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Efficient Market Theory and Rule 10b-5 Nondisclosure Claims: A Proposal for Reconciliation

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I. INTRODUCTION

Economic theory has never been the long suit of either the Securities and Exchange Commission (SEC) or the courts in the administration and interpretation of the federal securities laws. Nor has concern about theoretical consistency in achieving pragmatic results under the various securities statutes. Today, the SEC and the courts are on a collision course in the sea of economic theory. The SEC has begun to embrace, with open arms, the efficient market theory as a basis of its regulatory effort at the same time that the courts—albeit unwittingly—have cast the theory out, unwilling to accept its implications in antifraud cases.

In traditional form, the efficient market theory states that existing stock...
prices fully reflect all available information.\textsuperscript{3} In that form the proposition is less helpful in formulating regulatory policies than is a restatement of the theory in operational terms: if some adequate percentage of stock traders have all relevant information, prevailing market prices will be identical to those that would exist if all traders had the information.\textsuperscript{4} In its restated form, the efficient market theory suggests a notion of "virtual representation"\textsuperscript{5} in the stock markets. If some traders with the same interests as the average investor are given the power to set market prices after considering all relevant data, those prices can be accepted as fair by all similarly situated investors.

The efficient market theory was the explicit foundation on which the SEC based its recently adopted proposals for integration of disclosures mandated by the Securities Act of 1933\textsuperscript{6} and the Securities Exchange Act of 1934: 7

[Integration \ldots is predicated on the fact that information regularly is being furnished to the market, in part, through periodic reports under the Exchange Act. This information is evaluated by professional analysts and other sophisticated users, is available to the financial press and is obtainable by any other person who seeks it for free or at nominal cost. To the extent that the market uses this information, and it is adequately reflected in the price of a registrant's outstanding securities, there seems to be little need to reiterate this information in a prospectus in the context of a distribution. \ldots]

[The proposed registration] form is predicated on the Commission's belief that the market operates efficiently for these [widely followed] companies, \textit{i.e.\ldots}, that the disclosure in Exchange Act reports and other communications by the registrant, such as press releases, has already been disseminated and accounted for by the market place.\textsuperscript{8}

The efficient market theory, however, has a converse side. Withholding of information from those representatives who set fair prices, \textit{i.e.\ldots}, those trading during periods of new information, causes injury to \textit{all} who trade in the market, not just to the participants in the single price-setting trans-

\begin{enumerate}
\item \textsuperscript{4} Cf. J. LORIE & M. HAMILTON, \textit{The Stock Market—Theories and Evidence} 98 (1973).
\item \textsuperscript{6} Ch. 38, 48 Stat. 74 (current version at 15 U.S.C. §§ 77a-bbbb (1976)).
\item \textsuperscript{7} Ch. 404, 48 Stat. 881 (current version at 15 U.S.C. §§ 78a-111 (1976)).
\end{enumerate}
action with the person possessing undisclosed information. Nevertheless, courts have increasingly refused to hold defendants liable for the full losses of all participants in the market caused by the failure to disclose information, arguing that such results would impose "Draconian, exorbitant damages, out of all proportion to the wrong committed."  

The courts, approaching disclosure as a question of morality, have discarded the elements necessary to create market efficiency. Impelled initially by the apparent impossibility of appropriately allocating costs in litigation involving only some of the relevant parties, the concern over unfair damages soon controlled the substantive development of the antifraud provisions. Even where governmental enforcement rather than a private damage action was involved, the United States Supreme Court expressed shock that anyone could think that efficient markets were the purpose of Rule 10b-5's prohibition of nondisclosure of material facts. In Chiarella v. United States, the Court explicitly rejected the court of appeals holding, which was based on market efficiency:

[The Court of Appeals'] decision thus rested solely upon its belief that the federal securities laws have "created a system providing equal access to information necessary for reasoned and intelligent investment decisions." . . . The use by anyone of material information not generally available is fraudulent, this theory suggests, because such information gives certain buyers or sellers an unfair advantage over less informed buyers and sellers.

The Supreme Court found two defects in that reasoning, the more important being that no duty to disclose is owed to persons, even those engaged in price setting transactions, unless some special relationship exists between the person possessing the information and the party on the other side of the transaction.

10. 17 C.F.R. § 240.10b-5 (1982) [hereinafter cited as Rule 10b-5]. 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 to make the statements made, in light of the circumstances under which they were made not misleading,
(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.

12. Id. at 232 (quoting Chiarella v. United States, 588 F.2d 1358, 1365 (2d Cir. 1978)) (citation omitted).
13. Id. at 232-33.
The Supreme Court thus reflected the view stated more explicitly a few years earlier by the United States Court of Appeals for the Sixth Circuit:

We conceive it to be the act of trading which essentially brings the violation of Rule 10b-5, for it is this which brings the illicit benefit to the insider, and it is this conduct which impairs the integrity of the market and which is the target of the rule. If the insider does not trade, he has an absolute right to keep material information secret . . . . Investors must be prepared to accept the risk of trading in an open market without complete or always accurate information.14

II. A REVISIONIST HISTORY OF RULE 10b-5

The notion that open market investors must be prepared to accept the risk that the market does not reflect all available information runs counter to a major line of Rule 10b-5 cases involving open market trading. The following unconventional history of Rule 10b-5 suggests that courts have misapprehended the thrust of the rule for the same reason that the apocryphal blind men blundered in attempting to describe the elephant. Courts looking only at the trunk or the tail—insider trading cases—assumed they were viewing the entire elephant.

If one examines the development of Rule 10b-5 in cases involving publicly traded securities, he soon discovers that the focus of the rule has been upon timely disclosure of corporate information to traders in the open market. In a 1970 release, the SEC emphasized the role of the 1934 Act’s antifraud provisions in supplementing required Exchange Act periodic reports.15 The antifraud provisions require “full and prompt announcements of material facts regarding the company’s financial condition.”16 The necessity for prompt announcement—i.e., before the next periodic report was required to be filed with the SEC—was emphasized. The release mentioned the problem of insider trading almost as an afterthought. That is the point. Insider trading was originally a minor, albeit necessary, appendage to a broader notion designed to create efficient securities markets. This major thrust of Rule 10b-5 has been implemented through the rules of the major stock exchanges mandating immediate release of material corporate information.17

The formative doctrines relating to nondisclosure in open market trans-

16. Id.
actions were developed in the SEC’s *In re Cady Roberts & Co.* decision and
the opinion of the United States Court of Appeals for the Second Circuit
in *SEC v. Texas Gulf Sulphur Co.* It is important to examine carefully the
context in which the crucial statements, soon to harden into fixed formulae,
were made. The two cases were very different factually. *Cady Roberts* involved
no breakdown of the corporate disclosure process. *Texas Gulf Sulphur* did.

In *Cady Roberts*, the board of directors of Curtiss-Wright Corporation
voted a dividend cut on the morning of November 25, 1959, and followed
the prescribed route of authorizing immediate transmission of this news to
the New York Stock Exchange and the Dow Jones News Ticker Service.
The board vote of 11:00 a.m. appeared on the Dow Jones ticker tape by 11:48
a.m. During the minutes between the vote and dissemination of the in-
formation, a director of Curtiss-Wright gave his brokerage firm the dividend
news and the firm sold several thousand shares. Here the insider intervened
to profit during the unavoidable minutes of delay necessary to accomplish
timely corporate disclosure of information. No issue of corporate wrong-
doing was present. The case, a broker-dealer disciplinary action, raised only
the question of what to do about such incidental insider profits when the
basic corporate disclosure obligations were met. The finding that a viola-
tion of Rule 10b-5 occurred reflects the difficult but ancillary matter discussed
below—identifying what profit-taking is “fair” during the period of inform-
ation absorption by the market.

The same issue is presented, perhaps in more graphic form, in a famous
pair of cases involving Douglas Aircraft Company. The company spent
ten days, some of them with outside accountants, studying and refining data
indicating a substantial decline from earlier predictions in the company’s
six-month earnings figures before publicly announcing the decline. The
United States Court of Appeals for the Tenth Circuit held that the corpora-
tion “exercised good faith and due diligence in the ascertainment, the
verification, and the publication” of the earnings data, and thus did not
violate Rule 10b-5. However, tippees of insiders sold substantial amounts
of Douglas stock on the New York Stock Exchange during the brief period

19. 401 F.2d 833 (2d Cir. 1981), cert. denied sub nom. Coates v. SEC, 394 U.S.
20. 40 S.E.C. at 909. One common element in both *Cady Roberts* and *Texas
Gulf Sulphur* was an unexplained delay of some minutes in a telegrapher’s trans-
mision of the news. *Id.* (Western Union); 401 F.2d at 846-47 (Dow Jones ticker
tape). One wonders what employees of the telegraph office might have done with
the information during those crucial minutes. Cf. *Chiarella* v. United States, 445
U.S. 222 (1980) (printer’s employee used information deduced during printing pro-
cess to profit from pending corporate takeovers).
21. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d 228 (2d Cir.
1974); *Financial Industrial Fund v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th
of analysis prior to disclosure. The Second Circuit found that both these tippees and their non-trading tippers had violated the rule by their activities during the period of timely information dissemination and absorption by the market.23

In contrast to the situation involving timely corporate disclosure is the Texas Gulf Sulphur case.24 Here there was substantial intentional delay by the corporate issuer in disclosing information about mineral discoveries. Material information about the discoveries became available to the company by November 12, 1963, yet definitive disclosure was not made until April 16, 1964.25 While insider trading was involved, the non-purchasing corporate issuer failed to disclose relevant, material information for several months. That fact has often been overlooked since the SEC’s initial injunctive action focused only on false statements in a press release issued near the end of the nondisclosure period.

It is the peculiar factual setting of Texas Gulf Sulphur and the opinions reacting to it that initially pointed courts in the wrong direction in applying Rule 10b-5 to impersonal market situations. Texas Gulf Sulphur claimed that until less than three weeks before its full disclosure of the relevant information it had a legitimate business reason, unrelated to transactions in securities, for withholding the information. That reason was the company’s desire to purchase the land surrounding its mineral find at reasonable prices. In that narrow context, the court enunciated the now-famous “disclose-or-abstain” rule.26 This rule, which was directed to the few situations in which the law permits deliberate nondisclosure of relevant facts, has erroneously been expanded by later courts to cover every situation in which material information has not been disclosed.27

It is a mistake to assert that Rule 10b-5 in general permits abstention from insider trading as an alternative to prompt corporate disclosure. That notion has led courts to conclude erroneously that traders have no legitimate right to expect prevailing market prices to reflect available information.28 A distorted view of the disclose-or-abstain mandate has led to the common sense defying conclusion that a person purchasing stock at a price that does not reflect information about a drop in corporate earnings is not injured until an insider or tippee with the information happens to sell in the market.29

23. Shapiro, 495 F.2d at 235-38.
25. Id. at 843, 846, 852.
26. Id. at 848.
The disclose-or-abstain principle was misinterpreted as being the general rule rather than the narrow exception. The true scope of the rule is illustrated by the Second Circuit’s opinion in Heit v. Weitzen, a case deferred by the court until after its decision in Texas Gulf Sulphur. Belock Instrument Corporation, like Texas Gulf Sulphur, intentionally failed to disclose material information. Belock’s sin was its failure to disclose that a substantial amount of its reported income for 1964 came from overcharges on government contracts. Neither the corporate defendant nor its officers and directors who were defendants had sold securities during the period of nondisclosure. They had abstained rather than disclose. Yet this was not even suggested as a defense in the court’s opinion, which found that a valid Rule 10b-5 claim was alleged. Nor should it have been, for correctly understood, the disclose-or-abstain rule applies, in the language of Cady Roberts, only when disclosure “would be improper or unrealistic under the circumstances."

In a typical case, there is nothing improper about promptly disclosing relevant business information. Impropriety exists when premature disclosure would result in economic loss to the corporation and the benefit from nondisclosure is one which the law recognizes as proper.

Usually the withholding of material information in negotiating a contract is not appropriate. Contract law generally assumes that buyer and seller are both fully informed. Where one party has reason to know that the other is uninformed, the uninformed party who is affected materially and adversely will often be permitted to avoid the contract. A notable exception to this is the use of an agent for an undisclosed principal to purchase real estate at a more favorable price than would otherwise be available. The rationale for upholding contracts to purchase land on behalf of undisclosed principals over the objection of third party sellers has not been well articulated by the courts. However, it can best be explained as a method sanctioned in order to prevent the unfair leverage that otherwise could be exercised by the seller of a crucial parcel in a large planned development. Normally, where non-unique property is sought, an unreasonable seller can be bypassed for an alternative supplier. This is not possible when real estate held by only one supplier is involved. There the holdout may extort an unreasonable price from a potential land developer. Use of an undisclosed principal to avoid extortion by the holdout is a rather crude form of self-help. In comparable

30. 402 F.2d 909 (2d Cir. 1968).
31. Id. at 915.
32. 40 S.E.C. at 911.
35. See Restatement (Second) of Agency § 304 comment c, illustration 4 (1958).
37. My thanks to Professor Steven J. Eagle for suggesting this formulation.

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situations, more sophisticated approaches have been developed to assure that a fair price is available to a buyer subject to the leverage of holdouts, e.g., the use of eminent domain when the government wishes to purchase the land and judicial appraisal as to a holdout attempting to prevent a corporate reorganization.

Texas Gulf Sulphur found itself in one of those rare land acquisition situations in which the law condones nondisclosure. Premature disclosure by insiders would have violated their fiduciary duties to the company. In effect, Texas Gulf Sulphur had a business judgment defense to the charge of nondisclosure. Here, but only here, could it be said that stock traders in the open market could not legitimately expect that disclosure would follow rapidly upon corporate discovery of the material information. Only here was it acceptable for insiders to abstain instead of making disclosure.

Thus, Rule 10b-5 cases are of two types. In the first type—that in which corporate issuers promptly disclose relevant information but insiders trade during the inevitable time lag during which disclosure is being made—proper allocation of gains and losses during the period of market transition may lead to imposing liability only on insiders who trade, but not because the efficient market theory has been rejected. In that sense, a disclose-or-abstain rule applies during this brief but crucial transition period as a way of fostering efficient markets.

In the second type of case—that in which corporate disclosure is delayed—abstention is not an acceptable alternative for insiders absent the nearly unique Texas Gulf Sulphur situation. Rather, those insiders who fail to disclose incur liability without attendant trading because they have created a situation in which market prices fail to reflect information that traders legitimately expect has been absorbed by the market and is reflected in open market prices.

This fact is made clear in a group of more recent cases which hold that failure of non-trading defendants to promptly disclose material facts results in Rule 10b-5 liability because the defendants have committed a "fraud on the market," which has caused injury to the plaintiff. This fraud on the

market theory, at bottom, holds that investors have the right to expect markets to efficiently reflect all available information. As explained by Judge Higginbotham in *In re LTV Securities Litigation*:\footnote{88 F.R.D. 134 (N.D. Tex. 1980).}.

[T]he market . . . transmits information to the investor in the processed form of a market price. Thus, the market is performing a substantial part of the evaluation process performed by the investor in a face-to-face transaction. The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price. . . .

Recent economic studies tend to buttress empirically the central assumption of the fraud on the market theory—that the market price reflects all representations concerning the stock. Indeed, economists have now amassed sufficient empirical data to justify a present belief that widely-followed securities of larger corporations are efficiently priced . . .\footnote{Id. at 143-44.}

Many cases enunciating the disclose-or-abstain rule, however, involve trading tippees as defendants.\footnote{E.g., Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d 228, 237-38 (2d Cir. 1974). See generally A. JACOBS, supra note 27, at § 66.02[c].} As will be discussed below, tippees who are not in a position to disclose relevant information may avoid liability by abstaining from trading, even when insiders have delayed corporate disclosure.

### III. THE GAP BETWEEN EFFICIENT MARKET THEORY AND PRACTICE: IS INSIDER TRADING A BRIDGE OR A CHASM?

The perceived relationship of insider trading to efficient capital markets depends on the observer’s theology. One school believes that it is impossible for a corporation to keep the market constantly informed about significant changes in corporate affairs, so efficient market are furthered by insider trading which operates to “channel additional information to the market” less directly.\footnote{Wu, *An Economist Looks at Section 16 of the Securities Exchange Act of 1934*, 68 COLUM. L. REV. 260, 266 (1968).} Apostates, however, suggest that full information dissemination is possible and that insider trading merely impedes dissemination by creating incentives for delay or nondisclosure.\footnote{See Schotland, *Unsafe at Any Price: A Reply to Manne*, Insider Trading and the Stock Market, 53 VA. L. REV. 1425, 1448-49 (1967); Marsh, Book Review, 66 MICH. L. REV. 1317, 1319 (1968).}

Empirical evidence is inconclusive as to the possibility of full information dissemination. The evidence to date strongly suggests that, if achievable,
it has not yet been accomplished. This failure is easily obscured by financial literature which concludes that the "efficient market model stands up well." 46 The efficient market theory was primarily a response to technical analysts who argued that future prices could be predicted on the basis of past price movements. 47 Empirical evidence supports the conclusion that the market does reflect the chartists' historical price data, and even that it reflects other clearly public information. 48 But the evidence is strongly to the contrary regarding undisclosed inside information. It suggests that inside information is exploited over a period of time preceding public announcement, so that for a substantial period the market does not fully reflect such information. 49

This fact may not change the basic conclusion of the portfolio theorists that any particular investor cannot systematically locate underpriced stocks, since few investors have systematic access to inside information relating to more than a few issuers. But the availability of inside information does insure that there will be systematic distortions in investment decisionmaking since at any particular time a number of stock prices will not fully reflect all available information. Investors who assume that the price fully reflects the known risk will be in error.

For a substantial period of time, many assumed that it was the role of securities regulation to minimize the periods during which stock prices did not reflect all available information. 50 Indeed, the debate centered on whether market efficiency could best be achieved by direct information dissemination or indirect dissemination through trading by those possessing the data. More recently, however, the courts, including the Supreme Court, have called into question the entire goal of market efficiency. They have stated that the stock trader has no legitimate right to expect market prices to reflect available information, but only a right to expect that the persons with whom they deal will not have an informational advantage over them. This bizarre conclusion stems not from some newly devised economic notion but from reaction to an inadequate solution to the measure of damages issue. The question of how best to achieve market efficiency has been sidetracked.

46. Fama, supra note 3, at 385.
47. See id. at 388-400.
IV. THE PERSVERSION OF THEORY BY FEAR OF DRACONIAN DAMAGES

Judge Friendly, concurring in *Texas Gulf Sulphur*, called attention to an oft-perceived issue in private damage actions by open market participants—"large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers." This concern later became an important justification for the narrowing of Rule 10b-5.51

A closer examination of Judge Friendly’s statement is called for. His suggestion was that to the extent that damages are assessed against the corporate issuer, the ultimate impact falls on innocent shareholders. But it is hardly clear that *all* shareholders are innocent—in the sense that it is unjust that they respond in damages. Those shareholders, both insiders and others, who acquired their shares at artificially low prices because of the suppression of good news have been unjustly enriched. In *Texas Gulf Sulphur* itself, only some of the shareholders would be unjustly impacted by a judgment against the corporation. On the other hand, where bad news has been withheld, those who have been enriched are those who have ceased being shareholders. A judgment against the corporate issuer there will impact only on innocent investors.

Whenever the market does not immediately reflect available information, some persons are enriched and, to the identical extent, others are injured. We have always assumed that those who are fortuitously enriched by happening to trade during periods of inefficient pricing are entitled to their profits. It might as logically be argued that these "fortuitous investors" have nevertheless been unjustly enriched and that their transactions should be restructured to reflect the results that would have occurred had pricing been efficient.

The courts have never been willing to treat Rule 10b-5 in this way. Instead, they have assumed that if an injury is to be recompensed, it must be from the purses of those who are at fault. Damages against insiders become potentially Draconian only when courts assume both (1) that all those who have been injured should be made whole, and (2) that those who have been fortuitously enriched are entitled to retain their windfalls. The latter assumption may well be, in part, the product of inadequate procedural devices to achieve recovery from the larger group of enriched public investors.53

Much of the substantive interpretation of Rule 10b-5 has reflected concern about damages that are disproportionate to the insiders’ fault. At least two of the Supreme Court’s major creations in Rule 10b-5 jurisprudence can be traced to the fear of excessive damage awards.

51. 401 F.2d at 867 (Friendly, J., concurring).
In *Blue Chip Stamps v. Manor Drug Stores*, the Court concluded that investors who were deceived into purchasing or selling their stock at prices that did not reflect accurate information had standing to sue under Rule 10b-5. But those who were deceived into holding their current investments rather than selling, or those misled into not seizing an attractive opportunity to purchase, lacked standing as Rule 10b-5 plaintiffs.

While the *Blue Chip* majority rather unconvincingly spoke of the potential for extortionate settlements and the difficulty of proving causation, their less specifically articulated concern over exorbitant damages appears to lie more directly behind the decision. The majority said, "In the absence of the . . . [purchaser-seller standing] doctrine, bystanders to the securities marketing process could await developments on the sidelines without risk . . . ." The petitioners' brief before the Court was somewhat more explicit: 'Despite the fact that they were never participants in the market, but sat on the sidelines watching . . . , they will be able to recover for their alleged 'injury.' The amount of the potential 'profits' that could be sought via class actions for non-investors would be astronomical.'

Similarly, the Court's holding in *Ernst & Ernst v. Hochfelder* that scienter is a prerequisite to recovery under Rule 10b-5 can be seen as a conclusion primarily motivated by concern over the extent of damages recoverable from defendants. In *Ernst & Ernst*, the plaintiffs alleged a rather attenuated causal connection between the defendants' negligent audit and the plaintiffs' injury. A more careful audit would, they claimed, have led to the accountants disclosing their brokerage firm client's improper internal procedures. This in turn would have caused the SEC or the Midwest Stock Exchange to launch an investigation. The investigation would have discovered the fraudulent activities of the firm's president and would presumably have put a stop to them.

In traditional tort law, such an attenuated causal chain probably would fail to meet the standard of proximate cause. But the courts in Rule 10b-5 cases have focused on a broader causation-in-fact test. A causation-in-fact test here might have led to exorbitant damages for injuries that were unforeseeable to the defendants. By imposing a scienter requirement, the Court was able to limit damages to those situations in which the defendant

55. Id. at 730.
56. Id. at 747.
59. Id. at 190.
60. The court below, in fact, so held. Hochfelder v. Ernst & Ernst, 503 F.2d 1100, 1107 (7th Cir. 1974), rev'd on other grounds, 425 U.S. 185 (1976).
was substantially certain that his conduct would cause the injury for which he is liable. 63

This view of the holding is suggested by a lengthy footnote in the majority’s opinion. 64 The Court indicated that since "the language and history of § 10(b) [are] dispositive," it need not weigh "additional considerations of ‘policy,’ " 65 Nevertheless, it proceeded to do so:

This case, on its facts, illustrates the extreme reach of the standard urged by respondents. . . . [Plaintiffs] were not foreseeable users of the financial statements prepared by Ernst & Ernst . . . . The class of persons eligible to benefit from such a standard, though small in this case, could be numbered in the thousands in other cases. Acceptance of respondents’ view would extend to new frontiers the “hazards” of rendering expert advice under the Acts, raising serious policy questions not yet addressed by Congress. 66

Had courts more directly confronted the spectre of excessive damages, a more coherent jurisprudence of Rule 10b-5 might have developed. The proper focus might well permit Rule 10b-5 to be used as a tool for obtaining efficient pricing while avoiding unjust damage awards.

V. AN UNSHACKLED JURISPRUDENCE OF RULE 10b-5

Suppose the judiciary, in its wisdom, had never implied a private right of action for damages under Rule 10b-5. Unshackled from the spectre of Draconian monetary awards, how might the rule have developed?

There is no necessary requirement that the securities laws promote a concept of pricing efficiency. Some other concept of economic fairness might be adopted. However, as will be discussed, no alternative concept of fairness appears as a likely substitute. This, though, is for reasons somewhat more complex than those often suggested. A standard explanation of why pricing efficiency should be the goal of securities regulation links efficient prices in secondary trading to the proper allocation of funds among businesses seeking to raise capital in the primary markets. 67 But, as has been cogently pointed out by Professor Berle, 68 and later by Professor Kripke, 69 the secondary markets are primarily concerned with efficient allocation of savings to those investments that will pay maximum returns in light of their risks. Pricing in the secondary markets is at best only indirectly related to capital raising.

63. See RESTATEMENT (SECOND) OF TORTS § 8A (1965).
64. 425 U.S. at 214-16 n.33.
65. Id.
66. Id.
Comparatively little capital raising is done by the sale of stock at the prevailing market price. In the area in which the SEC has historically been most concerned about disclosure—1933 Act prospectuses—the disclosure is generally not for the purpose of price setting by market participants. That has already been done by negotiation between the issuer and the underwriter in the typical fixed-price offering. The investor cannot use the voluminous information required by the 1933 Act to precisely adjust prices. He can use it only to decide whether to accept or reject the public offering price previously set by the underwriters.

In deciding whether Rule 10b-5 should embody concepts of market efficiency, the question is whether it is most fair to allocate the return on savings by a system that adjusts prices to reflect the expected return at any point in time. In one sense, there is some unfairness in the efficient pricing model. Information becomes available over time. A series of real-world events becomes material to a stock’s price only when someone pieces those events together and relates them to the issuer’s affairs. Inchoate information, from which no inferential deductions have been made, is not reflected even in an efficient pricing model. The open market investor who buys or sells at a disadvantageous price one day, or one week, before informed price setters realize the relevance of events to a particular issuer are, in a sense, unfairly treated by unluckily choosing to trade before inchoate data has coalesced into material information.

In short, the efficient market model has a built-in element of chance or luck. In his classic investigation of insider trading, Professor Manne treated as irrelevant to a fair system the fact that certain traders “just missed” a price adjustment. His explanation appeared to be that only long term investors are entitled to be concerned about such fairness issues, and they were rarely caught by that unfairness. A better justification would seem to be that luck is by and large perceived as part of a fair game model. Recently, Daniel Yankelovich made the point in a broader context. Luck is accepted as part of a fair scheme of life because it is ultimately the most democratic of phenomena. Luck may benefit a person without regard to prior wealth, social status, or inherent merit.

Any system that attempts to allocate the benefits of inchoate information to persons who bought or sold during the period before events coalesced

70. In 1981, new plant and equipment expenditures by nonfarm businesses in the United States totaled $321.5 billion. Corporations in the same year raised only $70.6 billion in the securities markets, of which only $26.8 billion was from the sale of stock. The total market value of outstanding shares traded on all registered stock exchanges in 1981 was $490.7 billion, or over 18 times the value of newly issued shares sold in that year. U.S. DEP’T OF COMMERCE, SURVEY OF CURRENT BUSINESS at S-1, S-17, S-18 (1982).


would create severe problems in its application. A more easily administered system is to be preferred, at least so long as the element of luck inherent in it is not strongly objectionable. As suggested, the luck element may, far from being objectionable, have affirmative merits.

Having rejected a super-efficient pricing system, i.e., one that takes account of inchoate information, we are left with the inquiry whether the administrative difficulty of enforcing the classical efficient model is worth the candle. Commentators have suggested that markets will be efficient enough, and at less administrative cost, if price adjustments take place through insider trading until relevant information is fully reflected in the marketplace. Under such a system, outsiders who trade during the period of market adjustment miss the advantage of information known to some. But is this any more unfair than missing a financial gain by trading just before information has coalesced?

In general, permitting price adjustments through trading systematically rewards traders with inside information rather than creating a random system of sharing in the gains. Despite Professor Manne’s contention to the contrary, seldom are these insiders’ rewards ones that are their due. Certainly when insiders sell out on undisclosed bad news that was the result of their own mismanagement, the rewards are undeserved. Even profits from purchasing on good news are seldom allocated properly. Those who can afford to exploit the profits are often not those who were responsible for their being realized. At any rate, stock options often already provide appropriate rewards.

VI. INSIDERS AND OUTSIDERS—ABSTINENCE MAKES THE HEART GROW FONDER

If the goal of the antifraud provisions is viewed as one of insuring dissemination of relevant information to investors, then a reality of the marketplace must be reckoned with. Effective disclosure realistically can be expected from only a few sources. Disclosure of inside information can be expected from the issuer through the efforts of its management. It is unrealistic to expect most tippees, for example, to be in a position to make public disclosure. Even when the tippee is a large institution or a broker-dealer, which could attract financial press coverage to such a disclosure, the tippee often will not have sufficient information to make anything but a partial or conclusory disclosure. Moreover, where a tippee attempts to disclose information that has been intentionally concealed by management, management may respond with a denial. The only effect of tippee disclosure is likely to be the initiation of an investigation by enforcement authorities or the

74. See, e.g., H. MANNE, supra note 72, at 149; Wu, supra note 44, at 266-69.
75. H. MANNE, supra note 72, at 131-58.
When the undisclosed information is market information, the logical source of disclosure is the person intending to engage in the relevant market transaction. Thus a tender offeror is the expected source of information about a proposed offer.

In this light, the disclose-or-abstain concept should have another application. Efficient markets expect corporate management or the producers of market information to disclose and not to suppress the information, regardless of their trading. Thus non-trading insiders may be liable under Rule 10b-5. But tippees who are not in a position to make effective, credible public disclosure should have the option of abstaining from exploiting the information until it is disclosed by the issuer or the appropriate source without incurring liability. It is this notion that should be seen as underlying the Supreme Court’s language in *Chiarella* limiting disclosure obligations to those who have a duty to speak.78

VII. A PROPOSED APPROACH TO LIABILITY FOR NONDISCLOSURE

The above discussion has suggested several guiding principles:

1. Prompt disclosure of material information should be encouraged, regardless of whether insider trading occurs.
2. Disclosure can be expected only from the issuer and its management as to inside information and from a potential or actual market participant as to market information.
3. Distinctions should be made between insider profits that arise from trading during a period of intentional delay of disclosure and those that arise during the short but inevitable period during which prompt disclosure is being made.

These principles suggest that the award of damages in private suits under Rule 10b-5, Section 17(a) of the 1933 Act,79 and other related provisions serves two very different sorts of purposes. Insofar as the defendant is a person who can affect disclosure by the normally expected source, i.e., a member of management as to inside information or a person in control of the generator of market information, damages operate prophylactically to encourage prompt disclosure. The risk of loss in such cases must be sufficiently great so that a potential defendant is unwilling to risk nondisclosure. In such cases, limiting damages to disgorgement of profits is ineffective. At worst, a defendant will be in the same position as if he had insured prompt disclosure, and the chance of avoiding detection altogether is great. Those defendants who have the power to delay disclosure by the expected source should be subjected to the large risk of damages resulting from liability for all losses caused to traders by nondisclosure. However, where such a defendant can carry the burden of showing that the insider, or market participant in the case of market information, in fact disclosed in the most prompt fashion that could

be expected and did nothing to attempt to delay disclosure, it would seem appropriate to limit damages to the insider's profits and to impose no liability on the non-trading insider. In such a case, the insider has not abetted the major wrong at which the antifraud provisions are aimed—delay in disclosure. He should be in the position, to be discussed below, of the trader who can not obtain more rapid or more precise public disclosure than in fact occurred.

Just as an insider who trades without delaying prompt disclosure has not participated in a wrong, so a tippee who is not in a position to affect disclosure has not participated in diminishing market efficiency, whether or not disclosure by the normal source has been prompt. Indeed, in each of these cases, it can be argued that trading by insiders during the period of inevitable delay in compiling and disseminating information, or by tippees who cannot obtain more rapid disclosure, furthers market efficiency. Prices have begun to adjust to the data before it has been, or can be, released. Moreover, assuming a realistic assessment of how promptly dissemination could occur, for at least a portion of the period during which information is being compiled or evaluated, there remains the risk that first appearances will prove inaccurate. During this time, some risk is being assumed by inside and tippee traders. They are in a slightly different position than those trading after investigation proves that the inside information is certain.

Even here it is appropriate to impose some liability. Persons with inside information who did not or could not affect the promptness of disclosure should still be liable up to the amount of their profits. The effect of this measure of damages is to reconstruct market transactions to reflect pricing that would have occurred if efficient markets were unaffected by real world delays in prompt information dissemination. Such damage awards are justified on two related grounds. First, if no risk of liability existed in such transactions, persons who in fact could or did affect disclosure might be tempted to trade in hopes of there being insufficient evidence of their control or actual disclosure delay. Second, this deterrence is accomplished without unfairness to defendants since the hypothetical efficient market model is the pricing system that stock traders should legitimately expect to prevail.

VIII. IN CONCLUSION: ELKIND V. LIGGETT & MYERS, INC.—A MODEL OF CONFUSION

The December 1980 decision of the Second Circuit in Elkind v. Liggett & Myers, Inc. serves as a model to illustrate the working of the above suggestions and to demonstrate the hopeless muddle in which courts find themselves without this analytical framework. Elkind was a case in which corporate management did not promptly disclose earnings declines. On May 3, 1972, Liggett & Myers released first quarter earnings figures that showed approximately a twenty-five percent increase over the same quarter of 1971.

80. 635 F.2d 156 (2d Cir. 1980).
But on May 15, the board of directors learned that April, the first month of the next quarter, showed a ninety percent decline in earnings from those of April 1971. No disclosure was made until July 18, when preliminary six month figures became available.  

This would appear to be a clear case for imposing liability on the company or its management for all losses suffered by persons who purchased between May 15 and July 18. Here the company did not proceed with all due speed to compile and disclose the relevant data but intentionally withheld it from the public for over two months. The Second Circuit, however, found Liggett & Myers liable only because a tip was passed by its chief financial officer to a financial analyst on July 17, one day before the company issued its press release disclosing its six month figures. Liability was found to run only to persons who purchased Liggett & Myers stock between July 17 and the effective dissemination of the earnings data in a Wall Street Journal article on July 19. The Elkind court went even further and held that the tipper's maximum liability to even this narrow class of purchasers was limited to the profits that the tippee realized from its sale of 1800 shares.  

The major thesis of this Article is that Elkind's measure of damages is wrong. Disgorgement would be appropriate if the selling tippee had been the defendant, for the tippee could hardly have been expected to make public disclosure of the relevant data. Indeed, all the tippee-analyst in this case knew was that Liggett & Myers' chief financial officer had responded affirmatively to his question as to whether there was a "good possibility" that second quarter earnings were down. Where, however, the defendant is the corporation, which has primary responsibility for keeping the market informed of material information, all traders who were injured by having their expectations of efficient market pricing undercut should be entitled to recovery.

A simple response exists to the court's concern that the liability here will fall on innocent Liggett & Myers shareholders. The primary wrongdoers were individual corporate officers and directors. Liggett & Myers should seek indemnification from them to cure any stockholder injury.

81. Id. at 158.
82. Id. at 173.
83. Id. at 179.
84. Id. at 161.
85. This would not seem to be barred by the principle enunciated in Globus v. Law Research Serv., 418 F.2d 1276 (2d Cir. 1969), since the "corporation" was innocent of any wrongdoing. It was liable only vicariously for the wrongful acts of its officers and directors, carried out on its behalf.