View metadata, citation and similar papers at core.ac.uk
brought to you by CORE
provided by Cleveland-Marshall College of Law

Cleveland State University
EngagedScholarship@CSU

Cleveland-Marshall
College of Law Library

Cleveland State Law Review | Law Journals

1963

Wall Street Trading Firms as Securities Insiders

Alan R. Johnston

Lawrence A. Coles Jr.

Follow this and additional works at: https://engagedscholarship.csuohio.edu/clevstlrev

Part of the Securities Law Commons

How does access to this work benefit you? Let us know!

Recommended Citation

Alan R. Johnston & Lawrence A. Coles Jr., Wall Street Trading Firms as Securities Insiders, 12 Clev.-Marshall L. Rev. 369 (1963)

This Article is brought to you for free and open access by the Law Journals at EngagedScholarship@CSU. It has been accepted for inclusion in Cleveland State Law Review by an authorized editor of EngagedScholarship@CSU. For more information, please contact library.es@csuohio.edu.

Wall Street Trading Firms as Securities "Insiders"

*Alan R. Johnston and Lawrence A. Coles, Jr.**

> What the Court does today is substantially to eliminate "the great Wall Street trading firms" from the operation of § 16(b) [of the Securities Exchange Act of 1934]....

THIS IS THE OPENING SENTENCE of Justice Douglas' dissenting opinion in the recently decided case of *Blau v. Lehman.*[1] This is how many, including the Securities & Exchange Commission, which appeared as *amicus curiae,* view the effect of this decision.

While some quarters of the investment banking business are heartened by this decision, other quarters are concerned about the "elimination" viewpoint of Justice Douglas and the SEC and whether it portends further action on the part of the SEC to seek legislation to rectify what it deems a "large and unintended loophole in the statute".[2]

The purpose of this article is to examine this view of the *Blau* case, the implications of the SEC's decision *In The Matter of Cady, Roberts and Co.*[3] and the possible ramifications of this view and of the *Cady, Roberts* decision on the future trading activities of investment banking firms.[4]

The Blau Case

The plaintiff in the *Blau* case was a stockholder of Tide Water Associated Oil Company (the stock of which was listed on the New York Stock Exchange), who brought an action on

* Partner and associate, respectively, in the law firm of Thompson, Raymond, Mayer and Jenner, of Chicago, Illinois.

1 368 U. S. 403, 82 S. Ct. 451 (1962), affirming 286 F. 2d 786 (2d Cir., 1960). The opinion of the district court is reported at 173 F. Supp. 590 (S. D. N. Y., 1959).

2 *Supra* n. 1 at 411 (1962).

3 Securities Exchange Act Release No. 6668 (November 8, 1961), 1961 4 CCH Fed. Sec. L. Rep., Par. 76803.

4 This article is intended to be limited to the above subject matter. It is not intended to be another general critique of the *Blau* case, several of which have been previously published. See 37 Notre Dame Law. 538 (1962), 50 Ill. B. J. 631 (1962), and 3 B. C. Ind. & Com. L. R. 561 (1962). See also 14 Stan. L. Rev. 192 (1961), 34 Colum. L. Rev. 926 (1961), and 49 Geo. L. J. 779 (1961), commenting on the decision in the Court of Appeals. As to the general nature of stockholders' rights and duties inter sese [including Sec. 16(b)] see, 3 Oleck, Modern Corporation Law, ch. 62 (1959).

behalf of the company under § 16 (b) of the Securities Exchange Act of 1934 to recover, with interest, "short-swing" profits[5] allegedly realized in the trading of that company's securities by Lehman Brothers, a partnership engaged in investment banking, brokering of securities and the trading of securities for its own account. Also named as a defendant was a Joseph H. Thomas, a member of the partnership who was also a director of Tide Water.

The complaint did not allege that Tide Water was entitled to the "short-swing" profits of Lehman Brothers simply by virtue of one of its partners (Thomas) being a director of Tide Water and a purchase and sale by the partnership within a six months period. The complaint alleged, rather, that the partnership "deputed" Thomas to represent its interests as a director of Tide Water and that the purchase and sale within six months on the basis of the use of special and inside knowledge of Thomas, constituted a violation of § 16 (b) for which Tide Water was entitled to the entire profits realized by the partnership.[6]

The evidence was in conflict with the allegations of deputization and use of "inside" information by Lehman Brothers. The trial court found that there was no evidence that Lehman Brothers deputed Thomas to represent its interests as a director on the board of directors of Tide Water; that there had been no actual use of inside information; and that Lehman Brothers

---

[5] Section 16(b) of the Securities Exchange Act of 1934 (15 USC § 78p(b) (1958)) provides in part as follows:

> (b) 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 . . .

The six months period specified in Section 16(b) gives rise to the phrase "short swing" in describing these profits.

[6] The complaint sought to recover the entire profits on the transactions either from the partnership or Thomas himself. The Court found Thomas liable only for his proportionate share of the entire profits. This article is primarily concerned with the question of whether the profits realized by the partnership can be recovered. Reference will be made to the profits recoverable from Thomas only for purposes of clarification where necessary.

bought its Tide Water stock solely on the basis of public announcements by Tide Water without consulting Thomas.

These findings were not disturbed by either the Court of Appeals[7] or the Supreme Court[8] and both decisions were predicated thereon. Both the Court of Appeals and the Supreme Court held that the mere fact that a partner in Lehman Brothers was a director of Tide Water at the time of the "short-swing" transactions was not sufficient to make the partnership liable for the profits thereof; nor was the partner-director individually liable for all of such profits.[9]

Both the Court of Appeals and the Supreme Court based their decisions on an earlier decision of the Court of Appeals in *Rattner v. Lehman.*[10]

The *Rattner* case was decided on similar facts, i.e., a partner of Lehman Brothers was a director of Consolidated Vultee Aircraft Corporation and "short-swing" profits were realized by Lehman Brothers on the purchase and sale of Consolidated Vultee stock. The court there held the partner-director liable only for his proportionate share of the partnership profits. It refused to hold Lehman Brothers liable for the profits realized by it on the grounds that § 16(b) contained no provision requiring the partners of a "director" to account for profits realized by them.[11]

---

[7] 286 F. 2d 786, 789 (2d Cir., 1960).

[8] *Supra* n. 1.

[9] The Court of Appeals found Thomas liable only for his share of the total profits; that he was liable for such share irrespective of his waiver or disclaimer of such share. The Court stated that whether he actually received his share was immaterial as he is deemed to have realized profits and must account for them. 286 F. 2d 786, 790, 791 (2d Cir., 1960). This question was not before the Supreme Court and it did not rule thereon.

The question of whether Thomas was also liable for interest on his share of the profits was before the Supreme Court and it affirmed the Court of Appeals' denial of such interest on the grounds that the allowance of interest under these circumstances is a matter of judicial discretion and that there had been no showing that the denial was either so unfair or so inequitable as to require the court to upset it.

[10] 193 F. 2d 564 (2d Cir., 1952).

[11] It should be noted that the court in the *Rattner* case found support for its holding that the partner-director is liable for only his proportionate share of the partnership profits in SEC Rule X-16A-3 (as it then existed) which permitted a partner to file a report "only as to that amount of such equity securities which represents his proportionate interest in the partnership." 1961 2 CCH Fed. Sec. L. Rep., Par. 25811. The Rule was amended after the *Rattner* decision to require that a partner-director report the

(Continued on next page)

In view of the *Rattner* decision it is clear as to why the complaint in the *Blau* case did not simply allege that the partnership was liable because one of its partners was a director of Tide Water at the time of the "short-swing" transactions. This would have alleged the same facts upon which *Rattner* was decided. Instead, the plaintiff in the *Blau* case framed his complaint in terms of the partnership having "deputed" the partner-director to represent its interests on the board and that the purchase and sale was motivated by inside information. This complaint was undoubtedly inspired by some dictum of Judge Learned Hand in his concurring opinion in the *Rattner* case to the effect that while he agreed with the majority's construction of § 16 (b), he was not passing on the question "as to whether, if a firm deputed a partner to represent its interests as a director on the board, the other partners would be liable." [12]

Neither the Court of Appeals nor the Supreme Court had to reach this question in the *Blau* case as the findings of the trial court practically equated *Blau* to *Rattner* and the reviewing courts simply stood on the *Rattner* precedent, *i.e.*, no partnership liability can be predicated on the basis of the partner-director relationship alone.[13]

Dissenting Opinions in the Blau Case

Underlying the position of the vigorous dissenting opinions of Judge Clark in the Court of Appeals[14] and Justice Douglas in the Supreme Court,[15] is the question as to whether deputiza-

(Continued from preceding page)

entire amount of such equity securities held by his partnership. See Securities Exchange Act Release No. 4754 (1952).

While the Rule was further amended in 1961 to delete the requirement that a partner-director report the entire amount of such equity securities held by his partnership (see Securities Exchange Act Release No. 6487 (1961)), this requirement has now been incorporated into the instructions for the use of Forms 3 and 4 adopted by the SEC for the reports required to be filed under § 16(a) of the Securities Exchange Act. 1961 2 CCH Fed. Sec. L. Rep., Pars. 33701 and 33721.

[12] 193 F. 2d 564, 567 (2d Cir., 1952).

[13] It is of interest, however, that in deciding the *Blau* case, the Supreme Court, in dictum, suggested that Lehman Brothers would have been liable if it "functioned as a director" through Thomas, *i.e.*, had deputized Thomas to perform director duties for Lehman Brothers. Thus, while the Court of Appeals did not concur in Judge Learned Hand's observation in *Rattner* that a different case might be presented where the partner has been deputized, the Supreme Court, also in dictum, indicated that this would constitute a different case and the partnership would be liable.

[14] Judge Clark was joined in his dissent by Judge Smith.

[15] Justice Douglas was joined in his dissent by Chief Justice Warren.

tion is necessary to create a different case. Both dissents take the position that the relationship of a partner-director to his investment banking firm is such that by its nature the partner-director is deputized and inside information is used (or available for use). For example, Judge Clark accused the majority judges of the Court of Appeals of naivete in not recognizing the "facts of financial life." He alluded to Thomas' deposition testimony to the effect that Thomas advised his partners from time to time that Tide Water, under the new management, was a good investment; that he was asked for his opinion of the company and, after observing it for some time under the new management, advised that the new management was first-rate and that the company would do well under that management; that he had discussions with the trading partner who directed the firm's purchases of Tide Water stock and who testified that Thomas spoke highly of the Tide Water prospects.

As stated by Judge Clark:

> Unless judges are to be incredibly naive as to the facts of financial life, it is difficult to see what Thomas needed to say more to show that the lily was already gilded.[16]

Justice Douglas further elaborates on the concern expressed by Judge Clark. In commenting that the decision eliminates "the great Wall Street trading firms" from the operation of § 16 (b), he stated:

> This result follows because of the wide dispersion of partners of investment banking firms among our major corporations. Lehman Bros. has partners on 100 boards. Under today's ruling that firm can make a rich harvest on the 'inside information' which § 16 of the Act covers because each partner need account only for his distributive share of the firm's profits on 'inside information', the other partners keeping the balance. This is a mutilation of the Act.[17]

In tracing the history and purposes of Section 16 (b), Justice Douglas quoted from the Senate Reports on the hearings preceding the adoption of the Securities Exchange Act. For example, Senate Report 1455, 73rd Congress, Second Session, p. 68 states:

> Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their

---

[16] *Supra* n. 7 at 795.

[17] *Supra* n. 2 at 415.

> fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities. *Closely allied to this type of abuse was the unscrupulous employment of inside information by large stockholders who, while not directors and officers, exercised sufficient control over the destinies of their companies to enable them to acquire and profit by information not available to others.* (Emphasis added.)

This report reflects the premises upon which § 16 (b) is based, *i.e.,* because of the abuse that has been made of insider positions such as directorships and officerships of a corporation, a policy was adopted to discourage such activity. Such policy holds an officer or director liable for any profits realized on the purchase or sale, or sale and purchase, of his company's securities (if listed on a national exchange) within six months and such transactions are conclusively presumed to have been based on inside information and the profits are recoverable by the company.

While the provisions of Section 16 (b) may literally be confined to directors and officers, Justice Douglas observes that the purpose of § 16 (b) was being circumvented by a strained reading of the law, one that "allows all but one partner to share in the feast which the one places on the partnership table." [18] He and Judge Clark would read § 16 (b) as including the partnership under the circumstances of this case.

Is the Purpose of Section 16(b) Defeated by Excluding Partnership Profits From Its Coverage?

In view of the findings of the trial court, the dissenting opinions in the *Blau* case must be viewed as predicated on the thesis that the liability therein contemplated stems from the relationship of a partner-director to his partnership itself and not from the deputization of a partner nor from the use of specific inside information in a particular transaction. Critical then is whether the exclusion of partnership profits from the coverage of § 16 (b) under the facts of the *Blau* case defeats the statutory purposes of § 16 (b).

Unfortunately for the investment banking business, the past looms as a haunting specter over this issue. The reports on the adoption of the Securities Exchange Act are replete with con-

[18] *Supra* n. 2 at 420.

demnation of the abuses of insider information and the part played therein by large investment banking firms. Against this background must be viewed the purposes of the Act to put an end to such practices. For example, the policy behind § 16(b) was stated in *Smolowe v. Delendo Corp.*:

> We must suppose that the statute was intended to be thoroughgoing, to squeeze all possible profits out of stock transactions, and thus to establish a standard so high as to prevent any conflict between the selfish interest of a fiduciary officer, director or stockholder and the faithful performance of his duty.[19]

Justice Douglas attached as an appendix to this dissenting opinion, extracts of the opinion in *Lehman v. Civil Aeronautics Board*,[20] which deals extensively with the problem of interlocking directorates through the agency of an investment banking firm.

The court there pointed out, in the context of interlocking directorates, that an investment banking firm places its partners on boards of directors for the benefit of the investment banking firm; that the mere relationship gives rise to benefits to the firm. The court stated:

> The underwriting activities of Lehman Brothers is a substantial part of its business: substantial fees are also obtained by Lehman Brothers from merger negotiations. Profits from the fees are shared by the partners. Section 409(a) companies, with Lehman Brothers partners as directors, need and use both types of services, and the partner directors seek such business for the partnership. In doing so they act as representatives of the partnership. It follows that they act as representatives of fellow partners, some of whom are directors of air carriers. Is this representation within the meaning of the statute? Does Mr. Thomas, to use his case as illustrative, who is a Lehman Brothers partner and also a director of National Airlines, represent, as director of National Airlines, Mr. Lehman, another Lehman Brothers partner and director of Pan American? We think that the affirmative answer of the Board should not be disturbed. . . . In these activities there is not only literal representation by one partner of another in partnership business but the particular partnership business is as well the business of aeronautical enterprises of which the partners are directors.

---

19 136 F. 2d 231, 239 (2d Cir., 1943), cert. denied, 320 U. S. 751 (1943).

20 209 F. 2d 289, 292-294 (D. C. Cir. 1953), cert denied, 347 U. S. 916 (1954).

The court continued:

> When Mr. Thomas, again to illustrate, as director of National seeks to guide that company's underwriting business to Lehman Brothers he acts in the interest of and for the benefit of Mr. Lehman who is not only his underwriting partner but is also a director of an air carrier, Pan American. Mr. Lehman the partner is the same Mr. Lehman the director. The Board is not required to separate him into two personalities, as it were, and to say that Mr. Thomas represents him as a partner but not as a director, if, as in the case here, the representation is in regard to the carrying on of the affairs of Section 409 (a) companies. The undoubted representation which grows out of the partnership we think follows into the directorships when the transactions engaged in are not only by the partners but concern companies regulated by the statute, of which the partners are directors. This is representation within not only the language but the meaning of the statute.[21]

Position of the SEC

It is essentially this view of the relationship between investment banking partners and the partnership that gives rise to the SEC's position that it is immaterial whether a partnership actually deputizes one of its partners; that under the above circumstances, a partner is deemed to serve the interests of the partnership as a matter of law. Judge Clark, in his dissenting opinion in the *Blau* case stated:

> In fact I regard all this discussion whether or not the firm 'deputed' its members to sit on many corporate boards as naive. Obviously this was an arrangement of mutual benefit to both sides; what difference can it make in realities which extended the first invitation? And what further official 'deputation' is needed more than the mere fact of this mutually beneficial arrangement.[22]

The SEC's position is stated in their brief in the *Blau* case as follows (page 12):

> The prevalence of partners of investment banking firms on the boards of directors of the country's large corporations is not mere coincidence. Rather, it is the result of the delib-

[21] 136 F. 2d 289, 293 (D. C. Cir., 1953). Of course, no distinction is there made as to the type of benefits realized by investment banking firms, *i.e.,* whether there is a distinction between underwriting benefits, on the one hand, and trading benefits on the other. Investment bankers concede the underwriting benefits but take issue with the trading benefits.

[22] *Supra* n. 7 at 795.

erate effort of investment banking firms to establish close relationships with the issuers of securities. As was noted in *United States v. Morgan,* 118 F. Supp. 621, 652 (S. D. N. Y.), 'the competition for business by investment bankers must start with an effort to establish or continue a relationship with the issuer,' and the facts indicate that Lehman Brothers placed a partner on the board of Tide Water for this purpose (see pp. 3-4, supra). Membership on boards of directors is intimately related to the business of investment banking, for it is a most effective means of establishing a close relationship. Thus to disregard the relationship of the Lehman directorships to the business of the firm is to discount a significant portion of the firm's goodwill. . . .

The SEC's brief concludes (page 13):

> While the primary purpose of an investment banking firm in placing its partners on the board of corporations may be to obtain underwriting business, *it cannot be assumed in the light of the text and legislative history of Section 16(b) that a firm, which is also engaged in the business of trading in securities, will ignore in its trading activities the inside information obtained from partner-directors.* (Emphasis added.)

While the resolution of the question whether trading profits are realized from such a relationship in and of itself is difficult of proof, it would appear that there is sufficient concern that trading profits are realized from this type of relationship that the SEC will either continue its attempts to impose § 16(b) liability on partnership profits under the facts of the *Blau* case or seek alternative sanctions.

The Cady, Roberts Case As A Possible Alternative Sanction

Representative of the SEC's continuing efforts to equate a partner-director (or other representative) of an investment banking firm with the other partners and the firm itself is *In the Matter of Cady, Roberts and Co.,*[23] which Chairman Cary of the SEC himself has characterized as "a case of first impression and one of signal importance in our administration of the federal securities acts." [24]

The proceedings in *Cady, Roberts* were instituted by the SEC to determine whether Cady, Roberts and Co., and Robert M. Gintel, a partner, willfully violated the "anti-fraud" provisions of § 10(b) of the Securities Exchange Act, Rule 10b-5 pro-

[23] 1961 4 CCH Fed. Sec. L. Rep., ¶ 76803.

[24] *Id* at 81014.

Published by EngagedScholarship@CSU, 1963

mulgated under that Act and § 17 (a) of the Securities Act of 1933, by executing solicited orders and selling for discretionary accounts (upon an exchange) without disclosure to the buyers of non-public information as to the company's dividend action communicated to Gintel by a representative of Cady, Roberts and Co. who served on the company's board of directors.

The Commission found both Gintel and the registrant guilty of the charges, and sanctions were imposed pursuant to an offer of settlement which was accepted by the Commission as being in the public interest.

Pertinent to the *Blau* facts is the statement by the SEC of the special insider duties that arise out of special relationships to a corporation. The SEC decision states:

> The anti-fraud provisions are phrased in terms of 'any person' and that a special obligation has been traditionally required of corporate insiders, e.g., officers, directors and controlling stockholders. These three groups, however, do not exhaust the classes of persons upon whom there is such an obligation. Analytically, the obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. In considering these elements under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications. *Thus our task here is to identify those persons who are in a special relationship with the company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities.* Intimacy demands restraint lest the uninformed be exploited.[25] (Emphasis added.)

As to the responsibilities of disclosure of the partner receiving inside information, it was stated:

> The facts here impose on Gintel [selling partner] the responsibilities of those commonly referred to as 'insiders.' He received the information prior to its public release from a director of Curtiss-Wright, Cowdin, who was associated with the registrant [Cady, Roberts and Co.]. Cowdin's relationship to the company clearly prohibited him from selling the the securities affected by the information without disclosure. By logical sequence, it should prohibit Gintel, a part-

[25] *Id.* at 81017.

ner of the registrant. This prohibition extends not only over his own account, but to selling for discretionary accounts and soliciting and executing other orders.[26]

Thus, the SEC proceeded against Cady, Roberts and Co. with principles allied to its argument in the *Blau* case. In *Blau,* the SEC argued that an investment banking partnership which has a partner on a corporation's board of directors occupies a special relationship to that corporation which enables it to profit in its trading of that corporation's securities. In the *Cady, Roberts* case, the SEC underscores the special nature of that relationship by holding that if as a result of such relationship the partner-director (or other representative) communicates "inside" information to his partner in the investment banking firm, such partner, and the investment banking firm itself, will be committing *fraud* if they fail to make proper disclosure of such information in their trading activities.[27]

Thus, while investment banking firms may be insulated from liability under the facts of the *Blau* case, it is clear from the *Cady, Roberts* decision that the SEC is putting investment banking firms on notice that they will be liable for failure to disclose inside information obtained from representatives or partners who serve as directors of corporations whose securities they are trading.

Query, whether the disclosure obligations of the *Cady, Roberts* decision obviate the necessity for extending the sanctions of § 16 (b) to partnership profits under the circumstances of *Blau.* It might be argued that if the partnership is required to disclose all inside information in its trading activities, the objectives of § 16 (b) have been accomplished and there is no need to impose its sanctions on such profits.

The Prospects of Future Legislation

Investment banking firms have long enjoyed the underwriting and other business benefits of having partners or representatives serve as directors of corporations. The SEC claims that the *Rattner* case opened their eyes to the trading benefits that

26 *Ibid.*

27 While the penalty imposed in the *Cady, Roberts* case was relatively mild, the penalty could be much more severe. Obviously, the Commission was less concerned with the penalty than it was with establishing the principles therein involved.

may also be enjoyed. While investment banking firms do not dispute the first benefits, they do dispute that there are trading benefits or that they take advantage of inside information to realize trading benefits. The SEC, however, has contended that trading benefits do result or that at least the possibility of such benefits should subject the investment banking firms to the provisions of § 16 (b) under the *Blau* facts.

Whether the SEC deems the disclosure obligations of *Cady, Roberts* a satisfactory alternative to the § 16 (b) sanctions sought in the *Blau* case, is conjectural. If it does, it may not seek to amend § 16 (b) to extend that section to include partnership profits under the circumstances of *Blau.* On the other hand, if, notwithstanding the disclosure obligations of *Cady, Roberts,* it believes the possibility of abuse of insider positions is still likely in the special relationship of a partner-director to his partnership, it may recommend that Congress amend § 16 (b) to provide the sanctions sought in the *Blau* case. How successful the investment banking community will be in opposing such legislation if proposed will depend, in part, on whether investment bankers can demonstrate that the trading profits, if any, realized from having a partner-director on a corporation's board of directors are *de minimis non curat lex,* and that, in any event, the disclosure obligations of *Cady, Roberts,* if upheld by the courts, impose an effective alternative sanction against the use of inside information under these circumstances.