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The Role of Treble Damages In Legislative and Judicial Attempts to Deter Insider Trading

THE ROLE OF TREBLE DAMAGES IN LEGISLATIVE AND JUDICIAL ATTEMPTS TO DETER INSIDER TRADING

Congress enacted the Securities Exchange Act of 1934 ('34 Act)[1] to provide for protection of the investor in capital markets.[2] The '34 Act created the Securities and Exchange Commission (SEC)[3] to oversee and enforce federal securities legislation.[4] Among the practices that the SEC seeks to deter as harmful to the fairness and integrity of the securities exchanges is the trading of securities by one who possesses material[5] nonpublic information.[6] The insider trading sanctions, therefore, focus primarily on stock transactions by directors, managers, and controlling shareholders who possess nonpublic information likely to affect a reasonable investor's decision to trade.[7] Section

1. Securities Exchange Act of 1934, Pub. L. No. 291, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a-78kk (1982)) ('34 Act).

2. *See* S. REP. No. 792, 73d Cong., 2d Sess. 3-5 (1934); H.R. REP. No. 1383, 73d Cong., 2d Sess. 10 (1934), *reprinted in* 5 J. ELLENBERGER & E. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, items 17, 18 (1973) ('34 Act seeks to insure fair and honest markets for investors). Congress intended the '34 Act to deter the speculative practices that led to the stock market crash of 1929. *See* S. REP. No. 792, 73d Cong., 2d Sess. 3 (1934) (unfair speculation caused loss to investors); H.R. REP. No. 1383, 73d Cong., 2d Sess. 3 ('34 Act seeks to correct prior abuses of stock markets).

3. *See* 15 U.S.C. § 78d (1982) (establishing Securities and Exchange Commission)(SEC). The SEC consists of five commissioners appointed by the President with the advice and consent of the Senate. *Id.* § 78d(a). The commissioners may appoint other officers, attorneys, examiners, and other experts to assist in carrying out the functions of the SEC. *Id.* § 78d(b).

4. *See id.* § 78w (SEC has power to make rules and regulations to implement '34 Act). Congress foresaw the need for flexibility in the interpretation and enforcement of the '34 Act, and determined that vesting these powers in an administrative agency would fulfill that need. *See* S. REP. No. 792, 73d Cong., 2d Sess. 5-6 (1934) (SEC's administrative discretion avoids problems of rigid statutory regulation).

5. *See* TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976) (materiality means information that would be significant in investor's deliberations); SEC v. MacDonald, 699 F.2d 47, 49 (1st Cir. 1983) (en banc) (materiality means information that reasonable shareholder would consider important).

6. *See* S. REP. No. 792, 73d Cong., 2d Sess. 9 (1934) ('34 Act protects investors from insider speculation on nonpublic information); H.R. REP. No. 1383, 73d Cong., 2d Sess. 13 (1934) ('34 Act seeks to control unfair practices of corporate insiders). Congress determined that the practice of insider trading was a flagrant betrayal of fiduciary duties. *See* S. REP. No. 1455, 73d Cong., 2d Sess. 55 (1934), *reprinted in* 5 J. ELLENBERGER & E. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, item 21 (1973) (insider trading is unfair).

7. *See* S. REP. No. 1455, 73d Cong., 2d Sess. 55 (1934) (directors, officers, and large stockholders have unique opportunities to acquire and abuse inside information); S. REP. No. 792, 73d Cong., 2d Sess. 9 (1934) ('34 Act protects public interest by preventing officers, directors, and principal stockholders from speculating on nonpublic information); H. REP. No. 1383, 73d Cong., 2d Sess. 13 (1934) ('34 Act seeks to curtail abuse of inside information by corporate officers, directors, and controlling shareholders). The SEC has expanded the definition of an insider to include anyone in a fiduciary relationship with the company who gains access to inside

16[8] of the '34 Act, for example, requires corporate directors, officers, and holders of ten percent or more of a company's shares to surrender to the corporation any profits that accrue from purchases and sales of the company's stock occurring within a six month period.[9] Additionally, section 10(b)[10] of the '34 Act and SEC rule 10b-5[11] provide a broad prohibition against fraudulent, deceptive, and manipulative practices including insider trading.[12]

Congress empowered the SEC with several means of implementing the insider trading prohibitions.[13] A widely used SEC enforcement tool is the civil

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information by virtue of the relationship. *See In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961) (insider trading prohibitions not limited to officers, directors, and controlling stockholders). Subsequent court decisions have extended insider trading liability to persons who trade on material nonpublic information received from corporate directors, officers, or controlling shareholders. *See, e.g.,* Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 165 (2d Cir. 1980) (both tippers and tippees violate rule 10b-5 by trading on nonpublic information); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d 228, 235-36 (2d Cir. 1974) (trading on nonpublic information received from corporate insider violated § 10(b) and rule 10b-5). *See generally* Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws,* 93 HARV. L. REV. 322, 348 (1979) (recipient of inside information inherits insider's duty to disclose or refrain from trading).

8. 15 U.S.C. § 78p (1982).

9. *Id.*

10. 15 U.S.C. § 78j (1982) ('34 Act, § 10(b)). Section 10(b) provides in pertinent 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 Commissioner may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id.

11. 17 C.F.R. § 240.10b-5 (1983). Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in 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.

Id.

12. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc) (§ 10b and rule 10b-5 prohibit insider trading), *cert. denied,* 404 U.S. 1005 (1971). The *Texas Gulf Sulphur* court enunciated the "disclose or abstain" rule, which states that an insider must disclose inside information or abstain from trading. *See id.; see also In re* Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961) (insiders must disclose before trading or forego transaction).

13. *See* 15 U.S.C. § 78u(d) (1982) (SEC can seek injunctions against violations); *id.* § 78o-3 (SEC can discipline broker-dealers who violate '34 Act); *id.* § 78u(a) (SEC can investigate insider trading violations and publish findings). The '34 Act subjects violators to possible criminal fines of up to $10,000 and maximum five year prison terms. *See id.* § 78ff(a) (criminal penalties). The SEC can recommend criminal prosecution by transmitting evidence of violations to the United States Attorney General. *Id.* § 78u(d).

injunctive suit.[14] In addition to the SEC's specific statutory enforcement powers, courts have implied a private right of action against inside traders under section 10(b) and rule 10b-5.[15] Despite the efforts of the SEC and private plaintiffs, however, insider trading continues to flourish.[16] Since the present statutory provisions and implied private action provide little deterrent effect,[17] Congress currently is considering a proposed amendment to the '34 Act that would strengthen the SEC's power to deter insider trading.[18] The Insider Trading Sanctions Act (ITSA)[19] would authorize the SEC to seek treble damages from inside traders in addition to the SEC's current injunctive powers.[20]

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14. *See id.* § 78u(d) (SEC injunctive suits). To obtain injunctive relief against violators, the SEC must prove the occurrence of a past violation and show that future violations are reasonably likely. *See* SEC v. Commonwealth Chem. Sec., Inc., 574 F.2d 90, 100 (2d Cir. 1978) (SEC must demonstrate realistic likelihood that past violations will recur). The statutory authority for SEC injunctions, however, relieves the SEC of the normal civil burden of showing irreparable harm to obtain an injunction. *See* 15 U.S.C. 78u(d) (1982) (statutory injunctive authority); SEC v. Management Dynamics, Inc., 515 F.2d 801, 808 (2d Cir. 1975) (public interest in SEC enforcement of securities laws justifies injunctive relief without showing of irreparable harm).

15. *See, e.g.,* Herman & MacLean v. Huddleston, 103 S.Ct. 683, 690 (1983) (implied private action under § 10(b) survives despite availability of express remedies); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971) (Supreme Court recognized § 10(b) private right of action); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 96 & n.7 (10th Cir. 1971) (federal circuits recognize private right of action under § 10(b) and rule 10b-5, *cert. denied,* 404 U.S. 1004 (1971); Kardon v. National Gypsum Co., 69 F. Supp. 512, 513 (E.D. Pa. 1946) (federal district court first recognized § 10(b) implied private right of action); Note, *Conflict Resolved: An Implied Remedy Under Section 10(b) of the '34 Act Survives Despite the Existence of Express Remedies,* 40 WASH. & LEE L. REV. 1039, 1049 & n.6 (1983) (discussion of background of § 10(b) and rule 10b-5 private rights of action). The SEC has endorsed the implied private right of action as a needed supplemental deterrent to insider trading. *See* Brief for the Securities and Exchange Commission as Amicus Curiae in Support of Partial Affirmance at 6, Herman & MacLean v. Huddleston, 103 S.Ct. 683 (1983) (limited enforcement resources of SEC make private right of action vital to effective enforcement of § 10(b)).

16. *See* Memorandum of the Securities and Exchange Commission in Support of the Insider Trading Sanctions Act, H.R. REP. No. 355, 98th Cong., 1st Sess. 21, 21 (1983) (insider trading continues despite vigorous enforcement efforts) [hereinafter cited as SEC Memorandum]. Congress has noted that insider trading practices have become more frequent in recent years due to an increase in the number of mergers and tender offers which can cause the price of a target company's stock to fluctuate dramatically. *See* H.R. REP. No. 355, 98th Cong., 1st Sess. 5 (1983) (immense profit potential in mergers and tender offers is powerful lure to inside traders); *see also* Dooley, *Enforcement of Insider Trading Restrictions,* 66 VA. L. REV. 1, 1 (1980) (sharp increase in trading of target company shares before announcements of impending mergers or takeovers indicates presence of insider trading).

17. *See* H.R. REP. No. 355, 98th Cong., 1st Sess. 6 (1983) (existing remedies provide inadequate deterrent to insider trading); SEC Memorandum, *supra* note 16, at 24 (current insider trading remedies have insufficient deterrent effect).

18. *See infra* note 20 and text accompanying notes 19-20 (discussion of Insider Trading Sanctions Act (ITSA)).

19. H.R. 559, 98th Cong., 1st Sess. (1983).

20. *Id.* § 2. In addition to authorizing the SEC to seek treble damages for insider trading violations, ITSA would increase the current maximum criminal fine from $10,000 to $100,000. *Id.* § 3; *see supra* note 13 (discussion of '34 Act criminal penalties). The sponsors of ITSA pointed out that inflation has diminished the deterrent impact of the $10,000 fine set in 1934. *See* H.R. REP. No. 355, 98th Cong., 1st Sess. 8 (1983) (1983 dollar has one-seventh of 1934 value).

In SEC civil injunctive actions, section 21(e)[21] of the '34 Act authorizes the SEC to seek injunctions to prevent violations of the Act.[22] Although the language of the statute authorizes only injunctive relief, courts also have employed their equity powers to fashion appropriate remedies in each case.[23] An effective remedy involves disgorgement of any financial benefit, by which a court can deprive a defendant of any profits gained or losses avoided by the unlawful conduct.[24] Courts, however, have differed on how to measure the disgorgement remedy in SEC enforcement proceedings.[25]

In *SEC v. Shapiro*,[26] the Second Circuit required an inside trader to disgorge all "paper" profits accruing from an insider trade, even though the holding resulted in the defendant having to surrender a greater sum of money than he actually made on the transaction.[27] In *Shapiro*, defendant Berman periodically purchased shares in Harvey's Stores, Inc. (Harvey's) during negotiations for a profitable merger between Harvey's and another corporation.[28] The price of Harvey's shares rose significantly after public disclosure of the merger negotiations, and Berman sold portions of his holdings at a profit.[29] The proposed merger failed to occur, however, and the price of the Harvey's shares declined.[30] Berman sold the remainder of his Harvey's stock at prices lower than the price at which he had purchased some of the shares.[31] The Second Circuit affirmed a district court order requiring Berman to pay to a trustee the difference between the peak price and the purchase price of the shares, even though Berman had to pay more money than he

21. 15 U.S.C. § 78u(d) (1982).

22. *Id.; see supra* note 14 (description of SEC injunctive powers).

23. *See* Mills v. Electric Auto-Lite Co., 396 U.S. 375, 391 (1970) (Congress did not intend '34 Act to restrict courts' power to fashion appropriate relief); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1103-04 (2d Cir. 1972) (showing of securities violation properly invokes equity jurisdiction to fashion appropriate remedies); SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301, 1307 (2d Cir.) (Supreme Court has upheld lower courts' power to grant ancilliary relief in absence of specific statutory authority), *cert. denied*, 404 U.S. 1005 (1971); 15 U.S.C. § 78aa (1982) ('34 Act grants exclusive law and equity jurisdiction to federal district courts for '34 Act violations).

24. *See, e.g.*, SEC v. Blatt, 583 F.2d 1325, 1335 (5th Cir. 1978) (disgorgement deprives wrongdoer of ill-gotten gains); SEC v. Commonwealth Chem. Sec., Inc., 574 F.2d 90, 102 (2d Cir. 1978) (disgorgement is method of forcing defendant to surrender unjust enrichment); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1104 (2d Cir. 1972) (courts' discretion to compel disgorgement adds to deterrent effect of SEC enforcement). Courts do not exceed disgorgement because § 28(a) of the '34 Act precludes punitive damages. *See* 15 U.S.C. § 78bb(a) (1982) (§ 24(a) of '34 Act) (recoveries limited to actual damages).

25. *See* Brunelle, *Disgorgement of Insider Trading Profits in SEC Injunctive Proceedings*, 11 Sec. Reg. L.J. 371, 373 (1984) (federal courts have exhibited dramatic disagreement over measurement of disgorgement remedy in SEC actions); *infra* text accompanying notes 26-54 (discussion of different views on measuring disgorgement remedy in SEC actions).

26. 494 F.2d 1301 (2d Cir. 1974).

27. *See id.* at 1309.

28. *Id.* at 1303-05.

29. *Id.* at 1305.

30. *Id.*

31. *Id.*

actually made by selling shares after the price declined.[32] The *Shapiro* court reasoned that to require disgorgement only of actual profits might encourage insider trading by emasculating the deterrent effect of rule 10b-5.[33]

In contrast to the *Shapiro* decision, the First Circuit in *SEC v. MacDonald*[34] required an inside trader to disgorge a sum of money smaller than the defendant's actual profit.[35] In *MacDonald*, defendant MacDonald purchased shares in a real estate investment trust of which he was a trustee.[36] MacDonald purchased the shares while in possession of nonpublic knowledge of a major property acquisition and profitable lease negotiation by the trust.[37] After public disclosure of the information, the stock price rose significantly for a week before settling at a new high.[38] MacDonald held the stock for two more years, however, before selling at an even higher price.[39] The SEC obtained a disgorgement order requiring MacDonald to surrender the difference between the purchase price and the price at which MacDonald sold the shares.[40] A divided First Circuit reversed the disgorgement order, however, and held that MacDonald should have to disgorge only the difference between the purchase price and the price the shares attained within a reasonable time after public disclosure of the information.[41] The *MacDonald* court reasoned that defrauded shareholders could have mitigated their losses by repurchasing shares after public disclosure of the favorable information.[42] The *MacDonald* court ex-

32. *Id.* at 1309.

33. *Id.*

34. 699 F.2d 47 (1st Cir. 1983) (en banc).

35. *See id.* at 55; *infra* text accompanying notes 36-44 (discussion of *MacDonald* decision).

36. 699 F.2d at 48.

37. *Id.* In *MacDonald,* Realty Income Trust (RIT) owned the land beneath the Kroger building, a 25-story office building in Cincinnati, Ohio. *Id.* RIT acquired the Kroger building after the previous owner defaulted on mortgage payments. *Id.* Prior to default, however, the owner had been negotiating a profitable long-term lease of vacant office space with a prospective new tenant. *Id.* RIT continued the lease negotiations after acquiring the building. *Id.*

38. *Id.* at 49.

39. *Id.*

40. *Id.* at 48.

41. *Id.* at 55. In an *en banc* hearing, the First Circuit decided the disgorgement issue in *MacDonald. See id.* at 52 n.3 (SEC filed for rehearing *en banc* on damages issue). The *MacDonald* majority instructed the district court on remand to consider the price and volume at which RIT shares traded following disclosure of the inside information. *Id.* at 55. The *MacDonald* court surmised that a temporary leveling off of the postdisclosure rise in price would indicate the time at which the market had adjusted to the new information. *Id.* The *MacDonald* court concluded that the leveling off period before the price of the shares rose to the level at which MacDonald finally sold would be the proper time at which to measure MacDonald's damages. *Id.*

The *MacDonald* dissent argued in favor of full disgorgement of the difference between the purchase price and the price at which MacDonald sold the shares. *See id.* at 55-58 (Coffin, C.J., dissenting in part) (defendant should relinquish fruits of wrongdoing). The dissent stressed that full disgorgement was necessary to provide a deterrent to insider trading and to preserve the integrity of the securities markets. *See id.* at 55 (public policy justifies full disgorgement); *id.* at 56 (partial disgorgement is inadequate deterrent).

42. *Id.* at 53; *see* Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1306 n.27 (2d Cir. 1973) (defrauded sellers should mitigate damages by repurchasing shares after discovering fraud).

plained that an insider's decision to retain illegally acquired shares for further profits was no different from the insider's opportunity to sell for immediate profit and reinvest in something else.[43] The First Circuit held, therefore, that subsequent profits after the share price had responded to disclosure of inside information were beyond the reach of a court's equitable power to compel disgorgement.[44]

One court has rejected entirely the mere disgorgement of profits remedy as being an inadequate deterrent to insider trading.[45] In *SEC v. Randolph*,[46] the United States District Court for the Northern District of California refused to endorse a consent judgment for injunctive relief and disgorgement of profits in an SEC enforcement action.[47] In *Randolph*, defendant Randolph tipped nonpublic information concerning a corporate takeover to Randolph's father-in-law, who profited by trading in options for the target company's shares.[48] Randolph agreed with the SEC to disgorge profits from the options transactions and not to violate the securities laws in the future.[49] When the SEC requested the district court to sign the consent decree and enter final judgment, however, the court refused.[50] The *Randolph* court stated that the purpose of the securities laws is to deter unlawful conduct.[51] Criticizing mere disgorgement as having no deterrent effect,[52] the *Randolph* court dismissed the case, concluding that the SEC at least should have sought to recover interest on the illegal profits.[53] The *Randolph* court declared that anything less would not be in the public interest.[54]

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43. 699 F.2d at 54.

44. *Id.; see* SEC v. Blatt, 583 F.2d 1325, 1335 (5th Cir. 1978) (disgorgement power is remedial not punitive and extends only to amounts attributable to wrongdoing); *cf.* SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1104 (2d Cir. 1972) (disgorgement of income earned on illegal profits was error).

45. *See infra* text accompanying notes 46-54 (discussion of *SEC. v. Randolph*).

46. 564 F. Supp. 137 (N.D. Cal. 1983).

47. *Id.* at 138.

48. *Id.* at 138-39.

49. *Id.* at 139.

50. *Id.*

51. *Id.* at 140-41. The *Randolph* court stressed the importance of deterrence in SEC actions, stating that any compensation purpose should apply only to private actions. *Id.* at 141; *see* List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir.) (rule 10b-5 administrative proceedings seek to deter misconduct rather than compensate victims), *cert. denied*, 382 U.S. 811 (1965); Ellsworth, *Disgorgement in Securities Fraud Actions Brought by the SEC*, 1977 Duke L.J. 641, 649-51 (1977) (SEC disgorgement remedy is solely deterrent device).

52. *See* 564 F. Supp. at 141 (mere disgorgement is no deterrent to insider who must restore only illegal gain if caught).

53. *Id.* at 144; *see* SEC v. MacDonald, 699 F.2d 47, 55 (1st Cir. 1983) (assessment of prejudgment interest on disgorged profits is appropriate); Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 173 n.30 (2d Cir. 1980) (awarding prejudgment interest is within court's discretion); SEC v. Blatt, 583 F.2d 1325, 1335 (5th Cir. 1978) (court's disgorgement power includes assessment of interest on disgorged profits).

54. 564 F. Supp. at 144; *see id.* at 141 (court must consider whether proposed settlement is fair to public). In addition to the inadequacy of the mere disgorgement remedy as grounds for dismissal of the SEC's suit, the *Randolph* court declared that the SEC could enforce the consent agreement with the defendant on ordinary contract principles, rendering any judicial approval unnecessary. *Id.* at 144.

Similarly, courts considering private actions have exhibited disagreement over how to measure the disgorgement remedy.[55] The Second Circuit held for the first time in *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*[56] that an inside trader could be liable to private plaintiffs who purchased shares on an impersonal stock exchange.[57] In *Shapiro*, Merrill Lynch, Pierce, Fenner & Smith, Inc., (Merrill Lynch) was the managing underwriter for a proposed bond offering by Douglas Aircraft Corp. (Douglas).[58] During the course of this relationship, Merrill Lynch learned that Douglas soon would announce a decrease in earnings that contrasted with an earlier declaration anticipating favorable earnings.[59] Merrill Lynch disclosed this inside information to selected customers who sold large blocks of Douglas shares on the New York Stock Exchange (NYSE).[60] The plaintiffs in *Shapiro* purchased Douglas shares on the NYSE just before the unfavorable earnings announcement.[61] After disclosure of the decrease in Douglas' earnings, the plaintiffs sued Merrill Lynch and the selling customers for violation of section 10(b) and rule 10b-5.[62] The Second Circuit held that the defendants owed a duty to all Douglas shareholders who bought during the time that the defendants were selling either to disclose the information or refrain from trading.[63] The *Shapiro* court determined that sufficient causation existed to justify imposing liability on the defendants since the plaintiffs would not have bought the Douglas shares if the plaintiffs had known the information.[64] The court declared that this holding was consistent

55. *See* Note, *A New Measure of Damages for Tippee-Trading Violations Under Rule 10b-5:* Elkind v. Liggett & Myers, Inc., 1981 B.Y.U. L. Rev. 407, 407 (1981) (damages measure is least formulated aspect of § 10(b) and rule 10b-5 actions) [hereinafter cited as *New Measure of Damages*]; Note, *Damages for Insider Trading Violations in an Impersonal Market Context*, 7 J. Corp. L. 97, 107-10 (1981) (discussion of three damages measures considered by *Elkind* court) [hereinafter cited as *Impersonal Market Context*]; Comment, *Measure of Damages for Insider Trading:* Elkind v. Liggett & Myers, Inc., 56 St. John's L. Rev. 142, 143 & n.6 (1981) (measure of damages is uncertain because settling defendants allow few courts to reach damages issue [hereinafter cited as *Measure of Damages*]; Note, *The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities*, 26 Stan. L. Rev. 371, 371 (1974) (courts use variety of methods to determine damages amount). *See generally* 5B A. Jacobs, The Impact of Rule 10b-5 (rev. ed. 1980) (comprehensive study of remedies in rule 10b-5 cases); Mullaney, *Theories of Measuring Damages in Security Cases and the Effects of Damages on Liability*, 46 Fordham L. Rev. 277, 281-94 (1977) (discussion of developing law of damages in rule 10b-5 cases).

56. 495 F.2d 228 (2d Cir. 1974).

57. *Id.* at 241; *see* Note, *New Measure of Damages, supra* note 55, at 407 (*Merrill Lynch* established right of action for uninformed outsiders).

58. 495 F.2d at 231.

59. *Id.* at 231-32.

60. *Id.* at 232. In *Merrill Lynch*, Merrill Lynch, Pierce, Fenner & Smith (Merrill Lynch) disclosed nonpublic information concerning Douglas Aircraft Corp.'s (Douglas') unfavorable earnings expectations to customers who were institutional investors. *Id.* These large investors sold Douglas shares either from existing holdings or made short sales totalling approximately one-half of all Douglas shares sold on the New York Stock Exchange (NYSE) during the period of nondisclosure. *Id.*

61. *Id.* at 232-33.

62. *Id.* at 233. The *Merrill Lynch* plaintiffs sued on behalf of all persons who purchased Douglas shares during the period between the time the defendants learned the nonpublic information and the time of public disclosure. *Id.*

63. *Id.* at 238; *supra* note 12 (discussion of "disclose or abstain" rule).

with the deterrent purpose of section 10(b) and rule 10b-5.[65] The Second Circuit, therefore, affirmed the district court's denial of the defendants' motion to dismiss, leaving open the question of how to measure damages.[66]

Two extreme views on the measure of damages in private insider trading actions appear in the Sixth Circuit's decision in *Fridrich v. Bradford*.[67] In *Fridrich*, defendant J. C. Bradford, Jr. (Bradford) purchased shares in Old Line Life Insurance Company (Old Line) on a tip from Bradford's father, who was a director of Old Line, that Old Line had become the target of a corporate takeover plan.[68] After public disclosure of the takeover attempt increased the price of Old Line stock, Bradford sold his Old Line shares at a profit of thirteen thousand dollars.[69] The SEC required Bradford to disgorge the thirteen thousand dollar profit, and three plaintiffs subsequently brought a private suit seeking damages for lost profits.[70] The *Fridrich* plaintiffs had sold Old Line shares during the period when Bradford was buying the stock on the basis of inside information.[71] The United States District Court for the Middle District of Tennessee held Bradford liable to all three plaintiffs for a total of over three hundred thousand dollars.[72] Concluding that Bradford's inside trading violated rule 10b-5, the district court reasoned that the plaintiff investors' remedy should place the plaintiffs in approximately the same position the plaintiffs would have occupied if no fraudulent conduct had occurred.[73] The district court, therefore, measured Bradford's damages as the difference between the price at which each plaintiff sold Old Line shares and the highest price that Old Line stock reached within a reasonable time after disclosure of the takeover plans.[74]

On appeal, the Sixth Circuit disagreed with the district court's finding of liability and reversed.[75] The Sixth Circuit determined that Bradford's con-

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64. 495 F.2d at 240; *see* Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972) (disclosure duty coupled with materiality of undisclosed facts establishes requisite causation for recovery).

65. *See* 495 F.2d at 240 (quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 847-48 (2d Cir. 1968), *cert. denied*, 404 U.S. 1005 (1971)).

66. 459 F.2d at 241. The *Merrill Lynch* court recognized the possibility of awarding immense damages to a large plaintiff class, and suggested that placing a limitation on the amount of recovery might be proper. *See id.* at 242 (possibility of very substantial damages necessitates district court discretion).

67. 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977).

68. *Id.* at 309-10.

69. *Id.* at 311.

70. *Id.*

71. *Id.*

72. *See id.* at 308. In *Bradford*, the plaintiffs sued five defendants, including J.C. Bradford, Jr. (Bradford). *See id.* at 309 n.4 (defendants were two individuals and three companies). Bradford's liability to the plaintiffs for over $300,000 on a $13,000 profit was joint and several with the other defendants. *See id.* at 308. The Sixth Circuit noted that Bradford's $300,000 liability was not dependent on the amount of Bradford's profit. *Id.* at 308-09.

73. *See* Fridrich v. Bradford, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶94,723, at 96,408 (M.D. Tenn. 1974), *rev'd*, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977).

74. *Id.*, at 96,406-07.

75. 542 F.2d at 309.

duct did not cause the plaintiffs' injury because the plaintiffs sold their shares on an impersonal stock exchange.[76] The *Fridrich* court reasoned that Bradford's inside trading did not affect the plaintiffs' decision to sell their Old Line stock.[77] Noting that Bradford did not purchase any Old Line shares directly from the plaintiffs, the Sixth Circuit concluded that to hold Bradford liable would overextend the reach of rule 10b-5.[78]

In contrast to the all or nothing approaches in the *Fridrich* case, the Second Circuit adopted a compromise measure of damages for inside traders in a private action in *Elkind v. Liggett & Myers, Inc.*[79] In *Elkind*, two corporate officers of Liggett & Myers, Inc. (Liggett) disclosed to financial analysts that Liggett's earnings would decline.[80] The informed analysts tipped this information to several clients, who sold Liggett shares on the NYSE before the unfavorable information became public.[81] An investor who had purchased Liggett shares before public disclosure of the earnings decline brought a class action suit on behalf of all investors who purchased Liggett shares during the period of nondisclosure.[82] The United States District Court for the Southern District of New York held Liggett liable to all plaintiffs who purchased Liggett shares between the time of the tips to the analysts and the time of public disclosure.[83] The district court fixed damages at the difference between the price all plaintiffs paid for the Liggett shares and the market price of the shares at a reasonable time after the public disclosure.[84] The Second Circuit reversed this damages measure, stating that to hold the company liable for full damages to all plaintiffs would impose too harsh a penalty on the innocent shareholders of the corporation.[85] The *Elkind* court also stated that full recovery for plaintiffs who bought shares on an impartial exchange would be unfair because open market stock traders have no absolute right to inside information.[86] The *Elkind* court held, therefore, that plaintiffs should recover the difference between purchase price and postdisclosure market price only up to the amount of loss the inside sellers would have sustained had the sellers retained their

76. *Id.* at 318-19. The *Bradford* court disagreed with the causation analysis in *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc. Id.* at 319; *see supra* text accompanying notes 56-66 (discussion of *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*). *See generally* Rapp, Fridrich v. Bradford *and the Scope of Insider Trading Liability Under SEC Rule 10b-5: A Commentary*, 38 OHIO ST. L.J. 67, 80-87 (1977) (discussion of conflict between *Bradford* and *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* decisions).

77. 542 F.2d at 318.

78. *See id.* at 309 (imposing liability would constitute unwarranted extension of rule 10b-5).

79. 635 F.2d 156 (2d Cir. 1980); *see* Note, *New Measure of Damages, supra* note 55, at 407-13 (discussion of *Elkind*); Note, *Impersonal Market Context, supra* note 55, at 106-10 (examining *Elkins* court's reasoning); Comment, *Measure of Damages, supra* note 55, at 142-47 (discussion of *Elkind* decision).

80. *See* 635 F.2d at 160-61.

81. *Id.*

82. *Id.* at 158.

83. *Id.*

84. *Id.*

85. *See id.* at 170.

86. *Id.* at 169-70.

shares until public disclosure.[87] The Second Circuit held that the plaintiffs would share the recovery pro rata.[88]

The *Elkind* court recognized that pro rata recovery provided little incentive for private enforcement of the insider trading prohibitions.[89] Other courts also have noted that the disgorgement remedy does not fulfill adequately the congressional purpose of deterring insider trading.[90] In an effort to provide more stringent measures against insider trading, Congress presently is considering the Insider Trading Sanctions Act (ITSA).[91] ITSA would allow the SEC to exact treble damages from inside traders, thereby increasing the risk an insider must face when deciding whether to trade on the basis of material nonpublic information.[92]

Congress already had recognized the need for more extreme punitive measures in two federal statutes which currently employ the treble damages penalty.[93] Section four of the Clayton Antitrust Act,[94] for example, authorizes private plaintiffs to collect treble damages from defendants who violate the

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87. *Id.* at 173.

88. *Id.* The *Elkind* court examined three possible damages measures before deciding upon a limited pro rata disgorgement measure. *See id.* at 170-72. The court first considered the traditional out-of-pocket measure which would compensate each plaintiff fully for the difference between the price paid and the true value of the stock. *See id.* at 170. The *Elkind* court rejected this measure because of problems in proving true value and because the resulting sum would be exorbitant. *Id.* The *Elkind* court next considered a market repercussion approach, which would compensate plaintiffs only for the decline in market price directly attributable to the insider's trading. *See id.* at 171. The court rejected this measure because of the impossibility of proving to what extent a stock's decline was the result of insider selling and not other factors. *Id.* The *Elkind* court finally settled upon the third alternative, which would allow plaintiffs to recover the postpurchase decline in market price within a reasonable time after disclosure up to the amount of loss that the insider avoided by selling before disclosure. *Id.* at 172. *See generally,* Note, *New Measure of Damages, supra* note 55, at 414-16 (discussion of damages measure rejected in *Elkind*); Note, *Impersonal Market Context, supra* note 55, at 111-18 (analysis of *Elkind* alternative damages measures); Comment, *Measure of Damages, supra* note 55, at 147-51 (discussion of *Elkind* and possible damages measures).

89. *See* 635 F.2d at 173 (pro rata recovery could be inadequate to make class action worthwhile).

90. *See* SEC v. MacDonald, 699 F.2d 47, 56 (1st Cir. 1983) (Coffin, C.J., dissenting in part) (disgorgement is inadequate deterrent to insider trading); SEC v. Randolph, 564 F. Supp. 137, 141 (N.D. Cal. 1983) (mere disgorgement has little deterrent effect).

91. H.R. 559, 98th Cong., 1st Sess. (1983) (Insider Trading Sanctions Act (ITSA)). The United States House of Representatives passed ITSA on September 19, 1983, and ITSA currently is before the Senate. 41 U.S. CONG. Q. 1970 (Sept. 24, 1983); *see* The Wall Street Journal, Mar. 2, 1984, at 12, col. 6 (discussion of ITSA). The future of ITSA, however, is uncertain. *See* Brunelle, *supra* note 25, at 372 (special interest lobbies may block passage of ITSA).

92. *See* H.R. 559, 98th Cong., 1st Sess. § 2 (1983) (ITSA treble damage section); SEC Memorandum, *supra* note 16, H.R. REP. No. 355, 98th Cong., 1st Sess. 24 (1983) (treble damages would pose greater risk to inside traders).

93. *See infra* note 94, 96, and text accompanying notes 94-97 (discussion of Clayton Act and Racketeer Influenced Corrupt Organizations Act (RICO) treble damage provisions).

94. 15 U.S.C. § 15 (1982) (Clayton Act, § 4). Section 4 of the Clayton Act superseded the original antitrust treble damages provision in § 7 of the Sherman Act, Act of July 2, 1890, ch. 647, § 7, 26 Stat. 210 (1890) (repealed). Congress derived the idea of treble damages for antitrust violations from an early English monopolies statute. *See* 21 Jac., ch. 3 (1623) (English statute provided treble damages for individuals financially injured by restraint of trade). Con-

antitrust laws.[95] In addition, the Racketeer Influenced and Corrupt Organizations Act (RICO)[96] provides for a civil treble damages remedy.[97] ITSA, which bestows only the SEC with a right of action, contrasts with the Clayton Act and RICO provisions empowering private plaintiffs to seek redress for statutory violations.[98]

RICO allows private plaintiffs to recover treble damages by demonstrating that a defendant has committed two acts of racketeering activity within ten years.[99] Section 1(1)(D)[100] of RICO includes securities fraud within the statutory

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gress intended the treble damages remedy to encourage private plaintiffs to enforce the antitrust laws. *See* W. HAMILTON & J. TILL, ANTITRUST IN ACTION 10 (US. Temporary National Economic Committee Monograph No. 16, Washington, Government Printing Office, 1940), *quoted in* H. THORELLI, THE FEDERAL ANTITRUST POLICY 229 n.169 (1954) (Congress intended treble damages clause to make worthwhile policing of industry by injured members). *See generally* K. ELZINGA & W. BREIT, THE ANTITRUST PENALTIES: A STUDY IN LAW AND ECONOMICS 63-77 (1976) (discussion of background of private antitrust treble damages penalty).

95. 15 U.S.C. § 15 (1982).

96. 18 U.S.C. §§ 1961-68 (1982) (RICO). RICO is title IX of the Organized Crime Control Act of 1970, Pub. L. No. 91-452, 84 Stat. 941 (1970) (OCCA). Congress enacted RICO to curb the influence of organized crime on legitimate business enterprises. *See* Harper v. New Japan Sec. Int'l, Inc., 545 F. Supp. 1002, 1004 (C.D. Cal. 1982) (RICO seeks to curb infiltration of legitimate businesses by members of organized crime); H.R. REP. No. 1549, 91st Cong., 2d Sess. (1970), *reprinted in* 1970 U.S. CODE CONG. & AD. NEWS 4007, 4010 (1970) (legislative history of OCCA and RICO). RICO provides for the recovery of treble damages by private plaintiffs. 18 U.S.C. § 1964(c) (1982). Like the antitrust treble damages clause, the availability of RICO civil treble damages facilitates private enforcement of RICO's statutory provision. *See* Blakey & Gettings, *Racketeer Influenced and Corrupt Organizations (RICO): Basic Concepts—Criminal and Civil Remedies*, 53 TEMP. L.Q. 1009, 1048 (1980) (RICO's civil remedies part of broadly based legislative attack); Note, *Civil RICO: The Temptation and Impropriety of Judicial Restriction*, 95 HARV. L. REV. 1101, 1112-13 (1982) (congressional purpose for RICO treble damages is to inflict financial injury on criminals). *See generally* Bradley, *Racketeers, Congress, and the Courts: An Analysis of RICO*, 65 IOWA L. REV. 837, 838-45 (1980) (discussion of history and background of RICO).

97. 18 U.S.C. § 1964(c) (1982).

98. *See* H.R. 559, 98th Cong., 1st Sess. § 2 (1983) (ITSA treble damages provision for benefit of SEC). In addition to conferring a right of action for treble damages on private plaintiffs, the Clayton Act and RICO allow private plaintiffs to recover costs and attorneys' fees. *See* 18 U.S.C. § 1964 (c) (1982) (RICO costs and attorneys' fees); 15 U.S.C. § 15 (1982) (Clayton Act costs and attorneys' fees). ITSA does not provide for costs or attorneys' fees in SEC treble damages actions. *See* H.R. 599, 98th Cong., 1st Sess. § 2 (1983) (ITSA does not mention costs or attorneys' fees). *But see* 15 U.S.C. § 78aa (1982) ('34 Act provides that no costs be assessed for or against SEC); FED. R. CIV. P. 54(d) (no costs allowed against government agency unless authorized by statute).

99. *See* 18 U.S.C. §§ 1961-62, 64 (1982). Section two of RICO makes unlawful any pattern of racketeering activity or the use of funds derived from a pattern of racketeering activity in any enterprise affecting interstate commerce. *Id.* at § 1962. Section one of RICO defines a pattern of racketeering activity as two acts of racketeering activity occurring within ten years, the first act having occurred since enactment of the statute. *Id.* § 1961(5). Section one further lists various predicate acts which fall within the definition of racketeering activity and trigger the application of § 2. *Id.* § 1961(1). Section four of RICO authorizes private plaintiffs to collect treble damages plus costs and attorneys' fees for injury sustained by reason of a violation of § 2. *Id.* § 1964(c). Section four also provides for divestiture and injunctive relief. *Id.* § 1964(a). Section three contains RICO's criminal penalty provisions. *Id.* § 1963.

100. 18 U.S.C. § 1961(1)(D) (1982).

definition of racketeering activity.[101] A split of authority exists, however, over the general applicability of RICO to securities fraud claims.[102] Some courts have held that Congress intended RICO to apply only to securities transactions involving organized crime, and thus ordinary securities claims do not qualify for RICO treble damages.[103] Other courts have suggested, however, that Congress intended the judiciary to construe RICO's remedial measures liberally, thus rendering even ordinary violators of the securities laws liable for RICO treble damages.[104] While no private plaintiff has yet recovered treble damages for insider trading under RICO, the Second Circuit recently considered a RICO treble damages claim brought by a private investor against inside traders in *Moss v. Morgan Stanley*.[105]

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101. *Id.*

102. *See infra* notes 103-04 and accompanying text (discussion of different court interpretations of RICO's securities fraud provision); *see also* Coffield, *If RICO is Applied to Securities Fraud, Can Antitrust Be Far Behind?*, 52 ANTITRUST L.J. 379, 379-80 & n.4 (1983) (RICO's broad sweep threatens preemption of federal securities fraud law); MacIntosh, *Racketeer Influenced and Corrupt Organizations Act: Powerful New Tool of the Defrauded Securities Plaintiff*, 31 U. KAN. L. REV. 7, 14-67 (1982) (discussion of unresolved issues in RICO securities fraud litigation); Note, *RICO and Securities Fraud: A Workable Limitation*, 83 COLUM. L. REV. 1513, 1522-26 (1983) (application of RICO in ordinary securities litigation is improper) [hereinafter cited as *RICO and Securities Fraud*]; Note, *Application of The Racketeer Influenced and Corrupt Organization Act (RICO) to Securities Violations*, 8 J. CORP. L. 411, 437 (1983) (illustration of judicial conflict in interpreting proper breadth of RICO applicability to securities fraud claims) [hereinafter cited as *RICO Securities Violations*].

103. *See* Noonan v. Granville-Smith, 537 F. Supp. 23, 29 (S.D.N.Y. 1981) (court dismissed RICO securities fraud counts for failure to allege connection with organized crime); Adair v. Hunt Int'l Resources Corp., 526 F. Supp. 736, 747 (N.D. Ill. 1981) (application of RICO limited to entities involved with organized crime); *cf.* Waterman S.S. Corp. v. Avondale Shipyards, Inc., 527 F. Supp. 256, 260 (E.D. La. 1981) (court dismissed RICO antitrust claim for failure to show nexus with organized crime); Barr v. WUI/TAS, Inc., 66 F.R.D. 109, 113 (ordinary mail fraud claim not within RICO absent connection with organized crime). Courts have used other criteria besides the lack of connection with organized crime to narrow the scope of RICO civil liability. *See, e.g.*, Harper v. New Japan Sec. Int'l, Inc., 545 F. Supp. 1002, 1007 (C.D. Cal. 1982) (predicate securities violation alone not sufficient showing of injury by reason of RICO violation); Landmark Sav. & Loan v. Rhoades, 527 F. Supp. 206, 209 (E.D. Mich. 1981) (memorandum opinion) (mere showing of securities violation without more not sufficient to recover RICO treble damages). *See generally* Note, *RICO and Securities Fraud*, *supra* note 102, at 1526-34 (discussion of judicial attempts to narrow RICO); Note, *RICO Securities Violations*, *supra* note 102, at 417-436 (description of judicial use of enterprise, organized crime, and injury requirements to restrict scope of RICO).

104. *See, e.g.*, Moss v. Morgan Stanley, [Current Binder] FED. SEC. L. REP. (CCH) ¶99,478, at 96,762 & n.17 (2d Cir. 1983) (dictum) (neither language of statute nor legislative history mandates connection with organized crime); Cenco, Inc. v. Seidman & Seidman, 686 F.2d 449, 457 (7th Cir.) (dictum) (RICO forbids penetration of business by racketeering activity with or without involvement of organized crime), *cert. denied*, 103 S.Ct. 177 (1982); Mauriber v. Shearson/American Express, Inc., 546 F. Supp. 391, 396 (S.D.N.Y. 1982) (dictum) (RICO does not require allegation of organized crime connection); Farmers Bank v. Bell Mtg. Corp., 452 F. Supp. 1278, 1280 (D. Del. 1978) (RICO gives rise to treble damages remedy for ordinary securities fraud); *cf.* United States v. Aleman, 609 F.2d 298, 303 (7th Cir. 1979) (no organized crime connection required in criminal burglary RICO action), *cert. denied*, 445 U.S. 946 (1980). *See generally* Note, *RICO and Securities Fraud*, *supra* note 102, at 1517-20 (RICO applies to corporate takeover battles).

105. [Current Binder] FED. SEC. L. REP. (CCH) ¶99,478 (2d Cir. 1983).

In *Moss*, an investment analyst disclosed nonpublic information concerning an impending corporate tender offer to a stockbroker named Newman.[106] Newman purchased shares in the target company on the NYSE and tendered the shares to the offering corporation at a substantial profit.[107] A private plaintiff who had sold target company shares before the offer became public sued Newman and the investment analyst for violating section 10(b) and rule 10b-5.[108] The plaintiff also tried to recover treble damages from Newman under RICO.[109] The United States District Court for the Southern District of New York dismissed the plaintiff's complaint, holding that Newman had no duty to disclose inside information because no fiduciary relationship existed between Newman and the plaintiff.[110] The district court found, therefore, that the plaintiffs had no standing to sue Newman for violations of section 10(b) and rule 10b-5.[111] Furthermore, the district court dismissed the RICO claim by declaring that RICO's civil remedies do not apply to ordinary securities law violations.[112]

On appeal, the Second Circuit affirmed the district court's dismissal of the private action.[113] The Second Circuit, however, disagreed with the district court's view concerning RICO's applicability to securities fraud claims.[114] The Second Circuit affirmed the dismissal of the RICO claim on the ground that the plaintiff's failure to show a violation of section 10(b) or rule 10b-5 necessarily precluded any assertion of RICO securities fraud.[115] The *Moss* court stated in dictum, however, that a valid showing of ordinary securities fraud could satisfy RICO's pleading prerequisite, and thereby enable a private plain-

106. *See id.* at 96,751. In *Moss*, Warner-Lambert Company (Warner) planned to make a tender offer for Deseret Pharmaceutical Company (Deseret). *Id.* Warner employed the investment banking firm of Morgan Stanley & Co., Inc. (Morgan Stanley) to analyze Deseret's stock and determine an appropriate tender offer price for Deseret's shares. *Id.* An analyst employee of Morgan Stanley familiar with Warner's plans to acquire Deseret advised an acquaintance to purchase Deseret stock. *Id.* The acquaintance informed stockbroker Newman, who purchased shares for himself, the analyst, and the analyst's acquaintance. *Id.* The plaintiff brought a class action on behalf of all selling shareholders against Morgan Stanley as well as the three individual defendants, seeking RICO treble damages for violations of section 10(b) and rule 10b-5. *Id.* at 96,751-52. The plaintiff's appeal from the district court's dismissal of all RICO claims applied only to the claim against Newman. *Id.* at 96,752 n.4.

107. *Id.* at 96,751.

108. *Id.*

109. *Id.* at 96,752, *see supra* note 106 (plaintiff appealed dismissal of RICO claims against all defendants only as applied to Newman).

110. *See* Moss v. Morgan Stanley, Inc., 553 F. Supp. 1347, 1352-53 (S.D.N.Y.) (defendants owed no disclosure duty to plaintiffs), *aff'd* [Current Binder] FED. SEC. L. REP. (CCH) ¶99,478 (2d Cir. 1983); *see also* Dirks v. SEC, 103 S.Ct. 3255, 3261 (1983) (no disclosure duty exists in absence of fiduciary relationship); United States v. Chiarella, 445 U.S. 222, 232-33 & n.14 (mere acquisition of information does not create disclosure duty).

111. 553 F. Supp. at 1353.

112. *See id.* at 1361 (RICO should apply only to organized crime); *see also supra* note 103 (cases holding that connection with organized crime is necessary prerequisite to RICO claims).

113. Moss v. Morgan Stanley, Inc., [Current Binder] FED. SEC. L. REP. (CCH) ¶99,478, at 96,763 (2d Cir. 1983).

114. *See id.* at 96,763.

115. *Id.*

tiff to qualify for RICO treble damages in an insider trading action.[116]

The prospect of a treble damages penalty would present a much stronger deterrent to insider trading than current sanctions provide.[117] The two goals underlying the present statutory treble damages remedies are deterrence and compensation.[118] The deterrence theory supports the multiplication of damages on the assumption that the violator has broken the law before or will break the law again with impunity.[119] Applying a multiplier to actual damages will deter potential violators from trying to profit by illegal conduct on the chance that they likely can avoid prosecution.[120] Dividing the actual damage measure by the probability of prosecution will yield the appropriate damage multiplier.[121] Given the current perception that much insider trading goes undetected and unpunished, the deterrence theory of multiple damages supports the proposal for treble damages under ITSA.[122]

Compensation is the second reason for applying a multiplier to actual damages.[123] Awarding an injured plaintiff a sum of money greater than the economic injury incurred compensates the plaintiff for the costs and loss of productivity involved in litigating the suit.[124] Additionally, awarding multiple

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116. *See id.* at 96,759 & n.13 (dictum) (allegations of ordinary securities fraud can qualify for RICO claims); *supra* note 104 (cases holding that no organized crime connection is necessary for RICO liability).

117. *See* SEC Memorandum, *supra* note 16, at 24-25 (multiple civil penalty would present powerful deterrent to insider trading); *supra* notes 17, 90 and accompanying text (current remedies have little deterrent effect).

118. *See* R. POSNER & F. EASTERBROOK, ANTITRUST CASES, ECONOMIC NOTES, AND OTHER MATERIALS 542-45 (1981) (discussion of redress for victims and deterrence as goals of private enforcement of antitrust laws); R. POSNER, ANTITRUST LAW, AN ECONOMIC PERSPECTIVE 221 (1976) (deterrence and compensation are basic objectives of antitrust remedial system); *see also* Harper v. New Japan Sec. Int'l, Inc., 545 F. Supp. 1002, 1007 (C.D. Cal. 1982) (analogy to antitrust law is most logical way to interpret RICO treble damages clause).

119. *See* R. POSNER & F. EASTERBROOK, *supra* note 118, at 552 (multiple damages make up for undetected violations); R. POSNER, ECONOMIC ANALYSIS OF LAW 360 (1972) (multiple damages are proper when detection of violation is less than certain).

120. *See* R. POSNER & F. EASTERBROOK, *supra* note 118, at 552 (multiple damages are necessary to make potential violators foresee unprofitability of illegal conduct); R. POSNER, *supra* note 119, at 360 (multiple damages make potential violators realize that costs of violation will exceed benefits); R. POSNER, *supra* note 118, at 221 (greater costs attached to violation will deter activity).

121. R. POSNER & F. EASTERBROOK, *supra* note 118, at 552; R. POSNER, *supra* note 119, at 360; R. POSNER, *supra* note 118, at 223-24.

122. *See* SEC v. MacDonald, 699 F.2d 47, 56 (1st Cir. 1983) (Coffin, C.J., dissenting) (risk of detection of insider trading is less than 100%); *cf.* Brunelle, *supra* note 25, at 371 & nn.4,6 (inside traders stand little chance of detection). The great difficulties involved in gathering sufficient proof to support a conviction makes the likelihood of detecting and punishing insider trading violations especially small. *See* The Wall Street Journal, Mar. 2, 1984, at 12, col. 5 (tracking insider trading involves circumstantial evidence problems).

123. *See* R. POSNER & F. EASTERBROOK, *supra* note 118, at 542 (discussion of compensation goal). Posner regards the compensation goal as secondary to that of deterrence. *See* R. POSNER, *supra* note 118, at 221 (well-designed deterrence system would assure adequate compensation as byproduct).

124. *See* R. POSNER & F. EASTERBROOK, *supra* note 118, at 543 (plaintiffs will sue only if recovery is worth costs of suit).

damages encourages private plaintiffs to enforce the statutory prohibitions.[125] Since ITSA would provide only for the SEC and not private plaintiffs to collect treble damages, the private enforcement rationale does not apply.[126] Because ITSA would make treble damages awards payable into the United States Treasury, however, the proceeds of successful ITSA suits could "compensate" the government for the costs of funding SEC enforcement activities.[127] The funding of SEC enforcement through treble damages awards in turn could further the goal of deterrence by providing additional funding for expansion of enforcement capabilities.[128]

Some commentators in the antitrust field have attacked treble damages as being inefficient and unfair.[129] Proponents of the inefficiency argument against antitrust treble damages also assert that private enforcement is not proper.[130] Commentators discussing inefficiency argue that allowing treble damages encourages consumers to deal with violators rather than nonviolators in order to attain standing to assert treble damages claims.[131] Furthermore, the punitive aspect of treble damages encourages plaintiffs to bring nuisance suits in attempting to obtain out of court settlements from defendants who would rather bear a certain small loss than incur the costs of litigation and risk the possibility of an adverse judgment.[132] Finally, economic inefficiency results when excessive sums of money flow into litigation costs and courts become congested with private enforcement actions.[133] Proponents of the in-

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125. *Id.; see supra* note 94 (Congress foresaw private treble damages as aid to enforcement of antitrust laws). *See generally* Landes & Posner, *The Private Enforcement of Law*, 4 J. LEGAL STUDIES 1, 30-44 (1975) (discussion of positive economic implications of private law enforcement).

126. *See supra* note 98 and accompanying text (ITSA does not apply to private plaintiffs).

127. *Cf.* Note, *Damages to Uninformed Traders for Insider Trading on Impersonal Exchanges*, 74 COLUM. L. REV. 299, 316 (1974) (proposing that SEC receive benefit of disgorged profits) [hereinafter cited as *Uninformed Traders*].

128. *See id.* (disgorged profits could fund special SEC insider trading enforcement unit).

129. *See* K. ELZINGA & W. BREIT, *supra* note 94, at 84-96 (attacking treble damages as inefficient); 2 P. AREEDA & P. TURNER, ANTITRUST LAW ¶331(b) (1978) (attacking treble damages as unfair to defendants). *See generally* Sullivan, *Breaking Up the Treble Play: Attacks on the Private Treble Damage Antitrust Action*, 14 SETON HALL L. REV. 17, 25-67 (1983) (summary of and defenses to arguments against treble damages).

130. *See* K. ELZINGA & W. BREIT, *supra* note 94, at 112 (private enforcement has adverse side effects); *infra* notes 131-34 and accompanying text (discussion of adverse side effects of private enforcement); *cf. infra* note 150 (discussion of arguments against private actions for insider trading).

131. *See* K. ELZINGA & W. BREIT, *supra* note 94, at 84-90 (prospect of treble damages magnifies consumer's incentive to deal with antitrust violator). Elzinga and Breit note that inefficiency results from allowing treble damages because consumers deliberately will continue to incur greater losses in order to magnify the forthcoming reparations. *Id.* at 84. *But see* Sullivan, *supra* note 129, at 32 (tort and contract doctrines of mitigation of damages deny recovery to plaintiffs who deliberately incur loss).

132. *See* K. ELZINGA & W. BREIT, *supra* note 94, at 90-95 (discussion of groundless claims brought in hopes of recovering from defendants who prefer to avoid trial); *see also* R. POSNER & F. EASTERBROOK, *supra* note 118, at 544 (treble damages lead to overenforcement). *But see* Sullivan, *supra* note 129, at 40 (discussion of plaintiff considerations that make nuisance suits unlikely).

133. *See* K. ELZINGA & W. BREIT, *supra* note 94, at 95 (private treble damage actions involve

efficiency argument, therefore, assert that public enforcement with fines for penalties would be more economically efficient than private enforcement with treble damages awards.[134]

Proponents of the unfairness argument against treble damages in antitrust law assert that courts should have discretion to award less than treble damages when the harm caused by a defendant's conduct does not merit harsh punishment.[135] ITSA would permit this degree of discretion by allowing courts to impose up to three times the amount of damages.[136] The harm that ITSA treble damages seek to prevent is injury to the integrity of the stock exchanges as a whole.[137] Some insider trading violations will present a less severe threat to market integrity than others.[138] Courts in these circumstances could require mere disgorgement of profits or impose some other damages measure less than treble damages.[139]

The concept of injury to market integrity as a basis for deterring insider trading, however, has met with criticism from the standpoint of economic efficiency.[140] Some commentators on insider trading have argued that insider trading is efficient and should not be illegal.[141] These commentators assert that insider trading fulfills the purpose of securities legislation by providing more prompt disclosure of information that affects the value of stock in the

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complicated litigation strategies that congest federal courts); R. POSNER, *supra* note 118, at 228 (private plaintiffs' lawyers lack self restraint).

134. *See* K. ELZINGA & W. BREIT, *supra* note 94, at 112-38 (discussion of public enforcement with fines as more efficient alternative to private enforcement); *cf. infra* note 150 (discussion of arguments against private actions for insider trading).

135. *See* 2 P. AREEDA & D. TURNER, *supra* note 129, ¶331(b) (treble damages are punitive and not all violations deserve punitive damages); *see also* Sullivan, *supra* note 129, at 53-67 (summary of and defense to unfairness argument against treble damages). Congress has considered making antitrust treble damages discretionary but has not done so. *See id.* at 54 & nn.180-82 (discussion of congressional hearings on antitrust laws); *see also* K. ELZINGA & W. BREIT, *supra* note 94, at 65 & n.10.

136. H.R. 599, 98th Cong., 1st Sess. § 2 (1983); *see* SEC Memorandum, *supra* note 16, at 26 (ITSA does not mandate maximum penalty in every case).

137. *See* SEC Memorandum, *supra* note 16, at 22-23 (ITSA seeks to protect public confidence in securities markets).

138. *Compare* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 232 (2d Cir. 1974) (institutional investors in possession of material nonpublic information sold large blocks of company shares totaling one half of all company shares sold on NYSE during period) *with* SEC v. Randolph, 564 F. Supp. 137, 139 (N.D. Cal. 1983) (insider tipped information to father-in-law who profited on purchase of 65 call options).

139. *See* SEC Memorandum, *supra* note 16, at 26 (amount of penalty under ITSA would depend on facts and circumstances of each case).

140. *See infra* notes 141-45 and accompanying text (discussion of arguments in defense of insider trading).

141. *See* H. MANNE, INSIDER TRADING AND THE STOCK MARKET at v-vi (1966) (objective economic analysis without regard to moral judgment reveals that insider trading may have positive social and economic influence); Carlton & Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 861-95 (1983) (analysis of arguments against insider trading and conclusion that insider trading is beneficial and efficient form of managerial compensation). *But see* Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425, 1430-74 (1967) (refuting arguments in favor of insider trading).

market.[142] As stock prices respond to buying or selling by insiders, the investing public receives a signal that some new development affecting the value of the firm may have occurred.[143] Such signals could alert the investing public far in advance of the time that a corporation would deem prudent for public disclosure.[144] Furthermore, the commentators defending insider trading argue that profits from insider trading constitute an efficient form of compensation for managerial officers.[145]

In addition to conflicting views over insider trading's harmfulness to market integrity and the investing public, a controversy exists over who among private investors sustains injury from insider trading.[146] Whenever an insider deals directly with a private investor, ordinary principles of common-law fraud apply to justify imposing liability on the inside trader.[147] In transactions on imper-

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142. *See infra* notes 143-44 and accompanying text (insider trading facilitates prompt dissemination of information).

143. *See* H. MANNE, *supra* note 141, at 77-110 (analysis of insider trading effects on market prices); Carlton & Fischel, *supra* note 141, at 868 (insider trading causes price movements that convey information to investors); *cf.* Dooley, *supra* note 16, at 1 (increase in volume of shares traded supports inference of insider trading).

144. *See* H. MANNE, *supra* note 141, at 104-05 (insider trading could convey information that corporate interest would delay); Carlton & Fischel, *supra* note 141, at 868 (public announcement could destroy value to corporation of information that insider trading could convey); *see also* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). In *Texas Gulf Sulphur*, Texas Gulf Sulphur Co. (TGS) discovered valuable mineral deposits in Timmins, Ontario in November of 1963. *Id.* at 843-44. TGS did not acquire mineral rights to the land, however, until April of 1964. *See* H. MANNE, *supra* at 105 (discussion of *Texas Gulf Sulphur*). Disclosure of the discovery would have made the ultimate acquisition of mineral rights much more expensive. *Id.; see* 401 F.2d at 850 n.12 (delay in disclosure served valid business purpose). Insider trading by TGS officials, however, caused a significant increase in the market price of TGS shares well before disclosure occurred in April. *See id.* at 840 n.2 (tabulation of stock purchases by insiders showing increase in share prices). Manne acknowledges, however, that in some instances the allowance of insider trading would result in delay of corporate disclosure. *See* H. MANNE, *supra*, at 104 (insiders need time to exploit value of nonpublic information); *see also* Schotland, *supra* note 141, at 1148 (allowing insider trading would result in improper delay of disclosure).

145. *See* H. MANNE, *supra* note 141, at 131-45 (discussion of inside information as compensation to corporate officers); Carlton & Fischel, *supra* note 141, at 861 (allowing insider trading can be efficient form of compensation). Proponents of the compensation argument in favor of insider trading assert that possession of information is a property right that business firms should assign to the most economically efficient user. *Id.* at 863. Firms must choose to assign this right either to the firm's investors or to the firm's officers. *Id.* Firms generally assign the information rights to managers because firms and society realize a greater economic benefit from managers' use of information than from investors'. *See id.* at 866-72 (managerial rather than shareholder use of inside information provides greater economic benefit).

146. *See infra* notes 147-52 and accompanying text (discussion of developing law in private insider trading actions).

147. *See* Strong v. Repide, 213 U.S. 419 (1909). In *Strong*, the defendant purchased the plaintiff's minority interest in a corporation owning nearly worthless land in the Phillipines while in possession of nonpublic knowledge that the United States government soon would purchase the land. *Id.* at 421-27. The defendant was a director and 75% owner of the corporation and conducted negotiations with the government for the sale of the land. *Id.* at 431-32. The defendant effected the purchase by means of an agent who did not disclose the defendant as principal.

sonal market exchanges, however, the questions of causation and privity become more complex.[148] The general trend has been for courts to relax the common-law standards of causation and privity in order to find an inside trader liable to private plaintiffs who dealt on impersonal exchanges.[149] The Supreme Court, however, has exhibited a tendency to limit the class of private plaintiffs who could qualify for damages from inside traders.[150] The Court has held that the existence of a fiduciary relationship between the inside trader and the corporation's shareholders is an essential prerequisite to liability for insider trading.[151] This restriction on the availability of private actions frustrates the SEC's position that private enforcement is a needed supplemental deterrent to insider trading.[152]

ITSA treble damages would serve the SEC's goal of deterring insider trading.[153] ITSA addresses the insider trading problem from the standpoint of public enforcement against activity that Congress views as harmful to the public interest.[154] In this way, ITSA would provide an efficient enforcement

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Id. at 432. After the government purchased the land, the shares increased tenfold in value. *See id.* at 426. The Supreme Court held that under these facts the defendant incurred a duty to disclose before trading, and the defendant's trading without disclosure was fraud. *Id.* at 434. The *Strong* Court held that the defendant's fraud was the cause of the plaintiff's injury and ordered restitution of the shares. *See id.* at 434-35 (defendant's fraudulent conduct caused plaintiff's injury); *id.* at 422 (restitution order that Supreme Court affirmed). *See generally* H. MANNE, *supra* note 141, at 21-22 (discussion of *Strong v. Repide*).

148. *See* Note, *Uninformed Traders, supra* note 127, at 306-15 (discussion of causation and privity problems); Note, *Impersonal Market Context, supra* note 55, at 98 (causation and privity are difficult to show in market transactions). Causation is absent from impersonal market transactions because each investor would have traded regardless of the presence of any insiders in the market, and privity is absent because no investor knows who owned the same shares bought and sold. *Id.; see* Note, *Uninformed Traders, supra* note 127, at 306. *See generally* Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who Is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217, 1230-40, 1248-1311 (1981) (detailed explanation of how stock market works and difficulty of applying causation and privity standards to stock market transactions).

149. *See, e.g.*, Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 239 (2d Cir. 1974) (plaintiffs need not show privity in 10b-5 actions); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 101 (10th Cir.) (common-law privity does not apply to rule 10b-5 actions), *cert. denied*, 404 U.S. 1004 (1971); Globus v. Law Research Service, Inc., 418 F.2d 1276, 1291 (2d Cir. 1969) (common-law fraud elements not essential to show securities acts violations).

150. *See infra* note 151 and accompanying text. Some commentators have advocated complete abolishment of the private right of action for insider trading. *See* Note, *Uninformed Traders, supra* note 127, at 318 (suggesting elimination of private recovery for market transactions and leaving enforcement to SEC); Note, *Limiting the Plaintiff Class: Rule 10b-5 and the Federal Securities Code*, 72 MICH. L. REV. 1398, 1429 (1974) (private remedies do not further goals behind § 10(b) and rule 10b-5).

151. *See* Dirks v. SEC, 103 S.Ct. 3255, 3261 (1983) (fiduciary relationship necessary to impose disclosure duty); United States v. Chiarella, 445 U.S. 222, 232-33 (1980) (no disclosure duty arises without fiduciary relationship).

152. *See supra* note 15 (SEC supports private actions for added deterrence).

153. *See* SEC Memorandum, *supra* note 16, at 24-25 (multiple damages would pose powerful deterrent to insider trading).

154. *See supra* note 98 and accompanying text (ITSA for benefit of SEC not private plain-

mechanism to the SEC while leaving the dispute over the need for private remedies to the courts.[155] While the Supreme Court has yet to rule on the conflict between the circuits over the propriety of extending private insider trading liability to impersonal market transactions, the Court's inclination away from private enforcement is apparent.[156] Yet, a general perception persists that insider trading is unfair, and current deterrent measures have proven inadequate.[157] ITSA, therefore, properly supplies additional deterrent power to the public enforcement authorities while declining to address the private enforcement issue.

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tiffs); *supra* note 137 and accompanying text (Congress considers insider trading harmful to public's interest in market integrity).

155. *See supra* notes 146-52 and accompanying text (discussion of private actions against inside traders).

156. *See supra* notes 150-51 and accompanying text (discussion of Supreme Court limitations on private actions); *supra* notes 56-78 and accompanying text (*Shapiro* and *Fridrich* decisions illustrate Second and Sixth Circuits' disagreement about extending liability for market transactions).

157. *See* Brunelle, *supra* note 25, at 371 (disgorgement remedy is useless); Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement*, 70 CAL. L. REV. 1, 2 (1982) (insider trading prohibitions founded on strong intuition of unfairness).