Supp.). This occurs even if the disgorged funds have not been paid to the particular plaintiffs in the § 20A action, thus emphasizing the deterrent, rather than compensatory, nature of the cause of action under § 20A. *Id.*

Some ambiguity exists under § 20A(b)(2) regarding the appropriate measure of damages if, instead of the typical class action, separate suits are filed by several contemporaneous traders. Arguably the language of the section could be read to permit multiple judgments for disgorgement. Both the underlying rationale for the section and the House Committee Report on ITSFEA suggest, to the contrary, however, that the section is intended to limit to profits gained or loss avoided the total amount awarded to all contemporaneous traders, regardless of whether one or several actions are involved. See H.R. REP. NO. 910, 100th Cong., 2d Sess. 39 (1988), reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6064 n.22.

165. H.R. REP. NO. 910, 100th Cong., 2d Sess. 27 n.22 (1988), reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6064 n.22; see generally Wang, *The "Contemporaneous" Traders Who Can Sue An Inside Trader*, 38 HASTINGS L.J. 1175 (1987) (discussing case law defining contemporaneous trading).

166. 495 F.2d 228 (2d Cir. 1974).

167. *Id.* at 241.

168. 648 F.2d 88 (2d Cir. 1981).

169. *Id.* at 94-95.

170. *Shapiro*, 495 F.2d at 232; see *Wilson*, 648 F.2d at 94 (discussing this aspect of *Shapiro*).

171. *Wilson*, 648 F.2d at 94.

172. 559 F. Supp. 800 (S.D.N.Y. 1983).

173. *Id.* at 803.

174. *Id.* at 803 n.4.

175. 542 F.2d 307 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977).



*Fridrich* rejected the rationale of *Shapiro*<sup>176</sup> and required instead that a plaintiff show either that he had purchased securities from or sold them to the defendant, or that defendant's acts of trading in some other way affected plaintiff's decision to buy or sell.<sup>177</sup> Only such plaintiffs could show a causal connection between their losses and defendants' violations, that is, defendants' trading without disclosure of material nonpublic information. Other potential plaintiffs were injured only by the nondisclosure; defendants' trading added nothing to their injury.

This alternative notion of causation developed in *Fridrich* retains importance even after the enactment of ITSFEA. As previously discussed, Section 20A restricts contemporaneous trading cases to a disgorgement measure of damages.<sup>178</sup> However, Section 20A(d) provides that the section shall not be construed to limit or condition the right of any person to bring suit to enforce a requirement of the Securities Exchange Act or to limit or condition the availability of any implied right of action under the Act.<sup>179</sup> The House Committee Report explains this provision in part as follows:

The Committee recognizes that where the plaintiff demonstrates that he was defrauded by the defendant's insider trading and suffered actual damages proximately caused by the defendant's behavior, a cap of profit gained or loss avoided by the defendant, which is applicable for actions by contemporaneous traders, is not appropriate. Rather, in such an implied private cause of action, the plaintiff should be able to recover the full extent of those actual damages.<sup>180</sup>

Thus, Congress seems to acknowledge that the limitation of damages to disgorgement applies only to surrogate plaintiffs who have no true claim for compensatory relief against the inside trader or tipper. Plaintiffs who demonstrate the kind of true transactional causation described in *Fridrich v. Bradford*<sup>181</sup> are apparently not limited to disgorgement. Such a conclusion seems to modify the broad pre-ITSFEA statement of the rule regarding a cap on damages, articulated in the Second Circuit by *Elkind v. Liggett & Myers, Inc.*<sup>182</sup>

It is not clear that Congress understood all of these implications. Legislative history reveals that the main focus of this savings clause was Congress' concern about application of a disgorgement measure of damages in a peculiar type of misappropriation case—the case in which the victim of the misappropriation was also injured by trading in the securities involved. The House Committee

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176. *Id.* at 318-19 & 318 n.23.

177. *Id.* at 318-19.

178. See *supra* notes 160-64 and accompanying text.

179. 15 U.S.C. § 78t-1(a) (1988 Supp.). However, the House Committee deleted a proposed provision that would have affirmatively granted a private right of action, without a damage cap, to persons who could prove injuries actually caused by violations of rule 10b-5. This largely left to judicial development the articulation of the limits of recovery in actions by nonsurrogate plaintiffs. Kaswell, *supra* note 101, at 167-69. That judicial development must, of course, take account of the implications of the savings clause which was included in Section 20A(d).

180. H.R. REP. NO. 910, 100th Cong., 2d Sess. 28 (1988), reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 6043.

181. See *supra* text accompanying notes 175-77.

182. See *supra* text accompanying notes 153-55 (discussing the *Elkind* rule).

Report focused on *Anheuser-Busch Companies, Inc. v. Thayer*,<sup>183</sup> in which an Anheuser-Busch director allegedly misappropriated information regarding Anheuser-Busch's upcoming tender offer for shares of Campbell Taggart, Inc. which tippees used to purchase stock of Campbell Taggart. Anheuser-Busch alleged that it was the victim of the wrongful misappropriation because tippee trading inflated the price of Campbell Taggart shares, causing Anheuser-Busch to pay \$80 million more than it otherwise would have paid in its tender offer. In focusing on this case, the House Committee concluded that when the plaintiff can prove it suffered injury as a result of the defendant's insider trading, neither the contemporaneous trading requirement nor the limitation of damages to a disgorgement measure applies.<sup>184</sup>

### 3. Statute of Limitations

ITSFEA imposes a five-year statute of limitations on private actions brought by contemporaneous traders under Section 20A.<sup>185</sup> This limitation period in Section 20A(b)(4) runs from "the date of the last transaction that is the subject of the violation."<sup>186</sup> ITSFEA similarly retains a five-year limitation period in Section 21A(d)(5) for SEC actions seeking civil penalties for insider trading.<sup>187</sup> Because of contemporaneous judicial developments, the adoption of a five-year limitation period for these types of insider trading cases, while seemingly unremarkable, potentially has important implications for the use of rule 10b-5 outside the insider trading area.

As with many federal civil causes of action, no explicit statute of limitations applies to private civil actions under rule 10b-5.<sup>188</sup> Courts, therefore, have been required to determine the appropriate limitation period to apply. Until recently, relying largely upon the supposed intent of Congress,<sup>189</sup> the universally accepted principle has been that courts should apply the most analogous statute of limitations of the state in which the court sits.<sup>190</sup>

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183. No. CA3-85-0794-R (N.D. Tex. 1986).

184. H.R. REP. NO. 910, 100th Cong., 2d Sess. 28 (1988), reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6045. For other cases posing issues similar to those in *Anheuser-Busch*, see *FMC Corp. v. Boesky*, 673 F. Supp. 242 (N.D. Ill. 1987), rev'd, 852 F.2d 981 (7th Cir. 1988); *Litton Indus. Inc. v. Lehman Brothers Kuhn Loeb, Inc.*, No. 86 Civ. 6447 (S.D.N.Y.) discussed in L. SOLOMON, D. SCHWARTZ & J. BAUMAN, CORPORATIONS LAW AND POLICY 1297-98 (2d ed. 1988)).

185. 15 U.S.C. § 78t-1 (1988 Supp.).

186. *Id.* § 78t-1(b)(4).

187. *Id.* § 78u-1(d)(5).

188. Where express private rights of action were created by the Securities Exchange Act, limitations periods were also imposed. *E.g.*, § 9(e), 15 U.S.C. § 78i(e) (1988) (one year after discovery and three years after the violation); § 16(b), *id.* § 78(p)(b) (two years after profit realized); § 18(c), *id.* § 78r(c) (one year after discovery or three years after accrual); and § 29(b), *id.* § 78cc(b) (one year after discovery or three years after violation). However, no general limitations period was created to apply to implied private rights of action such as those under rule 10b-5.

189. For a historical development of the principles that resulted in the application of state limitation periods to federal causes of action when no explicit federal statute of limitations exists, see *Agency Holding Corp. v. Malley-Duff & Assocs.*, 483 U.S. 143, 157-65 (1987) (Scalia, J., concurring).

190. *E.g.*, *Herman & MacLean v. Huddleston*, 459 U.S. 375, 384 n.18 (1983); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 210 n.29 (1976). See generally 5C A. JACOBS, LITIGATION AND PRAC-

Two important concerns arise when this traditional approach is applied to rule 10b-5 cases. First, the approach creates a lack of uniformity,<sup>191</sup> making forum shopping a realistic possibility,<sup>192</sup> particularly in light of the broad venue provisions of the Securities Exchange Act.<sup>193</sup> Second, applicable state statutes of limitation are typically longer than limitation periods under the express antifraud provisions of the federal securities laws.<sup>194</sup> Therefore, rule 10b-5 often becomes the cause of action of choice when the limitation period has run on the more easily proven causes of action otherwise available, for example, causes of action under either Section 11 or 12(2) of the Securities Act of 1933.<sup>195</sup>

In recent years, the Supreme Court has signaled a change in the traditional doctrine that always required application of state limitation periods to federal claims in the absence of an express federal limitation provision. Instead, the Court has been willing to borrow an analogous federal limitations period when the analogous state statutes would be "unsatisfactory vehicles for the enforcement of federal law."<sup>196</sup> The need for a uniform limitation period for a particular federal cause of action may encourage borrowing of a single federal statute rather than diverse state statutes of limitation.<sup>197</sup>

These considerations led the Third Circuit in *In re Data Access Systems Securities Litigation*<sup>198</sup> to select a uniform federal statute of limitations for rule 10b-5 actions. The Third Circuit chose the limitation period prescribed in several provisions of the Securities Exchange Act of 1934<sup>199</sup> that created express private rights of action—one year after the plaintiff discovers the facts constitut-

TICE UNDER RULE 10b-5 § 235.02 (2d ed. 1988) (discussing use of state statutes of limitation, principles governing choice of applicable statute, and exceptions to these principles).

191. See L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 994-96 (2d ed. 1988); Schulman, *Statutes of Limitation in 10b-5 Actions: Complication Added to Confusion*, 13 WAYNE L. REV. 635, 642-43 (1967).

192. Bloomenthal, *The Statute of Limitations and Rule 10b-5 Claims: A Study in Judicial Laxitude*, 60 U. COLO. L. REV. 235, 271 (1989).

193. Securities Exchange Act, § 27, 15 U.S.C. § 78aa (1988 Supp.), gives exclusive jurisdiction to federal courts and permits suit to be brought in "any district wherein any act or transaction constituting the violation occurred," or in any "district wherein the defendant is found or is an inhabitant or transacts business." *Id.* Process may be served anywhere in the world that the "defendant may be found." *Id.*

194. For a compilation of the analogous state statute for each state, see 5C A. JACOBS, *supra* note 190, at § 235.02 (state statutes of limitation range from one year to ten years, with two-, three- and six-year statutes predominating).

195. 15 U.S.C. §§ 77k, 77l(2) (1988 Supp.). See, e.g., *Herman & MacLean v. Huddleston*, 459 U.S. 375, 387 (1983) ("availability of an express remedy under § 11 of the 1933 Act does not preclude defrauded purchasers of registered securities from maintaining [a rule 10b-5] action").

196. *DelCostello v. International Bhd. of Teamsters*, 462 U.S. 151, 161 (1983). See generally Bloomenthal, *supra* note 192, at 235-97 (discussing application of uniform federal statute of limitations).

197. See *Agency Holding Corp. v. Malley-Duff & Assocs.*, 483 U.S. 143, 153-54 (1987) (uniform limitation period for civil RICO actions).

198. 843 F.2d 1537, 1548-49 (3d Cir.), *cert. denied*, 109 S. Ct. 131 (1988); see Note, *In re Data Access Systems Securities Litigation: Finally A Step Towards Uniformity in 10b-5 Statute of Limitations Disputes*, 40 MERCER L. REV. 1045 (1989) (discussing background to and holding of *Data Access* decision); see also *Bernstein v. Crazy Eddie, Inc.*, 702 F. Supp. 962, 980-81 (E.D.N.Y. 1988) (adopting the *Data Access* holding).

199. Securities Exchange Act of 1934, § 9(e), 15 U.S.C.A. § 78i(e) (1988); § 18(c), *id.* § 78r(c); § 29(b), *id.* § 78(b).

ing the violation, and in no event more than three years after the violation.<sup>200</sup> This limitation period also is substantially similar to the limitation period in Section 13 of the Securities Act of 1933 for actions brought under Sections 11 and 12(2) of that Act.<sup>201</sup> Adoption of this limitation period thus may reduce substantially the attractiveness of rule 10b-5 as the basis for a cause of action by defrauded purchasers of securities, since, except for the statute of limitations period, other elements of a cause of action are often easier for a plaintiff to prove under Sections 11 and 12(2).<sup>202</sup>

Adoption of a uniform federal limitations period for rule 10b-5 actions need not, however, continue to make rule 10b-5 so unattractive an option for defrauded investors. *Data Access* was decided prior to the enactment of ITSFEA. Congress' adoption of a five-year limitation period in ITSFEA for insider trading cases provides a strong argument that this five-year period is now the most analogous limitation period for all claims under rule 10b-5.<sup>203</sup> One lower court decision has rejected this argument, however, finding that there is not a persuasive analogy between the five-year limitation period for insider trading cases and rule 10b-5 cases that are not related to insider trading or misappropriation of information.<sup>204</sup> The case is currently on appeal.<sup>205</sup>

The five year limitation period was first adopted in the Insider Trading Sanctions Act of 1984 as to actions for civil penalties.<sup>206</sup> ITSFEA carried the provision over into Section 20A's private action for damages by contemporaneous traders.<sup>207</sup> In each, Congress was certainly focusing upon insider trading rather than more broadly upon rule 10b-5. However, adoption of the limitation period of *Data Access*<sup>208</sup> in other rule 10b-5 cases would impose a statute of limitations shorter than that typically imposed through the current rule of borrowing of analogous state statutes. Currently, applicable state statutes range from one to ten years, with two-, three-, and six-year statutes predominating.<sup>209</sup> If any Congressional intent seems clear in recent years, it is to expand rather than restrict remedies for securities fraud.<sup>210</sup> Borrowing the five-year statute in

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200. *Data Access*, 843 F.2d at 1545-46, 1550.

201. Securities Exchange Act § 13, 15 U.S.C. § 77m (1982).

202. See 5 A. JACOBS, *supra* note 190, at § 3.01 (discussing elements of claims under various securities law provisions).

203. See *SEC Says ITSFEA Limitations Period Should be Applied to Rule 10b-5 Claims*, 21 Sec. Reg. & L. Rep. (BNA) 875 (June 16, 1989) (discussing SEC's amicus brief in *Lebman v. Aktiebolaget Electrolux*, No. 88-1114 (U.S. June 15, 1989), *cert. denied*, 109 S. Ct. 3214 (1989)).

204. *Ceres Partners v. GEL Assocs.*, 714 F. Supp. 679, 685-86 (S.D.N.Y. 1989).

205. See *SEC Urges Five-Year Limitations Period for Fraud Actions*, Fed. Sec. L. Rep. (CCH) No. 1354, at 3 (Sept. 6, 1989).

206. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, § 2, 98 Stat. 1264, 1264-65.

207. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677, 4681 (1988) (codified as amended at 15 U.S.C. § 78t-1(b)(4) (1988 Supp.)).

208. See *supra* text accompanying notes 199-203.

209. See 5C A. JACOBS, *supra* note 190, at § 235.02 (compiling analogous state statutes for each state).

210. This is reflected by enactment of the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 and ITSFEA, Pub. L. No. 100-704, 102 Stat. 4677 (1988). The House Report on ITSFEA stated: "In the view of the Committee, the present enforcement framework should be strengthened to curtail continuing insider trading and other market abuses." H.R. REP. NO. 910, 100th Cong., 2d Sess. 7, reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6044.

ITSFEA would permit courts to achieve the important goal of national uniformity and the concomitant prevention of forum shopping while not substantially restricting the existing availability of rule 10b-5.<sup>211</sup>

### G. *Investigatory Assistance to Foreign Securities Authorities*

As part of the SEC's increasing cooperation with foreign governments and foreign securities regulatory agencies, ITSFEA added Section 21(a)(2) to the Securities Exchange Act of 1934.<sup>212</sup> This section permits the SEC to provide investigatory assistance to foreign securities authorities.<sup>213</sup>

The section provides that:

[on] request from a foreign securities authority, the [SEC] may provide assistance . . . if the requesting authority states that [it] is conducting an investigation which it deems necessary to determine whether any person has violated, is violating, or is about to violate any laws or rules relating to securities matters that [it] administers or enforces. [In providing such assistance, the SEC may] conduct such investigation as [it] deems necessary to collect [pertinent] information and evidence.<sup>214</sup>

The House Committee Report on ITSFEA states that in order to protect against assisting "in an unfocused or unbounded foreign investigation, it is expected that a foreign authority seeking assistance [will include in its request] the facts which constitute a potential violation of its laws."<sup>215</sup> Section 21(a)(2) states that "[SEC] assistance may be provided without regard to whether the facts stated in the request would also constitute a violation of the laws of the United States."<sup>216</sup> The legislative history makes it clear that the SEC may issue a formal order of private investigation and issue and enforce subpoenas in connection with this investigation,<sup>217</sup> a power which it previously had only when investigating violations or potential violations of United States law, or of rules of United States self-regulatory organizations.<sup>218</sup> Congress intended that the same protections and remedies as in purely domestic investigations be available to witnesses in

211. The SEC, urging adoption of ITSFEA's five-year limitations period in private rule 10b-5 actions, argued in its amicus brief to the Second Circuit Court of Appeals in *Ceres Partners v. GEL Assocs.* that the one-/three- year limitations period chosen in *Data Access* was "devised for [causes of action] that generally give plaintiffs litigation advantages that they do not enjoy under Rule 10b-5." *SEC Urges Five-Year Limitations Period for Fraud Actions*, Fed. Sec. L. Rep. (CCH) No. 1354, at 3-4 (Sept. 6, 1989).

212. 15 U.S.C. § 78u(a)(2) (1988 Supp.). See Kaswell, *supra* note 101, at 171-75 (discussing SEC assistance to foreign securities authorities).

213. Additional legislation to enhance international securities enforcement cooperation is pending in Congress. See *House Approves SEC-Drafted Bill to Limit Access to Foreign Documents*, 21 SEC. REG. & L. REP. (BNA) 1463 (Sept. 29, 1989) (discussing proposed International Securities Enforcement Cooperation Act of 1989). See generally Levine & Callcott, *The SEC and Foreign Policy: The International Securities Enforcement Cooperation Act of 1988*, 17 SEC. REG. L.J. 115 (1989) (discussing proposals to enhance international enforcement cooperation).

214. 15 U.S.C. § 78u(a)(2) (1988 Supp.).

215. H.R. REP. NO. 910, 100th Cong., 2d Sess. 29, reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6066.

216. 15 U.S.C. § 78u(a)(2) (1988 Supp.).

217. H.R. REP. NO. 910, 100th Cong., 2d Sess. 29, reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6066.

218. See Securities Exchange Act of 1934, § 21(a)(1), 15 U.S.C. § 78u(a)(1) (1988 Supp.).

investigations for foreign authorities.<sup>219</sup>

Section 21(a)(2) requires the SEC to consider, in deciding whether to provide investigatory assistance, "whether [the foreign securities] authority has agreed to provide reciprocal assistance in securities matters to the [SEC]" and whether investigatory assistance "would prejudice the public interest of the United States."<sup>220</sup>

The term "foreign securities authority" is broadly defined in new Section 3(a)(50) of the Act<sup>221</sup> to mean "any foreign government, or any governmental body or regulatory organization empowered by a foreign government to administer or enforce its [securities] laws."<sup>222</sup>

In a related provision of ITSFEA, Congress appropriated funds for membership fees and official expenditures for the SEC's participation in the International Organization of Securities Commissions (IOSC).<sup>223</sup>

#### *H. Laying the Groundwork for Further Legislation*

ITSFEA contains two separate provisions regarding recommendations for possible additional legislation. The narrower of the two studies called upon the Commission to submit to Congress within sixty days of the enactment of ITSFEA recommendations with respect to extending the SEC's "authority to seek civil penalties or impose administrative fines for violations other than [of the insider trading provisions.]"<sup>224</sup> This provision was directed at legislative proposals growing out of the already-completed *Report of the National Commission on Fraudulent Financial Reporting* which had been chaired by former SEC Commissioner James C. Treadway, Jr.<sup>225</sup> In response to this, in January 1989, the SEC submitted extensive recommendations in its proposed Securities Law Enforcement Remedies Act of 1989.<sup>226</sup> This proposal would permit assessment of new civil penalties in both judicial and administrative proceedings, would permit both judicial and administrative orders prohibiting service as an officer or director of any reporting company, and would permit administrative enforcement of insider trading reporting requirements of Securities Exchange Act Section 16(a).<sup>227</sup>

The broader provision of ITSFEA is that found in Section 7 which authorizes, subject to sufficient appropriations, a broad study and investigation of the adequacy of the federal securities laws, including issues of insider trading, sur-

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219. H.R. REP. NO. 910, 100th Cong., 2d Sess. 29, reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6066.

220. 15 U.S.C. § 78u(a) (1988 Supp.).

221. *Id.* § 78c(a)(50).

222. *Id.* § 78u(a).

223. *Id.* § 78kk. See Kaswell, *supra* note 101, at 179 (Committee on Appropriations had been reluctant to appropriate funds without specific authorization).

224. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 3(c), 102 Stat. 4677, 4680 (codified at 15 U.S.C. § 78u-1, § 1 (1988 Supp.)).

225. Kaswell, *supra* note 101, at 171.

226. Securities Law Enforcement Remedies Act of 1989, [1988-89 Trans. Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,350.

227. *Id.*

veillance mechanisms, intergovernmental cooperation in enforcement, and "impediments to the fairness and orderliness of the securities markets and to improvements in the breadth and depth of the capital available to the securities markets."<sup>228</sup>

### III. CONCLUSION

ITSFEA is a piecemeal, but pragmatic, response to the perceived growth of insider trading in an internationalized securities market. In enacting it, Congress dismissed the academic arguments that favor insider trading, with a nod toward the less cerebral and more visceral reaction of the public to the seeming unfairness of insider trading. The House Report summarized the congressional reasoning thusly:

A modest number of economists and academics defend the practice of insider trading as promoting an efficient market . . . . But the far greater number of commentators support efforts to curb insider trading, viewing such efforts as crucial to the capital formation process that depends on investor confidence in the fairness and integrity of our securities markets.<sup>229</sup>

Also, as discussed, proper consideration of the background and legislative history of ITSFEA may affect judicial resolution of various long-standing securities law issues.

ITSFEA is certainly not the last word on reform in the rapidly changing capital markets of the late twentieth century. Legislative recommendations already submitted to Congress and the new special study authorized by ITSFEA may lay the groundwork for even more extensive changes in the near future.

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228. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 7, 102 Stat. 4677, 4682 (codified at 15 U.S.C. § 78b (1988 Supp.)). See Kaswell, *supra* note 101, at 176-79 (discussing ITSFEA provisions authorizing a new special study of securities law issues). For proposals regarding the scope of this study, see Sporkin, *U.S. Financial and Securities Markets Under Stress—Some Thoughts for Reform*, Toledo Transcript, Spring 1989, at 17; Cohen, *A Quarter-Century of Market Developments—What Should a New "Special Study" Study?*, 45 BUS. LAW. 3 (1989).

229. H.R. REP. NO. 910, 100th Cong., 2d Sess. 8, reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6045.