The Codification of Rule 10b-5 Private Actions in the Proposed Federal Securities Code

Peter J. Valeta
The author examines the effect the proposed Federal Securities Code has upon existing statutory and decisional law in rule 10b-5 private actions. Though the Code makes few changes in the applicable substantive law, it does introduce an element of consistency and harmony into an area burdened by statutory overlap and imprecision. The author adjudges this aspect of the Code to be one of its most significant contributions to the field of securities law.

I. INTRODUCTION

One of the greatest challenges to the draftsmen of the proposed Federal Securities Code was presented by section 10(b) and rule

---

* Candidate for Juris Doctor degree, University of Miami School of Law, May, 1980.
2. It shall be unlawful for any person, directly or indirectly, by the use of any
10b-5 of the Securities Exchange Act of 1934. The topic of private action under these provisions presently is "a judicial oak which has grown from little more than a legislative acorn." In the process of codification, therefore, it was necessary for the draftsmen to reconcile and incorporate the hundreds of decisions which have applied and construed the relatively sparse language of the above provisions.

This judicially-imposed nature of private actions under rule 10b-5 presents a body of law with such unsettled parameters that it does not lend itself to direct "pigeonholing." Therefore, any examination of the treatment of this area under the Code must begin with an exposition of the relevant Code provisions, followed by a comparison with analogous case law.

This article is not an extended discussion and commentary on the topic of civil liability for securities violations. Innumerable works have already been produced in that field and articles continue to appear as its fringes change. Rather, an effort has been made to describe the similarities and differences between the judicial law of rule 10b-5 and the corresponding codification, and to provide guidance for interpretation of the Code.

Parts I and II discuss the prohibitions of rule 10b-5 as they


3. 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.


5. "Those who appraise the product must compare it with the law as it now stands, not with the statutes and their gloss as they would like to have them be." Wechsler, Forward to Federal Securities Code at viii (1978).

6. Wherever differences have been found, however, an effort has been made to evaluate the changes.
appear in the Code and the liabilities and defenses thereto. Part III
covers secondary liability that can be imposed in addition to that
of the primary violator. Other defenses, common to many of the
liability provisions, are presented in Part IV, while Part V discusses
the remedies available in actions against violators.

II. GENERAL ANTIFRAUD LIABILITY

The general antifraud provisions of the proposed Federal
Securities Code are found in section 1602. Its terms gather the
many prohibitions against fraudulent conduct presently scattered
throughout the securities acts,7 thereby eliminating much of the
redundancy and overlap which presently exists.8 The general anti-
fraud aspects of rule 10b-5 are encompassed by section 1602(a),
which states that “It is unlawful for any person to engage in a
fraudulent act or to make a misrepresentation in connection with
(1) a sale or purchase of a security, an offer to sell or buy a security,
or an inducement not to buy or sell a security . . . . ”

A. Definitions

The scope of this section can only be understood through exam-
ination of its key terms, which are defined in Part II of the Code.10
“Fraudulent act”11 is broadly defined to include “an act, device,
scheme, practice, or course of conduct that (1) is fraudulent or (2)
operates or would operate as a fraud.”12 Silence or inaction, where

7. This section encompasses, in addition to rule 10b-5 § 17(a) of the Securities Act of
1933, §§ 9(a)(4), 10(b), 13(e), 14(e) and 15(c) (1-2) of the Securities Exchange Act of 1934
and rules 14a-9(a) and 15(c) (1-2) adopted thereunder, § 17(j) of the Investment Company
Act of 1940, and § 206 (1-2,4) of the Investment Advisers Act of 1940.
8. For example, fraudulent conduct in connection with a sale of securities violates the
letter of both rule 10b-5 and § 17(a) of the '33 Act (the source of the language of rule 10b-5).
10. In Part II the Code aggregates the definition of terms which are common to multiple
provisions, thereby aiding the creation of internal consistency and harmony.
11. Id. § 262(a).
12. Unfortunately, the use of the term “fraud” in defining “fraudulent” may create the
same problems which the courts faced in interpreting the first and third clauses of rule 10-5
(which also use the term “fraud”): Does use of the term “fraud” in these contexts require
incorporation of the common law elements of knowledge, intent, and reliance? See Prosser,
Because the Code later defines and incorporates these elements for specific types of
liability, however, it may be argued that the term “fraud” is intended in a broader sense:
Fraud, indeed, in the sense of a court of equity, properly includes all acts,
omissions and concealments which involve a breach of legal or equitable duty,
trust, or confidence, justly reposed, and are injurious to another, or by which an
undue and unconscientious advantage is taken of another.
there is a duty to act or speak, is expressly included therein.\textsuperscript{13} The existence of a fraudulent act, however, can only be found where the person in question acts with knowledge of, or in reckless disregard of, the fraudulent character of his actions.\textsuperscript{14}

"Misrepresentation" is the second activity proscribed by section 1602(a). It is described as "(1) an untrue statement of a material fact, or (2) an omission to state a material fact necessary to prevent the statements made from being misleading in the light of the circumstances under which they are made."\textsuperscript{15} The key phrase in this provision is the term "material fact,"\textsuperscript{16} which broadly encompasses "(a) a promise, prediction, estimate, projection, or forecast, or (b) a statement of intention, motive, opinion or law."\textsuperscript{17} Objective criteria are provided, however, which insure that estimates can be made without fear of unjustified accusations of misrepresentation if the projections do not develop as predicted.\textsuperscript{18}

The definition of materiality in the Code incorporates the "substantial likelihood" standard of \textit{TSC Industries, Inc. v. Northway, Inc.}\textsuperscript{19} into the analysis of the importance that the reasonable person would give the fact under scrutiny in choosing his course of action.\textsuperscript{20} Furthermore, the Code qualifies that determination where communications are made in situations analogous to face-to-face transactions. Regardless of what the reaction of a reasonable person

\textsuperscript{13} FED. SEC. CODE § 262(b).  
\textsuperscript{14} Id. § 262(c). Under § 1819(a)(4), however, § 262(c) would not apply or be necessary for purposes of an action to enjoin a violation of § 1602(a). Section 1819(a)(4) appears to codify existing law under SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963). \textit{But see} SEC v. Aaron, 2d Cir. #77-6091 (Mar. 13, 1979). In any event, § 1819(a)(4)(B) expands the scope of injunctive reach for fraudulent acts to situations where, regardless of intent, deception is indicated.  
\textsuperscript{15} FED. SEC. CODE § 297 (a).  
\textsuperscript{16} It should be noted that the draftsmen intended to reflect current judicial implications in 10b-5 actions that the statements be materially untrue, and that the plaintiff has been materially misled. \textit{See FED. SEC. CODE} § 259, comment (2) (Tent. Draft No. 2, 1973). \textit{Accord, Mills v. Electric Auto-Lite Co.}, 396 U.S. 375, 384 (1970).  
\textsuperscript{17} FED. SEC. CODE § 256.  
\textsuperscript{18} "A statement of fact . . . is not a misrepresentation if it (1) is made in good faith, (2) has a reasonable basis when it is made, and (3) complies with any applicable rule so far as underlying assumptions or other conditions are concerned." Id. § 297(b).  
\textsuperscript{19} 426 U.S. 438 (1976). There the Court rejected the Court of Appeals' standard of materiality as encompassing anything that "a reasonable shareholder might consider important" because it could extend liability to the mere possibility, however unlikely, that trivial items "might" become important. Id. at 445, 448-49.  
\textsuperscript{20} FED. SEC. CODE § 293(a). The application of this test is expressly limited to "under the circumstances," so that all relevant factors about a given plaintiff are included in the "reasonable person" test.
would be, materiality will be found when a person, in his communications with a small number of people, has actual knowledge that a given recipient will or is substantially likely to consider those facts given as important in determining a course of action."

"Fraudulent acts" and "misrepresentations" as thus defined are prohibited "in connection with" offers to buy or sell, inducements not to buy or sell, and actual purchases or sales of a security. As under rule 10b-5, this phrase indicates the necessity that there be a nexus between the fraud and the offer, inducement, purchase or sale. There is no indication that the Code requires anything beyond the loose "touching" nexus presently recognized under 10b-5. Similarly, the definitions in present securities laws of sale, purchase, buy and offer have been carried over into the Code without alteration.

B. Elements of a Cause of Action

It is now necessary to determine who is protected by the above prohibition and can therefore bring an action for its violation. Under rule 10b-5 a plaintiff in a civil action is required to be either a buyer or a seller, but there is no express provision in the Code on this point. While the terminology of many sections of Part XVII of the Code, which deals with civil liability, suggests no other qualification for bringing an action, the expressly recognized capacity of courts to imply new private actions leaves this question open. In any event, there has been no change in the ability of a corporation to bring an action as a purchaser.

Section 1703 describes the civil liabilities of a seller or buyer who has violated section 1602(a)(1). In a non-market setting,
where "the matching of buyers and sellers [would not be] substantially fortuitous," the violator would be liable to his buyer or seller. Yet where "the transaction is effected in a manner that would make the matching of buyers and sellers substantially fortuitous," anyone "who buys or sells between (1) the day when the defendant first unlawfully sells or buys and (2) the day when all material facts . . . become generally available" could recover.

Taken literally, this section does not appear to create liability in any situation of fraudulent action or misrepresentation where the defendant has not bought or sold, despite the draftsmen's assertion to the contrary, except in cases of insider trading or investment advising. Outside of these Code provisions, there is an action for fraudulent acts or misrepresentations in documents as well as for common law fraud for such behavior. Both of these require that the defendant have traded. Furthermore, where the violation is one of silence, the statute is unclear as to whether the draftsmen intended to impose an affirmative duty of disclosure under some circumstances. In any event, a cause of action could be judicially implied after consideration of the equities in any given case.
By providing objective criteria for determining the identity of plaintiffs in the market transaction, section 1703(b) establishes the liability implied under rule 10b-5 more clearly. Yet, where the transaction in question is effected in a manner which allows matching of buyers and sellers, the defendant is not, and should not, be liable to persons outside that group. Unless such a violator commits the fraudulent act or misrepresentation in a manner that is publicly noticeable, it is unlikely that his acts could have caused anyone other than his buyer or seller any harm.

In the market transaction, no liability attaches prior to unlawful buying or selling because causation is lacking. Similarly, after the information in question becomes "generally available," a plaintiff's losses or gains cannot be attributed to the defendant. While under this formula a defendant may be subject to claims not related to his fraudulent act or misrepresentation, the approach may be justified on several grounds. First, because determining liability by allocating the burden of proof cannot be done objectively in a market transaction with any accuracy, this construction presents one method of insuring the inclusion of all potential plaintiffs. Second, there are certain policies which are advanced by use of this method. The general scheme of investor protection is promoted by not foreclosing this remedy to a potential plaintiff. Also, the deterrence of undesirable behavior is necessarily enhanced by the added potential liability. Finally, the defendant's liability is not absolute; section 1703 sets forth defenses which can narrow it.

C. Defenses

One defense relates to the correction of misrepresentations and omissions:

A defendant has a defense to an action under section 1703(b) for violation of section 1602 (a) . . . if he proves that the misrep-
sentation or omission was corrected by means of a filing or press release or in any other manner reasonably designed to bring the correction to the attention of the investing public, except that this defense is not available against a plaintiff who bought or sold (1) before the facts as corrected became generally available or (2) in justifiable reliance on the misrepresentation or omission. Reliance on an omission is proved by proof of reliance on the particular filing or document and ignorance of the omission; but reliance on either a misrepresentation or an omission may be proved without proof that the plaintiff read a particular filing or document.  

As a result of this provision, there is an incentive for a defendant, actual or potential, to make corrections as quickly as possible in order to reduce his potential liability. Once he has made this correction generally available, liability accrues only upon a showing of justifiable reliance on the part of the plaintiff. While reliance is defined in the second sentence of section 1703(d), the modifier "justifiable" in the first sentence seems to suggest that an affirmative burden of proof is required from a plaintiff asserting reliance.

The question of what constitutes the plaintiff's burden also arises with regard to the defense of "plaintiff's knowledge." A defendant has a defense if he proves (1) that the plaintiff bought or sold with knowledge of the relevant facts or documents as they should have been disclosed or corrected, or (2) that any alleged falsity was obvious. Actual knowledge, of course, means that the plaintiff was not really misled. The "obvious falsity" standard of clause (2), however, is not clear in and of itself. To the extent that

45. FED. SEC. CODE § 1703(d).

46. One also has a duty to correct any statements of material fact made in a communication authorized by him regarding a purchase or sale, an offer to purchase or sell, or an inducement not to do so, which have become misrepresentative due to a subsequent event. While a reasonable effort will satisfy the requirements for performance of this duty, failure to make such a correction will give rise to liability under § 1703. See id. § 1602(b).

7. See note 76 and accompanying text infra.

48. Some courts have required proof of justifiable reliance (i.e., not only that the plaintiff relied, but that a reasonable man would have done so.) See Kohn v. American Metal Climax, Inc., 458 F.2d 255, 288 (3d Cir. 1972). This may imply a due diligence requirement on the plaintiff's part. See, e.g., Myzel v. Fields, 386 F.2d 718, 737 (8th Cir. 1967). Others have rejected such a stringent requirement. See, e.g., List v. Fashion Park, Inc., 340 F.2d 457, 462 n.3 (2d Cir. 1965). It is therefore unclear what the draftsmen meant by "justifiable reliance." It would seem reasonable, however, to place an affirmative burden of due diligence on the plaintiff once the defendant has made a threshold showing that he corrected (in the "generally available" sense) before the plaintiff traded.

49. "The fact that any or all of the directors and officers of a company plaintiff are defendants with knowledge of a fact does not of itself establish the company's knowledge of the fact." FED. SEC. CODE § 287(b).

50. Id. § 1703(e).
it was intended to reflect current case law, that lack of clarity is consistent.\textsuperscript{51} Perhaps the most realistic approach would be to decide the question of obviousness in light of the nature of the plaintiff,\textsuperscript{52} rather than by a nebulous "reckless" or "due diligence" standard. By focusing attention on to whom it is obvious, the plaintiff’s knowledge is determined not by abstract standards, but by the nature of the violation in question.

A defendant has a second defense based on the reasonableness of his conduct. In the non-market transaction he has an absolute defense if he can prove "that, as of the time of the sale, he reasonably did not believe that there was a misrepresentation."\textsuperscript{53} Reasonableness is based on the standard of the "prudent man under the circumstances in the conduct of his own affairs."\textsuperscript{54} Therefore, every buyer or seller who could face liability under these provisions has a duty to perform the same investigation and inspection that an issuer must undertake with regard to his securities, without regard to whether he is connected with the sources of any misrepresentations or omission.\textsuperscript{55} It may be impossible to qualify for this defense where there are informational materials available that the defendant did not create. In such a situation it will probably be necessary to construe this standard liberally due to the near impossibility of compliance with its requirements.

Other defenses are available under the Code. Given their general applicability to the several types of civil liabilities, discussion of them is best deferred to a later portion of this article.\textsuperscript{56} In addition the remedies available have a broad application and are better treated as a separate subject.

\section*{III. Insider Trading}

The prohibition against insider trading and trading by persons

\begin{footnotes}
\textsuperscript{51} See Depuy v. Depuy, 434 U.S. 911 (1977) (White, J., dissenting from denial of certiorari) (the standard of care required of plaintiffs under 10b-5 actions described as nonrecklessness, gross conduct, unreasonable conduct and due diligence).
\textsuperscript{52} Among the factors that could be weighed are the plaintiff’s general investment experience and practice, as well as his specific knowledge and experience.
\textsuperscript{53} Fed. Sec. Code § 1703(f)(1). In the market transaction he would have a similar defense except that it would not be available to the issuer. Id. § 1703 (f)(2).
\textsuperscript{54} Id. § 1703(g). See also id. § 299.34 (definition of reasonable).
\textsuperscript{55} This conclusion is confirmed on examination of earlier drafts of this provision which excluded any reference in the standard to "in the conduct of his own affairs" or the like. In commentary thereto the draftsmen indicated a desire to differentiate between the duty to one's own informational distributions and those of another. See Fed. Sec. Code § 402(d) and comments following.
\textsuperscript{56} See Part IV infra.
\end{footnotes}
“tipped” to inside information is a broad area of liability implied under rule 10b-5. There is no literal prohibition contained therein; rather, civil liability has been justified on the grounds that it is inherently unfair for one who possesses information intended only for business purposes to take advantage of that information while knowing that it is unavailable to those with whom he is dealing.\(^57\)

The Code has apparently accepted this rationale, and provides express prohibitions against such conduct. Section 1603 states:

It is unlawful for an insider to sell or buy a security of the issuer, if he knows a fact of special significance with respect to the issuer of the security that is not generally available, unless (1) the insider reasonably believes that the fact is generally available or (2), if the other party to the transaction (or his agent) is identified, (A) the insider reasonably believes that that person knows it, or (B) that person in fact knows it from the insider or otherwise.\(^58\)

An insider is subject to civil liability not because he bought or sold securities on the basis of inside information, but because he correctly perceived that such information provided an unfair advantage in dealing with another party. The insider must prove lack of intent to take advantage of the other party based on a reasonable belief in the knowledge of that party, or that such intent was negated by the fact that the other party knew of the information.

\section{A. Definitions}

The present uncertainty under rule 10b-5 as to who is an insider\(^59\) is reduced by the objective definition set forth in section 1603(b). “Insider” would, of course, include the issuer, its officers and directors, and all other persons “controlling, controlled by, or under common control with, the issuer.”\(^60\) In addition, anyone outside these classes who has or had access to inside information as a result of a present or prior relationship with the issuer is an insider.\(^61\)


\(^{58}\) FED. SEC. CODE § 1603(a).

\(^{59}\) In Cady, Roberts & Co., 40 S.E.C. 907, 912 (1962), for example, the status of an insider appeared to depend on his access to inside information. The Second Circuit seems to have added an alternative class of insiders (i.e., not only those having access, but those possessing the inside information). See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848-49 (2d Cir. 1968), cert. denied sub nom Coates v. SEC, 394 U.S. 976 (1969) (omitting reference, however, to the Cady, Roberts “access” test). See also 5 JACOBS, supra note 23, at § 66.02(a) n.21 (listing cases post-Texas Gulf Sulphur that discuss but do not resolve these tests).

\(^{60}\) FED. SEC. CODE § 1603(b)(1-2). See also definitions of director, id. § 241, officer, id. § 299.15, and control, id. § 230 (discussed infra at notes 108-111 and accompanying text).

\(^{61}\) Id. § 1603 (b)(3). The prohibition against trading by such a person, however, applies
The Code also includes within the class of insiders the group commonly referred to under rule 10b-5 as "tippers." "Insider" means . . . a person who learns such a fact from a person specified in section 1603(b) (including a person specified in section 1603(b) (4)) with knowledge that the person from whom he learns the fact is such a person . . . ." Under this definition, the issue is not whether one received the information directly from a tipper or indirectly from a tippee, but whether one knows that one is trading on the basis of inside information. All persons who are aware of the inside nature of the information on which they are trading are considered insiders.

The persons described above are prohibited from trading if they know a "fact of special significance . . . that is not generally available . . ." Each of these phrases is treated as a term of art under the Code and is separately defined. A fact may be "of special significance" in two ways. It must either be material and be likely to impact on the market price of a security if generally known or only to the extent that he knows the inside information by virtue of that relationship. Id. § 1603(c). He could trade on information received in any other manner not prohibited.

62. Id. § 1603(b)(4).
64. This concept has been referred to in several decisions, but there have not been any holdings to that extent. See, e.g., SEC v. Shapiro, 494 F.2d 1301, 1307 (2d Cir. 1974); Texas Gulf Sulphur, 401 F.2d at 852; Faberge, Inc., Sec. Ex. Act. Release No. 10,174 (May 25, 1973). Such a restriction is also unnecessary in light of § 1724(c), which extends the liability of the tippee to the tipper. See notes 129-134 and accompanying text infra. Under the broad definition of insider under § 1603(b)(4), this liability could be extended without regard to how far removed a tippee may be. Furthermore, the door is left open for the Commission or a court to decline to treat a tippee as an insider where "it would be inequitable, on consideration of the circumstances and the purposes of the Code (including the deterrent effect of liability) . . . ." FED. SEC. CODE § 1603 (b)(4).
65. The term "knowledge" is not specifically defined, but is to be interpreted in context. FED. SEC. CODE § 287. In the realm of civil liability this should mean more than negligent use of inside information. Cf. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1976). The question is left open whether actual knowledge or a lesser standard (e.g., reckless disregard) will suffice. Cf. FED. SEC. CODE § 299.50 (defining scienter).
66. Id. § 1603(a).
67. Recall that "fact" itself is defined. See id. § 256. See also note 17 supra and accompanying text.
68. Id. § 257(a). This market-impact approach was applied by the trial court in SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 280 (S.D.N.Y. 1966) citing List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965) and Kohler v. Kohler Co., 319 F.2d 634, 642 (7th Cir. 1963). The Second Circuit, however, held that a broader standard applies, relying on List v.
it must be especially important to a reasonable person in determining his course of action. Factors to be considered in determining whether the fact is especially important include the specificity of the fact and the difference between it and information generally available, as well as the nature and reliability of the fact.69

By providing a two-prong test for determining whether a fact is of special significance, the drafters intended to create a more exact definition of inside information than the definition of “material fact” found in the Code.70 The first prong adds the requirement of market impact to the fact of materiality. The second prong provides a slightly stricter standard than the materiality standard by requiring that the fact be “especially important” in light of the factors listed in the previous paragraph. An insider, then, is one who has access not just to a material fact, but to a fact of special significance. It is this type of information that an insider has a duty to disclose before he may trade in reliance on it, or, if he is prohibited from disclosing it, to refrain from trading.71

Significant reliance upon the reasonable investor test indicates a judgment that this prohibition should be predicated on its effects on individuals, and perhaps reflects policy objectives such as reduction of informational inequities and equal access to the rewards of securities investment.72 Nevertheless, the abstract detachment which inevitably follows any reasonable person test, especially where it is applied through hindsight, can easily result in an unrealistic picture.73 The market place by its very nature is both an evaluator of information and a reflector of individual effects in the aggregate. Considering that the persons most likely to alter their investment behavior had the inside information been available to all are those who decide whether or not to trade on the basis of the price

---

69. See Fashion Park for the reasonable investor test in Texas Gulf Sulphur, 401 F.2d at 849. See note 70 and accompanying text infra.
70. Id. § 293. See notes 20-21 and accompanying text supra.
71. This may be viewed as the desire of the draftsmen when one considers that previous versions included the stricter standard of “decisive importance” rather than “especially important.” See Id. § 1303(c).
72. The Second Circuit suggested that these are the underlying policies of the insider trading prohibition. Texas Gulf Sulphur, 401 F.2d at 848-52, 858.
73. It is possible that the market-impact test may also give an unrealistic picture. It may be inconclusive, for example, where the information at issue affects investors so differently that the net market-impact is negligible (i.e., some investors are induced to buy and others to sell). Such a result, however may indicate that the value of the information is not intrinsic, but rather lies in the individual’s ability correctly to assess and use the data. In that situation the insider who trades is not advantaged by possession of the information, but by his particular skills and experience, so that prohibiting such possession serves no purpose.
of a security, the market-impact test more accurately indicates what information is "of special significance." Furthermore, the market-impact test allows businessmen to judge with greater certainty what information falls within the prohibited classification because determinations of market-impact are regularly made by them and their advisors in other contexts. While this standard is by no means "scientifically" objective, it does offer a more refined analysis of the impact of inside information than does the reasonable person test.

The Code provides for a one-week "safe harbor" period, providing certain conditions are met. After one week a fact is automatically considered to be generally available. If the fact has not been disclosed by a filing or press release, the burden of proving general availability is placed on the one asserting the defense. In such cases, whether a fact is generally available is a question of fact to be determined by applying standards used under 10b-5. The new "safe harbor" rule provides businessmen with a clearer standard for determining when trading would be 'safe' for them.

74. See MANNE, INSIDER TRADING AND THE STOCK MARKET (1966), for a discussion of insider trading and its effects on "time-function" versus "price-function" investors.

This test may also allow the use of actual market-impact evidence more easily than the reasonable-investor test. Such information is likely to be available because a violation of insider trading provisions surfaces only upon disclosure and because the time lag before prosecution would allow the market to assess and reflect the importance of that information. Such evidence is more easily adapted to the market-impact test than others and with less likelihood of confusion.

75. A fact is "generally available" one week (or any other period prescribed by Commission rule) after it is disclosed by means of a filing or press release or in any other manner reasonably designed to bring it to the attention of the investing public. Otherwise the burden of proving that a fact is "generally available" is on the person who so asserts.

FED. SEC. CODE § 265

76. The factual nature of this inquiry has inhibited the clear articulation of standards for determining what efforts are reasonably directed to making facts publicly known and for judging the success of those efforts. See e.g., Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 102 (10th Cir. 1971); SEC v. Texas Gulf Sulphur, 401 F.2d at 853-54. The type of media used is a relevant factor to be considered. See Rochelle v. Marine Midland Grace Trust Co., 535 F.2d 523 (9th Cir. 1976) (newspapers), Faberge, Inc., Sec. Ex. Act. Rel. No. 10,174 (May 25, 1973) (broad tape). Yet this is by no means certain. Compare Van Gemert v. Boeing Co., 520 F.2d 1373, 1379-80 (2d Cir. 1975) (information appearing in small print in table of bond prices in the New York Times, in local newspapers, and on New York Stock Exchange ticker held not publicly disclosed) with Sperry v. Barggren, 523 F.2d 708, 711 (7th Cir. 1975) (two brief notices in local papers may be adequate dissemination).

77. The "safe harbor" approach has been advocated by some authorities in the context of rule 10b-5. See, e.g., Texas Gulf Sulphur, 401 F.2d at 854 n.18; Sandler & Conwill, Texas Gulf Sulphur: Reform in the Securities Marketplace, 30 Ohio L. J. 225, 264 n.184 (1969). In fact, the SEC has considered such a rule, but thus far has declined to issue one. See 5 JACOBS, supra note 23, at § 66.02[g] n.45.
In summary, where an insider possesses a "fact of special significance" about an issuer and its security which is not "generally available," he is prohibited from buying or selling that security,\textsuperscript{78} with two exceptions. One exception arises where "the insider reasonably believes that the fact is generally available . . . . "\textsuperscript{79} The second deals with face-to-face transactions. If the insider reasonably believes that the other party to the transaction knows the fact or if that party actually knows, there is no prohibition against trading.\textsuperscript{80} These are, of course, common sense exceptions. Failure to allow conduct based upon reasonable beliefs would face insiders with the continual risk of "trade-at-your-peril" without any legitimizing reason. There is no unfairness in a face-to-face transaction where one party reasonably believes the other party is acting with the same knowledge. Nor is the transaction fraudulent where one party believes he is acting without knowledge on the part of the other, if that party in fact has actual knowledge.

B. Liability and Defenses

Civil liability for violation of the prohibition against insider trading arises under the same provisions as does liability for violations of the more general antifraud provisions discussed in Part I.\textsuperscript{81} This liability extends only to actual purchasers or sellers of securities and not to those who simply failed to act as a result of the inside information.\textsuperscript{82} In the non-market transaction, an insider is liable only to his buyer or seller, while in the market setting, he is liable to anyone buying or selling between the day he first traded and the day the facts of special significance became generally available.\textsuperscript{83} An insider who has committed a violation by trading can attempt to make his knowledge generally available in order to limit his liability

\textsuperscript{78} The semi-objective nature of the Code's formula becomes apparent where disclosure is not effected by a filing or a press release. In that situation, the question of whether the means used were "reasonably designed to bring it to the attention of the investing public" is at issue \textit{Fed. Sec. Code} § 265. The corresponding decisional law under rule 10b-5 probably sets forth the criteria for this determination. \textit{See note 76 infra.}

\textsuperscript{79} Under the Code's inclusive definitions of buy and sell, \textit{Fed. Sec. Code} §§ 219, 299.46(a), insiders would probably be prohibited from placing orders with their brokers with instructions to delay execution until a public announcement is made under rule 10b-5. \textit{See Radiation Dynamics, Inc. v. Goldmuntz}, 464 F.2d 876, 891 (2d Cir. 1972); \textit{SEC v. Texas Gulf Sulphur}, 401 F.2d at 853 n.17.

\textsuperscript{80} \textit{Id.} § 1603(a)(1).

\textsuperscript{81} \textit{Id.} § 1603(a)(2).

\textsuperscript{82} \textit{Id.} § 1703. \textit{See notes 26-44 and accompanying text supra.}

\textsuperscript{83} \textit{Id.} § 1703(a-b). \textit{See notes 30-31 and accompanying text supra.}
and may thereby be able to raise the defense of correction against some plaintiffs.\textsuperscript{84} He also may have an express defense based on the plaintiff's knowledge.\textsuperscript{85} Other defenses common to civil liability actions under the Code, as well as means of measuring damages, are outlined below.

One defense presently recognized under rule 10b-5 appears, however, to have been omitted from the Code. It arises where it has been proven that the insider's decision to trade was not based on his inside information.\textsuperscript{86} The prohibition of section 1603(a) arises if the insider merely knows a fact of special significance.\textsuperscript{87} This creates a presumption that such an insider is trading on the basis of his knowledge, without provision for an affirmative showing of propriety.\textsuperscript{88}

On the whole, there has been little departure from the insider trading doctrine of rule 10b-5. Some standards of determination are more objective and others have been clarified. Under the Code, insiders, including tippees, are faced with the same choice they now have under rule 10b-5: either disclose, or abstain from trading and tipping.\textsuperscript{89} Otherwise, they must take the risk of committing a violation.

### IV. Secondary Liability\textsuperscript{90}

One result of the efforts to develop conciseness and uniformity in the Code is the separate provisions defining and describing elements of civil liability common to any private action for damages. By and large they represent a codification of other portions of existing 10b-5 decisional law.

84. Id. § 1703(d). See notes 45-48 and accompanying text supra. This defense is limited to where the plaintiff actually bought or sold before the facts became generally available.

85. Id. at 1703(e). See notes 49-52 and accompanying text supra.

86. This may be superfluous, however, since § 1603(a) creates an exception to the prohibition based on the plaintiff's knowledge. See note 80 and accompanying text supra.

87. See note 65 supra.

88. It is not clear how an irrebuttable presumption furthers the goals of this provision. See note 57 and accompanying text supra. While a defendant may have to carry a severe burden of proof to show that his trading was not due to any inside knowledge about the securities traded, there is no apparent justification of not allowing at least the opportunity to make such a showing.

89. One may not even have this choice if one is unable to effect disclosure (e.g., where one possesses inside information about a company with which he is not associated). See Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237-38 (2d Cir. 1974).

90. Primary liability, as the term is referred to in this article, is incurred by the active violator of § 1602 or § 1603. One who is liable by virtue of the provisions described in this Part (they are not the direct violators) are referred to as secondarily liable.
A. Fiduciary Relationship

One provision is designed to deal with fiduciary liability not directly governed by the provisions of section 1703. The operation of section 1709 is triggered upon violation of section 1602(a)(1) or 1602(b)(1) by a fiduciary in connection with a purchase or sale either for himself or for his beneficiary. If the beneficiary suffers a loss by reason of the violation, his fiduciary is liable to the extent of the loss.

Roles that are commonly considered fiduciary in nature are included in the catch-all phrase "or other fiduciary," so that the substance of a particular position rules over its form. Directors are expressly declared to be fiduciaries as well. There are also indications that other people associated with corporations could be considered fiduciaries under this provision just as they have been under

---

91. "Section 1709 [fiduciary liability] does not apply to the extent that section 1703 . . . applies." Id. § 1709(d). See the discussion of § 1703 in Part I, notes 26-44 and accompanying text supra.
92. See notes 7-25 and accompanying text supra (prohibition against fraudulent acts or misrepresentations in connection with a purchase or sale of a security).
93. See note 46 and accompanying text supra (duty to correct misrepresentations).
94. An agent, director, trustee, guardian, executor, administrator, receiver, or other fiduciary who, in connection with effecting a purchase or sale of a security for the account or benefit of himself or a person or estate to whom he stands in a fiduciary relationship (herein a "beneficiary"),
1. violates section 1602(a)(1) by means of a fraudulent act, or a misrepresentation made with scienter, or
2. fails to correct a statement of a material fact as required by section 1602(b)(1)(A) if the fiduciary acquired scienter with respect to the subsequent event there referred to as of a time sufficiently in advance of the purchase or sale to have had a reasonable opportunity to make the correction, or (B) to reflect the fiduciary's acquisition of scienter, as of such a time with respect to a misrepresentation previously made,

is liable to his company in the case of a director or a person who is a fiduciary by reason only of his being a controlling person of the company, or his beneficiary in the case of any other fiduciary, for any loss caused to the company or beneficiary by the violation or failure to correct.

95. The Code also provides that the reverse of this proposition is true. If the beneficiary in a fiduciary relationship makes a misrepresentation or fails to correct one, he will be liable for any loss caused thereby. Id. § 1709(b).
96. "An agent . . . trustee, guardian, executor, administrator, receiver . . . ." Id. § 1709(a).
97. Attorneys and accountants, for example, who committed a violation would probably be liable to their clients for losses caused thereby. Cf. de Haas v. Empire Petroleum Co., 286 F. Supp. 809, 815-16 (D. Colo. 1968), modified on other grounds, 435 F.2d 1223 (10th Cir. 1970).
98. See note 94 supra.
rule 10b-5.99

The liability of these fiduciaries arises only if they have committed the violation in question with scienter.100 Sciente is defined by the Code in terms of "actual knowledge" or "reckless disregard" of whether the statement is truthful.101 If the violation arises from a failure to correct,102 however, the fiduciary is liable only if he acquired scienter sufficiently before the purchase or sale to have afforded him "a reasonable opportunity to make the correction."103 Furthermore, a fiduciary who was not under a duty to correct104 is liable for failing to make a correction once he has acquired scienter.105

B. Controlling Persons

Secondary liability also exists under circumstances other than a fiduciary relationship. "A person who controlled a person liable under this Code . . . at the time of any act giving rise to liability whether the controlled person is liable directly or by virtue of section 1724, is liable to the same extent as the controlled person.

99. Section 1709(a) expressly creates a fiduciary position by reason of one's status as a "controlling person of the company." See also Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 10 (1971) (controlling stockholders as well as officers owe the corporation fiduciary duties). Even the status of majority stockholder may be sufficient to raise a fiduciary duty vis-a-vis minority shareholders. See Coffee v. Permian Corp., 474 F.2d 1040, 1044 (5th Cir. 1973), cert. denied 412 U.S. 920 (1973). But see Santa Fe Indus. v. Green, 430 U.S. 462 (1976) (§ 10b requires a private action to pass a "manipulative or deceptive" test, not merely unfairness by a fiduciary).

Broker/dealer liability (a topic beyond the scope of this article) can also arise under this provision as it does under 10b-5. See, e.g., Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949). Investment advisors, however, are expressly subject to liability hereunder. Fed. Sec. Code § 1709(c).

100. See note 94 supra.

101. "A person makes . . . a misrepresentation with 'scienter' if he knows that he is making a misrepresentation (or a misrepresentation is being made) or acts in reckless disregard of whether that is so." Id. § 299.50. While this is the first mention of this element essential to a private action under rule 10b-5 (see, e.g., Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976)), a similar requirement was engrafted into the definitions of misrepresentation, Fed. Sec. Code § 297, and fraudulent act, id. § 262. See notes 11-16 and accompanying text supra. A "scienter-like" requirement is also attached to § 1602 (b)(1)(A) (duty to correct) in the form of the defense of a reasonable belief that no misrepresentation existed to correct. Id. § 1703(f)(2). See note 53 and accompanying text supra.

102. See note 46 and accompanying text supra.


104. Recall that under § 1602(b)(1), the duty to correct fails only upon the person who made the statement of material fact which became a misrepresentation or under whose authority it was made.

105. Id. § 1709(a)(2)(B).
This provision is the counterpart of section 20(a) of the Securities Exchange Act of 1934.\textsuperscript{107}

Control is expressly defined in part II of the Code.\textsuperscript{108} As in the present law, it includes both \textit{de jure} power\textsuperscript{109} and \textit{de facto} power.\textsuperscript{110} One who owns or has the power to vote more than twenty-five percent of the outstanding voting shares of a company or, where there are no voting securities, twenty-five percent of the total equity, is presumed to control that company for purposes of this provision.\textsuperscript{111}

Of course, the controlling person must have been in control at the time of the violation.\textsuperscript{112}

The Code provisions are not the exclusive means of determining liability. Liability as a controlling person arises directly under common law agency principles without operation of section 1724.\textsuperscript{113} In such situations, he has those defenses recognized under the common law of agency in addition to those of the Code.

If his liability flows from section 1724, however, he is restricted to Code defenses.\textsuperscript{114} An additional defense is set forth in section 1724:

\begin{quote}
[A] controlling person who would not be liable for an act of the controlled person apart from section 1724(a) is not liable under the section if he proves (A) that he reasonably did not believe that the controlled person's conduct was unlawful or a breach of duty, or involved a fraudulent act, a misrepresentation, or non-
\end{quote}

\begin{notes}
\item[106] \textit{Id.} \textsection 1724(a).
\item[107] 15 U.S.C. \textsection 78t(a) (1976).
\item[108] \textquotedblleft Control\textquotedblright \ means the power, directly or indirectly, to exercise a controlling influence over the management and policies of a company or the activities of a natural person (either alone or pursuant to an arrangement or understanding with one or more other persons), whether through the ownership of voting securities, through one or more intermediary persons, by contract, or otherwise.
\item[109] \textit{FED. SEC. CODE} \textsection 230(a).
\item[109] \textit{See Rochez Bros., Inc. v. Rhoades, 527 F.2d 880, 890-91 (3d Cir. 1975).}
\item[111] \textit{FED. SEC. CODE} \textsection 230(b)(1). In this situation, all others are presumed not to control by virtue of ownership or voting power. \textit{Id.} \textsection 230(b)(2). Yet either of these presumptions “may be rebutted by evidence.” \textit{Id.} \textsection 230(b)(4).
\item[112] \textit{See note 106 and accompanying text supra.}
\item[113] Such liability may arise whether the controlling person actually failed to fulfill his duties as a principal, \textit{e.g.}, \textit{RESTATEMENT (SECOND) OF AGENCY} \textsections 212-14 (1958), or was without fault in his behavior, \textit{e.g.}, \textit{id.} \textsections 257-58. The application of agency principles as federal law under the securities laws is not a new concept. See SEC \textit{v. Management Dynamics, Inc., 515 F.2d 801, 813 (2d Cir. 1975)}; \textit{Lewis v. Walston \& Co., 487 F.2d 617, 623-24 (5th Cir. 1973)}; \textit{Johns Hopkins University v. Hutton, 422 F.2d 1124, 1130 (4th Cir. 1970). But see Kamen \& Co. v. Paul H. Aschkar \& Co., 382 F.2d 689, 696-97 (9th Cir. 1967).}
\item[114] \textit{See notes 45-55 and accompanying text supra.}
\end{notes}
This defense appears to be substantially the same as the "good faith" defense set forth in section 20(a) of the Securities Exchange Act of 1934 and stands on sound logical grounds. As long as the controlling person is not a direct violator and as long as there are no external policy reasons for the extension of liability, there is little reason for attaching liability to one who has relied on his reasonable beliefs, in good faith.

C. Aiding and Abetting

Civil liability is also extended to:

An agent or other person who knowingly causes or gives substantial assistance to conduct by another person (herein a "principal") giving rise to liability under this Code with knowledge that the conduct is unlawful or a breach of duty, or involves a fraudulent act, a misrepresentation, or non-disclosure of a fact of special significance by an insider (as defined in section 1603(b)).

More commonly referred to as an "aider and abettor" under rule 10b-5, a violator of this proscription is subject to sanctions equal to those imposed upon the primary violator by virtue of his "substantial assistance" in the commission of the violation.

The knowledge of the "assisting person" is the primary issue in determining liability hereunder. In light of the fact that "knowledge" is not defined by the Code, and because this provision taken as a whole appears to reflect the present law, the constructions given to it in this context under rule 10b-5 should be maintained.

117. In that situation he would, of course, be subject to direct liability for his acts.
118. Such reasons could be, for example, those behind the common law of agency. See note 113 supra and materials cited therein.
122. "Know" and its derivatives are not defined. Their meaning is left to construction in context." Fed. Sec. Code § 287(a).
In light of the determination by the Supreme Court in *Ernst & Ernst v. Hochfelder*\(^\text{123}\) that mere negligent conduct is insufficient to give rise to a private right of action under rule 10b-5, constructive knowledge, without more, would seem to be an inadequate basis upon which to charge one with "aiding and abetting." Any other inference would be suspect because constructive knowledge is insufficient to support a private cause of action against the primary violator.\(^\text{124}\) When the "assisting person," however, acts in reckless disregard of whether he is aiding in a violation, a failure to find a violation would be tantamount to endorsing what is, at best, conduct inimical to the proscriptions' goals of honesty and protection.\(^\text{125}\)

An "assisting person" must give "substantial assistance" before liability will arise. As in a rule 10b-5 judgment, liability will hinge upon a factual inquiry. While it is not necessary that the assistance given be indispensable to the commission of the primary violation,\(^\text{126}\) it must be more than ministerial.\(^\text{127}\) Where there is a factual finding that "substantial assistance" has been given with "knowledge" that the activity being assisted is violative, full liability for the primary violation is imposed on the assisting person.\(^\text{128}\)

A special kind of aiding and abetting is described separately in subsection (c).\(^\text{129}\) In essence, one who passes on inside information, a "tipper," assists in the violation of the prohibition against insider trading\(^\text{130}\) when his "tippee" trades on the basis of that data. Without a prohibition subjecting the "tipper" to liability for his assistance:

> insiders could easily evade their duty to refrain from trading on the basis of insider information. Either the transactions so traded

---

\(^{123}\) 425 U.S. 185 (1976).

\(^{124}\) See note 14 and accompanying text *supra*.  

\(^{125}\) Such a construction appears consistent with the apparent resolution by the Code of the "reckless disregard" question left open in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n.12 (1976). *See* FED. SEC. CODE § 299.50 (defining scienter in terms of reckless disregard).

\(^{126}\) *See*, e.g., Gross v. SEC, 418 F.2d 103 (2d Cir. 1969).

\(^{127}\) *See*, e.g., Rochez Bros. v. Rhoades, 527 F.2d 880, 888-89 (3d Cir. 1975).

\(^{128}\) *See* note 169 and accompanying text *infra* (discussing the measures of damages for violations).

\(^{129}\) An insider within section 1603(b)(1) to (3) inclusive (herein a "tipper") who discloses to an insider within section 1603(b)(4) (herein a "tippee"), or a tippee who discloses to another tippee, a material fact that is not generally available is liable under section 1703 (a) and (b) to the same extent as a tippee who is so liable, unless he (1) disclosed the fact for a proper purpose and in a proper manner and (2) reasonably believed that his tippee would not use the fact so as to become so liable. *FED. SEC. CODE* § 1724 (c). *See* notes 57-89 and accompanying text *supra*, for a discussion of § 1603.

\(^{130}\) *Id.* § 1603(a).
could be concluded by a relative or an acquaintance of the insider, or implied understandings could arise under which reciprocal tips between insiders in different corporations could be given.\textsuperscript{131}

In this way the Code prevents an insider from doing indirectly what he would be prevented from doing directly.

The occurrence of two events will trigger this liability. The first requisite is that the tipper disclose "a material fact that is not generally available."\textsuperscript{132} The second is that the "tippee" trade on the basis of that information. Only then will the "tipper" be liable to the same degree as the "tippee." There is a proviso to the general rule, however, excepting liability where the "tipper" can show that he gave the information for a proper purpose, in a proper manner,\textsuperscript{133} reasonably believing that the "tippee" would not use the information for trading.\textsuperscript{134}

D. Joint and Several Liability

The Code allows an injured party bringing a cause of action only one satisfaction of judgment no matter how many persons are liable to him.\textsuperscript{135} As a result of this joint and several liability, there is no need to join multiple defendants in an action; a secondary violator has the same liability as the primary one. Similarly, there are several sections in the present securities acts providing expressly


\textsuperscript{132} While an insider himself is prohibited from trading if he knows "a fact of special significance . . . that is not generally available," FED. SEC. CODE § 1603(a), he becomes liable as a "tipper" if he discloses "a material fact that is not generally available . . . ." Id. § 1724(c). It is not clear how these two standards differ under the Code. Compare id. § 257 (defining "fact of special significance") with id. §§ 256, 293 (defining "fact" and "material"). The policy inherent in both § 1603(a) and § 1724(c) is to deny trading advantage to anyone who has access to information which is not available to the general public. See note 57 supra. By using different phrases in the two provisions and by defining one to encompass conceivably more information than another, the Code creates an ambiguity which will undoubtedly lead to unnecessary litigation without furthering the policy underlying the imposition of liability.

\textsuperscript{133} FED. SEC. CODE § 1724(e)(2). Note, however, that the term "reasonable belief" suggests a negligence standard for liability. This represents an expansion of 10b-5 civil liabilities beyond Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976) ("we are quite unwilling to extend the scope of the statute [§ 10(b) and rule 10b-5] to negligent conduct").

\textsuperscript{134} "All liability under this Code . . . including section 1724, is joint and several, but a plaintiff may not recover, through satisfaction of judgment against more than one person, more than the amount recoverable without regard to section 1724(d)." FED. SEC. CODE § 1724(d).
for joint and several liability, although rule 10b-5 does not. The
courts, however, have implied it in various forms.

Where joint and several liability arises in a suit against multiple defendants, all the issues are not necessarily resolved. Although a plaintiff may win a judgment and receive satisfaction on it from one or more defendants, the latter still must determine for themselves the apportionment of the judgment through contribution. When liability under rule 10b-5 is derivative, there are questions of indemnification through insurance or by corporate contract or corporate by-laws. As in tort law, these unresolved issues are complicated by judicial considerations of public policy. While it is true that a securities violator pays damages to an injured party to compensate him for his injury, it is also true that under some sections the threat of liability is meant to be a deterrent for the proscribed behavior. Therefore, if indemnification is permitted, the deterrent effect of the liability is abated. Although the issue of indemnification, either by contract with the insurance company or the corporation, has not been extensively litigated, it has been permitted where an analysis of the policy behind the statutory liability is compensatory rather than punitive.

The Code specifies a framework within which indemnification other than by insurance is allowed if it meets standards established by the Commission by rule or by the courts through legal and equi-

---

138. Insurance policies for securities liability fall into two general categories. One encompasses general blanket policies covering all liability incurred by an officer or director in his official capacity, as well as those purchased covering all underwritings made over a period of time. The other includes policies covering only a specific offering. Kroll, Some Reflections on Indemnification Provisions and S.E.C. Liability Insurance in the Light of Bar Chris and Globus, 24 Bus. Law. 681, 685 (1969) [hereinafter Reflections].
139. Some states have enacted expressly exclusive indemnification statutes with regard to directors and officers. See, e.g., CAL. CORP. CODE § 317 (West 1979); N.Y. BUS. CORP. LAW § 727 (McKinney 1979). Others are non-exclusive, permitting a corporation to adopt indemnification by-laws broader than the statute provides. E.g., DEL. CODE ANN. tit. 8 § 145 (f)(1974). Underwriter indemnification, however, is usually contractual.
140. For example, in Globus v. Law Research, Inc., 418 F.2d 1276, 1288 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970), indemnity was held to be contrary to public policy under the Securities Act of 1933, § 11, 15 U.S.C. § 77k (1976), because the intent of the legislation was punitive rather than compensatory. On the contrary, the standards under 10b-5 are analogous to tort standards for negligence. This indicates a parallel compensatory intent making indemnification and insurance reimbursement more appropriate. See Reflections, supra note 139, at 687-88.
table precedent. The operative method\textsuperscript{141} is a weighing and balancing of the losses to the indemnitee and indemnitor and the effect of those losses on the deterrent nature of the liability. This issue is a federal question, not influenced by state policies in state indemnification statutes.\textsuperscript{142} Indemnification, however, "is invalid to the extent that the indemnitee is found guilty of bad faith, intentional misfeasance, or reckless disregard of his obligations and duties to the indemnitor or its security holder."\textsuperscript{143}

On the other hand, insurance indemnification is given a blanket acceptance.\textsuperscript{144} This seemingly double standard is obviated by the self-policing mechanism of most insurance policies. Because it is unlikely that insurers would extend coverage to intentional misconduct, the policy of the Code is protected. The cost of liability would fall on the intentional actor while the merely negligent violator would be allowed reimbursement. Thus, there are three ways in which indemnification can be denied: by the Commission by rule, the courts by equity, and the insurer by contract.

Contribution, a counterpart to indemnity, has been available to 10b-5 violators in some cases, but is not a clearly established right.\textsuperscript{145} The Code also allows contribution for civil liability where to do so would be consistent with the indemnification provisions discussed previously.\textsuperscript{146} Jointly liable persons may allocate liability

\textsuperscript{141} There is an underwriter exception to the general rules of § 1724 which codifies existing commission procedures. \textit{FED. SEC. CODE} § 1724(e)(2) & n.1.

\textsuperscript{142} An indemnification provision, whether contained in a statute, a bylaw or similar instrument, or a contract (other than a contract of insurance by an insurance company), is valid, apart from the expenses of a successful defense, only to the extent that

(A) the Commission provides by rule on consideration of such factors as the respective gains and losses of the indemnitee and indemnitee and the deterrent effect of the particular type of liability, or

(B) a court determines in accordance with the principles of common law and equity, applied as a matter of federal jurisprudence without regard to the statutory or other law of any State, and on consideration of the factors specified in section 1724(e)(3)(A).

\textit{Id.} § 1724(e)(3).

\textsuperscript{143} \textit{Id.} § 1724(e)(5).

\textsuperscript{144} "An insurance contract written by an insurance company is valid irrespective of (A) any State law to the contrary or (B) whether the premium is paid by the insured or any other person." \textit{Id.} § 1724(e)(4). This provision does not override the authority of states to prevent issuance of this insurance. \textit{Id.} § 1724 note (4).


\textsuperscript{146} \textit{FED. SEC. CODE} § 1724(f).
by contract either before or after liability is imposed. 147 Where there is no contract, "on consideration of the relative responsibility of each person for the loss incurred," 148 an order may be included in a judgment requiring just and equitable payments between the defendants, even to the extent of contribution amounting to indemnity. Alternatively, the court may determine that there is no liability for contribution. In any event no one may be ordered to pay more in contribution than his maximum liability would have been had he been a defendant in the primary action. 149

V. OTHER DEFENSES

In any action for civil liability, a defendant may argue that, either by agreement or by conduct, the parties have modified the availability of recovery under the securities laws. The Code expressly sets forth the requirements and limits of such defenses.

A. Waiver

Waiver 150 is one such defense. Under present securities laws, a contract provision in which a party waives, prior to breach, the right of action for noncompliance by another with the securities laws, is void. 151 Nevertheless, once a right under 10b-5 has matured and the plaintiff knows of the breach, his rights can then be waived. 152

Waiver under the Code is less restrictive. Present law voids such a contractual provision ab initio. The Code voids it as well but adds a proviso that it may operate where the parties are of equal bargaining strength as determined by their level of sophistication. 153

---

147. Id. § 1724(f)(1).
148. Id. § 1724(f)(2).
149. Id.
150. "[T]he voluntary or intentional relinquishment of a known right." Royal Air Properties, Inc. v. Smith, 333 F.2d 568, 571 (9th Cir. 1964).
152. Murtagh v. University Computing Co., 490 F.2d 810, 816-17 (5th Cir. 1974); Royal Air Props., Inc. v. Smith, 312 F.2d 210, 213-14 (9th Cir. 1962)(purpose of Securities Exchange Act is not to protect a wronged investor who waits to see how his investment turns out before invoking the Act).
153. A purported waiver of compliance with this Code . . . or a rule of recovery thereunder is void . . . (2) unless it is determined, on consideration of the financial and legal sophistication of the parties and the relationship between them, that the public policy underlying this Code does not require the application of this subsection.

It does void a provision, even where there is equal bargaining power, when it is in the interest of public policy to do so.154

The Code delimits waiver in another manner by declaring any “hold harmless” agreements given by investment companies to directors, officers, investment advisors or underwriters void where such person’s liability to the company or its security holders arises from “bad faith, intentional misfeasance, or reckless disregard of his obligations and duties.”155 This not only prevents emasculation of the deterrent provided by civil liability, but also proscribes attempts at an “end-run” around the limitations on indemnification.156 By disallowing these agreements, shareholder derivative suits are made possible if an investment corporation chooses not to sue one of the foregoing persons on a 10b-5 type violation.

Agreements to arbitrate civil liability have largely been prohibited under present securities laws because they are analogous to a waiver.157 Extending the waiver analysis to the Code, where the parties have sufficiently equivalent bargaining power, such an agreement could be construed as a “waiver of compliance with this Code” and thereby be enforceable under section 1725(a)(2).158 Otherwise, an advance agreement to arbitrate will not be a defense to an action. Such agreements, however, are enforceable among members of self-regulatory organizations.159 In contrast, these restrictions are not intended to affect good-faith settlements or agreements to arbitrate after the dispute arises.160

---

154. See note 140 and accompanying text supra.
156. See notes 138-143 and accompanying text supra.
158. See note 153 supra.
159. Self-regulatory organizations include national securities exchanges, registered securities associations, registered clearing agencies, and the Municipal Securities Rulemaking Board. Fed. Sec. Code § 299.54. Such organizations may act free of the restrictions of § 1725 when settling disputes between their members or participants. Fed. Sec. Code § 1725(c)(2). The Code permits an advance agreement to arbitrate disagreements arising over the rules of these agencies so long as the rule in question does not contravene the Code or a Commission interpretation of the Code or a judicial interpretation of it. Id. § 1725(c)(3).
160. Id. § 1725(c)(1).
B. Plaintiff's Conduct as a Defense

*In pari delicto* is a defense predicated on the plaintiff's conduct which may be raised under the Code:

In a private action created by or based on a violation of this Code . . . the defenses of unclean hands and in pari delicto are valid only to the extent (which may be complete) that it is so determined on consideration of (1) the deterrent effect of the particular type of liability, (2) the financial and legal sophistication of the parties, and (3) their relative responsibility for the loss incurred.\(^{161}\)

The defense is available where the plaintiff has committed a wrong against the defendant in the same transaction as that in which the plaintiff claims injury or where both plaintiff and defendant had a mutual intent to commit the same violation.\(^ {162}\) It has been recognized under section 1725(d), which codifies the factors to be considered in a decision to allow these defenses in a 10b-5 charge.\(^ {163}\) By limiting the defenses in this way, violations by a plaintiff in prior or subsequent transactions will not abrogate the defendant's liability in the present transaction.

In keeping with this apparent policy to limit defenses — unless there is an equitable reason to permit them — is the flexibility of the statute of limitations defense under rule 10b-5. The defense exists only as imposed by the courts because section 10(b) and rule 10b-5 do not express a limitations period and there is no generally applicable statutory period under the Securities Exchange Act of 1934.\(^ {164}\) Where a federal statute is silent on a statute of limitations, the court may use the statute of limitations from an applicable state statute, incorporating it into the federal common law, or may create a reasonable one as a matter of federal common law where the state statute does not further federal policies.\(^ {165}\)

\(^{161}\) Id. § 1725(d). "Unclean hands" is a companion defense to *in pari delicto*. It operates to bar a plaintiff from affirmative *equitable* relief where he himself is guilty of unlawful or inequitable conduct regarding the same transaction. See Graphic Sciences, Inc. v. International Mogul Mines, Ltd., [1974-75 Transfer Binder] Fed. Sec. L. REP. (CCH) ¶ 94,834 at 96,804 (D.D.C. 1974).

\(^{162}\) See Woolf v. S.D. Cohn & Co., 515 F.2d 591, 601 (5th Cir. 1975) (some unconscionable act committed by one seeking relief that has an immediate and necessary relation to the relief sought); Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50, 53 n.11 (S.D.N.Y. 1971) ("generally contemplates equal and simultaneous participation by the parties in the same illegal activity").

\(^{163}\) See Woolf v. S.D. Cohn & Co., 515 F.2d at 602-604.


The negative aspect of this procedure is that it has resulted in varying treatment for different plaintiffs, not only because different states have different time limits, but also because there is no uniformity on the choice-of-law issue as to which state limitations period should be chosen for the 10b-5 action. The Code sets forth a specific limitations period for 10b-5-type actions. An action may be brought up to one year after the plaintiff discovers or should have discovered the violation, but not more than five years after the purchase or sale by the plaintiff. This represents a long-needed improvement in the securities laws by freeing judicial time from complex determinations of applicable state law.

VI. Remedies

A. Damages Under 10b-5

Rule 10b-5 contains no express provisions concerning the remedies available in a private action. Thus, courts have implied private rights of action under the rationale of J. I. Case Co. v. Borak. The broad guidelines stated in that case indicated that the federal courts should adjust the private remedies "so as to grant the necessary relief . . . to make good the wrong done." Courts have since recognized the availability of both legal and equitable remedies and have refused to honor any contractually created limitations.

This implied grant of authority under such general guidelines has resulted in a case-by-case analysis with concomitant variations in the measurement of damages. Among the minimal restraints put upon damages calculations are the broad requirements that "no person permitted to maintain a suit for damages under the provi-

---


167. FED. SEC. CODE § 1727(b).


169. Section 21(d) of the Securities Exchange Act, 15 U.S.C. § 78u (d) (1976), which authorizes the Commission to bring an action for any violation of the 1934 Act and the rules and regulations thereunder, is the only express provision relating to implied rights of action.

170. 377 U.S. 426 (1964). Although this was a private action brought for violation of § 14 of the 1934 Act, 15 U.S.C. § 78n (1976), the Court's analysis was broadly focused on the propriety and necessity of providing "such remedies as are necessary to make effective the congressional purpose" behind the 1934 Act. 377 U.S. at 433.

171. Id.

172. See Crane Co. v. American Standard, Inc., 490 F.2d 332 (2d Cir. 1973) (recognizing the power to undo transactions or award damages).

sions of [the Exchange Act] shall recover, through satisfaction of judgment . . . a total amount in excess of his actual damage on account of the act complained of,"174 and that "damages are recoverable only to the extent that they can be shown."175 Beyond this, it has been left to the courts to determine and apply measures of damages when the question arises in diverse factual scenarios.176

An often used measure is "the difference between the fair value of all that the [defrauded] seller received, and the fair value of what he would have received had there been no fraudulent conduct."177 Value is determined as of the date of the transaction,178 so that the plaintiff recovers his "out-of-pocket" losses due to the violation.

In some cases a defrauded seller has recovered under an alternative "cover"179 measure of damage.180 While under this measure, the plaintiff need not actually "cover",181 he can recover the difference between the value he received upon the sale and the highest value the security attained within a reasonable time after the plaintiff discovered or should have discovered the fraud.182 This provides an alternative to a plaintiff who would have had no recovery under the "out-of-pocket" measure.183

Defrauded buyers have an alternative measure that is commonly referred to as the Chasins measure. In Chasins v. Smith, Barney & Co.,184 the plaintiff had been induced to purchase stocks from the defendant without disclosure of the latter's interest in them. Thus, the "evil [was] not the price at which Chasins bought but the fact of being induced to buy and invest for some future

---

177. Affiliated Ute Citizens v. United States, 406 U.S. at 155. See also, e.g., Harris v. American Inv. Co., 523 F.2d 220, 225 n.4 (8th Cir. 1975). The converse of this measure is used where a buyer has been defrauded.
178. Myzel v. Fields, 386 F.2d 718, 745 (8th Cir. 1967).
179. "Cover" refers to the replacement of an item after a seller has breached a duty to deliver. See Restatement of Restitution § 151 and comment (c) thereto (1937).
180. See 5B JACOBS, supra note 23, at § 260.03(c)(iii).
181. See, e.g., Baumel v. Rosen, 412 F.2d 571 (4th Cir. 1969); Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967).
183. This may occur, for example, where there is a misstatement of technical information that when truthfully disclosed would take a period of days to have an impact upon the price of a security.
184. 438 F.2d 1167 (2d Cir. 1970).
growth in these stocks without disclosure of Smith, Barney's interest . . . ." The Chasins court held that under such circumstances the proper measure of damages is the difference between the purchase price and the amount the buyer received upon his subsequent sale of the securities prior to his becoming aware of the violation of the Securities Exchange Act. Under such a formula, which is similar in some respects to the seller's "cover" remedy, a buyer can recover the difference between the amount he paid for the security and the lowest price it reached within a reasonable period after the plaintiff discovered or should have discovered the fraud.

Damages measurement in 10b-5 actions is, therefore, far from uniformly established. Profound differences may result from the courts' discretionary applications of the many formulae available to cases involving market transactions. Any of the measures could impose a very large liability upon a defendant without regard to the seriousness of his misconduct, the realistic market impact of his actions, or the actual influence which his actions had on the trading decisions of a potential multitude of claimants. The Code, on the other hand, brings much needed stability to this area. Along with defining the method of measuring damages, it sets forth the conditions under which alternative measures may be applied and authorizes adjustments where the transaction occurs in a market setting.

**B. Damages Under the Code**

Where the plaintiff is a buyer in a non-market transaction, the general rule allows him to recover the difference between the amount paid (plus interest) and the value of the security as of the end of a reasonable period, less any return received while he held the security. The "reasonable period" referred to is a reasonable time after the truth regarding the fraudulent act or misrepresentation becomes evident, the inside information becomes "generally available," or the plaintiff acquires actual knowledge. This creates an open-ended standard that allows a court to determine on the facts of each case when a plaintiff's claim ceases to be the result of the defendant's conduct and in reality is the result of the plaintiff's

---

185. *Id.* at 1173.
186. This may be especially true in the context of class actions. See *Green v. Occidental Petrol Corp.*, 541 F.2d 1335, 1341-42 (9th Cir. 1976) (Sneed, J., concurring).
188. *Id.* § 1708(a)(1).
189. *Id.* § 1703(b)(1).
inaction.\textsuperscript{190} If the plaintiff has sold any of that class and series of securities after his purchase but before the end of the reasonable period discussed above, his recovery is reduced by the amount received on the sale.\textsuperscript{191} In this way the plaintiff will not be unjustly enriched by any profits he makes on the interim sales. Under this method of measurement a compensatory result is achieved. The plaintiff, rather than unjustly benefitting from any profits made on interim sales, recovers the net loss suffered in the violative transaction.

A different measure, however, may apply:

[T]o the extent that the defendant bought a security of the class and series after his sale on which the action is based and before the end of the reasonable period . . . at a profit (compared with his sale price to the plaintiff) greater than the measure of damages as defined in the foregoing portion of section 1708(a)(1), the measure of damages is that profit . . . .\textsuperscript{192}

This formula is directed more at deterrence than compensation, for without it a defendant might risk being caught in a violation in exchange for the opportunity to obtain greater profits.

The Code provides for similar measures of damages where the plaintiff is a seller instead of a buyer. In this case the general rule provides for recovery of “the value of the security as of the end of the reasonable period . . . plus any return (with interest) that the buyer received on the security, less the amount (with interest) that the plaintiff received” on the sale.\textsuperscript{193} If the plaintiff bought a “security of the class and series after his sale” before the reasonable period expired, his recovery would be adjusted by the difference between that purchase price and the sale price to defendant. Additionally, if the defendant is able to sell that security at a relative profit during that time period, the plaintiff will be able to recover that profit if it exceeds the amount the general measure of damages provides for him.\textsuperscript{194}

In the market transaction, these same measures are used, adjusted by several additional considerations. For example, no alterations are made in the measure of damages for subsequent purchases

\textsuperscript{190} See id. § 1703(g).
\textsuperscript{191} Id. § 1708(a)(1)(A).
\textsuperscript{192} Id. § 1708(a)(1)(B).
\textsuperscript{193} Id. § 1708(a)(2).
\textsuperscript{194} Id. § 1708(a)(2)(A).
\textsuperscript{195} Id. § 1708 (a)(2)(B).
\textsuperscript{196} Id. § 1703(b).
or sales by a selling or buying plaintiff. While it has been asserted that permitting such alterations in the market context is inappropriate, a plaintiff who has mitigated his loss by trading in the interim period may be unjustly enriched by a recovery based upon the unadjusted general measure of damages. Despite their obvious impact, the ramifications of such factors to a defendant may be lessened by other adjustments to the market situation. Furthermore, the defendant may also reduce the amount of his liability by proving that his violation did not cause part or all of the loss. He may demonstrate this with proof that his actions were not "a substantial factor in producing the loss" or that the loss was not of the kind that "might reasonably have been expected" to occur as a result of the violation.

Regardless of the effects these variables may have upon the determination of damages, the Code makes it explicit that:

[the measure [of damages] (apart from any assessment of consequential damages or costs under section 1723(a) and (d)) is limited as if all the plaintiffs, together with all the members of the class in the case of a class action, had bought (or sold) only the amount of securities that the defendant had sold (or bought). . . .

The application of this limitation is easily understood in the insider trading situation, where the defendant is by definition buying or selling. It may also be applicable to actions for violation by fraudulent act or misrepresentation, because the defendant may commit the violation without trading. Nonetheless, it would seem that this limitation applies only where the defendant commits a violation by his act of trading.

197. Id. § 1708(b)(1).
198. Id. § 1708, note (3).
199. Id. § 1708(b)(2). This may also prove to reduce damages in a 10b-5 action, but as with that whole area of damages its use and parameters are not clearly defined. See 5B Jacobs, supra note 23 at § 260.03(f)(ii).
200. FED. SEC. CODE § 220. It may be argued that to the extent that the plaintiff's damages were mitigated by his purchase or sale during the interim period, the defendant's conduct did not cause a loss. See note 197 supra and accompanying text.
201. Id. § 1708(b)(3). The Code also delineates procedures whereby a defendant who is sued in more than one district court may protect himself from liability in excess of this provision. Once notice is given of the multiple suits against the defendant, the litigation will be transferred to a multidistrict judicial panel for such disposition as "will promote just and efficient conduct of the litigation." Id. § 1711.
202. Id. § 1603.
203. Id. § 1703(i).
204. This construction is possible under the power of the court to vary remedies as may be necessary. See id. § 1723(e).
As was stated earlier, equitable as well as legal remedies have been implied under rule 10b-5. Rescission is one such remedy, and is available where the violation occurs in a nonmarket transaction. The plaintiff-buyer can, upon tendering the security back to the defendant-seller, recover "the amount that he paid (with interest) less any return (with interest) that he received on the security." This amount may be further reduced by "any decrease that the defendant proves to have occurred in the market or other available price of the security since a reasonable period after" the material facts became generally available or the plaintiff acquired actual knowledge of those facts. Where the plaintiff is a seller, he can recover the securities sold upon tender to the defendant of the amount received (with interest) on the sale, "less any return (with interest) that the buyer received on the security." In addition, the seller must remit any increase in the price of the security that the defendant proves occurred after the previously described "reasonable period" elapsed. In all cases the plaintiff has the right to choose this remedy rather than damages except where the court finds that "rescission would unduly affect the rights of third parties or would be impractical."

D. Other Amounts Recoverable

Incidental relief is available under the Code in the same manner as in rule 10b-5 actions. Consequential and incidental damages can be recovered where the plaintiff proves they resulted from the conduct on which the action is based. They are not, however, subject to the market transaction limitations on amounts recovera-
and punitive damages are not available. Prejudgment interest, however, is recoverable, whether as part of the general measure of damages or as the court may otherwise direct. Additionally, the Code provides that where a court finds “bad faith or lack of merit” in the cause of action or defenses raised, it may assess costs, including attorney’s fees, against “any party at any time to give an undertaking for the payment of such costs.”

Finally, a court may shape relief to fit a particular case, within certain limits. In doing so the court cannot disturb the right of a defendant to reduce the extent of his liability by proving a lack of causation; nor can it impose punitive damages. A court may, however, permit variation in the definitions of rescission and measures of damages “on a showing that a different definition . . . would be plainly more appropriate on consideration of such factors as the plaintiff’s loss, the defendant’s profit, and the deterrent effect of the particular type of liability.” In this manner, courts will not be foreclosed by the statutory scheme from dealing appropriately with “the ‘J. Rufus Wallingford’ type . . . [who] would lie awake nights endeavoring to conceive some devious and shadowy way of evading the law” through manipulations that frustrate the remedies provided by the Code.

VII. Conclusion

The codification of 10b-5 issues has not resulted in major substantive changes in the existing statutory and decisional law. Clarification and objectification of this law, and the elimination of much of the overlap which previously plagued the civil liability statutes are the greatest gifts of the Code to the securities field. While the draftsmen have perhaps failed to revamp the tangled web of the securities law, the monumental effort of the Code to inject harmony

---

214. Id. § 1723(a)(2).
215. Nor are “damages for emotional distress.” Id. § 1723(b). There is no need to provide such additional incentives to encourage the filing of securities fraud actions. The widespread range of sanctions available to the Commission, when combined with the prospect of liability, provides a more than adequate deterrent. Cf. de Haas v. Empire Petroleum Co., 435 F.2d 1223, 1230-31 (10th Cir. 1970).
217. Id. § 1723(d).
218. Id.
219. Id. § 1723(e).
220. Id. § 1723(e)(2-3).
221. Id. § 1723(e).
222. Sperry & Hutchinson Co. v. Hudson, 190 Or. 458, 468-469, 226 P.2d 501, 505 (Or. 1950) (en banc).
Yet the described scope of civil liability under the Code is not and has not been fixed. The Commission is specifically empowered to “define . . . the conditions and restrictions” of the prohibitions in the Code by rule. It can also decree that rules of self-regulatory organizations receive the same treatment and give rise to liability as if they were express Code provisions. Finally, the judiciary is authorized to recognize a private action based on the proscriptions of the Code, even if there is no express liability under Part XVII. The ramifications of these provisions can only be appreciated, however, after they have been utilized.

On balance, though, the clarity and ease of use provided by a codification like this is a distinct improvement over the patchwork of present statutes and the presently nebulous private cause of action. Furthermore, the use of internally consistent standards and definitions is more conducive to the establishment of a comprehensive system of regulation. While some may object to the Code for its general failure to revise the present law, it should be remembered that an internally consistent statute may allow more accurate analysis and projection of the alternatives available to the investor when he enters the securities marketplace.

224. Id. § 1721(b).
225. Id. § 1722(a).
226. In this context, one should be aware of the broad power which the Commission will be able to wield if the Code is enacted.