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From *TGS* Conservatorships to Sarbanes-Oxley Fair Funds

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ABSTRACT

While the TGS *duo is justly known for its foundational work on the application of Rule 10b-5 to insider trading and corporate misstatements, two other aspects of the two cases are the focus of this contribution. The first is the development of the role of the SEC as conservator, derived originally from the equity side of federal bankruptcy law, but expanded to function as a general equitable remedy. That remedy faced difficult issues concerning the ranking of different victims of insider trading, in particular the status of an entity as a claimant in competition with victimized market participants. The second, often overlooked, is the two cases' pioneering role in the management of individual and in particular of class actions laid in a number of different jurisdictions, which is an issue that, for the first time, called into play the then-new Judicial Panel on Multidistrict Litigation.*

The first aspect leads in a fairly straight line to the Fair Funds component of the Sarbanes-Oxley Act of 2002 (as amended by the Dodd-Frank Act of 2010), and to the doctrinal development of that component in practice. The second aspect, however, was impacted over the following three decades by the growing judicial and statutory hostility to broadening the role of the private class action generally, and of its Rule 10b-5 segment specifically. Therefore, this article also contributes to the newer discourse about the respective roles of private versus public litigation in the field of securities regulation.

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* Prof. em., School of Law, University of California, Berkeley. In defense of what follows: This contribution does not propound a theory, is not a case study testing a theory, and is not an empirical study (the occasional figure or number is borrowed from others' empirical studies). It is a retrospective narrative of a fifty-year journey. I thank my colleague, Andrew Bradt, for guiding me through the federal-removal potholes that litter this road. Any not avoided herein as well as any errors are solely due to my poor navigational skills.

I. INTRODUCTION

HOW often is a case hailed as a legal landmark before it is even decided? In 1965, a year before the district court decision in *SEC v. Texas Gulf Sulphur Co.*,[1] let alone before the 1968 appellate decision we celebrate in this symposium,[2] major analyses of the SEC's complaint, written by prominent practitioners in the field of securities regulation, were published in leading journals.[3] Once the flurry of decisions was over, a further slew of articles began to appear, and the case immediately became a staple of corporation law casebooks.[4]

The complaint indeed represented a major step forward in the development of public enforcement of the broadly phrased § 10b of the Securities Exchange Act of 1934 ("Exchange Act"), and—following in the train of the decisions—of private litigation under its equally protean Rule 10b-5. It needs to be recalled that it was only in 1961 that the first SEC proceed-

1. *See generally* SEC v. Texas Gulf Sulphur, 258 F. Supp. 262 (S.D.N.Y. 1966), *aff'd in part, rev'd in part*, 401 F.2d 833 (2d Cir. 1968).

2. In fact, two major opinions were decided—the second more relevant to the following discussion. The first opinion is the one usually considered, as it contains the substantive discussion of both insider trading liability and corporate liability for misleading public statements. *See generally* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) [hereinafter TGS I]. The second, principally discussing remedies, is the starting point for the following discussion. *See generally* SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301 (2d Cir. 1971), *cert. denied*, 404 U.S. 1005 (1971) [hereinafter TGS II].

3. *See, e.g.*, Arthur Fleischer, Jr., *Securities Trading and Corporate Information Practices: The Implications of the* Texas Gulf Sulphur *Proceeding*, 51 Va. L. Rev. 1271 (1965); W. McNeil Kennedy & Herbert S. Wander, Texas Gulf Sulphur, *A Most Unusual Case*, 20 Bus. Law. 1057 (1965); William H. Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 Colum. L. Rev. 1361 (1965). Insightful on the complaint's provenance is the Symposium, *Insider Trading in Stocks,* 21 Bus. Law. 1009 (1966), which will be discussed in a bit more detail below.

4. Thanks to the vagaries of publication schedules, Norman D. Lattin, Richard W. Jennings & Richard M. Buxbaum, Corporations Cases and Materials 732 (4th ed. 1968) was the first to contain the original district court opinion. The first casebook to publish the principal appellate opinion we celebrate here was that of William L. Cary, Cases and Materials on Corporations 726 (4th ed. 1969).

ing based on insider trading—*In re Cady Roberts & Co.*[5]—had been decided.[6] Before *TGS* (but more or less contemporaneously with *Cady Roberts*) the only context in which this type of behavior had been sanctioned was in bankruptcy, where it was recognized as a ground for denial of compensation for services.[7] It therefore is no surprise that the decision was understood by contemporaneous observers as an important—and to many a necessary—breakthrough, especially since the common (state) law continued to reject liability for trading on the basis of non-disclosure of material information to "the market," as distinct from face-to-face trading.[8]

The importance of the *Cady, Roberts* move to the decision of the SEC to extend it beyond the financial services sector—i.e., to the *TGS* complaint—was perfectly obvious to the actors at the time. At the earlier-mentioned symposium on *TGS*, William Cary, the just-retired SEC Chairman, quipped that "I have been accused on occasion of having sired *Texas Gulf* out of *Cady Roberts*."[9] Considering the novelty of seeking judicial condemnation of insider trading not on the basis of directly misleading the market, it is indeed fair to see *TGS* as both a clear and an intentional expansion of the role of public enforcement of the transparency of the stock markets. Finally, the SEC itself more or less officially has recognized the two cases as the origin of the modern era.[10]

And with that introduction, it is time to turn to the case itself.

5. 40 S.E.C. 907 (1961).

6. Of course, actions against brokers and dealers for actively misleading or concealing material information from clients while trading with them, usually leading to cancelling their registration, had been based *inter alia* on Rule 10b-5 almost from its 1942 promulgation. A typical example is Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944), and its sequel, 174 F.2d 969, 976–77 (2d Cir. 1949). But while *Cady Roberts*, too, involved only cancellation of the tipper's broker-dealer registration, it was the first case involving non-disclosure in the anonymous context of a stock exchange as compared with the direct trading with customers that was the hallmark of these earlier cases. 40 S.E.C. at 907.

7. *See* Wolf v. Weinstein, 372 U.S. 633, 653–54 (1963). In addition, shortly before *TGS* arrived on the scene, the Supreme Court upheld the authority of the SEC to compel a registered investment adviser to disclose to clients its practice of "scalping"—purchasing securities for its own account, recommending their purchase to its clients, and then selling the securities once the market price rose (even if the rise was not causally traceable to either the firm's or the clients' purchases). *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 196–97 (1963). The charge was violation of § 17 of the Investment Advisers Act of 1940, which reads essentially as does § 10b. *Id.* at 189.

8. The classic case being Goodwin v. Agassiz, 186 N.E. 659, 661 (Mass. 1933). The hoary variant known as the "special facts doctrine" after Strong v. Repide, 213 U.S. 419, 431 (1909), while useful in the face-to-face situation, continues to this day to falter at the door of the impersonal-market one. *See* Lawrence A. Hamermesh, *Calling Off the* Lynch *Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087, 1103–04 (1996).

9. Symposium, *supra* note 3, at 1009.

10. *See* OFFICE OF THE INSPECTOR GENERAL, U.S. SEC. & EXCH. COMM'N, REPORT NO. 531, IMPROVEMENTS NEEDED IN THE DIVISION OF ENFORCEMENT'S OVERSIGHT OF FUND ADMINISTRATORS 2 (2015).

II. THE CHARGES IN *TEXAS GULF SULPHUR*[11]

TGS I is a foundational case in two senses. It represented not only a forward step in the just-described sense, but also decided a broad range of issues necessarily arising from that breakthrough. The headnotes placed on its coverage by the major databases alone make that point. Within its pioneering analysis of the basic issues of fraud and manipulation (as both the statute and Rule use the phrase), it formulated the "disclose or abstain" principle and fully discussed mode, time, and manner of appropriate disclosure. It described the types of "non-public market information" to be disclosed in the context of its parallel concern with the public-market participants as the addressees for whom disclosure would matter.[12] Perhaps most memorably in that connection, it developed the "magnitude discounted by probability" formulation of the materiality requirement of the legislative text. This is a concept underlying most of the subsequent jurisprudence, and though later refined for the purpose of its role in the "proxy fraud" Rule 14a-9 context, it is essentially compatible with that reformulation.[13]

The opinion tackled and articulated the application of the classic equation of recklessness with intent, and brought this centuries-old common law doctrine into the world of capital markets. It developed the embryonic *Cady, Roberts* formulation of the tipper and tippee into a full-blown doctrine, even if it is one that took decades of further refinement to lock into place. It paved the way for consideration of the role of stock options within the insider-trading framework, even to the point of their backdating, thus giving guidance to state courts treating that issue as a matter of fiduciary duty more generally. As an aside, and a first acknowledgement of the subject of this presentation, it used the stock-option context to begin its consideration of remedies—both in the already established sense

11. *See generally* TGS I, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

12. *See id.* (anticipating Basic, Inc. v. Levinson, 485 U.S. 224 (1988)).

13. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 450 (1976), reformulated the standard of materiality differently—"[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote". *Basic*, 485 U.S. at 231, purports to find in this "a standard of materiality under [all] *the securities laws*" (emphasis added) across the board. However, I submit that to the degree *TSC* differs from the *TGS I* formulation, it does so in the same sense *TSC Industries*' obiter dicta did when suggesting that a lower standard than recklessness might suffice for a Rule 14a-9 violation; namely, in the safeguards specific to honoring the importance of an unsullied shareholder vote. *See TSC Indus.*, 426 U.S. at 444. That, after all, was one of the messages of Mills v. Elec. Auto-Lite Co., 396 U.S. 375, 381 (1970): "The decision below, by permitting all liability to be foreclosed on the basis of a finding that the merger was fair, would allow the stockholders to be bypassed. . . . A judicial appraisal of the merger's merits could be substituted for the actual and informed vote of the stockholders." *See also* Gould v. American-Hawaiian S.S. Co., 535 F.2d 761, 770 (3d Cir. 1976), which speaks directly to the question of whether negligence would suffice for a violation of Rule 14a-9, a dictum generally followed in later cases. *Id.* at 777. "Materiality" in the § 10b sense is even less relevant in the Rule 14a-9 context of the election of directors, and their record of past behavior is at issue in terms of its disclosure. *See, e.g.*, Maldonado v. Flynn, 597 F.2d 789 (2d Cir. 1979). *But see, e.g.*, Gaines v. Haughton, 645 F.2d 761 (9th Cir. 1981).

of the permanent injunction, and in the still only nascent sense of restitution and rescission.

Finally, the opinion takes on the two important institutional issues: the duties and liabilities of the corporation in the field of public statements, and the functions and powers of the SEC (e.g., its authority to require correction of prior statements and even of rumors affecting public markets even if not emanating from the entity itself).

In short, *TGS I* and *II* qualify as one of a rare set of opinions that need—let alone deserve—this half-century retrospective. They remain foundational to this day.

III. THE ORIGINS OF THE CONSERVATORSHIP AS A REMEDIAL DEVICE

The path first leads not forward, but back: to the recognition that labeling the federal courts as courts of equity (as well as of law) had consequences. For present purposes it suffices to take the story back to judicial engagement with issues of bankruptcy and reorganization—specifically to Justice Douglas and his sweeping pronunciamento in *Pepper v. Litton*:

> Courts of bankruptcy . . . are invested 'with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in bankruptcy proceedings.' Consequently this Court has held that for many purposes 'courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity'. . . . [A] bankruptcy court is a court of equity at least in the sense that in the exercise of the jurisdiction conferred upon it by the act, it applies the principles and rules of equity jurisprudence.[14]

From that acorn has grown an entire jurisprudence, extending into neighboring fields such as the one at issue here—the field of securities regulation. As the following excerpt from *Pepper v. Litton* suggests, this extension in a sense was foreshadowed from the start:

> That equitable power also exists in passing on claims presented by an officer, director, or stockholder in the bankruptcy proceedings of his corporation. . . . A director is a fiduciary. So is a dominant or controlling stockholder or group of stockholders. Their powers are powers in trust. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside. While

14. *See* 308 U.S. 295, 303–04 (1939). To the same effect, at the same time and by the same Justice, *see* Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 114–15 (1939). The first case applying these bedrock principles in the securities field was a near contemporary: Deckert v. Indep. Shares Corp., 311 U.S. 282, 288 (1940) (Murphy, J.), a 1933 Securities Act case.

> normally that fiduciary obligation is enforceable directly by the corporation, or through a stockholder's derivative action, it is, in the event of bankruptcy of the corporation, enforceable by the trustee. For that standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation-creditors as well as stockholders.[15]

While the issue in the case of insider trading (and of corporate misstatements or omissions of material information) rests on the question of disclosure—of transparency—and not on abusive exercise of an insider's power of decision-making within the corporation, the fact that courts have had to struggle with this distinction suggests the institutional affinity of the two contexts of bankruptcy and of securities regulation, and thus the ease of bringing the equity features of bankruptcy administration to the latter field.

Even within the field of securities regulation, *TGS II* also had predecessors, though none with the precedential value of the case itself. Furthermore, its predecessors' principal use of equitable remedies was in the realm of injunctions to prohibit individuals and legal persons from future violations of relevant regulations, principally violations of the prohibition on insider trading.[16] This is not surprising, since until *Cady, Roberts* the recovery of profits was not the aim or hallmark of regulatory actions launched by the SEC. It was clear at the time, therefore, that *TGS II* was sailing into uncharted waters, and the opinion spends considerable time establishing the precedents the court claimed in justification of its holding:

> Appellants contend that, although the district court is given general equity powers under § 27 of the Act, the SEC does not have authority under the Act to seek anything but injunctive relief under § 21(e), together with whatever ancillary relief is necessary to enforce an injunction, such as the appointment of a receiver. . . . However, despite some legislative history purportedly to the contrary, we do not read § 21(e) as restricting the remedies which the SEC can pursue to injunctive relief.[17]

The court begins by tracing the history of receivership as "ancillary relief" in cases arising out of fraudulent or similar behavior of the affected entity's principals under a variety of market-regulatory statutes.[18] Appointment of a receiver as an ancillary remedy was a common feature in

15. *Pepper*, 308 U.S. at 306–07.

16. *See* generally George W. Dent, Jr., *Ancillary Relief in Federal Securities Law: A Study in Federal Remedies*, 67 MINNESOTA L. REV. 865 (1983). The authority of the SEC to order, and obtain judicial confirmation of, exclusion of financial-sector participants from their profession was and remains based on explicit statutory provisions and is not a part of this narrative.

17. TGS II, 446 F.2d 1301 (2d Cir. 1971), *cert. denied*, 404 U.S. 1005 (1971). The principal criticism of its reliance on the general equitable powers of the federal courts was levied shortly thereafter. *See* James R. Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 HARV. L. REV. 1779, 1800 (1976).

18. *TGS II*, 446 F.2d at 1307–08.

the "near-insolvency" subset of these situations; apparently it was introduced to the investor-protection field through cases involving the Investment Company Act of 1940.[19] These, however, typically involved entities for which bankruptcy proceedings would have been a valid, and indeed, required alternative had they been instituted.[20] In other words, the analogy was a forced one, considering that Texas Gulf Sulphur was hardly in financial straits.

Not resting on this questionable precedent, *TGS II* reached further, stating: "Moreover, in other contexts the Supreme Court has upheld the power of the Government without specific statutory authority to seek restitution, and has upheld the lower courts in granting restitution, as an ancillary remedy in the exercise of the courts' general equity powers to afford complete relief."[21]

While the cases cited for this proposition concern unfair labor practices and price-ceiling violations, one of them indeed is a sufficient source for its application. The price-control statute at issue in *Porter v. Warner Holding Co*. specified that in the event of a violation, "a permanent or temporary injunction, restraining order, or other order shall be granted . . . ."[22] Over a dissent based on the *exclusio alterius* canon of construction, the Court confirmed the bedrock principle:

> Unless otherwise provided by statute, all the inherent equitable powers of the District Court are available for the proper and complete exercise of that jurisdiction. And since the public interest is involved in a proceeding of this nature, those equitable powers assume an even broader and more flexible character than when only a private controversy is at stake.[23]

Given this background, the Court's reliance on § 27 of the 1934 Ex-

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19. *See* SEC v. Fiscal Fund, Inc., 48 F. Supp. 712, 714 (D. Del. 1943).

20. For a good treatment of this situation, including reference to the subject-matter jurisdictional limitations of the federal court, see Esbitt v. Dutch-American Mercantile Corp., 335 F.2d 141, 142 (2d Cir. 1964):

> All the parties are residents of New York, and since there is no diversity, the District Court had jurisdiction to entertain the receiver's suit only if it was ancillary to the SEC action. The defendant contends that a suit to collect a simple debt cannot be properly termed 'ancillary' to the SEC action. We cannot agree. If the receiver's suit is to aid in the accomplishment of the ends sought and directed in the SEC action, it is ancillary to the main action for jurisdictional purposes. . . . [I]t seems reasonably clear . . . that one of the aims of the SEC suit was to protect investors who had already been defrauded by the practices of the First Discount Corporation. If the assets of the First Discount Corporation are not promptly marshalled to provide a fund from which defrauded investors may be at least partially reimbursed, there is a strong possibility that these assets will be dissipated or wasted. A primary purpose of appointing a receiver is to conserve the existing estate.

21. *TGS II*, 446 F.2d at 1307.

22. 328 U.S. 395, 397 (1946).

23. *Id.* at 398. The dissent contended that the specifics of the statutory scheme indeed did exclude the restitution of illegal overcharges by necessary inference. *Id.* at 404 (Rutledge, J., dissenting).

change Act was fully supportable.[24] While the citation to its use in the *Mills* case[25] is not entirely apposite (there, it justified the grant of attorney's fees in a proxy-violation situation),[26] extending that section's reach to restitution of the insider-traders' profits was a small step:

> There is little doubt that § 27 of the Act confers general equity power upon the district courts . . . . While Mills was dealing with relief to private litigants, we deem the above statement to be fully applicable in enforcement actions by the SEC. Thus we hold that the SEC may seek other than injunctive relief in order to effectuate the purposes of the Act, so long as such relief is remedial relief and is not a penalty assessment.[27]

As to the argument that the required restitution was a penalty assessment, *TGS II* took a position essentially uncontested at the time, though one in another context questionable now:

> This contention overlooks the realities of the situation. In our prior opinion we found that these appellants had violated the Act by their purchases of TGS stock before there had been a public disclosure of the ore discovery. Restitution of the profits on these transactions merely deprives the appellants of the gains of their wrongful conduct. Nor does restitution impose a hardship in this case. . . . The court's order requires only restitution of the profits made by the violators prior to general knowledge of the ore strike on April 17, 1964, and, in effect, leaves the appellants all the profits accrued after that date. It would severely defeat the purposes of the Act if a violator of Rule 10b-5 were allowed to retain the profits from his violation.[28]

Nonetheless, *TGS II* did introduce a new element into this jurisprudential sequence, one bearing directly on the move to the Sarbanes–Oxley (SOX) Fair-Funds regime; namely, the need for the administration of a structured distribution scheme of the conservator's fund to eligible participants. While this of course is a standard feature of the receivership analogy already discussed, not to mention of the bankruptcy or reorganization alternative, it was a new feature in this conservatorship context and needed fleshing out. That discussion follows, after one preliminary digression.

The use of the implied-tort principle to generate a private cause of action from a regulatory statute, obviously both an assumption and a cause of the inevitable complications *TGS II* would generate, need not be rehearsed here. Suffice it to point out that this principle was first applied to § 10b and Rule 10b-5 in what rightly is considered the seminal case of

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24. Compare the roughly contemporaneous critique of the entire equitable-remedies scheme in Farrand, *supra* note 17, at 1780–84.

25. *See generally* Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970).

26. *Id.* at 388–89. "[W]e cannot fairly infer from the Securities Exchange Act of 1934 a purpose to circumscribe the courts' power to grant appropriate remedies." *Id.* at 391.

27. TGS II, 446 F.2d 1301, 1307–08 (2d Cir. 1971), *cert. denied*, 404 U.S. 1005 (1971).

28. *Id.* at 1308. The qualification now needed concerns the nature of the civil penalty for purposes of prescription and is discussed in Kokesh v. SEC, 137 S. Ct. 1635, 1643–44 (2017).

Kardon v. National Gypsum Co.[29] It survived the Burger Court's counter-revolution, though not without distinctly different levels of embrace—reluctantly in *Blue Chip Stamps v. Manor Drug Stores*,[30] and *Ernst & Ernst v. Hochfelder*,[31] more enthusiastically in *Herman & MacLean v. Huddleston*.[32]

That principle indeed is the bedrock on which the balance of this presentation is based; and at the same time the theme that ties together *TGS II* and the SOX's Fair Funds provisions. The first matter to be discussed in that connection is the structure of that conservatorship itself; the second, the complex interplay between that regime and the earlier- (or later) filed private actions by essentially the same category of victimized investors, who by and large had standing to proceed against the insiders.

A. The Relationship Between the *TGS* Distribution Scheme and Direct Individual or Class Actions by Eligible Shareholders

As already mentioned, some private actions had been filed before even the first *TGS* decision was issued, and more followed. The second decision recognized both the existence and possible ranking of private actions, albeit at first only in the context of the harm to, and possible recovery by, Texas Gulf Sulphur itself on the *Diamond v. Oreamuno*[33] rationale:

> [A] corporate enterprise may well suffer harm 'when officers and directors abuse their position to obtain personal profits' since 'the effect may be to cast a cloud on the corporation's name, injure stockholder relations and undermine public regard for the corporation's securities.' *Although the sellers of TGS stock who sold before April 17, 1964, may have a higher equity than TGS to recover from appellants the wrongful profits appellants obtained, this fact does not preclude conditional compensation to TGS.* Nor, as the appellants appear to imply, is the district court precluded from applying a state

29. *See* 69 F. Supp. 512, 513 (E.D. Pa. 1946). Without explicit citation thereto, the opinion clearly reflects the seminal argument of Ezra Ripley Thayer, *Public Wrong and Private Action*, 27 Harv. L. Rev. 317 (1914).

30. *See* 421 U.S. 723, 729–30 (1975) (Rehnquist, J.):

> Section 10(b) of the 1934 Act does not by its terms provide an express civil remedy for its violation. Nor does the history of this provision provide any indication that Congress considered the problem of private suits under it at the time of its passage. . . . Similarly there is no indication that the Commission in adopting Rule 10b-5 considered the question of private civil remedies under this provision.

31. *See* 425 U.S. 185, 196 (1976) (Powell, J.) (expressing similar reluctance).

32. *See* 459 U.S. 375, 386–87 (1983) (Marshall, J.); *see also Blue Chip Stamps*, 421 U.S. at 730 (internal citations omitted) ("This Court had no occasion to deal with the subject until 25 years later, and at that time we confirmed with virtually no discussion the overwhelming consensus of the District Courts and Courts of Appeals that such a cause of action did exist. Such a conclusion was, of course, entirely consistent with the Court's recognition in [J. I. Case Co. v. Borak, 377 U.S. 426, 432 (1964)], that private enforcement of Commission rules may '(provide) a necessary supplement to Commission action.'").

33. *See* 248 N.E.2d 910, 914 (N.Y. 1969).

concept of harm to the corporation."[34]

This holding, however, did not address the more complex issues of the right of direct actions once the conservatorship fund had been established, and assuming that right of the ranking of what then would become two sets of claims to that fund.

The first practical intimation of these issues, and of their appropriate resolution, had in fact already appeared in the district court's opinion that, on appeal, led to *TGS II*:

> The Coates settlement included the following provision: '. . . except that if Coates or his estate shall incur liability to any person or entity by reason of his purchases of Texas Gulf stock on April 16, 1964, . . . as a result of a judgment in or settlement of any other action *commenced prior to the date hereof*, Texas Gulf will, at the request of Coates or his estate, apply any or all of the remaining balance of said amount toward the satisfaction of such liability.'[35]

Since Texas Gulf Sulphur itself was a defendant in these cases, its obligation to turn over "excess" funds to directly impacted former shareholders (for these were the victims of the non-disclosure of material information who, by selling into a distorted low-price market, had *Blue Chip* standing) was close to self-evident, despite its own *Diamond v. Oreamuno* standing.

A separate preliminary issue concerns the legal characterization of the claims against the insider-traders. It is best formulated in the admittedly unusual situation present in *Haines v. St. Paul Fire & Marine Insurance Co*.[36] Plaintiffs (attorneys for a party subject to an SEC enforcement proceeding) sought judgment against their insurer on a professional liability policy for the costs of their own defense against these proceedings. They argued that the SEC was seeking either return of their fees ancillary to the principal injunctive relief it sought, or to hold them as aiders and abettors of their clients—a tort judgment. The court denied their effort to bring the insurer to their defense under the policy in terms directly relevant to the following discussion:

> Plaintiffs' argument fails to recognize the nature and purpose of the ancillary relief available under *Texas Gulf Sulphur*. . . . Disgorgement is available in a securities action only if one has made a profit. It is not equivalent to a tort damage award because the monetary award is measured not by the damage to plaintiff, but by the gain of the defendant. Disgorgement is limited only to those who profit by their by their wrongdoing and does not extend beyond that. . . . [I]f plaintiffs neither participated in nor profited from the offering, the remedy would be unavailable. . . . To find that plaintiffs could be liable for the profits of others, the court would have to ignore [the]

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34. TGS II, 446 F.2d 1301, 1308 (2d Cir. 1971), *cert. denied*, 404 U.S. 1005 (1971) (emphasis added).

35. SEC v. Texas Gulf Sulphur Co., 312 F. Supp. 77, 93 n.23 (S.D.N.Y. 1970) (emphasis added).

36. 428 F. Supp. 435 (D. Md. 1977).

rationale underlying the disgorgement remedy.[37]

B. The Substantive Law After *TGS I* and *II*—Phase One

The private action against both insider traders and corporations for misleading statements or omissions developed in three successive stages before reaching SOX. The first stage is best illustrated by the conflicting outcomes in the two marquee cases, *Shapiro v. Merrill Lynch, Pierce, Fenner and Smith, Inc.*,[38] and *Fridrich v. Bradford*,[39] decided in 1973 and 1976, respectively. Both cases involved corporate insiders tipping off clients about a material financial development; the clients then engaged in stock-market trading, selling in the first case and buying in the second, without any public disclosure of the respective material events. Class action status was not critical in *Shapiro*, but became critical in *Fridrich*.

Common to both, and the focus of this part of the discussion, was the still-open question of the fourth of the "five fingers of fraud," the element of causation.[40] In *Shapiro*, its relevance for anonymous-market trading that occurs without the face-to-face relation that establishes privity between the parties was denied:

> We consistently have held that causation is a necessary element of a private action for damages under Rule 10b-5. Indeed, we have refused 'to facilitate outsiders' proof of insiders' fraud' by 'reading out of (Rule 10b-5) so basic an element of tort law as the principle of causation in fact.' This is consistent with 'the basic concept that causation must be proved else defendants could be held liable to all the world.' And we have recognized that the aim of Rule 10b-5 'is to qualify, as between insiders and outsiders, the doctrine of caveat emptor—not to establish a scheme of investors' insurance.'
>
> As one branch of their absence of causation argument, defendants contend that there was no privity between themselves and plaintiffs. We hold here, as we have held before, that privity between plaintiffs and defendants is not a requisite element of a Rule 10b-5 cause of

37. *Id.* at 441–42. But the rise in value of property wrongfully purchased (face-to-face) may be part of the disgorgement remedy. *See* Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir. 1965), *cert. denied*, 382 U.S. 879 (1965) ("If the property is not bought from, but sold to the fraudulent party, future accretions not foreseeable at the time of the transfer even on the true facts, and hence speculative, are subject to another factor, viz., that they accrued to the fraudulent party. It may, as in the case at bar, be entirely speculative whether, had plaintiffs not sold, the series of fortunate occurrences would have happened in the same way, and to their same profit. However, there can be no speculation but that the defendant actually made the profit and, once it is found that he acquired the property by fraud, that the profit was the proximate consequence of the fraud, whether foreseeable or not. It is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them.").

38. 495 F.2d 228 (2d Cir. 1974).

39. 542 F.2d 307 (6th Cir. 1976). I borrow some of the following text from Richard W. Jennings & Richard M. Buxbaum, Corporations Cases and Materials 605–11 (5th ed. 1979).

40. *See* Amgen, Inc. v. Conn. Ret. Plans & Tr. Funds, 568 U.S. 455, 460–61 (2013) (reciting these elements).

> action for damages. For example, we have upheld Rule 10b-5 claims for relief where there have been no direct transactions between plaintiffs and defendants. . . . '[P]erhaps the first step is to realize that the common law requirement of privity has all but vanished from 10b-5 proceedings while the distinguishable 'connection' element is retained.' And we [have] recognized that 'before there may be a violation of the securities acts there need not be present all of the same elements essential to a common law fraud . . . .' In short, causation as an element of a Rule 10b-5 cause of action can be established notwithstanding lack of privity.[41]

Since the plaintiffs' request for class certification was not resolved, the decision did not deal directly with the consequence of this ruling on the quantum of damages. A brief *dictum*, however, signaled that this issue needed prudential consideration: "[W]e do not foreclose the possibility that an analysis by the district court of the nature and character of the Rule 10b-5 violations committed may require limiting the extent of liability imposed on either class of defendants."[42]

That issue was central to *Fridrich*, and at least inferentially explains its ruling concerning the causation requirement. Pursuant to a consent decree between the SEC and defendant, Fridrichs' tippee profits had been disgorged and escrowed along with the illicit profits of other principal defendants for eventual distribution to *Blue Chip*-eligible selling shareholders. One class eligible for participation in the eventual distribution instead sued for the difference between the false and later-corrected price. It recovered a judgment amounting to thirty times Fridrichs' profit. In a subtle and understandable effort to avoid such an outcome, given the disgorgement-of-profits framework, the court took the indirect route of revisiting the issue of causation in the non-privity context:

> The duty to disclose . . . is not an absolute one, but an alternative one, that of either disclosing or abstaining from trading. We conceive it to be the act of trading which essentially constitutes 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 [citing *TGS I*]. Investors must be prepared to accept the risk of trading in an open market without complete or always accurate information. Defendants' trading did not alter plaintiffs' expectations when they sold their stock, and in no way influenced plaintiffs' trading decision. . . . We hold, therefore, the defendants' act of trading with third persons was not causally connected with any claimed loss by plaintiffs who traded on the impersonal market and who were otherwise unaffected by the wrongful acts of the insider.[43]

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41. *Shapiro*, 495 F.2d at 238–39 (internal citations omitted).
42. *Id.* at 242.
43. *Id.* at 318–19.

It acknowledged its disagreement with *Shapiro*, though in part by setting up something of a strawman. The *Shapiro* court had rested a minor part of its opinion on a reading of the sixth finger of the elements of fraud; namely, the proof-of-damages ruling in the Supreme Court's *Affiliated Ute Citizens of Utah v. United States* opinion:[44]

> In our view, the correct measure of damages . . . is the difference between the fair value of all that the mixed-blood seller received and the fair value of what he would have received had there been no fraudulent conduct, . . . except for the situation where the defendant received more than the seller's actual loss. In the latter case damages are the amount of the defendant's profit.[45]

An influential revisit of this vexing problem arrived four years later with *Elkind v. Liggett & Myers, Inc.*, another tippee case, articulating the reasons why, on balance, the *Fridrich* disgorgement approach was the only appropriate one.[46] With this largely doctrinal conflict between these leading cases on the books, there matters rested until the beginning of the next phase of this march towards SOX.

C. The Substantive Law After *TGS I* and *II*—Phase Two

In 1988, Congress enacted the Insider Trading and Securities Fraud Enforcement Act (ITSFEA).[47] As a first case analyzing the statute described it:

> [The act] undercut the principal assumption of *Fridrich*—that traditional common law principles of privity and causation are the basis of securities fraud litigation. By enacting ITSFEA, Congress expanded the scope of remedies available to plaintiffs alleging injury from insider trading violations, and created statutory causes of actions as alternatives to common law causation and privity.[48]

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44. 406 U.S. 128 (1972). There, albeit in a face-to-face non-market context, the intentional omission of material facts led plaintiffs to sell their securities to purchasers who knew of and stood to gain substantial profits due to a *TGS*-like major shale oil strike.

45. *Id.* at 155 (citing the "increase in value" definition of disgorgement used in Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir. 1965)).

46. *See* Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 172–73 (2d Cir. 1980).

47. Pub. L. No. 100-704, 102 Stat. 4677 (1988), codified as § 20A of the Exchange Act, 15 U.S.C. § 78t-1(a) (2012) (allowing the private action to be brought by "any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased . . . or sold . . . securities of the same class.").

Despite the liberalization implicit in the statute, the "contemporaneous trading" standing requirement over time has been read narrowly, on balance more narrowly than before. *See generally* William K. S. Wang, *The "Contemporaneous" Traders Who Can Sue an Inside Trader*, 38 Hastings L.J. 1175 (1987) (describing the first half-decade of this judicial development).

48. *In re* Nord Res. Corp. Sec. Litig., Nos. C-3-90-380, C-3-90-391, C-3-90-409, C-3-90-410, 1992 WL 1258516, at *4 (S.D. Ohio Dec. 16, 1992):

> ITSFEA . . . created statutory causes of actions as alternatives to common law causation and privity. The fact that Congress also expressly included a then uncertain theory of insider trading liability, misappropriation, in the ambit of Rule 10b–5 violations, further indicates its desire to expand remedies for insider trading. Finally, legislative history cited approvingly decisions from the Second Circuit, collectively in tension with *Fridrich*, and one of

The basis for this reading is the clause allowing the private action to be brought by "any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased . . . or sold . . . securities of the same class."[49]

During this period, not coincidentally during the Carter Administration, another statute was enacted that foreshadowed SOX in the context of expanding the scope of administrative action. The Securities Enforcement Remedies and Penny Stock Reform Act of 1990, which despite the latter part of its name applies to all reporting companies, gave the SEC specific authorization to seek civil money penalties for violations of the Securities Act of 1933 and the Exchange Act of 1934, as well as of the Investment Company and Investors Advisers Acts of 1940.[50] The principal debate voiced criticism of the possibility of punishing merely negligent transgressions—focusing in particular on failures to issue the periodic reports required of the smaller but publicly held companies.[51] A more indirect but, in the context of this article's context, relevant criticism concerned the measure of the civil penalty in cases of serious transgressions, but (unlike insider trading) lacking a metric with which to quantify the penalty, leading to a budgetary resource problem.[52]

> which [*Shapiro*] expressly rejects its rationale. Reliance on *Fridrich* would be inconsistent with the will of Congress as expressed in ITSFEA . . . Accordingly, the ruling in *Fridrich* no longer defines the causation necessary to state a claim for insider trading.

Id. (internal citations omitted). The statute's bite, especially as to its liberal disgorgement definitions, has continued well into the SOX era. *See* SEC v. Svoboda, 409 F. Supp. 2d 331, 344 (E.D.N.Y. 2006). For a detailed factual application, *see* SEC v. Nadel, No. CV 11-0215, 2016 WL 639063, at *11–18 (E.D.N.Y. Feb. 11, 2016).

49. 15 U.S.C. § 78t-1(a). In United States v. O'Hagan, 521 U.S. 642, 665 n.11 (1997), the Court was invited to use the statute in support of its holding, but declined to do so on the ground that the "misappropriation" doctrine it there espoused would suffice.

50. Pub. L. No. 101-429, 104 Stat. 931 (1990) (codified in scattered sections of 15 U.S.C.). *See generally* Arthur Laby & W. Hardy Callcott, *Patterns of SEC Enforcement Under the 1990 Remedies Act: Civil Money Judgments*, 58 ALBANY L. REV. 5 (1994) (reviewing the statute fully only a few years after its enactment).

51. *See* Laby & Callcott, *supra* note 50. The authors cite Chairman Breeden's mollifying comment that the SEC had only once (and then, only an egregious case) used its authority to fine issuers who failed to file periodic reports under § 32 of the Securities Exchange Act (the only prior example of an express civil penalty authorization, and at that, only $100 per day of delay). *Id.* at 7 n.20. I can indirectly but personally confirm this. In 1958, as a new associate in a Rochester, New York, firm, I fielded an urgent call from a client's CEO asking what to do as his CFO had forgotten to make such a filing. In the absence of the relevant partner, I researched the issue, found the penalty provision, obtained the caller's approval to have the firm immediately cut a check for the five days' delay, and then sent it by special delivery to the SEC. On his return, the partner agreed the statute said what it did, but added that he had never heard of its use. He called an acquaintance in the relevant unit and learned that the SEC had never before received such a payment, but had deposited it in the agency's general account, as there was no ledger line specifying otherwise. I have it on information and belief that it became the unit's coffee fund for the next several years, but that probably was an apocryphal tale concocted by the partner.

52. *See id.* at 49. On the other hand, the scourge of the penny-stock phenomenon seems to have been significantly reduced by SEC actions under the statute, at least in the first few years following the enactment. *See Examination Sweep of Penny Stock Firms*

D. More Procedural Hurdles: From Rule 23 Class Actions to Multidistrict Litigation Consolidation[53]

One more sidetrack between *TGS* and SOX needs brief comment. As earlier indicated, a number of private class actions were instituted in the wake of the SEC cases, one of which was already filed in 1966.[54] Before their transfer to the Judicial Panel on Multidistrict Litigation, one group already had received class action certification, but on an unrealistically narrow basis.[55] Eligible were only those members who had sold their shares in the four-day period between the issuance of the April 12 misleading press release and its correction mid-morning of April 16 and had mitigated their losses by essentially immediate repurchases. A small number who sold only one day later, not to mention the far larger number who had sold earlier,[56] were excluded from the class.

One case, however (*Reynolds*, which was indeed the earliest of the private actions), had been filed in the Utah federal district. The plaintiff's effort to obtain class certification was denied, on the ground that all other cases had been filed in the Southern District of New York and were well on the way through pre-trial discovery.[57] His individual action, however, which meantime had been joined by three other parties, resulted in a judgment in which the damages were based on a different time span.[58] They had sold their shares only after April 12, but the normal generous period of loss mitigation had been applied, with the result that the large second burst of Texas Gulf Sulphur (TGS) shares' price rise was covered.[59] The four plaintiffs in *Reynolds*, after the mentioned removal, then

Finds Major Drop in Penny Stock Activity, SEC News Digest, June 29, 1994, at *1, 1994 WL 285118.

53. *See* Class Action Fairness Act of 2005, Pub. L. 109-2, 119 Stat. 4 (codified in various sections of 28 U.S.C.).

54. *See* the docket list attached to *In re* Texas Gulf Sulphur Sec. Litig., 344 F. Supp. 1398, 1400 (J.P.M.L. 1972). One case (*Reynolds*) actually had already been filed in 1966, in the Utah federal district, even before the lower court's decision in the SEC's case. *See generally* Reynolds v. Texas Gulf Sulphur Co., 309 F.Supp. 566 (D. Utah 1970), *aff'd sub nom*, Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir. 1971) (looking specifically at this chronology).

55. *See* Cannon v. Texas Gulf Sulphur Co., 53 F.R.D. 220, 222 (S.D.N.Y. 1971).

56. *Id.* Recall that in the SEC action the court ruled that only insider purchases from late fall onward fell under 10b-5's proscription.

57. *See* Reynolds, 309 F.Supp. at 567–59. Their class action plea was removed under § 1404 to the Southern District of New York, where all other cases (both federal and removed state actions) were pending.

58. *See Mitchell*, 446 F.2d at 105.

59. *See id.* The court's reasoning is worth stating, as it was one of the first grappling with these mitigation issues in a 10b-5 case in which the damages were not limited to the trader's profit disgorgement but were based on the company's misleading information that distorted the market:

> By Monday, April 20, the diligent and reasonable investor was informed of the most recent TGS statement [of April 16] and . . . after that duration a reasonable stockholder would not have relied upon the April 12 statement in selling his TGS stock. After the reasonable investor had opportunity to apprise himself the April 16 release and its import to investment, a reasonable time lapse may be allowed to expire to permit the investor to decide whether or not he would reinvest and take advantage of a[n upward] spiraling market.

applied in the class action pending in the Southern District of New York for inclusion of a sub-class consisting of persons who had sold their TGS shares later than April 16—albeit only one day later; in other words, those who by the earlier date had not yet become aware of or digested the implications of the corrective statement.[60]

In a somewhat cursory fashion, the court rejected this gambit, holding that the great majority of shareholders who had sold their holdings on the basis of the misleading April 12 release had done so by the end of day April 16. Based on this assertion, the court found that the *Reynolds* class failed the "numerosity" requirement.[61] At about the same time, the same court had rejected applications for class certification brought by those shareholders who had sold their shares earlier;[62] in other words, before the clearly misleading April 12 press release but during the time when TGS executives were purchasing shares of the company on the basis of what the SEC cases had found were Rule 10b-5 violations.[63] Two grounds were given for that rejection, the first of which anticipated developments decades later—this class, too, would be too numerous to manage.[64] The other rested on a doctrinal problem: Since these sales occurred during the period of material non-disclosure by the insider-traders, the causal relations between that non-event and plaintiffs' sales required individual proof and could not fit under "common questions of fact prerequisite."[65]

Four months later, the court approved settlement of both the federal class actions and the few state derivative suits over the objections of those who pointed to the better deal Reynolds and his two co-plaintiffs had received in the Utah litigation.[66]

As for the impact of the only recently authorized Judicial Panel for Multidistrict Litigation (JPML), important as it has become in later situations, it had only one trivial stage appearance in the *TGS* play. Before the settlement, the JPML had appointed Judge Bonsal, who was in charge of the Southern District actions, as the transferee judge under the relatively new § 1407, the multi-district litigation removal statute. Although the lead Utah plaintiff, earlier removed to the Southern District under § 1404, accepted the settlement, one—Fox—had continued his individual Utah action.[67] The defendants applied to the Multidistrict Litigation (MDL) panel to order his case's removal to the transferee court, and in

Id. The court considered both a nine- and a seventeen-day reflection period but did not have to choose because the "second-burst" market value peaked within the first period. *See id.*

60. *See Cannon*, 53 F.R.D. at 218.

61. *Id.* at 219.

62. Cannon v. Texas Gulf Sulphur, 55 F.R.D. 306, 307 (S.D.N.Y. 1971).

63. That is, under the "magnitude discounted by probability of occurrence" formula.

64. *Cannon*, 55 F.R.D. at 307.

65. *Id.*

66. *Id.* at 317. One other objector foreshadowed the arguments erupting after Basic, Inc. v. Levinson, 485 U.S. 224, 249–50 (1988); namely, that the costs of the settlement would harm the innocent shareholders of the company. *See Cannon*, 55 F.R.D. at 312.

67. *See In re* Texas Gulf Sulphur Sec. Litig., 344 F. Supp. 1398, 1399 (J.P.M.L. 1972).

one of the first decisions elaborating on the criteria for removal pursuant to § 1407, the JPML agreed and ordered the removal.[68]

E. Congress Clamps Down on the Private Action—Phase Three

This phase does not need extended discussion. The first scene of this act is the arrival of the Private Securities Litigation Reform Act of 1995.[69] Its pleading standard, and its mandatory stay of pre-trial discovery pending complete disposition of all defense motions, are and remain its central features (the former led to President Clinton's—overridden—veto).[70] Further restrictions with consequences for the appetite of plaintiff's bar to engage in this form of litigation include the reconfirmed disapproval of "aider-and-abettor" liability, the related switch from joint and several to proportional liability of secondary defendants (especially accounting firms with deeper insurance-policy pockets), and the lead-plaintiff provisions reducing the ability of the plaintiff's bar to control the strategies and tactics of the litigation.[71]

The second scene is the move, only three years later, to forestall plaintiffs' immediate effort to avoid this stringent statute by filing state-law versions of the securities acts in the state courts, especially in California with its own mini-Rule 10b-5. The Securities Litigation Uniform Standards Act of 1998 (SLUSA) provides that "[n]o covered class action" based on state law and alleging "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security" may be "maintained in any State or Federal court by any private party."[72] Home-state class actions, derivative suits, though a species of class actions, were exempted from this bar (the "Delaware exceptions," as they came to be called), and suits with less than fifty members were not preempted. But in all other respects, the statute was read broadly, especially in its reach of analogous state actions that could not have been brought in federal courts because of standing deficiencies.[73] In a candid opinion by Justice Stevens, laying out and deferring to congressional findings of abusive and frivolous cases (much in the spirit of the reasoning in the "prudential" *Blue Chip* case), closed that loophole and, with that closure, limited private class actions to the extremely narrow aperture left

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68. *Id.* at 1400.

69. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in 15 U.S.C. § 78u-4 (2012)).

70. *See* 15 U.S.C. § 78u-4(a)(2)(A), (b)(3)(B).

71. § 74u-3(a)(3), (b), (f). The effort of the plaintiff's bar to end-run these barriers by bringing actions under Rule 10b-5(c)—"scheme and artifice to defraud"—was blocked by Stoneridge Inv. Partners, LLC v. Sci. Atlanta, Inc., 552 U.S. 148, 159–60 (2008). For a good illustration of the pros and cons of the new "lead plaintiff" approach, *see* In re Cal. Micro Devices Sec. Litig., 965 F. Supp. 1327 (N.D. Cal. 1997).

72. § 78bb(f)(1)(A).

73. *See* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 547 U.S. 71, 84–89 (2006) (a state version of a Rule 10b-5 violation that would have failed in federal dress under *Blue Chip*'s rule that plaintiffs had to be purchasers or sellers was involved).

open by the 1995 statute.[74]

Nevertheless, nothing is ever fully clear. The statutory exemptions produced a slew of issues requiring judicial construction. These cases have led to a number of partly conflicting decisions. The two principal statutory exemptions—the state-of-incorporation exemption,[75] and the derivative-suit exemption[76]—are not particularly problematic. Others, involving issues not resolved by the statute, are another matter. Some are deep in the procedural weeds and are avoided here;[77] one, however, dealing with the common problem of mixed complaints, including both preempted and non-preempted charges, has led to conflicting decisions on their partial or total removal, and need at least to be referenced.[78]

Given all these difficulties and uncertainties, it remains the case that the private class action of the insider-trading/misleading corporate information type had fallen on hard times by 2002 and no longer seemed to be what to some was a robust check on the political and budget-constrained vagaries of regulatory control of these violations—to others, was an abuse of the class-action concept.[79] The ball thus was back in the arena of

74. *See id.* at 89.

75. § 77p(d)(1)(a) provides that "a covered class action . . . based upon the statutory or common law of the State in which the issuer is incorporated (in the case of a corporation) or organized (in the case of any other entity) may be maintained in a State or Federal court by a private party."

76. § 77p(f)(2)(B) provides that "the term 'covered class action' does not include an exclusively derivative action brought by one or more shareholders on behalf of a corporation."

77. The back-and-forth problems of removal and remand, in the context of non-appealability of interlocutory orders, are particularly complex and I do not delve into them here. *See generally* Kircher v. Putnam Funds Tr., 547 U.S. 633 (2006); Proctor v. Vishay Intertechnology, Inc., 584 F.3d 1208 (9th Cir. 2009). The impact of the Class Action Fairness Act (CAFA) of 2005, Pub. L. No. 109-2, 119 Stat. 4 (codified in various sections of 28 U.S.C.) also need not be pursued as it does not bear on Rule 10b-5 class actions, which arise not under the federal question subject matter jurisdiction, but on class actions based on diversity jurisdiction. Most *TGS* class actions were under the former; the few brought under state law in state courts (which cannot entertain Rule 10b-5 suits because of § 78aa's grant of exclusive jurisdiction to the federal courts) had been removed. Thus, the pool of cases which might have been subject to CAFA already had dried up.

78. The problem stems in large part from the Supreme Court's ruling on how to construe pleadings of this sort. *See* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 547 U.S. 71, 84–89 (2006) (extending the SLUSA removal requirement to cases brought under state-law versions of § 10b that, unlike their federal counterpart, permitted suits by non-trading plaintiffs (i.e., those who relied on misleading information to hold on to their securities)). Now, however, using a definition of "non-covered securities" (those not subject to removal) should allow a significant proportion of these cases to remain in state courts. *See* Chadbourne & Parke LLP v. Troice, 571 U.S. 377, 390 (2014).

79. There is a vast secondary literature on this development in the specific field of securities regulation. *See, e.g.*, John C. Coffee, Jr., Entrepreneurial Litigation: Its Rise, Fall, and Future Prospects (Harv. Univ. Press ed. 2015). A vivid indicator of the near-demise of the insider-trading and corporate-misstatement class actions lies hidden in the statistics of the MDL website. *See* United States Judicial Panel on Multidistrict Litigation, MDL Statistics Report—Docket Type Summary (Mar. 15, 2018). Of eight securities matters, only two such cases are there identified, and one of them is a derivative suit. Further, consider the sparse record of the past five years from the already-low starting point of 2012. *See* United States Judicial Panel on Multidistrict Litigation, Calendar Year Statistics (2012); United States Judicial Panel on Multidistrict Litigation, Calendar Year Statistics (2013); United States Judicial

regulatory actions, specifically those brought by the SEC. And in 2002, seven years after enactment of the PSLRA, and four years after SLUSA, Congress accepted that consequence when it enacted the Sarbanes–Oxley Act.

IV. WHERE ARE WE NOW?

Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc. was decided six years after the enactment of SOX,[80] and it is tempting to speculate that its unanimous holding denying any possibility of aider-and-abettor liability under Rule 10b-5 was an indirect recognition that the statute would substantially fill the field now vacated through the practical, if not formal, expulsion of the private class action by that time. While the core holding extending the earlier jurisprudence to the *Stoneridge* facts rests on other doctrinal grounds, one justification of the holding indeed does rest on the new Fair Funds regime.

Given that conclusion, how has § 308 of the Sarbanes–Oxley Act[81] changed the landscape in the field of insider trading and misleading corporate statements traditionally challengeable pursuant to Rule 10b-5?[82]

Nothing remains static, and the first recognition of that truism lies in the revival of the private class action to a place alongside, if not ahead of, SEC proceedings of the *TGS* type. At first, it seemed otherwise. In 2014, in *Halliburton Co. v. Erica P. John Fund, Inc.*,[83] the Supreme Court significantly cut back the fraud-on-the-market dogma and held that class certification was not to be considered before a ruling on whether plaintiffs' reliance on the rebuttable presumption of an efficient capital market—*Basic*'s basic point[84]—was justified.[85] Defendants were thus entitled to at least attempt to prove the lack of a price impact as a bar to class

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Panel on Multidistrict Litigation, Calendar Year Statistics (2014); United States Judicial Panel on Multidistrict Litigation, Calendar Year Statistics (2015); United States Judicial Panel on Multidistrict Litigation, Calendar Year Statistics (2016); United States Judicial Panel on Multidistrict Litigation, Calendar Year Statistics (2017).

80. Stoneridge Invest. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 165 (2008). Indeed, *Merrill Lynch* also fuels that suspicion. *See Merrill Lynch*, 547 U.S. at 84–89.

81. *See* 15 U.S.C. § 7246 (2012).

82. This provision, in the words of the SEC Report responding to it, required the SEC to "review and analyze enforcement actions by the Commission over the five years preceding the enactment of this Act that have included proceedings to obtain civil penalties or disgorgements to identify areas where such proceedings may be utilized to efficiently, effectively, and fairly provide restitution for injured investors. . . ." Securities Exchange Commission, Report Pursuant to Section 308(c) of the Sarbanes Oxley Act of 2002.

83. 134 S. Ct. 2398 (2014).

84. *See* Basic, Inc. v. Levinson, 485 U.S. 224, 249 (1988). The same challenge, however, was not allowed to target the "materiality" element of a fraud claim. *See Halliburton*, 134 S. Ct. at 2410. The Court had confirmed the holding on this point in a case decided just a year earlier. *See generally* Amgen v. Conn. Ret. Plans & Tr. Funds, 568 U.S. 455 (2013).

85. *See Halliburton*, 134 S. Ct. at 2416–17.

certification, since that demonstration could remove the common-basis-of-fact component of a certification.

The statistics on class action filings seemed to bear out that prediction. The year after the enactment of SOX, class action filings dropped below two hundred per year, and the 1997–2016 average also was below that number.[86] Since 2014, however, despite *Halliburton*, there has been a strong resurgence, from two hundred seventy-one filings in 2016 to four hundred twelve in 2017, with the first quarter of 2018 maintaining that level.[87] This figure, however, is misleading in the context of this narrative, as it includes all filings under § 11 and § 12(2) of the 1933 Securities Act, as well as filings relating to mergers and acquisitions. Dropping the last category reduces the filings to one hundred ninety-four, which as a proportion of all securities-regulation-related filings is significantly lower than in previous years.[88] And of more significance: All of the most recent set concerned corporate financial misrepresentations, and only twelve cases involved claims of insider trading.[89] In short, while class actions for alleged corporate misconduct have remained numerically significant, the insider-trading class action has all but disappeared.

These statistics highlight the arguable significance of regulatory filings by the SEC and Department of Justice (DOJ). Since this presentation concerns the contemporary role of conservatorship proceedings, a brief look at the use of § 308 is necessary.[90]

As amended in 2010 by the Dodd–Frank Wall Street Reform and Consumer Protection Act, the SEC is now allowed to distribute both penalties and disgorgements, not only to harmed investors but also to a newly-created Investor Protection Fund used to reward whistleblowers, as well as to the Treasury.[91] As a result, of the approximately 3,600 enforcement

86. *Securities Class Action Filings—2017 Year in Review*, CORNERSTONE RESEARCH 1, 39 (2018), https://www.cornerstone.com/publications/reports/securities-class-action-filings-2017-yir.

87. *See id*. For 2018 statistics, *see* STANFORD LAW SCHOOL, SECURITIES CLASS ACTION CLEARINGHOUSE, http://securities.stanford.edu/filings-cases.html (identifying eighty-eight filings through March 12, 2018) (last visited Mar. 12, 2018).

88. Taking just the 2016 and 2017 filings into account, Rule 10b-5 filings represented 67% of all 271 filings in 2016, as against 47% of the 412 filings in 2017, resulting in a smaller absolute number than in the previous year. *Securities Class Action Filings*, *supra* note 86, at 39. And the 2016 numbers themselves show a sharp proportional decline from the 85% level of the prior three years. *See id.*

89. *Id.* The drop in the proportion of (specifically) Rule 10b-5 filings alleging insider trading is even sharper when measured over the prior four years: from 18% in 2013, 16% in 2014 and 2015, to 10% in 2016, and to the mentioned 3% in 2017. *Id.*

90. Mention at least should be made of a partial predecessor, the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, *supra* note 5050, which authorized by the SEC to order disgorgement as a remedy in its administrative proceedings, and included further authorization for distribution to harmed investors.

91. *See* Pub. L. No. 111-203, 124 Stat. 1641 (2010) (codified in 15 U.S.C. § 7246(a)). It also eliminated the requirement that disgorgement, as well as penalties, had to be ordered in order to allow the latter to be included in distributions to harmed investors. *See* OFFICE OF THE INSPECTOR GENERAL, *supra* note 1010, at 3.

While this article essentially is limited to describing the journey from *TGS* to the present day, two important critiques of this development should at least be referenced, even if only

actions brought between fiscal year 2010 and fiscal year 2014, of which only half included any monetary relief, only three hundred fifty were considered for distribution, and only two hundred of these (both figures approximate) resulted in a distribution.[92] As for the actual amounts collected (as compared with the amounts ordered to be paid), the same 2015 Inspector General Report indicates modest (if non-trivial) flows: approximately $1.75 billion ($2.75 billion) in FY 2010, the year of the Dodd-Frank Act's enactment; $1.5 billion ($2.75 billion) for FY 2011; $1.1 billion ($3.1 billion) for FY 2012; $1.9 billion ($3.4 billion) for FY 2013; and $2.4 billion ($4.2 billion) for FY 2014.[93] As of July 2015, a total of approximately $6.75 billion was in the process of distribution in seventy-seven cases (presumably, though this is not stated, to "harmed investors" only).[94] This suggests a fairly active distribution process, though a number of the annual § 308 announcements disclose several years of ongoing distribution activity.[95]

Further, these annual § 308 announcements reveal a new, and perhaps unexpected, scenario: essentially all SEC actions involving the creation of a fair-fund distribution plan concern the financial sector. Specifically, SEC actions have been brought against investment banks, broker-dealers, and private equity funds. Apparently, the SEC does not use this procedure where other sectors of the economy are concerned. But, that does not end the story, as the disgorgement-of-profits remedy continues to be used, though today almost exclusively in the tipper-tippee context.[96] These cases, however, do not show up in the § 308 statistics, despite the common remedy of disgorgement.

Further, given the Supreme Court's recent formulation, albeit in the criminal law setting, of an expansive definition of the tipper-tippee rela-

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briefly. *See generally* Sonia Steinway, Comment, *SEC "Monetary Penalties Speak Very Loudly," but What Do They Say? A Critical Analysis of the SEC"s New Enforcement Approach*, 124 YALE L.J. 209 (2014) (showing with supporting data that most civil penalty if not disgorgement collections go to the U.S. Treasury rather than to harmed investors). More fundamentally, see Barbara Black, *Should the SEC Be a Collection Agency for Defrauded Investors?* 63 BUS. LAW. 317 (2008) (arguing that this newly enhanced function directly contributes to the political arguments against private, especially class action-based enforcement). I have mentioned the influence of SOX in this connection earlier; *see supra* note 81 and accompanying text.

92. *See id.* at 2.

93. *Id.* at 6 tbl.3.

94. *Id*.

95. *See also* U.S. SEC. & EXCH. COMM'N, DISTRIBUTIONS IN COMMISSION ADMINISTRATIVE PROCEEDINGS: NOTICES AND ORDERS PERTAINING TO DISGORGEMENT AND FAIR FUNDS, https://www.sec.gov/litigation/fairfundlist.htm (listing cases filed pursuant to § 308).

96. A cursory overview of cases decided since the recent and leading case of SEC v. Orbus, 693 F.3d 276 (2d Cir. 2012), identifies over a dozen reported cases brought by the SEC, almost all of them tipper-tippee situations. Two deserve notice for their doctrinal significance: SEC v. Kinnucan, 9 F. Supp. 3d 370, 375 (S.D.N.Y. 2014) with its careful distinction between a tipper's liability for direct-tippee profits, and SEC v. Sabrdaran, 252 F. Supp. 3d 866, 905–06 (N.D. Cal. 2017) with its more complex approach to the tipper's liability for the more remote downstream tippees' profits.

tionship in the area of family rather than business relationships,[97] one may see increased SEC activity in the wider civil litigation context as well.[98] In short, it may be that the distinction turns on the willingness of the financial sector to settle the relatively technical 1933 Act charges, as against the approach of both individual "trading" actors and corporate "misstatement" actors, to test the viability of defenses against charges that, in doctrinal terms, may be pushing for expansion of those doctrines.[99]

But these are—for now—idle speculations that should await the opportunity to celebrate the next birthday of *SEC v. Texas Gulf Sulphur*.

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97. *See generally* Salman v. United States, 137 S. Ct. 420 (2016) and United States v. Martoma, 894 F.3d 64 (2d Cir. 2017).

98. The journalistic stories concerning the political will of the SEC to act aggressively against these two classic § 10b violations is not something that can be rigorously evaluated within the constraints of this contribution.

99. As indeed was the case in *Sabrdaran* as well as—in the DOJ and not SEC context—in *Salman*. *See Salman*, 137 S. Ct. at 426; *Sabrdaran*, 252 F. Supp. 3d at 881.