This approach expands the class of potential plaintiffs and could therefore expose defendants to broader liability than would be the case if the defendant traded with someone in a face-to-face transaction.[239] To avoid "subject[ing] the defendant to greater total liability with respect to market transactions than with respect to face-to-face transactions,"[240] the Code provides for the limitation of damages in the open-market setting to make them commensurate with what they would be in the non-market setting.[241] Proration is necessary because plaintiffs who trade within the prescribed period[242] are essentially fungible.[243] Professor Louis Loss, the Reporter for the Code, acknowledges that the result of this approach to recovery is that there will be less recovery per plaintiff, but suggests that this is the best solution overall, despite the fact that it creates some problems of its own.[244]

For example, the following appears in a Comment to section 1702(e):[245]

> The solution of this aspect of the fungibility problem . . . creates its own problem: The defendant, for example, sells 10,000 shares on an exchange during a five-day period in which the total volume is 100,000 shares. At the time of decision the market is down 10 points. . . . There are three possibilities:

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[239]As noted, the ALI Code provides separately for face-to-face transactions. In such cases, only the (now known) party in privity can sue, and recovery is limited essentially to the difference between the price paid or received in the transaction with the insider and the value of the security after the market absorbs the (then disclosed) information. FEDERAL SECURITIES CODE § 1708(a) (ALI 1980).

[240]FEDERAL SECURITIES CODE at xlix(11) (ALI 1980). Loss comments in the Introduction that the defendant should be subject to no greater total liability with respect to market transactions than with respect to face-to-face transactions. *Id.*

[241]*Id.* § 1708(b). *See also id.* at xlix(11) (stating seller or buyer should have same liability whether the transaction is face to face or in the market).

[242]In face-to-face transactions, this means same day traders, *id.* § 1702(b); for market transactions, it means those trading until disclosure, *id.* § 1703(b).

[243]This is because of the fortuity of any attempt to match trades in the market setting. *See supra* text accompanying notes 221-25.

[244]*See* FEDERAL SECURITIES CODE § 1703(b) cmt. 1 (ALI 1980); *id.* § 1702(b) cmt. 2-3.

[245]*Id.* § 1702(e) cmt. 4. Section 1702(e) deals with the measure of damages for non-fraudulent trading violations. Though this comment does not directly refer to the insider trading provision, it explains the problem of damages in the open-market setting, where eligibility to sue is opened up beyond those in privity with the defendant. In that regard it is equally relevant to § 1703 and insider trading on the open market, as is indicated by cross-references between sections 1702 and 1703 and their comments. *See id.* § 1703(b) cmt. 1 (referring reader to comments to § 1702(b)). Section 1702(e) establishes the measure of damages for §§ 1702(a)-(b). *Id.* § 1702(e).

> (a) Treat every buyer during the [five-day] period as if he had bought from the defendant and give him $10 per share purchased. This would make the defendant liable for $1,000,000 — 10 times what his liability would have been . . . if he had sold the 10,000 shares face to face.
>
> (b) Limit the defendant's liability to $100,000 and insist on proof of privity of contract between plaintiff and defendant. This is the law today, and it is both impractical and nonsensical . . . .
>
> (c) Limit the defendant's liability to $100,000, but don't discriminate among those who bought during the [five-day] period. This residual choice does create an allocation problem, but that is solved by § 1711 [proration among plaintiffs].[246]

Thus, the specter of "Draconian liability" so feared by the court in *Fridrich*[247] is exorcized quite simply in the Code by limiting damages as some courts had already done.[248] If the phrase "contemporaneous trading" is substituted for the word "privity" in part (b) of the quotation above, the alternative described as "both impractical and nonsensical" in that Comment is essentially the alternative adopted by Congress in 1988.[249] The approach taken by the ALI Code is obviously not that taken by Congress in adopting an express private right of action for insider trading in ITSFEA. A discussion comparing the two approaches and pointing out inconsistencies between them follows.

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[246]*Id.* § 1702(e) cmt. 4.

[247]Fridrich v. Bradford, 542 F.2d 307, 309, 320-21 (6th Cir. 1976).

[248]The Second Circuit has limited damages to defendant's profits or loss avoided. *See* Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 172-73 (2d Cir. 1980).

A simple disgorgement measure may not serve to adequately deter insider trading. *See infra* Part IV.B. and note 373.

[249]*See* 15 U.S.C. § 78t-1(a) (1994), discussed *infra* Part II.C.2.

2. ITSFEA: Congressional Adoption of the Contemporaneous Trader Requirement

a. *An Express Action for Contemporaneous Traders*

The Insider Trading and Securities Fraud Enforcement Act of 1988[250] codified the contemporaneous trading requirement.[251] The statute does not define the term "contemporaneous."[252] While creating an express right of action, the statute throws no light on the question of precisely to whom the right belongs.[253] The legislative history of the statute does refer to the case law for the definition of the term, specifically citing *Shapiro, Wilson* and *O'Connor*.[254] It also gives some indication of Congress's understanding of the term, as well as its attitude toward the development of the implied right of action.[255]

In ITSFEA, Congress adopted a judicially-developed standard into the statutory right of action.[256] While creating an express private right of action, ITSFEA did not replace or restrict the right of action that the courts developed.[257] Not only did the implied action remain in place under

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[250]*See supra* note 16.

[251]Section 20A(a) of the Insider Trading and Securities Fraud Enforcement Act of 1988, 15 U.S.C. § 78t-1 (a) (1994), provides that:

> [a]ny person who violates any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security while in possession of material, non-public information shall be liable in an action in any court of competent jurisdiction to any person who, *contemporaneously with the purchase or sale of securities that is the subject of such violation*, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class.

Id. (emphasis added.) *See* LANGEVOORT, *supra* note 173, at 266-271 (stating that section 20A's standing test essentially codifies the Second Circuit's approach to the problem); WANG & STEINBERG, *supra* note 16, § 6.2.

[252]Section 20A(a) of the Insider Trading and Securities Fraud Enforcement Act of 1988, 15 U.S.C. § 78t-1(a) (1994); H.R. REP. NO. 100-910, at 27 (1988).

[253]*See* LANGEVOORT, *supra* note 173, at 270-71.

[254]H.R. REP. NO. 100-910, at 27 n.22 (1988) (citing to *Wilson, Shapiro* and *O'Connor*).

[255]*Id.* at 27. There are problems with ascribing intent, understanding and attitude to a body such as Congress. This article nevertheless uses those terms here when discussing the various statements of committees and individuals contained in the legislative history of the Insider Trading and Securities Fraud Enforcement Act of 1988. Although there are also many potential problems with using the materials of legislative history in interpreting a statute, such materials are not entirely without value.

[256]*Id.*

[257]15 U.S.C. § 78t-1 (1994). Section 78t-1(d) provides:

> (d) AUTHORITY NOT TO RESTRICT OTHER EXPRESS OR IMPLIED RIGHTS OF ACTION. — Nothing in this section shall be construed to limit or condition the right of any person to bring an action to enforce a requirement of this chapter or

ITSFEA, but the House Report on the bill states the Committee's intention that the substantive law as developed by the courts should continue to evolve.[258] The courts were to be given "leeway to develop . . . private rights of action in an expansive fashion in the future."[259]

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the availability of any cause of action implied from a provision of this chapter.

Indeed, suits continue to be brought under the implied right of action. *See, e.g.*, Neubronner v. Milken, 6 F.3d 666 (9th Cir. 1993) (involving an investor bringing action against an investment banker); *In re* Motel 6 Sec. Litig., No. 93 Civ. 2183(JFK), 1995 WL 431326 (S.D.N.Y. July 20, 1995) (alleging nationwide insider trading scheme concerning corporate acquisition); *In re* Browning-Ferris Indus. Inc. Sec. Litig., 876 F. Supp. 870 (S.D. Tex. 1995) (alleging fraud and insider trading in connection with earnings projections); *In re* Zenith Lab. Sec. Litig., [1993 Transfer Binder] Fed. Sec. L. Rep. ¶ 97,617 (D. N.J. Feb. 11, 1993) (claiming misrepresentation of material fact with respect to sale of stock); Colby v. Hologic, Inc., 817 F. Supp. 204 (D. Mass. 1993) (involving a purchaser of stock alleging insider trading and other securities fraud).

[258]H.R. REP. NO. 100-910, at 27 (1988). At the full Committee markup, the Committee had accepted an amendment to delete language in the bill that would have provided an express private right of action not only to contemporaneous traders, but also to other parties who could show they were injured by the insider trading. The House Report, in its Summary of Legislation, explains the import of the amendment:

> The Committee's intention in this amendment was to avoid creating an express private cause of action which might have the unintended effect of freezing the law or in any way restricting the potential rights of action which have been implied by the courts in this area. Rather, the Committee wanted to give[] the courts leeway to develop such private rights of action in an expansive fashion in the future.

Id. The Report goes on to specifically recognize that insider trading results in injury to others than just contemporaneous traders:

> Despite the absence of explicit statutory language for private rights of action outside of the contemporaneous trader plaintiff situation, the Committee recognized that there clearly are injuries caused by insider trading to others beyond contemporaneous traders. In the view of the Committee, Section 10(b), Rule 10b-5, and other relevant provisions of the Exchange Act have sufficient flexibility to recognize and protect any person defrauded, or harmed by a violation of any provision of this title or the rules or regulations thereunder by another person's purchasing or selling a security while in the possession of material, nonpublic information, or communicating such information to others.

Id. at 27-28.

[259]*Id.* at 27. Nearly identical language also appears in remarks of individual members of both houses. *See* 134 CONG. REC. 23,600 (1988) (remarks of Rep. Lent) ("I want to point out something we are not doing: The bill makes no change to the substantive law of insider trading. That body of law should continue to evolve without any influence from this bill."); *id.* 32,545 (statement of Sen. Proxmire, explaining provisions of the bill as unanimously approved by the House) ("[T]his provision [establishing an express private right of action for contemporaneous traders] is not intended to restrict the evolving law on private rights of action. To the contrary, the courts are given leeway to develop such private rights of action in an exp[a]nsive fashion in the future as they see fit."); *id.* 32,547 (remarks of Sen. Garn upon introduction of the legislation in the Senate) (stating that "[t]his legislation will not restrict or freeze the law in this area, but will give the courts leeway to develop private rights of action in such cases in an expansive fashion in the future").

Though the statute gives no definition of "contemporaneous" other than a reference to the case law,[260] there are some indications of how Congress may have meant the term to be applied. First, the circumstances of the statute's inception give an idea of what Congress was trying to accomplish with its enactment. ITSFEA was passed in reaction to a number of Wall Street scandals involving insider trading,[261] and to public outrage at the huge profits gained illicitly by Wall Street players seen to be already rich and still greedy.[262] Remarks of several members of Congress give support to the idea that Congress meant to strengthen enforcement generally and to endorse the private action in particular.[263]

Congress's actions would seem to have weakened prior concerns about the reach of the private right of action for insider trading. Early concerns about continued judicial expansion of what was merely an implied right of

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[260]H.R. REP. NO. 100-910, at 27 (1988).

[261]*See id.* at 11-14 (recounting series of insider trading scandals occurring in recent years and continuing through time of deliberation on this bill, e.g., Boesky, Levine, Wang, Lee). *See also* remarks of various members on Congress, *e.g.*, 134 CONG. REC. 23,601 (1988) (remarks of Rep. Markey) (recounting "incessant drumbeat of insider trading violations . . . [that has] continued nearly unabated for over 2 years"). Representative Markey further remarked that "[t]he litany of Wall Street horrors in the last few years has made it clear that present law is not doing its job. It is time for a tighter and tougher legal standard."). *Id.* at 23,602.

[262]*See, e.g.*, 134 CONG. REC. 23,602 (1988) (remarks of Rep. Markey) (remarking that "in the aftermath of the October crash of the stock market and the endless tales of Wall Street greed run amok, the public has demanded that its representatives respond"); *id.* at 23,599 (remarks of Rep. Dingell) (referring to recent prosecutions and guilty pleas of traders such as Dennis Levine and Ivan Boesky).

> Underlying the explosion of this type of conduct is a certain economic and social Darwinism which holds that the strong were meant to prevail over the weak, and that the strong have no accountability. . . . Boesky told a gathering of business school students: "Greed is all right, by the way. . . . I think greed is healthy. . . ." Well, this bill will, in a limited way, control and restrain greed.

Id. (quoting Ivan Boesky (1985)).

[263]*See* H.R. REP. NO. 100-910, at 7-16 (1988) (stating, in statement of "Purpose and Summary," that "[t]his legislation would augment enforcement of . . . [insider trading laws by] provid[ing] greater deterrence, detection and punishment of violations"); *id.* (stating, in "Background and Need for the Legislation," that "[i]n the view of the Committee, the present enforcement framework should be strengthened"); *id.* at 26 (stating, in "Summary of Legislation," at "Express Private Rights of Action," that "[t]he value of . . . [the express private rights of action] provision is evident in the testimony of SEC Chairman Ruder, who stated on July 11, 1988, . . . that 'private rights of action have traditionally served as an important supplement to the Commission's enforcement of the federal securities laws'"). *See also* 134 CONG. REC. 32,546 (1988) (remarks of Sen. Heinz) ("The SEC cannot fight this war alone. Consequently, Congress must give honest market participants a clear right to judicial action to take back illegal profits from insider traders."); *id.* (remarks of Sen. Garn) ("[This legislation] would strengthen enforcement efforts against insider trading, deter future violators, and reassure investors that our nation's securities markets are fair and honest.").

action[264] should have been eased by Congress's double endorsement of the legitimacy of the private right of action: not only did Congress codify the action, using judicially created concepts, but it also specified that the new express action would be adding to, not displacing, the implied action,[265] which it encouraged courts to continue to develop.[266] Now courts should not be so fearful of the spread of the "judicial oak . . . [that] has grown from little more than a legislative acorn."[267] Concerns with the expansion of the implied right were based not only on the breadth of the potential class of plaintiffs, but, more fundamentally, on the Constitutional legitimacy of implying the action from the language of section 10(b) of the 1934 Act. In ITSFEA, Congress gave its stamp of approval by adopting the private right of action in its then-current form.[268]

b. *Damage Limitations*

As discussed above,[269] the contemporaneous trader requirement was created in part to address the fear of huge potential damages.[270] An alternative response to this concern was to cap damages.[271] ITSFEA provided a damage cap: damages in the private right of action would be limited to the amount of profit gained or loss avoided by the insider who traded.[272] In using both the contemporaneous trader requirement and damage caps, however, Congress gave a double dose of cure to the problem of excessive potential damages. By not recognizing that the contemporaneous trader requirement was designed in part to address this issue, and by adopting damage caps in addition to the contemporaneous trader requirement, Congress may have unintentionally restricted the potency

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[264]*See, e.g.*, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737, 747-49 (1975) (discussing the role of judicial interpretation of § 10(b)); Fridrich v. Bradford, 542 F.2d 307, 309 (6th Cir. 1976) (concluding that under the circumstances of the case, imposition of civil liability was unwarranted).

[265]15 U.S.C. § 78t-1(d) (1994).

[266]*See supra* notes 256-57.

[267]*Blue Chip Stamps*, 421 U.S. at 737.

[268]*See supra* note 251.

[269]*Supra* Part I.

[270]*See* sources cited *supra* note 28. The other concern addressed by the requirement was the issue of causation, and assuring that the private right of action would be limited to those harmed by insider trading. *See supra* Part II.A.

[271]*Id. See also* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 242 (2d Cir. 1974) (leaving open the possibility that district court's analysis of the Rule 10b-5 violations "may require limiting the extent of liability imposed on . . . defendants").

[272]15 U.S.C. § 78t-1(b)(1) (1994). Subsection (b) also reduces potential damages by any amount already disgorged by defendant to the SEC. *Id.* § 78t-1(b)(2).

of the private action, thus hampering Congress's overall purpose of strengthening the enforcement of insider trading prohibitions.[273]

Compare the approach of ITSFEA with that of the ALI Federal Securities Code.[274] Like the ALI Code, ITSFEA adopted a damage cap.[275] But ITSFEA did not adopt the ALI Code's corresponding expansion of the class of potential plaintiffs. Instead, ITSFEA adopts the "contemporaneous trader" requirement from the case law.[276] The "contemporaneous trader" approach expands the class of potential plaintiffs beyond those in actual privity with the inside trader, but, as it has been applied by courts,[277] still limits the class to those who *might* have "trad[ed] *with*" the insider.[278] In adopting the contemporaneous trader requirement from the case law, ITSFEA continues a pretending to privity, something the ALI drafters obviously believed inappropriate for insider trading actions based on open-market trading.[279] Even though ITSFEA was passed in part to strengthen enforcement against insider trading,[280] it codified a private right of action that is narrower than that adopted by the ALI Code, and arguably narrower than that allowed in *Shapiro*[281] and *O'Connor*,[282] two of the three cases cited in the House Report for ITSFEA.[283] To the extent that courts applying the implied action had not limited damages to disgorgement, ITSFEA even narrowed the then-existing implied private action by specifically capping damages.[284] This raises the question of whether Congress intended this

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[273]*See supra* Part II.C.2.

[274]*See supra* Part II.C.1.

[275]Insider Trading and Securities Fraud Enforcement Act of 1988, 15 U.S.C. § 78t-1(b) (1994).

[276]*Id.* § 78t-1(a).

[277]*See* discussion *supra* Part II.B.

[278]Neubronner v. Milken, 6 F.3d 666, 669 (9th Cir. 1993) (quoting Wilson v. Comtech Telecomm. Corp., 648 F.2d 88, 94-95 (2d Cir. 1981) (emphasis added)). *See also, e.g., In re* Browning-Ferris Indus. Inc. Sec. Litig., 876 F. Supp. 870, 909 (S.D. Tex. 1995); Moskowitz v. Lopp, 128 F.R.D. 624, 634 (E.D. Pa. 1989).

[279]Congress chose not to define contemporaneous trading in the Insider Trading and Securities Fraud Enforcement Act of 1988. Rather, it referred to the case law of the time for the definition. This leaves the question of whether the meaning of the term was meant to evolve along with its meaning in the implied action. If Congress meant to codify the meaning of contemporaneous as it existed in the three cases it referred to for the term, then one should look to *Shapiro, O'Connor,* and *Wilson* for its meaning. Those cases do not use the term uniformly, though. Only *Wilson* took the restrictive approach that was followed in later cases. If Congress meant for the meaning of the term to develop with the case law, the more restrictive meaning would apply.

[280]*See supra* note 226 and accompanying text.

[281]Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974).

[282]O'Connor & Assocs. v. Dean Witter Reynolds, Inc., 559 F. Supp. 800 (S.D.N.Y. 1983).

[283]*See supra* text accompanying note 254.

[284]Insider Trading and Securities Fraud Enforcement Act of 1988, 15 U.S.C. § 78t-1(b) (1994).

effect, especially given the extensive language in the legislative history acknowledging the inability of the SEC to handle enforcement of insider trading prohibitions without the assistance of private attorneys general,[285] and indicating an intent to enhance enforcement.[286]

III. WHAT HAPPENS WHEN AN INSIDER TRADES: CAUSATION AND HARM

The development of the law of insider trading has involved a struggle to define the contours of a violation that resembles common law concepts, but is in fundamental ways very different from common law situations.[287] The development of the private right of action has involved additional problems, particularly in the areas of causation and extent of liability.

A. *General Difficulties With Using Tort Concepts in the Securities Fraud Context*

Insider trading is a form of securities fraud. Common law notions of fraud and deceit provided references for courts as they developed the law of securities fraud under section 10(b) and Rule 10b-5.[288] The fundamental tort principle that a defendant's action must have caused a harm in order to be actionable was also carried into securities fraud cases (including those involving insider trading), but with a measure of confusion.[289] The confusion has made it difficult to state with clarity the elements of a cause of action for securities fraud under section 10(b) and Rule 10b-5. For example, several commonly recognized elements are referred to as dealing with causation, and several things are meant by the term "causation" in the securities fraud context.[290] Reference is made to causation in fact,[291] which

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[285]*See, e.g.*, H.R. REP. 100-910, at 26 (1988) (stating that private rights of action are important supplements to SEC enforcement of the federal securities laws).

[286]Congress strengthened penalties in the Insider Trading and Securities Fraud Enforcement Act of 1988. The House Committee Report noted that even the authority to impose civil penalties given to the SEC several years earlier in the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 15 U.S.C. §§ 78a(note), 78c, 78c(note), 78o, 78t, 78u, 78ff (1994), had not resulted in adequate deterrence of insider trading, as evidenced by the trading scandals that had occurred since the passage of Insider Trading Sanctions Act of 1984. H.R. REP. NO. 100-910, at 11-12 (1988).

[287]*See* Alexander, *supra* note 17, at 1488 ("Securities class action litigation today has little in common with suits over the common law torts of fraud and misrepresentation . . . .").

[288]*See, e.g.*, Basic Inc. v. Levinson, 485 U.S. 224 (1988).

[289]*See* CLARK, *supra* note 9, § 8.10.

[290]*See* WANG & STEINBERG, *supra* note 16, § 3.4.3, at 96.

[291]*See, e.g.*, Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 238-39 (2d Cir. 1974) (stating that causation in fact had been established by the "uncontroverted fact[] that defendants traded in . . . [the corporation's] stock without disclosing material inside information").

is often established through the element of reliance.[292] This has also been referred to as "transaction causation."[293] The causal connection being established by that element is between defendant's actions and plaintiff's decision to trade.[294] Another category of causation is proximate cause, which can be established through privity.[295] This has also been referred to as "loss causation."[296] The causal connection being established here is

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[292]*See* Basic Inc. v. Levinson, 485 U.S. 224, 243 (1988) (discussing the causal connection element).

> Reliance provides the requisite causal connection. . . . There is, however, more than one way to demonstrate the causal connection. Indeed, we previously have dispensed with a requirement of positive proof of reliance, where a duty to disclose material information had been breached, concluding that the necessary nexus between the plaintiffs' injury and the defendant's wrongful conduct had been established.

Id. (citing Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972)). *See also* Wilson v. Comtech Telecomm. Corp., 648 F.2d 88, 92 (2d Cir. 1981) ("The element of reliance serves to restrict the potentially limitless thrust of [R]ule 10b-5 to those situations in which there exists causation in fact between the defendant's act and the plaintiff's injury."); CLARK, *supra* note 9, at § 8.10.5, at 329 (noting that "[t]he causation requirement is traditionally divided into two parts: (1) the violation must have been a cause in fact, or 'but-for' cause of the injury and (2) it must have been a legal or proximate cause of the injury").

[293]*See Wilson*, 648 F.2d at 92 n.7. *See also infra* note 296 and Part III.B.1 (discussing transaction causation and the special problems it poses as related to insider trading in the open market).

[294]*See infra* note 296.

[295]*See* CLARK, *supra* note 9, at 337. Clark notes that privity is not the only way to establish proximate causation, just as reliance is not the only way to establish "but-for" causation. "Just as reliance can be viewed as one specification of the causation-in-fact requirement, so privity can be considered as one specification of the proximate causation requirement." *Id.* He states that:

> it is important to remember that reliance is only one way of specifying for *some* contexts the general and primary requirement of but-for causation in tort law. Once this point is grasped, it is easier to think about alternative chains of causation of injury in fraud cases, and to recognize the possibility that even "non-relying" plaintiffs can be hurt by fraud.

Id. at 329.

[296]The terms "transaction causation" and "loss causation" appear in *Wilson*. The court states that:

> [i]n . . . [a prior case], this court spoke of the need for "a showing of both *loss causation* — that the misrepresentations or omissions caused the economic harm — and *transaction causation* — that the violations in question caused the . . . [plaintiff] to engage in the transaction in question." In the instant case, . . . demonstration of the latter is the critical issue, as once this is done, the former is demonstrated rather easily by Wilson's proof of some form of economic damage— the loss he suffered upon selling his shares of Comtech.

Wilson, 648 F.2d at 92 n.7 (quoting Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380 (2d Cir. 1974)). At least one court and one commentator have found these terms unhelpful. *See* LHLC Corp. v. Cluett, Peabody & Co., 842 F.2d 928, 931 (7th Cir. 1988); JACOBS, *supra* note 18, § 64.01[a] at 3-360 (calling the term "transaction causation" "confusing and unhelpful"); *id.* § 64.02, at 3-360 (calling "loss causation" "a term which serves more to confuse than to elucidate") (citing *LHLC Corp.*).

between defendant's actions and plaintiff's harm or loss; the idea is that a defendant should be liable only for reasonably foreseeable injuries.[297] Both forms of causation are necessary to a private claim for damages under section 10(b) and Rule 10b-5.[298]

These tort concepts caused some difficulties in securities fraud law.[299] As to loss causation, the problem is that in the market setting it is difficult to attribute a quantifiable amount of harm to a defendant's actions.[300] Because market prices can fluctuate due to a number of factors, the loss attributable to the defendant's actions is hard to pin down. A plaintiff may have purchased at a price that was higher than the actual value of the security at the time,[301] or may have sold at a price lower than what he could have received had the information at issue been truthfully disclosed. But the actual value, or the price he would have received had there been no material misstatements or omissions, is a matter of speculation. Expert opinion seeking to set a level of harm inevitably contains a degree of uncertainty.

Problems also exist with respect to transaction causation. For example, in the case of misleading statements made in a proxy statement, individual damages might be so small that there would be little incentive for any particular shareholder to bring suit. If the action was brought as a class action, proof of actual individual reliance by each plaintiff would be difficult. It would pose an obstacle to the suit even to prove that each shareholder actually had read the allegedly misleading statements.

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[297]This element involves a judgment about limiting defendants' liability to "an amount that is just or socially efficient." CLARK, *supra* note 9, at 337.

[298]*See supra* note 296 (quoting language that requires both transaction causation and loss causation be shown).

[299]Robert C. Clark has said:

> Once a private right of action under Rule 10b-5 was implied and recognized, there was bound to be a period of painful growth, as the courts struggled to give shape and meaning to the standard list of elements of a tort action as applied to the new context. Who was to have standing to bring private actions? Who could be sued? What exactly would constitute the duty imposed? What would be needed to show a violation of the duty and causation of injury? What would the measure of damages be?... [The case law developments] illustrate the importance of having one conception or another of the harm caused by insider trading.

CLARK, *supra* note 9, § 8.10, at 316.

[300]*Id.* § 8.10.7.

[301]That is, the value taking into account the undisclosed information. In the case of undisclosed negative information, if the information had been disclosed, the market price would have been lower at the time of plaintiff's purchase. The efficient capital market theory posits that the market price closely approximates the actual value of a security when it is heavily traded, since it reflects the bargained-for transactions of a large number of traders. It is assumed that the market quickly incorporates material information regarding the security into price. *See* Basic Inc. v. Levinson, 485 U.S. 224, 245-47 & n.24 (1988). The Court in *Basic* cites to sources for the efficient capital market theory. *See id.* at 246 n.24 (citing, *inter alia,* Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases*, 38 BUS. LAW. 1 (1982)).

Additional problems are posed where, as is the case with insider trading, the securities fraud claims involve omissions or nondisclosure instead of affirmative misrepresentations. How does one prove reliance on things never said?

To deal with problems such as these, and to shape the tort-based requirements to a form appropriate to behavior taking place in securities markets, courts developed approaches specific to this context. For example, if the omitted or undisclosed facts were important enough that they would likely affect the trading decision of a reasonable investor if known, then reliance by the person claiming harm might be presumed.[302]

B. *Particular Problems With Insider Trading in the Open Market*

1. Transaction Causation (Causation in Fact)

In the sub-category of securities fraud that is insider trading, both transaction causation and loss causation pose special problems. As to transaction causation, it is very easy to see how reliance by the person claiming harm would be justified in the case of a face-to-face transaction between a plaintiff and a defendant insider. In the open market, however, a buyer or seller usually does not know with whom he is trading. In this setting it may be difficult to see how a plaintiff has relied on an insider's having informed him of all material information relevant to the transaction prior to its taking place.[303] In what sense, then, can the insider's actions be said to have caused the plaintiff's transaction?[304] The confusion over how to answer this question stems from the alternative nature of the duty imposed on insiders with respect to insider trading.

Defendant's liability in a private action for insider trading damages is determined under the disclose or abstain rule: the insider has a duty to

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[302]The kind of information justifying the presumption of reliance is that deemed material. Materiality is required under Rule 10b-5. *See Basic*, 485 U.S. at 231 ("'An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding [whether to trade] . . . .'") (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (determining definition of materiality for proxy situation)).

[303]An argument can be made that such reliance is justified because investors should be able to presume and rely on the presumption that other market participants will obey the law, and not trade on inside information. The concept of § 10(b) and Rule 10b-5 as protecting the integrity of the market, *see, e.g., Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 236 (2d Cir. 1974), suggests such an argument. *See also* United States v. O'Hagan, 521 U.S. 642, 658 (1997) (noting the purpose of the 1934 Act "to insure honest securities markets and thereby promote investor confidence" and that investors would likely "hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law").

[304]This was the question posed by the *Shapiro* defendants and the *Fridrich* majority. *See supra* Part II.B.1.b.

either disclose nonpublic material information in his possession or abstain from trading on it.[305] The alternative nature of this duty has led to disagreement and confusion about transaction causation. An insider can avoid a violation either by abstaining from trading, or by disclosing and trading. This has led to the argument that, because a defendant inside trader could have satisfied his duty by choosing not to trade, and because the plaintiff who traded on the open market did not even know with whom he was trading, then the defendant's actions could not have induced plaintiff to trade, and causation is lacking.[306] In other words, the plaintiff would have traded even if the defendant had done nothing wrong. The potential defendant has violated no duty, as that party has selected a viable alternative under the disclose or abstain rule.[307] It is therefore argued that defendant is not liable to plaintiff because defendant's action could not have caused either the trade or any alleged harm.[308] This understanding of causation in the open-market setting leads to the dismissal of insider trading claims for lack of causation.

An alternative understanding of causation has supported insider trading claims in the open-market setting. Instead of looking at causation in terms of defendant's option not to trade, some courts look at causation in terms of the option defendant in fact chose.[309] Because defendant chose to trade, he was obliged to disclose. The argument is made that, had he disclosed, plaintiff would not have traded (at least not on the same terms), and in that sense defendant's illegal action did cause the transaction that resulted in harm to the plaintiff.[310] It seems entirely fair that defendant, having had the option to abstain from trading, and having abandoned that option by trading, should be barred from arguing that he should not be held liable because he could have chosen differently.

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[305] *See supra* note 78.

[306] *See, e.g.*, Fridrich v. Bradford, 542 F.2d 307, 318 (6th Cir. 1976); *Shapiro*, 495 F.2d at 233-34.

[307] *See, e.g.*, *Fridrich*, 542 F.2d at 318; *Shapiro*, 495 F.2d at 235-36.

[308] This is the understanding of causation that was advocated for unsuccessfully in *Shapiro* and adopted by the Sixth Circuit in *Fridrich*. *See* discussion of those cases, *supra* Part II.B.1.b.

[309] *See, e.g.*, *Shapiro*, 495 F.2d at 238.

[310] This is the approach to causation used by the Second Circuit in *Shapiro*. *See supra* Part II.B.1.b. A court may focus on one or the other understanding of causation based on what it perceives to be the gravamen of the offense — whether trading or nondisclosure. The Second Circuit focused on "trading without disclosing." *Shapiro*, 495 F.2d at 238. The Sixth Circuit focused on "trading" alone. *Fridrich*, 542 F.2d at 318 (stating that it is "the act of trading which essentially constitutes the violation of Rule 10b-5").

2. Loss Causation (Proximate Cause; Harm, Damages)

As to loss causation, open-market insider trading presents problems because it is difficult to say who is harmed. Looking to the common law, some argued that any harm from a trading violation must fall on the person who dealt with the violator, the person in privity. But the common law again proved a poor fit for securities fraud.[311]

Though the harm from insider trading may initially fall on the person who was on the other side of the insider's trade (i.e., the person in privity),[312] this initial investor may end up trading again, passing on the security, and the harm, to a subsequent investor. If the inside information is still undisclosed at the time of this second trade, this subsequent investor stands in the same position in this trade as the initial investor did in the initial trade. Any harm initially falling on the person in privity is then passed on to the person with whom he trades, and the person originally in privity cannot be said to suffer any harm from that point on.[313] To understand this better, it is helpful to step back and determine the precise harm caused by insider trading.[314]

a. *Market Harm*

One aspect of the harm caused by insider trading is that such behavior undermines the integrity of the markets.[315] Some have argued that, if it is known that some market participants will always be playing outside the rules, other potential investors will be less likely to play with the deck

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[311]A privity requirement also posed practical obstacles to private actions for insider trading in the open-market setting. Transactions in the markets take place with substantial anonymity between traders. Though some transactions could be traced through from seller to buyer (or vice versa), it was said that identifying the person in privity would be difficult or impossible in most cases of open-market trading. WANG & STEINBERG, *supra* note 16, § 3.3.7. Insiders could escape liability to private plaintiffs simply by making their illegal trades on the market instead of in face-to-face transactions. *See Shapiro*, 495 F.2d at 238.

[312]There are arguably other forms of harm that fall on traders generally and the market as a whole. *See* WANG & STEINBERG, *supra* note 16, ch. 2-3. *See also infra* notes 315-25 and accompanying text.

[313]*See* WANG & STEINBERG, *supra* note 16, § 3.3; FEDERAL SECURITIES CODE § 1703(b) cmt. 2 (ALI 1980), *quoted supra* Part II.C.1, text at note 236.

[314]Some argue there is no harm in insider trading, at least none worth regulating. *See* WANG & STEINBERG, *supra* note 16, ch. 2.

[315]The jurisprudence of the implied right of action does not focus on this aspect of harm. *But see* discussion of express right of action in the Insider Trading and Securities Fraud Enforcement Act of 1988, *supra* Part II.C.2, note 263 and accompanying text.

stacked against them, and less likely to enter the market in the first place.[316] This can undermine investor confidence and, ultimately, the ability of companies to raise capital for productive activities.[317] Insider trading, thus, may harm society at large, which depends on those companies for goods and services, as well as for employment and tax revenues.[318]

b. *Harm to Individuals*

Insider trading also harms individual market participants. A private action was implied in part because of this harm. The harm to individuals can be seen as having two aspects, one general and one specific.

1. General Harm to Individuals

The general harm imposed on individuals from insider trading is the harm from trading in a harmed market. All investors bear certain risks from trading on the market. There is the risk of financial loss due to changes that will occur in their investments. There is also the risk that other investors will have better skills to analyze the market or will have done better market research, and will therefore trade at an advantage over those with less skill or less time to exercise it in choosing and managing their investments.[319] These are known (though perhaps unquantifiable) risks borne by all market participants.[320]

Investors trading in markets where insider trading is known to take place bear the additional risk that some people are not playing by the rules. The market is, to some extent and in unpredictable times and places, fixed.[321]

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[316]*See, e.g.*, United States v. O'Hagan, 521 U.S. 642, 658-59 (1997), *quoted supra* note 106 (discussing two types of risks faced by traders).

[317]*See* Alexander, *supra* note 17, at 1497 (stating that "[f]raud and misrepresentation in capital markets threaten investors' security, impair the ability of business to raise capital, raise the cost of capital, and undermine the integrity [of the market]").

[318]Some have disagreed with the idea that insider trading results in harm to society. *See, e.g.*, WANG & STEINBERG, *supra* note 16, § 2.4, at 39 ("the supposed beneficial and harmful effects of insider trading on society are quite speculative").

[319]*See O'Hagan*, 521 U.S. at 658-59 (noting that the informational disparity that comes from nonpublic information is not one that can "be overcome with research or skill").

[320]It has been specifically noted that it is not the object of the securities laws to assure equal information to all market participants. *See, e.g.*, Chiarella v. United States, 445 U.S. 222, 232-33 (1980). Rather, the securities laws aim to assure that all play by the same rules. *See O'Hagan*, 521 U.S. at 658-59.

[321]*See O'Hagan*, 521 U.S. at 658-59, *quoted supra* note 106.

Some argue that this risk is also one that is appropriately borne by all market participants and that, therefore, insider trading should not be illegal. If it were not illegal, then everyone would expect it as a "normal market risk." The argument that this is an inappropriate risk depends on an

All market participants bear this additional risk.[322] The extent of the risk will depend on the likelihood that insider trading is occurring.[323] This risk can be addressed only through deterrence of insider trading. The level of risk of this harm will vary inversely with the level of deterrence.[324] Under current law only an incidental role is recognized for the private right of action in redressing this type of harm.[325]

2. Specific Harm to Individuals

Individuals will suffer additional harm if they are involved in specific instances of insider trading, to the extent that insiders benefit beyond what they would have earned without the inside information.[326] Those gains, which the law considers to be illicit, do not result from an insider's having superior skill in market research or analysis, nor do they result from his having added value to the market or in fact from any productive activity.[327] Rather, they come from other investors and at their expense: the insider's gain is matched by a corresponding loss on the other side of the market.[328]

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assumption that insider trading is wrong.

[322]Insiders will bear this additional risk to a lesser degree with respect to their own company's securities (though even there they may have less access to company information than other insiders), but will bear it equally with other investors with respect to the securities of other companies. The exception is where an insider learns confidential information about another company, by virtue of his position with his own company, for example, information that his company (Company A) is planning a takeover of another company (Company B). The Supreme Court's recent decision in *O'Hagan* confirmed that this trading advantage subjects the insider of Company A to insider trading sanctions for his trading of securities of Company B, the subject of a tender offer by Company A. *O'Hagan*, 521 U.S. at 666-67 (upholding SEC Rule 14e-3).

[323]That is, the higher the probability of insider trading, the greater the risk to all market participants of this type of harm.

[324]This assumes that the perception of deterrence is relatively accurate; to the extent it is not, the level of risk of this harm will vary inversely with the perceived level of deterrence.

[325]Though it is said that the private action serves to deter insider trading, in fact the contemporaneous trader requirement reflects a compensation-based theory of the private action, and is applied so narrowly that very little deterrence can be effected. *See* CLARK, *supra* note 9, § 8.5.4. For comments on compensation-based remedies in securities fraud cases not involving insider trading, see Alexander, *supra* note 17; Langevoort, *supra* note 25.

[326]Insiders may of course gain an advantage fairly, through their expertise, research (into publicly available information) and skills of analysis. Those who oppose the prohibition of insider trading would argue that the gain from insider trading should also be considered a fair gain, perhaps a perquisite of the insider's position within the company. Opponents of this position argue that insider trading gains are a poor form of executive compensation, given that they are unmeasurable and unmonitored, and that insider trading can be seen as essentially a misappropriation of corporate property (i.e., the corporation's property interest in its confidential information).

[327]*See O'Hagan*, 521 U.S. at 658-59, *quoted supra* note 106.

[328]*See, e.g.*, WANG & STEINBERG, *supra* note 16, § 3.3.5. The contemporaneous trader requirement is based primarily on this type of harm.

Professor Wang describes an additional harm due to the fact that the insider preempted

This harm initially falls on the person in privity with the insider.[329] If before the inside information is made public that person trades the stock he acquired from the insider, however, the harm is passed along with the security.[330] The process can continue further. This second person may trade again before the market price adjusts to take account of the information at issue, thereby passing the harm along again and netting out his position.[331] The person left holding that stock when the information is disclosed and integrated into the market price is the one on whom this specific harm ultimately falls.[332] Following the reasoning that led some courts to identify the person in privity as the one harmed, and to restrict the private right of action to that person, this analysis reveals that the person ultimately left holding the cards is the person harmed and the person who should have the right to bring an action to recover.[333] This may or may not be the person in privity. It depends on the trading that takes place between the time of the insider's trade and the time of disclosure, when "the game is up."[334]

IV. ELIGIBILITY TO BRING A PRIVATE ACTION FOR INSIDER TRADING

A. *Alternatives and Recommendations*

Given this understanding of causation and harm, there are several alternatives regarding who should be eligible to bring a private action for insider trading.[335]

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someone else from making the trade he himself made. *See id.* § 3.2. If the insider purchases at the current market price with knowledge that the security is actually worth much more and that the price of the security will (very likely) soon be going up, he preempts someone else who could otherwise have purchased those same shares at that same price. If that person had had the chance to purchase those shares, and had held them until the market price adjusted to whatever the insider knew, then that person would have made the profit (albeit by chance) that was instead made by the insider.

[329]*See id.* § 3.3.

[330]The assumption is made for the sake of simplicity that the market price for the security remains the same between the time the person in privity traded with the insider and the time he traded with a third person.

[331]*See* WANG & STEINBERG, *supra* note 16, § 3.3.

[332]*See id.*

[333]*See id.*

[334]Determining this point may not be easy. The market may begin to react on rumors even before the public disclosure of the information. After public disclosure, a question may remain as to how long it takes the market to fully integrate the information.

[335]For different lists (though with some overlap) of alternatives as to what is the proper class of plaintiffs to bring an implied action for damages for insider trading, see, e.g., WANG & STEINBERG, *supra* note 16, § 6.9; Robert B. Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349, 393 (1984) (listing three possible plaintiff groups: "(a) the person in privity with the insider; (2) all shareholders disadvantaged by lack of information; and (3) the corporation").

1. No One (No Private Right of Action)

One option is to eliminate the private cause of action. This alternative is predicated on the difficulties of identifying the individuals harmed by specific instances of insider trading. Some have argued that section 10(b) was never meant to provide a private right of action and that enforcement was intended to be, and should be, left to the SEC.[336] The problem with this option is that private enforcement is considered to be a necessary supplement to SEC enforcement.[337] The SEC itself has argued that it does not have sufficient resources to be the sole monitor of these activities and enforcer of these laws.[338]

If enforcement solely by the SEC makes sense, though, perhaps the answer to this problem is to increase the resources of the agency, thus eliminating the need for private supplement. This might seem to eliminate the problem of identifying the victims of the specific harm of insider trading. But the SEC, in enforcement actions and settlements, itself looks for the people to whom it would be reasonable to distribute any disgorged profits from insiders.[339] The SEC has used the group of contemporaneous traders for this purpose.[340] If the intention of the agency is to distribute funds to those harmed by insider trading, then the SEC would still need a tool to identify those harmed.[341] This need would continue even if the courts avoided the identification issue by eliminating the private right of action[342] and thereby the question of who has the right to sue.[343]

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[336]*See* Fridrich v. Bradford, 542 F.2d 307, 320-22 (6th Cir. 1976); David S. Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. U. L. REV. 627, 658 (1963); Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 432 n.209 (1990). Another problem is that Congress has established the private right of action in the ITSFEA. Elimination of the express action would therefore require Congressional action, which is unlikely. Although the ITSFEA endorsed the continued existence and development of the implied action, *see supra* Part II.C.2, there seems to be no barrier to the courts' eliminating the action they themselves implied.

[337]*See supra* note 25 and accompanying text.

[338]*See, e.g.*, H.R. REP. NO. 100-910, at 14 (1988) (citing testimony at legislative hearing on Insider Trading and Securities Fraud Enforcement Act of 1988 of SEC Chairman David S. Ruder). In addition to its role in providing compensation to victims of the conduct, the private action has an important role in deterring illegal conduct.

[339]*See, e.g.*, SEC v. Wang, 944 F.2d 80 (2d Cir. 1991) (upholding as reasonable a disgorgement plan which differentiates option traders from common stock traders).

[340]*Id.*

[341]*See supra* note 339.

[342]*See supra* note 337 and accompanying text.

[343]Of course, the SEC's problem could also be avoided by keeping the funds itself. This would avoid the problem of identifying those harmed as well as ameliorate the problem of inadequate resources. Such a system of enforcement would address the harm to the market and the general harm to individuals from playing in a "fixed" market. It would leave unaddressed the

2. Person or Persons Harmed (Specific, Individual)

A second option is to limit the private action to those harmed. This is what courts have attempted to do since they first implied the private action.[344] The contemporaneous trader requirement is based on a notion of harm that focuses on the specific individual harm described above, to the exclusion of both market harm and the general harm to individuals.[345] Even if the focus of the private action is limited to specific individual harm, however, the contemporaneous trader requirement is not a rational standard for determining who is entitled to sue.[346]

The early idea that privity should be required because only those in privity are harmed by the insider's trading[347] must be corrected to account for the market reality that initial trading disadvantages can be passed along on the same terms until the market integrates the information into the share price.[348] The person ultimately harmed is the person holding the securities when the information is disclosed.[349] Under the stated justifications for the contemporaneous trader requirement, that person (who may *not* be the person in privity) should be able to sue for damages for that specific harm.[350] One option, then, is to grant a right of action to that person. This would involve giving the right of action to the person in privity, unless that person

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specific harm to individuals that comes from being involved in specific instances of insider trading. *See supra* notes 326-34 and accompanying text. Better deterrence would reduce the frequency of such harm, but the specific occurrences of such harm would not be addressed unless the funds were distributed to individual traders. That, of course, leads right back to the problem of deciding to whom to give the recovery.

[344]*See generally* Thompson, *supra* note 335, at 391-97 (discussing possible plaintiffs).

[345]*Id.*

[346]Limiting the private right of action to those suffering this particular kind of harm is just one possible approach. Another would be to focus on the general harm to individuals that results from insider trading. *See supra* Part III.B.2. This would mean that even limiting the private action to those harmed (as is discussed in this section) would leave all market participants eligible to bring suit. The group would still be limited by *Blue Chips*'s purchaser/seller requirement. In addition to addressing the general harm to individuals by reducing the instances of insider trading, this approach would enhance the deterrence potential of the private action. It might be a more effective approach overall, as the compensation function of the private action works poorly at best. *See* Alexander, *supra* note 17, at 1489.

[347]*See supra* Part II.A.

[348]The terms of the subsequent trades may not be identical, but as long as insider trading is not again involved in these later transactions, any differences will be a product of normal variations, involving normal market risk. *See supra* note 320 and accompanying text.

[349]The assumption is made, for the sake of simplicity, that the insider sold on the basis of negative information.

[350]*See* WANG & STEINBERG, *supra* note 16, § 3.3.

traded again prior to the disclosure of the information, in which case the right would be given to the person with whom he traded, and so on.[351]

Such an approach would require tracing the chain of all pre-disclosure trades of the securities traded by the insider, to find the person or persons on whom the harm finally came to rest. If identifying the person in privity with the insider is difficult, or even impossible, then determining the person who ultimately bears this variety of harm is much more so. It would require identifying trading partners, not once, but perhaps many times over. The problem is that those persons cannot be identified.[352] Just as the privity requirement was abandoned in favor of a proxy (the contemporaneous trader requirement) in part because of identification problems,[353] the corrected "person harmed" requirement must be abandoned and a reasonable proxy sought.

3. Proxy for Those Harmed

A third option for who should be eligible to bring a private action comes from the reasoning that led courts to create the contemporaneous trader requirement. That requirement is based on the erroneous assumption that those in privity are the ones harmed.[354] If privity makes no sense (because those in privity are not necessarily the ones harmed) then a proxy for privity can make no more sense.[355] The contemporaneous trader requirement therefore is unjustified even in terms of what it was established to accomplish, that is, to act as a proxy for those harmed.

It might make sense, though, to do what the courts were trying to do with the contemporaneous trader requirement: if it is difficult or impossible to identify the persons actually harmed, then create a proxy for those people. The contemporaneous trader requirement is the proxy used for privity.[356] The analogous group to those trading contemporaneously, that would take into account a better understanding of where the harm falls, was indicated in the discussion above about who is harmed.[357] Because the harm can be passed along, shifting from trader to trader, the group should include more

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[351] *See id.*

[352] *See* WANG & STEINBERG, *supra* note 16, § 3.3.7. This may include more than one person if more than one share of the security was traded originally. The difficulty is increased exponentially to the extent that any trader along the line (including the insider) splits up the total number of shares initially traded, and sells portions of them to different people.

[353] This was not the only reason. *See* discussion of *Shapiro supra* Part II.B.1.

[354] *See* WANG & STEINBERG, *supra* note 16, § 3.3.

[355] *See supra* text accompanying notes 46-50.

[356] *See, e.g., id.*

[357] *See supra* Part III.B.2.

than just those who traded in temporal proximity to the defendant. The period of covered trading should begin with the insider's first trade and end when harm can no longer be passed on.[358]

The aspect of insider trading that makes it unfair, and therefore illicit, is the insider's market advantage, that is, his knowledge of the undisclosed material information. That market advantage ends with disclosure.[359] Once the information is disclosed, the next buyer (or seller) will not trade on the same terms, so the disadvantage first imposed by the inside trader on his trading partner comes to rest on the last person in the chain to have traded prior to disclosure. Traders along the chain of privity who trade after the insider and prior to disclosure are all on an equal footing vis-à-vis each other — they all trade ignorant of the inside information.[360] The point of disclosure is the point where the information starts to become integrated into the market price of the securities and, therefore, the point where any profit gained (or loss avoided) by the insider trading can be realized. Anyone trading after that point will not accept a trade on the prior terms, and therefore cannot have the original specific harm passed on to him.

To summarize this part of the discussion, the contemporaneous trader requirement represents an attempt to allow a right of action to those harmed by the insider's trading.[361] It takes into account the circumstances of securities trading, in which it is difficult to identify the actual victim when the trading takes place in the open market.[362] But it is based on the mistaken assumption that any harm from insider trading falls only on the one in privity with the insider. This approach fails to recognize that harm may fall on non-privity traders, while the person in privity may sustain no actual harm. The

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[358]*See* O'Connor & Assocs. v. Dean Witter Reynolds Inc., 559 F. Supp. 800, 803 (S.D.N.Y. 1983). To simplify identification problems for potential plaintiffs who traded on the same day as the insider, the period could begin at the start of the day when the insider first traded, as is done in the ALI Code. *See supra* note 234 and accompanying text.

It might be objected that, if the information is never disclosed, this period could go on endlessly, thus exposing the defendant to unlimited liability. *See, e.g.*, Wilson v. Comtech Telecomm. Corp., 648 F.2d 88, 94 (2d Cir. 1981) (noting that "extend[ing] 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"). This objection can be partially addressed through damage caps. *See infra* Part IV.B. Then, too, if the information is never disclosed, it is unlikely that the insider will ever realize a gain from his illicit trading. After all, it is the expected change in the price of the security, brought about by the market's reaction when the information is disclosed, that creates the gain for the inside trader.

[359]The reason that disclosure is a rational endpoint to the period over which the harm may be passed along is that the event of disclosure brings the harm to rest. The point just before disclosure is the last point when the next investor in the chain that began with the insider will be trading at a similar disadvantage as the person originally in privity with the insider.

[360]*See supra* Part III.B.2.b.2.

[361]*See supra* text accompanying notes 344-45.

[362]*Id.*

person or persons harmed, therefore, could be anyone trading along the chain of transactions until disclosure of the insider information. The contemporaneous trader requirement was developed by courts in part to deal with the difficulty of identifying the person in privity.[363] Those difficulties are amplified when this alternative understanding of harm is substituted for privity. A solution would be to follow earlier courts in using a proxy for those actually harmed, and to grant those people the right to bring suit. The proxy would be anyone trading from the time the insider first traded up until the disclosure of the inside information.[364]

B. *Scope of Liability: The Continuing Problem of Damages*

The second concern that gave rise to the contemporaneous trader requirement focused on the unlimited scope of potential liability.[365] A broad right of action could expose inside traders to extensive damages, well beyond any illicit gain. This is not the theoretical problem of causation (though that overlaps with this concern and they play on each other), but rather a practical concern. If a private right of action is allowed for open-market trading, and privity cannot be used to limit the group of those who can exercise that right, then what substitute can be used to serve the practical purpose privity was (in part) meant to serve?[366] Privity served to limit the liability to which a defendant could be exposed. Without a limitation of defendant's liability to the person with whom he trades, defendant "could... [be] liable to all the world."[367]

The perceived unfairness of this led some courts to refuse to subject the defendant to such liability.[368] One possible response to this is to say that that was a risk defendant bore by choosing to trade in violation of the law. Another is to say that such broad liability is unfair, that defendants should not be held liable for it all as "reasonably foreseeable," and that therefore

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[363]*See* Wang, *supra* note 16, at 1191.

[364]The action is generally considered to be available only to those who traded in the opposite direction to the insider. This requirement is also a part of the express action in the Insider Trading and Securities Fraud Enforcement Act of 1988, *see* 15 U.S.C. § 78t-1 (1994). *Accord* FEDERAL SECURITIES CODE § 1703(a)-(b) (ALI 1980).

[365]*See supra* Part II.A.

[366]*See* Fridrich v. Bradford, 542 F.2d 307, 322 n.33 (6th Cir. 1976) (explaining that "[i]t seems clear that if recovery is to be allowed against insiders in an open market context, some limitations upon damages must be imposed").

[367]*See* Wilson v. Comtech Telecomm. Corp., 648 F.2d 88, 94 (2d Cir. 1981); *Fridrich*, 542 F.2d at 323 n.2 (Celebrezze, J., concurring) (quoting Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1292 (2d Cir. 1969)).

[368]*See, e.g.*, *Fridrich*, 542 F.2d at 307 (refusing to hold liable defendant inside traders where trades took place on the open market and plaintiffs could not show privity).

such a large group of plaintiffs should not have the right to bring suit. A variation is to say that if defendant's gain came at someone's expense,[369] then surely there is a problem with saying that defendant's gain of, say, $100,000 should make him liable for the harms of a number of plaintiffs, which harms total $1,000,000.[370]

One solution would be to interpret the causation requirement so that it is not satisfied in cases of open-market trading.[371] A better solution is to deal with the problem of enormous potential damages directly by limiting the amount for which a defendant can be held liable. It is more appropriate to deal with the damage concern separately, through damage caps,[372] rather than skew the causation element to close the doors of the courts in order to address this special problem of insider trading. The measure of liability should be based on the amount of harm caused by defendant's violation, a harm which can be measured by defendant's profit gained or loss avoided by use of the inside information. If the private action is to assist in deterring future violations, the actual damages imposed must be some multiple of that basis. The multiple should be inversely related to the probability of detection and successful prosecution, and might be increased for a stronger deterrent effect.[373]

V. CONCLUSION

The contemporaneous trader requirement developed out of concerns about causation and harm under the implied right of action for insider trading.[374] The resolution of these issues can be confusing because of theoretical difficulties with taking principles of causation and harm from the

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[369]*See, e.g.*, WANG & STEINBERG, *supra* note 16, § 3.3.5.

[370]*See supra* text accompanying note 246.

[371]*See* Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976). *But see* CLARK, *supra* note 9, at 336. *See also supra* note 193 (quoting CLARK, *supra* note 9, at 336).

[372]*See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); FEDERAL SECURITIES CODE, (ALI 1980); Insider Trading and Securities Fraud Enforcement Act of 1988, 15 U.S.C. § 78t-1(a) (1994).

[373]Where the probability of detection and successful prosecution is less than 100%, a simple disgorgement cap for damages in private actions will not sufficiently deter. *See* CLARK, *supra* note 9, § 8.10.7, at 339. If the private action is a necessary tool in the enforcement of insider trading prohibitions, then it is necessary to increase the damages available in those actions to complete an enforcement scheme that possesses sufficient deterrent capacity. For recent proposals regarding damages in securities class actions, see Alexander, *supra* note 17 (not addressing the insider trading situation, but noting the problems with compensatory basis of damage schemes and the advantages of deterrence basis); Langevoort, *supra* note 25. Damages are an important part of any discussion seeking to maximize the effectiveness of enforcement of the insider trading laws.

[374]*See supra* Part II.A.

tort context and transferring them into the securities context.[375] Courts started with the idea that the implied right of action should be available to those harmed by insider trading. The person in privity was identified as the one harmed, and the contemporaneous trader requirement was developed as a proxy for privity because of the difficulty of identifying the one in privity. Even leaving aside the harm to the market and the general harm to individuals, and focusing only on the specific harm to individuals, the understanding of harm on which the contemporaneous trader requirement is based is mistaken. The person who initially trades with the insider (if he can be identified at all) is not necessarily the one on whom the harm from insider trading comes to rest. A corrected notion of harm would take into account the fact that the person initially trading with the insider may pass the harm along by trading the security again prior to disclosure of the information. Because identification problems are only exacerbated under this understanding, a proxy for those harmed would still be needed. A sensible proxy is that proposed by the American Law Institute in its Federal Securities Code: for open-market trading, anyone trading in the same stock as the insider between the time the insider trades and the time the information is disclosed should have a right to bring a private action for insider trading. Although this may be seen as opening up the class of traders eligible to bring suit and therefore leaving unaddressed the risk of inordinate liability for the inside traders, a cap on damages to make them commensurate with the insider's trades will make total liability equal to what it might be under either a privity requirement or the contemporaneous trader requirement. Such a change in the class of those eligible to bring suit would also eliminate the uncertainty of individual determinations of who qualifies as a contemporaneous trader in each case.

There are other problems surrounding the implied right of action for insider trading. Several of these have been mentioned but not dealt with in this article. The change advocated here would lay a solid foundation from which to consider and enact improvements to address those other problems.

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[375]Confusion also results from disagreements over the legitimacy, purpose, and scope of the implied right of action.