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## Securities Law -- Rule 10b-5 -- Civil Liability of Tippers and Tippees -- Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.

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The proposed contract analysis calls for the case-by-case evaluation of the merits of arbitration clauses as severable, bargained-for agreements. Arbitration agreements executed through the exercise of grossly disparate bargaining power and knowledge can be invalidated through the application of contract principles. The case-by-case approach permits such egregious agreements to be invalidated individually. Thus, the overly broad conclusive ban of the *Wilko* statutory construction is unnecessary. The case-by-case contract analysis of agreements to arbitrate securities disputes is capable, therefore, of effectuating the policies of the securities statutes, as declared in *Wilko*, while simultaneously enforcing arbitration agreements to the extent envisioned by the Arbitration Act.

FRANCIS E. GIBERSON

**Securities Law—Rule 10b-5—Civil Liability of Tipsters and Tippees: *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.***<sup>1</sup>—Defendant Merrill Lynch, Pierce, Fenner & Smith, Inc. (Merrill Lynch), and certain of its officers, directors and employees (the individual defendants)<sup>2</sup> acquired material inside information<sup>3</sup> concerning the unfavorable earnings outlook for Douglas Aircraft Company, Inc. through Merrill Lynch's position as prospective managing underwriter for a new issue of Douglas debentures.<sup>4</sup> The individual defendants conveyed this information to certain Merrill Lynch customers<sup>5</sup> (the selling defendants) who, after learning of this information, either sold from existing positions or made short sales of more than 165,000 shares of Douglas common on the New York Stock Exchange (NYSE).<sup>6</sup> These sales were made prior to a public announcement of the inside information by Douglas and without disclosure of the information either to the purchasers of the defendants' stock or to the general investing public.<sup>7</sup>

The plaintiffs alleged that they had purchased Douglas common on the NYSE after the selling defendants had sold and before

<sup>1</sup> 495 F.2d 228 (2d Cir. 1974).

<sup>2</sup> For the names of the individual defendants and their positions with Merrill Lynch, see *id.* at 232 n.4.

<sup>3</sup> This information was essentially that: (1) Douglas would report substantially lower earnings for the entire first six months than it had reported for the first five months of its 1966 fiscal year; (2) Douglas had sharply lowered its estimate of earnings for its full 1966 fiscal year since it now expected to have little or no profit for that year; and (3) Douglas had substantially reduced its projection of earnings for its 1967 fiscal year. *Id.* at 232.

<sup>4</sup> *Id.*

<sup>5</sup> For the names of the selling defendants, most of whom were institutional investors, see *id.*

<sup>6</sup> *Id.* The details of the fact situation are noted in Investors Management Co., Securities Exchange Act Release No. 9267, reprinted in [1970-71 Transfer Binder] CCH Fed. Sec. L. Rep., ¶ 78,163, at 80514, 80516-17 (July 29 1971).

<sup>7</sup> 495 F.2d at 232.

the information had become public.<sup>8</sup> However, there was no allegation that any of the plaintiffs had purchased directly from any of the selling defendants.<sup>9</sup> Shortly after the plaintiffs acquired the stock, Douglas issued a press release containing the information, after which the market price of Douglas common dropped substantially.<sup>10</sup> The complaint alleged that defendants breached a duty to disclose to the general investing public the material inside information concerning the financial condition of Douglas. It further alleged that the failure to disclose the information was a violation of the antifraud provisions of the securities laws.<sup>11</sup> Plaintiffs claimed that they would not have purchased Douglas stock if they had known of the information withheld by defendants, and therefore that they had sustained substantial damages as a result of defendants' conduct.

Holding that defendants could be liable for damages to all persons who, during the relevant period, bought Douglas stock without knowledge of the inside information,<sup>12</sup> the federal district court denied defendants' motion to dismiss for failure to state a claim upon which relief could be granted.<sup>13</sup> In order to allow interlocutory appeal the district court certified the question to the court of appeals.<sup>14</sup> Affirming the decision below, the United States Court of Appeals for the Second Circuit HELD: tippers and tip-

<sup>8</sup> *Id.* at 233.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at 231. Plaintiffs alleged that defendants' acts violated: §§ 10(b) and 15(c)(1) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b), 78o(c)(1) (1970); Rules 10b-5, 15c-1 and 2, 17 C.F.R. §§ 240.10b-5, 240.15c-1, 2 (1974); and § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a) (1970). Only the allegations raised under § 10(b) and Rule 10b-5 were involved on appeal. 495 F.2d at 234 n.10. Section 10(b) states:

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

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j (1970). Rule 10b-5 states:

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

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

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

(c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1974).

<sup>12</sup> *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 353 F. Supp. 264, 278 (S.D.N.Y. 1972).

<sup>13</sup> *Id.* at 268.

<sup>14</sup> 495 F.2d at 234. The certification was pursuant to 28 U.S.C. § 1292(b) (1970).

pees who violate the duty to disclose or abstain from trading will be liable for damages to all persons who, during the period in which the tippers and tippees traded in or recommended trading in the stock concerned, purchased the stock in the open market without knowledge of the material inside information in the possession of the tippers and tippees, despite a lack of privity and reliance.<sup>15</sup> The Second Circuit left to the district court the task of determining "the proper measure of damages."<sup>16</sup>

*Shapiro* appears to expand greatly the scope of the civil liability of violators of section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. By holding that one who violates his duty to "disclose or abstain" will be liable to all those who traded in the stock during the relevant period, the court has created a larger class of potential plaintiffs. Furthermore, by eliminating the previously existing requirement that a plaintiff in a non-disclosure case prove reliance,<sup>17</sup> the court has greatly increased the chances for successful prosecution of private 10b-5 actions.

The court's rationale for holding that both the non-trading tippers and trading tippees violated section 10(b) and Rule 10b-5 will be discussed in this note. Particular attention will be given to the elements of a tipper's violation. The court's rationale for imposing civil liability for damages on the respective defendants will then be analyzed, with the focus of the examination on the court's abandonment of the requirements of privity and reliance. Finally, the desirability of imposing broad civil liability will be considered in light of both the purposes served by private actions under Rule 10b-5 and other possible resolutions of the issues presented in *Shapiro*.

The Second Circuit held that the non-trading tippers' disclosure of confidential, material inside information to their customers, who subsequently sold Douglas stock in reliance on such information violated section 10(b) and Rule 10b-5.<sup>18</sup> This holding was based upon the Second Circuit's decision in *SEC v. Texas Gulf Sulphur Co.*,<sup>19</sup> a SEC injunction action in which it was held that certain corporate insiders who had disclosed material inside information to persons who subsequently engaged in transactions in the stock market had violated the securities laws.<sup>20</sup>

The court in *Shapiro* rejected defendants' two contentions that the holding in *Texas Gulf Sulphur* was not applicable in a private damages action, and that defendants' duty to disclose extended only to the actual purchasers of defendants' shares.<sup>21</sup> Evaluating the first

<sup>15</sup> 495 F.2d at 241.

<sup>16</sup> *Id.* at 242.

<sup>17</sup> *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir.), cert. denied, 382 U.S. 811 (1965).

<sup>18</sup> 495 F.2d at 237, 241.

<sup>19</sup> 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).

<sup>20</sup> 401 F.2d at 852, 856 n.23.

<sup>21</sup> 495 F.2d at 236-37.

contention, the court stated that "the strong public policy considerations behind our 'disclose or abstain' rule there [in *Texas Gulf Sulphur*] are equally applicable here."<sup>22</sup> The court rejected the defendants' second contention on the ground that accepting the defendants' narrow view of their duty would "frustrate a major purpose of the antifraud provisions of the securities laws: to insure the integrity and efficiency of the securities markets."<sup>23</sup>

Thus, *Shapiro* makes it clear that where a duty to disclose exists,<sup>24</sup> disclosure must be made to the entire investing public, rather than merely to the other party to the transaction.<sup>25</sup> However, because of some ambiguities in the language of the opinion, there remains some question as to what the elements of a tipper's violation are. The question left unanswered is whether tippee trading is necessary to hold that a tipper violated Rule 10b-5.

There is language in the *Shapiro* opinion which suggests that

<sup>22</sup> *Id.* at 236. The same result had been reached in an earlier decision not cited by the *Shapiro* court, *Astor v. Texas Gulf Sulphur Co.*, 306 F. Supp. 1333, 1340 (S.D.N.Y. 1969).

<sup>23</sup> 495 F.2d at 237. It has been suggested that the duty to disclose must extend to the investing public, because "in any active market disclosure to a particular individual is not feasible . . . ." Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 Colum. L. Rev. 1361, 1378 (1965). However, the impracticality of disclosure to particular individuals is only one reason to extend the duty owed to include the investing public. As the court noted, one of the main purposes of Rule 10b-5 is the promotion of the integrity and efficiency of the securities markets. 495 F.2d at 237. By this, the court referred to the market's function of "assessing the value that society places upon the efforts of a particular enterprise . . . . This function can be performed effectively only if the delicately calibrated balance of factors affecting demand and supply are allowed to have their impact upon the market place through an unrestricted flow of information and funds." *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 357 (2d Cir.), cert. denied, 414 U.S. 910 (1973). Limiting the insider's duty to disclose in a market transaction so as to require disclosure only to those persons who are in privity with him would not fulfill this purpose of the rule. Even if the insider complied with his duty, transactions based on knowledge not generally available would still be occurring in the market, thus distorting the market's estimate of value of that stock.

<sup>24</sup> The district court's opinion, apparently supported in this respect by the court of appeals, see 495 F.2d at 238, indicates that one in possession of inside information has no duty to disclose until he either recommends or trades in the security concerned. See *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 353 F. Supp. 264, 278 (S.D.N.Y. 1972). However, *Financial Indus. Fund, Inc. v. McDonnell Douglas Corp.*, [1970-71 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,004, at 90698 (D. Colo. 1970), a case arising out of the same facts as *Shapiro* and in which Merrill Lynch was a co-defendant, held that Merrill Lynch had a duty to disclose the inside information which it possessed, apparently regardless of whether or not it had divulged the information to others. *Id.* at 90700. It may be that this broadly defined duty of disclosure will not be placed upon all those in possession of inside information. The district court there indicated that the size and relationship of the co-defendants, and their proximity to the public were important in determining whether the duty to disclose existed. *Id.* at 90702.

<sup>25</sup> The court defined the group to whom defendants owed a duty as "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." 495 F.2d at 237. This seems to confuse the question of the scope of defendants' duty with the question of who has standing to sue for the breach of that duty. The correct view, as enunciated in the *Texas Gulf Sulphur* opinion, is that the duty extends to the entire "investing public." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968).

tippee trading is an essential element of a tipper violation.<sup>26</sup> The court said that for the purpose of determining whether section 10(b) and Rule 10b-5 were violated, one of the "critical facts" is that the tippees sold Douglas common.<sup>27</sup> The court's reliance on the holding in *Texas Gulf Sulphur*, a case in which the tippees traded,<sup>28</sup> also suggests the existence of the requirement of tippee trading. However, there are also indications in the *Shapiro* opinion that the court does not regard tippee trading as a *sine qua non* of a tipper's violation. The court stated that the defendants violated the securities laws "by trading in or recommending trading in" Douglas common.<sup>29</sup> Furthermore, in defining the scope of their liability, the court noted that the defendants would be liable for damages to plaintiffs who had purchased Douglas common in the open market during the same period defendants had traded in or recommended trading in that stock.<sup>30</sup> If the court meant that a tipper's liability is determined by the period within which he recommended trading in the stock, it follows that his violation of Rule 10b-5 occurred at the point at which the recommendation was made and not when his tippee subsequently traded.<sup>31</sup>

There are apparently valid policy arguments in support of a rule that tipping is a violation independent of tippee trading. The purposes of Rule 10b-5 are best served by discouraging the selective disclosure of material inside information at its source. This purpose is most effectively accomplished by viewing the tipper's act as a violation without regard to his tippee's actions. However, while this may be a desirable end, it may not be achievable through use of Rule 10b-5 since, in the absence of tippee trading, the requisite "in connection with the sale or purchase of a security" element seems to be lacking.<sup>32</sup> At least one case, *SEC v. Lums, Inc.*<sup>33</sup> has held that tippee trading is essential to a tipper's violation. In that case, a director of the defendant corporation had conveyed material information concerning Lum's revised earnings forecast to a broker. The broker in turn had relayed this information to one of his customers who subsequently sold his holdings in Lum's stock. In discussing the scope of Rule 10b-5, the court said that disclosure of material, non-public corporate information was a violation of the Rule, where

<sup>26</sup> 495 F.2d at 235-36.

<sup>27</sup> Id. See also text at note 18 supra.

<sup>28</sup> 401 F.2d at 841 n.4, 852, 856 n.23.

<sup>29</sup> 495 F.2d at 238 (emphasis added).

<sup>30</sup> Id. at 241 (emphasis added).

<sup>31</sup> See 2 A. Bromberg, *Securities Law: Fraud—SEC Rule 10b-5 § 7.5(3)(c)*, at 190.9 (1973); *SEC v. Glen Alden Corp.*, [1967-69 Transfer Binder] CCH Fed. Sec. L. Rep., ¶ 92,280, at 97342 (S.D.N.Y. 1968); *Merrill Lynch, Pierce, Fenner & Smith, Inc., Securities Exchange Act Release No. 8459*, reprinted in [1967-69 Transfer Binder] CCH Fed. Sec. L. Rep., ¶ 77,629, at 83347, 83349 (Nov. 25, 1968) (all indicating that tippee trading may not be an essential element of a tipper's violation).

<sup>32</sup> For the language of Rule 10b-5, see note 11 supra.

<sup>33</sup> 365 F. Supp. 1046 (S.D.N.Y. 1973).

it was foreseeable that the information would or might be traded upon, and a purchase or sale in fact took place.<sup>34</sup> Whether or not tipping alone is a violation of Rule 10b-5, it would seem that a tipper whose tippee does not trade will not be liable for damages since no private party has been injured absent any trading.<sup>35</sup>

Turning its attention to the tippees, the *Shapiro* court held that the duty to disclose or abstain would also be imposed on them.<sup>36</sup> The tippees argued that, since they were not in a position to make effective public disclosure of information about a company with which they were not associated, a distinction should be drawn between them and the tippers.<sup>37</sup> The court rejected this contention, stating that the duty imposed is not a naked duty of disclosure, but a duty to abstain from trading unless disclosure is made.<sup>38</sup>

The court did say that a tippee's duty to disclose was predicated upon his knowledge or constructive knowledge of the confidential corporate source of the information.<sup>39</sup> Thus, those remote tippees who are unaware of the original source of the tip do not possess a duty either to abstain or disclose, and will not violate the Rule by trading. However, it has been suggested that, since remote tippee trading is a foreseeable risk of tipping, a tipper may be civilly liable in damages for the transactions of even remote tippees.<sup>40</sup>

Defendants' principal argument against the imposition of liability in this action was that their activity did not cause damage to the plaintiffs. They argued that the plaintiffs, being ignorant of defendants' actions, did not in any way rely on the defendants, and thus would have purchased Douglas stock whether or not defendants had violated the law by trading.<sup>41</sup> They also argued that the precarious financial condition of Douglas, rather than defendants' securities laws violations, precipitated the sudden, substantial drop in the market price of Douglas stock and thus constituted the cause of the losses sustained by the plaintiffs.<sup>42</sup>

These arguments present two distinct points: (1) that defendants did not induce the plaintiffs to buy, and hence any losses suffered by the plaintiffs because they did buy were not caused by the defendants; and (2) that defendants' illegal transactions did not adversely affect the value of Douglas common, and hence any losses suffered by the plaintiffs because of a drop in the value of their stock were not caused by the defendants.<sup>43</sup>

<sup>34</sup> *Id.* at 1057.

<sup>35</sup> 2 A. Bromberg, *supra* note 31, § 7.5(4), at 190.11.

<sup>36</sup> 495 F.2d at 237.

<sup>37</sup> *Id.*

<sup>38</sup> *Id.* at 238.

<sup>39</sup> *Id.*

<sup>40</sup> 2 A. Bromberg, *supra* note 31, § 7.5(4), at 190.12.

<sup>41</sup> 495 F.2d at 238.

<sup>42</sup> *Id.*

<sup>43</sup> The idea of causation has received little scrutiny in 10b-5 cases, and is not yet

The court, apparently ignoring defendants' second contention,<sup>44</sup> held that the plaintiffs had shown causation in fact by proof of non-disclosure of a material fact.<sup>45</sup> Prior to this decision, a plaintiff in a non-disclosure case was required to show both that the defendant had failed to disclose a material fact and that the plaintiff had relied upon the fact, *i.e.*, that he would have acted differently had he known of the withheld fact.<sup>46</sup> The *Shapiro* decision removes the need to prove reliance in a 10b(5) non-disclosure case, an element on which many a plaintiff's case has faltered.<sup>47</sup> By requiring that a plaintiff in a non-disclosure case show only the defendant's breach of a duty to state a material fact in order to prove causation in fact, the *Shapiro* court may greatly facilitate recovery in such cases.

The court based its holding that the plaintiffs had established causation primarily upon the Supreme Court's decision in *Affiliated Ute Citizens v. United States*.<sup>48</sup> There, the plaintiffs were mixed-blood Indians who had held shares in the property of the tribe. Defendants were a bank, which had agreed to act as transfer agent for the shares and which had physical possession of the shares, and two employees who purchased the Indians' shares for their own accounts and those of others. Plaintiffs alleged that the two employees had violated Rule 10b-5 by failing to inform the plaintiffs of their position as market makers and of facts regarding the true value of the stock. The court of appeals held that there was no showing of reliance and hence there could be no recovery under Rule 10b-5.<sup>49</sup> The Supreme Court reversed, on the grounds that under the circumstances of the case, involving primarily a failure to disclose, positive proof of reliance was not a prerequisite to recovery. The withholding of a material fact established causation in fact.<sup>50</sup>

The defendants in *Shapiro* argued that the *Ute* decision did not apply to their case, since the fact situations were distinguishable. They pointed out that unlike *Ute*, there were no face to face transac-

developed to the base point of distinguishing between causation of the transaction and causation of the economic loss. The former seems adequately supplied by materiality and reliance . . . . The latter appears to be the proper focus for inquiry.

2 A. Bromberg, *supra* note 31, § 8.7(1), at 215-16. In *Astor v. Texas Gulf Sulphur Co.*, 306 F. Supp. 1333 (S.D.N.Y. 1969), the court noted that to establish defendants' liability, plaintiffs would have to show both transaction causation and loss causation. *Id.* at 1341-42.

<sup>44</sup> While there might be cases in which the withheld facts which caused a plaintiff to make the transaction did not, when released, cause the harmful change in the stock's value, *Shapiro* is not such a case. The facts concealed were those that did result in Douglas stock's diminution in value. This may be why the court did not discuss defendants' second contention.

<sup>45</sup> 495 F.2d at 238.

<sup>46</sup> *List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir. 1965).

<sup>47</sup> *E.g.*, *Reyos v. United States*, 431 F.2d 1337, 1348 (10th Cir. 1970), *rev'd sub nom. Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972); *List v. Fashion Park, Inc.*, 340 F.2d 457, 464 (2d Cir. 1965).

<sup>48</sup> 406 U.S. 128 (1972).

<sup>49</sup> *Reyos v. United States*, 431 F.2d 1337, 1348 (10th Cir. 1970).

<sup>50</sup> 406 U.S. at 153-54.



tions in *Shapiro*.<sup>51</sup> Reasoning that the test of causation in fact established by *Ute* applied to transactions on national securities exchanges as well as in face to face situations, the court rejected this contention.<sup>52</sup>

The Second Circuit did not discuss defendants' further argument that the *Ute* test was intended to apply only in cases, unlike *Shapiro*, where the plaintiff could show a general reliance upon the defendant,<sup>53</sup> although this argument is supported by *Simon v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,<sup>54</sup> a Rule 10b-5 action. There, the plaintiff alleged that the defendant had withheld certain material inside information. The district court found that the plaintiff had failed to prove specific reliance.<sup>55</sup> Plaintiff argued that *Ute* was applicable, and hence he did not have to show specific reliance on particular omissions to establish causation in fact. The Fifth Circuit held that a plaintiff in a non-disclosure case must show general reliance on a defendant's representations in order to have the benefit of the *Ute* test of causation in fact.<sup>56</sup> The court found that *Ute* did not apply to the case before it, since the facts showed that the plaintiff was a sophisticated investor who made his own investment decisions and did not generally rely on the defendant's recommendations.<sup>57</sup>

The resolution of the Second and Fifth Circuits' conflicting interpretations of *Ute* is of great importance for future 10b-5 actions. However, it is not entirely clear which interpretation is correct. It is true, as the *Simon* court noted,<sup>58</sup> that *Ute* involved unsophisticated investors who "considered [the] defendants to be familiar with the market for the shares of stock and relied upon them when they desired to sell their shares."<sup>59</sup> Thus, it may be that the Court's concern for these unsophisticated investors caused it to fashion a limited exception to the usual test for causation in fact. However, the language of the Court's holding seems to support the *Shapiro* court's interpretation of unrestricted applicability:

Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. . . . [The] obligation to disclose and [the] withholding of a material fact establish the requisite element of causation in fact.<sup>60</sup>

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<sup>51</sup> 495 F.2d at 240.

<sup>52</sup> *Id.*

<sup>53</sup> See Brief for Defendant-Appellants at 22-23, *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974).

<sup>54</sup> 482 F.2d 880 (5th Cir. 1973).

<sup>55</sup> [1972-73 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,604, at 92783 (N.D. Tex. 1972).

<sup>56</sup> 482 F.2d at 884.

<sup>57</sup> *Id.*

<sup>58</sup> *Id.*

<sup>59</sup> 406 U.S. 128, 152 (1972).

<sup>60</sup> *Id.* at 152-53.

The elimination of the element of reliance in Rule 10b-5 non-disclosure cases virtually establishes a scheme of investors insurance, something the Rule was arguably not designed to accomplish.<sup>61</sup>

Given the Supreme Court's manifest intention to interpret section 10(b) and Rule 10b-5, as not requiring positive proof of reliance, at least in situations similar to those presented in *Ute*, it is arguable that, in the interest of fairness, the coverage of this "investors insurance" should be limited to those who are financially unsophisticated and who generally rely on the defendant's recommendations. This would have the effect of removing the large bulk of securities transactions from the scope of the investors insurance, while providing extra protection to those arguably most in need of it. Nevertheless, it is submitted that the *Shapiro* court's interpretation of *Ute* will be far more effective in fulfilling the three major purposes of private 10b-5 actions, *i.e.*, deterrence, disgorgement, and compensation,<sup>62</sup> since it will permit any of the many potential plaintiffs in such an action to establish a right to recovery upon a showing of non-disclosure of a material fact. The *Simon* court's narrower interpretation would not be nearly as effective. Since it would be the rare case in which a plaintiff could establish his general reliance upon the defendant's advice, and thus qualify for the benefit of the *Ute* causation in fact test, the *Simon* court's interpretation would have the effect of imposing the pre-*Ute* requirement of proof of specific reliance in most cases.

The *Shapiro* court alternatively held that, even on the basis of the pre-*Ute* decisions, the plaintiffs had established causation in fact. The court relied primarily upon *List v. Fashion Park, Inc.*<sup>63</sup> for this holding. The plaintiff in *List* was a minority stockholder of Fashion Park, Inc., who had determined to sell his shares in the company shortly after the directors of the corporation, unknown to the plaintiff, had passed a resolution that the company seek to negotiate a sale or merger.<sup>64</sup> A defendant, one of the directors, purchased some of plaintiff's shares. The director revealed neither the fact of his position nor the existence of the corporation's decision to sell or merge. Sometime after the Plaintiff had sold his shares at a modest profit, a sale of the company was effectuated at a large profit per share.<sup>65</sup> The plaintiff subsequently brought an action, claiming that the defendant had violated Rule 10b-5 by not disclosing his corporate position or the possibility of a future sale of the corporation.<sup>66</sup> The court held that in a non-disclosure case, the

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<sup>61</sup> *List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir.), cert. denied, 382 U.S. 811 (1965).

<sup>62</sup> See text at notes 70-74 *infra*.

<sup>63</sup> 340 F.2d 457 (2d Cir. 1965).

<sup>64</sup> 340 F.2d at 460.

<sup>65</sup> *Id.*

<sup>66</sup> *Id.*

plaintiff had to show his reliance upon a material, withheld fact in order to establish causation. It explained that to show reliance, the plaintiff need only prove that he would have acted differently if the fact withheld had been disclosed.<sup>67</sup> However, the court found, on the facts, that the plaintiff had not shown reliance, because he failed to prove that he would not have sold his stock if he had known of the defendant's position.<sup>68</sup> Relying upon the *List* test for causation, the *Shapiro* court held that the plaintiffs' allegation, that they would not have bought Douglas common if the withheld information had been disclosed, established a claim of causation in fact sufficient to withstand the motion to dismiss.<sup>69</sup>

An evaluation of the desirability of the broad scope of liability *Shapiro* imposed on the tippees and tippees must proceed from an understanding of the place of civil damage suits in securities law. By rejecting defendants' argument that adequate sanctions for violations of Rule 10b-5 already exist in the form of administrative and injunctive proceedings which can be brought by the SEC, the *Shapiro* court recognized that a primary purpose for allowing private actions is the resulting increase in the deterrent effect of the securities laws.<sup>70</sup> Another important purpose is to divest one who has violated the law of his gains. As Professor Loss has noted with respect to damage recoveries: "[A]s with the many prophylactic rules developed in the law of trusts, it is more important to take the profit away from the insider than to worry about who gets it."<sup>71</sup> Although the court in *Shapiro* did not rule on the question of the amount of damages, it did imply that the district court should limit the damages recoverable to the profits made by or the compensation paid to the defendants.<sup>72</sup> This indicates that one of the court's primary interests may be the disgorgement of the defendants' profits.

The final function of civil damage actions in securities law is to compensate those injured by the unlawful conduct. The *Shapiro* court did not directly discuss this purpose of civil damage actions, although it noted that a factor relevant to the determination of damages is "what expenses were incurred and what losses were sustained by the plaintiffs . . ."<sup>73</sup> The compensatory function of damages in cases where the Rule 10b-5 violations occurred in the open-market has apparently not been pressed very vigorously by those courts or writers who have advocated liability to all those trading in the security during the relevant period. A reason for this may be that a requirement that an illegal trader make whole all those who were in the market during the relevant period would be

<sup>67</sup> *Id.* at 462-63.

<sup>68</sup> *Id.* at 464.

<sup>69</sup> 495 F.2d at 240.

<sup>70</sup> *Id.* at 241 n.18.

<sup>71</sup> 6 L. Loss, Securities Regulation 3575 (Supp. 1969).

<sup>72</sup> 495 F.2d at 242.

<sup>73</sup> *Id.*

likely to inflict financial destruction upon the violator, a result which seems unwarranted.<sup>74</sup> Thus, it can be seen that the compensation of victims of securities laws violations is a less important purpose in private actions with fact situations similar to that of *Shapiro*.

In light of the deterrence and disgorgement purposes of private 10b-5 actions for damages, it appears that the *Shapiro* rule will be fairly effective in furthering the goals of Rule 10b-5. By expanding the class of persons able to bring actions for these violations, and lowering their burden of proof on the matter of causation, the court has increased the threat of successful private actions, and thus greatly increased the deterrent and disgorgement effect of such actions.<sup>75</sup> However, there exists one drawback to allowing a large class of persons to bring actions against 10b-5 defendants. Assuming that the court will limit the liability of a defendant to the amount of his profit, the *Shapiro* rule will have little deterrent or disgorgement effect where the defendant is a small trader in a relatively active market. In that case, the amount of damages available to any individual plaintiff may be too small to induce anyone to bring the suit.<sup>76</sup> Thus, persons with inside information might not be deterred from carrying on relatively small transactions under the *Shapiro* approach.

The appropriateness of the *Shapiro* rule establishing broad civil liability should be evaluated in light of the alternatives. One alternative which has been proposed is to limit the scope of a defendant's liability to include only those injured persons in privity with him.<sup>77</sup> Analyzing this proposal in light of the purposes of private 10b-5 actions for damages, it can be seen that there would be both advantages and disadvantages in comparison to the *Shapiro* approach. A great disadvantage of requiring privity is the reduction in the number of possible plaintiffs. It is arguable that if there are fewer people who have standing to sue, there is less likelihood that an action will be brought. Thus, the deterrent and disgorgement effect of private actions will be decreased. More importantly, given the impersonal nature of the securities exchanges, establishing privity with a particular defendant will be a difficult task. It has been said that in such cases, privity could be established only by the fortuitous

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<sup>74</sup> Ruder & Cross, Limitations on Civil Liability Under Rule 10b-5, 1972 Duke L.J. 1125, 1132; Note, 83 Harv. L. Rev. 1421, 1423 (1970); Note, 30 Wash. & Lee L. Rev. 527, 545 (1973).

<sup>75</sup> It may be argued that a rule which requires that a person who has made an illegal gain merely return that gain has little deterrent effect, since a person faced with such limited liability has much to gain and little to lose. However, this does not necessitate the conclusion that such a rule is totally ineffectual. Private 10b-5 actions are designed to complement rather than substitute for SEC civil and criminal enforcement of the securities laws. It is the effect of private actions in combination with other sanctions which results in the deterrent effect.

<sup>76</sup> 2 A. Bromberg, *supra* note 31, § 8.7(2), at 219; Note, 80 Harv. L. Rev. 468, 476 (1968).

<sup>77</sup> Note, 80 Harv. L. Rev. 468, 476 (1968).

matching of time-stamped purchase and sale orders.<sup>78</sup> Thus, while proving privity is not an impossible task,<sup>79</sup> establishing standing to sue will be much easier under the *Shapiro* rule.

However, there are two apparent advantages to the requirement of privity. In the case of small traders on active markets, limiting the right of recovery to those in privity with the defendant would have the advantage of decreasing the number of persons who could share in the relatively small recovery, thus increasing the chances that a suit would be brought, and enhancing the deterrent and disgorgement effects of private actions. Secondly, limiting the right to recovery to those in privity with the defendant would seem to fulfill the compensatory function of these actions, since there would be no artificial limitation on recovery precluding the award of full damages to each plaintiff.<sup>80</sup>

It is submitted, however, that the advantages of the *Shapiro* rule outweigh those of the rule limiting recovery to those in privity with the defendant. The larger class of potential plaintiffs, and the ease with which they can establish a right to damages will be far more effective in fulfilling the deterrent and disgorgement purposes of private actions by making the institution and success of such actions more likely. This advantage does not seem to be outweighed by the increase in deterrent and disgorgement effect on small transactions that the privity rule would generate.

Although the privity rule appears to fulfill the compensatory function of private 10b-5 actions, it is arguable that one in fortuitous privity with a Rule 10b-5 violator should have no greater right to recovery than anyone else who traded in the stock during the relevant period. The duty of disclosure extends to the entire investing public. If that duty is breached by trading without revealing inside information to the public, then all persons who traded in the stock are equally injured by trading at an over or under rated price. The fact that some people have by chance acquired shares traceable to the defendant should not give them a right to recovery to the exclusion of their less fortunate fellow traders.<sup>81</sup> If this is so, then a

<sup>78</sup> "Where transactions are executed on an exchange, the difficulty of matching purchases and sales between given individuals is such that liability would depend only upon a more or less fortuitous matching of time-stamped purchase and sale orders or certificates subsequently delivered to the clearing house." Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 Colum. L. Rev. 1361, 1377-78 (1965).

<sup>79</sup> W. Cary, *Cases and Materials on Corporations* A-112 (4th ed. 1969).

<sup>80</sup> It should be noted that the effect of allowing only those in privity with the defendant to recover full damages will be to limit the amount of damages to the amount of the defendant's profit, since the measure of a plaintiff's loss is also the measure of a defendant's gain. 2 A. Bromberg, *supra* note 31, §§ 7.4(6)(e) n.198, 8.7(2) n.80, at 188, 218. Thus, in this respect, a rule limiting the liability of the defendant to those in privity with him will have no greater, or lesser, deterrent or disgorgement effect than the *Shapiro* rule.

<sup>81</sup> Professors Painter and Loss reject the privity theory, asserting that the fortuitous matching of buy and sell orders should not give one person a greater right to recovery than another. Painter, *supra* note 78, at 1378; Loss, *supra* note 71, at 3574.

rule limiting recovery to those in privity with the defendant would not come any closer to fulfilling the compensatory purpose, since many persons with a claim to compensation would go totally unsatisfied, while only a few would be made whole. It is submitted that it may be more equitable to provide at least some compensation for all, rather than full compensation for the few who can establish privity through the fortuitous matching of buy and sell orders. Finally, the compensatory function of private damage actions in the case of open-market violations of the disclose or abstain rule is open to serious question under either the privity or the *Shapiro* rule.<sup>82</sup>

The court's finding of the Rule 10b-5 violations on the part of all defendants is clearly supported by reason and authority. However, there is some question as to whether the authority depended upon for the imposition of such broad civil liability for damages supports the court's conclusions. In any case, the result of *Shapiro* seems desirable in terms of its effectiveness in fulfilling the purposes of private actions in Rule 10b-5 cases.

ROGER BRUNELLE

**Securities Law—Fraud—Rule 10b-5 Private Actions—Adoption of Flexible Duty Standard—*White v. Abrams***<sup>1</sup>—Defendant, Abrams, was a trusted friend and investment advisor of plaintiffs, White and others. Abrams encouraged plaintiffs to make substantial investments in several corporations which subsequently went bankrupt.<sup>2</sup> The corporations paid Abrams substantial commissions for obtaining the investments.<sup>3</sup> Plaintiffs brought a suit seeking rescission and punitive damages for violations of section 17(a) of the Securities Act of 1933,<sup>4</sup> section 10(b) of the Securities Exchange Act of 1934,<sup>5</sup> SEC

<sup>82</sup> Thus, it has been argued that a violation of Rule 10b-5 of the type which occurred in *Shapiro* has not really damaged anybody. Note, 80 Harv. L. Rev. 468, 475 (1966); Comment, 16 U.C.L.A. L. Rev. 404, 409-10 (1969).

<sup>1</sup> 495 F.2d 724 (9th Cir. 1974).

<sup>2</sup> Id. at 727.

<sup>3</sup> Id.

<sup>4</sup> 15 U.S.C. § 77q(a) (1970). Since the relevant language of section 17(a) is almost identical to the language of Rule 10b-5, the court assumed that the elements of a private action under that section are the same as those of an action under Rule 10b-5. 495 F.2d at 727 n.2.

<sup>5</sup> 15 U.S.C. § 78j(b) (1970), which provides in part:

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

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.