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A CAUSE OF ACTION FOR OPTION TRADERS AGAINST INSIDER OPTION TRADERS

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A recent Note in this Review argued that a cause of action should be available under rule 10b-5 for traders of options on corporate stock against insider traders of options on the same stock. Surprisingly, the Note ignored the fact that Congress has already approved such an action in section 20(d) of the Insider Trading Sanctions Act of 1984. The Note acknowledged that “section 20(d) . . . ma[de] insider trading or tipping in stock options unlawful to the same extent as trading or tipping in the underlying security,” but the author erroneously concluded that “[t]his provision applies only to SEC enforcement suits.”

The Note’s restrictive interpretation is plainly wrong. Section 20(d) provides:

Wherever communicating, or purchasing or selling a security while in possession of, material nonpublic information would violate, or result in liability to any purchaser or seller of the security under any provision of this chapter, or any rule or regulation thereunder, such conduct in connection with a purchase or sale of a put, call, straddle, option, or privilege with respect to such security or with respect to a group or index of securities including such security, shall also violate and result in comparable liability to any purchaser or seller of that security under such provision, rule, or regulation.5

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4 Note, supra note 2, at 1962 (footnote omitted).

Although the reference to "comparable liability" leaves open important questions concerning the extent of the plaintiff class\(^6\) and the nature of the remedy, the last clause of this provision unambiguously refers to private causes of action.

The clause is ambiguous, however, in its reference to "that security." The phrase could mean either the underlying security (for example, the common stock) or the derivative security (for example, the option).\(^7\) Under the first interpretation, Congress authorized a private cause of action against insider option traders only for plaintiffs who had traded the underlying stock. Under the second interpretation, Congress authorized a private cause of action against insider option traders only for plaintiffs who had traded the equivalent option.\(^8\)

Only the second interpretation makes sense. Congress could not have intended to exclude the person on the other side of the trade from the class of "purchaser[s] or seller[s] of that security" authorized to act as plaintiffs. The legislative history of the Insider Trading Sanctions Act makes clear that the troublesome phrase "that security" refers to the derivative security. In 1984, Senator Alfonse D'Amato was chair of the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs. When the Insider Trading Sanctions Act was introduced on the Senate floor, Senator D'Amato's remarks in support of the bill included the following illustration of the effect of section 20(d):


In its Supreme Court brief, the United States advanced an alternative theory to justify Chiarella's conviction. The brief argued that, by trading, Chiarella, whose direct employer was a financial printer preparing takeover announcements, breached his duty to his indirect employers, the acquiring corporations. *See Chiarella*, 445 U.S. at 235. The Court did not rule on the validity of this "misappropriation theory" because it had not been submitted to the jury. *See id.* at 235–36. *See generally* Wang, *supra*, at 1271–74, 1294–97 (discussing the 10b-5 "misappropriation theory"); *infra* note 13 (discussing the theory's use by private plaintiffs). In *Carpenter v. United States*, 108 S. Ct. 316 (1987), an evenly divided Supreme Court upheld criminal convictions under § 10(b) and rule 10b-5 based on the "misappropriation theory," but the opinion dealt only with the defendants' concurrent mail and wire fraud convictions (which the Court upheld unanimously). The four Justices who voted to reverse the convictions under § 10(b) and rule 10b-5 gave neither their reasons nor their names. *See id.* at 320.

\(^6\) See *infra* notes 12–13.

\(^7\) For a more detailed analysis of this ambiguity in section 20(d), see Wang, *The "Contemporaneous" Traders Who Can Sue an Inside Trader*, 38 Hastings L.J. 1175, 1188–91 (1987).

\(^8\) Apparently, no reported case has interpreted § 20(d) since the Insider Trading Sanctions Act's enactment in August 1984.
For example, if, in a given set of circumstances, a corporate officer would violate the antifraud provisions by purchasing any securities issued by his employer, subjecting himself to liability to selling shareholders, then he would violate the antifraud provisions to the same extent by purchasing options with respect to these securities, and subject himself to comparable liability to selling option holders and other similarly situated persons in the derivative market.\(^9\)

The Senate added section 20(d) to a bill passed by the House.\(^10\) In 1984, Congressman John Dingell was chair of the House Committee on Energy and Commerce. When Congressman Dingell introduced the final version of the Insider Trading Sanctions Act on the floor of the House, he inserted in the \textit{Congressional Record} an explanation of various Senate amendments and included (verbatim) the same example quoted above.\(^11\)

Both the language of section 20(d) and its legislative history indicate that Congress presumed that at least some private stock-trading plaintiffs had an implied cause of action against certain insider traders of publicly traded stock. Although the Supreme Court has never directly addressed this issue,\(^12\) judicial precedent in the Second Cir-


\(^11\) See id. at H7758 (statement of Rep. Dingell); Wang, supra note 7, at 1189-90 (discussing the legislative history of § 20(d)). There was neither a Senate Banking Committee report nor a House-Senate conference report on any of the Senate amendments to the Insider Trading Sanctions Act, including § 20(d). See 130 CONG. REC. H7758 (statement of Rep. Dingell).

\(^12\) The leading Supreme Court insider trading cases involving rule 10b-5 are Chiarella v. United States, 445 U.S. 222 (1980), and Dirks v. SEC, 463 U.S. 646 (1983); neither was a private civil action for damages. As I read \textit{Chiarella}, the Court is suggesting that an implied rule 10b-5 cause of action under the "special relationship" theory exists but that the only private party who can sue an insider trader \textit{on this ground} is the party on the other side of the trade. See Wang, supra note 5, at 1270-71. Identifying the party in privity with a stock market insider trader is not as difficult as many commentators believe. See Wang, supra note 7, at 1179 n.20.

Harvey Pitt's analysis of \textit{Chiarella} is similar. See Pitt, \textit{After the Fall: The Ins and Outs of Rule 10b-5}, in TWELFTH ANNUAL INSTITUTE ON SECURITIES REGULATION 643, 662-63 (A. Fleischer, M. Lipton & R. Mundheim eds. 1980). Although \textit{Chiarella} was a criminal case, the Second Circuit has relied on it to deny standing to a class of private civil plaintiffs. See Moss v. Morgan Stanley, Inc., 719 F.2d 5 (2d Cir. 1983), cert. denied sub nom. Moss v. Newman, 465 U.S. 1025 (1984); see also infra note 13 (discussing Moss).

Nevertheless, many commentators disagree with my conclusion that only the party in contractual privity can bring a private 10b-5 action against the stock market insider trader under the "special relationship" theory. Professor Langevoort, for example, states:

It is possible to read \textit{Chiarella} as saying that only the party in privity has standing to sue. . . . But this is little more than inference drawn from dicta, probably not enough to overcome the legitimate concern expressed in \textit{Shapiro} that a privity requirement in the context of open market insider trading would be foolishly formalistic . . . .

D. LANGEVOORT, INSIDER TRADING HANDBOOK 285-86 (1987); accord Note, Laventhall v. General Dynamics Corporation: \textit{No Recovery for the Plaintiff-Option Holder in a Case of Insider
cuit, the most important circuit in securities litigation, supported Congress' assumption that some stock traders could sue certain stock market insider traders.\(^{13}\) The intent of section 20(d) was to allow

Trading Under Rule 10b-5, 79 NW. U.L. REV. 780, 792 n.72 (1984) ("The Court sought to limit only the defendant class . . . and did not consider, even in passing, what group of investors might comprise the plaintiff class . . . ."). Several courts and commentators have concluded that, despite Chiarella and Dirks, "contemporaneous" traders have a rule 10b-5 cause of action against a stock market insider trader liable under the "special relationship" theory. \(^{5}\) See, e.g., \(^{5}\) In re McDonnell Douglas Corp. Sec. Litig., 587 F. Supp. 625, 630 (E.D. Mo. 1983) (stating that although Dirks reaffirmed the special relationship requirement, "[t]he Supreme Court did not discuss or limit the application of the 'contemporaneous trading' rule"); 5A A. Jacobs, Litigation and Practice Under Rule 10b-5 \& 66.02[a][iii][D] (ed rev. ed. 1987). Ironically, the Second Circuit has applied Chiarella to limit the class of plaintiffs who can sue "misappropriators," but not the class of plaintiffs who can sue an insider trader liable under the "special relationship" theory endorsed in Chiarella. See infra note 13.

I may be wrong in concluding that under Chiarella only the party in contractual privity can sue a stock market insider trader who breaches a rule 10b-5 "special relationship." Even so, the class of plaintiffs allowed to sue such a defendant should include at least the party on the other side of the transaction. Such a plaintiff should have the right to rescind under section 29(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78cc (1982), which renders voidable any contract made in violation of the Act or of any rule promulgated thereunder. See generally Gruenbaum & Steinberg, Section 29(b) of the Securities Exchange Act of 1934: A Viable Remedy Awakened, 48 Geo. Wash. L. REV. 1 (1979).

\(^{13}\) In that Circuit, a stock market insider trader who violates rule 10b-5 under the "special relationship" theory becomes liable to "contemporaneous" traders. See Wilson v. Comtech Telecommunications Corp., 648 F.2d 88, 94-95 (2d Cir. 1981); see also Wang, supra note 5, at 1279-82 (discussing the Wilson case); Wang, supra note 7 (discussing the meaning of "contemporaneous"). Although decided after Chiarella, Wilson does not cite the Supreme Court's opinion. District courts in the First and Eighth Circuits have endorsed Wilson's "contemporaneous" plaintiff class. See, e.g., Abelson v. Strong, 644 F. Supp. 524 (D. Mass. 1986); \(^{5}\) In re McDonnell Douglas Corp. Sec. Litig., 587 F. Supp. 625, 630 (E.D. Mo. 1983) (citing dictum from Laventhal v. General Dynamics Corp., 704 F.2d 407, 412 (8th Cir.), cert. denied, 464 U.S. 846 (1983)). But cf. Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977) (attempting to outline what a private plaintiff suing a stock market insider trader under rule 10b-5 must demonstrate, but failing to explain clearly whether the essential element is privity of contract, causation of harm by the insider's act of trading, either of the above, or both). See generally Wang, supra note 5, at 1262-67, 1284, 1316 (analyzing Fridrich).

The Second Circuit has since held that trading stock on material nonpublic information does not make the defendant trader liable to "marketplace," or even "contemporaneous," traders, if liability under rule 10b-5 is based on the "misappropriation" theory. See Moss, 719 F.2d at 10-13, 15-16. See generally supra note 5. Moss at least limits the scope of Wilson's "contemporaneous trader" holding. One might argue that Moss raises doubts as to Wilson's continued vitality. Moss does not refer to Wilson, however. Therefore, the appropriate interpretation of Moss is that it implicitly limits the Wilson holding to defendants who breach a "special relationship."

analogously situated option-trading plaintiffs an equivalent private cause of action against insider traders of options. In short, the legislative history of section 20(d) clearly demonstrates that Congress enacted the provision to remedy one of the problems discussed in the Note. A private cause of action against insider traders of options is now available to option-trading plaintiffs.