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# Section 16(b): Re-evaluation is Needed

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# SECTION 16(b): RE-EVALUATION IS NEEDED

PHILIP M. GERSON*

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The purpose of this article is to critically evaluate section 16(b) of the Securities Exchange Act of 1934.[1] This section of the act has produced volumes of comment by lawyers and economists as even the most cursory research will reveal. Most of the writers have at least agreed upon a statement of the statute's basic purposes, but even as to this point there is some disagreement. Stimulated by the discord among the authorities, this article undertakes a reconsideration of the need for section 16(b), its effectiveness and the results it has produced.

## I. IS SECTION 16(b) NEEDED?

### A. *The Congressional Purpose*

The purpose of section 16(b) is to prevent statutory insiders from making short swing speculative profits by trading in the securities of their

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1. 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. . . .

15 U.S.C. § 78p(b) (1964).

companies.[2] Congressional sentiment at the time of the statute's enactment included a general feeling of outrage at the use of inside information[3] by corporate officials for personal profit. Illustrative of the evidence which precipitated the congressional indignation which culminated in the enactment of section 16(b) was the testimony of Albert H. Wiggin, Chairman of the Finance Committee of the Brooklyn-Manhattan Transit Corporation. Wiggin reported that he had sold a large number of shares of BMT stock after learning that the corporation's regular dividend would be passed, but before this news was made public.[4] After the news was released the market price of BMT shares dropped dramatically at which time Wiggin repurchased the shares he had sold before disclosure.[5] Without the benefit of an economic analysis of this practice, or a study of its pervasiveness, Congress adopted a preventive measure described by its architect as a "crude rule of thumb."[6] The statute purports to accomplish its stated goal by deterring the conduct at which it is aimed. By making certain profits recoverable by the corporation the incentive for insiders to speculate was to be removed.[7]

### B. *The Theory of the Statute*

Prior to 1934 corporate insiders were free to trade in the securities of their companies without federal regulation. State regulation was minimal[8] and most states followed the rule that insider trading did not offend the rights of shareholders.[9] Erosion of the majority rule began with the case of *Strong v. Repide,*[10] which held that a director and substantial shareholder was liable to another shareholder from whom he had purchased securities through an agent because his failure to disclose material information relating to the value of the securities constituted a "special

2. Testimony of Thomas G. Corcoran, *Hearings on S. 84 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess., pt. 15, at 6557 (1934).

3. Inside information has been defined as undisclosed corporate news which if disclosed would substantially affect the market price of the securities of a corporation, and which can be exploited by one privy to the information before public disclosure. H. MANNE, INSIDER TRADING AND THE STOCK MARKET 55 (1966). Accordingly, "[i]nsider trading arises wherever persons, including corporations, having fiduciary duties, purchase or sell shares and the transactions are wholly or in part motivated by 'inside' information acquired in the performance of their functions as fiduciaries." W. PAINTER, FEDERAL REGULATION OF INSIDER TRADING 2, 3 (1968).

4. *Hearings on S. 84 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess., pt. 4, at 3024-28 (1933).

5. *Id.*

6. Testimony of Thomas G. Corcoran, *Hearings on S. 84 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess., pt. 15, at 6557 (1934).

7. Testimony of Thomas G. Corcoran, *Hearings on H.R. 7852 and 9720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 137 (1934).

8. *See generally* Yourd, *Trading In Securities by Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act*, 38 MICH. L. REV. 133, 139-43 (1939).

9. Voellmeck v. Harding, 166 Wash. 93, 6 P.2d 373 (1931); Carpenter v. Danforth, 52 Barb. 581 (N.Y. 1868); Fisher v. Budlong, 10 R.I. 525 (1873). For a collection of cases on this point *see* Annot., 84 A.L.R. 615 (1933).

10. 213 U.S. 419 (1909).

circumstance."[11] Based upon the principle that inside information is a corporate asset, more recent cases have held that trading for personal benefit by insiders who make use of this asset is a breach of the fiduciary duty owed the corporation. Because a fiduciary duty has been violated, these cases hold the insider liable to the corporation as a constructive trustee for any profits realized in the transactions.[12]

Section 16(b) was drafted to incorporate this principle into the Securities Exchange Act of 1934.

> [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.[13]

Notwithstanding the origin of the statute, section 16(b) differs from the common law approach significantly. First, it requires both a purchase and a sale to trigger liability whereas either may suffice under the common law. Second, the transactions must occur within a six-month period to be actionable. Finally, actual use of inside information is not required.[14]

The theory behind section 16(b) deserves questioning.[15] Its essence,

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11. *Id. But see* Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659 (1933), which distinguished *Strong* from cases where personal dealings between directors and stockholders were replaced by transactions impersonally conducted over a securities exchange without disclosure to either party of the identity of the other.

12. Brophy v. Cities Service Co., 31 Del. Ch. 241, 70 A.2d 5 (1949); Diamond v. Oreamundo, 29 App. Div. 2d 285, 287 N.Y.S.2d 300 (1968). The American Law Institute has also approved this principle.

> [I]f [a corporate officer] has "inside" information that the corporation is about to purchase or sell securities, or to declare or to pass a dividend, profits made by him in stock transactions undertaken because of his knowledge are held in constructive trust for the principal. He is also liable for profits made by selling confidential information to third persons, even though the principal is not adversely affected.

RESTATEMENT (SECOND) OF AGENCY § 388, comment *c* (1957).

13. Testimony of Thomas G. Corcoran, *Hearings on H.R. 7852 and 9720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 133 (1934). Eight years later the chairman of the Securities and Exchange Commission underscored this premise as the heart of the statute:

> The Exchange Act proceeds on the theory that the confidential information which a corporate insider cannot help but have is information which in a real sense belongs to the corporation, since he acquired it confidentially and in his representative capacity as an official or principal stockholder of the corporation. Thus, this information is regarded by the act as the corporation's property, not the personal property of the insider to do with as he chooses. Since such corporate knowledge is the property of the beneficiary corporation, any profits resulting from its use belong to the insiders no more than does the inside information itself.

*Hearings Before House Committee on Interstate and Foreign Commerce on Proposed Amendments to Securities Act of 1933 and to Securities Exchange Act of 1934*, 77th Cong., 1st Sess. 1257 (1942), *quoted in* Diamond v. Oreamundo, 29 App. Div. 2d 285, 287 N.Y.S.2d 300, 305 n.4 (1968). *See also* Conant, *Duties of Disclosure of Corporate Insiders Who Purchase Shares*, 46 CORNELL L.Q. 53, 64 (1960).

14. Cook & Feldman, *Insider Trading Under the Securities Exchange Act*, 66 HARV. L. REV. 385, 409-10 (1953).

15. Criticism of the theory underlying section 16(b) is not intended to all applications of the theory. When used as a basis for the common law action for insider trading, it is flexible and can be adapted to the peculiar circumstances of particular cases. For example, an agent may, with the consent of his principal, engage in transactions with the principal for profit.

of course, is that inside information is a corporate asset which may not be expropriated by an insider for personal use. Corporate assets, broadly defined, include all property rights, tangible and intangible, belonging to the corporation. To be sure, a reasonable argument can be made that information about a corporation is property and thus a corporate asset. However, to appraise the validity of the theory, this asset must be characterized in terms of its value and utility to the corporation. Naturally, this information has both value and utility to a corporation for the performance of its economic functions as an operating business. However, since corporations are legally restricted[16] from using inside information to speculate in their own securities, and as a rule do not trade in their own securities, it is at least arguable that the corporate asset of inside information has no value or utility to the corporation for purposes of speculation or investment. Accordingly, there is no harm to the corporation from this expropriation of the corporate asset of inside information and its attendant breach of a fiduciary duty. Moreover, the theory underlying section 16(b) cannot, in this instance, call to its defense the general claim that a breach of a fiduciary duty need not be accompanied by a resultant harm to the principal[17] because the statute excludes other general rules applicable to the relationship between fiduciary and principal.[18]

Therefore, the legal premise which forms the theoretical foundation of section 16(b) does not survive the scrutiny of examination and appears to be a groundless rationalization for the statute. However, more important than the theoretical justification for section 16(b) is the broader question of whether insider trading has a harmful or beneficial economic effect.

### C. *The Scope of Insider Trading*

The impetus for the enactment of section 16(b) included a desire to protect outside shareholders and other securities traders from the alleged

*See* Palmer v. Chamberlin, 191 F.2d 532, 539 (5th Cir. 1951). In contrast, consent by stockholders to transactions giving rise to liability under section 16(b) is no defense to an action brought under the statute. *See* Perlman v. Timberlake, 172 F. Supp. 246, 257 (S.D.N.Y. 1959). Furthermore, changes in the common law rule would require delicate legislation or judicial interpretation with probable far reaching consequences. Statutory change or abolition of section 16(b) poses no equivalent danger of unintended sweeping reform.

16. Corporations, like individuals, are subject to Rule 10b-5 of the Securities Exchange Act of 1934 which forbids purchases or sales by persons possessing undisclosed material facts which would affect the judgment of an outsider. Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963). Accordingly, inside information has no speculative utility in the hands of a corporation. For this and other reasons, corporations generally do not trade in their own securities and when they do their motive usually is to fund employee stock option plans or to fend off take-over bids by other companies. Kennedy, *Transactions By A Corporation In Its Own Shares*, 19 BUS. LAW. 319 (1964).

17. Robertson v. Chapman, 152 U.S. 673 (1894); Schuhmacher v. Lebeck, 103 Kan. 458, 173 P. 1072 (1918).

18. Trading by insiders without the benefit of inside information would not be actionable under general fiduciary principles. *See* the authorities cited in notes 10 & 12 *supra*. But section 16(b) imposes liability even if insiders are in fact innocent of the misuse of inside information. Blau v. Max Factor & Co., 342 F.2d 304, 307 n.6 (2d Cir. 1967).

abuses of insider trading. Reflecting upon instances such as the Wiggin episode, the Second Circuit noted that:

> the Congressional hearings indicate that [Section] 16(b), specifically, was designed to protect the "outside" stockholders against at least short-swing speculation by insiders with advance information.[19]

Accordingly, analysis of the advantages and disadvantages of insider trading is meaningless without an understanding of the scope of the practice. Only by weighing the extent of insider trading against its evils or rewards can accurate conclusions be drawn about its value. It is disheartening that so much zeal has been expressed by those who deplore insider trading without the benefit of an empirical study of the incidence of the practice.

If the inclination to trade is any indication of the volume of insider trading, a recent survey retrospectively confirms the suspicions held by Congress thirty-six years ago. The *Harvard Business Review* reports that 42% of the respondents to a questionnaire concerning the ethics of American businessmen stated that they would purchase the securities of a corporation that was a candidate for merger with their own companies.[20] Admittedly, these businessmen would not be statutory insiders under section 16(b) in this instance.[21] Nevertheless, the hypothetical circumstances posed by the questionnaire are analagous to the types of insider trading situations against which section 16(b) is directed. Furthermore, the respondents did not consider insider trading to be one of the eight business practices they would most like to see eliminated.[22]

Perhaps the most enlightening information concerning the propensities of insiders to trade in the securities of their companies appears in a recently published study conducted under a grant by the Ford Foundation and a large brokerage house.[23] In the period from 1950 to 1960 the trades (purchases and sales) of insiders in 30 companies listed on the New York Stock Exchange were studied. The greatest number of trades in any one company for the period studied was 146.[24] The least number of

19. Smolowe v. Delendo Corp., 136 F.2d 231, 235 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

20. Baumhart, *How Ethical Are Businessmen?*, 39 HARV. BUS. REV. 6, 16 (July-Aug. 1961). Fourteen percent of those polled said they would disclose the information to a good friend; two percent said they would tell their stockbroker; and fifty-six percent said they would do nothing. *Id.*

21. Assuming they were not officers, directors, or more than ten percent stockholders in the target company, they would not come within the reach of section 16(b).

22. Baumhart, *How Ethical Are Businessmen?*, 39 HARV. BUS. REV. 6, 160 (July-Aug. 1961). Caution is urged in attaching significance to the replies to this question. It is plausible to suppose that the respondents considered use of inside information unethical but less so than other practices. For example, corporate bribery by gifts and favors was the most disliked business practice. *Id.*

23. Lorie & Niederhoffer, *Predictive And Statistical Properties of Insider Trading*, 11 J. LAW & ECON. 35 (1968).

24. *Id.* at 40.

trades of insiders in any one company was 14.[25] In 20 (two-thirds) of the companies surveyed there were 50 or less trades by insiders.[26] In five of the companies surveyed there were between 50 and 85 trades.[27] In the remaining five companies there were between 94 and 146 trades for the period studied.[28] Interpolating these statistics, the average number of trades for the period was 50 for each company or five per company, per year. The median number of trades was somewhat less, approximately 36.5 per company for the period studied, or 3.6 trades by insiders per company, per year.[29]

According to those who conducted the study, these statistics apparently demonstrate that insider trading is not widespread. Nor does it appear to be of abusive proportions in particular companies at the present time. Moreover, in view of the fact that the boards of directors, officers, and more than ten percent shareholders as a group, in many New York Stock Exchange companies number well over 100, the amount of insider trading appears insignificant. Correlating this information with a survey of mergers and dividend payments the researchers concluded that:

> Our own limited study of mergers, dividend reductions and increases, and earnings increases, etc., also failed to uncover systematic exploitation of confidential information by insiders.[30]

Despite the contribution this study has made, any conclusions drawn therefrom must be made with caution. Present legal restrictions certainly inhibit insider trading to some degree. Section 16(b) at a minimum discourages some purchases and sales within a six-month period by statutory insiders. Rule 10b-5 promulgated under section 10(b) of the Securities Exchange Act of 1934[31] further limits the use of inside information by corporate officials for personal trading.[32] Whether insider trading would markedly increase without these legal restraints is at least an open question.

Another qualification of this study that must be acknowledged is that

25. *Id.*

26. The total number of trades by insiders for the 30 companies between 1950 and 1960 was 1,509. *Id.*

27. *Id.*

28. *Id.*

29. Fifteen companies had 36 or less trades. Fifteen had 37 or more trades. *Id.*

30. *Id.* at 46.

31. 17 C.F.R. § 240.10b-5 (1970).

32. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). Commenting on this case, one writer has concluded that the amount of trading by insiders was insignificant and did not justify the public uproar and administrative zeal that followed. *See* Whitney, *Section 10b-5: From Cady, Roberts To Texas Gulf: Matters Of Disclosure*, 21 BUS. LAW. 193 (1965). A thorough discussion of Rule 10b-5 may be found in Ruder, *Pitfalls in the Development of a Federal Law of Corporations by Implication Through Rule 10b-5*, 59 NW. U.L. REV. 185 (1964). Other restrictions on the sale of securities by insiders may be found in the Securities Act of 1933. Insiders who qualify as issuers or underwriters under the Act must register their shares before sale may be accomplished lawfully. *See* 15 U.S.C. § 77(e) (1964).

the researchers were unable to determine the usual volume of shares traded by insiders.[33] In 1,305 transactions by directors the mean purchase was 244 shares.[34] In 1,077 transactions by more than ten percent shareholders the mean purchase was 863 shares.[35] The conclusion of the study was that variances of great proportions in the number of shares traded made accurate generalization impossible.[36] The inability to uncover the normal volume of insider trades limits the value of the analysis. If the relatively infrequent transactions of insiders involve substantial blocks of stock it is likely that insider trading is substantial despite the small number of actual transactions.

Furthermore, it must be remembered that the survey dealt only with New York Stock Exchange companies which are the largest most stable group of corporations in America. If over-the-counter companies had been studied, the findings of the study might have differed significantly. Most companies in this almost limitless group of corporations are much smaller, more volatile, and subject to less public scrutiny, attention, and regulation than are companies listed on the New York Stock Exchange. For these reasons, over-the-counter companies are perhaps the most fertile territory for insider speculation.

On balance, the available evidence suggests that insider trading is not widespread. Although, the absence of a comprehensive survey requires caution in the making of any evaluation as to the need for legal restraints, it can be concluded that a compelling case has not been made to show that insider trading is pervasive, widespread, or of abusive proportions.

### D. *The Effect of Insider Trading on Outsiders*

Almost all who have discussed insider trading have concluded that the participation of insiders in the trading markets, armed with inside information, harms other traders. The most vigorous and articulate dissent has come from Professor Henry Manne. Professor Manne criticizes both his predecessors and his contemporaries for never pushing "beyond a sense of moral outrage"[37] in their condemnation of insider trading. Indeed, the cornerstone of his analysis is that "[i]t is not enough simply to say

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33. Lorie & Niederhoffer, *Predictive And Statistical Properties of Insider Trading*, 11 J. LAW & ECON. 35, 39, 42 (1968).

34. *Id.* at 39.

35. *Id.* at 42. It is not surprising that the mean purchase for more than ten percent shareholders was higher than the mean purchase for directors. These insiders are large shareholders by definition, hence it is understandable that they purchase larger quantities of shares than do directors who frequently do not have large stockholdings in the companies they serve.

36. *Id.* Even if a normal or average number of shares traded could be established, account would also have to be taken of the number of shares outstanding and the market price of the shares. Clearly, no accurate comparison of the number of trades and the number of shares traded can be made between a large New York Stock Exchange company with 10 million shares outstanding and an over-the-counter company with 100,000 shares outstanding. Likewise, a transaction involving 100 shares of a $10 stock cannot be profitably compared with a transaction involving 100 shares of a $300 stock.

37. H. MANNE, INSIDER TRADING AND THE STOCK MARKET vi (1966).

that insider trading is unfair. If it is unfair, it must be unfair to somebody."[38] This writer agrees with that critique and adopts Professor Manne's premise as a starting point for objective analysis.

The typical circumstance in which insider trading produces allegedly harmful effects is where the insider, by virtue of his relationship with his company, possesses information that will probably materially affect the market price of the securities of his corporation once it is made public[39] For purposes of this analysis, it will be assumed that insiders possess information of a character that is likely to cause an upward price movement when disclosed. It will be assumed further that the time and manner of disclosure of the information is the same whether or not insider trading actually occurs.[40] The following then is a consideration of each class of outsiders (non-insiders) and how they are affected by insider trading.

### 1. SHAREHOLDERS WHO DO NOT SELL PRIOR TO PUBLIC DISCLOSURE

The existing shareholder, whether a long term investor or a short term speculator who has purchased shares prior to the insider's entry into the trading market and holds those shares until after the inside information has been disclosed to the public is not harmed by the presence of insiders in the trading market. The shares he holds will, after disclosure, reflect the full value of the inside information.[41] Therefore, existing non-selling shareholders profit (or suffer losses) from the release of corporate news whether or not insiders trade.

### 2. SHAREHOLDERS WHO SELL PRIOR TO PUBLIC DISCLOSURE

These persons are identifiable as those who, prior to public disclosure, sell their shares to insiders and others seeking to purchase shares in the insider's company. Opponents of insider trading have made the charge, as criticism of Professor Manne's view, that these outsider-sellers, especially those who sell to the insiders, are harmed by not knowing the information known by insiders.[42] Put another way, if outsiders knew what insiders knew they would not sell their shares. This criticism is unsound. Discounting for the moment the possible effects of the presence of insiders in the market on the competition for shares and any influence that they

38. *Id.* at 93. Professor Manne relates the story of a classroom episode in which a frustrated female law student unable to logically defend prohibitions on insider trading stomped her foot and shrieked, "I don't care; it's just not right." *Id.* at 15 n.42.

39. *See* note 3 *supra* for a definition of inside information.

40. Any contrary assumption would be indicative of manipulation on the part of the insider. A full discussion of the dangers posed in this regard and the need for section 16(b) to militate against this evil is not considered herein. For a discussion of the question of whether insider trading contributes to or causes corporate manipulation, *see* H. MANNE, INSIDER TRADING AND THE STOCK MARKET 147-54 (1966) (suggesting that it does not).

41. *Id.* at 60, 61, 106 & n.5.

42. *See* Painter, Book Review, 35 GEO. WASH. L. REV. 146, 149 (1966); Poser, Book Review, 53 VA. L. REV. 753, 754 (1967).

might exert on the price, the outsiders would sell in any case because their decision to sell is made for reasons independent of the presence of insiders in the trading market. Even those who sell directly to insiders are not harmed because the identity of the buyer is unknown. If insiders were not present in the trading market those who sell to insiders would merely sell to someone else.[43] Although insiders may possess an advantage not possessed by outsider-sellers, the latter group are not prejudiced by the exploitation of that advantage. Furthermore, if an outsider-seller did have the same information possessed by an insider-buyer it would probably be valueless because as public information it would cause a price increase before he could take advantage of it.[44] On the other hand, if public disclosure had not been made, possession of the information would make the outsider an insider![45]

Of more substance is the claim that outsider-sellers are harmed by the influence of insider-buyers on the market price of the securities. Without insider trading prior to the public release of information that will materially affect the market price of the securities, the market price will remain stable, all other factors being equal, until disclosure is made at which time a sharp vertical increase in the price of the securities will occur.[46] In contrast, the trading of insiders prior to public release of the information will cause a gradual increase in the price of the securities that will level off when it reflects the full value of the information.[47] This rise in prices will effect differently two groups of outsiders. First, outsider-sellers who sell for reasons other than the price rise created by the presence of insiders in the market will receive a benefit they would not have received in the absence of the inside trading. Second, outsider-sellers whose trading decisions are a function of price may be induced to sell by the gradual price increases caused by insiders. Hence these persons may lose out on the full value of the profit they otherwise would have realized by a steep vertical price increase.[48] The harm to these price function sellers is a direct result of insider trading. To measure this harm the

43. Hetherington, *Insider Trading and the Logic of the Law*, 1967 WISC. L. REV. 720, 723-25.

44. *Id.*

45. Of course, only statutorily defined classes of persons, officers, directors, and more than ten percent shareholders, may be insiders under section 16(b). However, under Rule 10b-5, persons who otherwise are outsiders, by possession and use of inside information become "tipees" and may be liable as insiders under the rule. Kuehnert v. Texstar Co., 412 F.2d 700 (5th Cir. 1969); Ross v. Licht, 263 F. Supp. 395, 409-10 (S.D.N.Y. 1967).

46. H. MANNE, INSIDER TRADING AND THE STOCK MARKET 87-90 (1966).

47. *Id.* One critic of Professor Manne has argued that insider trading does not have this effect on stock prices. Rather, it is contended, insider trading is just one of many factors influencing stock prices. *See* Kripke, Book Review, 43 N.Y.U. L. REV. 212, 213 (1967). Admittedly, insider trading is just one more factor. However, all other factors being equal, it probably does have the effects attributed to it by Professor Manne. If not, the conclusion may be drawn that insider trading is insignificant and does not cause harmful effects on outsiders as some writers have charged. *See* notes 48 & 55 *infra* and corresponding text.

48. *See* Hetherington, *Insider Trading and the Logic of the Law*, 1967 WISC. L. REV. 720, 724.

degree to which the insider trading occasions a gradual rather than a vertical price increase must be determined. This is a difficult measurement to make that requires empirical study before conclusions may be drawn with absolute certainty. However, reasoning from the premise that the available information suggests that insider trading is insignificant compared with total stock trading volume,[49] it can be safely said that no convincing evidence exists to show that insider trading substantially inhibits the otherwise vertical movement of stock prices. Moreover, the realities of the marketplace indicate that even without insider trading unintended and subtle leaks of inside information as well as differing interpretations of publicly released corporate information generally cause gradual rather than steep vertical price curves.[50]

Even if it is conceded that this harmful effect is significant, no harm is done in net economic terms because a corresponding benefit is produced for outsider-buyers whose decision to buy is a function of price. Thus, for each outsider-seller who is induced to sell by the gradual price increase insiders may cause, there ought to be an outsider-buyer who is, for the same reason, induced to buy. This economic equation attributed to insider trading merely redistributes value between price function traders who are speculators.[51] Since no economic loss is thrust upon any other class of market participants, the practical consequence of insider trading with respect to securities price curves is simply a readjustment of the market odds for speculators who can adapt their actions to this economic fact.

In addition, another economic standoff is produced by the influence of insider trading on the curve of securities prices. Those outsider-sellers who sell for reasons other than price will receive a higher price for their shares because insiders have forced a gradual increase in price prior to disclosure.[52] If insider-buyers did not force a gradual increase in price, these outsider-sellers would not profit at all from inside information because the price would, other factors remaining equal, remain at a stable level until disclosure was made.[53] Therefore, those outsiders selling between the time insider-buyers enter the market and the time at which disclosure is made benefit from insider trading. By an equal amount, outsider-buyers who purchase shares for reasons other than price will lose because they must pay more for their shares. Rationalizations for this allocation of profit and loss are discussed *infra.*

49. *See* notes 24-30 *supra* and accompanying text.

50. *See* W. BAUMOL, THE STOCK MARKET AND ECONOMIC EFFICIENCY 47-53 (1965); S. ROBBINS, THE SECURITIES MARKETS 46-47 (1966).

51. H. MANNE, INSIDER TRADING AND THE STOCK MARKET 102 (1966); HETHERINGTON, *Insider Trading and the Logic of the Law,* 1967 WISC. L. REV. 720, 724.

52. H. MANNE, INSIDER TRADING AND THE STOCK MARKET 102 (1966).

53. *Id.* This result has been argued as a beneficial by-product of insider trading as it occurred in the *Texas Gulf Sulphur* case. The presence of insiders in the market competing for the shares of sellers willing to sell "at the market" was described as a favorable happenstance for such sellers because the greater number of willing buyers ultimately produced a higher price. *See* Whitney, *Section 10b-5: From Cady, Roberts to Texas Gulf: Matters of Disclosure,* 21 BUS. LAW. 193, 201 (1965).

3. NON-SHAREHOLDERS WHO DO NOT BUY PRIOR TO DISCLOSURE

This class of persons includes the vast majority of public investors. Among them are all persons who are not shareholders in the companies of insiders until after public disclosure of inside information is made, or who never become shareholders in such companies. These individuals suffer no economic injury because of insider trading. Of course, insiders possess opportunities which are not possessed by the persons comprising this class of investors, namely, the chance to profit by exploiting undisclosed corporate news. Unfortunately this opportunity cannot by definition be shared with the investing public. Unless it is retained and used by a few, inside information is no longer valuable. On the other hand, this group of individuals cannot be harmed by insider trading. They lose nothing if insiders trade profitably. They would gain nothing if insiders did not.

4. NON-SHAREHOLDERS WHO BUY PRIOR TO PUBLIC DISCLOSURE

Discounting for the moment the influence of insider trading on the price movement of securities, these outsider-buyers, like the outsider-sellers discussed above, make their investment decisions for reasons independent of the presence of insiders in the trading market. They are not harmed by their ignorance of what insiders know because they would purchase shares even if insiders were not trading.

However, the circumstances differ somewhat when the effect of insider trading upon the price movement of the securities in which insiders trade is considered. Outsider-buyers who buy for reasons other than price will be forced to compete with insider-buyers for shares prior to disclosure.[54] The amount of harm these outsider-buyers may suffer is the amount by which insider trading causes a departure from the vertical upward movement which should occur without insider trading.[55] If insider-buyers were not present to bid up the price of the shares prior to disclosure, these outsider-buyers would presumably be able to purchase shares at a lower price and thereby realize a greater profit when public disclosure is made.

Subject to the qualifications made above with respect to the probability that insider trading has little if any influence on the gradual upward movement of securities prices because of the small amount of insider trading that actually occurs,[56] and the fact that stock prices generally increase gradually for reasons other than the presence of insiders in the trading markets,[57] the harm suffered by outsider-buyers is a real one. However, there is no net economic loss because outsider-sellers profit by an amount equal to the loss that outsider-buyers may experience. If

54. H. MANNE, INSIDER TRADING AND THE STOCK MARKET 102-04 (1966); W. PAINTER, FEDERAL REGULATION OF INSIDER TRADING 354 (1968).

55. *See* note 49 *supra* and corresponding text.

56. *Id.*

57. *See* note 50 *supra*.

insiders gradually bid up the price of shares in which they trade, outsider-sellers benefit to the extent that outsider-buyers suffer.

The obvious economic result of this situation is that insider trading may produce an economic redistribution of profit and loss. This equation is justifiable because it produces fewer large gains for outsider-buyers and fewer large losses for outsider-sellers. Or, if both outsider-buyers and outsider-sellers have either a gain or a loss, insider trading will moderate each by producing an averaging effect between the two. Thus, outsiders undertake less risk in their investments and speculations when prices move gradually because the situation giving rise to immediate unavoidable losses is eliminated by the insider trading. Accordingly, reduced opportunity for immediate gains is also decreased. This phenomena may be rationalized on the ground that it encourages investment by discouraging speculation. Based on the notion that outsider speculation is more often harmful than beneficial, this result is economically desirable.[58]

The limited class of outsider-buyers, whose trading decisions are a function of price, will benefit from any moderation of the price curve caused by insider trading. These persons profit if they are induced by insider trading to purchase shares that will increase in price.[59] Complimenting this benefit is an offsetting harm to outsider-sellers whose trades are price motivated. This offsetting harm has been discussed *supra*.

E. *The Effect of Insider Trading on the Securities Markets*

As important as the economic effects of insider trading on particular classes of individual participants in the trading markets, is the macroeconomic impact of insider trading on the securities markets. Section 16(b) was not enacted to interfere with the investment transactions of insiders.[60] Instead, the section was promulgated only to deter short-swing speculation by insiders.[61] The distinction between speculation and investment is made by the statute. Purchases and sales that occur within any six-month period represent speculation.[62] All other transactions represent investment.[63] As used by economists, the term "speculation" may embrace almost all securities transactions.[64] But for present purposes the term will be narrowed to mean trading by insiders that is motivated by the belief

58. *See* note 68 *infra* and corresponding text.

59. *See* H. MANNE, INSIDER TRADING AND THE STOCK MARKET 60-61, 106 & n.5 (1966).

60. SEC, STATEMENT WITH RESPECT TO PROPOSED AMENDMENTS TO SECTIONS 12, 13, 14, 15, 16, 20(c) AND 32(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND Section 4(1) OF THE SECURITIES ACT OF 1933, *Hearings on S. 1642 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency*, 88th Cong., 1st Sess. 400 (1963).

61. Comment, *Short-Swing "Purchase and Sales" Under the Securities Exchange Act*, 61 Nw. U.L. REV. 448, 449 (1966).

62. *Id.* at 450.

63. *Id.*

64. Speculation has been broadly defined as the purchase or sale of goods with the expectation of gain solely from a change in market value not occasioned by the actual use of the goods or their transformation into other products for re-sale in another market. *See* Kaldor, *Speculation and Economic Stability*, 7 REV. ECON. STUDIES 1 (1939-1940).

that undisclosed corporate information when publicly disclosed will materially affect the market price for the securities of the corporation. It should be noted that this definition of speculation is the same as the meaning heretofor attributed to insider trading.

The classical economic view regards informed speculation by insiders as a beneficial economic force. Speculation of this kind stabilizes the market by offsetting the excesses to which securities prices are susceptible. Thus, informed insider speculation, according to the classical economic view, helps to avoid periods of "plenty" or "scarcity."[65] If the market price of a security is too high (or too low), entry into the trading market by an insider-speculator will cause a price adjustment so that the market price more accurately reflects the intrinsic value of the security.[66] The insider-speculator is able to perform this function because his access to inside information vests him with superior market judgment not possessed by outsiders.[67] The outsider-speculator is willing to perform this function because it is profitable for him to do so.

However, if insiders trade without superior market knowledge their presence in the market will be destabilizing and will cause wider rather than narrower price fluctuations.[68] Therefore, it may be postulated that speculation by outsiders is generally harmful because it is uninformed speculation which does not produce stabilizing effects. Accordingly, it is likely that outsider-speculation frequently exacerbates excessive price movements rather than moderating them. Theoretically it would appear that insider-speculation is beneficial and that outsider-speculation is harmful.

Empirical studies verify this theory by demonstrating that insider-speculators are superior forecasters of the value that the trading market will ultimately place on securities. A study of insider trading in selected New York Stock Exchange companies showed that after a "purchase" by insiders, the mathematical probabilities favored a large increase in the market price of the stock by a margin of 2.5 to 1,[69] while after a "sale" by insiders, the probability of a large price increase was 1.1 to 1.[70] In other words, the mathematical probability of a large price increase was more than twice as great after a purchase by insiders as after a sale by insiders. Although insiders are not clairvoyant, the study found that:

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65. Wu, *An Economist Looks at Section 16 of the Securities Exchange Act of 1934*, 68 COLUM. L. REV. 260, 265 (1966).

66. Kaldor, *Speculation And Economic Stability*, 7 REV. ECON. STUDIES 1 (1939-1940).

67. This benefit of insider trading to the securities markets must be qualified by the available evidence which suggests that the amount of insider trading is probably insignificant. Accordingly, the benefits produced are probably of minor significance. *See* notes 23-30 *supra* and accompanying text.

68. Kaldor, *Speculation And Economic Stability*, 7 REV. ECON. STUDIES 1, 2 (1939-1940); Wu, *An Economist Looks at Section 16 of the Securities Exchange Act of 1934*, 68 COLUM. L. REV. 260, 266 (1966).

69. Lorie & Niederhoffer, *Predictive And Statistical Properties of Insider Trading*, 11 J. LAW & ECON. 35, 47 (1968).

70. *Id.*

> When insiders accumulate a stock intensively, the stock can be expected to outperform the market during the next six months. Insiders tend to buy more often than usual before large price increases and to sell more often than usual before price decreases.[71]

Despite their finding that insiders were unable to successfully predict price changes during successive time periods, the researchers concluded that insiders are superior forecasters of large price changes in the companies in which they traded.[72]

Notwithstanding the overall market performance of insiders as a group, the fact remains that some insider-speculators for a variety of reasons exhibit inferior market judgment that has a destabilizing effect like that produced by uninformed outsider-speculators. This fact is not cause for alarm because these insider-speculators lose money as a natural consequence of their bad market judgment. Unless they can correct this weakness, they will be forced to stop trading.[73]

Dissent from the classical view centers around the notion that speculation distorts securities prices away from intrinsic value because speculators concern themselves with the forecasting of mass psychology rather than fundamental factors such as earnings, growth, product innovation and other corporate developments which reflect intrinsic value.[74] This viewpoint has been advanced as an explanation for the apparent relationship between political news and the day to day movement of securities prices.[75] In the broadest sense this observation accurately depicts the effect of speculation. However, this pattern of trading is the antithesis of the trading conduct of insider-speculators. Insiders have gained the attention of Congress because they based their trading decisions on corporate information; not on mass psychology.[76] Therefore, even though outsider-speculation probably does sway securities prices away from intrinsic value, insider-speculation produces the opposite result.

### F. *Curtailing Insider Trading Without the Statute*

The objection to insider trading which section 16(b) is intended to remedy is the unfair use of confidential corporate information for per-

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71. *Id.* at 52.

72. *Id.* at 38, 47.

73. It has been stated that no insider would continuously engage in fruitless and costly speculation. *See* Kaldor, *Speculation And Economic Stability*, 7 REV. ECON. STUDIES 1, 2 (1939-1940); Wu, *An Economist Looks at Section 16 of the Securities Exchange Act of 1934*, 68 COLUM. L. REV. 260, 266 (1966).

74. *See* J. KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY 153-58 (1936).

75. Kaldor, *Speculation And Economic Stability*, 7 REV. ECON. STUDIES 1, 8 (1939-1940). It has been suggested that if speculators trade based on their expectations of what other speculators will do, speculators could, by combining in monopolistic fashion, eliminate most day-to-day market fluctuations. *Id.*

76. *See* notes 4 & 5 *supra* and corresponding text.

sonal benefit. Assuming arguendo that this practice is for the reasons commonly alleged, undesirable, section 16(b) is not necessary to accomplish the desired end.

Rule 10b-5 of the Securities Exchange Act of 1934, has been interpreted to prohibit the conduct at which section 16(b) was aimed. Although rule 10b-5 does not make all short-swing trading by insiders profitless, it does circumscribe the use of inside information by insiders in the trading markets.[77] The Securities and Exchange Commission, primary enforcer of rule 10b-5, has taken the position that the breadth of the rule's prohibitions is almost limitless, so long as unfair advantage is taken of outsiders.

> These anti-fraud provisions are not intended as a specification of particular acts or practices which constitute fraud, but rather are designed to encompass the infinite variety of devices by which undue advantage may be taken of investors and others.[78]

In addition to enforcement by the Securities and Exchange Commission, rule 10b-5 confers an implied private right of action on injured parties.[79] Patently then, many of the alleged evils of insider trading come within the ambit of rule 10b-5.

The use of section 16(b) to produce the same deterrent established by rule 10b-5 can only be defended on the ground that it is more practical because, unlike rule 10b-5,[80] the application of section 16(b) does not require proof of the actual use of inside information.[81] To be sure, the section 16(b) plaintiff faces an easier task than does his rule 10b-5 counterpart. Under rule 10b-5 the insider may defend by showing that although he traded prior to disclosure, he did not possess material facts about the company, or that the facts he possessed were not material. These obstacles to recovery, omitted from section 16(b), are desirable in view of the fact that the objective of both provisions is the prevention of insider *exploitation* of confidential corporate information. It is a just result that those who have not partaken of the forbidden fruit escape liability.

The problem of proof under rule 10b-5 is not as difficult as it may seem. Any insider would be hard pressed to show that he was not aware of material facts about the company such as dividend payments, acquisitions and mergers, new product innovations, management changes, or any fundamental change in corporate policy. In fact, proof of insider status

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77. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969).

78. In the Matter of Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961).

79. Hooper v. Mountain States Securities Corp., 282 F.2d 195 (5th Cir. 1960), *cert. denied,* 365 U.S. 814 (1961); Matheson v. Armbrust, 284 F.2d 670 (9th Cir. 1960), *cert. denied,* 365 U.S. 870 (1961); *Cf.* J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

80. List v. Fashion Park, Inc., 340 F.2d 457, 462-63 (2d Cir.), *cert. denied,* 382 U.S. 811 (1965); Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963).

81. Smolowe v. Delendo Corp., 136 F.2d 231, 236 (2d Cir.), *cert. denied,* 320 U.S. 751 (1943).

at the time a material fact exists appears to raise an inference that an insider had knowledge of the fact.[82] On the other hand, proof of the materiality of facts known by insiders presents a question of judgment for the trier of fact. Although questions of this kind are often difficult, the marshalling of information necessary to make this determination is relatively simple. Materiality depends upon whether the average investor would attach trading significance to the information.[83] Evidence bearing on the investor's behavior can be readily discovered without insider cooperation and cannot be camouflaged by insiders. The difficulties in assessing information possessed by insiders as material or not is a better burden for the law to assume than the responsibility for arbitrarily imposing liability without regard for the presence of the alleged evil.

In brief, the only result added by section 16(b) is that it may ensnare some who have not made use of undisclosed corporate information for no substantial evidence exists to show that rule 10b-5 is too narrow or cumbersome to accomplish the goal section 16(b) was enacted to achieve.

## II. Is Section 16(b) Effective?

### A. *The Effect of the Statute in Curtailing Exploitation of Inside Information*

The enactment of section 16(b) came amidst a feeling of optimism about its chances for success. The Senate Committee on Banking and Currency reported that the section would make short-swing transactions by insiders "difficult or impossible."[84] Unfortunately, the landslide of discussions that have followed in the wake of section 16(b) have included little or no evaluation of the success this statute has achieved in attaining its expressed goal. Notwithstanding the general unsupported claims that the section has been a success[85] or a failure,[86] no comprehensive empirical study of section 16(b)'s effectiveness has been attempted.

Enforcement of section 16(b) may be by the corporation, sueing on its own behalf, or if the corporation refuses or does not diligently prosecute, by any shareholder.[87] In general corporations have demonstrated reluctance to bring suits because of dangers posed to corporate morale,

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82. *See* SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). One writer referring to the decision of the district court in the *Texas Gulf Sulphur* case, 258 F. Supp. 262, 277 (S.D.N.Y. 1966), stated that the required standard of proof "leaves virtually nothing to be proved in order to win in a Rule 10b-5 action." Ruder, *Corporate Disclosures Required by the Federal Securities Laws: The Codification Implications of Texas Gulf Sulphur*, 61 Nw. U.L. Rev. 872, 884 (1967).

83. SEC v. Texas Gulf Sulphur, 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

84. S. Rep. No. 792, 73d Cong., 2d Sess. 9 (1934), *quoted in* Lowenfels, *Section 16(b): A New Trend In Regulating Insider Trading*, 54 Cornell L. Rev. 45, 58 (1968).

85. *See* Painter, *The Evolving Role of Section 16(b)*, 62 Mich. L. Rev. 649, 650 (1964).

86. *See* Lowenfels, *Section 16(b): A New Trend In Regulating Insider Trading*, 54 Cornell L. Rev. 45, 61 (1968).

87. *See* note 1 *supra*.

the desire of other insiders to protect their own de facto right to speculate, and unwillingness to proceed unless liability is a legal certainty.[88] Likewise, there is little incentive for individual shareholders to initiate a suit for recovery of profits which inure to the corporation. This is true despite the fact that shareholders benefit indirectly from recovery, in proportion to their stock holdings. The significance of these obstacles to enforcement is revealed by the fact that until 1940 no section 16(b) actions had been brought.[89] During the next eleven years, only 31 suits were brought under the statute.[90] In recent years however, section 16(b) has become more popular among corporate gadflies, attorneys, and legitimately disgruntled shareholders.[91]

Despite increasingly zealous enforcement, section 16(b) probably has not had a substantial impact on insider trading because its mechanical objective terms may be easily avoided with a minimum of inconvenience. It is precisely this feature of the statute which prompted Professor Loss to opine that section 16(b) is the "most cordially disliked provision"[92] of the securities acts. Most securities lawyers wink at section 16(b) as they advise their clients on how to safely escape its grasp. The following is a brief discussion of some of the more obvious ways in which corporate information may be profitably exploited by insiders without running afoul of the statutory requisites necessary to trigger liability. The potential for and probable use of these and other devices to avoid section 16(b) forms the basis of this writer's belief that the statute has not succeeded in appreciably limiting the use of undisclosed corporate information by insiders.

### 1. THE REQUIREMENT OF A PURCHASE AND SALE WITHIN SIX MONTHS[93]

Section 16(b) was designed so as "not to interfere with an insider's investment transactions."[94] This distinction is ostensibly accomplished by the rule of thumb which creates liability only if a purchase and a sale occur within a six-month period. Presumably, unless an insider purchases and sells within a period of six months he is an investor; not a speculator. The economic validity of this premise is certainly open to question. The

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88. *See* comment, *Insider Trading: The Issuer's Disposition Of An Alleged 16(b) Violation*, 1968 DUKE L.J. 94.

89. *See* Wagner, *Deputization Under 16(b): The Implications of Feder v. Martin Marietta Corporation*, 78 YALE L.J. 1151, 1165 (1969).

90. *Id.*

91. Liberal rulings with respect to attorney's fees have made the members of the bar section 16(b)'s policemen. *See* comment, *Insider Trading: The Issuer's Disposition of an Alleged 16(b) Violation*, 1968 DUKE L.J. 94, 102-08. One attorney has found these fees so attractive that he may accurately be described as a professional section 16(b) litigant.

92. II L. LOSS, SECURITIES REGULATION 1087 (2d ed. 1961).

93. A sale followed by a purchase within any six month period would also give rise to liability. *See* note 1 *supra*.

94. SEC, STATEMENT WITH RESPECT TO PROPOSED AMENDMENTS TO SECTIONS 12, 13, 14, 15, 16, 20(c) AND 32(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND Section 4(1) OF THE SECURITIES ACT OF 1933, *Hearings on S. 1642 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency*, 88th Cong., 1st Sess. 400 (1963).

distinction is artificial because it ignores the insider-trader's intent and use or non-use of undisclosed corporate information.

The broadly stated goal of preventing the unfair use of inside information is frustrated by this attempt to differentiate between investment and speculation. Obviously, as many commentators have pointed out,[95] an insider who has purchased a security may after six months and one day sell the security without liability under section 16(b). The holding period does not make insider trading profitless because the passage of six months does not appreciably dilute the speculative value of the knowledge of merger developments, dividend payment changes, new product developments, management changes, or fundamental alterations of corporate policy. Furthermore, no hardship is caused by forcing an insider to hold for six months for the reason that the preferential tax treatment given long term capital gains is extended only to securities that are held six months or more.[96] The significance of this fact is that in nearly all cases insiders prefer to hold for at least six months before completing purchase and sale of securities for reasons independent of section 16(b)'s prohibitions.

In realistic terms, there are probably very few cases where insiders cannot make profitable use of inside information because they must separate their purchases and sales by more than six months.

### 2. THE REQUIREMENT THAT THE DEFENDENT BE AN OFFICER, DIRECTOR, OR MORE THAN TEN PERCENT SHAREHOLDER

The original draft of section 16(b) included a provision prohibiting insiders from giving inside information to others.[97] This provision was omitted from the final draft because it was felt that it would be too difficult to enforce.[98] This omission is important because it permits insiders in different companies to exchange information about their companies without liability under section 16(b). By exchanging information with each other, insiders may profit indirectly from the inside information they possess.[99] Professor Manne suggests that this technique is widely used and that loosely organized information banks for "back scratching" purposes exist between insiders.[100] While it seems a bit far fetched that this practice has even reached a semi-organized state, it is plausible, if not

95. II L. LOSS, SECURITIES REGULATION 1088 (2d ed. 1961); Halleran & Calderwood, *Effect of Federal Regulation on Distribution of and Trading in Securities*, 28 GEO. WASH. L. REV. 86, 115 (1959); 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, 73 (1966).

96. INT. REV. CODE OF 1954, § 1222(3).

97. *See* Smolowe v. Delendo Corp., 136 F.2d 231, 236 (2d Cir. 1943).

98. *Id.*

99. H. MANNE, INSIDER TRADING AND THE STOCK MARKET 28, 30 (1966); 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, 73 (1966).

100. H. MANNE, INSIDER TRADING AND THE STOCK MARKET 62-71 (1966).

likely, that the practice does occur between small groups of insiders on a limited basis. Moreover, even if the information is given gratuitously to friends or relatives rather than in exchange for the inside information of other insiders, the alleged evil section 16(b) seeks to prevent will still occur if the beneficiaries of insider generosity speculate with the information given them. Thus, the limited application of section 16(b) to officers, directors, and more than ten percent shareholders patently allows frustration of its objectives by the simple device of exchanging or giving away valuable undisclosed corporate information.

### B. *The Effect of the Statute in Remedying the Alleged Evils of Insider Trading*

Indisputably, section 16(b) purports to counter the alleged evils of insider trading by deterrance;[101] not by remedying its consequences. Accordingly, it is not surprising that section 16(b) offers no relief to those who have allegedly suffered from insider trading.[102] Recovery may be had only by the corporation and the corporation has not been harmed.[103] Additionally, the sanctions of section 16(b) may be imposed only where an insider has realized a profit.[104] Hence, if insider trading produces any of the harmful effects it allegedly causes and no profit is realized there is no liability to anyone under the statute.[105] Not only is there no remedy available in this case, but there also is no penalty that may be assessed against insider traders. Thus, if section 16(b) is at all successful in accomplishing its goal, the line must be drawn at the point where its deterrent effect becomes unpersuasive since it cannot compensate the alleged victims of insider trading.

## III. IS SECTION 16(b) UNDESIRABLE?

At the very least, judicial interpretations of section 16(b) have surprised many lawyers and businessmen. Surprise has matured into the criticism that "the statute has been extended by the courts, acting presumably on the intent of Congress, to catch many transactions which Congress undoubtedly had not the slightest intention of catching."[106] Apparently

101. *Id.* at 26; Painter, *Section 16(d) [sic] of the Securities Exchange Act: Legislative Compromise or Loophole*, 113 U. PA. L. REV. 358, 359 (1965).

102. H. MANNE, INSIDER TRADING AND THE STOCK MARKET 26 (1966). However, outsiders who trade with insiders in transactions that violate section 16(b) may benefit from corporate recovery by the amount that the increase of corporate assets is reflected in the market value of their shares.

103. *See* II L. LOSS, SECURITIES REGULATION 1088 (2d ed. 1961); Wagner, *Deputization Under 16(b): The Implications Of Feder v. Martin Marietta Corporation*, 78 YALE L.J. 1151, 1163 (1969). More attention is given the question of whether corporations are harmed by insider trading at page 156 *supra*.

104. *See* II L. LOSS, SECURITIES REGULATION 1088 (2d ed. 1961).

105. The meaning of the term "profit" as used in this context differs markedly from the economic meaning of the term. See discussion at page 163 *infra*.

106. Halleran & Calderwood, *Effect of Federal Regulation on Distribution and Trading in Securities*, 28 GEO. WASH. L. REV. 86, 115 (1959).

alluding to the ease with which section 16(b) may be avoided in situations where it was intended to apply and the complimentary danger of its application to transactions falling outside its objectives, one writer has remarked that "in recent years section 16(b) has become a trap and a snare for the unsophisticated or the poorly counselled . . . ."[107]

Congress probably recognized this potential when it granted the Securities and Exchange Commission the administrative power to exempt certain transactions.[108] Notwithstanding that authority, it is evident that this preemptive power which has resulted in eleven administrative rules,[109] has failed to relieve many of the inequities suffered under section 16(b). This follows since clairvoyance would be needed to anticipate all possible hardships and even when an inequitable situation is forseen the administrative power of the Securities and Exchange Commission must acquiesse when its exercise would conflict with judicial pronouncement. In short, too much that cannot be undone has already been done.

On the other hand one observer has noted that in recent years many courts have taken a more flexible stance in interpreting the statute.[110] Recent cases reveal that some attenion is now being given to the question of whether the conduct of the insider defendent was the type Congress intended to reach.[111] Despite this judicial trend and the administrative rule making power of the Securities and Exchange Commission, the pendulum has already swung irreversably toward the inequitable consequences of mechanical application. The following is a brief discussion of some of these unfortunate results.

### A. *Computation of Profits*

The most striking example of the unjust application of section 16(b) is the method employed to compute profits realized by insider speculators. Unfortunately, the statute itself offers no guide as to what Congress meant by the words "any profit realized." The method of computation adopted by all courts was first announced in the case of *Smolowe v. Delendo Corp.*[112] The Second Circuit held that profits realized under section 16(b) are determined by matching the lowest purchase price paid against the highest sales price received, no matter how much time has lapsed between the two transactions, if any purchase and sale (or sale and purchase) occur within a six month period.[113] Thus, for purposes of computing profits real-

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107. Lowenfels, *Section 16(b): A New Trend In Regulating Insider Trading*, 54 CORNELL L. REV. 45, 63 (1968).

108. *See* note 1 *supra*.

109. *See* 17 C.F.R. § 240.16b-1-11 (1969).

110. Lowenfels, *Section 16(b): A New Trend In Regulating Insider Trading*, 54 CORNELL L. REV. 45, 50, 63 (1968).

111. *See e.g.*, Ferraiolo v. Newman, 259 F.2d 342, 345-46 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

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

113. *Id.*

ized under section 16(b), the price paid when securities purchases were made twenty-five or more years ago may be used as a floor and a current sale as a ceiling if an insider has made any purchase of those securities within six months of a sale. Punishment has been added to misfortune where insiders have been held accountable for profits received in transactions in which they actually suffered a substantial economic loss.[114]

Legal writers have applauded the fact that little judicial sympathy has been forthcoming in such cases based on the rationalization that this construction merely maximizes the deterrent Congress erected to discourage insider speculation.[115] Such reasoning is suspect because neither the statute nor its legislative history suggest that Congress intended the deterrent to exceed remedial and approach penal sanctions. In the first place, Congress expressly rejected a version of the statute which included penal measures.[116] Furthermore, the legislative history suggests that Congress intended that corporate recovery approximate as closely as possible the economic profit realized. Discussing the situation where a corporate insider for personal reasons is forced to make a sale that would give rise to liability under the statute, Thomas G. Corcoran, architect of section 16(b) said: "Let him get out what he put in, but give the corporation the profit."[117] Moreover, the provision for administrative exemptions, which recognizes the possibility of sweeping mechanical application to innocent insider trading, strongly suggests that a harsh and inflexible computation of profits was not intended.

A related question is whether an insider may be liable under both section 16(b) and rule 10b-5 and incur double liability.[118] In this way an insider trader could be liable to his corporation under section 16(b) and also to the outsider with whom he traded. There is nothing in the Securities Exchange Act of 1934 or the rules of the Securities and Exchange Commission which expressly prevents such a result. The fact that actions under the statute are brought on behalf of the corporation and that actions under the rule are brought on behalf of an individual seems to suggest that both actions can be maintained independently. Recovery by two different plaintiffs for the same wrong does not appear to contravene any general legal principle or stated public policy. Accordingly, it does seem inequitable to cut off the rights of an outsider at any time within six

114. *See* Gratz v. Claughton, 187 F.2d 46 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951), where despite an economic loss of more than $300,000, the defendant was liable for profits under section 16(b) of over $300,000.

115. *See* Cook & Feldman, *Insider Trading Under The Securities Exchange Act*, 66 HARV. L. REV. 612-14 (1953).

116. *Id.* at 407.

117. 15 *Hearings on S. 84, 56, and 97 Before the Senate Comm. on Banking and Currency*, 73d Cong., 2d Sess. 6430 (1934).

118. It is even possible for an insider to incur "treble liability" if section 16(b) and rule 10b-5 are applied to the same series of transactions. An insider could be liable to both his seller and his buyer under rule 10b-5 as well as to his corporation for the same purchase and sale under section 16(b).

months by a second transaction over which he had no control.[119] On the other hand, accepting the theory of section 16(b), it would likewise be inequitable and out of line with judicial interpretations of the term "profits realized" to deprive the corporation of its recovery to the extent that an amount was paid by the insider to an outsider pursuant to a 10(b)-5 judgment. Furthermore, the effect of the latter construction would be to limit the application of section 16(b) to cases where a rule 10b-5 suit was not maintainable because the insider was innocent of misuse of corporate information.[120] This would be anomolous because misuse of corporate information is the stated evil section 16(b) was enacted to combat.[121]

This potential application of section 16(b) and rule 10b-5 to one series of transactions makes both laws take on a penal character.[122] At least in the case of section 16(b), this result is contrary to the legislative intent.[123]

### B. *Attorney's Fees*

Although section 16(b) makes no express allowance for the reimbursement of expenses incurred in bringing an action under the statute, compensation for expenses including attorney's fees has been awarded out of the fund recovered by the corporation on the theory that the corporation must pay the reasonable expenses of one who has benefited the corporation.[124] Awards of compensation to reimburse shareholders have also been justified on the ground that such compensation may often provide the "sole stimulus" for private enforcement.[125] This is especially apparent in cases where the benefit to individual shareholders from corporate recovery is infinitesimal. In most cases, vigorous prosecution can be expected only by offering an attorney a potential fee of up to one-half[126] of the amount ultimately recovered.

Accordingly, the plaintiff's attorney frequently finances the litigation because he is the party most interested in the outcome. Such conduct is akin to champerty even though it may not, in all cases, fulfill the technical

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119. III L. Loss, SECURITIES REGULATION 1473 (2d ed. 1961).

120. *Id.* at 1473-74.

121. *See* note 1 *supra.*

122. *See* 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, 73 (1966).

123. *See* notes 116 & 117 *supra* and accompanying text.

124. Smolowe v. Delendo Corp., 136 F.2d 231, 241 (2d Cir.), *cert. denied,* 320 U.S. 751 (1943); Magida v. Continental Can Co., 176 F. Supp. 781, 782 (S.D.N.Y.), *aff'd* 231 F.2d 843 (2d Cir.), *cert. denied* 351 U.S. 974 (1956). Recovery of attorney's fees has been allowed even though the attorney's client was not a party of record, Gilson v. Chock Full O' Nuts Corp., 331 F.2d 107 (2d Cir. 1964).

125. Smolowe v. Delendo Corp., 136 F.2d 231, 241 (2d Cir.), *cert. denied,* 320 U.S. 751 (1943).

126. *See* Grossman v. Young, Civil No. 35-459 (S.D.N.Y. 1948), in which the plaintiff's attorney was awarded a fee of $42,500 out of a total recovery of $85,000.

definition of a champertous bargain.[127] Furthermore, the propriety of this type of conduct is subject to scrutiny under state statutes[128] and the Canons of Professional Ethics of the American Bar Association.[129] In any event, it may be stated that sound public policy does not favor the maintenance of suits by attorneys for personal benefit in the name of a client without a substantial interest in the outcome of the litigation. Nevertheless, courts passing on his question have reasoned that,

> [p]resumably Congress is aware of the opportunity presented to attorneys to finance suits for their benefit, but apparently it regards public policy against proved and repeated violations of fiduciary responsibility by corporate officers at the expense of the public more detrimental to public good than the violation of generally accepted ethics by attorneys.[130]

Weighing the evil of champertous agreements against that which section 16(b) was enacted to combat, the decision has been that "[w]hatever the ethics of the situation, the purpose of the statute [should be] fulfilled."[131]

Enforcement by the Securities and Exchange Commission, instead of by shareholders on behalf of the corporation has been suggested as a solution to the dilemma which now exists.[132] Since no charge of champerty could be made against the Securities and Exchange Commission, the statutory purpose could be accomplished without ethical problems. This alternative has been criticized on the ground that self-executing controls are preferable to government enforced restrictions because the Securities and Exchange Commission does not have the resources needed for effective enforcement.[133] Although administrative enforcement would certainly be inconvenient, the costs could be compensated by awarding the Securities and Exchange Commission a small percentage of any recoveries. Unethical conduct should not be encouraged by statute, especially where the ultimate result is to compensate one who has suffered no harm. On balance, the better course seems to be to eliminate private enforcement and its ethical

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127. Champerty may be defined as a bargain by a stranger to a suit, by which he undertakes to carry on the litigation at his own cost and risk, in consideration of receiving, if successful, a part of the proceeds or subject sought to be recovered. Small v. Mott, 22 Wend. 403, 406 (N.Y. Ct. Err. 1839).

128. *See e.g.*, FLA. STAT. § 877.01 (1967); N.Y. JUDICIARY LAW § 488 (McKinney 1968).

129. ABA CANONS OF PROFESSIONAL ETHICS No. 10.

130. Magida v. Continental Can Co., 176 F. Supp. 781, 783 (S.D.N.Y.), *aff'd*, 231 F.2d 843 (2d Cir.), *cert. denied*, 351 U.S. 974 (1956).

131. *Id.*

132. *See* II L. LOSS, SECURITIES REGULATION 1053-54 (2d ed. 1961). A provision similar to section 16(b) has been recommended for Ontario. To avoid the "unseemly" practice of suing only for the purpose of obtaining legal fees, the Ontario Attorney General has recommended enforcement by the Ontario Securities Commission. REPORT OF THE ATT'Y GEN. COMM. ON SEC. LEGISLATION 228-29 (1965).

133. *See* Cary, *Recent Developments in Securities Regulation*, 63 COLUM. L. REV. 856 (1963); Cary, Book Review, 75 HARV. L. REV. 857 (1962).

problems in favor of public enforcement, despite the inconveniences that might be caused.

### C. *The Statute as an Offensive Weapon*

Plainly, section 16(b) was intended to act as a shield against the alleged evils of insider trading.[134] Imagination and corporate vengence have demonstrated that the statute may be used as a sword as well. A recent news story relates the method in which a target company responded to the unsuccessful efforts of another corporation to gain control.[135] In 1968 Gulf & Western Corporation acquired 750,000 shares of Armour & Company. When the Justice Department blocked a takeover effort, Gulf & Western sought a buyer for its 9.8% interest and arranged a sale at a handsome $18,000,000 profit. Armour reacted by making a public offer to repurchase 20% of its outstanding stock[136] at a price substantially lower than the price at which Gulf & Western had negotiated to sell, thus making Gulf & Western the beneficial owner of 12.5% of Armour's stock and a statutory insider under section 16(b).[137] To avoid

134. *See* page 146 *supra.*

135. *The Conglomerate's War to Reshape Industry*, TIME, March 7, 1969, at 78-79.

136. There may have been room to question the legality of Armour's repurchase of its own shares. Limitations on the right of a corporation to repurchase its own shares to fend off corporate takeover suitors may apply to these circumstances. *See* Kennedy, *Transactions By A Corporation In Its Own Shares*, 19 BUS. LAW. 319 (1964). Questions of fraud under federal securities laws may also have been involved. *But see* O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964).

137. Because of the unique nature of these circumstances, the question of whether a corporation may be made an insider by an issuer's repurchase of its own shares has not been judicially established. Obviously, Gulf & Western was unwilling to risk a judicial test; and it appears unlikely that other companies would gamble either. This appears to be a prudent position for several reasons.

For purposes of the reporting requirements of section 16(a), one is a more than ten percent shareholder if more than ten percent of the *outstanding* shares are held, exclusive of any shares held by the issuer. 17 C.F.R. § 240.16a-2 (1970). Since transactions exempt from section 16(a) are also exempt from section 16(b), 17 C.F.R. § 240.16a-10 (1970), it may be inferred that transactions not exempt from section 16(a) are also not exempt from section 16(b). Hence, it may be postulated that only outstanding shares are counted in determining whether one is a more than ten percent shareholder for purposes of section 16(b). Accordingly, Gulf & Western was a more than ten percent shareholder after the repurchase by Armour because repurchased shares are not counted in determining the beneficial ownership requirement.

However, it may be argued that Gulf & Western came within the exception to section 16(b) which provides: "This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of purchase and sale, or the sale and purchase, . . ." *See* note 1 *supra.* Since Gulf & Western was not a more than ten percent shareholder at the time it purchased Armour's stock, but became a more than ten percent shareholder afterward, this exception may apply by analogy to the question of when the percentage status must arise. Although no case has been decided on these facts, the leading case on the meaning of the words "at the time of purchase and sale" suggests that the exception would not apply to Gulf & Western. In *Stella v. Graham-Paige Motors Corp.*, the Second Circuit adopted the reasoning of the district court which denied the defendant's motion for summary judgment on the ground that the defendant was a more than ten percent shareholder both at purchase and sale because the purchase brought his ownership over the ten percent mark. Thus, it is not necessary to have been a more than ten percent owner before the purchase. *Stella v. Graham-Paige Motors, Corp.*, 232 F.2d 299 (2d Cir.

having all of its profits purged under section 16(b)[138] Gulf & Western sold 150,000 shares of Armour stock at a price lower than that at which it had previously negotiated to sell. This sale brought Gulf & Western's ownership of Armour below ten percent, and it was then able to dispose of its remaining shares without liability under section 16(b)[139] at the price it had negotiated. In sum, this tactic did not rob Gulf & Western of all its profits in Armour's stock. However, the takeover was prevented and the profit on the shares representing ownership in excess of ten percent was lost.

This result is anomolous. By use of the clever ploy outlined above, it is very possible that section 16(b) will ultimately be construed to allow outsiders to be made statutory insiders involuntarily.[140] Conceivably, this

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1956), *motion for summary judgment denied,* 104 F. Supp. 957 (S.D.N.Y. 1952). The language used by the district court in reaching this conclusion suggests that an intervening event, after purchase, which made ones holdings exceed the ten percent statutory norm, would make the purchaser subject to section 16(b).

> [I]f the words "at the time" are construed to mean "simultaneously with," a shareholder would become subject to the provisions of § 16(b) as soon as his ownership exceeded 10% of the outstanding shares. *Id.* at 960.

More support for the inference drawn from *Stella,* that Gulf & Western would not come within the statutory exception, may be found in the district court's development of the facts in its opinion denying the defendant's motion for summary judgment. The district court stated that the defendant, who was an original subscriber for more than ten percent of the issuer's shares, lost his insider status when subsequent public offerings diluted his interest to less than ten percent. *Id.* If one may lose insider status as a more than ten percent shareholder, by an intervening corporate event, it seems reasonable that when one gains insider status as a more than ten percent shareholder by similar means, such status will be read back to the time of purchase.

Further verification may be found in section 16(a). That section provides that "Every person who is . . . the beneficial owner of more than ten percentum . . . shall file . . . after he becomes such beneficial owner . . . ." 15 U.S.C. § 78(p)(a) (1964). Thus, section 16(a) applies to more than ten percent owners even if they become such by means other than a purchase. Since Gulf & Western was not exempt under section 16(a), it probably was also not exempt under section 16(b). *Cf.* 17 C.F.R. § 240.16a-2 (1970).

138. Gulf & Western could have easily escaped liability by waiting six months from the date of its most recent purchase of Armour stock before selling. Had it done so, no claim under section 16(b) could have arisen. The apparent urgency faced by Gulf & Western could have been caused by the reluctance of its buyer, General Host Corporation, another takeover suitor, to wait six months. *See The Conglomerate's War To Reshape Industry,* TIME, March 7, 1969, at 78-79.

139. At the time of the sale of the 150,000 shares of Armour stock, Gulf & Western was a beneficial owner of more than ten percent of the outstanding stock. If the other necessary elements for liability under section 16(b) were present, any profits realized (*see* notes 112-14 *supra,* and corresponding text) were recoverable by Armour. Since this transaction reduced Gulf & Western's holdings to less than ten percent of the outstanding shares, the remaining shares could be sold without liability under section 16(b) since Gulf & Western was not a more than ten percent shareholder at the time of sale. *See* note 137 *supra.*

140. Several cases have considered the voluntariness of an insider's conversion of securities on the issue of whether such conversion is a sale within the meaning of the statute. *Compare* Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), *cert. denied,* 359 U.S. 927 (1959), *with* Roberts v. Eaton, 212 F.2d 82 (2d Cir.), *cert. denied,* 348 U.S. 827 (1954). It appears unlikely that this argument would succeed for one involuntarily made an insider, since the decision to sell within six months is voluntary. The defending insider could only contend that the statute applied to him involuntarily, not that he was forced to violate it.

result could occur inadvertently, as well as intentionally, when a corporation repurchases a substantial amount of its shares. There is irony in this situation, and it may well be the ultimate insult to the equitable application of section 16(b). Is it logical that a provision enacted to militate against the rewards of being privy to corporate confidences may be susceptible of application to a corporation's most hostile and feared enemy? Present public rebukes and government dislike of conglomerate giants cannot justify this distortion of purpose which appears to be the logical extension of previously decided principles of construction. Public opinion and government policy alike are fickle. Even if they were not, the inherent injustice of applying the statute to outsiders appears to be inexcusable.

### D. *Deputization*

The problem of who is a statutory insider has been one of the most troublesome questions of interpretation under section 16(b). Especially difficult has been the application of the theory of "deputization." Under the statute, a partnership or corporation is an insider in another company if a partner, officer, or director is an insider in that other company.

In *Rattner v. Lehman*,[141] a partner of Lehman Brothers, an investment banking firm, was made a director of Consolidated Vultee Aircraft Corporation. During his tenure, Lehman Brothers purchased and sold securities of Consolidated Vultee Aircraft within six months, realizing a profit on the transactions. With the qualification that the result might be different if the partner serving on the board of directors of the issuer knew of the transactions, the court excused the partnership from liability under section 16(b).[142]

Deputization, as a basis for holding the partnership liable because of a partner's service on the board of directors of another company, was born in the concurring opinion of Judge Learned Hand. The distinguished jurist noted that:

> [T]he only question is whether partners are liable for whatever profits the firm may make, whenever one of their members is a director, and only because he is a director. I agree that § 16(b) does not go so far; but I wish to say nothing as to whether, if a firm deputed a partner to represent its interests as a director on the board, the other partners would not be liable. True, they would not even then be formally "directors"; but I am not prepared to say that they could not be so considered; for some purposes the common law does treat a firm as a jural person.[143]

The next time this theory arose was in the case of *Blau v. Lehman*,[144]

141. 193 F.2d 564 (2d Cir. 1952).
142. *Id.*
143. *Id.* at 566.
144. 173 F. Supp 590 (S.D.N.Y. 1959), *aff'd*, 286 F.2d 786 (2d Cir. 1960), *aff'd*, 368 U.S. 403 (1962).

which coincidentally involved the same partnership defendant as in the *Rattner* case. The basic similarity of the facts in *Blau* to those in *Rattner*, and the additional fact that the Lehman partner joined the issuer's board at the issuer's invitation prompted the district court to find no liability.[145] Noting that "there [was] no evidence of any deputization or other affirmative action by the firm . . ." and that "we do not see how any sort of deputizing can make the partners or the partnership a 'director' within the meaning of Section 16(b)," the Second Circuit affirmed the district court's decision.[146] Granting certiorari for the first time in a case involving section 16(b), the Supreme Court approved the theory that one may be deputed to serve the interests of a partnership on the board of directors of another company for purposes of section 16(b), but held that the facts presented did not make out such a case.[147]

The latest judicial pronouncement on the deputization theory came in the case of *Feder v. Martin Marietta Corp.*[148] Conceding that a partnership or a corporation may be liable under section 16(b) because it had deputized a partner or officer, (although no case had been previously decided which held that deputization had in fact occurred) the Second Circuit held that the president of Martin Marietta was deputized to serve on the board of Sperry Rand Corporation. The decision was based upon six findings of fact which were substituted for findings of the district court that were "clearly erroneous."[149] According to the Second Circuit, Martin Marietta's president was deputized to serve on Sperry Rand's board for six reasons:[150]

1. Martin Marietta's president approved all of the firm's investments;
2. Martin Marietta's president was in a position to acquire inside information about Sperry Rand;
3. Martin Marietta's president was furnished inside information relating to the business outlook at Sperry Rand;
4. Martin Marietta's president, in a letter of resignation from Sperry Rand's board of directors, stated that it appeared to Sperry Rand officials extending him the invitation to serve, that Martin Marietta should be represented on the board because of its large stockholdings;

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145. Blau v. Lehman, 173 F. Supp. 590 (S.D.N.Y. 1959).

146. Blau v. Lehman, 286 F.2d 786, 789 (2d Cir. 1960).

147. Blau v. Lehman, 368 U.S. 403 (1962). In a vigorous dissent joined by Chief Justice Warren, Justice Douglas argued that the decision of the majority permitted Wall Street partnerships to reap the benefits of inside information without liability because the practical effect of the decision was to make partnerships immune from section 16(b). *Id.* at 414-15.

148. 406 F.2d 260 (2d Cir. 1969). Two other cases besides those discussed herein have mentioned the deputization theory. *See* Marquette Cement Mfg. Co., 239 F. Supp. 962 (S.D.N.Y. 1965); Molybdenum Corp. of America v. Int'l. Mining Corp., 32 F.R.D. 415 (S.D.N.Y. 1963).

149. This finding was made purusant to FED. R. CIV. P. 52(a). Feder v. Martin Marietta Corp., 406 F.2d 260, 263 (2d Cir. 1969).

150. *Id.* at 264-66.

5. The board of directors of Martin Marietta formally approved its president's appointment to Sperry Rand's board;

6. Martin Marietta had representatives or deputies serving on the boards of directors of other corporations.

Away at last from the mechanical unyielding statutory terms of section 16(b), the courts now have an opportunity, in applying the deputization theory, to channel the application of the statute toward the kinds of conduct it was intended to reach, and to exclude all other circumstances. Unfortunately, it appears that the first such opportunity was bypassed because the *Feder* court did not define the test for deputization or attach differing weights to the factors which influenced its conclusion. Interpreting the opinion, it seems from the factual observations made by the court, that any representation given a corporation or partnership on the board of directors of another corporation by an officer or partner, will amount to deputization. There is no apparent reason for this construction as opposed to one creating liability only where an officer or partner is deputed for the purpose of permitting his corporation to make short-swing profits based on inside information. This latter construction excludes all cases save those expressly made the targets of the statute.[151]

The implications of the deputization theory, if construed as broadly by other cases as it was apparently construed in *Feder* are great. Corporate executives and other distinguished persons are becoming increasingly reluctant to serve as directors because of recent monumental changes in the liabilities of directors.[152] In fact, the existing shortage, plus the wholesale resignations that seem likely to occur in the future, have stimulated the formation of employment agencies specializing in the recruitment of directors for frustrated companies.[153] Expansion of the application of the deputization theory will make outside directors even more relucant to accept positions and will force the breakup of many interlocking directorships.[154] Although this may appear to be a relatively harmless and unimportant problem, closer analysis suggests that the American corporate complexion may be significantly altered.

A recent Congressional report reveals that American commercial banks have substantial representation on the boards of many of the nation's largest companies.[155] For example, 49 banks had interlocking directorships with 286 of the 500 largest industrial corporations in

151. It may be unnecessary to apply section 16(b) at all since rule 10b-5 may apply to cases where a partner is serving on the board of directors of another company for purposes of permitting his partnership to make short-swing profits based on inside information conveyed by the deputed partner. *See In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).

152. The Wall Street Journal, March 13, 1969, at 1, col. 6.

153. *Id.*

154. The Wall Street Journal, February 24, 1969, at 1, col. 6.

155. SUBCOMM. ON DOMESTIC FINANCE OF THE HOUSE COMM. ON BANKING AND CURRENCY, COMMERCIAL BANKS AND THEIR TRUST ACTIVITIES: EMERGING INFLUENCE ON THE AMERICAN ECONOMY, 90th Cong., 2d Sess. Vol. 1 (1968) *quoted in*, Wagner, *Deputization Under 16(b): The Implications of Feder v. Martin Marietta Corporation*, 78 YALE L.J. 1151, 1168 (1969).

America.[156] One bank owned five percent or more of one or more classes of stock in 401 companies.[157] Another bank reported that it had 326 interlocking directorships with 278 companies.[158] Deputization under section 16(b) may be found in any case where the trust department of a bank trades in the securities of a company with which the bank has an interlocking directorship. This may be especially cumbersome for large banks which may face serious restrictions on their ability to freely make investment decisions based only on the interests of their customers.[159] On the other hand, it may be argued that interlocking directorships between commercial banks and large corporations are undesirable. If this is true, it is a matter for the direct attention of Congress and not for de facto resolution through enforcement of section 16(b).

Investment bankers also have a substantial number of interlocking directorships with public corporations. Investment bankers usually become directors in connection with a public offering of securities in which they are involved.[160] To protect their reputations for underwriting good stocks, and to protect themselves as market makers in the after market, investment bankers often provide companies with a sophisticated outside director who can assist management.[161] In the future, *Rattner* and *Blau* may be limited to cases where the outside director does not in any way represent his firm on the board of directors of another company. Any representation, no matter how innocent, may give rise to a finding of deputization under *Feder*. Accordingly, a valuable service now provided by investment bankers may be eliminated or seriously curtailed. On balance, thorough study may prove this to be a desireable result. But as with the case of commercial banks, the elimination of interlocking directorships between public companies and investment banking firms should be the subject of legislation, not judicial pronouncement.

## IV. CONCLUSION

Even though it may be an overstatement, there is some truth to the charge that section 16(b) benefits corporations and plaintiff's attorneys who have suffered no harm at the expense of insiders who have caused no harm. The admitted inability of this writer to measure, with precision, the degree of truth in that claim is a handicap shared by all others who have promoted, criticized, or defended section 16(b). What is needed to accurately determine whether sound public policy requires or should tolerate the statute, is a comprehensive joint study by lawyers and economists. It is hoped that this article will help stimulate further inquiry and discussion along these lines.

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156. *Id.* at 3.
157. *Id.* at 4.
158. *Id.*
159. Wagner, *Deputization Under 16(b): The Implications of Feder v. Martin Marietta Corporation*, 78 YALE L.J. 1151, 1170 (1969).
160. W. PAINTER, FEDERAL REGULATION OF INSIDER TRADING 62-63 (1968).
161. *Id.*