A [DIS]SEMBLANCE OF PRIVITY: CRITICIZING THE CONTEMPORANEOUS TRADER REQUIREMENT IN INSIDER TRADING*

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*The title is drawn in part from *Fridrich v. Bradford*, 542 F.2d 307, 325 (6th Cir. 1976) ("without at least a 'semblance of privity,' defendants' liability could extend to complete strangers") (quoting Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701, 706 (S.D.N.Y. 1951)("A semblance of privity between the vendor and purchaser of the security in connection with which the improper act, practice or course of business was invoked seems to be requisite . . . ."), *aff'd*, 198 F.2d 883 (2d Cir. 1952)).

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I. INTRODUCTION

In 1934, not long past the trough of the Great Depression, Congress passed and the President signed the Securities Exchange Act.[1] The Act was aimed at restoring confidence in the securities market by combating fraud. Sections 10(b) and 16,[2] in particular, were written to address market manipulation and insider trading, respectively. As section 16 turned out to be ineffective to combat insider trading on its own, section 10(b), and specifically Rule 10b-5[3] promulgated by the Securities Exchange Commission (SEC) under the authority of the 1934 Act, gradually became the chief weapon against insider trading. Whereas section 16 provided for recovery by a corporation of gains realized by certain insiders from trades in it stock,[4] section 10(b) apparently did not provide for any recovery by the defrauded, but only for government actions against the insider. The courts, however, recognizing both that the government could not effectively act against every inside trader and that those harmed deserved to recover damages, gradually implied a private cause of action under section 10(b). Unlike section 16, however, with its clear limits on who could recover against whom, section 10(b) had no such limits because the drafters had not contemplated the defrauded acting as private attorneys general.[5] The courts therefore developed limits on the action, including limits on the potential group of plaintiffs. Among the limits was a "contemporaneous trader requirement," a kind of surrogate for privity in the impersonal securities market.[6] Congress, in recognizing and codifying the private right of action in 1988,[7] also codified the contemporaneous trading requirement.[8]

Codification was obviously unnecessary, given the extant judicial decisions. The decision to codify the contemporaneous trader requirement, however, was not just unnecessary, but also unwise. The contemporaneous trader requirement itself was never easy to apply; absent real privity it was essentially indeterminate. Worse, it ignored both the complexities of causation in a modern securities market and the real harms of insider trading.

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[1]Securities Exchange Act, ch. 404, tit. 1, 48 Stat. 881 (June 6, 1934) (codified as amended at 15 U.S.C.A. § 78a (West 1977)).

[2]*Id.* §§ 78j(b), 78p.

[3]17 C.F.R. § 240.10b-5 (1997).

[4]Section 16(b) provides for an insider's disgorgement of gains resulting from his purchase and sale of the company's securities within six months. It applies only to trades by officers, directors, and beneficial owners of more than 10% of any equity security. 15 U.S.C.A. § 78p(b) (West 1997).

[5]*Id.* §§ 78p, 78j(b).

[6]*See infra* Part II.B.

[7]15 U.S.C. § 78t-1(a) (1994).

[8]*Id.*

Still worse it created an obstacle to efficient deterrence of the very act for which the private right was discovered — insider trading.

The contemporaneous trader requirement should be replaced with a more appropriate designation of who is allowed to bring a private action for insider trading. This article will discuss the concerns that gave rise to the contemporaneous trader requirement and various alternatives for addressing them. It argues that the alternative chosen by the courts and Congress, the contemporaneous trader requirement, does not satisfactorily address those concerns. Those concerns are better addressed by a different alternative, which expands the availability of the private action, but provides a cap for damages.[9]

Part II begins with a background section on the concerns that gave rise to the contemporaneous trader requirement and other alternatives the courts could have chosen for dealing with those concerns. Part II also reviews the adoption of the contemporaneous trader requirement by the courts and the legislature. One section reviews the cases in which the requirement was initially developed and summarizes subsequent judicial development of the principle. It points out that the requirement was flawed from its creation, poorly addressing the concerns it was created to alleviate. The next section reviews a different alternative for addressing those concerns, that adopted in the American Law Institute's proposed Federal Securities Code. The final section of Part II discusses Congress's adoption of the contemporaneous trader requirement as part of the express private right of action in the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA). Part III discusses in greater detail what happens when an insider trades and the practical problems of causation and harm. It points out that the alternative the courts and Congress chose to address those issues fails to do so appropriately. Part IV goes on to explore a range of possible alternatives to the contemporaneous trader requirement. It recommends that the requirement, which currently restricts the private right of action to those trading on the same day as, or within a few days of, the defendant insider, be replaced by a doctrine opening the private action to all those who traded after the insider and prior to public disclosure of the information.

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[9]This combination of a broader eligibility to bring suit and damage caps is not new. It is the rule proposed by the American Law Institute in its Federal Securities Code. FEDERAL SECURITIES CODE (ALI 1980). *See infra* Part II.C.1. Others have criticized the contemporaneous trader requirement. *See, e.g.*, ROBERT C. CLARK, CORPORATE LAW § 8.10.5, at 336-37 (1986) (reasoning that the compromise position represented by the contemporaneous trader rule "appears to make an irrational distinction between public traders who can and cannot be plaintiffs"). What this article adds is a systematic critique of the current standard in terms of the very justifications offered for it by the courts that developed it.

II. DEVELOPMENT OF THE CONTEMPORANEOUS TRADER REQUIREMENT

A. *Introduction to the Contemporaneous Trader Requirement: The Problems it Was Created to Address, Alternative Solutions, and Why the Requirement Is an Unsatisfactory Solution*

The prohibition of insider trading is an established part of the American legal landscape. The Supreme Court's June 1997 decision in *United States v. O'Hagan*[10] indicates that it is alive and well. Insider trading is generally defined as trading on the basis of nonpublic information by individuals who learned of the information by virtue of their position within the company.[11] As with other varieties of securities fraud, the law of insider trading reflects a struggle to define the contours of a statutory violation that, while resembling certain common law concepts, differs in fundamental ways from common law approaches to liability and compensation.[12] One aspect of that struggle involves the theoretical basis of the insider's violation, in particular the issues of factual and legal causation of actual loss.[13] This is one source of contention and confusion. Another is the existence and scope of a private right of action, in particular the potential scope of a defendant's liability for damages to plaintiffs.[14] The struggle over these issues of

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[10]521 U.S. 642 (1997).

[11]The Supreme Court recently stated the basic theory of insider trading liability:

> Under the "traditional" or "classical theory" of insider trading liability, §10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information. Trading on such information qualifies as a "deceptive device" under §10(b), we have affirmed, because "a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation." That relationship, we recognized, "gives rise to a duty to disclose [or to abstain from trading] because of the 'necessity of preventing a corporate insider from... tak[ing] unfair advantage of... uninformed . . . stockholders.'"

Id. at 651-52 (quoting Chiarella v. United States, 445 U.S. 222, 228-29 (1980)). The prohibition "applies not only to officers, directors, and other permanent insiders of a corporation, but also to attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation." *Id.* (citing Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983)). The discussion in this article is limited to the case where the insider traded on a national securities market.

[12]Some of the concepts that have proven to be problematic in the securities market context are reliance, causation and standing. Courts have adapted these elements in an attempt to give force to the law while maintaining some requirement of a causal link. *See infra* Part III.

[13]*Id.*

[14]The decisions in which the contemporaneous trader requirement originated reflect a concern with the extent of liability because of the possibility of excessive damages. *See, e.g.*, Wilson v. Comtech Telecomm. Corp, 648 F.2d 88, 94 (2d Cir. 1981) (stating a concern with extending the period of liability because that "could make the insider liable to all the world"); Fridrich v. Bradford, 542 F.2d 307, 323 (6th Cir. 1976) (Celebrezze, J., concurring) (discussing the

causation and scope of liability is reflected in the development of the contemporaneous trader requirement. This is the requirement that to be eligible to bring a private action to recover for insider trading, a person must have traded contemporaneously with the insider. The contemporaneous trader requirement evolved in the courts[15] and was later adopted by Congress.[16] Though the requirement was created to address real difficulties in the law of insider trading, it is an inappropriate and unnecessary resolution of the problems posed by the complexity of causation in the market setting and the nature of the harm caused by insider trading.[17] This requirement renders the private action inadequate as both a legal and a policy tool.

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importance of "defining the scope of civil liability under [R]ule 10b-5 in an open market context"). Later courts express concern about the extent of liability in terms of the great number of possibly baseless suits a defendant may have to defend against. *See* Neubronner v. Milken, 6 F.3d 666, 670-71 (9th Cir. 1993). Both policy concerns have led courts to narrow the group of potential plaintiffs. *See infra* Part II.B.

[15]The case most often cited for this requirement is *Wilson v. Comtech Telecomm. Corp.*, 648 F.2d 88 (2d Cir. 1981). *Wilson* cites to a concurrence in an earlier case, which is itself often cited for the requirement. *See Fridrich*, 542 F.2d at 323 (Celebrezze, J., concurring). *See also* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237 (2d Cir. 1974) (holding that "defendants owed a duty . . . not only to the purchasers of the actual shares sold by defendants . . . but to all persons who during the same period purchased . . . [the] stock in the open market without knowledge"); O'Connor & Assocs. v. Dean Witter Reynolds, Inc., 559 F. Supp. 800, 803 (S.D.N.Y. 1983) (following *Shapiro* and *Wilson*, holding that "the duty to 'disclose or abstain' is owed not only to those who trade directly with the possessor of inside information, but in general to those who trade 'during the same period' as, or 'contemporaneously' with, the possessor of inside information").

[16]The judicially created contemporaneous trader requirement was adopted by Congress in the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA). Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988) (codified at 15 U.S.C. §§ 78c(a), 78o, 78t-1, 78u(a), 78u-1, 78ff(a), 78kk, 80b-4a (1994)). The implied right of action remained undisturbed by the Act. 15 U.S.C.A. § 78t-1(d) (West 1997), quoted *infra* note 257.

The requirement has been discussed in detail by William K.S. Wang, in an article published the year before the Insider Trading and Securities Fraud Enforcement Act of 1988 was passed. William K.S. Wang, *The "Contemporaneous" Traders Who Can Sue an Inside Trader*, 38 HASTINGS L.J. 1175 (1987). *See also* WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING ch. 6 (1996) (discussing the contemporaneous trader requirement).

The Supreme Court has not decided the issue of who may sue in an implied action for damages. *See id.* § 6.1, at 395.

[17]As mentioned *supra* Part I, it is also an obstacle to an efficient level of deterrence of insider trading and an awkward standard to apply; it admits of no rational application. Perhaps in part because of this, courts have come to apply it in the narrowest way possible, essentially recreating a privity requirement for private insider trading actions. For a critique of the deterrent and compensatory effects of the current scheme of damages in securities class action suits, see Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487 (1996) (noting that the current scheme of damages does not advance the goals of the securities law, but on the contrary, hinders them; limiting discussion to cases where defendant has not traded, and therefore excluding insider trading as requiring a modification of the analysis presented).

Once courts implied a private right of action, the question arose as to who could bring suit. Initially, courts chose privity. Because the courts initially implied the private action under the tort principle that anyone harmed by a violation of a statute could sue to redress the harm,[18] it seemed sensible to follow the tort requirement at the time of showing privity between the parties. This meant that only the person who had traded with the defendant insider could bring suit.[19] Privity is an ineffective standard when trading takes place on an anonymous securities market, as it is unreasonable to require potential plaintiffs to prove they had actually traded with the defendant insider.[20] Not only would privity be difficult (if not impossible) to prove,[21] any matching of purchase and sale orders for particular shares of stock would be largely fortuitous.[22] Privity could not be demonstrated in the majority of cases where insider trading had occurred.[23] A privity requirement would substantially prevent private enforcement of the prohibition against insider trading.[24] Although public enforcement by the SEC would not be inhibited by a requirement that private plaintiffs prove privity, it was believed that the SEC did not have adequate resources to provide enforcement at levels sufficient to deter insider trading.[25] The conclusion of many was that private enforcement is a necessary complement to SEC enforcement, and that the objectives of the law could not be fully achieved if privity were required of private plaintiffs.

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[18]*See* ARNOLD S. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10b-5, § 8.02[a] (1997) (citing RESTATEMENT OF TORTS), and sources cited therein.

[19]*See, e.g.*, Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701, 706 (S.D.N.Y. 1951) ("A semblance of privity between the vendor and purchaser of the security in connection with which the improper act, practice or course of business was invoked seems to be requisite . . . ."), *aff'd per curiam*, 198 F.2d 883 (2d Cir. 1952). Courts no longer require privity for a private action under Rule 10b-5.

[20]*See, e.g.*, William H. Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 COLUM. L. REV. 1361, 1372 (1965).

[21]*Id.*

[22]*See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 236 (2d Cir. 1974) (citing Painter, *supra* note 20, at 1372, 1377-78). *See also* Louis Loss, *Introduction* to FEDERAL SECURITIES CODE at xlix (ALI 1980) (quoted *infra* note 225).

[23]The exception to this is the case of face-to-face trading, in which the plaintiff knows with whom he traded. Even where privity can be shown, however, it is not clear that those in privity are the ones harmed by the insider's trades. *See infra* Part III.

[24]*See* CLARK, *supra* note 9, § 8.10.6, at 337 (stating that "[w]ithout . . . [the rejection of privity], the Rule 10b-5 class action could hardly have developed").

[25]*See, e.g.*, Basic Inc. v. Levinson, 485 U.S. 224, 230 (1988) ("Judicial interpretation and application, legislative acquiescence, and the passage of time have removed any doubt that a private cause of action exists for a violation of § 10(b) and Rule 10b-5, and constitutes an essential tool for enforcement of the 1934 Act's requirements."). This is still a commonly held position. *See* Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 652 (1996) (assuming necessity of private action).

If privity is not required, however, the issue remains as to how far the connection between defendant's actions and plaintiff's harm should be attenuated. In any given period there may be thousands of people trading in the shares of a single security. If an insider trades on inside information, and privity is not required, then each of those persons is a potential plaintiff who could sue the inside trader. If all those traders can bring suit, the insider's liability could be astronomical in comparison with any profit realized by the illicit trading. At the pole of strict privity, the policies against insider trading would be inadequately realized through loss of the impact of the private action. At the opposite pole of no privity, the system becomes too loose, with a serious risk of unintended Draconian results that would cause their own injustices.[26] Anyone trading in the same security as the insider would have a right of action.

The abandonment of privity left courts with two concerns. First, they had to consider what causal link should be required between a potential plaintiff's harm and a defendant's conduct (and therefore what harm should be legally cognizable).[27] Second, they had to address the fear that the private right of action, no longer confined by a privity requirement, would leave "'defendants . . . liable to all the world.'"[28]

These two concerns are related. Each informs the other; both are rooted in the theoretical and practical difficulties of pinning down causation and harm in the insider trading context.[29] The question of what harms will be legally cognizable will be answered in part based on a judgment about the

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[26]For an example of this, see *infra* Part II.C.1.c.

[27]In doing this, the courts were trying to identify those persons harmed by the conduct that violated the statute under which the private action was implied. As noted, in early cases, the private right was implied on a tort theory, according to which "'a person injured by a violation of a statute enacted for his benefit is entitled to sue . . . and recover . . . damages.'" JACOBS, *supra* note 18, § 8.02[a] (quoting Astor v. Texas Gulf Sulphur Co., 306 F. Supp. 1333, 1340 (S.D.N.Y. 1969)).

The concept of causation of harm from insider trading can be confusing. Two types of causation are necessary for a private action. The first has to do with the causal link between the defendant's actions and plaintiff's decision to trade. It has been referred to as "transaction causation." *See* Wilson v. Comtech Telecomm. Corp., 648 F.2d 88, 92 n.7 (2d Cir. 1981) (citing Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 380 (2d Cir. 1974), *cert. denied*, 421 U.S. 976 (1975)). The second type of causation has to do with the causal link between the defendant's actions and plaintiff's harm or loss. It has been referred to as "loss causation." *Id.* These concepts are discussed more fully *infra* Part III.

[28]Fridrich v. Bradford, 542 F.2d 307, 323-24 n.2 (6th Cir. 1976) ("Causation, as an element of 10b-5, must be proved in some form or 'else defendants could be held liable to all the world.'" (quoting Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1292 (2d Cir. 1969))). For an example of how insider trading defendants might be liable for damages out of all proportion to their trading, see *infra* text accompanying note 246.

[29]*See* WANG & STEINBERG, *supra* note 16, ch. 2.

extent of liability to which a defendant should be subject by law.[30] The coupling of the two concerns led to the birth of a second alternative to the question of who could bring suit, the contemporaneous trader requirement.[31] As to causation, courts began to rule that only contemporaneous traders could sue, since only they "suffer the disadvantage of trading with someone who has superior access to information."[32] As to liability, the contemporaneous trader requirement served for some judges to limit the class of potential plaintiffs sufficiently to quell concerns about the possibility of enormous liability for defendants.[33] In spite of early suggestions that anyone trading up until the disclosure of the inside information could sue,[34] the courts came to apply the contemporaneous trader requirement more restrictively. They eliminated from the potential plaintiff class all but those who had traded within a few days of, or in some cases on the same day as, the defendant insider.[35]

The contemporaneous trader requirement addressed concerns about causation and excessive potential liability by limiting the number of prospective plaintiffs. As it has evolved, the requirement has also disposed of many suits at an early stage, either because a named plaintiff turned out to have traded more than a few days after the defendant,[36] or because

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[30]The concern about damages rests in part on a hesitancy about the extent (if any) to which insider trading actually causes harm, and to whom. Some would argue that insider trading is beneficial, or at least does not result in harm worth regulating against. *See id.* (providing a summary of arguments and citations); *id.* ch. 3 (providing a summary of what harm is caused by insider trading, and to whom). Another source of hesitancy concerning the extent of liability to which defendants should be subject was the implied nature of the private action. Some courts were uneasy about extending an action created by the courts and (at the time) unendorsed by Congress. *See, e.g.*, *Fridrich*, 542 F.2d at 307.

[31]*See infra* Part II.B.1.

[32]Wilson v. Comtech Telecomm. Corp., 648 F.2d 88, 94-95 (2d Cir. 1981). *See, e.g.*, Neubronner v. Milken, 6 F.3d 666, 669 (9th Cir. 1993) (continuing to cite and quote this point); Clay v. Riverwood Int'l Corp., 964 F. Supp. 1559, 1568 (N.D. Ga. 1997); *In re* Browning-Ferris Indus. Inc. Sec. Litig., 876 F. Supp. 870, 909 (S.D. Tex. 1995) (same); Backman v. Polaroid Corp., 540 F. Supp. 667, 669 (D. Mass. 1982) (same).

[33]*Wilson*, 648 F.2d at 94.

[34]O'Connor & Assocs. v. Dean Witter Reynolds, Inc., 559 F. Supp. 800, 803 (S.D.N.Y. 1983). *See also* FEDERAL SECURITIES CODE (ALI 1980) discussed *infra* Part II.C.1 (proposing a private action open to those trading until disclosure).

[35]*See, e.g.*, *Neubronner*, 6 F.3d at 670 (noting that courts have found the "requirement not met if the plaintiff's trade occurred more than a few days apart from the defendant's"); Wilson v. Comtech, 648 F.2d 88, 95 (2d Cir. 1981) (holding that one month was not to be considered contemporaneous trading).

[36]*See, e.g.*, Buban v. O'Brien, No. C94-0331 FMS, 1994 U.S. Dist. LEXIS 8643, at *8-9 (N.D. Cal. June 16, 1994) (holding plaintiff did not trade contemporaneously with defendant where the trading dates were a minimum of three days apart).

contemporaneous trading was not pleaded with sufficient particularity to meet the pleading requirements for fraud.[37]

However handy this second alternative may have seemed for circumscribing the class of potential plaintiffs, it is inherently unsatisfactory as a response to the two concerns that spawned it. First, it is unsatisfactory in expressing the necessary causal link justifying a private right of action. Initially, the notion was that anyone who suffered the disadvantage of trading without the benefit of the information illicitly used by the insider, deserved the protection of the insider trading laws.[38] This notion was soon reconstituted. Some courts claimed that there was no sufficient causal link justifying a right to sue except for the person who turned out to have bought the actual shares the defendant had sold, and therefore only that person should have a right to bring an action against the insider.[39] Because it was difficult to identify that person when trading took place on the open market, courts either restricted the private right of action to situations involving face-to-face trading (by refusing to imply an action for open-market trading),[40] or devised some proxy for the trader who was actually in privity with the insider.[41] The contemporaneous trade requirement became a proxy for privity.[42]

The confinement of the private right of action to those who traded during the period of insider trading is based on the belief that only those who

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[37]*See, e.g., Neubronner,* 6 F.3d at 673 (stating that the plaintiff's case was dismissed because he failed to specifically plead contemporaneous trading).

[38]Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 241 (2d Cir. 1974). *See*discussion of *Shapiro* and comparison with Judge Celebrezze's concurrence in *Fridrich, infra* Part II.B.1.

[39]Fridrich v. Bradford, 542 F.2d 307, 318-20 (6th Cir. 1976).

[40]*See, e.g., id.* at 319-20 (stating that though "Congress certainly never intended § 10(b) to be limited in its scope solely to face-to-face transactions," open market violations can be addressed by agency enforcement and not by private actions). *See also* discussion of *Fridrich infra* Part II.B.1.b (discussing *Fridrich*'s refusal to allow an implied private right of action in the open-market setting).

[41]*See, e.g.,* Wilson v. Comtech Telecomm. Corp., 648 F.2d 88, 95 (2d Cir. 1981) (stating that insider trading defendants should only be liable to those trading contemporaneously). *See also Fridrich,* 542 F.2d at 323 (Celebrezze, J, concurring) (supporting a contemporaneous trading requirement), and discussion *infra* Part III (discussing difficulties of both causation and harm that led to development of a proxy for privity).

[42]*See, e.g., Buban,* 1994 U.S. Dist. LEXIS 8643, at *7 (stating that "[t]he requirement of contemporaneousness developed as a proxy for the traditional requirement of contractual privity between plaintiffs and defendants").

Use of a proxy for privity might have been appropriate if the rejection of privity had been based solely on grounds of the impracticality of proving it in open-market transactions. There was, however, more to the rejection than practicality. A privity requirement was abandoned because it was seen as inappropriate, not just because it was hard to prove. *See* discussion *infra* Part II.B.1.b and c.

might have traded with the insider could have been harmed by the illegal conduct.[43] This view of the harm caused by insider trading has been challenged. Not only has it been argued that the harm flows beyond those who were (or who might have been) in privity with the insider, it is also said that those in privity may not be harmed at all.[44] If that is the case, then the contemporaneous trader requirement, though it may be a fair proxy for privity, is a poor proxy for those harmed by insider trading. The concept is both over and under-inclusive. It may include privity traders who suffer no harm and exclude later traders who are harmed.[45]

The contemporaneous trader requirement is also an unsatisfactory response to the second concern that gave rise to it. That was the concern that, absent a privity requirement, a defendant might be subject to enormous liability for insider trading.[46] This concern is highlighted in situations where a defendant has traded few shares or has realized little profit from the insider trading.[47] The contemporaneous trader requirement addresses the concern about damages by allowing fewer people to sue.[48] If the reason for creating a proxy for privity was the belief that insider trading only harms the one in privity, however, then even the contemporaneous trader requirement subjects inside traders to too much liability, because it allows a larger number of traders to sue than those with whom the defendant possibly could have traded.[49] So the contemporaneous trader requirement fails to address the foundational concern of disproportionate damages. Thus, it fails even on its own (incomplete) assumption about harm. This failure is magnified once the

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[43]*See* WANG & STEINBERG, *supra* note 16, ch. 3.

[44]*Id. See* FEDERAL SECURITIES CODE § 1703(b) cmt. 2 (ALI 1980), discussed *infra* Part II.C.1. These sources note the fact that the person in privity may trade again before disclosure to someone without knowledge, thereby recouping any loss suffered by the initial trade with the insider. *See infra* Part III.B (discussing harms caused by insider trading).

[45]This was precisely the reason given in the comments to the proposed ALI Federal Securities Code for the Code's providing a private right of action for all those who traded after the defendant up to the disclosure of the information, instead of limiting the action for open-market traders either to those in privity, or to same-day traders. *See infra* Part II.C.1 (discussing ALI Code).

There is another argument in favor of eliminating the contemporaneous trader requirement and broadening the class of people eligible to bring suit. A broadened class of potential plaintiffs, acting as private attorneys general, could strengthen the deterrence function of private enforcement by increasing the likelihood that suit will be brought against violators. Professor Alexander suggests that an efficient level of deterrence depends in part on the predictability of liability. *See* Alexander, *supra* note 17, at 1493.

[46]*See Wilson,* 648 F.2d at 94-95.

[47]*See, e.g.*, Fridrich v. Bradford, 542 F.2d 307, 308-09 (6th Cir. 1976) (expressing grave concerns with the fact that defendant might be held liable for the losses of the many plaintiffs who might bring suit, even though he profited little in comparison to those losses).

[48]*See id.* at 323 (noting the "need to restrict the scope of civil liability of insiders trading in the open market" because of concerns about "grossly disproportionate" damage awards).

[49]*See infra* Part IV.A.

understanding of harm is adjusted to include those not in privity who also may have been harmed. The contemporaneous trader requirement is an inappropriate as well as inadequate response to the concern over unlimited potential liability.

In sum, the contemporaneous trader requirement, as applied, makes little sense given the concerns that gave rise to it. The concern with unlimited damages is better addressed, as it has been in ITSFEA and by some courts, by damage limitations.[50] The concern about causation is better addressed by a requirement that better reflects the nature of the harms caused by insider trading. Further, because it unduly restricts the number of people who can bring suit, the contemporaneous trader requirement is also an obstacle to effective deterrence of insider trading.

B. *Judicial Creation and Development of the Contemporaneous Trader Requirement*

1. Foundational Cases

a. *Introduction*

In 1974 the Second Circuit decided *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*[51] This case is often cited in discussions of the contemporaneous trader requirement and is one of the cases to which Congress referred[52] when it adopted the requirement.[53] Over the next nine years, three other decisions were important in the development of the principle. First, in *Fridrich v. Bradford*,[54] the Sixth Circuit, taking a position very different from that of the Second Circuit, discussed the private action in terms of causation and the policies and purposes of section 10(b) and Rule 10b-5.[55] A concurrence in that case has often been cited by courts adopting and commenting on the contemporaneous trader requirement.[56] Then, back in the Second Circuit, two cases again applied the requirement; in the

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[50]*See infra* Part II.C.

[51]495 F.2d 228 (2d Cir. 1974).

[52]*See* H.R. REP. NO. 100-910, at 27 n.22 (1988). *See* discussion *infra* Part II.C.2.

[53]*See* Insider Trading and Securities Fraud Enforcement Act of 1988, § 20A(a), 15 U.S.C.A. § 78t-1(a) (West 1997).

[54]542 F.2d 307 (6th Cir. 1976).

[55]*Id.* at 314-21.

[56]*See, e.g.*, Wilson v. Comtech Telecomm. Corp., 648 F.2d 88, 95 (2d Cir. 1981) (citing the concurrence in *Fridrich*).

appellate court, *Wilson v. Comtech*,[57] and in the Southern District of New York, *O'Connor & Associates v. Dean Witter Reynolds, Inc.*[58]

These cases illuminate the concerns that underlay the development of the contemporaneous trader requirement, but they leave open a number of questions. With one exception,[59] there is no explicit guidance as to how the requirement is to be applied, nor indeed precisely what purpose it was meant to serve. The cases are important, however, because they show the concerns that courts were trying to address with the principle. They also show what can happen when slight misunderstandings of the harms caused by insider trading are coupled with slight misapplications of the initial principle. The result has been a doctrine that has become increasingly problematic as it has proceeded further along a mistaken path of development.[60]

b. *Two Circuit Courts With Disparate Approaches:* Shapiro *and the* Fridrich *Majority*

These two early cases illustrate the struggle over the theoretical and practical legitimacy of the private cause of action.[61] Each involves a claim of harm and a plea for damages by private parties who had traded in a public

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[57]*Id.*

[58]559 F. Supp. 800 (S.D.N.Y. 1983).

[59]*O'Connor* does draw one clear line, holding that the period of contemporaneous trading begins only once the insider has traded. This is not actually a matter of the definition of the contemporaneous trading requirement. Rather, it is based on the understanding of the violation itself, and the fact that there can be no harm (and hence no redress) prior to the initial violation. *Id. See also infra* Part II.B.1.d (discussing the rationale and holding of the *O'Connor* case).

[60]The cases are also important because they are constantly cited by later cases as authority for the contemporaneous trader requirement. Three (*Shapiro, Wilson,* and *O'Connor*) are cited as authority for the requirement in the House Report for the Insider Trading and Securities Fraud Enforcement Act of 1988, which established an express private right of action for insider trading. H.R. REP. NO. 100-910, at 27 (1988) (citing Wilson v. Comtech Telecomm. Corp., 648 F.2d 88 (2d Cir. 1981); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); O'Connor & Assocs. v. Dean Witter Reynolds, Inc., 559 F. Supp. 800 (S.D.N.Y. 1983)). For other discussions of these cases, see, e.g., Stephanie F. Barkholz, *Insider Trading, the Contemporaneous Trader, and the Corporate Acquirer: Entitlement to Profits Disgorged by the SEC*, 40 EMORY L.J. 537 (1991) (discussing the contemporaneous trader requirement and problems such as causation and no clear definition of "contemporaneous"); Howard M. Friedman, *The Insider Trading and Securities Fraud Enforcement Act of 1988*, 68 N.C. L. REV. 465 (1990) (referring to the context and impact of Insider Trading and Securities Fraud Enforcement Act of 1988); Wang, *supra* note 16 (defining the class of "contemporaneous" traders who can sue); William K.S. 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, 1255-84 (1981) (defining the class of Rule 10b-5 plaintiffs who can demonstrate causation when suing a stock market inside trader for damages).

[61]*See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976).

market.[62] At the time these cases were decided, courts were struggling with the issue of whether to allow an implied cause of action for open-market trading.[63] The anonymity of the trading made it hard to imagine how there could be a causal link between a plaintiff and a defendant who (1) had never dealt directly with each other and (2) could not show a transactional link (i.e., that the shares purchased by one had been sold by the other).[64] The courts in both *Shapiro* and *Fridrich* addressed identical defenses based on a lack of causation.[65] The Second Circuit in *Shapiro* denied defendants' motion for judgment on the pleadings, rejecting the defense and the theory of causation argued by defendants.[66] Two years later, the Sixth Circuit in *Fridrich* reversed a judgment for plaintiffs,[67] adopting the same theory of causation as had been rejected by the Second Circuit, and refusing to allow an implied private right of action in the open-market setting.[68]

Both courts addressed the concern about enormous potential damages, again taking different approaches.[69] The Sixth Circuit saw that concern as part of the justification for denying liability.[70] The Second Circuit separated the damage issue from the issue of liability, reasoning that damages could be limited if necessary after liability was determined.[71]

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[62]*See generally* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974) (discussing claims and resulting damages); Fridrich, v. Bradford, 542 F.2d 307 (6th Cir. 1976) (same).

[63]*See, e.g., id.* at 314-16, 320-21 (citing to cases with different outcomes on implied cause of action for open-market trading).

[64]*See, e.g., Shapiro*, 495 F.2d at 236.

[65]*Fridrich*, 542 F.2d at 318-20; *Shapiro*, 495 F.2d at 234, 238.

[66]*Shapiro*, 495 F.2d at 238.

[67]*Fridrich*, 542 F.2d at 323.

[68]*Id.* at 318-21.

[69]*Id.* at 309, 321-22; *Shapiro*, 495 F.2d at 242.

[70]*Fridrich*, 542 F.2d at 323.

[71]*Shapiro*, 495 F.2d at 242.

1. *Shapiro*[72]

In *Shapiro*, plaintiffs asked the court to allow a private action for damages for insider trading that had taken place on the open market.[73] Defendants, who allegedly had traded on the basis of inside information, argued that they should not be liable for damages to plaintiffs absent proof that plaintiffs had traded with defendants.[74] In essence, the defense was lack of causation. Both the district court and the Second Circuit rejected this argument and denied defendants' motion for judgment on the pleadings.[75]

The Second Circuit used the concept of temporal proximity of trading to refer to the class of persons who could bring a private action for damages.[76] The court did not use the term "contemporaneous," nor did it make the temporal proximity of trading a standing requirement.[77] The court held that defendants had a duty to disclose the information or abstain from

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[72]Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974), *aff'g* 353 F. Supp. 264 (S.D.N.Y. 1972); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1975-76 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,377 (S.D.N.Y. Dec. 5, 1975).

The Second Circuit opinion is cited in the House Report on the Insider Trading and Securities Fraud Enforcement Act of 1988 as authority for the contemporaneous trader requirement, H.R. REP. NO. 100-910, at 27 n.22 (1988), even though the term does not appear in the opinion. *See* Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 353 F. Supp. 264 (S.D.N.Y. 1972). Though the notion that the class of plaintiffs protected included those who had traded from the time defendants began trading to the time of effective disclosure of the information was a part of the opinion the Second Circuit was reviewing, the term itself appears only in the district court's subsequent opinion. *See Shapiro*, [1975-76 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,377, at 98,878.

[73]*See Shapiro*, 495 F.2d at 231.

[74]*Id.* at 236.

[75]*Id.* at 231, 236; *Shapiro*, 353 F. Supp. at 268, 273.

[76]The court said:

> We hold that defendants owed a duty — for the breach of which they may be held liable in this private action for damages— not only to the purchasers of the actual shares sold by defendants (in the unlikely event they can be identified) but to all persons who during the same period purchased Douglas stock in the open market without knowledge of the material inside information which was in the possession of defendants.

Shapiro, 495 F.2d at 237. Later in the opinion the court used almost the same language when it determined that defendants were liable. *Id.* at 241.

[77]The court noted that, though defendants had argued a lack of standing before the district court, they did not emphasize this point on appeal. *Id.* at 238 n.15. The district court had rejected defendants' standing argument, analyzing the issue in terms of the "purchaser or seller" rule of Birnbaum v. Newport Steel Corp., 193 F.2d 461, 463 (2d Cir. 1952). *Shapiro*, 353 F. Supp. at 270-71. The *Birnbaum* rule was later adopted by the Supreme Court in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). *Blue Chip* is the Supreme Court's only statement on standing in this area. The rule from *Blue Chip* is that plaintiffs must have actually traded the stock. *See id.* at 751-55 (refusing to extend the implied private right of action to those who alleged they had been fraudulently induced *not* to trade). *See also* United States v. O'Hagan, 521 U.S. 642, 664 (1997) (referring to *Blue Chip* for standing requirement in private actions under § 10(b)).

trading on it,[78] and that this duty extended to all those who traded "during the same period."[79] In so holding, the court rejected defendants' argument that they owed no duty except to those in privity with them.[80] In response to defendants' argument that, because there was no privity, plaintiffs' claim must fail for lack of causation, the court held causation could be shown without privity.[81]

The causation discussion illustrates the problems caused by the alternative nature of a defendant's duty under the "disclose or abstain" rule.[82]

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[78]The Second Circuit's seminal decision in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), set the stage for development of the contemporaneous trader requirement. This 1968 decision marked the beginning of a great expansion in litigation under Rule 10b-5 by establishing the duty of insiders to either (1) disclose material inside information or (2) abstain from trading on it. *Id.* at 848. In *Texas Gulf Sulphur*, the court noted that "a corporation's misleading material statement may injure an investor irrespective of whether the corporation itself, or those individuals managing it, are contemporaneously buying or selling the stock of the corporation." *Id.* at 861.

The SEC implied the "disclose or abstain" duty in 1961, *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961); the Second Circuit later adopted it in *Texas Gulf Sulphur*. The Supreme Court later modified the duty, saying that there must exist some "relationship of trust and confidence" before nondisclosure of inside information will give rise to liability under the disclose or abstain rule. Chiarella v. United States, 445 U.S. 222, 230 (1980). Some commentators have taken *Chiarella* to mean that privity is required for private liability for insider trading. *See, e.g.*, Wang, *supra* note 60, at 1224-25 (discussing the *Chiarella* decision).

The Supreme Court's discussion of *Chiarella* in *O'Hagan* casts doubt on that notion. The language in Chiarella that led some people to think it required privity is quoted by the Court in *O'Hagan*: "The Court said in *Chiarella* that § 10(b) liability 'is premised upon a duty to disclose arising from a relationship of trust and confidence *between parties to a transaction*.'" *O'Hagan*, 521 U.S. at 662 (quoting *Chiarella*, 445 U.S. at 230 (emphasis added)). It is the emphasized language that seems to have led some to believe that *Chiarella* suggested a privity requirement. The Court rejected the *O'Hagan* appellate court's use of that language to reject the misappropriation theory of liability under § 10(b). The Court said that, in *Chiarella*, those statements were used to reject the notion that "§ 10(b) stretches so far as to impose" the disclose or abstain duty on all market participants, requiring everyone to forgo trading when in the possession of material, nonpublic information. *Id.* It then specifically confined the *Chiarella* language to that context.

The Court in *O'Hagan* was examining *Chiarella*'s effect on the misappropriation theory and not on the classical insider trading theory that is discussed in this article. Also, neither *Chiarella* nor *O'Hagan* was a private action. Still, the confinement of these words in *Chiarella*, along with the Court's expansion of § 10(b) liability by recognition of the misappropriation theory, certainly undermines the argument that *Chiarella* suggests that privity is required in private actions for traditional insider trading.

Whatever the relationship required by *Chiarella*, it is clear that it exists in the case of trading by a "corporate insider[], who . . . [has] an obligation to place the shareholder's welfare before . . . [his] own . . . [and should not] benefit personally through fraudulent use of material, nonpublic information." *Chiarella*, 445 U.S. at 230. This article addresses only trading by corporate insiders, so the disclose or abstain duty is assumed to apply.

[79]*Shapiro*, 495 F.2d at 237.

[80]*Id.* at 239.

[81]*Id.*

[82]*See supra* note 78. *See also* discussion *infra* Part III.B.1 (discussing problems caused by alternative nature of disclose or abstain duty).

The rule provides that an insider must *either* disclose the inside information *or* abstain from trading on it.[83] Defendants used this alternative nature of the rule to argue that, as they could have satisfied their duty by not trading, and plaintiffs would have traded anyway, their violation of the duty could not have caused plaintiffs' loss.[84] The district court summarized defendants' lack of causation argument as: (1) plaintiffs did not allege privity; (2) having thus had no knowledge of defendants' transactions, plaintiffs would have purchased even if defendants had not sold; (3) "therefore, defendants did not induce plaintiffs to buy any stock and, hence, did not cause plaintiffs' damage."[85] Thus defendants emphasized the "trading" aspect of a violation, and argued that plaintiffs' actions could not have been caused by defendants' trading, as plaintiffs would have taken the same action (trading the securities) even if defendants had not traded.[86]

The Second Circuit approved the reasoning of the lower court,[87] which had described the violation as not simply "trading," but rather "trading without disclosing."[88] Causation, then, depends not simply on whether plaintiffs would have traded even if defendants had not, but rather on whether plaintiffs would have traded had defendants disclosed what they knew.[89] Both courts rejected defendants' causation argument and found that

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[83]*Shapiro*, 495 F.2d at 236 (citing SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968)).

[84]Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith Inc., 353 F. Supp. 264, 275 (S.D.N.Y. 1972).

[85]*Id.* at 273.

[86]*Id.*

[87]*Shapiro*, 495 F.2d at 234.

[88]*Shapiro*, 353 F. Supp. at 278. The court stated:

> [T]he fraud is not, as defendants would have this Court rule, the act of trading.... The essence of the fraud was the nondisclosure of material information when defendants chose to make their sales. Thus, employing the proper conception of defendants' fraudulent acts, plaintiffs have alleged that defendants' fraud "induced" them to purchase shares they would not otherwise have purchased.

Id. at 276-77 n.5.

[89]*Shapiro*, 495 F.2d at 240.

> Even on the basis of the pre-*Affiliated Ute* [cases]... we would reject defendants' essential causation argument, namely, that, absent an allegation that plaintiffs' purchase of Douglas stock was *induced* by defendants' non-disclosure of material inside information, the requisite element of causation is lacking. On the contrary, the Rule 10b-5 causation in fact requirement is satisfied by plaintiffs' allegation that they *would not have purchased* Douglas stock *if they had known of the information withheld by defendants*."

Id. (emphasis added).

plaintiffs' allegations of causation were sufficient to survive defendants' motion for judgment on the pleadings.[90]

In addition to their causation argument, defendants argued against plaintiffs' theory of liability because of the huge damages to which it could subject inside traders, damages out of proportion to either the number of shares traded or the profit realized.[91] Defendants argued that this result was "contrary to reason, and to the weight of authority."[92] Both the district court and the Second Circuit acknowledged the concern about potentially "Draconian liability,"[93] but refused to accept defendants' argument that it required rejection of plaintiffs' theory of liability.[94] The district court noted that defendants' position led to the "equally repugnant result" that an insider could escape liability even to the person in privity.[95] Defendants' theory was that causation was missing since plaintiffs would have traded even if defendants had not, but that is equally true of a person who could prove privity (since he would have traded even if defendants had not).[96] The result of defendants' theory of liability would be a complete shield from private liability for unlawful insider trading in the open market.[97] The Second

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[90]As noted, defendants' argument that they were not liable to plaintiffs was based on an alleged lack of causation. *Shapiro*, 353 F. Supp. at 275. Part of the causation argument was based on the lack of privity. Defendants also argued that, even if privity were not required, plaintiffs still had to show a link between defendants' nondisclosure and plaintiffs' purchases of the stock. Defendants' construction of the requirement was that plaintiffs had to show their trades were induced by the nondisclosure. The court rejected this argument and reasoned that the proper causation test for a nondisclosure case such as this was "causation in fact." *Shapiro*, 495 F.2d at 238. That test is established not by showing that defendants' nondisclosure induced plaintiffs' trades, but rather by showing that "'the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact.'" *Id.* at 239 (quoting List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir. 1965)).

The *Shapiro* court took the causation in fact standard from the decision in *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972). The Second Circuit said *Affiliated Ute* had "dispens[ed] with . . . proof of reliance as a prerequisite . . . [for] recovery in a private damage action" based on nondisclosure. *Shapiro*, 495 F.2d at 240. Although "[d]efendants [in *Shapiro*] argue[d] that the *Affiliated Ute* rule of causation in fact should be confined to . . . case[s] . . . involv[ing] face-to-face transactions" (as had *Ute*), the Second Circuit maintained that *Ute* was controlling on the causation issue. *Id.* It said the *Ute* rule was not dependent on the "character of the transaction" (that is, whether it was face-to-face or on a national securities exchange), "but rather . . . [on] whether . . . [there was a duty] to disclose the inside information." *Id.* This position is contrary to that later taken by the Sixth Circuit in *Fridrich*. *See* discussion *infra* Part II.B.1.b.2.

[91]*Shapiro*, 353 F. Supp. at 277.

[92]*Id.*

[93]*Shapiro*, 495 F.2d at 242. *See Shapiro*, 353 F. Supp. at 277.

[94]*Shapiro*, 495 F.2d at 242; *Shapiro*, 353 F. Supp. at 277-78.

[95]*Shapiro*, 353 F. Supp. at 277.

[96]*Id.*

[97]*Id.*

[U]nder defendants' theory, defendants would not be liable even to an actual purchaser of their shares, since even that purchaser, having been unaware of

Circuit, in affirming, separated the damage issue from the issues of whether there had been a violation and whether defendants were liable to plaintiffs in the private action.[98] The possibility of enormous damages was not taken by the court to require any re-working of the underlying theory of liability.[99] Rather, any problem of unfair damages could be addressed with by the district court, which might find it appropriate to limit recovery.[100]

2. *Fridrich*[101]

Two years later, the Sixth Circuit embraced the position argued unsuccessfully by defendants in *Shapiro*, to reverse a district court opinion that had closely followed *Shapiro*.[102] In *Fridrich*, the Sixth Circuit rejected what it saw as an unjustified expansion of the implied action under Rule 10b-5 to non-privity open-market traders.[103] The court's reasoning seems to have been driven by its grave concern about enormous potential liability for defendants.

Where the Second Circuit rejected the argument that privity was required for causation, the Sixth Circuit saw no causal link in the absence of privity.[104] In analyzing causation, this court emphasized the fact that defendants' decision to trade had not affected plaintiffs' decision to trade.[105] It therefore reasoned from the same perspective argued by defendants in *Shapiro*. Judge Engel's majority decision acknowledged that defendants' trading without disclosing may well have been a violation of Rule 10b-5, but

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> defendants' transactions, would have completed his transaction with another if the defendants had not traded. . . . Thus, . . . any insider who trades on a national securities exchange is insulated from liability to any individual investor.

Id. at 277-78. This same fact is recognized and dealt with in the provision on insider trading in the ALI Code. *See* discussion of § 1703 of the Code, *infra* Part II.C.1.

[98]*See generally* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974) (separating analysis on damages and liability).

[99]*See id.* at 242.

[100]*Id.*

[101]Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976).

[102]*Id.* at 312. The district court had granted damages to those who had traded "during the period of nondisclosure." *Id.* (quoting Fridrich v. Bradford, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. ¶ 94,723 (M.D. Tenn., June 17, 1974)).

[103]*Id.* at 309 (stating that "[b]ecause we conclude that under the circumstances of this case imposition of civil liability constitutes an unwarranted extension of the judicially created private cause of action under Rule 10b-5, we reverse the judgment of the district court").

[104]*Id.* at 318-19.

[105]*Fridrich*, 542 F.2d at 318.

concluded that the violation resulted in no compensable harm to plaintiffs.[105] Rather, the court saw only harm to the market, which it said could be addressed by government enforcement.[107]

The court's construal of the causal link required between defendants' actions and plaintiffs' harm was in part the result of its inability to accept the principle that defendants in open-market trading should be exposed to liability for damages "almost unlimited in their potential scope."[108] The

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[105]*Id.* According to the court, the harm that results from trading that makes it illegal is simply that the trading "impairs the integrity of the market." *Id.* The majority opinion acknowledged that § 10(b) should not be limited to face-to-face transactions, but reasoned that enforcement in the anonymous market context should be by the SEC. *Id.* at 320.

According to the court, the fact that insiders have an absolute right not to disclose (as long as they do not trade) means that non-insiders will always face a risk that they will be trading on incomplete information. *Id.* at 318. Describing this as a normal market risk, one about which plaintiffs have no right to complain, the court stated: "Investors must be prepared to accept the risk of trading in an open market without complete or always accurate information. Defendants' trading did not alter plaintiffs' expectations when they sold their stock, and in no way influenced plaintiffs' trading decision." *Id.* The court, however, fails to note that this normal market risk is altered when defendants enter the market and trade on the nonpublic information. Though noninsiders must accept the risk that comes with having incomplete information, they should not bear the different risk of trading in a market where others do not share that risk. If insider trading is illegal (and it is), then market participants' reliance on its nonoccurrence is justified. The Second Circuit in *Shapiro* had noted this point. *See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d at 228, 236 (2d Cir. 1974) ("'the [disclose or abstain] Rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal *access* to material information . . .'") (emphasis added) (quoting SEC. v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968)).

The Supreme Court recently noted the distinction between the two types of risk, one appropriately borne by all traders, one not:

> Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on . . . nonpublic information is unchecked by law. An investor's informational disadvantage vis-à-vis a[n] . . . [insider] with material, nonpublic information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill.

United States v. O'Hagan, 521 U.S. 642, 658-59 (1997). *See also infra* text accompanying note 321 (noting that traders bear the additional risk that some people are not playing by the rules). The Supreme Court in *O'Hagan* was discussing the misappropriation theory of insider trading. Its analysis is equally (if not to a greater extent) applicable where an insider trades on nonpublic information.

[107]*Fridrich*, 542 F.2d at 322.

[108]*Id.* at 320-21. The court saw this as the inevitable state of affairs once the restrictions imposed by a privity requirement were abandoned. *See id.* at 321.

> Where private civil actions under Rule 10b-5 have been employed in essentially face-to-face situations, the potential breadth of the action was usually contained. However, extension of the private remedy to impersonal market cases where plaintiffs have neither dealt with defendants nor been influenced in their trading decisions by any act of the defendants would present a situation wholly lacking in the natural limitations on damages present in cases dealing with face-to-face transactions.

court considered the suggestion that the damage problem could be dealt with by a limitation on the amount of recovery, as had been suggested in *Shapiro*,[109] but found that such an approach should be left to Congress or to the SEC.[110] In any event, the court said, since it found no causation, it saw no need to follow that suggestion in the case before it.[111]

c. *Two Opinions With a Common Resolution:* Wilson *and the Celebrezze Concurrence in* Fridrich

The approaches to causation and damages in *Shapiro* and *Fridrich* are in some ways polar opposites. Two other opinions from the same two circuits take a middle road, allowing a private right of action for contemporaneous traders.[112]

Judge Celebrezze concurred in the *Fridrich* judgment, but took a different approach to the private right of action than did the majority.[113] Celebrezze discusses the issues that led the *Fridrich* majority, and the Second Circuit in *Shapiro*, to different results in similar situations,[114] and attempts to reconcile the two opinions.[115] He does this by means of the contemporaneous trader requirement, for which he cites *Shapiro*.[116] Five

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Id. The court here seems to make a judgment about causation based on a concern about a separate issue, that is, damages. Robert C. Clark has noted the fact, suggesting that such a move might well give one pause. *See* CLARK, *supra* note 9, at 336; *infra* note 193.

[109]Unlike the Second Circuit in *Shapiro*, the Sixth Circuit declined to separate this problem from the consideration of liability. Further, though it mentions that a similar solution was proposed by the American Law Institute in its Federal Securities Code, discussed *infra* Part II.C.1., it rejects taking that approach through the courts. *Fridrich*, 542 F.2d at 322. The court does acknowledge that "if recovery is to be allowed against insiders in an open market context, some limitations upon damages must be imposed." *Id.* at 322 n.33.

[110]*See Fridrich*, 542 F.2d at 320-22 (contending that damage limitations should be left to Congress or to the SEC).

[111]*Id.* at 322.

[112]Wilson v. Comtech Telecomm. Corp., 648 F.2d 88, 94-95 (2d Cir. 1981); *Fridrich*, 542 F.2d at 326-27 (Celebrezze, J., concurring).

[113]*See Fridrich*, 542 F.2d at 323-27 (Celebrezze, J., concurring).

[114]The differences between *Fridrich* and *Shapiro* can to some extent be explained by differences in their factual situations. For example, in *Fridrich*, the private action was brought after an SEC enforcement action on the same facts had been brought, and the Sixth Circuit wrote its opinion in *Fridrich* after the defendants had been ordered to disgorge their trading profits under a settlement of the SEC action. *See* CLARK, *supra* note 9, at 335-36. The fact that defendants had already been ordered to give up their profits may well have exacerbated the Sixth Circuit's concern about the additional liability in which a private action could result. *Id.*

[115]*See id.* at 336-37.

[116]*Fridrich*, 542 F.2d at 326-27 (Celebrezze, J., concurring). Celebrezze rejects the *Shapiro* district court's subsequent interpretation of the Second Circuit opinion as allowing a right of action to all those who traded up till the time of disclosure. *Id.* at 327. *See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1975-76 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,377, at

years later, the Second Circuit adopted substantially the same approach in *Wilson v. Comtech.*[117]

1. Celebrezze Concurrence in *Fridrich*

Judge Celebrezze read the majority opinion in *Fridrich* not as repudiating the disclose or abstain rule in private damage actions but as "imposing a rational limitation on the scope of civil liability under [R]ule 10b-5."[118] Celebrezze agreed that some restriction of liability is needed in the open-market setting, and also that there must be some causal link between a defendant's breach and a plaintiff's loss, "'else defendants could be held liable to all the world.'"[119]

In spite of this concern about causation, Celebrezze did not follow the majority in denying that causation existed in the open-market context and rejecting a private right of action for open-market trading.[120] Instead, he followed the Second Circuit's reasoning in *Shapiro* in noting that such a rejection would leave a loophole in enforcement, allowing violators to escape liability for insider trading merely by making their illegal trades in the open market.[121]

Judge Celebrezze therefore supported a private right of action in open-market situations, but realized that some limitation on who could bring such an action was necessary because otherwise "the number of . . . plaintiffs could be astronomical and the possible . . . damages . . . [could] be grossly disproportionate to the volume of the insider trading."[122] In exploring

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98,877-78 (S.D.N.Y. Dec. 9, 1975).

[117]*Wilson,* 648 F.2d at 94. *Wilson* and *Shapiro* were decided by different panels of the Second Circuit. *Wilson* is the second case cited in the legislative history of Insider Trading and Securities Fraud Enforcement Act of 1988 for the contemporaneous trader requirement. *See* H.R. REP. NO. 100-910, at 27 n.22 (1988).

[118]*Fridrich,* 542 F.2d at 323 (Celebrezze, J., concurring).

[119]*Id.* at 323 n.2 (quoting Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1292 (2d Cir. 1969)). Celebrezze noted that a defendant should not be a "virtual insurer" to those who traded weeks after defendant ceased trading, as had plaintiffs. *Id.* at 323. He therefore supported the court's ruling in favor of defendants. *See id.* at 326-27.

[120]*Id.* at 323-27.

[121]*Id.* at 324 (citing *Shapiro,* 495 F.2d at 236-37). Celebrezze was not satisfied with the *Fridrich* majority's position that such enforcement should be left to the SEC. He argued that private enforcement was a necessary supplement to SEC actions, and noted that private enforcement served both the deterrence and the compensation functions of Rule 10b-5. *Id.* at 324, 326.

[122]*Fridrich,* 542 F.2d at 323 (Celebrezze, J., concurring). Celebrezze cites *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 745-47 (1975), for its expression of "alarm at the potentially vast number of persons who could conceivably bring civil suits under [R]ule 10b-5 absent meaningful restrictions on the scope of the judicially-created cause of action." *Fridrich,* 542 F.2d at 323. Celebrezze continues: "The Supreme Court exhorted federal courts to consider the practical implications of extending civil remedies to those who bear only a tangential relationship

possible limitations, he noted that the common law requirements of privity and reliance had fallen into disfavor as inappropriate in the open-market setting.[123] But his concerns about causation and damages led him back to those requirements: without reliance, he said, there is no causative link; "without at least a 'semblance of privity,' defendants' liability could extend to complete strangers."[124] Looking to *Shapiro* for its discussion of causation in fact,[125] Celebrezze concluded that limiting the private cause of action to the group of contemporaneous traders constitutes a rational solution to these problems.[126]

Celebrezze nevertheless criticized the *Shapiro* district court's approach to the breadth of the disclose or abstain duty.[127] In its subsequent opinion on a motion for class certification, the *Shapiro* district court had interpreted the Second Circuit's opinion to say that the duty applies to all

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to the transactions giving rise to violations of [R]ule 10b-5." *Id.* (citing *Blue Chip Stamps*, 421 U.S. at 749).

[123]*Fridrich*, 542 F.2d at 325 ("Due to the impersonal nature of trading on the open market and the remedial purpose of [R]ule 10b-5, 'privity' and 'reliance' as means for limiting the plaintiff class have generally fallen into disfavor." (citing Painter, *supra* note 20, at 1372)). "Requiring privity . . . would create an insurmountable obstacle . . . [to] plaintiffs." *Id.* (citing Painter, *supra* note 20, at 1372, 1377-78). Privity was a part of proving reliance, and reliance has little relevance where the trading is generally not face-to-face, and where it is generally based on nondisclosure.

[124]*Id.* (quoting Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701, 706 (S.D.N.Y. 1951), *aff'd per curiam*, 198 F.2d 883 (2d Cir. 1952)). "A semblance of privity between the vendor and purchaser of the security in connection with which the improper act, practice or course of business was invoked seems to be requisite . . . ." *Joseph*, 99 F. Supp. at 706.

[125]*See supra* note 90.

[126]*Fridrich*, 542 F.2d at 326 (Celebrezze, J., concurring) ("Non-contemporaneous traders do not require the special protection of the 'disclose or abstain' rule because they do not suffer the disadvantage of trading with someone who has superior access to information"). *See also id.* at 326 n.11 (stating that "the mechanics of the market necessitate designation of the class of contemporaneous investors as surrogate plaintiffs for those who actually traded with the insiders"). For a criticism of this approach, see CLARK, *supra* note 9, at 336-37. Professor Clark states that:

> Celebrezze's compromise [between denying a right of action for non-privity traders and leaving the private action open too broadly] is by no means an ideal one, of course. A case may well arise in which, even given his semblance of privity limitation, an individual defendant will be held liable for damages vastly exceeding his illicit profits. Furthermore, from the point of view of the public investors, all of them who traded the wrong way in the dark and were injured, relative to what would have happened had there been timely disclosure, the compromise position seems arbitrary. And, of course, if the harm of insider trading is viewed as including its tendency to create a bias against timely disclosure of important information, the Celebrezze compromise appears to make an irrational distinction between public traders who can and cannot be plaintiffs.

Id. See also WANG & STEINBERG, *supra* note 16, § 6.4.5, at 449 ("[A]llowing all contemporaneous traders to sue is dubious in an *implied* cause of action. . . . [T]he victims of the insider trade are not necessarily among those trading contemporaneously.") (commenting on Wilson v. Comtech Telecomm. Corp., 648 F.2d 88 (2d Cir. 1981)).

[127]*Fridrich*, 542 F.2d at 327 (Celebrezze, J., concurring).

those trading until the inside information is disclosed.[128] Celebrezze said that "[u]nder this view, . . . [claimants] would be able to recover their losses from [defendants] even though there was no possible connection between their trading and that of the insiders."[129] This statement reflects an incomplete understanding of the harm caused by insider trading, and the fact that harm can be passed along, trader to trader, until disclosure.[130] It also represents a misunderstanding of the "connection" that is required by section 10(b) and Rule 10b-5.[131]

Celebrezze's reading of the Second Circuit's disclose or abstain duty is inconsistent with the Second Circuit's own statement of the duty.[132] Celebrezze's reasoning is nearly the same as the Sixth Circuit majority's, which itself is identical to the *Shapiro* defendants' argument.[133] The Second Circuit had called this argument a misconstrual of the disclose or abstain rule.[134] The Sixth Circuit said privity was necessary, and therefore limited the private right of action to face-to-face trading situations.[135] Celebrezze agreed with the majority that privity is an appropriate requirement, but would have granted a private right of action to proxies for those in privity because of the impracticalities of requiring privity and the belief that the action should be available for open-market trading.[136] In part because of its acknowledgment that a privity requirement would be impractical, the Second Circuit had said defendants had a disclose or abstain duty to all those *trading during the same period.*[137] Celebrezze takes a slightly different approach. He limits the disclose or abstain duty to those *trading with* the defendants,

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[128]Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, [1975-76 Transfer Binder] Sec. L. Rep. (CCH) ¶ 95,377 at 98,878 (S.D.N.Y. Dec. 5, 1975) (stating "duty extends to all purchasers trading contemporaneously with defendants' wrongdoing, that is, 'while such . . . information remains undisclosed'") (quoting SEC v. Texas Gulf Sulphur, 401 F.2d 833, 848 (2d Cir. 1968)). The language quoted above from *Shapiro* is quoted in full by Celebrezze in *Fridrich*, 542 F.2d at 327. The Second Circuit may have meant the period to remain open until disclosure. The decision is not clear on this point, since the total period between defendants' trading and disclosure of the information was only four days. *See Shapiro*, 495 F.2d at 232-33.

[129]*Fridrich*, 542 F.2d at 327 (Celebrezze, J., concurring).

[130]*See* discussion *infra* Part III.

[131]*See Fridrich*, 542 F.2d at 326 (Celebrezze, J., concurring) ("There was admittedly no connection between Appellants' trading and Appellees' decision to sell their . . . stock. Appellees are in precisely the same situation they would have been in if Appellants had chosen to abstain from trading.") This analysis of the connection requirement is questionable. The Supreme Court has held that the requirement is met even when the defendant did not trade with those harmed by his illegal conduct. *See* United States v. O'Hagan, 521 U.S. 642 (1997).

[132]*Fridrich*, 542 F.2d at 326 (Celebrezze, J., concurring).

[133]*Id.*

[134]*Shapiro*, 495 F.2d at 236. *See* discussion of *Shapiro, supra* Part II.B.1.b.

[135]*Fridrich*, 542 F.2d at 318.

[136]*Id.* at 324-26 (Celebrezze, J., concurring).

[137]*Shapiro*, 495 F.2d at 237.

but then, acknowledging the same practical difficulty with a privity requirement, extends the private right of action to contemporaneous traders as proxies for those in privity.[138]

Though the two phrases emphasized above have been taken by courts to be equivalent, the latter has allowed the tightening of the contemporaneous trader requirement to exclude those who could not possibly have traded with the defendant. In subsequent cases, evidence has been presented on the volume of trading or how quickly trades in the stock at issue are processed.[139] This evidence is used to justify the exclusion from the contemporaneous trader category of those who traded more than a few days after the defendant.[140]

This approach ignores a major part of the Second Circuit's reasoning in *Shapiro*. The court did not extend the group of possible plaintiffs beyond those actually in privity merely because privity would be hard to prove.[141] It did not, as does Celebrezze, designate privity traders as the sole beneficiaries of the disclose or abstain rule, and then grant a right of action to proxies in recognition of practical difficulties.[142] Rather, it explicitly held that the disclose or abstain duty itself extends to same period traders:

> [t]o hold that Section 10(b) and Rule 10b-5 impose a duty to disclose material inside information only in face-to-face transactions or to the actual purchasers or sellers on an anonymous public stock exchange, would be to frustrate a major purpose of the antifraud provisions of the securities laws: to insure the integrity and efficiency of the securities markets. . . . We hold that defendants owed a duty — for the breach of which they may be held liable in this private action for damages — *not only to the purchasers of the actual shares sold by defendants* (in the unlikely event they can be

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[138]*Fridrich*, 542 F.2d at 326 (Celebrezze, J., concurring).

[139]*See, e.g.*, *In re* Aldus Sec. Litig., [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,376, at 95,987 (W.D. Wash. Mar. 1, 1993) (concluding that "given the unquestionably high volume of Aldus stock traded daily during the period in question, it is clear that plaintiffs did not trade with defendants . . . as no plaintiffs traded on the days of the allegedly wrongful trades"); *In re* AST Research Sec. Litig., 887 F. Supp. 231, 233 (C.D. Cal. 1995) (noting "the growing trend among district courts . . . to adopt a restrictive reading of the term 'contemporaneous' at least with respect to shares heavily traded on a national exchange") (citing *In re Aldus Sec. Litig.*, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,376, at 95,987).

[140]*See, e.g.*, Buban v. O'Brien, No. C94-0331 FMS, 1994 U.S. Dist. LEXIS 8643 (N.D. Cal. June 16, 1994) (trading within three days does not satisfy "contemporaneous" requirement). *See also infra* Part II.B.2 (discussing developments restricting private actions).

[141]*Shapiro*, 495 F.2d at 236.

[142]*Id. See, e.g.*, Fridrich v. Bradford, 542 F.2d 307, 323-27 (6th Cir. 1976) (Celebrezze, J., concurring).

> identified) but to *all persons who* during the same period *purchased... stock in the open market without knowledge* of the material inside information which was in the possession of defendants.[143]

The language of the first quoted sentence can perhaps be stretched to allow Celebrezze's interpretation that the duty in fact extends only to trading partners, and the plaintiff class is broadened to proxies only because identifying those in privity is impractical.[144] The second sentence, however, clearly points to a different understanding of the Second Circuit's intent.[145] It explicitly says that, even if the privity traders are identified, the disclose or abstain duty extends to all the same period traders. It is not limited to those in privity.[146] Defendants in *Shapiro* had argued that the only duty owed was to purchasers of the specific shares they sold, and that since their trades were made on the open market and not in face-to-face transactions, the disclose or abstain rule did not apply to them.[147] The Second Circuit explicitly rejected that conception of the duty, saying that defendants' argument "totally misconstrue[d]" its rule.[148] Only secondarily did the court note that the argument also ignored practical difficulties in identifying those in privity.[149]

The reason the Second Circuit saw an insider's disclose or abstain duty as extending beyond those who turned out to have traded with him is that limiting the duty to those in privity would limit the rule's effectiveness to non-market trades.[150] In face-to-face transactions, the insider could satisfy his duty and disclose to his trading partner before trading (thereby avoiding

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[143]*Shapiro*, 495 F.2d at 237 (emphasis added).

[144]*Id.*

[145]*Id.*

[146]*Id.* This statement is consistent with the *Shapiro* district court's interpretation of the Second Circuit, which Celebrezze specifically rejects. *See supra* note 88.

[147]*Shapiro*, 495 F.2d at 236.

[148]*Id.*

[149]*Id. See* O'Connor & Assocs. v. Dean Witter Reynolds, Inc., 559 F. Supp. 800, 805 (S.D.N.Y. 1983) (discussing problems with a privity requirement). The court stated that:

> [a]lthough the Court of Appeals did note in *Shapiro* the practical difficulties of matching particular sales with particular purchases, the Court's decision was based primarily not on that rationale but rather on the conclusion that "it would make a mockery of the 'disclose or abstain' rule if we were to permit the fortuitous matching of buy and sell orders to determine whether a duty to disclose had been violated."

Id. (quoting *Shapiro*, 495 F.2d at 236). *Cf.* Wang, *supra* note 16, at 1191 ("If the rationale underlying the 'contemporaneous' class of plaintiffs is the difficulty of ascertaining the party in privity, all those who might have been in privity would be allowed to sue.").

[150]*See Shapiro*, 495 F.2d at 236-37.

a violation).[151] In the open market, where the insider does not know before trading who his trading partner will be, he cannot avoid a violation by disclosing only to his trading partner.[152] Therefore, to serve its purpose at all, the duty to disclose must apply to all who, with that information, might alter their choice about whether or not to trade.[153]

This may seem a slim distinction to make between the *Shapiro* and Celebrezze analysis and rule. It is, however, one that is critical to the later development of the contemporaneous trader requirement, and to the justification given for using it to limit the private right of action.[154] As will be seen in the discussion of the *Wilson* case that follows, it is a distinction that was either unnoticed or simply rejected by a different panel of the Second Circuit. That panel adopted the contemporaneous trader requirement five years after Celebrezze's concurring opinion in *Fridrich*.[155]

2. *Wilson*[156]

In dismissing a plaintiff's claim for insider trading, the Second Circuit in *Wilson* adopted substantially Judge Celebrezze's approach in his concurrence in *Fridrich*.[157] The plaintiff Wilson argued that, since the

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[151]*See id.*

[152]*See id.*

[153]*Id. See also* Painter, *supra* note 20, at 1378 ("Since in any active market disclosure to a particular individual is not feasible, the duty to disclose, if such a duty exists, must be owed to all members of that ill-defined class of stockholders who, with the benefit of inside information, would alter their intention to [trade] . . . ."); *Shapiro*, 495 F.2d at 236 n.14 (quoting same). Note, however, that Painter goes on to say that the duty should apply only to "same period" traders. Painter, *supra* note 20, at 1378.

As indicated by the *Shapiro* language, it seems nonsensical to suggest that the duty to disclose is owed only to a person or persons whose identities cannot be ascertained until after the opportunity to avoid a violation by disclosing has passed. An insider could never satisfy the "disclose and trade" alternative by disclosing only to those with whom he will trade when he has no idea who those people will turn out to be. The notion that the disclose or abstain duty runs only to trading partners is carried over from the situation of face-to-face trading and makes no sense in the context of anonymous trading on the open market.

[154]*See, e.g.*, Wilson v. Comtech Telecomm. Corp., 648 F.2d 88 (2d Cir. 1981).

[155]*Id.*

[156]*Id. Wilson* is the second case to which the legislative history of the Insider Trading and Securities Fraud Enforcement Act of 1988 refers for the contemporaneous trader requirement. *See* H.R. REP. NO. 100-910, at 27 n.22 (1988). Wilson was a sophisticated investor who apparently purchased Comtech stock on the advice of his broker, not in reliance on any misstatements or omissions of Comtech's. After affirming the district court's finding that the reliance requirement was not satisfied, the Second Circuit dismissed plaintiff's first claim based on the company's failure to correct alleged misstatements. It then went on to address briefly plaintiff's claim that trading by the company and one of its officers provided an independent basis of liability. *Wilson*, 648 F.2d at 94.

[157]*Wilson* 648 F.2d at 94-95.

company and an insider had traded in stock while information about a change in earnings remained undisclosed,[158] the district court wrongfully dismissed his action.[159] The district court had found that defendants had no disclose or abstain duty to Wilson, who had traded a month after the insiders sold.[160] The Second Circuit addressed this argument by citing to both *Shapiro* and the Celebrezze concurrence in *Fridrich*.[161] It first noted that, in *Shapiro,* it had held that an insider selling stock had "a duty to disclose *only* to those who purchased the stock 'during the same period' as the insiders' sales."[162] It then acknowledged that the *Shapiro* district court in a subsequent opinion had interpreted that phrase to mean the period from the time of the defendants' trades to the time of disclosure.[163] The *Wilson* court noted, however, that in *Shapiro* that entire period was only four days long.[164] In its rejection of the *Shapiro* district court's "until disclosure" interpretation,[165] the Second Circuit in *Wilson* sounded like the Sixth Circuit in *Fridrich*.[166] It mentioned the same two reasons for limiting the private cause of action as did both the majority and the concurrence in *Fridrich*.[167]

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[158]*Id.* at 94. Just before rejecting plaintiff's argument, the Second Circuit quoted a statement of the disclose or abstain rule that indicates an obligation for insiders to abstain from trading during the period of nondisclosure of material inside information. "'[A]nyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it . . ., or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.'" *Id.* (quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc)). The court is quoting from its own decision in *Texas Gulf Sulphur*, the case that first announced the disclose or abstain rule.

[159]*Id.*

[160]*Id.*

[161]*Wilson*, 648 F.2d at 94-95.

[162]*Id.* (emphasis added) (quoting *Shapiro*, 495 F.2d at 237). *Shapiro* does not contain the restrictive language used in *Wilson*. Whereas *Wilson*'s language implies the *Shapiro* court was establishing the outer limits of the duty, *Shapiro* was in fact engaged in rejecting the limit argued by defendants. *Shapiro* said the disclose or abstain duty is owed "*not only* to the purchasers of the actual shares sold by defendants . . . but to all persons who during the same period [traded]." *Shapiro*, 495 F.2d at 237 (emphasis added). The thrust in *Shapiro*, then, is one of extension beyond privity traders, rather than restriction to same period traders. The language in *Wilson* is somewhat misleading as to *Shapiro*'s holding. This allows the *Wilson* court to more easily adopt Judge Celebrezze's (mistaken) understanding of the extent of the disclose or abstain duty, and the contemporaneous trading solution he bases on that understanding.

[163]*Wilson*, 648 F.2d at 94.

[164]*Id.*

[165]Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1975-76 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,377, at 98,878 (S.D.N.Y. Dec. 5, 1975). *See* O'Connor & Assocs. v. Dean Witter Reynolds, Inc., 559 F. Supp. 800, 803 (S.D.N.Y. 1983).

[166]Wilson v. Comtech Telecomm. Corp., 648 F.2d 88 (2d Cir. 1981); Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976).

[167]Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976).

First, it raised the specter of unlimited potential liability.[168] Second, it said that those who do not trade with the insider do not need the protection of the disclose or abstain rule; hence there was, in this case, no duty to the plaintiff, the violation of which could result in liability to him.[169] The court followed Judge Celebrezze in limiting the disclose or abstain duty to contemporaneous traders.[170] However, again
following Judge Celebrezze, it diverged from its own prior statement of the reach of the disclose or abstain duty, speaking in terms that smack of privity:

> [a]ny duty of disclosure is owed only to those investors trading contemporaneously with the insider; non-contemporaneous traders do not require the protection of the "disclose or abstain" rule because they do not suffer the disadvantage of *trading with* someone who has superior access to information.[171]

Because Wilson had purchased his shares a month after the insider sales, the court said he did not trade contemporaneously.[172] It therefore affirmed the district court's dismissal of the action.[173]

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[168] *Wilson*, 648 F.2d at 94 (explaining 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").

[169] *Id.* at 94-95.

[170] *Id.*

[171] *Wilson*, 648 F.2d at 94-95 (emphasis added) (citing Fridrich v. Bradford, 542 F.2d 307, 326 (6th Cir. 1976) (Celebrezze, J., concurring)). The language quoted in the text has been quoted by many subsequent cases in reference to the contemporaneous trader requirement. *See supra* note 32.

[172] *Wilson*, 648 F.2d at 95.

[173] *Id.* One commentator had the following to say about *Wilson*:

> *Wilson* is strange, for a "contemporaneousness" rule simply reverts back to the notion of privity. The court said that "non-contemporaneous traders do not require the protection of the disclose or abstain rule because they do not suffer the disadvantage of trading with someone who has superior access to information." But that is true of anyone not in privity with the defendant. While the court did not offer a precise definition of "contemporaneousness," it seems to be establishing a concept of "constructive privity" — limiting standing, if not to persons whose shares actually came from or went to the defendant, to those whose shares might have but for the fortuities of marketplace matching.* In this sense, however, the result is subject to the same criticism that *Shapiro* offered against the privity requirement itself, for the plaintiff in *Wilson* was no less affected or injured by the defendant's conduct than those who might be fortunate enough to meet the contemporaneousness standard.

* Read strictly, this concept might be applied in cases involving widely followed issuers by granting standing to those persons whose trades were executed on the same day or days that defendant traded, so long as that occurred after defendant breached his duty to disclose.

d. *A Final Early Word:* O'Connor[174]

The final case cited in the legislative history of ITSFEA for a definition of the contemporaneous trader requirement is the only case that draws a clear line for the requirement. *O'Connor* was decided by the same district court that had considered *Shapiro*.[175] In *O'Connor*, the court dismissed an action as to particular defendants in spite of plaintiff's attempt to argue the contemporaneity standard in its own favor.[176] This ruling was made even though plaintiff had traded just hours before the defendants.[177] While acknowledging that the disclose or abstain duty was not confined to those in privity with defendants, the court ruled that the duty to disclose was not breached until defendants began trading.[178] Therefore, it reasoned, those who had traded before the insider could claim no harm.[179]

Not only did the *O'Connor* court reject defendants' argument that privity was required generally in a private action for damages, it went further and said that, even if defendants could name those with whom they had actually traded, the action would still not be limited to those in privity.[180] Referring back to *Shapiro*, the court said that, although the difficulty of matching trades in an anonymous market was one reason *Shapiro* did not

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D. LANGEVOORT, INSIDER TRADING REGULATION 269 (1990 ed.). As Langevoort predicts here, courts in fact have come to read the requirement strictly and to limit standing to same day trading, or even to trading within a few hours, where the stock at issue is heavily traded. *See* WANG & STEINBERG, *supra* note 16, § 6.5.5-.7.

[174]O'Connor & Assocs. v. Dean Witter Reynolds, Inc., 559 F. Supp. 800 (S.D.N.Y. 1983). *O'Connor* is the third case cited in the legislative history of Insider Trading and Securities Fraud Enforcement Act of 1988 as authority on the contemporaneity standard. H.R. REP. NO. 100-910, 27 n.22 (1988).

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

[176]*Id.* at 803, 806.

[177]*Id.* at 802.

[178]*Id.*

[179]*O'Connor*, 559 F. Supp. at 803. The court reasoned that:

> [t]he fact that strict privity between buyer and seller is not required . . . does not mean that the element of causation may be dispensed with. . . . Thus, although the liability of one who trades on inside information may extend to all those who trade between the date of the defendant's sales and the date of public disclosure of the inside information, [*see* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1975-76 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,377, at 98,878 (S.D.N.Y. Dec. 5, 1975); *cf. Wilson*, 648 F.2d at 94-95] liability does not extend to those who traded prior to the defendant's breach of his duty to "disclose or abstain" — that is, prior to the date of the defendant's trades.

Id.

[180]*See id.* at 805. One defendant had argued that, because buyers and sellers in the options market could be readily matched, cases doing away with the privity requirement in an anonymous market should not apply to options cases. *Id.*

require privity, it was not the only reason, nor was it the primary one.[181] *Shapiro* had said that the disclose or abstain duty was

> imposed "to insure the integrity and efficiency of the securities market," a purpose which in *Shapiro* was held to require that liability extend to all those who traded during the same period as the defendants and who would not have traded had they known of the inside information possessed by the defendants.[182]

As to the concern about unlimited liability, the court explained out that if damages are limited to the disgorgement of profits, a defendant could claim no prejudice for a class including all contemporaneous traders.[183]

2. Subsequent Judicial Developments

The foundational cases provide no precise outlines to the contemporaneous trader requirement. Similarly, Congress provided no definition of contemporaneous trading when it codified the private right of action in 1988.[184] Cases decided since then have added little to our understanding of what exactly constitutes contemporaneous trading. The requirement, however, has been subject to increasingly strict interpretations. A number of cases have suggested that it requires that a plaintiff's trading take place on the same day as defendant's.[185] Also, the procedural positioning of the contemporaneous trading argument is being used to dispose of private actions at very early stages of litigation.

Though *Shapiro* and *Fridrich* specifically declined to use contemporaneous trading as a standing requirement, many courts since then have followed *Wilson* in making it a matter of standing,[186] and have dismissed actions prior to discovery for failure to plead contemporaneity

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[181] *Id.*

[182] *Id.* (quoting *Shapiro*, 495 F.2d at 237, 239-40). *See* discussion *supra* Part II.B.1.b.

[183] *O'Connor*, 559 F. Supp. at 805. By this time, the Second Circuit had adopted the disgorgement measure of damages in *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980).

[184] *See* discussion of the Insider Trading and Securities Fraud Enforcement Act of 1988, *infra* Part II.C.2.

[185] *In re* Aldus Sec. Litig., [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,376 (W.D. Wash. Mar. 1, 1993); *In re* Stratus Computer, Inc. Sec. Litig., No. 89-2075-Z, 1992 U.S. Dist. LEXIS 22481 (D. Mass. Mar. 27, 1992) (only same day trades contemporaneous). *See* Backman v. Polaroid Corp., 540 F. Supp. 667, 671 (D. Mass. 1982) (trades two and seven days apart not contemporaneous).

[186] *See supra* note 77.

with sufficient particularity.[187] In addition, the standard for pleading has itself been tightened in some courts. The Ninth Circuit now holds that contemporaneous trading is a "circumstance constituting fraud,"[188] and the level of particularity that is now considered to satisfy the pleading requirement is tighter than it was in the past. Finally, at least one court has used this position in conjunction with the 1995 Private Securities Litigation Reform Act[189] to raise further obstacles to private actions for insider trading.[190]

3. Summary of Judicial Creation and Development

Preceding sections have described initial problems created by the contemporaneous trader requirement. This requirement was based on an incomplete understanding of causation and harm in the insider trading context.[191] The creation of the requirement involved two mistakes. First, it was based on a mistaken notion that the only persons harmed by insider trading are those in privity with the insider.[192] Second, it involved a mistaken attempt to respond to the problem of disproportionate potential liability by limiting access to the private right of action, rather than by imposing a rational cap on the damages to which an inside trader could be subject.[193]

The history of the creation and development of the requirement by the courts reveals an exacerbation of these mistakes and the problems they

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[187]*See, e.g.*, Neubronner v. Milken, 6 F.3d 666, 670 (9th Cir. 1993) (stating that plaintiff's "allegation of a three-year period of contemporaneous trading is clearly insufficiently specific to establish contemporaneity").

[188]*Id.* at 670 (holding that "contemporaneous trading is necessarily a 'circumstance constituting fraud' because an insider can not be liable to a private party under section 10(b) and Rule 10b-5 without having traded contemporaneously; thus, contemporaneous trading must be pleaded with particularity under [Fed. R. Civ. Pro. 9(b)]"). Rule 9(b) provides that "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity."

[189]Pub. L. No. 104-67, 109 Stat. 737 (1995).

[190]*In re* Silicon Graphics, Inc. Sec. Litig., 970 F. Supp. 746 (N.D. Cal. 1997). For a review of some of the cases described broadly in this section, see WANG & STEINBERG, *supra* note 16, at § 6.5.

[191]*See, e.g.*, O'Connor & Assocs. v. Dean Witter Reynolds, Inc., 559 F. Supp. 800 (S.D.N.Y. 1983); Wilson v. Comtech Telecomm. Corp., 648 F.2d 88 (2d Cir. 1981); Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974).

[192]*See* sources cited *supra* note 191.

[193]*See* CLARK, *supra* note 9, at 336 ("The *Fridrich* court's decision to impose a just limitation on the defendant's liability for damages by means of a holding on what appears to be another subject — whether defendant in fact caused injury — must leave jurists uncomfortable."). *See also supra* text accompanying note 108 (quoting the *Fridrich* court's rationale).

cause, through the ever more strict application of the requirement by courts.[194] Cases decided since the foundational cases have continued and, for the most part, have compounded the original problems with the contemporaneous trader requirement.[195] The original concern over limiting the private action to trading that has the appropriate causal connection with the illegal conduct has led courts not only to adopt the contemporaneous trader requirement, but also to restrict its reach.[196] The perceived need to limit the scope of potential liability continues to be a touchstone when courts are using and interpreting the requirement.

C. *Other Developments That Inform the Critique of the Contemporaneous Trader Requirement*

The previous section discussed the creation and development of the contemporaneous trader requirement in the courts. This section presents non-judicial perspectives that inform the critique of that requirement. It begins with a discussion of the American Law Institute's Federal Securities Code. In the Code, the product of a decade of study, the ALI adopted standards for the private cause of action for insider trading.[197]

Next, this section discusses the congressional adoption of the contemporaneous trader requirement in the Insider Trading and Securities Fraud Enforcement Act in 1988.[198] ITSFEA provided an express private right of action for contemporaneous traders. Congress did not define the term "contemporaneous," but rather referred to the case law for its definition.[199] Three of the cases discussed in the previous section were cited as authority for the contemporaneous trader requirement.[200] The legislative history of ITSFEA also contains comments that may shed some light on what Congress might have been requiring, and why.

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[194]*See supra* note 185 and accompanying text.

[195]*See supra* notes 184-90 and accompanying text.

[196]*See* cases discussed *supra* Part II.B.1.-2.

[197]Just a year after the publication of the ALI Federal Securities Code, an article was published discussing in detail the harm caused by insider trading. In Wang, *supra* note 60, at 1225-45, 1304-11, Professor Wang presented an interesting exposition of how, and to whom, insider trading results in harm, and also commented on the approach taken in the ALI Code.

[198]Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988) (codified at 15 U.S.C. §§ 78c(a), 78o, 78t-1, 78u(a), 78u-1, 78ff(a), 78kk, 80b-4a (1994)).

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

[200]*Id.* at 27 n.22.

1. The ALI Federal Securities Code: Private Action Open to Those Trading Until Disclosure[201]

a. *Introduction*

In 1980, the American Law Institute published the Official Draft of its Federal Securities Code.[202] The Code was the product of a decade of careful work, constant revision, and input from a number of experienced and esteemed members of the bench and bar, the public sector, and the academy.[203] Though the Code was never passed into law by Congress,[204] it reflects the informed thinking of knowledgeable people under circumstances (and in a time frame) that allowed a more comprehensive and careful drafting than is usually the case in the press and the politics of the legislative

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[201]FEDERAL SECURITIES CODE (ALI 1980). For other discussions of the insider trading provisions of the ALI Code, see WANG & STEINBERG, *supra* note 16, ch. 8; Wang, *supra* note 60, at 1304-11. For general discussions of the ALI Code, see, e.g., *A Symposium on the Proposed Federal Securities Code*, 1 PACE L. REV. 279 (1981) (analyzing the ALI Code); Symposium, *The American Law Institute's Proposed Federal Securities Code*, 32 VAND. L. REV. 455 (1979) (analyzing the ALI Code); Lewis D. Lowenfels, *The Case Against the Proposed Federal Securities Code*, 65 VA. L. REV. 615 (1979) (stating that the proposed code is not necessary to solve many of the existing problems and creates more serious problems).

[202]FEDERAL SECURITIES CODE at vii (ALI 1980). The idea for the Code was originally discussed at an American Law Institute Council meeting in 1964 by Professor Louis Loss and then Chairman of the SEC William L. Cary. *Id.* The idea received the support of the American Bar Association's Committee on Federal Regulation of Securities. *Id.* The project was meant to unify and integrate various federal statutes affecting securities, and also to improve them, clarify them, and eliminate inconsistencies and overlaps. *Id.* The drafting involved the close participation of a group of Consultants and Advisors, and the cooperation of both the ABA and the SEC. The project took a full decade to complete. *Id.* at xxi. The Official Draft was endorsed by the ABA and later by the SEC. Statement Concerning Codification of the Federal Securities Law, Securities Act Release No. 6377, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,090 (Jan. 21, 1982); Statement Concerning Codification of the Federal Securities Law, Securities Act Release No. 6242, [1980 Transfer Binder] Fed Sec. L. Rep. (CCH) ¶ 82,655 (Sept. 18, 1980).

[203]*See* FEDERAL SECURITIES CODE at xxi-xxiii (ALI 1980); HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW § 1.01 (1997) (stating that "the proposed Code was exposed to many points of view in the drafting process and involved some of the best minds in the field of securities law").

[204]The Code was presented to Congress in 1980, but Congress did not act on it. "[W]hen the ALI's Federal Securities Code was presented to Congress in 1980, Congress essentially yawned and declined to act. Unfortunately, 'good government' reform does not excite powerful constituencies nor generate the level of emotion necessary to stir a lethargic Congress into action." John C. Coffee, Jr., *Re-Engineering Corporate Disclosure: The Coming Debate Over Company Registration*, 52 WASH. & LEE L. REV. 1143, 1145-46 (1995).

process.[205] The Code has influenced the work of judges and regulators.[206] It is illuminating to consider the approach of the Code to the issues surrounding the contemporaneous trader requirement.

The Code would make express the implied private right of action for insider trading.[207] The Code does not adopt a requirement of contemporaneous trading for open-market[208] insider trading.[209] Rather, it grants a private action to all those trading from the day the defendant trades until disclosure of the information.[210] It also provides for damage caps that limit a defendant's total liability in the open-market setting.[211]

b. *Who Can Bring a Private Action*

Code section 1703 sets up the private right of action for insider trading.[212] Section 1703(b) deals with transactions effected in the market and provides that a person who violates various of the substantive fraud provisions, including those covering insider trading, "is liable for damages to a person who buys or sells during the period beginning at the start of the day when the defendant first unlawfully sells or buys, and ending at the end of the day when all material facts . . . become generally available."[213] Thus,

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[205]*Id.* at 1145 ("Almost everyone in the field applauded this effort, accomplished under the magisterial direction of Harvard Professor Louis Loss. Eventually, even the SEC endorsed this approach . . . .").

[206]*See* Norman S. Poser, *A Monument to a Regulatory System*, 92 MICH. L. REV. 1797, 1797 (1994) ("Although never enacted into law, the Code has profoundly influenced judicial decisions and SEC rulemaking.").

[207]*See* FEDERAL SECURITIES CODE at xlvi (ALI 1980); *id.* § 1703.

[208]In the area of civil liability for Rule 10b-5 type violations, the Code deals separately with market and non-market transactions. *See* FEDERAL SECURITIES CODE §§ 1702(a)-(b), 1703(a)-(b) (1980).

[209]It does adopt a same day trading requirement for private actions based on other types of securities fraud. *See id.* § 1702(b).

[210]*Id.* § 1703(b).

[211]*Id.* §§ 1703(i), 1708(b).

[212]Section 1703 is titled "Sales and Purchases By Fraud or Misrepresentation." The substantive elements of a violation are provided in § 1603. Also relevant to this discussion is Code § 1702. Section 1702 provides for liability for "Illegal Sales and Purchases." It addresses "non-fraud-type violations that have to do with sales or purchases of securities." FEDERAL SECURITIES CODE § 1702(a) cmt. (1)(a) (ALI 1980).

[213]This allows the possibility that plaintiff will have traded before defendant, though on the same day. FEDERAL SECURITIES CODE § 1703(b) (ALI 1980). This seems to conflict with *O'Connor & Assocs. v. Dean Witter Reynolds, Inc.*, 559 F. Supp. 800 (S.D.N.Y. 1983), but it does simplify the identification of qualifying plaintiffs.

the Code adopts the designation of the class of potential plaintiffs advocated for in this article and assumed by the district court in *Shapiro*.[214]

The drafters of the Code did not adopt this designation of the class of potential plaintiffs unmindful of alternatives. In fact, for different situations, the Code uses three different requirements mentioned in this article: privity,[215] same day trading,[216] and trading after the insider and prior to disclosure of the information.[217] The first alternative, requiring privity between plaintiffs and defendants, is used by the Code, but only for situations in which it is deemed appropriate.[218] Thus the Code requires privity where the courts have always required it, in face-to-face transactions.[219] For such "transactions not effected in the markets," the violator is liable to "his buyer or seller."[220] This is the requirement both for insider trading and other fraudulent securities trading covered in section 1703(a),[221] and for the parallel provision dealing with non-fraudulent violations involving securities trading covered in section 1702(a).[222] "[I]f," however, "a transaction is effected in a manner that would make the matching of buyers and sellers substantially fortuitous,"[223] that is, for "transactions effected in the markets,"[224] privity is deemed inappropriate.[225]

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[214]Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1975-76 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,377, at 98,878 (S.D.N.Y. Dec. 5, 1975). *See also* Wang, *supra* note 60, at 1307 ("This classification is roughly equivalent to the *Shapiro* or *Elkind* class of plaintiffs."). Robert C. Clark apparently also assumes this was the Second Circuit's approach. *See* CLARK, *supra* note 9, § 8.10, at 335.

[215]*See supra* Parts II.A., III (discussing the problems surrounding privity).

[216]*See supra* note 185 and accompanying text (discussing same day trading).

[217]*See supra* Part II.B. (noting key cases involving insider trading).

[218]FEDERAL SECURITIES CODE at xlix(10) (ALI 1980).

[219]*Id.* § 1702(a).

[220]*See id.* (stating sellers or buyers are liable to their buyer or seller).

[221]*Id.* § 1703(a).

[222]FEDERAL SECURITIES CODE § 1702(a) (ALI 1980).

[223]*Id.* at xlix(10).

[224]*Id.* § 1703(b).

[225]Section 1702, like § 1703, deals separately with market and non-market transactions. The general approach of the Code in this area is to distinguish between market and non-market trades. The drafters recognized the fortuitousness of any matching of buyers and sellers in market transactions:

> (10) *Face-to-face versus market transactions*: Today [Rule 10b-5 and other provisions] . . . ignore the very real differences between face-to-face transactions and purchases in an organized market, where the tracing of certificates from seller to buyer (or vice versa), if mechanically possible at all, produces an altogether fortuitous result. The successor provisions, §§1702-03, treat the two types of transactions separately, so that, if a transaction is effected in a manner that would make the matching of buyers and sellers substantially fortuitous, all persons who buy or sell on a given day are treated alike (§§1702(b), 1703(b)).

The Code deals with the fortuitousness of matching trades in the open-market setting differently than have the courts. Instead of creating a class of potential plaintiffs who might have been in privity with the defendant, a group with "constructive privity," the Code simply acknowledges the fortuity and designates what the drafters deemed to be a sensible class given that, in these situations, "any concept of privity of contract is meaningless."[226]

For different kinds of market transactions, the Code uses both the second and third alternatives listed above. For civil liability for open-market violations of a variety of types covered under section 1702(b), it provides a "same day" trading requirement.[227] Section 1702 is "designed essentially *to protect the buyer or seller in the particular transaction* rather than to regulate the industry generally."[228] Thus, when it is deemed appropriate, the Code uses the restrictive version of the contemporaneous trading requirement.[229] The fact that the drafters of the Code used this designation of a class of potential plaintiffs in the section of the Code immediately preceding the insider trading provision strongly suggests that their failure to adopt it for insider trading suits was an intentional rejection of the contemporaneous trader alternative that was developing in the courts at the time.[230]

The third alternative listed above was chosen for insider trading where the trades took place in the market. Recall that section 1703 deals with fraudulent sales and purchases and covers insider trading.[231] In non-market situations, it mirrors the provisions of section 1702, and makes defendants

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Id. at xlix(10). Professor Loss points out in his Introduction to the Code that "the comments — though most of them accompanied the earlier drafts, and their final version here reflects many suggestions from members of the advisory groups and others — must be understood to be the Reporter's, not the Institute's." *Id.* at xxii.

[226]FEDERAL SECURITIES CODE at xliv(b) (ALI 1980) (commenting generally on Fraud and Civil Liability portions of Code). *See also id.* § 1702(e) cmt. 4(b) ("[To] insist on . . . privity of contract between plaintiff and defendant . . . [would be] both impractical and nonsensical . . . .").

[227]*See id.* § 1702(b). Section 1702(b) provides that "a seller or buyer who acts as in section 1702(a) is liable for damages to a person who buys or sells a security of the same class on a day when the defendant unlawfully so acts." *Id.* Damages under subsection (b) are limited so they will be no greater than under subsection (a). *See id.* § 1702(e)(2). *See also id.* § 1702(b) cmt. 3 (stating that defendant's exposure is no more than under § 1702(a)).

[228]*See id.* § 1702(a) cmt. 1(a).

[229]As mentioned above in the discussion of *Shapiro* and Celebrezze's opinion in *Fridrich*, the contemporaneous trader requirement was narrowed into a proxy for privity, restricting the private right of action to those who traded within a few days of, or on the same day, as the defendant. *See supra* Part II.B.1.

[230]*See* cases discussed *supra* Part II.B.1.

[231]FEDERAL SECURITIES CODE § 1703 (ALI 1980).

liable to their trading partners for rescission or damages.[232] In market situations, however, it does not mirror section 1702.[233] As indicated above, instead of making the defendant liable only to same day traders, it opens the category of potential plaintiffs to everyone trading from the time the defendant did until disclosure of the information.[234]

The explanation given for rejecting a "same day" trading requirement for eligibility to sue for insider trading, in spite of the fact that the Code uses such a requirement for other circumstances, is worth noting.[235] A comment following section 1703(b) explains this deviation:

> So far as describing eligible plaintiffs is concerned, section 1703(b) necessarily departs from the same-day formula of section 1702(b). For under that formula persons who bought on a day when the defendant sold and who later resold before the facts became generally available would have standing but normally would be unable to show damages under . . . [the applicable damage provisions of the Code], whereas *their* buyers would be able to show damages if they held until the facts became generally available but would lack standing; and the result might be immunity for the defendant.[236]

This is an acknowledgment that the harm from an insider's trade may be transferred up until the time disclosure is made, and that therefore the one in privity may not be harmed.[237]

c. *Damage Limitations; Proration of Damages*[238]

As noted, the Code requires neither privity nor contemporaneous trading for eligibility to sue for insider trading in the open-market setting.

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[232]*Id.* § 1703(a) (violator "liable to his buyer or seller").

[233]*Id.* § 1703(b) cmt. (2).

[234]*Id.* § 1703(b) (stating that a violator "is liable for damages to a person who buys or sells during the period beginning at the start of the day when the defendant first unlawfully sells or buys, and ending at the end of the day when all material facts . . . become generally available").

[235]FEDERAL SECURITIES CODE § 1703(b) (ALI 1980).

[236]*Id.* § 1703(b) cmt. 2. This is the same reason the Second Circuit in *Shapiro* gave for rejecting defendants' theory of liability based on the concern about enormous potential liability. *See supra* notes 91-100 and accompanying text (discussing *Shapiro*).

[237]*See infra* Part III.

[238]The idea of capping damages has been discussed by a number of commentators. *See* sources cited *supra* note 9. Several commentators specifically refer to the ALI Code's proposal. *See, e.g.*, Langevoort, *supra* note 25, at 657-62 (discussing a damage limitation high enough to deter securities fraud).