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Toward a More Efficient Deterrence of Insider Trading: The Repeal of Section 16(b)

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Cover Page Footnote

Assistant Professor of Law, Stetson University College of Law. B.S. 1984, DePaul University; J.D. 1987, Duke University School of Law. I would like to thank Robert Batey, Alfred F. Conard, James D. Cox, James E. Felman, Michael S. Finch, Jerome C. Latimer and Morgan Shipman for their comments on this Article. I would also like to thank Robert Lowe for his valuable research assistance.

TOWARD A MORE EFFICIENT DETERRENCE OF INSIDER TRADING: THE REPEAL OF SECTION 16(b)

MARLEEN A. O'CONNOR*

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INTRODUCTION

SCANDALS involving such modern-day Al Capones as Ivan Boesky and Dennis Levine¹ have motivated Congress to enact strong measures to combat insider trading.² In 1984, Congress raised the potential penalties to “three times the profit gained or loss avoided” from insider trading under the Insider Trading Sanctions Act³ (“ITSA”). Insider trading scandals, however, continued after the enactment of ITSA, prompting Congress to adopt the Insider Trading and Securities Fraud Enforcement Act⁴ (“ITSFEA”) in 1988. ITSFEA imposes liability for

1. Gary Lynch, former director of the Securities and Exchange Commission’s (“SEC”) Enforcement Division, has remarked that “the insider trading wars truly began” on May 12, 1986, when the SEC filed charges against Dennis Levine. See Lynch, Foreword—Insider Trading Symposium, 26 Am. Crim. L. Rev. 3, 5 (1988) (citing SEC v. Levine, No. 86 Civ. 3726 (S.D.N.Y. July 1, 1986)). Mr. Levine settled with the SEC for \$11.6 million and a permanent bar from the securities industry, pleading guilty to four felony counts. On the criminal side, Mr. Levine received a two-year prison sentence and a \$362,000 fine. See Wise, *Levine Sentence Seen in Line with Insider-Trading Penalties*, N.Y.L.J., Feb. 24, 1987, at 1, col. 3. After the Levine affair, the SEC quickly filed charges against Ivan Boesky, a famous Wall Street arbitrageur, alleging that Mr. Boesky obtained material nonpublic information from Mr. Levine concerning tender offers, mergers, and other corporate transactions. See Lynch, *supra*, at 5 (citing SEC v. Boesky, No. 86 Civ. 8767 (S.D.N.Y. Nov. 14, 1986)). Mr. Boesky consented to a combination of disgorgement and civil penalties totaling a record \$100 million, a guilty plea on felony charges, and a permanent bar from the securities industry. See Judge Morris Lasker *Sentencing Boesky*, N.J.L.J., Dec. 31, 1987, at 6, col. 1.

2. The term “insider trading” covers a wide variety of unlawful trading by persons who possess material nonpublic information. For example, Mr. Levine and Mr. Boesky were market professionals who did not hold positions within the corporations giving rise to the information that they used to trade. The purpose of this Article is to advocate the repeal of section 16(b); thus, this Article focuses upon a limited group of corporate insiders including directors, officers, and controlling shareholders.

3. Pub. L. No. 98-376, 98 Stat. 1264 (1984) (codified as amended in scattered subsections of 15 U.S.C. § 78). See *infra* notes 140-143 and accompanying text.

4. Pub. L. No. 100-704, 102 Stat. 4677 (1988) (codified as amended in scattered subsections of 15 U.S.C. § 78). Congress enacted ITSFEA to “provide greater deter-

insider trading upon persons who have some control over insiders in order to induce those persons to take steps to prevent insider trading violations.⁵ In enacting ITSA and ITSFEA, Congress focused on deterring insider trading, while continuing to allow the courts to define the substantive violation of insider trading under Rule 10b-5.

Fifty years before ITSA, Congress envisioned a very different form of attack upon insider trading. Congress enacted section 16(b) of the Securities Exchange Act of 1934, believing that the only effective means to control insider trading was to impose strict liability upon a narrow group of insiders for a limited range of trades, without requiring any proof that inside information was actually used.

Although most reform efforts have concentrated on deterring insider trading under "the Rule 10b-5 regime,"⁶ deterrence is also the primary goal of section 16(b).⁷ This Article considers whether the methods used to deter insider trading under section 16(b) are economically efficient in light of the modern weapons in the insider trading arsenal. Insider trading regulation should minimize both the social harm caused by insider

rence, detection and punishment of violations of insider trading." House Committee on Energy and Commerce, H.R. Rep. No. 910, 100th Cong., 2d Sess. 7, *reprinted in* 1988 U.S. Code Cong. & Admin. News 6043, 6044 [hereinafter *1988 House Report*].

5. See *infra* notes 156-166 and accompanying text.

6. This Article uses the term "Rule 10b-5 regime" to refer to the substantive regulation of insider trading under Rule 10b-5 and Rule 14e-3 promulgated by the SEC under sections 10(b) and 14(e), respectively, of the Securities Exchange Act of 1934, as well as the deterrence mechanisms under ITSA and ITSFEA.

7. Section 16(b) provides:

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

15 U.S.C. § 78p(b) (1988). Compensating victims is also a significant goal of insider trading regulation. See Karjala, *Statutory Regulation of Insider Trading in Impersonal Markets*, 1982 Duke L.J. 627, 629-33. This Article concludes, however, that the regulation of insider trading should pursue the goal of compensation only to the extent that it does not conflict with the goal of deterrence. See *infra* notes 326-328 and accompanying text.

trading and the enforcement costs incurred in the fight against it.⁸ This Article uses this cost-minimization principle to compare the efficiency of the oldest system to prevent insider trading, section 16(b), with the newer methods provided by ITSA and ITSFEA. This comparison demonstrates that the same level of deterrence produced by section 16(b) could be achieved more efficiently by methods subsequently added to the Rule 10b-5 regime. Thus, this Article concludes that the repeal of section 16(b) would promote the efficient regulation of insider trading.⁹

Part I provides an overview of cost-minimization principles used in developing an efficient deterrence strategy.¹⁰ This Part considers the frequency of insider trading and the social harm it causes to demonstrate the difficulties in applying economic deterrence theories in formulating a regulatory response to the problem.¹¹ This Part then presents the historical development of insider trading regulation under section 16(b) and Rule 10b-5, including recent developments under ITSA and ITSFEA.¹² This historical presentation reveals that for over half a century, practitioners and academicians have criticized section 16(b) and questioned its efficacy. In addition, this historical perspective demonstrates that the Rule 10b-5 regime provides a much more powerful deterrent than does section 16(b).

8. Gary Becker was the first modern scholar to use an economic approach to the deterrence of illegal activity. See Becker, *Crime and Punishment: An Economic Approach*, 76 J. Pol. Econ. 169 (1968). Professor Dooley applied this law and economics approach to insider trading regulation under Rule 10b-5 in 1980, but did not include an analysis of section 16(b). See Dooley, *Enforcement of Insider Trading Restrictions*, 66 Va. L. Rev. 1, 3 (1980). For earlier economic comparisons of section 16(b) with Rule 10b-5 prior to the enactment of ITSA and ITSFEA, see Ishizumi, *Insider Trading Regulation: An Examination of Section 16(b) and a Proposal for Japan*, 47 Fordham L. Rev. 449 (1979); Note, *An Economic Analysis of Section 16(b) of the Securities Exchange Act of 1934*, 18 Wm. & Mary L. Rev. 389 (1976) [hereinafter Note, *An Economic Analysis*]; Note, *A Framework for the Allocation of Prevention Resources with a Specific Application to Insider Trading*, 74 Mich. L. Rev. 975 (1976) [hereinafter Note, *A Framework*]. The Becker model has been used extensively in the antitrust context. See, e.g., K. Elzinga & W. Breit, *The Antitrust Penalties: A Study in Law and Economics* 112-16 (1976); Schwartz, *An Overview of the Economics of Antitrust Enforcement*, 68 Geo. L.J. 1075, 1076-81 (1980). Some commentators have criticized the economic approach to the "psychology of deterrence" as being "too mechanical." Hovenkamp & Schwartz, *Treble Damages and Antitrust Deterrence: A Dialogue*, 18 Antitrust L. & Econ. Rev. 67, 79 (1986) (comment by Professor Schwartz).

9. For recent commentary urging the repeal or reform of section 16(b), see Samuelson, *The Prevention of Insider Trading: A Proposal for Revising Section 16 of the Securities Exchange Act of 1934*, 25 Harv. J. Leg. 511, 522-28 (1988) (urging repeal of section 16(b) and filing section 16(a) reports 90 days in advance); Painter, *How to Control Insider Trading*, A.B.A. J., Mar. 1, 1987, at 38 (section 16(b) "eclipsed" by Rule 10b-5); Klein, *Outsider Proposes Change in Insider Trading Bill*, Legal Times, Dec. 12, 1983, at 8, col. 1 (Congress should repeal section 16(b) or shorten the short-swing period). See generally Smith, *Section 16(b): Too Much or Too Little?*, N.Y.L.J., Apr. 6, 1989, at 5, col. 1 (discussing proposed section 16(b) modifications).

10. See *infra* notes 15-17 and accompanying text.

11. See *infra* notes 20-43 and accompanying text.

12. See *infra* notes 44-189 and accompanying text.

Parts II and III of this Article present two lines of analysis to support the position that Congress should repeal section 16(b). Part II critically examines a 1987 ABA Task Force's reasons for retaining section 16(b).¹³ This analysis reveals that the Task Force's rationales are no longer valid in light of recent developments, particularly the enactment of ITSFEA. Part III then pursues an economic analysis of the weapons in the insider trading arsenal and reviews factors pertaining to the deterrence of insider trading, such as detection, punishment, and enforcement.¹⁴ ITSA and ITSFEA change the dynamics of insider trading enforcement by destroying whatever utility section 16(b) may have once possessed. Thus, this Article concludes that section 16(b) is an archaic, blunt weapon which no longer serves a useful purpose in the effort to deter insider trading.

I. INSIDER TRADING AND THE DUAL SYSTEM OF REGULATION

A. *An Efficient Deterrence of Insider Trading*

In designing an efficient deterrence strategy, it is necessary to evaluate existing insider trading regulation for its impact on potential offenders and the overall enforcement system.¹⁵ An economic analysis of deterrence starts with the assumption that a person violates the insider trading laws in order to make a profit. This economic analysis also assumes that in deciding whether to engage in insider trading, an insider will make a calculation of the profits from insider trading by weighing the expected benefits against the expected penalties. An insider will then compare the returns from insider trading to the returns from other activities. On the cost side of the insider trading profit equation, an insider will calculate the expected penalty by taking into account the probability of detection, the probability of successful prosecution, and the severity of the potential sanction.¹⁶ While preventing the social harm insider trading causes, an efficient enforcement system should also attempt to minimize the expenditures made to influence the cost side of an insider's profit equation. To the extent possible, a regulatory system should reduce the enforcement costs associated with detecting, prosecuting and penalizing offenders.¹⁷

13. See *Report of the Task Force on Regulation of Insider Trading, Part II: Reform of Section 16*, 42 Bus. Law. 1087, 1089-93 (1987) [hereinafter *Section 16(b) Task Force*]; see *infra* notes 190-285 and accompanying text.

14. See *infra* notes 286-449 and accompanying text.

15. See, e.g., Easterbrook, *Detrebling Antitrust Damages*, 28 J. L. & Econ. 445, 449 (1985) (three types of costs must be minimized, which involve tradeoffs); Schwartz, *supra* note 8, at 1076-77 (same).

16. See Schwartz, *supra* note 8, at 1076.

17. See *id.* In determining the optimal amount of resources to be devoted to the insider trading problem, an alternative approach would consider the intersection of the marginal social benefit curve and the marginal social cost curve derived from insider trading regulation. See K. Elzinga & W. Breit, *supra* note 8, at 13. The marginal social benefit curve is derived from the total benefits received by reducing the harm that insider trading causes. See *id.* The marginal social benefit of insider trading regulation corresponds to the social harm caused by insider trading under the cost-minimization approach used above. Under either approach, from an economic standpoint, society should

Unfortunately, an absence of empirical data impedes the application of these economic principles to the insider trading problem. No recent evidence exists to determine whether insider trading regulation has had any significant deterrent effect.¹⁸ In addition, there is no reliable data concerning the amount of social harm insider trading causes, that is, the frequency with which the practice occurs and who it harms. Indeed, the secretive nature of insider trading suggests that these issues may evade empirical analysis.¹⁹ In the absence of such statistical data, several economic theories provide insight in designing an efficient deterrence strategy. These theories, however, reveal a debate over the nature of the social harm caused by insider trading.

B. *The Social Harm of Insider Trading*

1. How Often Does Insider Trading Occur?

The limited empirical evidence available suggests that insider trading is one of the most common violations of the federal securities laws.²⁰ Government informants have testified that insider trading is a widespread and, within certain circles, accepted practice.²¹ The insider trad-

not attempt to deter all insider trading. *See, e.g.*, Becker, *supra* note 8, at 170 (phrasing optimal enforcement question as, alternatively, how much resources are used to enforce laws or how many offenses should be permitted); Stigler, *The Optimum Enforcement of Laws*, 9 J. Pol. Econ. 526, 526-27 (1968) (society must forego "complete" enforcement because it is too costly).

18. One study reviewing section 16(a) reports concluded that the decisions in *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961) and *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, *cert. denied*, 394 U.S. 976 (1969), had no detectable impact upon the incidence of insider trading. *See* Jaffe, *The Effect of Regulation Changes on Insider Trading*, 5 Bell J. Econ. & Man. Sci. 93 (1974). *But see* R. Clark, *Corporate Law 282* (1986) (discounting results of Jaffe study because prior to 1984, Rule 10b-5 only threatened disgorgement; thus there was no reason to expect any increase in deterrence).

19. *See, e.g.*, Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School"*, 1986 Duke L.J. 628, 644 (insider traders will not cooperate with empiricists so long as practice is illegal); Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 Mich. L. Rev. 1051, 1057-58 (1982) (same).

20. Several insider trading studies based upon section 16(a) reports show that insiders consistently earn higher returns than public investors. *See, e.g.*, J. Choper, J. Coffee & C. Morris, *Cases and Materials on Corporations 467* (3d ed. 1989) (discussing study by Ann Poulsen and Greg Jarrell involving 172 tender offers between 1981 and 1985 that concluded insider trading accounts for one-third of market activity before companies announce takeover bids); Baesel & Stein, *The Value of Information: Inferences from the Profitability of Insider Trading*, 14 J. Fin. & Quan. Anal. 553, 554 (1979) (studies indicating insiders on average made "unusual" returns); Lorie & Niederhoffer, *Predictive and Statistical Properties of Insider Trading*, 11 J. Law & Econ. 35, 38-46 (1968) (insiders generally outperform the market); *see also* *Poll Finds Majority Thinks Insider Trading Is Common*, Wall St. J., June 6, 1986, at 3, col. 2 (two out of every three people polled thought insider trading was common).

21. Investigators have acknowledged that Ivan Boesky gave the government " 'a window on the rampant criminal conduct that has 'permeated the securities industry.' " *SEC to Bring More Insider Trading Cases, but Not for Several Months, Ruder Says*, 19 Sec. Reg. & L. Rep. (BNA) 1923 (Dec. 18, 1987). The government has also disclosed that Mr. Boesky " 'revealed that criminal conduct is at the heart of a substantial amount

ing scandals also reveal that two developments have increased the expected return side²² of the insider's profit equation: hostile tender offers have expanded the number of opportunities for insider trading, while options markets have made the offense more profitable.²³ Indeed, the insider trading scandals that occurred after Ivan Boesky and Dennis Levine received heavy penalties and prison terms graphically illustrate that those who violate the insider trading laws are willing to take significant risks to attain large returns.²⁴

2. Who Is Hurt by Insider Trading?

There is much disagreement over the nature of the social harm that insider trading causes. This social harm is relevant not only in determining the efficient level of enforcement, but also in establishing the analytical framework upon which insider trading regulation is based.²⁵ The most common rationale given for the regulation of insider trading is that the practice undermines the expectations of fairness that are the foundations of the public's confidence in the securities markets.²⁶ Commentators have advanced more specific theories based upon three distinct harms resulting from insider trading: injury to investors, loss in the efficiency of the stock markets, and harm to the insider's corporation. This Article takes the position that only the threat of harm to the corporation sufficiently justifies regulating insider trading. More specifically, insider

of market activity by established securities industry professionals.' " 1988 House Report, *supra* note 4, at 11 (quoting the U.S. Attorney in the Boesky case).

22. The term "deterrence" only focuses on the cost side of the violator's profit equation. No commonly used term centers upon the benefit side of the equation. See J. Wilson, *Thinking About Crime* 49 (1983).

23. See, e.g., *Insider Trading Sanctions Act of 1983: Hearing on H.R. 559 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 98th Cong. 2d Sess. 20 (1984) (statement of SEC Chairman Shad) ("the recent conjunction of tender offers and acquisitions with the availability of trading in standardized option contracts. . . have fundamentally altered the risk-reward equation with respect to insider trading").

24. The SEC recently brought its second largest insider trading enforcement action against Stephen Sui-Kuan Wang, Jr., a financial analyst at Morgan Stanley & Co., Inc. See Pitt & Shapiro, *The Revised Insider Trading Proscriptions Act of 1988: A Legislative Remedy for a Problem that Persists*, 26 Am. Crim. L. Rev. 7, 7 (1988) (citing SEC v. Wang, No. 88 Civ. 4461 (S.D.N.Y. filed June 27, 1988)). The SEC accused Mr. Wang of tipping information concerning pending transactions in twenty-five companies. Mr. Wang entered a guilty plea in related criminal charges. See *Former Stock Analyst Admits Insider Guilt*, N.Y. Times, Sept. 8, 1988, at D6, col. 1. The Wang case has been called "astonishing" because nearly all the illegal acts occurred after the civil and criminal charges were announced against Levine and Boesky. See Pitt & Shapiro, *supra*, at 7-8.

25. See Dooley, *supra* note 8, at 29.

26. See, e.g., 1988 House Report, *supra* note 4, at 8 (1988) (public expects stock prices to reflect publicly available information); *Report of the Task Force on Regulation of Insider Trading, Part I: Regulation Under the Antifraud Provisions of the Securities Exchange Act of 1934*, 41 Bus. Law. 223, 227 (1985) ("[P]eople will not entrust their resources to a marketplace they don't believe is fair, any more than a card player will put his chips on the table in a poker game that may be fixed.") [hereinafter *Rule 10b-5 Task Force*].

trading harms corporations by impairing the agency relationship between management insiders and their corporations.²⁷ Before examining this agency theory in more detail, it is helpful to review briefly the other two theories of the harms of insider trading.²⁸

Under the first theory, insider trading injures the individual investor who trades with the insider because the investor does not share the insider's informational advantage.²⁹ Although this argument has intuitive appeal, insider trading that occurs through impersonal stock exchange transactions does not harm individual investors because there is no causal connection between an investor's decision to buy or sell a particular security and the insider's secretive trading in the same security based upon nonpublic information. Investors follow their own strategies, which are completely unaffected by whether an insider is also trading at the same time. Thus, insider trading does not mislead or harm the other investors in any way.³⁰ Therefore, this theory does not help in establishing the analytical foundation for the regulation of insider trading and in

27. See Cox, *supra* note 19, at 657-59.

28. Some commentators maintain that insider trading provides significant benefits and, if legalized, corporations would allow their managers to engage in the practice. These commentators argue that insider trading enhances market efficiency by promoting smoother stock price changes; that it creates an efficient system for managerial compensation; and that there is no empirical evidence that it is harmful. See, e.g., H. Manne, *Insider Trading and the Stock Market* 30-31 (1966) (criticizing section 16(b), but finding it less objectionable than insider trading regulation under Rule 10b-5); see also Carlton & Fischel, *The Regulation of Insider Trading*, 35 *Stan. L. Rev.* 857 (1983) (insider trading is an efficient way to compensate corporate management); Manne, *Insider Trading and the Law Professors*, 23 *Vand. L. Rev.* 547 (1970) (responding to criticism and reaffirming position taken in *Insider Trading and the Stock Market* (1966)); Wu, *An Economist Looks at Section 16 of the Securities Exchange Act of 1934*, 68 *Colum. L. Rev.* 260 (1968) (regulation of insider trading under section 16(b) and Rule 10b-5 may be harmful to the economy). Commentators who support insider trading regulation assert that insider trading is a poor substitute for disclosure because there is too much "noise" associated with trading; if managers were allowed to take their compensation from insider trading they could profit from good news as well as bad news; and the fact that there is no statistical data concerning the harms from insider trading is equally consistent with the conclusion that such trading is not subject to scientific analysis. See Cox, *supra* note 19, at 642-655; see also Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 *Va. L. Rev.* 1425, 1430-37 (1967) (noting flaws in Manne's thesis that insider trading is unfair).

29. See, e.g., Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 *S. Cal. L. Rev.* 1217, 1235-40 (1981) (insider trading induces trades that would not otherwise occur).

30. Professor Cox has rejected this theory:

Insider trading is at most a fortuity for the investor because the investor is no worse off when the insider trades than when the insider does not trade. . . . If the insider neither trades nor discloses his confidential material information, one can nevertheless expect the investor to pursue his trading plan. Sellers naturally are disadvantaged by the nondisclosure of good news, just as buyers are disadvantaged by the nondisclosure of bad news. These considerations, however, cast no light on why the insider's decision to trade should prompt disclosure.

determining the necessary amount of enforcement resources needed to deter insider trading.

The second theory posits that insider trading impedes the stock market's allocational efficiency. Under this theory, investors discount the amount they are willing to pay for the stock of corporations whose managers frequently engage in insider trading because those managers may engage in abusive practices in order to exploit inside information, such as manipulating corporate disclosures in order to trade.³¹ Thus, this theory concludes, insider trading impairs the stock market's allocational efficiency because the investors' discounting causes investors to withdraw resources from more valuable uses. This explanation, however, does not withstand closer scrutiny.

The "investment portfolio theory" casts doubt upon the validity of the claim that insider trading harms the stock market's allocational efficiency.³² According to the investment portfolio theory, investors cannot know in advance which firms present a risk of insider trading because of the secretive nature of the practice.³³ As a result, investors are forced to assume that every investment presents the same risk of insider trading as that of the market as a whole. Thus, investors will discount the value of each firm's securities by the estimated average risk of insider trading for all firms.³⁴ Investors holding diversified portfolios will not be injured by insider trading, because their losses on one security will be offset by the higher returns from those firms whose insiders do not trade.³⁵

Given that insider trading does not harm investors who hold diversified portfolios, it follows that insider trading does not harm the stock market's allocational efficiency. Investors' discounting for the average risk of insider trading will cause each firm's cost of capital to rise at the same rate. As a result, the investors' discounting for insider trading will not affect the amount of capital that investors allocate to each firm.³⁶ Consequently, this allocational efficiency theory cannot justify regulating

Cox, *supra* note 19, at 635 (footnotes omitted); see also Dooley, *supra* note 8, at 33 ("There is no causal connection between insider trading and outsiders' losses.").

Professor Cox does not ignore the possibility that insiders injure outsiders by preempting bargaining opportunities. Professor Cox rebuts this argument by asserting that the insiders' purchases are normally so small that they do not significantly preempt the opportunities of outsiders. See Cox, *supra* note 19, at 635 n.33. In addition, any harm to outsiders will be offset by the benefits that insider trading produces in market efficiency. See *infra* text accompanying notes 259-267.

31. See Schotland, *supra* note 28, at 1448-49; Mendelson, *The Economics of Insider Trading Reconsidered* (Book Review), 117 U. Pa. L. Rev. 470, 476-77 (1969) (reviewing H. Manne, *Insider Trading and the Stock Market* (1966)).

32. See Cox, *supra* note 19, at 638-39.

33. See *id.* at 638.

34. See Dooley, *supra* note 8, at 41 (citing Akerlof, *The Market For "Lemons": Quality, Uncertainty and the Market Mechanism*, 84 Q. J. Econ. 488 (1970)).

35. See Cox, *supra* note 19, at 638.

36. Professor Cox explains: "Because capital allocation occurs within the context of a comparative assessment among competing choices, any change that affects the cost of capital for all firms at the same rate will not affect the relative comparisons made by

insider trading or help establish the appropriate amount of enforcement resources. Rather, the theory demonstrates that insider trading harms all firms because all firms will face a higher cost of capital due to investor discounting.³⁷ Arguments based upon the portfolio theory are consistent with the position taken in this Article that insider trading harms corporations: investors discount the value of all firms' securities for the average risk of insider trading because it harms the agency relationship between management insiders and their corporations.

Within any agency relationship, there is a divergence between the principal's interests and the agent's interests, creating significant agency costs.³⁸ In corporations, the interests of managers and shareholders differ because managers do not have the incentive to work as hard as they would if they received the entire benefit from their efforts.³⁹ To a certain extent, managers will find it in their self-interest to shirk, embezzle and deceive. To reduce these agency costs, shareholders attempt to motivate managers by tying management's compensation to the shareholders' gain. Therefore, managers are often encouraged to own and trade the corporation's securities in order to align their interests with those of the shareholders.⁴⁰ Although shareholders find it in their self-interest to allow managers to own the corporation's securities, managers will have the incentive to abuse this privilege by trading on material inside information.

Managers' trading on material inside information widens the divergence between the shareholders' interests and the managers' interests, thus creating additional agency costs for the corporation. If a laissez-faire approach were taken toward insider trading, shareholders would be unable to motivate the managers' behavior because the shareholders would not be able to control the amount of compensation that managers receive.⁴¹ Similarly, if managers could freely engage in insider trading, they would have the incentive to concentrate more on their own trading agendas at the expense of the shareholders' long-term welfare. In concentrating on their own trading agendas, corporate officials would attempt to manipulate corporate events and the timing of information

investors that drive the allocation of capital among the various investment choices." *Id.* at 639-40.

37. *See id.* at 640.

38. *See* Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305, 308 (1976); *see also* Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. Rev. 738, 745-46 (1978) (discussing competing values of efficiency and fairness and the costs involved in certain "exchange conflicts of interest" transactions).

39. *See* Anderson, *supra* note 38, at 774-75.

40. *See* Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J. L. & Econ. 375, 387-89 (1983).

41. *See* Cox, *supra* note 19, at 658-59. In addition, insider trading may hurt a corporation's reputation. *See, e.g.*, *Diamond v. Oreamuno*, 24 N.Y.2d 494, 498-99, 248 N.E.2d 910, 912-13, 301 N.Y.S.2d 78, 81-82 (1969) (insider trading can harm the "prestige and goodwill" of the company).

releases to induce price-swings in the firm's stock in order to create opportunities to engage in insider trading.⁴²

In order to reduce the agency costs caused by the divergence of shareholders' and management's interests, the government imposes minimum fiduciary duties that govern the agency relationship between management insiders and their corporations.⁴³ The following review of the historical development of insider trading regulation reveals that fiduciary duty principles underlie the analytical framework of insider trading regulation under section 16(b) and Rule 10b-5. Thus, this dual system of insider trading regulation is based upon principles that are consistent with the position taken in this Article, that insider trading harms the agency relationship between managers and corporations.

C. *The Historical Development of the Dual System of Insider Trading Regulation*

Since 1934, when Congress enacted section 16(b),⁴⁴ practitioners and academicians have criticized the provision and urged its repeal because it is ineffective in deterring insider trading. Efforts to repeal section 16(b) became stronger when Rule 10b-5 developed in 1961 as an alternative method of regulating insider trading. Although regulation under Rule 10b-5 eventually overlapped with that of section 16(b), until 1984 the two systems accomplished different regulatory goals. Section 16(b) attempted to deter insiders from misusing nonpublic information in the first place by imposing strict liability for a narrow range of transactions. In contrast, Rule 10b-5 merely required insiders to disgorge their wrongful profits from insider trading to compensate for harm after it occurred. In enacting ITSA in 1984, Congress shifted the focus of regulation under Rule 10b-5 from compensation to deterrence. An overview of recent developments reveals that the Rule 10b-5 regime provides a much more powerful deterrent than section 16(b). Although the dual system of regulation now has the common goal of deterring insider trading, the two

42. See Schotland, *supra* note 28, at 1448-49. In addition, if the corporation attempted to invest in a secret project, insider trading would tend to draw attention to the undisclosed projects and make them more costly for the corporation. See, e.g., Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. Legal Stud. 801, 804-05 (1980) (prohibition against insider trading protects property rights of corporation in inside information because trading on this information is likely to raise transaction costs).

43. See, e.g., Carlton & Fischel, *supra* note 28, at 888 ("Fiduciary duties are standard-form contractual terms that govern agency relationships. They allow the parties to avoid excessively lengthy and detailed agreements, thereby reducing the costs of contracting." (footnote omitted)).

44. For an in-depth discussion of section 16(b), see A. Jacobs, Section 16(b) of the Securities Exchange Act of 1934 *passim* (1989); L. Loss, Fundamentals of Securities Regulation 541-82 (1988); P. Romeo, Comprehensive Section 16 Outline: Insider Reporting and Liability Under § 16 of the Securities Exchange Act of 1934 *passim* (1986). For an extensive treatment of the regulation of insider trading under Rule 10b-5, see 5 A. Jacobs, Litigation and Practice Under Rule 10b-5 (1987); D. Langevoort, Insider Trading Regulation (1989).

methods "are at opposite jurisprudential poles on the objective-subjective or predictability-fairness continuum."⁴⁵ These different approaches have prompted one commentator to remark: "Rule 10b-5 is a fairly refined weapon aimed at discrete acts of wrongdoing. Section 16(b), on the other hand, is a spring gun that can easily hit the innocent as well as the guilty."⁴⁶

1. Section 16(b)'s Spring-Gun Approach

In the wake of the 1929 stock market crash, Congressional hearings demonstrated that some viewed insider trading profits as a usual emolument of office:

Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities. Closely allied to this type of abuse was the unscrupulous employment of inside information by large stockholders who, while not directors and officers, exercised sufficient control over the destinies of their companies to enable them to acquire and profit by information not available to others.⁴⁷

Based upon these findings, Congress enacted section 16(b) "[f]or the purpose of preventing the unfair use of [inside] information which may have been obtained by [an insider] by reason of his relationship to the issuer."⁴⁸ Congress designed section 16(b) to deter what were believed to be the most prevalent forms of the abuse of inside information.⁴⁹ First, Congress regarded a limited group of insiders as presenting the greatest

45. L. Loss, *supra* note 44, at 543; *see also* A. Conard, R. Knauss & S. Siegel, *Enterprise Organizations* 943 (1987) (although the two regimes have a common goal, they "proceed by very different routes").

46. L. Soderquist, *Securities Regulation* 462 (1988).

47. *Senate Banking and Currency Committee, Stock Exchange Practices*, S. Rep. No. 1455, 73d Cong., 2d Sess. 55 (1934) [hereinafter *1934 Senate Report*]. Congress heard of one instance where Albert H. Wiggin, the chairman of a corporation, and his two brothers made a short-swing profit of \$9 million by disposing of their shares before the corporation announced that it would not pay a dividend and repurchasing the shares after the price fell. *See* S. Rep. No. 792, 73d Cong., 2d Sess. 9 (1934). The Committee on Interstate and Foreign Commerce referred to section 16(b) as the "anti-Wiggin provision." H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13 (1934) [hereinafter *1934 House Report*]; *see also* Ishizumi, *supra* note 8, at 457 ("The most fundamental mistake [in enacting section 16(b)] was Congress' emotional reaction to the Great Crash.").

48. 15 U.S.C. § 78p(b) (1988) (preamble to section 16(b)); *see supra* note 7 for the entire provision.

49. *See, e.g.*, *Foremost-McKesson, Inc. v. Provident Secs. Co.*, 423 U.S. 232, 243 (1976) ("In § 16(b) Congress sought to 'curb the evils of insider trading [by] . . . taking the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great.'") (quoting *Reliance Electric Co. v. Emerson Electric Co.*, 404 U.S. 418, 422 (1972)); *see also* 2 L. Loss, *Securities Regulation* 1040-44 (2d ed. 1961) (Congress sought to deter insider trading with section 16(b)). *But see* Dooley, *supra* note 8, at 56-59 (Congress' main concern was to supplement section 9, which deals with manipulation, not insider trading).

risk of misusing inside information. Accordingly, section 16 only applies to the directors, officers, and greater-than-ten-percent stockholders of companies registered under section 12 of the 1934 Act.⁵⁰ Second, Congress assumed that in many instances an insider's attempt to profit from the misuse of inside information would occur through off-setting transactions within a six-month period.⁵¹ Therefore, section 16(b) insiders are liable for the profit realized from short-swing transactions, that is, purchasing and selling, or selling and purchasing, any equity security of the issuer within a six-month period.

Most importantly, Congress concluded that imposing strict liability upon these specified insiders for this narrow range of trades was the only effective way to deter insider trading.⁵² As the draftsman of section 16(b) explained: "You hold the director, irrespective of any intention or expectation to sell the security within six months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb . . ." ⁵³ In order to create an *in terrorem* effect, Congress rejected a requirement of showing the actual use of information, even where no wrong was apparent, in favor of a highly mechanical approach. Thus, section 16(b) insiders are liable for short-swing trading whether or not they have access to inside information or act upon it when trading, and regardless of whether they have any intention, upon making a purchase or sale, of making a later purchase or sale within six months.⁵⁴ Consequently, section 16(b) is routinely described as: "flat,' 'arbitrary,' 'sweeping,' 'strict,' 'objective' and

50. Section 12 requires the registration of companies that have their securities listed on national securities exchanges. See 15 U.S.C. § 781(b) (1988). Section 12 also requires registration of companies that have assets in excess of five million dollars and a class of equity securities held by 500 or more record holders. See *id.* § 781(g)(1)(B); 17 C.F.R. § 240.12g-1 (1989).

51. For an extensive analysis of the reasoning behind the establishment of the six-month period, see *Blau v. Max Factor & Co.*, 342 F.2d 304, 308 (9th Cir.) (six-month trading prohibition minimizes misuse of confidential information without discouraging long-term investment), *cert. denied*, 382 U.S. 892 (1965); Comment, *Section 16(b): An Alternative Approach to the Six-Month Limitation Period*, 20 UCLA L. Rev. 1289 (1973).

52. As one commentator notes: "With the exception of an issuer's liability for a false registration statement and the responsibility for selling securities in violation of the 1933 Act's registration provisions, all remedies other than section 16(b) impose liability only if the defendant had some degree of fault." Jacobs, *An Analysis of Section 16 of the Securities Exchange Act of 1934*, 32 N.Y.L. Sch. L. Rev. 209, 367 (1987) (footnotes omitted).

53. *Stock Exchange Practices: Hearings on Senate Res. 56 and 97 Before the Senate Comm. on Banking and Currency*, 73d Cong., 2d Sess. 6557 (1934) (statement of Thomas G. Corcoran) [hereinafter *1934 Senate Hearings*].

54. Courts do not recognize equitable defenses to section 16(b) such as waiver and estoppel by the corporation. See, e.g., *Texas Int'l Airlines v. National Airlines*, 714 F.2d 533, 537 (5th Cir. 1983) (equitable defenses would "thwart the remedial purpose of the statute"), *cert. denied*, 465 U.S. 1052 (1984); *Magida v. Continental Can Co.*, 231 F.2d 843, 846 (2d Cir.) ("language and purpose of the statute preclude an estoppel"), *cert. denied*, 351 U.S. 972 (1956); *Riseman v. Orion Research, Inc.*, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,455, at 98,276 (D. Mass. Mar. 20, 1984).

'prophylactic.'⁵⁵

In enacting the strict six-month trading restriction, Congress attempted to establish minimum fiduciary standards for section 16(b) insiders by removing the temptation to seek short-swing profits and to manipulate corporate events.⁵⁶ In accordance with these fiduciary duty notions, section 16(b) requires the insider to disgorge short-swing profits to the corporation. Congress explained: "[Section 16(b)] is simply an application of an old principle of the law that if you are an agent and you profit by inside information concerning the affairs of your principal, your profits go to your principal."⁵⁷

Congress enacted two other provisions as part of the section 16 scheme.⁵⁸ Section 16(a) requires section 16 insiders to file public reports listing their holdings of equity securities of their companies and their transactions in such securities.⁵⁹ Congress adopted section 16(a) for two reasons. First, Congress believed that "the most potent weapon against the abuse of inside information is full and prompt publicity."⁶⁰ Second, section 16(a) reports allow public investors to review insiders' purchases and sales for suggestions of the insider's private opinions about the company's future.⁶¹ Congress also enacted section 16(c),⁶² which makes it unlawful for section 16 insiders to engage in short-selling or sales against

55. R. Clark, *supra* note 18, at 295 (quoting adjectives used by courts and commentators).

56. *See Section 16(b) Task Force, supra* note 13, at 1092.

57. *Stock Exchange Regulation: Hearing on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess.* 133 (1934) (statement of Thomas G. Corcoran); *see also* Restatement (Second) of Agency § 388 comment c (1958) (an agent is under duty to give to principal profits made in connection with transactions conducted on principal's behalf). Some states allow a corporation to recover from an inside trader based on agency principles similar to those used under section 16(b). *See, e.g., In re Orfa Secs. Litig.*, 654 F. Supp. 1449, 1455 (D.N.J. 1987) (derivative claim based on insider trading states a cause of action under New Jersey law); *Diamond v. Oreamuno*, 24 N.Y.2d 494, 504, 248 N.E.2d 910, 916, 301 N.Y.S.2d 78, 86 (1969) (derivative action under New York law is the "only effective remedy" against insider trading not covered by federal law). *But see Freeman v. Decio*, 584 F.2d 186, 196 (7th Cir. 1978) (*Diamond* decision "an example of judicial securities regulation"; no derivative suit under Indiana law); *Schein v. Chasen*, 313 So. 2d 739, 747 (Fla. 1975) (no derivative suit under Florida law).

58. Congress enacted two other section 16 subsections in 1964 when section 12(g), 15 U.S.C. § 78l(g) (1988), was added to the 1934 Act to extend registration requirements to the over-the-counter market: section 16(d), 15 U.S.C. § 78p(d) (1988), exempting market-making activity from 16(b) and 16(c); and section 16(e), 15 U.S.C. § 78p(e) (1988), exempting arbitrage transactions unless otherwise covered by SEC rules.

59. *See* 15 U.S.C. § 78p(a) (1988). Section 16(a) requires section 16 insiders to file an initial report of their holdings of equity securities of the issuer on Form 3. Section 16 insiders must file Form 4 within ten days of the end of the month in which they have transactions in the securities. The SEC publishes the results of these reports in a monthly pamphlet entitled *Official Summary of Securities Transactions and Holdings*. The SEC has proposed several changes in the rules promulgated under section 16(a). *See infra* notes 269-273 and accompanying text.

60. *1934 House Report, supra* note 47, at 13.

61. *See id.* at 24.

62. 15 U.S.C. § 78p(c) (1988).

the box in their company's equity securities.⁶³ This restriction prevents insiders from "in effect betting against the performance of their own company."⁶⁴ In contrast to section 16(b), sections 16(a) and 16(c) have been relatively noncontroversial.⁶⁵

As soon as Congress enacted section 16(b) in 1934, commentators began criticizing the provision:

The six months' test bears no relationship to the evil sought to be remedied; it is a bed of *Procrustes* into which it is sought to fit proper and improper transactions. While it is of course difficult to establish in any particular case whether or not inside information has been made use of, nevertheless, the difficulties in applying such a test of liability are no justification for imposing an artificial test of liability which bears no true relation to the evil sought to be remedied.⁶⁶

In 1941, the criticism of section 16(b) prompted a major campaign for its repeal. Representatives of the securities industry argued that section 16(b) was "neither logical nor effective in preventing a dishonest person from taking advantage of his position."⁶⁷ The securities industry maintained that section 16(b) did not effectively deter insider trading because the provision did not cover individual purchases or sales based upon inside information.⁶⁸ Another criticism stressed that section 16(b) arbi-

63. A section 16(b) insider sells short by selling a security he does not own; an insider sells against the box when he does not deliver a security that he has sold within "twenty days thereafter, or does not within five days after such sale deposit it in the mails or other usual channels of transportation." 15 U.S.C. § 78p(c) (1988).

64. *Section 16(b) Task Force*, *supra* note 13, at 1098.

65. *See id.* at 1097.

66. Seligman, *Problems Under the Securities Exchange Act*, 21 Va. L. Rev. 1, 5 (1934).

67. *Proposed Amendments to the Securities Act of 1933 and to the Securities Exchange Act of 1934: Hearings on H.R. 4344, H.R. 5065, H.R. 5832 Before House Comm. on Interstate & Foreign Commerce, 77th Cong., 1st Sess. 1248 (1941)* (statement of George P. Rea, President of New York Curb Exchange) [hereinafter *1941 Hearings*]. In addition to the above reasons, the industry representatives argued that the repeal of section 16(b) would enhance market liquidity because section 16(b) insiders could purchase the corporations' stock when the demand for the stock declined. *See* L. Loss, *supra* note 48, at 1088-89. *But see* Ishizumi, *supra* note 8, at 485 (section 16(b)'s importance to markets does not justify its maintenance in view of its exorbitant cost and the existence of other regulatory provisions in the federal scheme). This Article does not take the position that the market liquidity argument is a proper reason to repeal section 16(b).

Industry representatives also argued that the corporation was not the proper party to receive the profits disgorged from short-swing trading because the corporation does not suffer any harm. *See 1941 Hearings, supra* at 1254-62; *see also* Ishizumi, *supra* note 8, at 455-56 (agency theory does not support corporation's right to receive the "illegally acquired fruit"). *But see* L. Loss, *supra* note 48, at 1089 n.214 (corporation, for lack of alternatives, is proper party to recover; moreover, section 16(b) does not preclude buyers and sellers from recovering under other statutes). This Article adopts the position that insider trading does harm the corporation; thus the corporation is the proper party to compensate if the goal of compensation does not conflict with the goal of deterrence. However, because this Article assumes that deterrence is the primary goal of insider trading, it is irrelevant who brings suit or who receives the disgorged profits. *See infra* notes 326-328 and accompanying text.

68. *See 1941 Hearings, supra* note 67, at 1248.

trarily imposed liability upon legitimate transactions that occurred within six months, but did not prevent trades based upon the actual misuse of inside information that occurred six months and one day apart.⁶⁹ One representative summed up the repeal effort by declaring: "This part of the law has, in truth, burned down the barn in order to kill the rats."⁷⁰ The securities industry, however, did not offer alternative legislation. Its representatives stated that efforts to draft a substitute provision had failed, and resolved that it was not possible to draft exact regulations to deal with the insider trading problem.⁷¹ The opponents of section 16(b) took the extreme position that the expansion of section 16(a)'s filing requirements and section 16(c)'s prohibition of short sales would sufficiently deter insider trading.⁷²

The 1941 repeal effort failed. Congress apparently agreed with the SEC's reasons for opposing section 16(b)'s repeal: "It is, indeed, a curious argument that, because the statute does not cover all possible evils, it should be repealed, even though it does reach the most vicious and usual form of that evil."⁷³ The SEC also emphasized the value of section 16(b)'s minimum fiduciary standards: "speculation in their [corporation's] securities by corporate management is in itself a deleterious practice. Corporate officials then tend to serve two masters—their corporations and, on the side, their pocketbooks."⁷⁴

At the time of the first repeal campaign in 1941, there was no case law interpreting section 16(b).⁷⁵ In the early 1940s, the courts strictly interpreted section 16(b) under what later become known as the "objective approach."⁷⁶ Under the objective approach, courts mechanically applied section 16(b) to any exchange of shares that vaguely resembled a purchase or sale, without regard to whether the imposition of liability would further the purposes of the statute.⁷⁷ These courts asserted that

69. *See id.*

70. *Id.* at 1249.

71. *See id.* at 1252 ("Principally because of the intangible nature of the offense against which the law is directed, the old problem of trying to legislate honesty into a man, it has proven impossible satisfactorily to write an exact prohibition.")

72. *See id.*

73. *Id.* at 1255 (statement of Commissioner Purcell).

74. *Id.* at 1260.

75. *See id.* at 1253-54 (noting one suit filed at time of 1941 hearings).

76. In 1943, Judge Clark stated: "It is apparent . . . from the language of § 16(b) itself, as well as from the Congressional hearings, that the only remedy which its framers deemed effective for this reform was the imposition of a liability based upon an objective measure of proof." *Smolowe v. Delendo Corp.*, 136 F.2d 231, 235 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

77. This approach is clearly illustrated in *Park & Tilford Inc. v. Schulte*, 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947). Therein, Judge Clark stated:

We think a conversion of preferred into common stock followed by a sale within six months is a "purchase and sale" within the statutory language of § 16(b). . . . Defendants did not own the common stock in question before they exercised their option to convert; they did afterward. Therefore they acquired the stock, within the meaning of the [1934] Act.

Id. at 987.

“arbitrary and sweeping coverage was deemed necessary to insure the optimum prophylactic effect.”⁷⁸ In the 1950s, however, courts began to express concern over the “purposeless harshness”⁷⁹ of an unquestioning application of the “crude rule of thumb”⁸⁰ as more situations arose involving unorthodox transactions that Congress could not have anticipated would come within section 16(b)’s reach.⁸¹ To alleviate this overly strict application of section 16(b), courts developed the “pragmatic approach,” blurring the once clear lines of section 16(b) by “inquir[ing] whether the transaction . . . serve[d] as a vehicle for the evil which Congress sought to prevent.”⁸² Under this approach, courts restricted the application of section 16(b) in some cases involving unorthodox transactions by inquiring whether there was a possibility for the speculative abuse of inside information.⁸³ The pragmatic approach has caused a great deal of uncertainty and many inconsistencies in the application of section 16(b).⁸⁴ As a result, there is much confusion concerning the definitions of some of section 16(b)’s basic terms such as “purchase” and “sale.”⁸⁵

78. *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 422 (1972) (quoting *Bershad v. McDonough*, 428 F.2d 693, 696 (7th Cir.), *cert. denied*, 400 U.S. 992 (1979)).

79. *Blau v. Lamb*, 363 F.2d 507, 519 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967).

80. *1934 Senate Hearings*, *supra* note 53, at 6557.

81. *See, e.g.*, *Blau v. Lamb*, 363 F.2d 507, 521 (2d Cir. 1966) (conversion of preferred stock into common stock did not involve the possibility for speculative abuse), *cert. denied*, 385 U.S. 1002 (1967); *Blau v. Mission Corp.*, 212 F.2d 77 (2d Cir. 1954) (stock conversion a “sale” covered by section 16(b)).

82. *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 594 (1973); *see also Ferraiolo v. Newman*, 259 F.2d 342, 344 (6th Cir. 1958) (first articulation of pragmatic approach), *cert. denied*, 359 U.S. 927 (1959).

83. *See Blau v. Lamb*, 363 F.2d at 519-20.

84. *See, e.g.*, Hazen, *The New Pragmatism Under Section 16(b) of the Securities Exchange Act*, 54 N.C.L. Rev. 1, 55 (1975) (“[W]hat had been originally intended to provide the courts with a self-determining, mechanical formula has emerged into but an analytical starting point for judicially created doctrines of liability.”); *see also* 3B H. Bloomenthal, *Securities and Federal Corporate Law* 10.04(3)(b), at 10-22 (1989) (“After interpreting Section 16(b) liberally for several years as a remedial statute, the courts, and particularly the Supreme Court, have eroded much of 16(b) away”); Note, *An Economic Analysis*, *supra* note 8, at 402 (statute “modified beyond recognition by judicial interpretation”).

For an extensive discussion of the confusion produced by the two approaches, *see* Deitz, *A Practical Look at Section 16(b) of the Securities Exchange Act*, 43 Fordham L. Rev. 1 (1974) (noting confusion when section 16(b) is applied to mergers, stock options, convertible securities, puts and calls); Tomlinson, *Section 16(b): A Single Analysis of Purchases and Sales—Merging the Objective and Pragmatic Analyses*, 1981 Duke L.J. 941 (dissimilar approaches to similar fact situations by different courts have left numerous insiders liable for transactions they could not have known were covered by section 16(b)); Wentz, *Refining a Crude Rule: The Pragmatic Approach to Section 16(b) of the Securities Exchange Act of 1934*, 70 Nw. U. L. Rev. 221 (1975) (pragmatic approach prevents unfair results).

85. *See Section 16(b) Task Force*, *supra* note 13, at 1103-12.

2. Rule 10b-5's More Refined Approach

During the early 1960s, when courts frequently restricted section 16(b)'s reach under the pragmatic approach, the SEC found an opportunity to use Rule 10b-5 to combat insider trading. Unlike section 16(b), which explicitly addresses insider trading, Rule 10b-5 is a general antifraud provision.⁸⁶ In 1961, the SEC announced in an administrative proceeding that Rule 10b-5 prohibited trading based upon material nonpublic information.⁸⁷ The SEC held that liability under Rule 10b-5 is conditioned upon a finding that the person trading upon nonpublic information had a duty either to disclose the information before trading or to abstain from trading.⁸⁸ As originally formulated, this "disclose-or-abstain" duty prohibited anyone from trading based on material nonpublic information.⁸⁹ The SEC imposed this comprehensive duty based upon the theory that investor confidence in the stock market depends upon the belief that everyone has the same access to information when trading.⁹⁰ Thus, in contrast with Congress' limited definition of insiders in section 16, the SEC's definition under Rule 10b-5 reached an extensive array of insiders. Further, unlike section 16(b) which imposes strict liability, Rule 10b-5 liability depends upon the insider's acting with scienter⁹¹ when trading based upon material⁹² nonpublic information.

In 1964, when the SEC first began to use Rule 10b-5 to combat insider trading, representatives of the securities industry launched another campaign to repeal section 16(b) as part of a bill proposing significant amendments to the federal securities laws. These representatives advised Congress that section 16(b) "ha[d] aroused strong feelings, and there

86. In 1942, the SEC adopted Rule 10b-5 using its authority under section 10(b), to prohibit any misstatement or omission of a material fact in connection with the purchase or sale of securities. *See* L. Loss, *supra* note 44, at 726-27 (history behind the promulgation of Rule 10b-5).

87. *See In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

88. *See id.* at 911 ("[I]nsiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. [If disclosure would be] improper or unrealistic [the insider must] forego the transaction.").

89. *See id.* at 912.

90. The SEC stated:

Analytically, the obligation rests on two principle elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.

Id. (footnote omitted).

91. The Supreme Court has held that scienter is a requirement under Rule 10b-5 in both SEC and private actions. *See* *Aaron v. SEC*, 446 U.S. 680, 691 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212-14 (1976). Lower courts have held that recklessness satisfies the scienter requirement. *See, e.g., IIT v. Cornfeld*, 619 F.2d 909, 923 (2d Cir. 1980).

92. *See infra* notes 247-253 and 334-335 and accompanying text for a discussion of the materiality standard under Rule 10b-5.

ha[d] been a persistent demand for its revision or repeal.”⁹³ In addition to the reasons given in 1941, the representatives asserted that the pragmatic approach had caused considerable confusion in the application of section 16(b).⁹⁴ This repeal effort failed, however, because a congressional committee concluded: “Basically we had no desire to see our vital legislative program [the 1964 amendments] impeded in any way by a presumably long drawn out, bitter, and often technical controversy over various aspects of section 16.”⁹⁵

In 1968, the Second Circuit firmly established Rule 10b-5 as a comprehensive means to regulate insider trading in *SEC v. Texas Gulf Sulphur*⁹⁶ by approving the SEC’s formulation of the disclose-or-abstain rule. At this stage, Rule 10b-5 applied to every situation in which section 16(b) imposed liability. Thus, a dual system of regulation clearly governed section 16 insiders: section 16(b) automatically applied to purchases and sales within a six-month period, while Rule 10b-5 applied to trading with scienter based upon material nonpublic information.

Although the two prior repeal campaigns had failed, many commentators continued to call for the repeal of section 16(b). They argued that the development of insider regulation under Rule 10b-5 had rendered section 16(b) obsolete: “Prior to 1968, when 10b-5’s utility was uncertain, the desirability of extending section 16(b)’s coverage as far as was statutorily permissible was evident; but with 10b-5’s development, the abolition of or at least a more narrow approach to 16(b) may well be called for.”⁹⁷

93. *Part 2 Investor Protection: Hearings on H.R. 6789, H.R. 6793, S. 1642 Before a Subcomm. of the House Comm. on Interstate & Foreign Commerce, 88th Cong., 1st Sess. 1201 (1964) [hereinafter 1964 Hearings].*

94. *See id.* at 1203-04. The special study conducted in connection with the amendments reviewed the issue of whether the legislature should statutorily reverse the Supreme Court’s decision in *Blau v. Lehman*, 368 U.S. 403 (1962). *See 1964 Hearings, supra* note 93, at 1201. In this case, the Court addressed whether a partnership, Lehman Brothers, had “deputized” one of its partners to sit on a corporation’s board of directors. The partnership had profited from short-swing transactions in the corporation’s stock. The Court held that the partnership would have to disgorge its short-swing profits if the plaintiff could fulfill its burden of proving the partnership had deputized the partner to sit on the corporation’s board on behalf of the partnership. *See Lehman*, 368 U.S. at 411; *see also Wagner, Deputization Under Section 16(b): The Implications of Feder v. Martin Marietta Corporation*, 78 Yale L.J. 1151 (1969) (analysis of deputization issue).

95. *1964 Hearings, supra* note 93, at 1201.

96. 401 F.2d 833, 848 (2d Cir. 1968) (the duty to disclose-or-abstain is “based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information.”), *cert. denied*, 394 U.S. 976 (1969) (citation omitted).

97. *Hazen, supra* note 84, at 3; *see also Lowenfels, Section 16(b): A New Trend in Regulating Insider Trading*, 54 Cornell L. Rev. 45, 64 (1968) (“The logical extension of . . . the arguments . . . would be the advocacy of the repeal of section 16(b).”); *cf. Note, Split Sale Schemes Under Section 16(b): Additional Justification for the Supreme Court Majority’s Approach in Reliance Electric Co. v. Emerson Electric Co.*, 45 Temp. L.Q. 501, 516 (1972) (“[N]early all loopholes in Section 16(b) can be plugged by the liberal approach taken by the courts in applying Rule 10b-5.”).

In 1973, the American Law Institute ("ALI") also questioned whether section 16(b) regulation was necessary. The ALI noted as the most important reason for the repeal of section 16(b): "[T]he jurisprudence that has developed under Rule 10b-5 . . . has rendered obsolete the concept of *automatic* recapture of *certain* short-term profits of *certain* insiders."⁹⁸ The ALI concluded, however, that "[section] 16(b) has a symbolic significance that must be, and deserves to be, recognized."⁹⁹ Therefore, the ALI favored retaining section 16(b), while allowing the SEC to promulgate rules to "smooth[] some of [its] rough edges."¹⁰⁰

The ALI did not explain what it meant by section 16(b)'s "symbolic significance," and many have criticized this rationale.¹⁰¹ Professors Jennings and Marsh argue that "the function of Section 16(b) would appear to be to impose unjust liability upon entirely innocent persons," but nevertheless, the ALI was "told by the Reporter [of the *Federal Securities Code*] that no discussion would be permitted of the policy of Section 16(b); it had to be accepted as sacred."¹⁰² Another commentator remarked: "[s]uch a 'symbolic significance' does not deserve to be maintained at such exorbitant cost, especially in view of the fact that the federal securities regulation scheme now has, in addition to section 16(a)'s filing requirements and section 16(c)'s prohibition against short sales, rule 10b-5's antifraud provisions."¹⁰³

Beginning in 1972, the Supreme Court limited the application of section 16(b) in a series of three decisions. Although the Court alternated between using the objective and pragmatic approaches, it consistently moved toward a narrower reach of section 16(b). As the three cases demonstrate, when a literal interpretation of section 16(b) excluded the transaction, the Court used the objective approach to find that the provision did not apply to the transaction. When a literal interpretation included the transaction, however, the Court focused upon the purposes of section 16(b) under the pragmatic approach to find that the transaction did not involve the opportunity for the speculative abuse of inside information.

In *Reliance Electric Co. v. Emerson Electric Co.*,¹⁰⁴ the Court first used the objective approach and held that a greater-than-ten-percent beneficial owner could reduce his section 16(b) liability by splitting a sale transaction into two steps. In the first step, an insider could sell enough stock to

98. 2 ALI, Fed. Sec. Code § 1714 commentary at 751 (1980). The ALI listed several other grounds for repealing section 16(b): "(a) that [section 16(b)] is needlessly arbitrary to the point of being quixotic; (b) that it has acted as a trap for the unwary; [and] (c) that the Commission has made insufficient use of its exemptive authority." *Id.*

99. *Id.*

100. *Id.*

101. For the author's examination of section 16(b)'s symbolic significance in an era of insider trading scandals, see *infra* notes 247-285 and accompanying text.

102. R. Jennings & H. Marsh, Securities Regulation 1402 (1987).

103. Ishizumi, *supra* note 8, at 485.

104. 404 U.S. 418 (1972).

reduce his beneficial ownership below the ten percent threshold;¹⁰⁵ section 16(b) would apply to disgorge the profits from this sale. After the seller reduced his ownership below ten percent, he was no longer a section 16(b) insider. Therefore, in the second step, the seller could sell his remaining stock without being liable for the additional profit under section 16(b).¹⁰⁶

A year later, in *Kern County Land Co. v. Occidental Petroleum Corp.*,¹⁰⁷ the Court turned to the pragmatic approach to narrow the reach of section 16(b). The Court rejected the objective approach's literal interpretation of section 16(b): "[W]here alternative constructions of the terms of [section] 16(b) are possible, those terms are to be given the construction that best serves the congressional purpose of curbing short-swing speculation by corporation insiders."¹⁰⁸ In this case, Occidental acquired over ten percent of Kern in a hostile battle for control. In order to avoid a takeover by Occidental, Kern entered into a friendly merger with Tenneco. Occidental exchanged its Kern shares for Tenneco shares pursuant to the merger.¹⁰⁹ Occidental's exchange of Kern shares for Tenneco shares occurred within six months of the purchase of the Kern shares. Thus, the issue arose whether the exchange was a section 16(b) sale that would make Occidental strictly liable for the profits. Using the pragmatic approach, the Court held that there was no section 16(b) sale: "[T]he involuntary nature of Occidental's exchange, when coupled with the absence of the possibility of speculative abuse of inside information, convinces us that [section] 16(b) should not apply to transactions such as this one."¹¹⁰

In 1976, the Supreme Court in *Foremost-McKesson, Inc. v. Provident Securities Co.*¹¹¹ again limited the application of section 16(b) by strictly interpreting the provision. In that case, Provident sold its assets to Foremost in exchange for over ten percent of Foremost's securities.¹¹² Pursuant to the parties' agreement, Provident quickly sold the Foremost securities. The Court considered whether the purchase making Provident a greater-than-ten-percent owner of Foremost was a section 16(b) purchase.¹¹³ Interpreting the statute literally, the Court held that this exchange was not covered by section 16(b). In restricting the application of section 16(b), the Court noted that other remedies for insider trading were available:

105. In the first step beneficial ownership was reduced from 13.2 percent to 9.96 percent. Fourteen days later the remaining shares were sold. *See id.* at 420.

106. *See id.* at 423.

107. 411 U.S. 582 (1973).

108. *Id.* at 595 (quoting *Reliance Electric Co. v. Emerson Electric Co.*, 404 U.S. 418, 424 (1972)).

109. *See id.* at 588.

110. *Id.* at 600.

111. 423 U.S. 232 (1976).

112. *See id.* at 235-36.

113. *See id.* at 237.

Section 16(b)'s scope, of course, is not affected by whether alternative sanctions might inhibit the abuse of inside information. Congress, however, has left some problems of the abuse of inside information to other remedies. These sanctions alleviate concern that ordinary investors are unprotected against actual abuses of inside information in transactions not covered by [section] 16(b).¹¹⁴

Carrying the Court's reasoning to its furthest extent, section 16(b) would appear to be unnecessary, because at this stage Rule 10b-5 regulation clearly overlapped with that of section 16(b).¹¹⁵ The Supreme Court partially undercut this reasoning in 1980 when it severely limited the scope of Rule 10b-5's application to insider trading.¹¹⁶

In 1980, the Supreme Court in *Chiarella v. United States*¹¹⁷ rejected the theory that section 10(b) and Rule 10b-5 imposed a comprehensive duty to disclose material nonpublic information before trading.¹¹⁸ Instead, the Court held that the only persons subject to the disclose-or-abstain rule are those with a preexisting fiduciary relationship to the corporation in whose shares the person trades.¹¹⁹ Three years later in *Dirks v. SEC*,¹²⁰ the Court reaffirmed these principles by applying the fiduciary

114. *Id.* at 255. In *Foremost*, the Court also noted: "Rule 10b-5 has been held to embrace evils that *Foremost* urges its [broad] construction of [section] 16(b) is necessary to prevent." *Id.* at 255 n.29. *But see* *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 435 (1972) (Douglas, J., dissenting) ("[T]he protection [section] 16(b) affords is as necessary today as it was when the statute was enacted.")

115. *Cf.* *R. Hamilton, Corporations* 1022 (3d ed. 1986) ("If the [*Foremost*] Court is right that in-and-out trading should be controlled by rule 10b-5 wherever possible, isn't section 16(b) really unnecessary?")

116. *See id.*

117. 445 U.S. 222 (1980).

118. *See id.* at 235. The Court reversed the criminal conviction of *Chiarella*, a financial printer who deciphered the printing codes used to hide the target's identity in an upcoming takeover.

119. The Supreme Court stated: "When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. We hold that a duty to disclose under [section] 10(b) does not arise from the mere possession of nonpublic market information." *Id.* The Court also noted that "the duty to disclose arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.'" *Id.* at 228 (quoting Restatement (Second) of Torts § 551(2)(a) (1976)).

120. 463 U.S. 646 (1983). The defendant *Dirks*, a securities analyst, received information of fraudulent activity within Equity Funding of America from a former officer of the corporation. *See id.* at 649. After an extensive investigation and efforts to persuade the SEC to investigate the fraud, *Dirks* advised his clients to sell their shares in the corporation. *See id.* The Supreme Court reversed the SEC's censure of *Dirks* for tipping inside information to his clients. *Dirks* set forth the following two-part test for tippee liability under Rule 10b-5. First, it is necessary to show that when the insider communicated the inside information to the tippee, the insider did so for an improper purpose breaching the insider's fiduciary duty. *See id.* at 660. The improper purpose test questions whether the insider will receive a personal gain, either directly or indirectly, from his disclosure. *See id.* at 662. Second, the tippee must know or should have known that the insider's communication was both improper and in breach of a fiduciary duty owed by the insider to his corporation. *See id.* at 666. The Court held that *Dirks* did not violate this test because the insider who disclosed the information to *Dirks* had not done so for an improper purpose in breach of the insider's fiduciary duty to his corporation. *See id.* at 665; *see*

duty analysis to the situation in which a person tips information to another person who trades. In *Dirks*, the Court disclaimed the broader theory that investor confidence in the stock market depends upon the belief that everyone has the same access to information.¹²¹ The Court maintained that this theory "could have an inhibiting influence on the role of market analysts"¹²² who are "necessary to the preservation of a healthy market."¹²³ Analysts promote the stock market's efficiency by closely following the prices of stocks and exploiting any opportunity to make a profit from temporary deviations of market prices from prices that reflect all of the publicly available information.¹²⁴ Thus, the Court emphasized that a duty to disclose inside information when trading arises from a preexisting fiduciary relationship, taking a "macroeconomic, free-market perspective [that] elevate[d] market efficiency over the risk of injury to individual investors."¹²⁵

The fiduciary duty analysis in *Chiarella* and *Dirks* left significant gaps in Rule 10b-5's regulation of the total range of trades based upon inside information. For the most part, however, Rule 10b-5 regulation continued to overlap with that of section 16(b). Two groups of section 16(b) insiders, directors and officers of section 12 companies, clearly owe fiduciary duties to their corporations; thus, they have the duty to disclose or abstain from trading under *Chiarella*. In addition, another group of section 16(b) insiders, greater-than-ten-percent stockholders of section 12 companies whose holdings are sufficient to constitute control, have fiduciary obligations to their corporations.¹²⁶ After the *Chiarella* decision,

also *SEC v. Switzer*, 590 F. Supp. 756, 766 (W.D. Okla. 1984) (person who overhears information not liable as tippee); *Cox*, *supra* note 19, at 632 (criticizing *Dirks* Court's personal benefit test because analysts further market efficiency whether tipper benefits or not).

The *Dirks* Court also noted that some outsiders such as accountants and lawyers may become temporary insiders. See *Dirks*, 463 U.S. at 655 n.14; see also *SEC v. Lund*, 570 F. Supp. 1397 (C.D. Cal. 1983) (director of one corporation became temporary insider of another corporation after learning confidential information in connection with a joint venture).

121. See *Dirks*, 463 U.S. at 657-58.

122. *Id.* at 658.

123. *Id.*

124. See Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549, 568-69 (1984). An efficient market is one that reflects all available knowledge about a company in the price of the company's securities. See J. Cox, *Financial Information, Accounting, and the Law: Cases and Materials* 183-88 (1980); Fischel, *Use of Modern Finance Theory in Securities Fraud Involving Actively Traded Securities*, 38 Bus. Law. 1, 8 (1982); Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 Stan. L. Rev. 1031, 1035-40 (1977).

125. *Rule 10b-5 Task Force*, *supra* note 26, at 225; see also Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 Mich. L. Rev. 613, 624-27 (1988) (courts restrict insider trading regulation to enhance market efficiency).

126. See D. Langevoort, *supra* note 44, at 72. Professor Langevoort notes:

Corporate law has over the last few decades begun to impose fiduciary obligations of fairness and loyalty on persons who are in a position to control corporate activity as a result of their stock ownership, even though they may not

however, Rule 10b-5 did not apply to a small group of noncontrolling stockholders holding more than ten percent of the stock of section 12 companies, because noncontrolling stockholders do not owe fiduciary duties to the other stockholders.¹²⁷ Rule 10b-5, however, would apply to such noncontrolling stockholders as tippees.¹²⁸ With later developments in insider trading regulation, a dual system of regulation would again govern these section 16(b) transactions by noncontrolling shareholders.¹²⁹

Two developments filled the gaps left by *Chiarella* and *Dirks* in Rule 10b-5's regulation of insider trading. First, the SEC enacted Rule 14e-3¹³⁰ to combat insider trading in the area that poses the greatest risk of abuse, tender offers. The SEC based Rule 14e-3 on the theory that the possession of material nonpublic information about an impending tender offer, standing alone, gives rise to the duty to disclose the information or to abstain from trading. In promulgating Rule 14e-3, the SEC acted under statutory authority other than section 10(b); thus, the *Chiarella* Court's restrictions upon Rule 10b-5's regulation of insider trading do not apply to Rule 14e-3.¹³¹

The second development involved the lower court's use of the misappropriation theory to expand the reach of Rule 10b-5 under the *Chiarella* Court's fiduciary duty analysis.¹³² Under the misappropriation theory,

serve themselves as officers or directors. Since such persons have the same sort of access to information as a result of their position of power as the typical officer or director, it makes sense to extend the abstain or disclose obligation to them as well.

Id. (citing *Speed v. Transamerica Corp.*, 71 F. Supp. 457 (D. Del. 1947)).

127. See D. Langevoort, *supra* note 44, at 72 (citing *Feldman v. Simkins Industries*, 679 F.2d 1299, 1304 (9th Cir. 1982) (14 percent noncontrolling shareholder)).

128. See D. Langevoort, *supra* note 44, at 73.

129. A noncontrolling shareholder who received nonpublic information from his corporation may owe a duty of trust and confidence to the corporation if the corporation reveals the information relying upon the shareholder not to use the information for his own personal use. *Cf.* *United States v. Reed*, 601 F. Supp. 685, 706-08 (S.D.N.Y.) (discussing reliance test and de facto control tests giving rise to a fiduciary duty), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985).

130. 17 C.F.R. § 240.14e-3 (1989).

131. Because it is based on a possession theory, there was some question whether Rule 14e-3 was valid. See *O'Connor & Assocs. v. Dean Witter Reynolds, Inc.*, 529 F. Supp. 1179, 1189-93 (S.D.N.Y. 1981) (upholding SEC's authority to promulgate Rule 14e-3); D. Langevoort, *supra* note 44, at 182 (citing Note, *Private Causes of Action Under SEC Rule 14e-3*, 51 Geo. Wash. L. Rev. 290, 295-96 (1983)).

132. The misappropriation theory was first discussed by Chief Justice Burger in his dissent in *Chiarella*. Chief Justice Burger emphasized that *Chiarella* traded upon information obtained through his employment. He then indicated that an individual might breach a duty *other than a fiduciary duty*, such as a duty owed to an employer, by trading upon inside information. See *Chiarella v. United States*, 445 U.S. 222, 243-45 (1980) (Burger, C.J., dissenting). The Court did not hold *Chiarella* liable under this theory because the issue was not presented to the jury. See *id.* at 236; see also *SEC v. Materia*, 745 F.2d 197, 203 (2d Cir. 1984) (SEC used theory against financial printer who misappropriated information about impending tender offers), *cert. denied*, 471 U.S. 1053 (1985); *Moss v. Morgan Stanley Inc.*, 719 F.2d 5, 13 (2d Cir. 1983) (no private cause of action under

Rule 10b-5 applies to traders who misuse confidential information in breach of a fiduciary duty owed to someone other than the corporation whose shares are traded. For example, Rule 10b-5 would apply if an employee breaches a fiduciary duty owed to an employer when the employee misuses the employer's confidential information in order to trade.¹³³ The misappropriation theory, however, is of questionable validity, because the *Chiarella* Court seemed to reject the notion that the courts should comprehensively apply Rule 10b-5 to ensure investor confidence in the market.¹³⁴

Beginning in 1983, several groups proposed legislation to define insider trading to replace the judicial development of the law under Rule 10b-5.¹³⁵ These groups argued that a legislative definition was necessary to clarify the law, particularly with respect to the viability of the misappropriation theory.¹³⁶ The groups were unable to reach a consensus on various proposals for specific prohibitions of insider trading.¹³⁷ Congress rejected these efforts, focusing instead upon deterring insider trading, which left the courts to continue to define the violation under Rule 10b-5.¹³⁸

3. The Development of a Stronger Deterrent to Insider Trading

Prior to 1984, the principal remedies for insider trading under Rule 10b-5 were an injunction against future violations and disgorgement of the profit made or loss avoided by the illegal trade.¹³⁹ Therefore, an in-

misappropriation theory), *cert. denied*, 465 U.S. 1025 (1984); *United States v. Newman*, 664 F.2d 12, 15-16 (2d Cir. 1981) (criminal liability possible if employee breaches fiduciary duty to employer by misappropriating employer's information and trading based upon it), *cert. denied*, 464 U.S. 863 (1983).

133. The lower courts have found that a wide variety of fiduciary duties can give rise to Rule 10b-5 liability. *See, e.g.*, *United States v. Reed*, 601 F. Supp. 685, 718 (S.D.N.Y.) (son owes duty to father not to trade upon confidential information father discloses to son), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985); *see also Hiler, The Judiciary Considers the Nature of Confidential Relationships in Insider Trading Cases—A Look at United States v. Reed*, 13 Sec. Reg. L.J. 128 (1985).

134. *See Rule 10b-5 Task Force, supra* note 26, at 236-37 (noting the "troublesome nature" of the misappropriation theory and its tension with the Supreme Court's perspective in *Chiarella*).

135. Senator D'Amato, chairman of the Senate Securities Subcommittee, drafted a provision which would penalize a trader "if he employs the information in violation of his own fiduciary or contractual obligations, or if to his knowledge the information is imparted to him in violation of the fiduciary or contractual obligations of the person imparting such information to him." *The Insider Trading Sanctions Act of 1983: Hearing on H.R. 559 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 98th Cong., 2d Sess. 8 (1984). Milton Freeman drafted a counterproposal. *See id.* at 81-83.

136. *See id.* at 1-2.

137. 130 Cong. Rec. 20,105-09 (1984) (Senator D'Amato stopped efforts to draft a legislative definition in order to allow the treble damages provision to pass).

138. *See H.R. Rep. No. 355*, 98th Cong., 2d Sess. 13, *reprinted in* 1984 U.S. Code Cong. & Admin. News 2274, 2286 (1984) [hereinafter *1984 House Report*].

139. Class actions provided a great deal of deterrence following the Second Circuit's decision in *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir.

sider had little to lose under Rule 10b-5 as these sanctions merely moved the insider back to the position he would have been in had he not traded. In 1984 Congress enacted ITSA,¹⁴⁰ shifting the focus of Rule 10b-5 regulation to the deterrence of insider trading through stiffer penalties.¹⁴¹ Two factors prompted Congress to adopt ITSA: the growing dissatisfaction with the changes in Rule 10b-5 regulation under *Chiarella* and *Dirks* and the increasing detection of insider trading.¹⁴² ITSA authorized the SEC to seek, and a federal court in its discretion to impose, civil penalties on insiders of up to "three times the profit gained or loss avoided"¹⁴³ as a result of insider trading.

Although Congress declined to enact a legislative definition in 1984, efforts to replace the judicial development of insider trading regulation under Rule 10b-5 continued.¹⁴⁴ Some of the demand for a legislative

1974). In *Shapiro*, the Second Circuit held that the insiders were liable to all those who traded in the open market at the same time as the insiders for the loss in value of the security after the inside information became public. *See id.* at 238-41. This *in terrorem* effect was eliminated in *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980), when the Second Circuit stated that such "[d]raconian, exorbitant damages, [were] out of all proportion to the wrong committed." *Id.* at 170. The *Elkind* court held that the insiders were liable for the plaintiffs' losses, but limited the amount recoverable to the amount of the insider's gain or losses avoided from insider trading. *See id.* at 172.

140. *See supra* note 4. For an extensive analysis of ITSA, see Langevoort, *The Insider Trading Sanctions Act of 1984 and its Effect on Existing Law*, 37 Vand. L. Rev. 1273 (1984); Silver, *Penalizing Insider Trading: A Critical Assessment of the Insider Trading Sanctions Act of 1984*, 1985 Duke L.J. 960; Comment, *The Insider Trading Sanctions Act of 1984: Did Congress and the SEC Go Home Too Early?*, 19 U.C. Davis L. Rev. 497 (1986); Note, *Treble Damages, Deterrence, and Their Relation to Substantive Law: Ramifications of the Insider Trading Sanctions Act of 1984*, 20 Val. U.L. Rev. 575 (1986); Note, *The Role of Treble Damages in Legislative and Judicial Attempts to Deter Insider Trading*, 41 Wash. & Lee L. Rev. 1069 (1984).

141. The legislative history states that ITSA's purpose is to "provide a sufficient deterrent so that people will think twice before they engage in what all of us would call thievery." *Insider Trading Sanctions and SEC Enforcement Legislation: Hearing on H.R. 559 Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce*, 98th Cong., 1st Sess. 2 (1983) (statement of Representative Wirth, Chairman of Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce).

142. *See id.*; Silver, *supra* note 140, at 966-67.

143. 15 U.S.C. § 78u-1(a)(2) (1988) (§ 78u-1(a) was amended by ITSFEA in 1988 to apply to controlling persons). ITSA does not contain specific criteria to determine the amount of profits to be recovered, stating the amount shall be determined "in light of the facts and circumstances." *Id.* Only the SEC can seek the treble damage penalties under Rule 14e-3 and Rule 10b-5; private parties cannot seek such relief. The SEC has not provided any guidelines for when it will seek such a penalty, although it requests this remedy in almost all insider trading cases. *See Levine, Mathews & Callcott, Current Developments Affecting Insider Trading Enforcement Actions and Litigation, 1988-89, ALI-ABA Course Materials 3*, 79 (1989).

144. Several groups made proposals for a legislative definition. *See S. 1380*, 100th Cong., 1st Sess., 133 Cong. Rec. S. 8247 (daily ed. June 17, 1987) (bill submitted by Senators Riegle and D'Amato); *Definition of Insider Trading (Part II): Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess. 52-56, 84-90 (Aug. 7, 1987) (SEC and New York Stock Exchange's Legal Advisory Committee submitted proposals); *Rule 10b-5 Task Force, supra* note 26. Efforts were made to reconcile the various drafts. *See Securities and Ex-*

definition abated¹⁴⁵ in 1987, when an evenly-divided Supreme Court affirmed without opinion the use of the misappropriation theory in *Carpenter v. United States*.¹⁴⁶ In *Carpenter*, a writer for the "Heard it on the Street" column in the *Wall Street Journal* tipped the contents of unpublished articles to friends.¹⁴⁷ The Court affirmed the Second Circuit's decision upholding the writer's criminal conviction for insider trading based upon the misappropriation of confidential information in breach of the writer's duty to his employer. After *Carpenter's* narrow affirmation of the use of the misappropriation theory, many argued that a legislative definition was still necessary.¹⁴⁸ In 1988, Congress again declined to adopt such a definition,¹⁴⁹ although it is likely that Congress will consider the issue in the near future.¹⁵⁰

While Rule 10b-5's application to the insider trading problem may be unclear in some instances, it is not necessary to address these issues here. In most cases, the dual system of insider trading regulation applies to section 16(b) insiders.¹⁵¹ After Congress enacted ITSA, however, this dual system of regulation is no longer justified because the Rule 10b-5

change Commission Proposed Insider Trading Bill (Nov. 18, 1987), reprinted in SEC Compromise Proposal on Insider Trading Legislation; Accompanying Letter, and Analysis by Ad Hoc Legislation Committee, 19 Sec. Reg. & L. Rep. (BNA) 1817 (Nov. 27, 1987); see also *Symposium: Defining "Insider Trading"*, 39 Ala. L. Rev. 337 (1988) (extensive analysis of these proposals).

145. See, e.g., D. Langevoort, *supra* note 44, at 385 ("Some of the impetus for legislation clearly was lost as a result of the Court's failure to strike down the [misappropriation] theory . . ."); Phillips, *New Insider Trading Legislation*, Nat'l L.J., Nov. 14, 1988, at 17, col. 1 (100th Congress' interest in definition dissipated after *Carpenter*).

146. 108 S. Ct. 316 (1987).

147. The information in *Carpenter* involved market information, that is, information not produced by the corporation. The Court found that although the *Wall Street Journal* did not use any information obtained from the companies, the prices of the securities discussed in the articles were often affected once the article was published. The *Journal* had a policy not to reveal the identities of the companies until the articles were published. See *Carpenter*, 108 S. Ct. at 319.

148. See, e.g., Cox, *Choices: Paving the Road Toward a "Definition" of Insider Trading*, 39 Ala. L. Rev. 381, 394 (1988) (arguing that "Chiarella's emphasis on the necessity of a fiduciary relationship is the linchpin in the current drive toward defining insider trading"); Langevoort, *Setting the Agenda for Legislative Reform: Some Fallacies, Anomalies and Other Curiosities in the Prevailing Law of Insider Trading*, 39 Ala. L. Rev. 399, 405 (1988) (same); Pitt, *Winans Case: The Limits of Securities Law*, Legal Times, Nov. 23, 1987, at 18, col. 1 (*Carpenter* "exposes the SEC to potential difficulties in future prosecutions of alleged insider trading, at least in the absence of any clarifying legislation").

149. See 1988 House Report, *supra* note 4, at 11 ("[T]he court-drawn parameters of insider trading have established clear guidelines for the vast majority of traditional insider trading cases, and . . . a statutory definition could potentially be narrowing, and in an unintended manner facilitate schemes to evade the law.").

150. The legislative history acknowledges: "The Committee did not believe that the lack of consensus over the proper delineation of an insider trading definition should impede progress on the needed enforcement reforms . . ." 1988 House Report, *supra* note 4, at 11; see also 134 Cong. Rec. S. 17129 (daily ed. Oct. 21, 1988) (Senator Proxmire urging reintroduction of bill providing insider trading definition).

151. See *supra* notes 126-131 and accompanying text. A dual system of regulation may not cover the purchases and sales of noncontrolling greater-than-ten-percent stockholders

regime and section 16(b) now seek to achieve the same regulatory goal, the deterrence of insider trading. With developments under ITSFEA, the Rule 10b-5 regime clearly provides a more powerful deterrent than section 16(b).

a. ITSFEA

In 1988, Congress unanimously approved ITSFEA,¹⁵² demonstrating the strong support for a significant increase in insider trading deterrence.¹⁵³ Congress provided control person liability, express private rights of action, and bounties for informants in order to promote the detection and successful prosecution of insider trading.¹⁵⁴ Congress also enhanced deterrence by increasing the criminal penalties for insider trading violations.¹⁵⁵

The most significant provision under ITSFEA provides for the imposition of penalties upon "controlling persons" who fail to take steps to prevent insider trading.¹⁵⁶ In 1984, Congress specifically declined to im-

to the extent that the misappropriation theory is invalid and the inside information does not pertain to tender offers.

152. See 1988 House Report, *supra* note 4, at 11 ("Despite the stiffer penalties enacted by Congress in 1984, the last few years have seen a dramatic increase in insider trading cases, including cases against some of the most prominent officials in Wall Street investment banking firms.").

153. The House passed ITSFEA on September 13, 1988, by a 410-0 vote. The Senate then passed the bill without opposition by a voice vote on October 21, 1988. See Kaswell, *An Insider's View of the Insider Trading and Securities Fraud Enforcement Act of 1988*, 45 Bus. Law. 145, 151 (1989). Thus, no Senate or Conference committee reports accompanied the act. The President signed the bill on November 19, 1988. See Romano & Flannery, *Insider Trading Laws Tougher*, N.Y.L.J., Dec. 5, 1988, at 39, col. 4 ("The Senate's last minute substitution of the House bill for its own bill was apparently prompted by the legislators' desire to enact a law before the term ended . . ."); Eisenberg, *After Decade of Effort, Legislators Still Can't Rule the Stock Market*, Legal Times, Nov. 28, 1988, at 14, col. 1 ("In contrast to the six-year effort to define insider trading, the bill to increase the penalties seemed to come out of nowhere and proceed with blazing speed."); see also Kaswell, *supra*, at 145-56 (political process leading up to enactment of ITSFEA).

154. See 1988 House Report, *supra* note 4, at 16-23.

155. Congress enacted two other provisions under ITSFEA. First, Congress authorized the SEC to conduct an extensive study of the federal securities laws. The SEC has made only two such studies in the history of the federal securities laws. Section 16(b) could fall under one of the categories listed for examination, "the extent of 'improper trading' while in possession of insider information." Smith, *Another SEC Study—Is it Needed? Is It Enough?*, N.Y.L.J. Jan. 26, 1989, at 5, col. 2. Second, Congress authorized the SEC to assist foreign governments in insider trading investigations. See 15 U.S.C. § 78u(a)(2) (1988). In deciding whether to provide such assistance the SEC is instructed to consider whether the foreign government seeking assistance provides reciprocal assistance and whether compliance would prejudice the public interest. See *id.*

156. Cf. R. Posner, *Economic Analysis of Law* 397-98 (3d ed. 1986) (if penalties are sufficiently high, corporations will respond by taking internal corrective action to prevent agent's misconduct); Fisse, *Reconstructing Corporate Criminal Law: Deterrence, Retribution, Fault, and Sanctions*, 56 S. Cal. L. Rev. 1141, 1160-61 (1983) (goal of deterring corporate crime can be achieved by "[t]hreats of punishment directed at corporations [which] are intended to catalyze the adoption of sound policies of compliance").

plement such a provision.¹⁵⁷ By 1988, however, Congress perceived the need to use control person liability provisions to create an incentive for private enforcement of insider trading regulation:¹⁵⁸

The Committee intends through the broadening of controlling person civil penalty liability to increase the economic incentives for such persons to supervise vigorously their employees. Effective supervision of securities firms of their employees and agents is a foundation of the federal regulatory scheme of investor protection. With respect to insider trading in particular, the necessity for appropriate supervision to prevent violations is evident in view of the special opportunities for abuse in this area.¹⁵⁹

In order to avoid liability under the control person provisions, many companies establish internal surveillance systems to police their employees for insider trading violations.¹⁶⁰

In determining who is a controlling person under ITSFEA, the drafters directed the courts to look to the case law under section 20(a) of the 1934 Act.¹⁶¹ ITSFEA's legislative history notes that "[c]ontrolling person" may include not only employers, but any person with [the] power to influence or control the direction or the management, policies, or activities of another person.¹⁶² Directors, officers, and controlling shareholders usually fall under this definition;¹⁶³ thus, section 16 insiders may have the responsibility to prevent insider trading under ITSFEA.

The SEC can seek, and a federal court can impose, civil penalties upon controlling persons up to "*the greater of \$1,000,000, or three times the amount of the profit gained or loss avoided [by the controlled person] as a result of [the] violation.*"¹⁶⁴ In order for a court to grant such relief,

157. ITSA expressly provided that the civil penalty could not be imposed upon controlling persons under section 20(a) of the 1934 Act and upon employers under the doctrine of respondeat superior. See 15 U.S.C. § 78u(d)(2)(B) (Supp. II 1984) (repealed by ITSFEA on November 19, 1988).

158. See H. Bloomenthal, *Emerging Trends in Securities Law* § 5.09, at 5-25 (1989).

159. *1988 House Report*, *supra* note 4, at 17.

160. See, e.g., S. Winer & P. Butler, *The Insider Trading and Securities Fraud Enforcement Act of 1988 and Expansion of Control Person Liability* 42-43 (1989) (one of the primary factors in determining recklessness will be whether internal controls appropriately safeguarded against insider trading); Romano & Flannery, *supra* note 153, at 32 (absence of internal policies may evidence reckless conduct); *Requirements of Insider Trading Act Go Beyond Securities Firms*, *Lynch Says*, 21 Sec. Reg. & L. Rep. (BNA) 65 (1989) (Gary Lynch stated: "[T]here could be a case where the mere fact that a firm failed to establish any policies and procedures whatsoever would be deemed to be reckless conduct."). ITSFEA specifically imposes liability upon broker-dealers who knowingly or recklessly fail to establish, maintain, or enforce any policy or procedure necessary to maintain an adequate system of supervision and internal controls to detect securities law violations. See 15 U.S.C. § 78o(f) (1988).

161. See *1988 House Report*, *supra* note 4, at 17.

162. *Id.*

163. See D. Langevoort, *supra* note 44, at 213-14; Goelzer, *Liability for Insider Trading After the Insider Trading and Securities Fraud Enforcement Act of 1988*, 1989 ALI-ABA Course Materials 629, 638.

164. 15 U.S.C. § 78u-1(a)(3) (1988) (emphasis added). "[P]rofit gained" or "loss

the SEC must show that the controlling person either "knew or was reckless in disregarding the indications that its controlled person was engaging in insider trading or tipping."¹⁶⁵ Contemporaneous traders can sue controlling persons for the profit gained or loss avoided by the insider unless the controlling person "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."¹⁶⁶

ITSFEA also establishes an express private right of action for persons who traded contemporaneously with a person who violated the insider trading laws.¹⁶⁷ The House Committee endorsed the misappropriation theory:

[T]he codification of a right of action for contemporaneous traders is specifically intended to overturn court cases which have precluded recovery for plaintiffs where the defendant's violation is premised upon the misappropriation theory. . . . The Committee believes that this result is inconsistent with the remedial purposes of the Exchange Act, and that the misappropriation theory fulfills appropriate regulatory objectives in determining when communicating or trading while in possession of material nonpublic information is unlawful.¹⁶⁸

Without full congressional support, however, the House Committee's approval of the misappropriation theory does not resolve the issue of the theory's validity.¹⁶⁹

avoided' is the difference between the purchase or sale price of the security and the value of that security as measured by the trading price of the security a reasonable period after public dissemination of the nonpublic information." 15 U.S.C. § 78u-1(f) (1988). This penalty does not apply to insider trading violations involving face-to-face transactions. If the insider trading violation involves tipping, control person liability is limited to the aggregate of direct tippees' profits gained or losses avoided. See 15 U.S.C. § 78u-1(a)(3) (1988).

165. 1988 House Report, *supra* note 4, at 18.

166. 15 U.S.C. § 78t(a) (1988). ITSFEA expressly provided that the newly-created liability of controlling persons was subject to this pre-existing good faith defense. See 15 U.S.C. § 78u-1(b)(3) (1988). The controlling person would have the burden of establishing the defense. Some courts construe this good faith defense as proving a lack of recklessness. See, e.g., *G.A. Thompson Inc. v. Partridge*, 636 F.2d 945, 960 (5th Cir. 1981); *Carpenter v. Harris Upham & Co.*, 594 F.2d 388, 394 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979). Other circuits have required a "culpable participation" standard. See, e.g., *Orloff v. Allman*, 819 F.2d 904, 906 (9th Cir. 1987); *Kersh v. General Assemblies of God*, 804 F.2d 546, 549 (9th Cir. 1986).

167. See 15 U.S.C. § 78t-1(a) (1988). ITSFEA does not define "contemporaneously."

168. 1988 House Report, *supra* note 4, at 26-27 (citations omitted).

169. See *id.* at 10. In addition to contemporaneous traders, the Committee indicated that other private plaintiffs may have standing to sue if they can prove injury. See 1988 House Report, *supra* note 4, at 28. More specifically, the legislative history indicates that a corporation that alleges that insider trading forced it to pay more for a target company may have standing to sue insiders. The legislative history referred to one "prominent" non-contemporaneous trader suit where an acquiring company was found to have standing to sue a tipper because the tipping caused the price of the target stock to increase. See 1988 House Report, *supra* note 4, at 28 (citing *Anheuser-Busch Cos. v. Thayer*, No. 85-079 (N.D. Tex. 1986)); *Litton Indus., Inc. v. Lehman Bros. Kuhn Loeb, Inc.*, No. 86-6447 (S.D.N.Y. Aug. 19, 1986). *But see* *FMC Corp. v. Boesky*, 673 F. Supp. 242, 251

Private parties are limited to recovering the profit gained or loss avoided by the insider's violation. In addition, any penalties that the insider pays to the SEC will reduce the amount contemporaneous traders can recover.¹⁷⁰

Congress also enacted a provision authorizing the SEC to reward informants with a bounty of up to ten percent of the insider trading profits recovered.¹⁷¹ The SEC has the sole discretion to determine when to award a bounty and its amount.¹⁷²

ITSFEA increased the criminal penalties under the 1934 Act from \$100,000 to \$1,000,000 for natural persons, and from \$500,000 to \$2,500,000 for entities.¹⁷³ Congress also raised the maximum prison sentence from five to ten years with the expectation that judges will impose longer sentences for insider trading.¹⁷⁴ Beginning in 1988, several insider trading cases resulted in criminal prosecutions,¹⁷⁵ shifting the focus in insider trading enforcement from civil to criminal sanctions to deter insider trading. As this shift occurs, the line between criminal and civil prosecutions begins to blur; the only requirement necessary to convert a civil action into a criminal violation is to prove that the insider acted willfully instead of merely recklessly.¹⁷⁶ One court has interpreted "willfully" as some "realization on the defendant's part that he was doing a wrongful act . . . and that the knowingly wrongful act involved a *significant risk* of effecting the violation that occurred."¹⁷⁷

b. *Mail and Wire Fraud Statutes and RICO*

In addition to the changes brought by ITSFEA, a review of the historical development of insider trading regulation would not be complete without discussing the recent developments under the mail and wire

(N.D. Ill. 1987) (corporation has no standing to sue), *rev'd on other grounds*, 852 F.2d 981 (7th Cir. 1988). See generally Note, *Insider Trading and the Corporate Acquirer: Private Actions Under Rule 10b-5 Against Agents Who Trade on Misappropriated Information*, 56 Geo. Wash. L. Rev. 600 (1988) (arguing acquiring company has a private claim for damages under Rule 10b-5 against person who misappropriates and trades upon takeover information from acquirer).

170. See 15 U.S.C. § 78t-1(b)(2) (1988).

171. See 15 U.S.C. § 78u-1(e) (1988).

172. See 1988 House Report, *supra* note 4, at 22.

173. See 15 U.S.C. § 78ff(a) (1988).

174. See 1988 House Report, *supra* note 4, at 23; see also 134 Cong. Rec. S. 17219 (daily ed. Oct. 21, 1988) (remarks of Senator Heinz) ("Those who violate the securities laws from inside the board rooms and trading rooms must learn that they will also spend time inside our jail rooms.").

175. See, e.g., Levine, Mathews & Callcott, *supra* note 143, at 3 (citing cases). Prior to 1984, criminal prosecutions under Rule 10b-5 were rare. See *Insider Trading Sanctions and SEC Enforcement Legislation: Hearings on H.R. 559 Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce*, 98th Cong., 1st Sess. 67 (1983).

176. See 15 U.S.C. § 78ff(a) (1988).

177. United States v. Chiarella, 588 F.2d 1358, 1370 (2d Cir. 1978) (citing lower court judge's charge to the jury) (emphasis added), *rev'd on other grounds*, 445 U.S. 222 (1980).

fraud statutes¹⁷⁸ and RICO.¹⁷⁹ Securities violations and mail and wire fraud violations may serve as predicate acts to establish a pattern of racketeering activity under RICO.¹⁸⁰ The government's ability to prosecute insider trading was substantially enhanced by the Supreme Court's decision in *Carpenter*. In that case, the Court unanimously held that confidential business information was a form of protected property under the mail and wire fraud statutes, and that these statutes prohibit the misappropriation of such property.¹⁸¹ In 1988, the Department of Justice began to use RICO against accused inside traders,¹⁸² and it is likely that the government will use RICO more often to prosecute insider trading.¹⁸³

Although direct enforcement of the mail and wire fraud statutes is confined to criminal prosecutions brought by the United States, the *Carpenter* decision will also have an impact on private causes of action for insider trading under RICO.¹⁸⁴ Private parties can use mail and wire fraud violations as predicate acts in establishing a pattern of racketeering,¹⁸⁵ and receive treble damages upon a showing that the violation caused injury to the plaintiff's "business or property."¹⁸⁶ These developments will significantly influence the potential violator's deterrence calculus; combining the treble profit penalty under ITSA and the treble damages award under RICO with the disgorgement remedy under Rule

178. See 18 U.S.C. § 1341 (1988) (mail fraud); *id.* § 1343 (wire fraud).

179. See *id.* §§ 1961-1968.

180. See *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 482-83 (1985) ("pattern of racketeering activity" can be satisfied by as few as two violations, neither of which need have resulted in a conviction or any enforcement action by a public agency).

181. *Carpenter's* holding with regard to the mail and wire fraud issue was surprising after the Supreme Court's holding in *McNally v. United States*, 107 S. Ct. 2875 (1987). In *McNally*, the Court held that "schemes to defraud citizens of their intangible rights to honest and impartial government" were not covered by the mail and wire fraud statutes. See *id.* at 2879. In *Carpenter*, the Court limited the *McNally* decision as dealing with services, intangible rights that are too "ethereal" to fall within the scope of the mail and wire fraud statutes. See *Carpenter*, 108 S. Ct. at 320. For a critical analysis of the mail and wire fraud aspects of the *Carpenter* decision, see Coffee, *Hush!: The Criminal Status of Confidential Information After McNally and Carpenter and the Enduring Problem of Overcriminalization*, 26 Am. Crim. L. Rev. 121 (1988) (*Carpenter* "historically unsound"); Dreeben, *Insider Trading and Intangible Rights: The Redefinition of the Mail Fraud Statute*, 26 Am. Crim. L. Rev. 181 (1988) (*Carpenter* and *McNally* demonstrate difficulties in using mail fraud statute against insider trading violations).

182. For a discussion of criminal RICO, see United States Department of Justice, *Racketeer Influenced and Corrupt Organizations (RICO): A Manual for Federal Prosecutors* (1985).

183. See D. Langevoort, *supra* note 44, at 236; Levine, Mathews & Callcott, *supra* note 143, at 3; Brodsky, *Practical Effects of Ruling by Supreme Court in 'Winners'*, N.Y.L.J., Dec. 8, 1987, at 1, col. 1.

184. For a discussion of civil RICO and securities law violations, see Note, *Application of the Racketeer Influenced and Corrupt Organizations Act (RICO) to Securities Violations*, 8 J. Corp. L. 411 (1983).

185. See 18 U.S.C. § 1962(c) (1988) (making it a crime to conduct or participate in the conduct of an enterprise through a pattern of racketeering activity).

186. 18 U.S.C. § 1964(c) (1988) (standing for any person injured in his business or property).

10b-5 may lead to a penalty seven times the profit gained or loss avoided by insider trading.

The historical development of the dual system of insider trading regulation demonstrates that when Congress enacted section 16(b)'s rather unusual regulatory mechanism in 1934, it believed that most insider trading practices involved short-swing transactions within six months, and that a mechanical approach was the only effective means to prevent these practices. This historical perspective also reveals that section 16(b) has survived despite heavy attacks for over fifty-five years. Professor Loss believes: "By now the section's very longevity has increased its life expectancy."¹⁸⁷ No other country, however, has effective comparable regulation, and several countries have rejected this "example of 'native American radicalism.'"¹⁸⁸ More importantly, the issue of the repeal of section 16(b) took on new dimensions in 1984 and 1988, when Congress enhanced the deterrence of insider trading regulation under the Rule 10b-5 regime. In 1987, an ABA Task Force examined whether section 16(b) still served a useful purpose.¹⁸⁹ The next section of this Article critically examines the Task Force's rationales for retaining section 16(b).

II. ARGUMENTS OF THE TASK FORCE IN FAVOR OF RETAINING SECTION 16(b)

In 1987, an ABA Task Force addressed the question: "Given the development of the insider trading doctrine under rule 10b-5, the substantial limitations of section 16(b) in preventing insider trading, and the hardships that it imposes, is the statute needed?"¹⁹⁰ The Task Force con-

187. L. Loss, *supra* note 48, at 1089.

188. Munter, *Section 16(b) of the Securities Exchange Act of 1934: An Alternative to 'Burning Down the Barn in Order to Kill the Rats,'* 52 Cornell L.Q. 69, 70-71 (1966). The statute was considered "too radical for Castro's Cuba." *Id.* at 71. Japan, however, does have a section 16(b)-type statute, but there has never been a suit under the provision. *See id.*

189. *See Section 16(b) Task Force, supra* note 13. The Task Force conducted its examination of section 16(b) in conjunction with a two-part review of insider trading regulation. For its report on insider trading regulation under Rule 10b-5 and Rule 14e-3, see *supra* note 26.

190. *Section 16(b) Task Force, supra* note 13, at 1092. The Task Force recognized criticism "that section 16(b) is ineffectual in preventing insider trading and does not even address all the ways in which insider trades can be perpetuated, while it imposes punitive liability on the innocent, the naive, and the unaware corporate officers who unwittingly sell in violation of, for example, the labyrinthine restrictions of rule 16b-3." *Id.* at 1091-92.

The Task Force proposed many changes in the structure of sections 16(a) and 16(b), including a suggestion that section 16 insiders file section 16(a) Form 4 reports within two days of any purchase or disposition. The Task Force also recommended the following changes, among others, in section 16(b): decreasing the short-swing period from six months to three months; providing definitions for "beneficial ownership," "officers," and "directors;" applying section 16(b) to equity securities other than those of the issuer; excluding certain unorthodox transactions from section 16(b); and permitting former shareholders of an acquired company to sue under section 16(b). *See id.* at 1092-93.

cluded that section 16 still serves important public policy purposes by removing the temptation for corporate officers to manipulate corporate events, removing the temptation to profit from short-term price fluctuations, and penalizing the use of inside information, particularly soft information.¹⁹¹ This section examines whether these purposes are valid, and whether ITSFEA's control person provisions would achieve these goals more efficiently. In addition, this section considers whether section 16(b) continues to have "symbolic significance" in the war against insider trading because the insider trading scandals may have shaken investors' confidence in the stock market.

*A. The Temptation to Manipulate Corporate Events and
to Seek Short-Swing Profits*

The Task Force maintained that section 16(b) establishes "minimum standards of fiduciary conduct"¹⁹² by reducing the incentives for corporate managers to manipulate corporate events and to seek short-swing profits.¹⁹³ Some commentators have praised section 16(b)'s fiduciary standards: "Congress has written a rule of conduct for corporate management more effective than management could have written for itself and devised a more effective means of enforcing it."¹⁹⁴ In 1988, however, Congress authorized substantial penalties for controlling persons who recklessly disregard insider trading violations in order to encourage corporations to implement internal compliance systems to police their employees for insider trading violations.¹⁹⁵ Congress, in effect, now requires corporations to write their own rules of fiduciary conduct to prevent insider trading. Given this development, the question arises: if Congress repealed section 16(b), would corporations replace section 16(b)'s six-month trading restriction with more effective and efficient internal corporate rules to eliminate the temptation for corporate managers to seek short-swing profits and to manipulate corporate events?

To answer this question, it is first necessary to analyze whether the control person provisions are efficient. As noted previously, the government imposes minimum fiduciary standards to decrease the agency costs involved in the divergence between the interests of shareholders and managers.¹⁹⁶ In determining whether an externally-imposed fiduciary standard is efficient, it is important to consider whether the external regulation approximates the internal corporate rules that shareholders and managers would devise if the parties could contract without significant

191. *See id.* at 1092 (citation omitted).

192. *Id.*

193. *See id.*

194. Woodside, *Resume of the Report of the Special Study of Securities Markets and the Commission's Legislative Proposals*, 19 Bus. Law. 463, 478 (1964).

195. *See supra* notes 156-166 and accompanying text.

196. *See* Anderson, *supra* note 38, at 780.

transaction costs.¹⁹⁷ Thus, with respect to the control person provisions, it is necessary to examine whether managers and shareholders would find it in their self-interest to bargain for internal controls to reduce the agency costs created by insider trading.¹⁹⁸ Prior to 1988, however, most corporations did not take affirmative steps to discourage their managers from engaging in insider trading.¹⁹⁹ Accordingly, the possible reasons why shareholders and managers did not privately contract to implement self-policing systems must be analyzed. This examination reveals that control person liability is an efficient regulatory solution, because significant transaction costs prevent managers and shareholders from bargaining for self-policing systems to reduce the agency costs that arise from insider trading.

1. Efficiency of Control Person Liability

As discussed earlier, insider trading causes social harm by generating agency costs because shareholders lose some of their ability to motivate managements' behavior through compensation incentives.²⁰⁰ Investors cannot determine which firms have higher agency costs because they cannot detect insider trading. As a result, investors will discount the value of each firm's stock by the average agency costs for all firms;²⁰¹ this discounting process will raise the cost of capital for all firms. Because management's compensation often is tied to the value of their firm's securities, managers have an opportunity to increase their compensation by lowering their firm's cost of capital. Managers could lower their firm's cost of capital by incurring "bonding costs"²⁰² to signal to the

197. This principle is derived from Coase's Theorem which provides a law and economics analysis for choosing legal rules. Under the Coase Theorem, in the absence of transaction costs, parties will bargain for an efficient outcome regardless of the legal rule. See Coase, *The Problem of Social Cost*, 3 J. L. & Econ. 1, 15 (1960). If there are positive transaction costs, parties may not be able to bargain to achieve an efficient result. In the presence of such costs, the government, in establishing legal rules, should attempt to approximate the result that private parties would reach if they could contract without significant transaction costs. See, e.g., R. Posner, *supra* note 156, at 46; see also Anderson, *supra* note 38, at 781 ("Just as contract and warranty law and consumer protection legislation can promote both efficiency and fairness by providing standardized rules for transactions with high contracting and monitoring costs, corporation codes can perform a similar function by providing standardized rules to govern shareholder-management relations.").

198. Cf. Carlton & Fischel, *supra* note 28, at 865 ("[The] prohibition [of insider trading] could be justified only if it were clear that the parties themselves had attempted to deter insider trading by contract and that the government had a comparative advantage in enforcing such contracts.").

199. See *id.* at 861-66; Dooley, *supra* note 8, at 45-46. But see Pitt & Shapiro, *The Revised Insider Trading Proscriptions Act of 1988: A Legislative Remedy for a Problem that Persists*, 26 Am. Crim. L. Rev. 7, 39 (1988) (prior to ITSFEA, majority of controlling persons already cognizant of their obligations to prevent insider trading).

200. See *supra* notes 39-42 and accompanying text.

201. See *supra* note 34 and accompanying text.

202. Sellers incur bonding costs to establish better quality under conditions of uncertainty. See Dooley, *supra* note 8, at 44-45. Commentators use the term bonding costs,

market that their firms have reduced the possibility of insider trading. These bonding costs would include the types of internal controls that Congress seeks to encourage firms to implement under the control person provisions.

In deciding whether to incur bonding costs, managers would compare the returns available from insider trading to the returns available from indirectly increasing their compensation by improving the value of their firm's securities.²⁰³ Calculation of the returns from investing in self-policing systems would focus upon the short-term rewards such systems would provide to enhance the managers' compensation packages,²⁰⁴ and would not take into account the long-term benefits that such systems would provide to the corporation's shareholders. Given managements' short-term perspective, the high returns available from insider trading might overshadow any compensation benefits it would receive from implementing internal controls.

Managers who do not engage in insider trading would still profit from incurring bonding costs. However, social and psychological barriers within corporations make it doubtful that those managers who do not engage in insider trading would force their will upon those managers who might lose substantial profits from insider trading.²⁰⁵ Consequently, it is unlikely that managers would find it in their self-interest to establish self-policing systems voluntarily, because the returns from insider trading would probably exceed the managers' returns from implementing such systems.

Although it is unlikely that managers would voluntarily incur bonding costs, shareholders would still find it in their self-interest to reduce the agency costs caused by insider trading. Therefore, it is necessary to determine why, in the past, shareholders have been unable to contract privately with managers to establish internal controls to prevent insider trading. Some commentators have argued that shareholders did not attempt to prevent insider trading because the corporation is not harmed by the practice.²⁰⁶ These commentators assert that insider trading regulation as a whole is inefficient, based on the absence of private contracts

those costs incurred by managers to reduce agency costs, to distinguish from the costs assumed by shareholders to reduce agency costs which are called "monitoring costs." See Jenson & Meckling, *supra* note 38, at 323-26.

203. See, e.g., Anderson, *supra* note 38, at 781 (management will not draft contracts against its own interests); Haft, *supra* note 19, at 1058 (those who would propose restrictions are those who would benefit from insider trading).

204. Management's attention is usually focused on short-term returns that are quickly reflected in the company's stock prices. The threat of a takeover, in particular, causes managers to focus on short-term payoffs, even though the stock price may not accurately reflect the underlying value of the business.

205. See Haft, *supra* note 19, at 1058. See generally Cox & Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 *Law & Contemp. Probs.* 83 (1985) (social and psychological barriers within a corporation make it doubtful that the corporation will voluntarily police itself).

206. See Carlton & Fischel, *supra* note 28, at 864-66.

to control the practice.²⁰⁷ Given the high agency costs that insider trading imposes, however, shareholders can reap substantial gains from employing internal rules to reduce insider trading.

Professor Dooley explains:

[A]n investor who opposes insider trading might pay ten dollars per share of X Corporation if he is assured that insiders of X will not trade on confidential information. Without such assurance, he would pay only nine dollars per share. If the risk of insider trading could be reduced by one-half, the shareholder would value the share at \$9.50. Assuming that active monitoring can reduce the incidence of insider trading, a rational shareholder would incur [costs] . . . as long as [these costs] increase[] the marginal value of the share to him.²⁰⁸

Thus, shareholders have the incentive to reduce the agency costs of insider trading by bargaining with managers to establish self-policing systems. Shareholders would find it in their self-interest to allot to managers a portion of the returns from reducing the agency costs of insider trading to persuade managers to implement self-policing systems. Managers, however, would find it in their self-interest to agree to such a bargain only if the additional compensation offered by shareholders was sufficient to offset the returns from insider trading. Consequently, one explanation for the absence of private contracting for internal controls is that managers have found the rewards from insider trading to be more attractive than those from such private contracting.

Even if shareholders could offer managers sufficient returns to incur bonding costs, several factors suggest that such bargaining would not take place because of free-rider problems²⁰⁹ and high transaction costs. A shareholder confronts an inherent free-rider problem in contracting for an internal surveillance system because the shareholder will not realize the entire return from his investment; the passive shareholders receive a 'free ride' because there is no effective way to prevent them from receiving a proportionate amount of the benefits.²¹⁰ Even in the absence of the free-rider problem, shareholders would be discouraged from bargaining with managers because managers have a natural advantage over the negotiation process; managers would be tempted to "manipulate the contract to earn the rewards of apparently complying with its provisions and at the same time secretly trading outside [their] established compensation schedule[s]."²¹¹ Thus, ITSFEA's control person obligations may take

207. *See id.*

208. Dooley, *supra* note 8, at 42.

209. Free-rider problems occur when it is difficult or impossible to exclude those persons who have not paid for the use or enjoyment of a public good. *See* C. Goetz, *Cases and Materials on Law and Economics* 28 (1984). For discussion of the free-rider problem facing shareholders trying to curb managers from self-dealing, *see* Anderson, *supra* note 38, at 779; Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 *Harv. L. Rev.* 1161, 1168-72 (1981).

210. *See* Cox, *supra* note 19, at 655-56.

211. *Id.* at 657; *see also* Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privi-*

the place of the bargain that high transaction costs prevent managers and shareholders from reaching.

Other explanations for why firms took a passive position towards insider trading prior to 1988 do not withstand closer analysis. According to these explanations, which assume that shareholders could overcome the difficulties in negotiating with managers, shareholders would not contract to implement self-policing systems for two reasons. First, shareholders would not benefit from such a contract because there is no need to supplement public regulation.²¹² It is unlikely, however, that shareholders would regard internal controls as superfluous, given the prevalence of insider trading and the costs that such trading imposes upon the managers' agency relationship with the corporation. Second, even if additional restrictions are necessary, corporations do not have the capability to prevent insider trading;²¹³ public enforcement is probably the only effective way to enforce the prohibition against insider trading because public officials can monitor trading through the stock exchanges' computer surveillance systems.²¹⁴ This rationale is also seriously flawed. Corporations could simply contract with the stock exchanges to supervise the trading of the firm's securities.²¹⁵ More importantly, computerized monitoring is not the only means to detect insider trading. As a review of some of the internal controls adopted under ITSFEA indicates, corporations may be in a better position than the government to police for insider trading due to their greater information about the certainty and costs of enforcement.²¹⁶ In order to avoid control person liability, corporations will take a variety of steps to supervise the flow of nonpublic information and to deter trading by managers likely to have access to this information.

2. Devising Internal Rules of Fiduciary Conduct to Prevent Insider Trading

The control person provisions, in effect, decentralize the process of formulating precise regulations to prevent insider trading. In order to avoid control person liability, firms will tailor their self-policing systems to meet their specific risks of insider trading. ITSFEA presumably requires

leges, and the Production of Information, 1981 Sup. Ct. Rev. 309, 334 (despite agreement to forego inside trading, managers can trade anyway knowing they will probably avoid detection).

212. See J. Choper, J. Coffee & C. Morris, *supra* note 20, at 466.

213. Unlike private corporations, public enforcers can also "obtain search warrants, use grand juries, engage in plea bargaining, obtain bank records from foreign jurisdictions, . . . and employ administrative sanctions (such as suspending a broker dealer)." *Id.*; see also Easterbrook, *supra* note 211, at 333 (corporations lack devices to detect insider trading); Gilson & Kraakman, *supra* note 124, at 634 n.224 (high cost of insider trading monitoring suggests that collective monitoring and enforcement would be most efficient).

214. See J. Choper, J. Coffee & C. Morris, *supra* note 20, at 466.

215. See Carlton & Fischel, *supra* note 28, at 890.

216. See *id.*; Dooley, *supra* note 8, at 46.

each firm to balance the marginal cost of implementing surveillance procedures against the marginal benefit of detecting insider trading.²¹⁷ Each firm will derive the marginal cost of establishing internal controls from the total costs of designing, testing, and implementing a self-policing system, including the loss of productivity from putting the controls in effect.²¹⁸ Each firm will calculate the marginal benefit of detecting insider trading from the amount of control person liability the firm avoids, taking into account the risk that its employees will engage in insider trading.²¹⁹ In assessing the risk of insider trading, firms will consider such factors as the type of nonpublic information involved and the number of employees that have such information.²²⁰

Where the possibility of insider trading is small, corporations will issue general firm policies against insider trading and restrict access to confidential information.²²¹ Firms that have a higher risk of insider trading may limit their employees' trading to certain periods following important public disclosures²²² and may require employees to clear all trades through the general counsel's office.²²³ Alternatively, these firms may employ independent brokers to administer periodic investment programs so that the timing of purchases and sales of the firm's securities is outside the control of its employees.²²⁴ Some firms may need to go as far as issuing a flat prohibition against trading in the firm's securities.²²⁵ In addition, firms with a significant risk of insider trading may have the incentive to disclose nonpublic information earlier than usual in order to reduce their exposure to control person liability.²²⁶

Regardless of the degree of risk a firm faces and the types of internal

217. See S. Winer & P. Butler, *supra* note 160, at 44; see also Cox, *supra* note 19, at 639 ("[A] firm will balance the marginal cost of each additional unit of bonding, monitoring, and signaling against the accompanying marginal benefits of reducing its managers' trading."); Jensen & Meckling, *supra* note 38, at 345-51 (agency costs involve monitoring costs incurred because of manager's incentive to exploit outside shareholders). No firm will be completely free from insider trading because it is too costly to eliminate the practice entirely.

218. See S. Winer & P. Butler, *supra* note 160, at 47.

219. See *id.* at 44.

220. See *id.*

221. See *id.* at 47-52.

222. See, e.g., New York Stock Exchange Listed Company Manual § 309.00, 4 Fed. Sec. L. Rep. (CCH) ¶ 26,100, at 19,103-04 (1983) (suggesting that an insider may trade after the firm issues the annual report, quarterly results, proxy statement, or prospectus, so long as the insider contacts the chief executive officer to ensure that there are no important undisclosed developments).

223. See S. Winer & P. Butler, *supra* note 160, at 49.

224. See New York Stock Exchange Listed Company Manual, *supra* note 222, ¶ 26,100, at 19,103.

225. See S. Winer & P. Butler, *supra* note 160, at 49.

226. See *id.* at 50. This incentive may have a healthy effect on the allocative efficiency of the market as a whole; absent trading by the corporation in its own stock, there is no affirmative duty to disclose nonpublic information. See generally Bauman, *Rule 10b-5 and the Corporation's Affirmative Duty to Disclose*, 67 Geo. L.J. 935 (1979) (discussing extent of corporation's duty to disclose material information).

controls it devises, a firm will need auditing procedures to ensure that its employees comply with its programs.²²⁷ Firms with a high risk of insider trading will supplement these auditing procedures with a review of their employees' trading records and tax returns.²²⁸ To strengthen the deterrence of these self-policing programs, firms will impose sanctions upon employees who engage in suspicious conduct.²²⁹ Internal discipline may take the form of liquidated damages, discharge, and forfeiture of benefits.²³⁰

A firm that fails to self-police for insider trading will face a substantial penalty for each insider trading violation by its employees. Therefore, the next issue to address is who will ultimately bear the penalty imposed under the control person provisions.²³¹ Investors will discount the value of each firm's securities to counterbalance the firm's risk of control person liability.²³² As a result, investors are not harmed when the firm incurs the control person penalty, because they will receive a higher rate of return to compensate for this risk. Thus, the penalty falls upon firms rather than investors; firms that fail to self-police will have a higher cost of capital.²³³ Firms will attempt to lower their cost of capital by signaling to the market that they have decreased their potential exposure by implementing effective internal compliance systems.²³⁴

In sum, control person liability is an efficient regulatory solution because it approximates the bargain that shareholders and managers would reach if they could contract without significant transaction costs. Firms that fail to establish such systems will have a higher cost of capital because investors will demand a higher rate of return to compensate for the risk of control person liability. This analysis provides the groundwork to examine whether, assuming Congress repealed section 16(b), section 12 companies would substitute section 16(b)'s six-month trading restriction with more efficient internal rules.

3. Replacing Section 16(b)'s Rule of Conduct

Section 16(b) is an extremely rough approximation of the agreement that shareholders and managers of section 12 companies would reach if they could contract without significant transaction costs; the six-month

227. See S. Winer & P. Butler, *supra* note 160, at 50-51.

228. See *id.* at 57; Carlton & Fischel, *supra* note 28, at 864.

229. See Coffee, "No Soul to Damn: No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment, 79 Mich. L. Rev. 386, 408 (1981); Fisse, *supra* note 156, at 1161.

230. See Carlton & Fischel, *supra* note 28, at 864; Dooley, *supra* note 8, at 46.

231. See, e.g., Coffee, *supra* note 229, at 409 (discussing who should bear the penalty); Kadish, *Some Observations on the Use of Criminal Sanctions in Enforcing Economic Regulations*, 30 U. Chi. L. Rev. 423, 430-34 (1963) (same).

232. Cf. Mendelson, *supra* note 31, at 477-78 (firms experiencing insider trading have higher cost of capital).

233. See K. Elzinga & W. Breit, *supra* note 8, at 135; Frankel, *Implied Rights of Action*, 67 Va. L. Rev. 553, 577 (1981).

234. See Dooley, *supra* note 8, at 46-48.

trading restriction is necessarily overinclusive for some companies and underinclusive for others. Although section 16(b)'s "crude rule of thumb" is a poor substitute for private contracting, some may argue that the short-swing trading rule is necessary because section 16(b) insiders pose a high risk of abusing their access to confidential information. No data exists to support this position. Section 12 companies, however, may experience more financial developments that offer insider trading opportunities, thus increasing the risk that their insiders will engage in insider trading.

Section 12 companies will design their self-policing systems taking into account section 16(b)'s trading restriction on their officers, directors and greater-than-ten-percent shareholders. Section 12 companies will supplement the six-month trading rule with internal controls to the extent necessary to avoid control person liability. Assuming that section 12 companies have a high risk of insider trading, the repeal of section 16(b) would create a gap in their surveillance programs. This gap would expose these companies to potential liability under ITSFEA. As the risk of control person liability increased, investors in section 12 companies would insist on a higher return for their investment, which would raise the cost of capital for section 12 companies. To reduce this cost, section 12 companies would implement more rigorous internal controls to fill the void left by the repeal of section 16(b).

Allowing section 12 companies to substitute privately section 16(b)'s externally imposed trading restriction with their own internal corporate rules would be efficient, because section 12 companies could tailor their self-policing systems to meet their specific risks of insider trading. The decentralized system of regulation under the control person provisions avoids the inefficiencies of section 16(b)'s blunt regulation because firms have an inherent advantage over the government in formulating internal corporate rules; corporations have better information than the government concerning the risks of insider trading and the costs of preventing the practice.²³⁵ As a result, the control person provisions will likely have a greater impact than section 16(b) upon the internal operations of a firm in two respects. First, self-policing systems are more likely to increase managerial efficiency by deterring managers from looking for insider trading opportunities. Second, these procedures may lead to a greater reduction of informational delays and manipulation of corporate events.²³⁶

The ability of insiders to manipulate corporate events is most acute when insiders engage in short-selling. Therefore, section 16(c)'s standardized restriction against short-selling serves a useful purpose, because it is likely to correspond to the type of internal controls that firms would

235. *See id.* at 46.

236. *See* Haft, *supra* note 19, at 1051-64. *But see* Easterbrook, *supra* note 211, at 333 (firms have reasons other than insider trading for delaying the release of information).

enact in its absence.²³⁷

In sum, under the control person provisions, Congress encourages firms to write rules of fiduciary conduct to control insider trading that are more effective than section 16(b). If Congress repealed section 16(b), firms would substitute the six-month trading restriction with individually tailored self-policing systems. These internal systems would more efficiently achieve section 16(b)'s most important goals: removing the temptation for managers to seek short-swing profits and to manipulate corporate events. With this conclusion, it is appropriate to turn to the Task Force's final rationale for retaining section 16(b).

B. *Insider Trading on Soft Information*

The Task Force maintained that section 16(b) still serves a valid purpose because:

[Section 16(b)] penalize[s] the unfair use of inside information by insiders. This includes both trading on inside information in violation of rule 10b-5 and the use of "softer" information of the type that insiders often have but that members of the investing public do not: the ability to make better informed guesses as to the success of new products, the likely results of negotiations, and the real risks of contingencies and other uncertainties, the underlying facts of which have been publicly disclosed.²³⁸

Apparently, the Task Force was particularly concerned about preventing section 16(b) insiders from trading upon subjective or future-oriented information, known as "soft information,"²³⁹ which is not regulated by Rule 10b-5. Under Rule 10b-5, a manager can trade upon nonmaterial soft information. Given that the two systems of insider trading regulation take conflicting approaches, the issue arises whether section 16(b)'s efforts to prevent insiders from trading upon nonmaterial soft information are efficient. The development of disclosure policies pertaining to soft information provide insight into this issue. This historical perspective demonstrates that, although Congress strongly disfavored the disclosure of soft information when section 16(b) was enacted in 1934, recently

237. *But see* Carlton & Fischel, *supra* note 28, at 893 (shareholders may not contract to ban short-selling because this type of transaction may convey valuable information about the firm and induce managers to make better investment decisions).

238. *Section 16(b) Task Force, supra* note 13, at 1092 (footnote omitted).

239. For more extensive commentary on the many issues posed by soft information, see Brudney, *A Note on Materiality and Soft Information Under the Federal Securities Laws*, 75 Va. L. Rev. 723 (1989); Dennis, *Mandatory Disclosure Theory and Management Projections: A Law and Economics Perspective*, 46 Md. L. Rev. 1197, 1213 (1987); Hiler, *The SEC and the Courts' Approach to Disclosure of Earnings Projections, Asset Appraisals, and Other Soft Information: Old Problems, Changing Views*, 46 Md. L. Rev. 1114 (1987); Kerr, *A Walk Through the Circuits: The Duty to Disclose Soft Information*, 46 Md. L. Rev. 1071 (1987); Schneider, *Nits, Grits, and Soft Information in SEC Filings*, 121 U. Pa. L. Rev. 254 (1972); Steinberg & Goldman, *Issuer Affirmative Disclosure Obligations—An Analytical Framework for Merger Negotiations, Soft Information, and Bad News*, 46 Md. L. Rev. 923 (1987).

the SEC and the courts have begun to encourage the disclosure of soft information in order to enhance market efficiency. Further analysis reveals that management's trading upon nonmaterial soft information is an efficient means to facilitate the process by which soft information reaches the stock market.

1. History of the Regulation of Soft Information

In the wake of the 1929 stock market crash, Congress enacted section 16(b) to prevent insider trading and other securities laws to ensure the disclosure of factual, verifiable data.²⁴⁰ Because it regarded soft information as inherently unreliable, the SEC adopted a paternalistic attitude to protect unsophisticated investors from managers who might make overly optimistic projections.²⁴¹ Thus, the SEC at first prohibited the disclosure of soft information.²⁴² Commentators criticized the SEC's strict position, arguing that the free flow of soft information would promote market efficiency.²⁴³ Recently, the SEC recognized that "the availability of forward-looking and analytical information is important to an investor's assessment of a corporation's future earning power and may be material to informed investment decision-making."²⁴⁴ Therefore, the SEC relaxed its position by permitting or even encouraging managers to disclose soft information.²⁴⁵ The SEC has not yet gone so far as to require the disclosure of soft information.²⁴⁶

In 1988, the Supreme Court briefly addressed the issue of insider trad-

240. See Steinberg & Goldman, *supra* note 239, at 937-38.

241. See *id.* at 934-46.

242. See Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1294 (2d Cir. 1973). *But see* Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 565 (E.D.N.Y. 1971) (requiring disclosure of management's estimate of assets and intended reorganization of target company).

243. See Dennis, *supra* note 239, at 1213; Steinberg & Goldman, *supra* note 239, at 935.

244. Guides for Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5992, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,756, at 81,036 (Nov. 7, 1978).

245. See Statement by the Commission on Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5699, [1975-76 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,461, at 86,201-02 (Apr. 23, 1976) (permitting soft information in 1933 Act registrations statements and 1934 Act filings). Rule 175 encourages the disclosure of projected future revenues by providing managers with a safe harbor if the projections are made upon a reasonable basis and in good faith. See 17 C.F.R. § 230.175 (1988); Safe Harbor Rule for Projections, Securities Act Release No. 6084, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,117, at 81,938-45 (June 25, 1979). See generally Fiffis, *Soft Information: The SEC's Former Exogenous Zone*, 26 UCLA L. Rev. 95 (1978) (discussing potential benefits and liabilities in release of soft information); Note, *Mandatory Disclosure of Corporate Projections and the Goals of Securities Regulation*, 81 Colum. L. Rev. 1525 (1981) (arguing mandatory disclosure of corporate projections will not further investor protection and could impair market efficiency); Note, *The SEC Safe Harbor for Forecasts—A Step in the Right Direction?*, 1980 Duke L.J. 607 (arguing for refinement of SEC safe harbor rule for disclosure of forecasts).

246. Some commentators argue that the SEC should require the disclosure of soft in-

ing upon soft information under Rule 10b-5 in *Basic Inc. v. Levinson*.²⁴⁷ The *Basic* Court's main concern was whether a bright-line test was appropriate to judge the materiality under Rule 10b-5 of soft information concerning merger negotiations.²⁴⁸ The Court refused to adopt a bright-line test,²⁴⁹ indicating that such a test would not achieve the purpose of the materiality standard "to filter out essentially useless information that a reasonable investor would not consider significant . . . in making his investment decision."²⁵⁰ In a footnote, the *Basic* Court rejected the notion that there was a lower materiality standard for insider trading upon soft information:²⁵¹ "[a] fact does not become more material to a shareholder's decision because it is withheld by an insider or because an insider might profit by withholding it."²⁵² The Court, however, indicated that insider trading upon soft information may serve as "an indication of materiality."²⁵³ Thus, the Court recognized that managers may trade upon nonmaterial soft information under Rule 10b-5.

In addressing another issue in *Basic*, the Court implicitly recognized

formation to enhance market efficiency. See Dennis, *supra* note 239, at 1218-21; Steinberg & Goldman, *supra* note 239, at 935.

Although the SEC has not yet mandated the disclosure of soft information, a few courts do require disclosure of this information in certain circumstances. See, e.g., *Starkman v. Marathon Oil Co.*, 772 F.2d 231, 241 (6th Cir. 1985) (requiring that "soft information such as asset appraisals and projections must be disclosed [when] the reported values are virtually as certain as hard facts"), *cert. denied*, 475 U.S. 1015 (1986). 247. 108 S. Ct. 978 (1988).

248. In *Basic*, the New York Stock Exchange called upon corporate officers to confirm rumors concerning unusual trading in the company's stock. Although the company was engaged in merger negotiations, the officers responded that they were not aware of any events that would cause unusual trading. See *id.* at 981 n.4. In *Greenfield v. Heublein, Inc.*, 742 F.2d 751 (3d Cir. 1984), *cert. denied*, 469 U.S. 1215 (1985), the Third Circuit held that merger negotiations were immaterial as a matter of law until the parties had reached an agreement on both the price and the structure of the merger. See *id.* at 756-57. The SEC refused to adopt the bright-line rule for determining whether preliminary merger negotiations were material. See *In re Carnation Co.*, Exchange Act Release No. 22214, [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801, at 87,592 (July 8, 1985).

249. See *Basic*, 108 S. Ct. at 985-86. The Supreme Court rejected the Third Circuit's bright-line test, which focused upon whether the parties had established the price and structure of the merger.

250. *Id.* The *Basic* Court adopted the standard enunciated in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976): "[T]here must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available." *Basic*, 108 S. Ct. at 983 (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

251. In *Basic*, the Supreme Court rejected the theory raised in *SEC v. Geon Industries, Inc.*, 531 F.2d 39, 48 (2d Cir. 1976), that materiality has a different aspect in insider trading cases and that information takes on an added charge just because it is inside information. See *Basic Inc. v. Levinson*, 108 S. Ct. 978, 988 n.18 (1988). The Court stated: "We find no authority in the statute, the legislative history, or our previous decisions, for varying the standard of materiality depending on who brings the action or whether insiders are alleged to have profited." *Id.*

252. *Id.* (quoting *Pavlidis v. New England Patriots Football Club, Inc.*, 737 F.2d 1227, 1231 (1st Cir. 1984)).

253. *Id.*

the link that connects managers' trading upon nonmaterial soft information to the efficiency of the stock markets. In *Basic*, the Court adopted the "fraud on the market theory," which serves as a presumption of investor reliance in certifying class actions under Rule 10b-5.²⁵⁴ Under this theory, investors who never read or relied upon a misstatement can bring suit under Rule 10b-5 if the misstatement distorted the market price of the stock. The Court adopted this theory to ensure that the "market price reflects as nearly as possible a just price."²⁵⁵

The efficient market hypothesis provides the support for the "fraud on the market theory." The efficient market hypothesis posits that the price of a stock immediately reflects all available public information about the company.²⁵⁶ This is so because analysts seek to profit from temporary deviations in stock prices from prices that reflect all known information about the company.²⁵⁷ Thus, the *Basic* Court's emphasis upon market efficiency accords with the *Dirks* Court's earlier recognition that "market efficiency in pricing is significantly enhanced by [analysts'] initiatives to ferret out and analyze information."²⁵⁸

This historical perspective demonstrates that the SEC and the Supreme Court favor the disclosure of soft information to promote market efficiency. With this background, it is possible to examine why section 16(b)'s goal of preventing managers from trading upon nonmaterial soft information is inefficient.

2. Repealing Section 16(b) Would Enhance Market Efficiency

The Task Force favored retaining section 16(b) to prevent insiders from trading upon nonmaterial soft information that was not regulated by Rule 10b-5. Congress, however, should repeal section 16(b), because allowing insiders to trade upon nonmaterial information promotes market efficiency. In most cases, insider trading upon nonpublic information simply has too much "noise" associated with it to be an efficient substitute for clear corporate announcements.²⁵⁹ Management trading upon nonmaterial soft information, however, may provide an essential process

254. See *id.* at 988-90. See generally Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C.L. Rev. 435 (1984) (arguing fraud on the market theory demands stricter adherence to common-law reliance requirement).

255. See *Basic Inc. v. Levinson*, 108 S. Ct. 978, 991 (1988) (quoting H.R. Rep. No. 1383, 73d Cong., 2d Sess. 11 (1934)).

256. See *supra* note 124 and accompanying text.

257. See *id.*

258. *Dirks v. SEC*, 463 U.S. 646, 658 n.17 (1983). But see Stout, *supra* note 125, at 615-37 (questioning whether the market efficiency goal of securities regulation is appropriate).

259. Professor Manne has argued that insider trading has the beneficial effect of promoting smooth stock price changes by slowly adjusting the stock's market price to its post-disclosure equilibrium price. See H. Manne, *supra* note 28, at 78-104. But see Gilson & Kraakman, *supra* note 124, at 629-34 (insider trading is a relatively inefficient way of communicating stock value information to market).

by which nonmaterial soft information reaches the stock market, enhancing market efficiency.²⁶⁰ Two factors impede the disclosure of soft information to the market. First, corporations do not have a general obligation to disclose soft information.²⁶¹ Second, managers are reluctant to disclose this type of information because they risk massive liability if the forecast turns out to be incorrect.²⁶²

Allowing managers to trade upon nonmaterial soft information may provide them with the necessary incentive to disclose indirectly this type of information to stock market analysts.²⁶³ Although nonmaterial information is by definition not relevant to rational investors,²⁶⁴ analysts can piece together several bits of nonmaterial information to produce forecasts about the future prices of a company's stock.²⁶⁵ Managers' trading upon nonmaterial information signals to analysts about the insiders' private opinions about the company.²⁶⁶ Efforts by these analysts ensure that the firm's stock prices reflect the information revealed by insider trading. Managers may be tempted to manipulate stock prices by giving analysts false signals; however, once misled, analysts would not continue to follow such leads.²⁶⁷

Requiring section 16 insiders to file section 16(a) reports on or before

260. Professor Cox explains:

[O]fficers may early in a firm's third quarter possess nonpublic information that the firm has finally obtained control over the production costs for one of its many products while wholesale distributors are busy inquiring about two other product lines. The corporation does not disclose these facts because they are too tentative. Nevertheless, any investor selling during the period of nondisclosure would certainly benefit by whatever effects knowledge of these events will have on the market. . . . Under these circumstances, an unwitting outsider may welcome the insider's trading if it provided even modest upward propulsion in the stock's price.

Cox, *supra* note 19, at 647; see also Cox, *Insider Trading Regulation and the Production of Information*, 64 Wash. U.L.Q. 475, 484-85 (1986) (noting that management forecasts can have a similar effect).

261. See *supra* note 246 and accompanying text.

262. See Steinberg & Goldman, *supra* note 239, at 936-37; see also Carlton & Fischel, *supra* note 28, at 868 (firm can disclose information through insider trading that it otherwise would not for fear of massive liability).

263. See Carlton & Fischel, *supra* note 28, at 868. Insider trading upon nonmaterial information promotes market efficiency because, as studies demonstrate, managers are more accurate than analysts in making financial forecasts. See Cox, *supra* note 260, at 481 n.17.

264. See *supra* notes 249-250 and accompanying text.

265. See Fischel, *Insider Trading and Investment Analysts: An Economic Analysis of Dirks v. Securities and Exchange Commission*, 13 Hofstra L. Rev. 127, 140-44 (1984); Lorie, *Insider Trading: Rule 10b-5, Disclosure, and Corporate Privacy: A Comment*, 9 J. Legal Stud. 819, 820-21 (1980).

266. See, e.g., Dorfman, *Journal Launches Insider Trading Feature*, Wall St. J., Aug. 31, 1988, at 28, col. 2 (analysts monitor section 16(a) reports); Koretz, *Tracking Corporate Insiders to Get in on a Good Thing*, Bus. Wk., May 19, 1986, at 34 (model portfolio study following insiders' trades yielded higher than average returns); Marcial, *Taking a Cue from Company Insiders*, Bus. Wk., May 12, 1986, at 88 (market drops generally preceded by heavy insider selling).

267. See Carlton & Fischel, *supra* note 28, at 892.

the day they trade would take into account the market's sensitivity to the information provided by insider trading upon nonmaterial information.²⁶⁸ Prompt section 16(a) reporting would significantly aid the efforts of analysts to investigate developments giving rise to soft information.²⁶⁹ In addition, such disclosure would better serve the congressional policy underlying section 16(a) that allows public investors to review insiders' purchases and sales for suggestions of the insider's opinions about the company's future.²⁷⁰ In order to ensure that insiders promptly fulfill their duties to file section 16(a) reports,²⁷¹ the SEC should enact its proposed changes in the rules promulgated under section 16(a) that would impose penalties upon section 16 insiders who file late.²⁷² Other SEC proposals would require section 12 companies to disclose annually late section 16(a) filings. Through public disclosure of late filings, the SEC seeks to encourage section 12 companies to implement compliance programs to assist their insiders in filing section 16(a) reports.²⁷³

In conclusion, section 16(b)'s six-month trading restriction imposes significant costs by deterring activity that would enhance the market's informational efficiency. Compared to section 16(b)'s flat six-month restriction, Rule 10b-5's materiality standard better balances the need to prevent insider trading against the benefits provided by allowing managers to trade. Thus, an examination of the Task Force's rationales for retaining section 16(b) reveals that they are no longer valid in light of recent developments. In searching for a reason to continue section 16(b)

268. Several commentators and legislators have pushed for such reform in the past. *See, e.g.*, Klein, *supra* note 9, at 9; *Section 16(b) Task Force*, *supra* note 13, at 1102 (noting Senator Chafee's proposal for same-day section 16(a) reports and \$50,000 penalty for late filing). The Section 16(b) Task Force concluded that same day or prior reporting was not practical and recommended that section 16 insiders file Form 4 reports within two business days of the transaction. *See id.* The SEC did not adopt this suggestion in their proposals to overhaul the rules promulgated under section 16(b). *See infra* note 268.

269. *Cf.* Carlton & Fischel, *supra* note 28, at 868 ("The greater the ability of market participants to identify insider trading, the more information such trading will convey.").

270. *See infra* note 61 and accompanying text.

271. *See Cox*, *supra* note 260, at 501 n.77 ("Any linkage of the insider trading practices with the larger corporate aims of improving voluntary disclosure practices must deal with the reality that insiders will not comply fully with the detailed restrictions and concomitant record keeping such a linkage necessitates.").

272. *See Ownership Reports and Trading By Officers, Directors and Principal Stockholders*, Exchange Act Release No. 26333, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,343, at 89,626-27 (containing Proposed Item 405 to Regulation S-K, Proposed New Item 7 to Schedule 14A, Proposed New Item 10 to Form 10-K) [hereinafter *Ownership Reports*]. The SEC enacted these proposals in response to findings that 48 percent of the section 16(a) reports were filed late in 1986 and 43 percent were filed late in 1988. *See id.* at 89,625 n.208. In addition, the SEC proposed legislation giving it the ability to impose a fine for late filings. *See id.* at 89,626 n.211. The SEC submitted proposed legislation and a supporting memorandum to Congress on September 28, 1988 and January 24, 1989. *See* 21 Sec. Reg. L. Rep. (BNA) 156-57 (Jan. 27, 1989).

273. *See Bagley & Newell, 55 Years Later: Revisions Proposed for Sec. 16*, Nat'l L.J., July 3, 1989, at 15, col. 1; *Companies Urged to Institute Compliance Programs*, 4 Corp. Couns. Wkly. (BNA) No. 25, at 8 (June 21, 1989).

regulation, the next section of the Article explores whether section 16(b) has "symbolic significance" in the war against insider trading.

*C. Section 16(b)'s "Symbolic Significance" in the War
Against Insider Trading*

In 1973, the ALI favored retaining section 16(b) because the provision has "symbolic significance that deserves to be recognized."²⁷⁴ Section 16(b) may have symbolic significance in the war against insider trading in two respects. First, investors may regard section 16(b) as a symbol of market integrity at a time when insider trading scandals have shaken their confidence in the stock market.²⁷⁵ Second, Congress may view section 16(b) as a political symbol in its efforts to take a tough stance against insider trading.

In the wake of the 1987 stock market crash,²⁷⁶ the possibility that investors attach symbolic significance to section 16(b) is undoubtedly important. The legislative history of ITSFEA recognizes that one of the primary goals of insider trading regulation is to "restore the confidence of the public in the fairness and integrity of our securities markets."²⁷⁷ Indeed, Congress enacted section 16(b) to renew investor confidence in the market after the 1929 stock market crash.²⁷⁸ Arguments about investor confidence, however, are difficult to evaluate. No statistical evidence supports the proposition that insider trading has eroded investor confidence in the market.²⁷⁹ Therefore, notions about investor confidence may lead to overregulation.²⁸⁰

Assuming that insider trading scandals have shaken investor confidence in the market, one might contend that despite section 16(b)'s ineffi-

274. See *supra* notes 98-103 and accompanying text.

275. As expressed by one commentator:

At a time when investor confidence in the integrity of the securities markets has been rocked by a series of insider trading scandals, it would be a large step backward to further erode that confidence by repealing a provision that not only is recognized as a symbol of the fight against improper insider trading, but also is highly effective in preventing the occurrence of several forms of such trading.

P. Romeo, Section 16 Treatise § 1.05(2) (to be published in 1990 by Executive Press, Inc.) (draft on file at *Fordham Law Review*) (citation omitted).

276. On October 19, 1987, the Dow Jones average of thirty industrial stocks lost 22.6 percent of their value. See Presidential Task Force on Market Mechanisms, Report of the Presidential Task Force on Market Mechanisms 1 (1988). One trillion dollars was lost from the stock market decline during a four-day period beginning October 13, 1987. See *id.*

277. 1988 House Report, *supra* note 4, at 7.

278. See 1934 Senate Report, *supra* note 47, at 21; 1934 House Report, *supra* note 47, at 13; see also Rubin & Feldman, *Statutory Inhibitions upon Unfair Use of Corporate Information by Insiders*, 95 U. Pa. L. Rev. 468, 468 (1947) (profit taken by managers on inside trades often obtained at the stockholders expense prior to enactment of section 16(b)).

279. Cf. Klein, *The October 1987 Market Crash*, 20th Ann. Inst. on Sec. Reg. 79 (1988) (comprehensive review of the 1987 market crash).

280. See, e.g., Cox, *supra* note 148, at 382 (investor confidence rationale leads to overregulation).

ciency, it is better to leave the matter as it is, rather than resort to repeal. Such apprehension is unwarranted. As discussed previously, corporations would replace section 16(b)'s six-month restriction with internal surveillance systems under ITSFEA. To the extent that the repeal of section 16(b) would shake investor confidence in section 12 companies, investors would discount the stock in section 12 companies to compensate for any loss of confidence. In order to reduce their cost of capital, section 12 companies would implement more rigorous systems of internal controls to signal to the market that the repeal of section 16(b) did not affect their ability to prevent insider trading.

Even if retaining section 16(b) would have some small comforting effect upon the stock market, this comforting effect would be undermined because business people would continue to be trapped by an archaic law. These incidents, which are inevitable under section 16(b), will serve to strengthen the growing perception that insider trading regulation is seriously flawed.²⁸¹ Repealing this symbol of mindless formalism would acknowledge that insider trading regulation has advanced to the point that other weapons in the insider trading arsenal have effectively rendered section 16(b) obsolete.²⁸²

Section 16(b) may also have "symbolic significance" in a political sense. The public's outrage at the recent insider trading scandals may decrease the political acceptability of repealing section 16(b).²⁸³ Congress may hesitate to send confusing signals to the public declaring that it is taking a tough stance on insider trading, while simultaneously repealing the only provision of the federal securities laws that explicitly addresses insider trading. Indeed, any suggestion of eliminating one of the weapons used to combat insider trading is likely to provoke a strong public reaction. In the heat of Congress' crusade against insider trading, however, efficiency interests should not be subordinated to political interests without sufficient justification.²⁸⁴ Given the current political climate for reform of the insider trading laws, Congress has a "rare opportunity"²⁸⁵ to repeal section 16(b)'s anachronistic regulation.

281. See *supra* notes 144-150 and accompanying text.

282. One could use the investor confidence rationale to argue that the repeal of section 16(b) may strengthen the public's perceptions of the legitimacy of insider trading regulation and thus, the public's confidence that the markets are being efficiently regulated.

283. For articles addressing how politics have shaped insider trading regulation, see Gilson, *The Political Dimension of Insider Trading*, 19 Stan. Law. 34 (Fall 1987) (discussing how recent insider trading scandals have revived debate whether insider trading should be legal); Macey, *From Courts to Congress: The Politicization of Insider Trading Regulation*, 15 Cornell L.F. 9, 9 (1988) (special-interest groups influenced development of insider trading laws).

284. See Ishizumi, *supra* note 8, at 452-55 (moral or political reasons may cause overregulation of insider trading).

285. Klein, *supra* note 9, at 8. In 1983, Mr. Klein advocated the repeal of section 16(b): "It is not often that Congress decides to devote any time to issues of this character. It seems a shame not to make the most of the opportunity." *Id.* Fifteen years earlier, however, one commentator believed that the repeal of section 16(b) was not practical:

In conclusion, the Task Force's reasons for retaining section 16(b) do not withstand closer analysis. ITSFEA's control person provisions would efficiently replace the minimum fiduciary standards embodied in section 16(b)'s six-month trading restriction. The final goal, which seeks to penalize insider trading upon nonmaterial soft information, is inefficient because this goal operates to impede the valuable flow of information to the market. Moreover, repealing section 16(b) would symbolize efforts to enhance the efficiency of insider trading regulation. In order to assess fully the merits of repealing section 16(b), it is necessary to proceed to an economic analysis of the deterrence aspects of the dual system of insider trading regulation.

III. AN ECONOMIC ANALYSIS OF THE WEAPONS IN THE INSIDER TRADING ARSENAL

This section uses cost-minimization principles to evaluate the efficiency of section 16(b)'s scheme authorizing the "automatic recapture of certain short-term profits of certain insiders."²⁸⁶ First this section examines the tradeoffs that are made in designing an efficient enforcement system to deter unlawful activity. Next, this section conducts an economic analysis of the tradeoffs involved under the Rule 10b-5 and section 16(b) regimes. This evaluation provides the groundwork for comparing section 16(b)'s method of deterring insider trading with that of the other weapons in the modern arsenal of insider trading enforcement.

A. An Overview of Cost-Minimization Principles

Three tradeoffs are made in developing an efficient deterrence strategy.²⁸⁷ The first involves using a general standard or a specific rule to regulate the proscribed activity.²⁸⁸ The second tradeoff entails devoting resources to the detection and prosecution of violations or increasing the sanction imposed upon violators.²⁸⁹ The final tradeoff concerns employing public versus private resources to enforce the regulation.²⁹⁰ Choices made under one tradeoff influence decisions relating to a proper balance achieved under the other tradeoffs. In addition, the tradeoffs generate a

"Congress has many more pressing and important problems than the fate of one comparatively obscure provision of the federal securities laws." Lowenfels, *supra* note 97, at 64.

286. ALI, *supra* note 98, at 751 (emphasis in original).

287. See Becker, *supra* note 8, at 180-85; Schwartz, *supra* note 8, at 1076-79.

288. Professors Ehrlich and Posner were the first to examine in detail how increasing the specificity of regulation would enhance deterrence. See Ehrlich & Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. Legal Stud. 257 (1974); see also Schwartz, *supra* note 8, at 1087-91 (discussing per se rule or rule of reason in the antitrust context).

289. See, e.g., Becker, *supra* note 8, at 183-84 (to save resources used to detect violations, fine should be at maximum level, in order to reduce probability of detection to minimum level); Polinsky & Shavell, *The Optimal Tradeoff Between the Probability and Magnitude of Fines*, 69 Am. Econ. Rev. 880, 883 (1979) (optimal probability of detection is at lowest level when fine is at highest level).

290. See Frankel, *supra* note 233, at 578; Landes & Posner, *The Private Enforcement of Law*, 4 J. Legal Stud. 1 (1975).

cost of errors, an important cost of enforcement. The cost of errors includes resources consumed in prosecuting innocent people and resources diverted from legitimate activity.²⁹¹

1. The Specificity-Generality Tradeoff

The degree of specificity with which a regulation is expressed produces distinct costs and benefits in developing a system of deterrence.²⁹² Regulations are more precise as the number of facts that result in legal consequences decreases.²⁹³ To facilitate understanding of the "specificity-generality continuum,"²⁹⁴ the term "specific rule" describes a law that precisely details behavior that will produce definite legal outcomes.²⁹⁵ The phrase "general standard" refers to regulation that employs vague criteria relevant to legal judgments.²⁹⁶

Overall, a specific rule enhances the efficiency of a deterrence strategy in two ways. First, precise regulations have an impact on the cost side of the potential violator's risk-reward equation. Because a specific rule employs very few factual issues to determine whether certain activity is illegal, it increases the likelihood that the defendant's conduct will fall within its narrow parameters and thus be deemed illegal. In addition, because a specific rule does not provide for discretionary exceptions, it also raises the probability that the defendant will be convicted for engaging in the illegal activity.²⁹⁷ Second, a specific rule reduces the amount of resources the enforcement system consumes in prosecuting violators. A precise rule promotes deterrence and decreases the number of violations that occur; thus it lowers the amount of resources required for the detection of the illegal activity and the total number of cases brought before the judicial system.²⁹⁸ Specific regulation also conserves judicial resources, because cases concerning a specific rule involve only a few factual issues that take less time to litigate.²⁹⁹ Given only a limited number of facts to dispute, parties can more accurately predict the outcome of litigation; thus, a specific rule also increases the likelihood that parties will settle their disputes outside the court system.³⁰⁰

Although precisely detailed regulations advance the efficiency of a deterrence strategy, they also have several disadvantages which may out-

291. See Stigler, *supra* note 17, at 528.

292. See Ehrlich & Posner, *supra* note 288, at 257.

293. See *id.* at 261.

294. *Id.* at 257.

295. See *id.* at 258 ("The simplest kind of rule, then, takes the form: if *X*, then *Y*, where *X* is a single, simple, determinate fact (e.g., the car's speed) and *Y* is a definite, unequivocal legal consequence—a judgment of liability or nonliability—that follows directly from proof of *X* (e.g., driver has violated traffic code).")

296. See Ehrlich & Posner, *supra* note 288, at 258.

297. See *id.* at 264.

298. See *id.*

299. See *id.*

300. See *id.* at 265 (citing Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. Legal Stud. 399, 423-26 (1973)).

weigh the benefits if the rule does not accurately categorize the prohibited conduct. Specific rules tend to be both overinclusive and underinclusive.³⁰¹ The overinclusive aspects of a specific rule encompass activity that is not harmful under the regulatory goal. Consequently, this overinclusiveness raises the cost of errors as a result of prosecuting innocent people³⁰² and diverting resources from legitimate conduct.³⁰³ Because a specific rule also tends to be underinclusive, it fails to cover conduct that results in the same harms the regulation seeks to prevent. A regulatory system can solve the underinclusive aspects of a specific rule by using a general standard to supplement specific regulation.³⁰⁴

The flexibility of the vague criteria used under a general standard provides enforcement officials with more discretion than does a specific rule. Under a general standard, enforcement officials can take into account a wide variety of factors in determining whether a defendant's activity is harmful. Since more factors are taken into account, a general standard tends to consume more enforcement resources than does a specific rule. A general standard, however, produces a lower cost of errors than a specific rule. A general rule decreases the chance of prosecuting innocent persons, because enforcement officials have more discretion under a general rule's vague criteria to determine whether the defendant's conduct was illegal.³⁰⁵ The vagueness inherent in a general standard, however, increases the cost of errors by generating a "chilling effect," causing some people to forgo legitimate conduct because they are unsure of the range of permissible activity.³⁰⁶

On the whole, a specific rule increases deterrence and saves judicial resources.³⁰⁷ These benefits must be weighed against the costs resulting from a specific rule being both underinclusive and overinclusive.³⁰⁸ By enhancing deterrence and saving judicial resources, a specific rule influences the next tradeoff made in designing a deterrence strategy, the certainty-severity tradeoff.

2. The Certainty-Severity Tradeoff

The second tradeoff made in designing an efficient deterrence strategy involves the choice between devoting resources to detecting and prose-

301. *See id.* at 267.

302. *See id.*

303. *See id.* at 263-64.

304. *See id.*

305. *See Schwartz, supra* note 8, at 1077. Professor Schwartz states: "The possibility of error in applying the legal standard to the facts of the case implicates another essential tradeoff. Process costs designed to reduce the incidence of error must be traded off against the costs that result from the occurrence of error." *Id.*

306. *See Ehrlich & Posner, supra* note 288, at 263.

307. *See id.* at 275. *But see Schwartz, supra* note 8, at 1091 (favoring in the antitrust context a "general standard [which] explicitly stat[es] the governing considerations rather than a series of per se prohibitions and a focus on completed acts rather than inchoate conduct").

308. *See Schwartz, supra* note 8, at 1082.

cutting violators or increasing the severity of the potential sanction imposed. This certainty-severity tradeoff determines the expected penalty on the cost side of the equation an insider uses to calculate the risks and rewards of insider trading. An efficient deterrence strategy would establish sanctions that equal the expected returns of insider trading, with the optimal sanction depending upon the probability that an insider will be detected and convicted.³⁰⁹ To illustrate, if the probability of detecting and convicting insider trading was 100 percent, the fine should equal the profit gained or loss avoided from insider trading. If the probability of detection and conviction was 10 percent, then the fine should equal ten times the profit gained or loss avoided by the insider's illegal trade.³¹⁰

An effective enforcement system can deter insider trading either by increasing the probability of detection and conviction, or by raising the severity of the potential sanction.³¹¹ Consequently, an efficient deterrence strategy could minimize the costs of enforcement by reducing the chance of detection and conviction and raising the amount of the sanction.³¹² For example, assume it costs \$500,000 to detect 10 percent of the insider trading violations; if a \$10,000 fine is imposed, an insider faces an expected fine of \$1,000. Assume further that enforcement costs could be reduced from \$500,000 to \$5,000 by detecting only 1 percent of the insider trading violations. If the resources devoted to detection were reduced and the fine was raised from \$10,000 to \$100,000, the insider would still face an expected fine of \$1,000. These examples are based on the assumption that insiders are risk-neutral. The conclusion reached, however, holds true when an insider's attitude toward risk is examined.

An efficient deterrence strategy takes into account an insider's risk-bearing nature, that is, the amount of utility lost from a decrease in income.³¹³ An insider's attitude toward risk will determine the rate at which the insider discounts the expected value of the penalty in calculating the risks and rewards from insider trading. Insiders tend to be risk averse.³¹⁴ Thus, they lose more utility from a decrease in income than they receive from an equal increase in income.³¹⁵ As a result, risk averse

309. See R. Clark, *supra* note 18, at 291.

310. See Diver, *The Assessment and Mitigation of Civil Money Penalties by Federal Administrative Agencies*, 79 Colum. L. Rev. 1435, 1467 (1979). Professor Diver notes: "Mere removal of economic benefit will usually be insufficient by itself to secure compliance with regulatory standards. It is necessary, at least in theory, to multiply the documented benefit by a factor representing the likelihood of escaping punishment altogether." *Id.*

311. See, e.g., Becker, *supra* note 8, at 183-84; Polinsky & Shavell, *supra* note 289, at 881.

312. See A. Polinsky, *An Introduction to Law and Economics* 74-76 (1983); see also Block & Lind, *Crime and Punishment Reconsidered*, 4 J. Legal Stud. 241, 246 (1975) (fines higher than offender's wealth do not add to deterrence).

313. See K. Elzinga & W. Breit, *supra* note 8, at 120; Polinsky & Shavell, *supra* note 289, at 881.

314. See K. Elzinga & W. Breit *supra* note 8, at 126-29. *But see* Coffee, *supra* note 229, at 395 (empirical evidence shows that typical corporate management is not risk averse).

315. See K. Elzinga & W. Breit, *supra* note 8, at 120.

insiders prefer the "large probability of a small loss to the small probability of a large loss."³¹⁶ An efficient penalty structure produces the least amount of utility for the potential violator. Consequently, the use of a high fine with a lower probability of detection will more effectively deter risk-averse insiders.³¹⁷

In designing an efficient penalty structure, it is also necessary to consider a principle known as "marginal deterrence," which posits that the amount of the penalty should vary with gravity of the act committed.³¹⁸ Otherwise, "[if a] thief has his hand cut off for taking five dollars, he had just as well take \$5,000."³¹⁹ Under the principle of marginal deterrence, the "[e]xpected penalties [should] increase with expected gains so there is no net marginal gain from larger offenses."³²⁰ For example, the penalties for insider trading should increase to correspond to the marginal benefit an insider receives from investing more money in illegal trading.³²¹

The cost of errors also must be taken into account in trading off the certainty of prosecution and the severity of the penalty.³²² Raising the amount of the penalty magnifies the harm of prosecuting innocent people and deterring legitimate activity.³²³ To decrease these errors, the deterrence strategy can devote more resources to the enforcement process. An efficient deterrence system, however, will balance these additional enforcement expenditures against the costs generated by error.³²⁴

In review, an effective enforcement system can conserve resources in deterring risk-averse insiders by raising the expected penalty to correspond to the expected gains from insider trading. The deterrence system must weigh the savings in enforcement resources produced by increasing the severity of the penalty against the negative affects that this strategy has on the cost of errors.³²⁵ The next tradeoff involves the amount of resources devoted to enforcement.

316. *Id.*

317. The opposite conclusion would hold if insiders are risk-preferrers. A risk-preferrer receives more utility from an increase in income than he loses from an equal decrease in income. Thus, the use of a low fine with a higher probability of detection will deter more effectively risk-preferring insiders. *See id.*

318. *See* Posner, *Retribution and Related Concepts of Punishment*, 9 J. Legal Stud. 71, 73-74 (1980); Stigler, *supra* note 17, at 527.

319. Stigler, *supra* note 17, at 527.

320. *Id.* at 531. For the moral perspective of marginal deterrence, see Andenaes, *The Morality of Deterrence*, 37 U. Chi. L. Rev. 649 (1970).

321. Marginal deterrence does not apply if a sufficiently high penalty and low probability of enforcement deter all inside trading. *See* Block & Sidak, *The Cost of Anti-trust Deterrence: Why Not Hang a Price Fixer Now and Then?*, 68 Geo. L.J. 1131, 1134-35 (1980). Another tradeoff made under an efficient deterrence strategy concerns the use of fines as opposed to imprisonment. *See infra* notes 368-370 and accompanying text.

322. *See* Block & Sidak, *supra* note 321, at 1136-38.

323. *See* Frankel, *supra* note 233, at 573.

324. *See* Schwartz, *supra* note 8, at 1077.

325. *See id.* at 1087 ("The usual argument for a per se rule is that the saving in process costs resulting from the adoption of the rule exceeds in value whatever adverse consequences occur because of the over-and underinclusiveness of the general prohibition.").

3. The Private v. Public Enforcement Tradeoff

The final tradeoff made in designing an efficient deterrence strategy involves the choice between public and private resources to enforce regulations. Assuming the primary goal of insider trading regulation is deterrence,³²⁶ rather than compensation, it is irrelevant who prosecutes violators or who receives the penalty.³²⁷ This assumption is sound; there is no need for compensation if the deterrence strategy is effective.³²⁸ Academicians debate whether public or private enforcement will efficiently prevent illegal activity,³²⁹ but most view public enforcement as more efficient than private enforcement.³³⁰ Private parties are motivated by high damage awards, and thus do not consider the underlying rationale of the regulation. With private enforcement, every increase in the penalty leads to more enforcement.³³¹ When public enforcement is used, however, the penalty can be increased with a corresponding decrease in the probability of detection and conviction.³³²

In conclusion, increasing the degree of specificity of the regulations employed, the amount of the sanction imposed upon violators, and the level of public resources used for enforcement tends to promote the efficiency of a deterrence strategy. The advantages attained in deterring violators must be weighed against the corresponding costs of prosecuting innocent persons and discouraging legitimate conduct. Using these cost-minimization principles, it is possible to analyze the deterrence strategies under the Rule 10b-5 and section 16(b) regimes.

B. The Rule 10b-5 Regime

1. The Specificity-Generality Tradeoff

The Rule 10b-5 regime employs several general standards that cause uncertainty in applying its vague criteria to particular insider trading cases. Rule 10b-5 liability depends upon finding that an insider breached a fiduciary duty and that the insider traded upon material inside information. Under ITSFEA, control person liability depends upon finding that the defendant is a control person, and that the control person recklessly disregarded whether insider trading violations were occurring.

326. See Frankel, *supra* note 233, at 578; Landes & Posner, *supra* note 290, at 6.

327. See K. Elzinga & W. Breit, *supra* note 8, at 66; Karjala, *supra* note 7, at 642. The SEC, IRS, and private parties have begun to litigate disputes over the profits disgorged from insider trading in the courts. See Ostroff, *IRS, SEC Fight over Insider Trading Profits*, L.A. Daily J., Sept. 11, 1986, at 5, col. 1.

328. See Easterbrook, *Predatory Strategies and Counterstrategies*, 48 U. Chi. L. Rev. 263, 319 (1981).

329. See Becker & Stigler, *Law Enforcement, Malfeasance, and Compensation of Enforcers*, 3 J. Legal Stud. 1 (1974); Breit & Elzinga, *Private Antitrust Enforcement: The New Learning*, 28 J. L. & Econ. 405, 413 (1985).

330. See Schwartz, *supra* note 8, at 1092.

331. See *id.*; Breit & Elzinga, *supra* note 329, at 412.

332. See K. Elzinga & W. Breit, *supra* note 8, at 116; Landes & Posner, *supra* note 290, at 8.

Under Rule 10b-5, the most significant sources of uncertainty are the vague criteria used in determining what types of fiduciary duties give rise to liability. This uncertainty, though significant, does not affect whether Congress should repeal section 16(b). Although Rule 10b-5's application to certain traders is unclear, it would apply to most section 16(b) transactions because these transactions involve an insider who owes fiduciary duties to the preexisting shareholders of section 12 companies.³³³

Under Rule 10b-5, it must also be shown that the insider traded on information that was material. To date, most insider trading cases have involved information that was clearly meaningful to the rational investor.³³⁴ Although the criteria used in determining whether information is material are vague, the flexibility of the materiality standard provides an efficient balance between the investors' informational needs and the benefits provided by allowing managers to trade.³³⁵

Turning to ITSFEA, the most significant source of uncertainty concerns the criteria for determining who is a "controlling person."³³⁶ Once again, the outcome of this debate over the uncertainty caused by these vague standards does not affect the analysis of whether section 16(b) should be repealed. Most section 16(b) insiders will have a duty to establish internal controls to police for insider trading³³⁷ because directors, officers, and greater-than-ten-percent shareholders usually have the "power to influence or control the direction or the management, policies, or activities of another person."³³⁸

Under ITSFEA, the plaintiff must also establish that the control person was reckless, that is, that the controlling person disregarded "whether circumstances suggesting employee violations exist."³³⁹ Although the recklessness standard will cause some uncertainty, it provides the benefit of decentralizing the responsibility of designing precise rules; the recklessness standard requires firms to tailor their self-policing systems to meet their specific risks of insider trading violations. Imposing a private duty to establish internal rules reduces the enforcement

333. See *supra* notes 126-129 and accompanying text. The legislative history's approval of the misappropriation theory adds some credibility to the notion that Rule 10b-5 applies to the noncontrolling ten percent shareholders of section 12 companies.

334. See Eisenberg, *Insider Trading Law: Basic Principles and New Developments*, 20th Annual Inst. on Sec. Reg. 107 (1989) (noting SEC has lost one case on materiality issue). In addition to being material, the information traded upon must also be nonpublic. Before trading, insiders must allow the market a sufficient amount of time to absorb the new information. The market is deemed to absorb the information when a significant number of investors have knowledge of the information. Similar to the materiality issue, whether information is public or not is rarely a problem in most insider trading cases. See D. Langevoort, *supra* note 44, at 141.

335. See *supra* notes 259-267 and accompanying text.

336. See *supra* notes 161-162 and accompanying text.

337. See *supra* note 160 and accompanying text.

338. 1988 House Report, *supra* note 4, at 17.

339. *Id.* at 18.

costs incurred in designing, implementing and enforcing the regulatory scheme.

The Rule 10b-5 regime's use of general standards in conjunction with high penalties may enhance deterrence because the general standards may have an *in terrorem* effect on potential violators.³⁴⁰ The lack of clear boundaries will cause a risk-averse insider to raise the rate used to discount the expected penalty, which will increase the expected cost side of the insider's profit calculation. Thus, the general standards may save enforcement resources by avoiding complex Rule 10b-5 litigation. Because a risk-averse insider can not accurately predict the amount of the expected penalty, the insider will have a strong incentive to settle for a fraction of the penalty to avoid paying the entire penalty.³⁴¹ This benefit is especially important with respect to criminal cases which involve a higher standard of proof than civil suits.³⁴²

An evaluation of the Rule 10b-5 regime's general standards must weigh these advantages against the disadvantages that the vague criteria produce by increasing the cost of errors.³⁴³ Like any general standard, the absence of precise contours in Rule 10b-5 will deter lawful as well as unlawful activity.³⁴⁴ Indeed, the vague criteria used under Rule 10b-5 raise the issue whether Rule 10b-5's regulation of insider trading can meet the constitutional requirement of specificity in the criminal context.³⁴⁵ As discussed previously, overall, general standards reduce the cost of errors because the flexibility of the general standards tends to

340. See Silver, *supra* note 140, at 1000-01 ("[T]he defendant may be overly encouraged to settle the case for an amount less than three times the amount of profit gained.").

341. See *id.*

342. See *id.* at 963.

343. See D. Langevoort, *supra* note 44, at 14.

344. See Silver, *supra* note 140, at 1000. Some people will forego legitimate transactions because of the fear of severe sanctions. See Coffee, *Too Many White Collar Prosecutions*, Wash. Post, June 25, 1989, at B7 col. 1 (criminal sanctions deter at considerable cost of "anxiety and insecurity to those in the industry who are now subjected daily to the threat of severe penalties for even minor transgressions of often vague rules").

345. The General Accounting Office submitted to the Chairman of the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce a report stating:

A question exists as to whether Congress may be required to specifically define by statute the behavior constituting "insider trading" if criminal sanctions for this violation are to be imposed under securities laws. The government's use of criminal sanctions for insider trading under existing federal securities laws has been questioned in the courts. At issue, in part, is whether relevant provisions of the Securities Exchange Act of 1934 can meet the constitutional principle of "specificity" required of criminal law. Depending on future court decisions, a more precise definition of the term may be required, if contested criminal sanctions for this violation are to be sustained under the securities laws.

United States General Accounting Office, *Securities Regulation: Efforts to Detect, Investigate, and Deter Insider Trading* 58 (1988) (cited in Pitt, Caplan & Mann, *Liability for Insider Trading Under the Federal Securities Laws*, 1989 ALI-ABA Course Materials 241, 362-63); see also Arkin, *Materiality in Insider Trading Cases*, N.Y.L.J., Aug. 11, 1988, at 3, col. 1; *Federal Criminal Liability Urged for Insider Trading of Securities*,

provide enforcement officials with the discretion to avoid convicting innocent persons. The Rule 10b-5 regime, however, may not produce this benefit, because the uncertainty of the standards in conjunction with severe penalties may cause too many defendants to settle.³⁴⁶

The need for a legislative definition of insider trading raises the question whether such a definition would advance deterrence. One way to enhance deterrence is to simplify prosecution efforts by lowering the plaintiff's burden of proof. This would increase the expected value of the potential penalty to the insider, producing the same effect as raising the multiplier of the damage award.³⁴⁷ For example, the plaintiff's burden would decrease if a legislative definition of insider trading provided that a violation occurs when an insider trades while in the possession of inside information, rather than based on inside information.³⁴⁸ By raising the probability of successfully prosecuting an insider trading violation, such a definition would have two effects. First, the higher probability would cause an insider to increase the expected value of the sanction, which would make insider trading less profitable. In addition, simplifying prosecution efforts would lower the amount of enforcement resources consumed in convicting violators.

To summarize, the Rule 10b-5 regime's use of general standards in conjunction with severe penalties may enhance deterrence by producing an *in terrorem* effect and by saving judicial resources. The flexibility of the general standards may reduce the cost of errors in prosecuting innocent persons. These benefits must be weighed against the corresponding costs that the uncertainty of the general standards has in deterring legitimate activity and encouraging too many defendants to settle. By enhancing deterrence and conserving judicial resources, the general standards under the Rule 10b-5 regime influence the certainty-severity tradeoff.

2. The Certainty-Severity Tradeoff

Under the Rule 10b-5 regime, the chances of detecting an insider trading violation are low because insiders can easily conceal their trading.³⁴⁹ Stock exchanges discover most violations through the use of electronic surveillance.³⁵⁰ Once an exchange uncovers questionable trading,³⁵¹ the

N.Y.L.J., Jan. 22, 1987, at 1, col. 3 (by using regulations that focus on civil liability present law ignores traditional standards for imposing criminal liability).

346. See Silver, *supra* note 140, at 1001.

347. See K. Elzinga & W. Breit, *supra* note 8, at 65-66.

348. See *supra* note 148 (discussing other proposals for a legislative definition of insider trading).

349. See D. Langevoort, *supra* note 44, at 19-20. In 1985 and 1986, 83,000 transactions involved opportunities for insider trading; only 468 potential violations were referred to the SEC. Ultimately, 203 of these were investigated. See *id.*

350. See *Exchanges Are Spending Millions to Detect Illegal Insider Stock Trading*, 18 Sec. Reg. & L. Rep. (BNA) 1099 (July 25, 1986).

351. See Timmeny, McGonigle & Lenett, *Defending SEC Insider Trading Investigations*, ALI-ABA Course Materials 213, 213-15 (1989) (when stock prices exceed their

matter is referred to the SEC. Suspicious trading is not enough to prove that a person traded upon inside information; the SEC must establish the connection between the insider's trades and his access to inside information through circumstantial evidence.³⁵² Verifying this link, however, is not difficult with respect to section 16(b) insiders, because it is usually clear whether the insider had access to inside information.

ITSFEA increased the probability of detecting insider trading by providing the SEC with the authority to award bounties to informants³⁵³ who assist the SEC's enforcement efforts. The IRS, for example, has efficiently enhanced its enforcement efforts by using a bounty program,³⁵⁴ and most people believe that the mere presence of the SEC's "price-on-his-head" program³⁵⁵ will provide some deterrence.³⁵⁶ Despite the IRS's success, however, some commentators question whether the SEC's bounty provision will result in a net increase in enforcement because the SEC currently receives more tips than it has time to investigate.³⁵⁷ In addition, some commentators argue that the bounty program itself may actually undermine efforts to impose a self-policing duty upon firms; informants may try to claim bounty rewards rather than comply with the firm's internal surveillance program.³⁵⁸ Congress resolved this conflict, however, by giving the SEC absolute discretion to award bounties.³⁵⁹

In addition to a low probability of detection, the Rule 10b-5 regime produces high enforcement costs. ITSFEA's legislative history acknowledges: "Perhaps the greatest problem in the battle against insider trading is a lack of resources."³⁶⁰ In response to this problem, ITSFEA declared

historical prices, SRO's conduct preliminary investigation; the SROs monitor large volumes of trading preceding corporate announcements).

352. As ITSFEA's legislative history notes: "[P]art of the problem in deterring and punishing insider trading violations is the difficulty of effectively prosecuting these cases. The biggest obstacle is making the vital connection between an investor and the possession of inside information (i.e., what he knew, when he knew it and how he found it out)." *1988 House Report, supra* note 4, at 15; *see also* Ingrassia, *Trying Task: For SEC, Developing Insider-Trading Cases Is Frustrating Work*, Wall St. J., July 2, 1986, at 1, col. 5. (only 15-20 percent of SEC investigations successful).

353. *See supra* notes 171-172 and accompanying text.

354. *See 1988 House Report, supra* note 4, at 15-16 (during 1986, IRS received \$256 million as a result of \$1.3 million in bounty payments); Franklin, *Mutiny over the Bounty?*, N.Y.L.J., Nov. 17, 1988, at 5, col. 2 (between 1975 and 1984 IRS collected an average of \$16.4 million, with rewards averaging \$456,000). The IRS uses a sliding scale for its bounties: 10 percent for the first \$75,000 recovered, 5 percent for the next \$25,000, and 1 percent thereafter, capped at \$100,000. *See id.* at 5, col. 2.

355. *See* Roberts, *Securities Lawyers Fear Abuse of New Insider-Trading Bill*, L.A. Daily J., Oct. 27, 1988, at 1, col. 2.

356. *See id.*

357. *See, e.g.,* Levine, Mathews & Callcott, *supra* note 143, at 88 (prospect of a bounty may encourage people to provide false information); Roberts, *supra* note 355, at 1, col. 2 (same); *see also* D. Langevoort, *supra* note 44, at 24 (questionable whether bounty will be effective in ferreting out inside traders due to secretive nature of insider trading).

358. *See* Roberts, *supra* note 355, at 2, col. 1; D. Langevoort, *supra* note 44, at 24.

359. *See 1988 House Report, supra* note 4, at 23.

360. *Id.* at 14.

that "the war against insider trading must be fought on many fronts."³⁶¹ On one front, the SEC has almost doubled its enforcement efforts in the last four years.³⁶² The Commission, however, has a limited budget,³⁶³ which is rapidly consumed in labor-intensive insider trading investigations. Thus, significant public resources are needed to increase the probability of detecting insider trading by even a modest amount. Therefore, on another front, Congress raised enforcement resources at minimum government cost by enlisting private firms to self-police for insider trading violations.³⁶⁴

In light of the high costs of detection and enforcement under Rule 10b-5, ITSA and ITSFEA increased the potential sanctions for insider trading. When the treble damage remedy available under RICO is taken into account, the insider now faces the threat of damages seven times the profits gained or loss avoided by insider trading. This penalty substantially changes the insider's profit calculation, even in the face of the countermotivating high stakes in the takeover and options markets. Believing that monetary penalties were insufficient, Congress expanded the potential prison term from five to ten years, declaring that this is the "type of message white-collar criminals will understand the best."³⁶⁵ In the past, courts have been reluctant to imprison white-collar criminals.³⁶⁶ Some commentators, however, believe that the jail sentences in recent insider trading cases represent a new trend in the deterrence of insider trading.³⁶⁷

The efficiency of a deterrence strategy can be enhanced by employing different types of punishment.³⁶⁸ Some commentators argue that imposing a sufficiently large fine upon white-collar criminals would result in the same level of deterrence provided by imposing a short prison term, without consuming scarce prison resources.³⁶⁹ Like most commentators,

361. *Id.*

362. From 1934 to 1984, the SEC brought a total of 121 enforcement proceedings under Rule 10b-5. The SEC brought 105 cases during 1984 to 1987. See S. Winer & P. Butler, *supra* note 160, at 4.

363. See Sontag, "Desperate" SEC Seeks More Aid, Nat'l L.J., May 1, 1989, at 1, col. 4 (many people considering self-funding for the SEC because it is unlikely that Congress will appropriate more to SEC's budget).

364. See *supra* notes 217-224 and accompanying text.

365. 1988 House Report, *supra* note 4, at 16. The House Committee strongly believed that "a jail term was the most important deterrent" for insider trading. Moreover, it stated that "courts should impose jail terms for the commission of these crimes, and expects that raising the ceiling will increase the certainty of substantial prison sentences." *Id.* at 23.

366. See Mann, Wheeler & Sarat, *Sentencing the White Collar Offender*, 17 Am. Crim. L. Rev. 479 (1980).

367. See *supra* note 175 and accompanying text.

368. See Schwartz, *supra* note 8, at 1077.

369. See, e.g., K. Elzinga & W. Breit, *supra* note 8, at 33 (prison term not much of deterrence due to judge's reluctance to impose it); Posner, *Optimal Sentences for White-Collar Criminals*, 17 Am. Crim. L. Rev. 409, 410 (1980) (a large fine is preferable to prison terms because it is less expensive to impose and provides the same deterrence value).

Professors Elzinga and Breit question whether a deterrence strategy can tradeoff large fines and prison terms:

To be assigned to a cell of eighteen by twenty feet, surrounded by stone and steel walls, and provided with only a cot, table, and stool for furnishings and a sink to wash in is an unattractive prospect, especially for someone accustomed to a high salary, well-appointed offices, and living quarters filled with modern conveniences. Perhaps worse, so far as the businessman is concerned, is the humiliation of being handcuffed, fingerprinted, and whisked away from family and friends by a United States marshal.³⁷⁰

Therefore, most commentators argue that even short prison terms will provide more deterrence than large fines because an insider, comfortable with his standard of living, will have a difficult time adjusting to the prison environment.

Under the Rule 10b-5 regime, courts have a great deal of discretion to correlate the severity of the sanction to the gravity of the harm the insider committed.³⁷¹ Such a relationship between conduct and liability enhances marginal deterrence.³⁷² In two instances, however, reducing the penalty imposed upon violators may not promote deterrence. First, trial courts have rejected the SEC's request for treble damages in a few cases;³⁷³ the conflicting signals sent by the courts and the SEC may lessen the deterrence value of the treble damage sanction.³⁷⁴ Second, defendants often settle insider trading cases, agreeing to pay a fraction of the sanction to avoid the risk of a court imposing a heavier sanction.³⁷⁵ The lower sanctions imposed in settlements may decrease deterrence.³⁷⁶ This negative effect, however, must be balanced against the savings in resources that can be used to detect and prosecute additional violations.³⁷⁷

Controlling persons face potential penalties up to the greater of \$1,000,000 or three times the insiders' profit gained or loss avoided from

370. K. Elzinga & W. Breit, *supra* note 8, at 43; *see also* Coffee, *Corporate Crime and Punishment: A Non-Chicago View of the Economics of Criminal Sanctions*, 17 Am. Crim. L. Rev. 419 (1980) (questioning whether large fines and prison terms can be traded off in the antitrust context); Mann, Wheeler & Sarat, *supra* note 366, at 486 (judges believe prison provides greatest deterrence to white-collar crime).

371. *See* Dooley, *supra* note 8, at 26.

372. *See supra* notes 318-321 and accompanying text.

373. *See, e.g.*, SEC v. Karcher, No. 88-2021 (C.D. Cal. Sept. 14, 1988) (court rejected imposition of penalty); SEC v. Ingram, 694 F. Supp. 1437 (C.D. Cal. 1988) (rejecting penalty where there were no past violations and future violations are unlikely).

374. *See* Levine, Mathews & Callcott, *supra* note 143, at 80-81 ("*Ingram* and *Karcher* may indicate that at least sometimes it is still worthwhile to litigate . . . rather than accepting a settlement that includes an injunction and civil penalties."). The court's rejection of the SEC's request for treble damages may have a negative effect upon the deterrence value of the penalty. This would not occur, however, if the SEC were given the power to administer the sanction. *See* Silver, *supra* note 140, at 963 n.23.

375. *See* Frankel, *supra* note 233, at 575.

376. *See* Note, *A Framework*, *supra* note 8, at 1010.

377. *See id.*

insider trading.³⁷⁸ ITSFEA provides courts with the discretion to avoid imposing Draconian sanctions upon smaller firms. Congress probably set the penalty at a sufficiently high level so that larger firms will also employ effective self-policing systems. In order to avoid disproportionate deterrent effects upon different size firms, Congress should eliminate the \$1,000,000 and treble profit or loss avoided caps. The efficiency of the control person penalty structure would be enhanced if the courts were given the discretion to impose penalties upon control persons based upon a percentage of the controlling persons' profits.³⁷⁹

To avoid liability, controlling persons may use internal corporate sanctions to enhance the effectiveness of their self-policing systems. Although private firms are limited in the types of penalties that they can impose,³⁸⁰ the probability of these sanctions being imposed is high.³⁸¹ Consequently, corporate discipline may result in greater deterrence than public sanctions.³⁸²

In sum, the Rule 10b-5 regime uses severe sanctions to overcome the problems it faces with detection and enforcement. These severe penalties, however, increase the costs of prosecuting innocent persons and deterring legitimate activity. The amount of enforcement resources is affected by the balance struck under the next tradeoff, between private versus public enforcement.

3. The Private v. Public Enforcement Tradeoff

This Article adopts the theory that insider trading harms the agency relationship between management insiders and their corporations.³⁸³ Thus, the logical enforcement choice would at first appear to be the shareholders' derivative suit.³⁸⁴ Like insider trading regulations, derivative suits seek a high degree of deterrence, with compensation as a secondary objective.³⁸⁵ In the insider trading context, however, derivative suits would not achieve these goals because shareholders cannot adequately monitor for insider trading. In addition, the control person provisions overcome the shareholder's difficulties with detection by imposing liability upon corporations that fail to incur bonding costs. Thus, corporate recovery under a shareholders' derivative suit would conflict with

378. See *supra* note 164 and accompanying text.

379. See K. Elzinga & W. Breit, *supra* note 8, at 59.

380. See *supra* notes 229-230 and accompanying text.

381. See Dooley, *supra* note 8, at 46. *But see* Coffee, *supra* note 370, at 458-60 (little evidence that fines cause firms to adopt internal disciplinary mechanisms).

382. See R. Posner, *supra* note 156, at 397-98.

383. See *supra* notes 39-42 and accompanying text.

384. See Haft, *supra* note 19, at 1068.

385. See *id.* (citing Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 Colum. L. Rev. 261, 302-09 (1981)). Professor Haft proposes: "[T]he most realistic method to deter insider trading might be to provide . . . corporate recovery of double or treble the amount of the insider's profit or loss avoidance." *Id.* at 1069.

the control person provision's goal to penalize firms that fail to establish self-policing systems.

ITSFEA provided an express right of action for contemporaneous traders to sue insiders. As discussed previously, however, insider trading does not harm contemporaneous traders,³⁸⁶ and thus these parties should not be compensated. In addition, suits by contemporaneous traders conflict with the goal of efficient deterrence for three reasons. First, private parties do not increase the level of detection because they merely free-ride on the SEC's ability to police for insider trading violations through electronic surveillance systems.³⁸⁷ Second, the class actions brought by contemporaneous traders consume an enormous amount of available judicial resources in defining and certifying the class, giving notices and processing individual claims.³⁸⁸ Finally, private attorneys follow the lead of the SEC and sue in those insider trading cases that promise "the largest judgment with the least [amount] of time."³⁸⁹ Thus, the problems with private enforcement are especially acute under the Rule 10b-5 regime.³⁹⁰

As discussed previously, high damage awards motivate private parties to overenforce the law. This problem does not arise under ITSA and ITSFEA because the SEC is the only party that can enforce the discretionary treble damages penalties.³⁹¹ Under RICO, however, private parties can sue to recover mandatory treble damages.³⁹² In the antitrust context,³⁹³ the mandatory treble damage provision may cause courts to take a restrictive interpretation of the law.³⁹⁴ Courts, however, liberally construe the RICO provisions.³⁹⁵ Although private parties so far have had limited success in using RICO,³⁹⁶ the threat of treble damages does have some settlement value.³⁹⁷

386. See *supra* notes 29-30 and accompanying text.

387. See Dooley, *supra* note 8, at 16 & n.82 ("private actions play a trivial role in regulating insider trading [because those] actually brought are largely parasitic").

388. See *id.*

389. Frankel, *supra* note 233, at 579.

390. For these reasons, Professor Dooley's conclusion appears valid: "Even if private suits could be justified on compensatory grounds, the limited ability of private litigants to initiate enforcement suggests it would be more efficient for the government to collect damages for private claimants in a *parens patriae* action." Dooley, *supra* note 8, at 28 n.134 (citing Dam, *Class Actions: Efficiency, Compensation, Deterrence and Conflict of Interest*, 4 J. Legal Stud. 47, 64-66 (1975) (discussing private antitrust actions)).

391. See *supra* note 143 and accompanying text.

392. See Dooley, *supra* note 8, at 28 (treble damages for private parties will not increase detection).

393. See *id.* at 24 n.114; Frankel, *supra* note 233, at 575.

394. See Sullivan, *Breaking Up the Treble Play: Attacks on the Private Treble Damage Antitrust Action*, 14 Seton Hall L. Rev. 17, 22-23 (1983).

395. See *Sedima S.P.R.L. v. Imrex Co., Inc.*, 473 U.S. 479, 497-98 (1985).

396. Private persons have two hurdles to overcome to sue civilly under RICO. First they must prove that there were two predicate acts. Second, the insiders must have invested in, maintained an interest in, or participated in an "enterprise." See Brodsky, *supra* note 183, at 32.

397. See J. Choper, J. Coffee & C. Morris, *supra* note 20, at 499.

In sum, the Rule 10b-5 regime's use of general standards in conjunction with high penalties produces a high degree of deterrence at minimal cost. Private causes of action, however, fail to increase detection and impede efforts to control the level of enforcement. In turning to the section 16(b) regime, note that each of the tradeoffs made under the Rule 10b-5 regime tend to be at the opposite end of the continuum from those under section 16(b).

C. The Section 16(b) Regime

1. The Specificity-Generality Tradeoff

Section 16(b) "is about as subtle as a sledge hammer":³⁹⁸ an insider who makes a short-swing trade within six months is automatically liable. In order for section 16(b)'s specific rule to operate efficiently, the provision must accurately categorize the prohibited activity.³⁹⁹ Because section 16(b)'s "crude rule of thumb" does not directly address the insider trading problem,⁴⁰⁰ courts refer to the statute as "an extremely crude rule of a most deformed and misshapen thumb."⁴⁰¹ Although a specific rule is inherently both overinclusive and underinclusive,⁴⁰² these problems are particularly troublesome under section 16(b).

Commentators and courts criticize section 16(b) for catching minnows while letting many big fish escape.⁴⁰³ Section 16(b) is underinclusive be-

398. Woodside, *supra* note 194, at 476.

Section 16(b) is about as subtle as a sledge hammer, and perhaps this is why people tend to get a little emotional about it. It doesn't leave much room for argument. Therein, in part, lies its virtue. The clamor for certainty is pretty well satisfied in this section of the law. It does not make short-swing trading illegal. It does not prohibit. It merely says if you trade, pay over the profit. It speaks with an eloquence not often misunderstood.

Id. at 476-78.

399. See Schwartz, *supra* note 8, at 1090. This is especially true in the case of Section 16(b), because the provision focuses on "inchoate violations in which it is not actual harm but some increased likelihood that harm will occur which provides the principle rationale for the [restriction]." *Id.*

400. See, e.g., Ishizumi, *supra* note 8, at 452 ("Aiming for a dramatic effect, Congress erred in selecting this bootstrap regulatory method of lumping together the actual abuse of inside information and the nonuse of inside information in trying to prevent 'the unfair use of information.' This disparity between the end and the means is the source of section 16(b)'s efficiency defects." (footnote omitted)); Klein, *supra* note 9, at 8 ("I doubt that there are many who believe that [section] 16 makes much sense today either as an approach to insider trading or otherwise.").

401. Provident Secs. Co. v. Foremost-McKesson, Inc., 331 F. Supp. 787, 792 (N.D. Cal. 1971), *aff'd*, 506 F.2d 601 (9th Cir. 1974), *aff'd*, 423 U.S. 232 (1976).

402. See Ehrlich & Posner, *supra* note 288, at 270.

403. See, e.g., Adler v. Klawans, 267 F.2d 840, 845 (2d Cir. 1959) ("Congress recognized . . . that § 16(b) would not correct all the practices thought to be evil; obviously the six month limitation alone 'let many fish out of the net' . . ."); Ishizumi, *supra* note 8, at 472 ("One of the most significant sources of inefficiency and inequity under this limitation is that such insiders can evade liability and pocket virtually all of the speculative profit by tipping off their confidants. Here again, section 16(b) functions only as a fishing net for minnows." (footnote omitted)); Munter, *supra* note 188, at 72-74 (noting the twin dilemma of 16(b); its lets many guilty insiders escape while it catches many innocent ones).

cause it does not apply to persons other than directors, officers, and greater-than-ten percent beneficial owners of section 12 companies. With regard to this limited group of insiders, section 16(b) does not cover individual purchases or sales, purchases and sales six months or more apart, or tipping inside information to others to trade.⁴⁰⁴ In addition, although most insider trading occurs by using options to maximize profits, section 16(b) may not apply to the purchase of options because these derivative securities are not equity securities of the issuer.⁴⁰⁵

Although section 16(b) applies only to a narrow group of trades, the section's drafters believed that the mechanical rule would produce a substantial *in terrorem* effect.⁴⁰⁶ Section 16(b), however, does not provide much deterrence because its arbitrary restrictions are easy to evade.⁴⁰⁷ Indeed, the Supreme Court has held that "[l]iability cannot be imposed simply because the investor structure[s] his transaction with the intent of avoiding liability under § 16(b)."⁴⁰⁸ Hence, an insider can avoid section 16(b) by waiting exactly six months, or by tipping inside information to another to conduct the trades.⁴⁰⁹ Under the dual system of insider trading regulation, however, Rule 10b-5 applies to most of the transactions

404. Section 16(b) was initially drafted to prohibit insiders from disclosing "confidential information" to any other person and provided that the issuer could recover the profits made by a tippee within six months of the disclosure. See *Hearings Before the Comm. on Interstate and Foreign Commerce on H.R. 7852 and H.R. 8720*, 73d Cong., 2d Sess. 9-10 (1934). The House deleted that provision as well as the provision for insiders' liability for tipping and left only the reporting provisions now contained in section 16(a).

405. See *Section 16(b) Task Force*, *supra* note 13, at 1103-08.

406. In addressing the *in terrorem* effect of section 16(b), Professors Jennings and Marsh have argued: "It has never been demonstrated whether this principle of 'Punish the innocent, in order to terrorize the guilty' works to any extent, and no one has even made an attempt to produce such evidence." R. Jennings & H. Marsh, *supra* note 102, at 1402; see also Note, *A Framework*, *supra* note 8, at 999 ("Congress accepted the danger of subjecting the innocent to 16(b) liability in order to obtain maximum deterrence.").

407. As one commentator has noted:

[A]n arbitrarily narrow rule such as section 16(b), when literally applied, tends to produce inaccurate conclusions concerning its efficiency. Because a rigid rule allows for easy avoidance, the probability of holding an insider liable under the objective approach could be much lower than it actually appears.

Note, *An Economic Analysis*, *supra* note 8, at 409. But see Note, *A Framework*, *supra* note 9, at 1004-05 n.81 (section 16(b) successful in deterring limited amount of insider trading; not meant to deter most insider trading).

408. *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 422 (1972).

409. As explained by one commentator:

An insider who purchases stock and sells it exactly six months later (e.g., a purchase at 8:00 a.m. on January 15 followed by a sale at 4:00 p.m. on July 14 would be a transaction of exactly six months) is not within the statutory period of "less than" six months and is therefore not a target of section 16(b), while an insider who sells just one day earlier (e.g., at any time on July 13) is subject to the section.

Ishizumi, *supra* note 8, at 472 (footnotes omitted); see also Munter, *supra* note 188, at 73 ("The morals of this kind of insider would seem no more worthy of approbation than those of his brethren who happen to sell one day earlier, and there is no reason to 'reward' his cunning."). Note that Rule 10b-5 and state law would still apply to the section 16(b) insider who waits exactly six months.

that are not covered by section 16(b). Thus, the fact that section 16(b) is underinclusive is not the primary concern.

Section 16(b)'s major source of inefficiency results from the provision's overinclusiveness because it indiscriminately penalizes the innocent along with the guilty.⁴¹⁰ Indeed, in describing section 16(b), the Second Circuit acknowledged: "Congress decided in order to throw out the bathwater that the baby had to go too."⁴¹¹ An insider intent on trading on inside information can easily evade section 16(b);⁴¹² thus, the provision only results in trapping unwary "minnows," those people who do not receive the legal advice to wait exactly six months.

In addition to the costs involved in prosecuting innocent people, section 16(b) produces a high cost of errors by deterring legitimate business activity. Section 16(b)'s use of the terms "purchase" and "sale" cover many transactions that Congress could not have contemplated in 1934. The section 16(b) insider risks that an imaginative plaintiff's lawyer will argue that almost any exchange concerning the issuer's stock involves a section 16(b) purchase or sale. To be safe, the section 16(b) insider must restructure any transaction that even remotely falls within section 16(b)'s grasp.⁴¹³ Although the drafters intended section 16(b) to be a simple rule, the provision produces "byzantine complexity";⁴¹⁴ the six-month period serves to "immeasurably complicat[e] . . . in totally artificial ways, perfectly legitimate corporate activities such as stock options, stock appreciation rights, stock redemptions, takeovers, mergers, and conversions."⁴¹⁵

Section 16(b) produces a high cost of errors that has increased over time as the rule became obsolete. Two efforts to temper Section 16(b)'s

410. Professor Loss defends section 16(b) as follows: "[I]t would be illusory to pretend that one could ever have both equity and relative automaticity." L. Loss, *supra* note 49, at 1089-90.

411. *Blau v. Lamb*, 363 F.2d 507, 515 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967). In defense of the provision, the statute's draftsman maintained: "You have to have a general rule. In particular transactions it might work a hardship, but those transactions that are a hardship represent the sacrifice to the necessity of having a general rule." *1934 Senate Hearings*, *supra* note 53, at 6558.

412. See *Jacobs*, *supra* note 52, at 346 (insiders presumably are aware of section 16(b) and its provisions); Note, *An Economic Analysis*, *supra* note 8, at 411 ("The American Law Institute has noted that 'section 16(b) should afford sufficient deterrence to those who are aware of it . . .'" (quoting ALI Fed. Sec. Code § 1413 comment 21, at 140 (Tent. Draft No. 2 (1973))) (emphasis supplied by Note author).

413. See *Deitz*, *supra* note 84, at 37 ("The only safe course . . . is to refrain from buying and selling . . .").

414. *Section 16(b) Task Force*, *supra* note 13, at 1090 ("[T]he effort to avoid its reach often adds Byzantine complexity to many employee compensation plans.").

415. Klein, *supra* note 9, at 10; see also Block & Barton, *Section 16(b) of the Exchange Act: An Archaic Insider Trading Statute in Need of Reform*, 12 Sec. Reg. L.J. 203, 218 (1984) ("Section 16(b) is plainly archaic in modern hostile takeover battles.").

In addition, these transactions are needlessly complicated because the six-month period is simply too long given that the value of information quickly dissipates over time. See *Section 16(b) Task Force*, *supra* note 13, at 1088 (arguing three months is long enough); Klein, *supra* note 9, at 9 (arguing 30 days is long enough).

harsh effects have only aggravated the problem by adding complexity.⁴¹⁶ First, some courts inquire whether there was a possibility for speculative abuse of inside information under the pragmatic approach.⁴¹⁷ These courts, however, have compounded the confusion over the application of section 16(b) by alternating between the objective approach and pragmatic approach in reaching their decisions.⁴¹⁸ Second, although the SEC has used its authority to promulgate rules to exempt transactions from section 16(b), these rules have become so complex that only experts can grasp them.⁴¹⁹ The SEC's proposed changes⁴²⁰ to these rules are not sufficient to overcome the problems inherent in section 16(b)'s "crude rule of thumb" approach. To render the area more coherent, Congress should reevaluate the conceptual foundations of section 16(b).⁴²¹

In review, section 16(b) does not provide deterrence because insiders can easily evade the clear lines of the simple rule. In addition, section 16(b) produces a high cost of errors by penalizing innocent persons and deterring legitimate activity. Section 16(b)'s simple rule also influences the balance struck under the next tradeoff, the certainty-severity tradeoff.

2. The Certainty-Severity Tradeoff

Section 16(b) has a unique enforcement mechanism under which the corporation or shareholders may sue a section 16(b) insider to recover short-swing profits on behalf of the corporation.⁴²² The SEC has no

416. See R. Clark, *supra* note 18, at 300 ("One wonders whether a supposedly flat prophylactic rule like section 16(b) can long retain its objective character in such a system of adjudication.").

417. See Note, *A Framework*, *supra* note 8, at 999 ("Uncertainties [in the pragmatic approach] have tempered the strong prevention influence embodied in the section's mechanical six-month test.").

418. See *supra* notes 104-114 and accompanying text.

419. See Ehrlich & Posner, *supra* note 288, at 270. These rules also involve high administrative costs for the SEC as well as section 16(b) insiders. See *Ownership Reports*, *supra* note 272, at 89,600 (citation omitted) (SEC receives more requests for no-action advice concerning section 16 rules than any other area); see also Schwartz, *supra* note 8, at 1089 ("specifying in advance a series of stereotyped criteria that keep process costs low").

420. See *Ownership Reports*, *supra* note 272, at 89,598; see also Ehrlich & Posner, *supra* note 288, at 277 (must alter rules "to keep pace with economic and technological change").

421. But see H. Bloomenthal, *supra* note 158, § 5.12, at 5-41 ("The promise is for a more reasoned and simplified approach to Section 16(b) liability which, hopefully, will put to rest its reputation as a trap for the unwary.").

422. A security holder has the right to bring a section 16(b) action regardless of the good faith or reasonable business judgment of the corporation's directors in deciding not to bring suit. See Comment, *Insider Trading: The Issuer's Disposition of an Alleged 16(b) Violation*, 1968 Duke L.J. 94, 99-101. Section 16(b) expressly provides that "the owner of any security of the issuer" can bring suit; therefore, an action under section 16(b) is not subject to Rule 23.1 of the Federal Rules of Civil Procedure, regulating derivative actions by shareholders, which requires the plaintiff to have been a security holder at the time of the alleged violation. See *Blau v. Oppenheim*, 250 F. Supp. 881, 883 (S.D.N.Y. 1966); L. Loss, *supra* note 49, at 1052. Consequently, a section 16(b) plaintiff may purchase a single share after the violation for the sole purpose of bringing suit.

power to enforce section 16(b),⁴²³ and unlike most provisions of the 1934 Act, section 16(b) does not give rise to criminal liability.⁴²⁴ Private enforcement efforts are facilitated by the summaries of section 16(a) reports that the SEC publishes each month.⁴²⁵ These reports provide the means for discovering section 16(b) violations. In addition, the courts promote private enforcement by awarding high attorney's fees in section 16(b) cases. These fees provide the motivating factor behind most section 16(b) suits because shareholders only indirectly benefit from corporate recovery.⁴²⁶

Section 16(b)'s private enforcement mechanism produces a high probability of detecting section 16(b) violations. The prospect of liberal attorneys' fees provides a strong incentive for the section 16(b) plaintiffs' bar to serve as an ever-hungry watchdog over the monthly section 16(a) reports.⁴²⁷ Once a violation is detected, the plaintiff usually will succeed in proving liability because it is usually clear whether a violation has occurred.⁴²⁸ Under the objective approach, enforcement costs are low because there is a high probability that the parties will settle.⁴²⁹ To the extent that the courts use the pragmatic approach and definitional uncertainties remain, parties have an incentive to litigate.⁴³⁰ The pragmatic approach leads to costly suits that involve inquiries similar to those in Rule 10b-5 cases:⁴³¹ under the pragmatic approach it is necessary to show the "possibility of speculative abuse" of inside information,

423. The SEC, however, may adopt rules exempting certain transactions that are not within the purpose of the section. See 17 C.F.R. §§ 240.16b-1 to 240.16b-11 (1989).

424. The drafters of section 16(b) deleted provisions imposing criminal sanctions from early drafts of the provision believing that such sanctions were too harsh. See Cook & Feldman, *Insider Trading Under the Securities Exchange Act*, 66 Harv. L. Rev. 385, 407 (1953) (citing 15 *Hearings Before Senate Comm. on Banking and Currency on S. Res. 84, 56, and 97*, 73d Cong., 2d Sess. 6430 (1934)).

425. See *supra* note 59 and accompanying text.

426. Courts grant substantial attorney's fees in section 16(b) actions which may be as high as one-half of the profits recovered. See *Smolowe v. Delendo Corp.*, 136 F.2d 231, 241 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943); L. Loss, *supra* note 48, at 1052.

427. See L. Loss, *supra* note 44, at 550 (citing *Whiting v. Dow Chemical Co.*, 523 F.2d 680, 689 (7th Cir. 1975)); Ishizumi, *supra* note 8, at 462 (Congress may have thought that "100% enforcement was . . . the most inexpensive method for society to prevent the abuses of insider information."); Note, *A Framework*, *supra* note 8, at 1005 ("The probability that an offender will be punished . . . for a 16(b) violation has been brought very close to one through a combination of procedural and reporting techniques.").

428. See Note, *An Economic Analysis*, *supra* note 8, at 407-08.

429. See Jacobs, *supra* note 52, at 346 ("Congress hoped section 16(b)'s application would require little judicial interpretation. Indeed, the volume of section 16(b) cases over the years, particularly recently, has been quite small considering the section's practical importance.").

430. Justice Douglas once remarked: "Instead of a section that is easy to administer and by its clearcut terms discourages litigation, we have instead a section that fosters litigation because the [pragmatic approach] holds out the hope for the insider that he may avoid § 16(b) liability." *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 612 (1973) (Douglas, J., dissenting).

431. See Note, *An Economic Analysis*, *supra* note 8, at 425.

whereas Rule 10b-5 requires the actual abuse of inside information.⁴³²

Although section 16(b)'s private enforcement system operates at low cost, the efficient operation of this system only serves to raise the costs of errors produced by section 16(b)'s overinclusive rule. The high rate of detection of section 16(b) violations includes people who have not traded upon inside information, and thus guarantees that businesspersons will forgo legitimate conduct. In addition, section 16(b)'s penalty structure aggravates the costs of errors because the *in terrorem* penalty does not follow the principle of marginal deterrence.

Unlike most specific rules that employ strict liability,⁴³³ section 16(b) imposes a penalty if the insider engages in a series of transactions.⁴³⁴ Courts calculate the amount of section 16(b) "profits" to be disgorged by using the "lowest-in-highest-out" method. Under this method, the lowest purchase price is matched against the highest sale price, the next lowest purchase price is matched against the next highest sale price, and so forth in order to disgorge the largest amount of profit possible.⁴³⁵ Courts adopted this method to enhance section 16(b)'s *in terrorem* effect; even in settlement procedures, courts usually insist on imposing the full amount of recovery under the high-low calculation.⁴³⁶ This method, however, produces bizarre results that have no relation to the wrong committed.⁴³⁷

432. *See id.*

433. *See Ehrlich & Posner, supra* note 288, at 269.

434. *See, e.g., Gratz v. Claughton*, 187 F.2d 46 (2d Cir.) (liability of over \$300,000 even though transactions resulted in \$400,000 loss), *cert. denied*, 341 U.S. 920 (1951). *See generally Painter, The Evolving Role of Section 16(b)*, 62 Mich. L. Rev. 649, 650 (1964) (transactions are sometimes broken down into whatever components are necessary to create a matching that maximizes profits). Transactions used in this process cover a period of just under one year. *See L. Soderquist, supra* note 46, at 489 ("For example, in the case of a 100 share sale on July 1, 50 shares involved in a matching could have been purchased on February 1 and 50 on November 1, even though February and November are more than six months apart.").

435. In adopting this method the Second Circuit reasoned:

The statute is broadly remedial. . . . We must suppose that the statute was intended to be thoroughgoing, to squeeze all possible profits out of stock transactions, and thus to establish a standard so high as to prevent any conflict between the selfish interest of a fiduciary officer, director, or stockholder and the faithful performance of his duty.

Smolowe v. Delendo Corp., 136 F.2d 231, 239 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

436. *See, e.g., Lewis v. Wells*, 325 F. Supp. 382 (S.D.N.Y. 1971) (settlement for less than full amount defeats Congress' goal of disgorgement). In some cases, if the corporation's recovery is doubtful, a court is likely to accept less than the maximum recovery. *See, e.g., Plaskow v. Clausing Corp.*, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,228, at 95,978 (S.D.N.Y. June 1, 1983) (\$34,500 settlement; \$49,000 possible recovery); *Lewis v. Chapman*, 416 F. Supp. 855, 857 (S.D.N.Y. 1976).

437. The method for calculating the amount to be disgorged has been subject to severe criticism: "[T]he SEC has gotten so fascinated with the algebraic formulae which a fertile mind can conceive under Section 16(b) that it has never walked away a hundred paces and taken a good look at the monstrosity which has been created. . . ." Calderwood, *Section 16(b)—Another Noble Experiment Gone Wrong* 32 (address before American Society of Corporate Secretaries, New York, New York, April 21, 1960) quoted in L. Loss, *supra* note 48, at 1088 n.212. Some commentators are concerned with the problem of double liability under section 16(b) and Rule 10b-5. *See Ishuzumi, supra* note 8, at 453-

Thus, section 16(b)'s high rate of detection and unusual penalty structure increase the errors caused by the overinclusive aspects of the rule.

3. The Private v. Public Enforcement Tradeoff

Section 16(b)'s corporate recovery approach is consistent with the theory that insider trading harms the agency relationship between managers and their corporations. Some commentators have applauded section 16(b)'s reliance on private enforcement, exclaiming that it is "rare good fortune when controls can be self-executing, without government interposition."⁴³⁸ While in most circumstances this is true, this is not the case with section 16(b), because the efficiency of the enforcement mechanism increases the cost of errors produced by the simple rule. Because section 16(b)'s crude rule of thumb does not accurately categorize insider trading violations, the efficient enforcement mechanism operates to catch insiders who are not using inside information and to deter legitimate business activity. In most cases where a specific rule is employed, the problem of overinclusiveness is handled by providing enforcement officials with the discretion to waive application of the rule.⁴³⁹ As noted previously, however, the SEC has no enforcement power under section 16(b), and private parties motivated by attorney's fees will not take into account the purpose of the regulation. Indeed, the section promotes champerty,⁴⁴⁰ for example, it would be possible for an attorney who discovers a section 16(b) violation to give a plaintiff enough money to buy one share of stock for the sole purpose of bringing a section 16(b) suit.⁴⁴¹

In sum, the section 16(b) regime's simple rule does not promote deterrence and produces a high cost of errors. In comparing the tradeoffs made under the two systems of insider trading regulation, it becomes apparent that the strengths of one scheme correspond to the weaknesses of the other.

D. *A Comparative Analysis of the Rule 10b-5 and Section 16(b) Deterrence Strategies*

Under the first tradeoff, the section 16(b) regime and the Rule 10b-5

55. The issue of double liability was recently litigated in *National Westminster Bancorp NJ v. Leone*, 702 F. Supp. 1132, 1137 (D.N.J. 1988). The *National* court held that section 16(b) does not intend for the corporation to recover that part of insider profits disgorged in settlement of a SEC fraud action. *See id.* at 1140.

438. Cary, *Book Review*, 75 Harv. L. Rev. 857, 860 (1962).

439. *See Ehrlich & Posner, supra* note 288, at 268.

440. *See Note, An Economic Analysis, supra* note 8, at 408 (the social costs of champerty are outweighed by the public benefits from private enforcement). Champerty is not a defense to a section 16(b) action. *See Magida v. Continental Can Co.*, 231 F.2d 843 (2d Cir.), *cert. denied*, 351 U.S. 972 (1956).

441. *See 2 T. Hazen, Securities Regulation* § 12.3, at 23 n.21 (2d ed. 1990) ("The rationale of these cases is that it is up to the state or federal bar to take appropriate disciplinary action against the attorney. Attorney misconduct thus should not interfere with the remedial purposes of section 16(b).").

regime are at opposite ends of the specificity-generality continuum.⁴⁴² Section 16(b)'s unwieldy rule provides clarity, but it creates a great risk that it will automatically and indiscriminately apply to innocent persons. The Rule 10b-5 regime, while it is more expensive to enforce, provides safeguards to protect innocent persons.⁴⁴³ Although the standards under Rule 10b-5 produce uncertainty in some instances, the fiduciary duty and the control person standards clearly apply to section 16(b) insiders in most cases. The flexibility of the materiality standard under Rule 10b-5 and the recklessness standard under the control person provisions provide efficiency benefits that outweigh the loss in certainty. In addition, unlike the Rule 10b-5 regime's vague standards, which provide a built-in mechanism for change, section 16(b)'s simple rule cannot adapt to new situations and has become obsolete.

ITSFEA enhanced the severity-certainty tradeoff under the Rule 10b-5 regime by providing bounties to increase the probability of detection, control person liability to provide enforcement resources, and longer prison terms to increase the sanctions imposed. Controlling person penalties, however, that are based upon a sliding scale using a percentage of the control person's profits would provide more deterrence.⁴⁴⁴

Unlike the problems with detection and prosecution under Rule 10b-5, section 16(a)'s reporting and section 16(b)'s simple provisions lead to a high probability of detection and low cost of enforcement. If one focuses *solely* on the enforcement mechanism of the section 16(b) regime, rather than on the choice of rule itself, there would appear to be no reason to repeal section 16(b). When the rule's overinclusiveness is taken into account, however, section 16(b)'s high cost of errors clearly outweighs the savings in process costs.

Although the penalty imposed under section 16(b) aggravates the cost of errors, some commentators have argued that the penalty calculation under the high-low method enhances deterrence.⁴⁴⁵ To the contrary, this penalty is merely a transfer of wealth from section 16(b) insiders to the legal profession with no corresponding increase in efficient enforcement of the insider trading laws. One could have argued that the section 16(b)

442. See L. Loss, *supra* note 44, at 543 ("[Section] 16(b) and Rule 10b-5 are at opposite jurisprudential poles on the objective-subjective or predictability-fairness continuum."); Dooley, *supra* note 8, at 57 ("[T]he narrow scope of [section 16(b)] is attributable to a failure of imagination, subsequently remedied by the creative development of rule 10b-5 to regulate informational advantages more comprehensively.").

443. *But see* Jacobs, *supra* note 52, at 347 ("Section 16(b)'s occasional trapping of the unwary is clearly an insufficient ground to repeal the statute. A breach of rule 10b-5, . . . is much harder to prove.").

444. See K. Elzinga & W. Breit, *supra* note 8, at 132-38.

445. See *Gratz v. Claughton*, 187 F.2d 46, 52 (2d Cir.) (overall intent of the statute is to serve as a deterrent and for that reason it may be well in some instances to impose a "crushing liability[y]"), *cert. denied*, 341 U.S. 920 (1951). *But see* L. Loss, *supra* note 44, at 560 ("It might [be more] apt to recall the condemned prisoner who, when asked if he had any last words before the noose was pulled, replied: 'Yes, sir, this sure is gonna teach me a lesson.'").

penalty provided some deterrence prior to 1984, however, this argument became invalid after Congress implemented a treble damage penalty for insider trading under ITSA. The substantial penalties currently available under the Rule 10b-5 regime provide more effective and efficient deterrence than section 16(b)'s bizarre high-low penalty structure.

Under the third tradeoff, using a shareholders' derivative suit as an enforcement mechanism would compensate for the harm that insider trading imposes upon the agency relationship between managers and their corporations. Allowing a derivative suit under the Rule 10b-5 regime, however, would conflict with the control person provision's goal to penalize firms that fail to establish effective self-policing systems. Section 16(b)'s corporate recovery approach not only compensates the correct party, it also involves fewer procedural safeguards and thus consumes less judicial resources than the Rule 10b-5 regime's private class action suits for contemporaneous traders.⁴⁴⁶ Section 16(b)'s use of private enforcement operates efficiently, but given the nature of the simple rule, it is rare that any actual insider trading is being detected and prosecuted.

In conclusion, an economic analysis of the weapons used to combat insider trading demonstrates that the Rule 10b-5 regime has a high degree of deterrence, avoiding the costs resulting from section 16(b)'s failure in attempting to achieve maximum deterrence.⁴⁴⁷ ITSA and ITSFEA have efficiently increased the deterrence aspect of insider trading regulation under Rule 10b-5 to such an extent that it is no longer necessary to suffer the costs of section 16(b)'s "spring gun" approach. The same level of deterrence accomplished by section 16(b) could be achieved with far less cost by control persons through their self-policing systems. Thus, section 16(b) regulation wastes valuable resources that are desperately needed to deter insider trading under the Rule 10b-5 regime.⁴⁴⁸

CONCLUSION

The shock waves from the insider trading scandals have created pressure for the overhaul of insider trading regulation. While most of the controversy over insider trading regulation has focused on the Rule 10b-5 regime, some of the pressure for reform has spilled over to section 16(b). Although an ABA Task Force reviewed section 16(b) in 1987, and although the SEC reviewed the rules promulgated thereunder in 1988 and 1989, these reform efforts are inadequate; new weapons in the insider trading arsenal have rendered section 16(b) obsolete.

Attention should focus upon the repeal of section 16(b) because Congress will return to the insider trading problem in the future. Thus, Con-

446. See R. Clark, *supra* note 18, at 263.

447. *But see* Carlton & Fischel, *supra* note 28, at 861-66 (public enforcement with high penalties might deter a significant amount of insider trading, particularly because regulators, unlike firms, are not disciplined by markets).

448. See Note, *A Framework*, *supra* note 8, at 1006-07.

gress may have a rare opportunity to repeal this anachronistic provision: fifty-five years of experience with section 16(b) reveal that it is not a rational and efficient deterrence system. In taking a tough stance on insider trading, Congress should not let the passion of the insider trading wars allow "a triumph of politics over principle."⁴⁴⁹ If this occurs, when the passion subsides and the next decade brings a new white-collar crime, we will be left with section 16(b) and will have lost a valuable opportunity.

449. Macey, *supra* note 283, at 9.

