

Winter 1990

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Philip J. Boeckman

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### Recommended Citation

Philip J. Boeckman, *War on Insider Trading: Is Fighting over Officer a Losing Battle, The*, 55 Mo. L. REV. (1990)

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## NOTES

# THE WAR ON INSIDER TRADING: IS FIGHTING OVER "OFFICER" A LOSING BATTLE?

*C.R.A. Realty Corp. v Crotty*<sup>1</sup>  
Reproposed SEC Rule 16a-1(f)<sup>2</sup>

### I. INTRODUCTION

[T]he president of a corporation testified that he and his brothers controlled the company with a little over 10 percent of the shares; that shortly before the company passed a dividend, they disposed of their holdings for upward of \$16 million and later, repurchased them for about \$7 million, showing a profit of approximately \$9 million on the transaction.<sup>3</sup>

Examples of flagrant, inequitable trading by corporate insiders, as in the case above, permeated the 1934 report of the Senate Banking and Currency Committee. Congress was prompted to enact section 16 of the Securities Exchange Act of 1934 (the Act).<sup>4</sup> The goal was to deter corporate insiders from abusing their positions of trust to enhance their personal trading profits at the expense of their shareholders.<sup>5</sup> Section 16 is the only provision in the federal securities laws explicitly designed

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1. 878 F.2d 562 (2d Cir. 1989).

2. 54 Fed. Reg. 35,667 (1989) (to be codified at 17 C.F.R. § 240.16a-1(f)) (reproposed Aug. 18, 1989) [hereinafter 1989 Revised Proposal]; see also 21 Sec. Reg. & L. Rep. (BNA) No. 34, at 1323, 1343 (Aug. 25, 1989).

The 1989 proposal was a revision of a 1988 proposal. See 53 Fed. Reg. 49,997 (1988) (proposed Dec. 13, 1988) [hereinafter 1988 Proposal].

3. S. REP. NO. 792, 73d Cong., 2d Sess. 9 (1934).

4. 15 U.S.C. § 78p (1988).

5. The preface to section 16(b) states that the section is aimed at "preventing the unfair use of information which may have been obtained by [a corporate insider] by reason of his relationship to the issuer." 15 U.S.C. § 78p(b) (1988).

to regulate the unfair use of nonpublic information by corporate insiders.<sup>6</sup>

Section 16 "represents a threefold attack upon possible abuses of inside information by corporate insiders."<sup>7</sup> Section 16(a) requires every officer or director of a company with an equity security registered under section 12 of the Act, as well as every person who is directly or indirectly the beneficial owner of more than 10% of any class of any such equity security, to report her stockholdings and transactions in her companies' securities to the Securities and Exchange Commission (SEC).<sup>8</sup> Section 16(c) makes it unlawful for insiders to engage in "short sales" of their companies' equity securities.

The cause of action created by section 16(b) allows any shareholder or the corporation to bring suit to force an insider, anyone listed in section 16(a) who is required to register transactions, to disgorge profits made on a purchase and sale or a sale and purchase within a six month period of his or her companies' equity securities. Because the sales and purchases must occur within six months, transactions to which section 16(b) liability attaches are referred to as "short-swing profit transactions." Section 16(b) states in part:

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 a period of less than six months, . . . shall inure to, and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer on entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter . . . .<sup>9</sup>

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6. The other statutory provisions of the federal securities laws that are used to combat insider trading are general anti-fraud provisions. *See, e.g.*, 15 U.S.C. § 78i, j (1988) (sections 9 and 10 of the 1934 Securities Exchange Act).

7. 3B H. BLOMENTHAL, *SECURITIES AND FEDERAL CORPORATE LAW* 10-12 (rev. ed. 1978).

8. The Securities and Exchange Commission is the agency charged with principal responsibility for the enforcement and administration of the federal securities laws.

9. 15 U.S.C. § 78p(b) (1988).

The most distinctive feature of section 16 is that it establishes objective standards of unacceptable insider trading conduct. Indeed, in the 1934 hearings before the Senate Banking and Currency Committee, an administration spokesperson described section 16(b) as a "crude rule of thumb."<sup>10</sup> No analysis is required and no defense is permitted to determine whether the designated insiders actually took unfair advantage of their positions or were in possession of any nonpublic material information when they traded. This approach clearly simplifies enforcement of the trading prohibitions. In doing so, it creates a sharp contrast with the increasingly complex insider trading litigation under section 10(b) of the Act. For example, issues of fiduciary duty, scienter, materiality, reliance, and causation—which often are critical in applying the antifraud prohibitions in section 10(b)—are irrelevant to an analysis using section 16. Yet, it is section 10(b) of the Act that has emerged over the years as the primary tool for restricting insider abuses.<sup>11</sup>

Recent litigation and discussion of section 16 has focused mostly in the area of unorthodox transactions—the acquisition or disposition of stock by merger, of convertible securities, and of stock rights and options.<sup>12</sup> In analyzing these "unorthodox" transactions, the emphasis of the early courts on an objective approach shifted over the years to a subjective or "pragmatic" analysis.<sup>13</sup> The essence of this pragmatic view of section 16(b) is that, in unorthodox transactions, a case-by-case factual analysis must be made to determine whether there exists the possibility for speculative abuse to which section 16(a) is directed.<sup>14</sup>

10. 15 *Stock Exchange Practices, Hearings before Senate Comm. on Banking and Currency*, 73d Cong., 2d Sess. 6557 (1934) (testimony of Thomas G. Corcoran). This characterization was approved in *Booth v. Varian Assocs.*, 334 F.2d 1, 5 (1st Cir.), *cert. denied*, 379 U.S. 961 (1964).

11. *Committee on Federal Regulation of Securities, Report on the Task Force on Regulation of Insider Trading Part II: Reform of Section 16*, 42 BUS. LAW. 1087, 1091 (1987) [hereinafter *Committee on Federal Regulation of Securities*]. The Committee is part of the Section of Corporation, Banking, and Business Law of the American Bar Association.

12. See Bateman, *The Pragmatic Interpretation of Section 16(b) and the Need for Clarification*, 45 ST. JOHN'S L. REV. 772 (1971); Hazen, *The New Pragmatism under Section 16(b) of the Securities Exchange Act*, 54 N.C.L. REV. 1 (1975); Lang & Katz, *Section 16(b) and 'Extraordinary' Transactions: Corporate Reorganizations and Stock Options*, 49 NOTRE DAME L. REV. 705 (1974).

13. Comment, *Section 16(b) of the Securities and [sic] Exchange Act of 1934: Is a Vice President an Officer?* 58 NEB. L. REV. 733, 737 (1979).

14. See, e.g., *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973); *Bershad v. McDonough*, 428 F.2d 693 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971); *Newmark v. RKO General, Inc.*, 425 F.2d 348 (2d Cir.), *cert.*

Recent cases have applied the subjective analysis to factual situations not involving unorthodox transactions.<sup>15</sup>

Consistent with the development of a pragmatic approach, the courts have applied a subjective definition in determining who is an officer for purposes of imposing section 16(b) liability. Generally, such a subjective test focuses on the officer's job duties and potential access to inside information. *C.R.A. Realty Corp. v. Crotty* involves the application of this subjective definition to an officer confronted with insider trading charges. The approach of the Second Circuit Court of Appeals in *Crotty*, however, is significant because the court focuses almost exclusively on the officer's potential access to inside information, and hence, distinguishes itself as the most subjective test a court has applied to the determination of officer status.

Pursuant to the authority granted by Congress in the Act,<sup>16</sup> the SEC enacted rule 3b-2, which provided a listing of employees qualifying as an officer for purposes of section 16(b).<sup>17</sup> But, the courts chose to rebuke the power of the SEC to define officer,<sup>18</sup> and instead, relied upon a subjective definition in contrast to the objectivity of rule 3b-2. In 1989, the SEC responded to the courts' challenges and proposed a definition which, besides listing specific employees qualifying for officer status, focused on whether the employee's position was one with executive policy-making functions.<sup>19</sup> Although it offers less objectivity than the original listing, the revision still avoids the courts' subjective inquiry into access to inside information.

*denied*, 400 U.S. 854 (1970).

15. *See, e.g.*, *American Standard, Inc. v. Crane Co.*, 510 F.2d 1043 (2d Cir. 1974), *cert. denied*, 421 U.S. 1000 (1975) (no liability without opportunity for speculative abuse); *Pier 1 Imports v. Wilson*, 529 F. Supp. 239 (N.D. Tex. 1981) (no liability despite a voluntary sale of securities pursuant to a merger by an insider who had no access to inside information); *Wentz, Refining a Crude Rule: The Pragmatic Approach to Section 16(b) of the Securities Exchange Act of 1934*, 70 NW. L. REV. 221, 223 (1975) ("the pragmatic approach can and should be used in all applications of 16(b)").

16. 15 U.S.C. § 78c(b) (1983) ("The Commission . . . shall have power by rules and regulations to define technical, trade, accounting, and other terms used in this chapter, consistently with the provisions and purposes of this chapter."); 15 U.S.C. § 78w(a)(1) (1983) ("The Commission . . . shall . . . have power to make such rules and regulations as may be necessary or appropriate to implement the provisions of this title . . . and may for such purposes clarify persons . . .").

17. 17 C.F.R. § 240.3b-2 (1988).

18. For discussion of the authority of the SEC to issue rule 3b-2, *see infra* notes 171-73 and accompanying text.

19. *See* 1989 Revised Proposal, *supra* note 2.

After examining the differences between the objective definition of the SEC and the subjective approach as manifested in *Crotty*, this Note discusses the impact of such a disparity. Because of the benefits a uniform approach offers to combating insider trading, the courts are urged to heed the authority of the SEC and adopt the proposed revision to rule 3b-2. Although Congress designed section 16 to prevent the kind of trading described at the beginning of this Note, abuse of inside information still occurs today<sup>20</sup> and leaving the definitional differences unresolved contributes to the continuation of such trading.

## II. THE FACTS AND HOLDING OF *CROTTY*

From December 19, 1984 to July 24, 1985, Joseph Crotty, while a vice president at United Artists, Inc. (United Artists), purchased 7,500 shares of United Artists stock and sold 3,500 shares, realizing a profit of \$66,620.<sup>21</sup> C.R.A. Realty Corporation (C.R.A.) brought suit under section 16(b) of the Securities Exchange Act of 1934 to compel Crotty to disgorge this profit.<sup>22</sup>

20. According to one commentator:

Experts who track trading by corporate insiders can point to many cases where the insiders bought ahead of the good news and bailed out before the bad news. Earlier this year, executives at several major computer companies—including Data General, Digital Equipment, and Wang Laboratories—were heavy sellers of shares before disclosure of earnings disappointments, layoffs, and sluggish sales.

Laderman, *The Epidemic of Insider Trading*, BUS. WEEK, Apr. 29, 1985, at 88.

21. C.R.A. Realty Corp. v. Crotty, 663 F. Supp. 444, 445 (S.D.N.Y. 1987), *aff'd*, 878 F.2d 562 (2d Cir. 1989). The transactions were as follows:

December 19, 1984—purchased 2,500 shares at \$9.62 per share;  
 January 17, 1985—sold 1,500 shares at \$26.13 per share;  
 July 10, 1985—purchased 5,000 shares at \$4.81 per share;  
 July 10, 1985—sold 1,000 shares at \$20.88 per share;  
 July 24, 1985—sold 1,000 shares at \$23.38 per share.

*Id.*

The district court calculated Crotty's short-swing profit as \$59,405. *Id.* The court apparently matched the 5,000 shares bought at \$4.81 against the 3,500 shares sold at the three different prices. Since Crotty sold only 3,500 shares, the profit should be calculated based on the purchase of 3,500 shares, not 5,000 shares. See L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 560 (2d ed. 1988).

22. *Crotty*, 663 F. Supp. at 445. C.R.A. also named United Artists as a defendant in the suit. Since United Artists was an unnecessary party, it was rightfully ignored throughout the litigation. *Id.*

C.R.A. is "an organization incorporated to act as a private attorney general to purchase stock and commence actions against corporate officials for violations of the federal securities laws." *Crotty*, 878 F.2d at 564. Because C.R.A. bought

The only contested issue was whether Crotty was an officer for purposes of section 16(b), as both parties apparently acknowledged the transaction as being appropriate for short-swing profit liability.<sup>23</sup> Crotty, adopting the subjective approach as set forth in several federal court of appeal cases,<sup>24</sup> claimed his title was merely honorary and that he had no access to inside information.<sup>25</sup> C.R.A. contended that Crotty's title of vice president was sufficient alone to qualify him as a section 16(b) insider.<sup>26</sup> C.R.A.'s position followed the objective definition of officer provided in SEC rule 3b-2.<sup>27</sup> The plaintiff argued in the alternative that, under Crotty's subjective approach, he was still an officer because he did have access to inside information.<sup>28</sup>

If Crotty prevailed and the court applied a subjective approach, the facts surrounding Crotty's employment at United Artists would be crucial. A United Artists employee since 1969,<sup>29</sup> Crotty became head film buyer in 1980 for the corporation's western division.<sup>30</sup> In 1982 the board of directors elected him vice president.<sup>31</sup> The promotion was not accompanied by any changes in salary or duties.<sup>32</sup>

Crotty and his staff of thirty were responsible for buying and distributing films for the ninety-three United Artists theaters in the western division states.<sup>33</sup> He had virtually complete and autonomous

10 shares of United Artists stock in 1986, it had shareholder status and had standing to sue Crotty. C.R.A. was unsuccessful in convincing United Artists to proceed against Crotty. *Id.*

23. *Crotty*, 663 F. Supp. at 444.

24. See *infra* text accompanying notes 51-87.

25. *Crotty*, 663 F. Supp. at 444-45.

26. C.R.A. Realty Corp v. Crotty, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,140 (S.D.N.Y. 1988).

27. 17 C.F.R. § 240.3b-2 (1982).

28. *Crotty*, 663 F. Supp. at 447.

29. *Crotty*, 878 F.2d at 564.

30. *Id.* United Artists, at the time of Crotty's short-swing transactions, was divided into three divisions: western, southwestern, and eastern. Each division had a head film buyer. The corporation is now structured differently. *Id.*

31. *Crotty*, 663 F. Supp. at 445.

32. *Id.* at 444. Furthermore, Crotty was not a director of the company, never attended or was asked to attend a board of directors meeting, and never received any non-public information from the board. *Id.*

33. *Id.* The appellate opinion stated there were 351 "movie screens." *Crotty*, 878 F.2d at 564. The western division states were California, Nevada, Washington, Idaho, Arizona and Utah. *Crotty*, 663 F. Supp. at 445.

Specifically, Crotty's duties included negotiating and signing agreements, pursuant to which United Artists obtained movies for exhibitions, supervising their distribution, and settling contracts when the movies' "runs" were completed. Crotty also helped supervise the western division's advertising

control of the division's film buying.<sup>34</sup> The sole corporate official he reported to was the president;<sup>35</sup> he did this only if he wanted to exceed a predetermined limit for a cash advance to a distributor.<sup>36</sup>

Crotty received from Entertainment Data, Inc., an independent contractor, an accounting of the daily gross revenue receipts for United Artists films in the western division.<sup>37</sup> The gross revenue from Crotty's division was routinely about 35-36% of United Artists' gross revenue from movie exhibitions.<sup>38</sup> This amounted to around 15-18% of the company's total gross revenue.<sup>39</sup>

The district court initially addressed the issue of Crotty's status as an officer when it denied defendant's motion to dismiss and denied the summary judgment motions of both parties. Indicating that it is usually inappropriate to resolve such an issue in a summary judgment,<sup>40</sup> the court denied the motions because of insufficient proof of Crotty's access or lack of access to confidential information.<sup>41</sup>

The trial resulted in the dismissal of C.R.A.'s complaint.<sup>42</sup> The district court held that the evidence revealed that Crotty was a middle management employee whose duties did not provide access to confidential information about the company's financial plans or its future

department. *Crotty*, 878 F.2d at 564.

34. *Crotty*, 878 F.2d at 564.

35. *Crotty*, 663 F. Supp. at 445.

36. *Id.* This occurred only two or three times per year. *Crotty*, 878 F.2d at 564.

37. *Crotty*, 878 F.2d at 567. In addition to giving this overnight data to Crotty, Entertainment Data, Inc. gave the information to most major movie exhibitors and distributors in Los Angeles and San Francisco, as well as to several daily trade publications. *Id.*

38. *Id.* at 564. In fiscal year 1985, the western division's revenue totaled \$86,497,000, or 36.6% of the \$236,422,000 in total theater revenue. *Crotty*, 663 F. Supp. at 445.

39. *Crotty*, 878 F.2d at 564. The 1985 revenues were 18.2% of the \$476,062,000 of total corporate revenue. *Crotty*, 663 F. Supp. at 445.

40. *Crotty*, 663 F. Supp. at 446-47. The district court was confident, however, that determination of the issue rested on whether Crotty had access to inside information. The court never discussed the applicability of rule 3b-2, but instead focused on the approach set forth in *Colby v. Klune*, 178 F.2d 872 (2d Cir. 1949). *Crotty*, 663 F. Supp. at 446-47.

41. *Crotty*, 663 F. Supp. at 447. The court stated that evidence of Crotty's knowledge of United Artists' daily gross revenue receipts was not sufficient for a determination of access to inside information. *Id.*

42. [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,141 (S.D.N.Y. 1988).



operations.<sup>43</sup> The court's conclusion appeared to be based on Crotty's complete lack of involvement with the board of directors, the autonomous nature of his job and the lack of an accompanying change in salary or duties upon his promotion.<sup>44</sup>

The district court's ruling that Crotty's duties did not provide access to inside information was upheld in a 2-1 decision by a panel of the Second Circuit.<sup>45</sup> The court held that it was the duties or functions of an employee—especially his access to inside information—rather than his corporate title that determined whether the liability provision of section 16(b) applied.<sup>46</sup>

### III. PAST TREATMENT OF OFFICER STATUS DETERMINATIONS

#### A. *In the Beginning*

Although the term "director" is defined in the Act,<sup>47</sup> Congress did not provide a definition of the term "officer." Therefore, the SEC adopted rule 3b-2,<sup>48</sup> which currently defines "officer:" "A president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, and any person routinely performing corresponding functions with respect to any organization whether incorporated or unincorporated."<sup>49</sup>

In establishing an objective approach to defining officer, the SEC interpreted rule 3b-2 to mean that a determination of officer status

43. *Id.* The evidence presented by C.R.A. consisted solely of testimony that Crotty's job title was that of vice president. *Id.*

44. *Id.* at ¶¶ 94,140-141.

45. *Crotty*, 878 F.2d at 563. The panel consisted of Chief Judge Oakes and Circuit Judges Timbers (majority) and Meskill (dissenting).

46. *Id.* at 567. The court found that *Colby v. Klune*, 178 F.2d 872 (2d Cir. 1949), required the plaintiff to establish that it was more likely than not that the duties of the trader provided access to inside information. *Id.*

47. 15 U.S.C. § 78c(a)(7) (1982) defines director as: "Any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated."

48. *See supra* note 16 for the authority pursuant to which the SEC acted in adopting rule 3b-2.

49. 17 C.F.R. § 240.3b-2 (1982). The rule originally read: "A president, vice president, secretary, treasurer, comptroller, and any other person who performs for an issuer, whether incorporated or unincorporated, functions corresponding to those performed by the foregoing officers." 17 C.F.R. § 240.3b-2 (1948).

depended upon the actual performance of the duties of that office.<sup>50</sup> Consideration of the individual's access to inside information was not included in the SEC definition.

In *Colby v. Klune*<sup>51</sup> the Court of Appeals for the Second Circuit questioned the authority of the SEC to issue such a confining rule, and proceeded to formulate a broader test which it considered to be more sympathetic with the purposes of the Act. The trial court had granted the defendant's summary judgment motion on the grounds that the defendant was not an officer because of his title of production manager.<sup>52</sup> In reversing the district court, the court of appeals assumed "for the moment" that rule 3b-2 was not authorized by the statute and gave its own construction of the term "officer":<sup>53</sup>

It includes, *inter alia*, a corporate employee performing important executive duties of such character that he would be likely, in discharging these duties, to obtain confidential information about the company's affairs that would aid him if he engaged in personal market transactions. It is immaterial how his functions are labelled or how defined in the by-laws . . . .<sup>54</sup>

This "momentary assumption" became one of the main sources of confusion in the line of cases dealing with the officer question, causing later courts to question rule 3b-2.<sup>55</sup> Furthermore, although the court

50. Statement of the Commission Respecting Distinctions, Exchange Act Release No. 2687, 11 Fed. Reg. 10,967, 10,981-82 (Sept. 27, 1940), provides in part:

[A]n assistant would be an "officer" if his chief is so inactive that the assistant is really performing his chief's functions. However, an assistant, although performing some functions which might be those of his chief, would not be an "officer" so long as those duties were under the supervision of his chief. . . . Subject to the foregoing, assistant treasurers, assistant secretaries, and assistant comptrollers, for example, are not to be considered "officers" for the purposes of this definition.

51. 178 F.2d 872 (2d Cir. 1949).

52. 83 F. Supp. 159, 162 (S.D.N.Y. 1949).

53. *Colby*, 178 F.2d at 873. The court felt that the plaintiff should be allowed to produce evidence at trial relevant to the new definition. *Id.*

54. *Id.*

55. See *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Livingston*, 566 F.2d 1119 (9th Cir. 1978); *Morales v. Holiday Inns, Inc.*, 366 F. Supp. 760 (S.D.N.Y. 1973); *Selas Corp. of America v. Voogd*, 365 F. Supp. 1268 (E.D. Pa. 1973); *Gold v. Scurlock*, 324 F. Supp. 1211 (E.D. Va. 1971), *rev'd on other grounds sub nom. Gold v. Sloan*, 486 F.2d 340 (4th Cir. 1973), *cert. denied sub nom. Gold v. Scurlock*, 419 U.S. 873 (1974).

of appeals specifically reserved judgment on the Commission's statutory authority to issue rule 3b-2,<sup>56</sup> the result created a judicial definition focusing on access and requiring a subjective analysis. On the other hand, the definition of officer in rule 3b-2 simply enumerated specific employees, including anyone else performing corresponding functions. Thus, despite the SEC's approach emphasizing objectivity,<sup>57</sup> both approaches still served to find non-officers, who were officers in substance, liable.<sup>58</sup>

Two federal district court cases in California, both following closely on the heels of *Colby*, held that rule 3b-2 was a valid exercise of SEC power and disregarded as *dictum* the test proposed in *Colby*.<sup>59</sup> Both cases involved determinations about whether assistant officers were

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It seems clear that the rule is within the statutory power of the SEC to make rules and regulations, and no court has held that the rule is invalid. Indeed, the court's "assumption of invalidity was relegated to the purest form of *dictum* by the court's conclusion that the granting of the summary judgment would have been erroneous even if the rule were valid." *Lockheed Aircraft Corp. v. Rathman*, 106 F. Supp. 810 (S.D. Cal. 1952). *See infra* text accompanying notes 171-73.

56. *Colby*, 178 F.2d at 873.

57. According to the *Colby* opinion, the memorandum filed by the SEC stated that an employee's responsibility for policy and his or her participation in executive councils are factors for determining officer status. *Id.* at 875.

Because of the Second Circuit's indifference to the Commission's interpretations, the SEC sought to amend its definition to more closely resemble the *Colby* approach. *See* Report of Directors, Officers, and Principal Stockholders, Exchange Act Release No. 4718, 17 Fed. Reg. 5674 (June 24, 1952). Because the comments received on the proposal were overwhelmingly negative, however, the Commission decided not to adopt it and simply await further judicial expression. Report of Directors, Officers, and Principal Stockholders, Exchange Act Release No. 4754, 17 Fed. Reg. 8900, 8901 (Oct. 4, 1952). The comments expressed disapproval of the additional proof that would be required and the uncertainty accompanying such an approach. *Id.*

58. *Colby* was truly in the spirit of section 16. The commentators generally have supported the opinion. *See, e.g.,* Comment, *supra* note 13, at 741. According to one commentator, the holding "was necessary to avoid making section 16(b) an empty shell enabling all but a very few employees of any corporation to be exempt through a purposeful structuring of corporate titles." Comment, *supra* note 13, at 741.

59. *Lockheed Aircraft Corp. v. Campbell*, 110 F. Supp. 282 (S.D. Cal. 1953); *Lockheed Aircraft Corp. v. Rathman*, 106 F. Supp. 810 (S.D. Cal. 1952).

liable. Although each employed a more objective test than *Colby*,<sup>60</sup> neither decision was given much consideration by later courts.

### B. *The Expansion Years*

Four cases decided in 1973<sup>61</sup> adopted the subjective approach proffered in *Colby* and applied it to the converse factual situation: a titled officer attempting to escape section 16(b) liability because he or she was not an officer in substance.<sup>62</sup> The Commission, again advocating an objective approach to determining officer status, believed an officer by title had to be found liable because the definition of officer in rule 3b-2 was satisfied.<sup>63</sup> According to the SEC, under rule 3b-2 there could be a factual inquiry into the functions performed by a person, but only when the person was not titled an officer.<sup>64</sup>

Although each of the four cases from 1973 grappled with whether to apply an objective or subjective approach, all of the cases agreed with the proposition that an officer by title was not liable if he was not an officer in substance. *Schimmel v. Goldman*<sup>65</sup> and *Selas Corp. of*

60. *Rathman* interpreted rule 3b-2 to relate to officers, regardless of title, whose functions corresponded to one of the officers enumerated in the rule. *Rathman*, 106 F. Supp. at 813. *Campbell* departed somewhat from the strict objectivity of *Rathman* and allowed evidence concerning the nature of the defendant's duties. *Campbell*, 110 F. Supp. at 285. The court concluded that the nonofficer defendant was not a section 16(b) officer under either the Commission's definition or *Colby*'s definition. *Id.*

61. *Morales v. Holiday Inns, Inc.*, 366 F. Supp. 760 (S.D.N.Y. 1973); *Selas Corp. of America v. Voogd*, 365 F. Supp. 1268 (E.D. Pa. 1973); *Schimmel v. Goldman*, 57 F.R.D. 481 (S.D.N.Y. 1973); *Gold v. Scurlock*, 324 F. Supp. 1211 (E.D. Va. 1971), *rev'd on other grounds sub nom. Gold v. Sloan*, 486 F.2d 340 (4th Cir. 1973), *cert. denied sub nom. Gold v. Scurlock*, 419 U.S. 873 (1974).

62. *Colby* only addressed whether a nonofficer, who in substance was an officer, could be liable under section 16(b). Comment, *supra* note 13, at 741. One commentator has argued that the 1973 cases erroneously applied the *Colby* test, because the fact situations before the courts in 1973 were far different than that before the *Colby* court. *Id.* at 745. The commentator believed *Colby* was correctly decided because it addressed the problem of officers avoiding short-swing profit liability by simply changing formal job titles. *Id.* He asserted, however, that applying *Colby* to the reverse fact situation was unsound because such a problem was not presented when an officer in title claimed not to be an officer in substance. *Id.*

63. *Id.* at 744-45.

64. *Id.*

65. 57 F.R.D. 481 (S.D.N.Y. 1973). *Schimmel* approved a settlement partly because a factual question existed about whether the vice president was an insider for section 16(b) purposes. *Id.*

*America v. Vooga*<sup>66</sup> applied both the *Colby* and the SEC reasoning in analyzing whether the officer defendants were within the parameters of section 16(b). The two other cases, *Gold v. Scurlock*<sup>67</sup> and *Morales v. Holiday Inns, Inc.*,<sup>68</sup> applied subjective *Colby*-like tests, and inquired whether access to confidential information was likely because of the officers' duties.

In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Livingston*,<sup>69</sup> the Ninth Circuit Court of Appeals ignored the position of the SEC and adopted an approach similar to that offered by *Colby*. The court held that the title "Vice President" only created an *inference* that the person holding the title had the executive duties and the opportunities for confidential information that the title implied.<sup>70</sup> The inference could be overcome by proof that the title was merely honorary and did not carry with it any of the executive responsibilities that might otherwise be assumed.<sup>71</sup> In determining whether the defendant's title was merely honorary the *Livingston* court, like the *Colby* court, inquired into the access to inside information.<sup>72</sup> The *Livingston* court, however, modified the *Colby* approach by initially focusing on whether the title of the officer was honorary.

66. 365 F. Supp. 1268 (E.D. Pa. 1973). *Selas* granted summary judgment for the corporation because, under either approach, the vice president defendant was liable. *Id.*

67. 324 F. Supp. 1211 (E.D. Va. 1971), *rev'd on other grounds sub nom. Gold v. Sloan*, 486 F.2d 340 (4th Cir. 1973), *cert. denied sub nom. Gold v. Scurlock*, 419 U.S. 873 (1974). *Gold* was reversed by the Fourth Circuit Court of Appeals because the purchase transaction (a merger) was not a purchase for purposes of section 16(b). Before the appellate court decided the case, however, other courts, including *Schimmel* and *Selas*, relied on the district court opinion. Additionally, the Ninth Circuit misapplied the appellate decision in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Livingston*, 566 F.2d 1119, 1122 (9th Cir. 1978).

68. 366 F. Supp. 760 (S.D.N.Y. 1973). The district court in *Morales* held that the vice president's claim that he was not an officer within the meaning of section 16(b) was lacking in merit; consequently, the court refused to approve a settlement between the plaintiff corporation and the defendant. *Id.* at 762-63.

69. 566 F.2d 1119 (9th Cir. 1978).

70. *Id.* at 1122.

71. *Id.* The court stated that confidential information is information about the company's affairs that would help the employee make decisions affecting his market transactions in the company stock. Confidential information does not mean simply any information not available to the public. *Id.* at 1122-23.

72. *Id.* at 1121. The defendant in *Livingston* was one of 48 persons who were account executives but who had been awarded the title of vice president as part of an "Account Executive Recognition Program" without a change of their account executive duties. The company had 350 "executive vice presidents" who performed executive and managerial functions. *Id.*

In 1981, responding to the confusion generated by the four 1973 cases, particularly *Livingston*, the Commission revised its interpretation of rule 3b-2.<sup>73</sup> The SEC formally recognized that determination of officer status "hinge[d] on an examination of all the relevant facts."<sup>74</sup> Although refusing to revise rule 3b-2 (because each case depended upon its own facts), the SEC did agree that, for section 16(b) purposes, officers could be non-officers due to insignificant functions, and non-officers could be officers due to significant functions.<sup>75</sup>

The release expressly supported *Livingston*.<sup>76</sup> It stated that if a vice president was so in name only (one who had no significant duties and who did not participate in the company management), and had no access to inside information, then he or she was not an officer for section 16(b) purposes.<sup>77</sup> Thus, the SEC did approve of a subjective inquiry into access to inside information; however, the SEC interpretation still focused primarily on an employee's functions.

### C. Full Bloom

The 1981 release by the SEC offered the possibility that perhaps the courts would retreat from their subjective inquiry into an officer's access to confidential information, and adopt the mostly objective test of the SEC, which focused on the employee's functions. But three cases decided since the 1981 release ignored the flexible approach set forth in the release, and instead followed the subjective inquiries established in *Colby* and *Livingston*.<sup>78</sup>

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73. Interpretation Release on Rules Applicable to Insider Reporting and Trading, Exchange Act Release No. 18114, 46 Fed. Reg. 48,147, 48,148-49 (Oct. 1, 1981).

74. *Id.*

75. *Id.*

76. *Id.*

77. *Id.*

78. Three other cases since the 1981 SEC release considered issues similar, but not analytically helpful, to those raised in officer status cases. In *Pier One Imports of Georgia, Inc. v. Wilson*, 529 F. Supp. 239, 243 (N.D. Tex. 1981), the court concluded that the defendant's "unorthodox transaction," a sale of stock in connection with a tender offer, did not present an opportunity for speculative abuse. *Id.* Hence, the defendant was not liable for profits made on the transaction. The court found there was no opportunity for speculative abuse mostly because of the honorary nature of defendant's position as vice president. *Id.*

In *Sullair Corp. v. Hoodes*, 672 F. Supp. 337, 338 (N.D. Ill. 1987), the court held that the former chairman of the board and CEO was liable for short-swing profits, notwithstanding the corporation's decision to terminate the officer three days prior to the initial sale. The court said the defendant's ability to gain

In *National Medical Enterprises, Inc. v. Small*,<sup>79</sup> the Ninth Circuit Court of Appeals supported *Livingston's* subjective inquiry into access to inside information to determine section 16(b) liability. But the court restricted its *Livingston* test to "a very limited exception applicable only where the title is essentially honorary or ceremonial."<sup>80</sup> The court reasoned that *Livingston* did not require a case by case detailed factual inquiry into an officer's actual access to confidential information.<sup>81</sup> Only if evidence existed that the officer's title was honorary, was there an examination into the officer's access to inside information.<sup>82</sup> Hence, the court, finding the defendants' titles to be non-honorary, upheld the summary judgment against the vice presidents, even though they claimed to have no access to inside information.<sup>83</sup> Although still allowing a subjective inquiry to take place, the Ninth Circuit, after *Small*, required a defendant officer to present evidence that his or her title was honorary before any inquiry into access occurred.

The Sixth Circuit Court of Appeals, in *Winston v. Federal Express Corp.*,<sup>84</sup> followed the original Ninth Circuit approach set forth in *Livingston*. Unlike *Small's* requirement of evidence of an honorary title, this approach focuses on access to inside information to determine if the title is honorary. The *Winston* court stated that an exception to the rule that the employee's title determined insider status existed when the title was essentially honorary or ceremonial.<sup>85</sup> Determining the nature of the title depended upon the employee's access to insider information.<sup>86</sup> Unlike the Ninth Circuit in *Livingston*, the Sixth Circuit, to overcome the presumption of access, required substantial evidence that there was no possible access to inside information.<sup>87</sup> *Winston* and

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access to inside information at the time of the sale was "completely irrelevant." *Id.* at 338.

In *Jammies Int'l, Inc. v. Nowinski*, 700 F. Supp. 189, 193 (S.D.N.Y. 1988), the defendant argued for summary judgment on the grounds that he was not an insider because his title of vice president was purely honorary. The court acknowledged *Livingston* and *Colby*, and denied the motion because resolution of the issue depended on factual questions. *Id.*

79. 680 F.2d 83, 84 (9th Cir. 1982).

80. *Id.*

81. *Id.*

82. *Id.*

83. *Id.*

84. 853 F.2d 455 (6th Cir. 1988).

85. *Id.* at 456-57.

86. *Id.*

87. *Id.* at 457. The defendant vice president ceased performing duties for the corporation on August 27th, and his resignation was effective on September 30th. He purchased stock on September 30th; then, on March 26th, he sold the shares for a profit in excess of \$176,000. *Id.* at 456.

*Small* represent variations on the subjective approaches originally established by *Colby* and *Livingston*; however, the inquiries demanded by each case are resolved ultimately by focusing on the officer's access to inside information.

The district court for the Northern District of Illinois, in *C.R.A. Realty Corp. v. System Software Associates*,<sup>88</sup> granted summary judgment for C.R.A. on the issue of whether the defendant was an officer for purposes of section 16(b).<sup>89</sup> The defendant, in performing the functions of comptroller, was not vested with any executive duties, but did have access to the company's financial records.<sup>90</sup>

The court analyzed the defendant's officer status according to the three approaches it deemed available. Under the test promulgated by the SEC in rule 3b-2, the defendant was obviously an officer because the rule expressly provides that comptrollers are officers.<sup>91</sup> The court ignored the 1981 release recognizing that functions also can be considered. According to the test approved by the Ninth Circuit in *Small*, the defendant was an officer because his title was not honorary or ceremonial.<sup>92</sup> Finally, the court analyzed the defendant's status under *Colby's* access to inside information test. Although agreeing that the *Colby* approach offered the defendant a much stronger argument, the court still found him to be an officer due to the financial records to which he had access.<sup>93</sup>

Although the *System Software* court must be commended for such an accurate and comprehensive analysis involving each of the approaches for determining officer status, the case reflected the state of confusion existing about how to determine officer liability. Consequently, in an effort to resolve the difference existing between the approaches, the SEC proposed rule 16a-1(f).<sup>94</sup> The proposed rule was released in August of 1989, as part of the first comprehensive review of the section 16

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The court, upholding the trial court's determination, found that the defendant produced no evidence that, after he quit, the company had shielded him from the potential access to confidential information his old job provided. *Id.* at 456-57.

88. No. 88 C-0052 (N.D. Ill. Feb. 1, 1989) (WESTLAW, 1989 W.L. 8508).

89. *Id.* at 1.

90. *Id.* at 2-3.

91. *Id.* at 6.

92. *Id.*

93. *Id.* at 7.

94. 1989 Revised Proposal, *supra* note 2, at 1325.



regulatory scheme.<sup>95</sup> The proposed rule<sup>96</sup> defines officer for section 16 purposes according to the rule 3b-7 definition of "executive officer":

The term officer shall mean an issuer's president, principal financial officer, controller or principal accounting officer, any vice-president of the issuer in charge of principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function or any other person who performs similar policy-making functions for the issuer . . . .<sup>97</sup>

Besides more specifically listing the officers qualifying for section 16(b) liability, the proposal changes the focus from the emphasis in rule 3b-2 on "any person . . . performing corresponding functions" to an emphasis on any person performing *executive policy-making* functions.<sup>98</sup>

The release restates the Commission's 1981 position that title alone is not determinative.<sup>99</sup> The revised definition is a reflection of the Commission's concern that the rule 3b-2 definition is inaccurate and overly broad, especially when considering that section 16(b) is designed, in its opinion, to apply to officers with access to inside information and not necessarily to those with particular titles.<sup>100</sup> The SEC reasoned

95. 1988 Proposal, *supra* note 2, at 49,998. The Commission offered various reasons for the proposed changes to section 16. *See id.* at 49,999-50,000. Most important was the changing nature of securities, as evidenced by the mushrooming of trading in both old and new derivative securities. *Id.* Similarly, employee benefit programs have become more widespread, complex, and diverse. According to the SEC, the developments have not fit easily into the 1934 regulatory framework, resulting in "interpretive uncertainty, substantial litigation, and, in some instances, unnecessary regulatory burdens." *Id.* at 49,998. The complexity of the section was blamed for the delinquency rate in excess of 40% in required transaction reports in 1986, 1987, and 1988 and for the difficulty in detecting these delinquent filers. *Id.* at 50,000.

The changes appear to be aimed at making the application of section 16 simpler and more reasonable. If such goals are accomplished, enforcement by the SEC might be easier and more justifiable.

96. The revised definition was originally rule 16a-1(g). It was relocated to rule 16a-1(f) for easier reference. The proposed revision of the officer definition received more comments after the 1988 Proposal than after any of the other section 16 proposals. 1989 Revised Proposal, *supra* note 2, at 1325. The comments generally were concerned with the narrowing of the definition. *Id.* As a result, the 1989 definition was expanded to include principal financial officers, controllers or principal accounting officers, and officers of an issuer's parent who perform policy making functions for the issuer. *Id.*

97. 1989 Revised Proposal, *supra* note 2, at 1343.

98. *Id.*

99. *Id.* at 1325.

100. 1988 Proposal, *supra* note 2, at 50,000.

that persons exercising policy-making functions have routine access to material non-public information; those without such functions are not likely to have such access.<sup>101</sup> If officers without policy-making functions come into possession of inside information, the SEC believes the antifraud provisions of the Act will prohibit abuse of the information and impose liability.<sup>102</sup>

The release cited *Crotty* with approval.<sup>103</sup> Significant for reasons later developed, the SEC cited *Crotty* for the proposition that "it is the duties of an employee . . . rather than his corporate title which determine whether he is an officer."<sup>104</sup> The portion deleted originally read "especially his access to inside information."<sup>105</sup>

#### IV. SOLIDIFYING THE SUBJECTIVE APPROACH: THE *CROTTY* DECISION

##### A. *The Majority Opinion*

The Second Circuit in *Crotty* enumerated five arguments supporting its holding that the duties of an employee, especially his or her access to inside information, determined whether there was section 16(b) liability for a person titled as an officer.<sup>106</sup>

First, the court elaborated that rule 3b-2 did not require imposing liability merely by virtue of the employee being titled an officer.<sup>107</sup> Interpreting rule 3b-2 as a flexible guideline, the court relied on the

101. *Id.*

102. *Id.* Another policy argument set forth in the proposal is that many companies (72% in one study) already rely on the executive officer definition in determining officer status for purposes of section 16. 1989 Revised Proposal, *supra* note 2, at 1326.

The Commission further cited the harshness of section 16, given the legal and regulatory developments that had occurred since its enactment, as support for the revision. 1989 Revised Proposal, *supra* note 2, at 1326.

103. 1989 Revised Proposal, *supra* note 2, at 1325. The 1988 proposal cited the district court decision in *Crotty* with approval. 1988 Proposal, *supra* note 2, at 50,000.

104. 1989 Revised Proposal, *supra* note 2, at 1325.

105. *Crotty*, 878 F.2d at 567.

106. *Id.* at 567.

107. *Id.* at 566. This was different than the "momentary assumption" in *Colby* that rule 3b-2 was invalid. See *supra* text accompanying notes 53-55. The *Colby* court was acting on its own, without SEC guidance or legal precedent, in not literally applying rule 3b-2. But *Crotty* was acting consistent with the SEC, which, after *Colby*, had indicated plainly that a strict application of the rule was not required. See *supra* text accompanying notes 73-77 and 94-105.

1981 and 1988 SEC releases as evidence that the SEC itself did not believe the rule should be applied rigidly.<sup>108</sup>

Second, the majority relied on *Colby v. Klune* and three other Second Circuit cases<sup>109</sup> as precedent for the proposition that duties and functions, rather than title, determine officer status.<sup>110</sup> Admitting that *Colby* involved facts converse to those of the instant case, the court found that the reasoning of *Colby* still was applicable.<sup>111</sup>

The court's third argument involved the precedential value of three other circuits following a similar approach.<sup>112</sup> Acknowledging that the Ninth Circuit in *Small* established that a person's title as officer automatically brought him or her within section 16(b), the court noted that *Livingston* and *Small* recognized an exception when the title was merely honorary or ceremonial.<sup>113</sup> The majority also cited *Winston* and *Gold* as Sixth and Fourth Circuit cases generally following the subjective approach.<sup>114</sup>

108. *Crotty*, 878 F.2d at 565.

109. *Id.* SEC v. Aaron, 605 F.2d 612, 616-17 (2d Cir. 1979), *vacated on other grounds*, 446 U.S. 680 (1980), held that despite the lack of an executive title, an employee who participated in management discussions and held supervisory responsibility was liable potentially under the registration and anti-fraud provisions of the Securities Act of 1933.

In *Ellerin v. Massachusetts Mutual Life Insurance Co.*, 270 F.2d 259, 265 (2d Cir. 1959), the court held that when a corporation issued two series of preferred stock with different rates and prices, and an insurance company became owner of 10% of the issued stock of one series, the insurance company was not a beneficial owner of 10% of any equity security so as to be a section 16(b) insider. Although the court held that the statute was to be interpreted literally, it cited *Colby* as standing for the proposition that corporate labels were not binding on the court. *Id.* at 265.

The *Crotty* opinion also cited *Morales v. Holiday Inns, Inc.*, 366 F. Supp. 760 (S.D.N.Y. 1973). See *supra* note 68 and accompanying text for discussion of this case.

110. *Crotty*, 878 F.2d at 566.

111. *Id.* The only justification offered by the court for applying *Colby* to the correlative fact situation was that *Colby* was the law of the circuit. *Id.*

112. *Id.* The *Crotty* court termed its approach as "functional." *Id.* A more accurate term for the approach is "access-oriented."

113. *Id.*

114. *Id.* The Fourth Circuit actually decided *Gold* on different grounds than the lower court. The district court, however, held that a corporate officer with merely administrative duties was not an insider. *Gold v. Scurlock*, 324 F. Supp. 1211, 1215 (E.D. Va. 1971), *rev'd on other grounds sub nom.* *Gold v. Sloan*, 786 F.2d 340 (4th Cir. 1973), *cert. denied sub nom.* *Gold v. Scurlock*, 419 U.S. 873 (1974). See *supra* note 67 and accompanying text for discussion of this decision.

The majority next concluded that the approach established by *Colby* was consistent with that of the Supreme Court in section 16(b) cases.<sup>115</sup> The court cited *Foremost-McKesson Inc. v. Provident Securities Co.*<sup>116</sup> and *Kern County Land v. Occidental Petroleum Corp.*<sup>117</sup> as displaying a preference by the Supreme Court to use potential access to inside information as the key to liability, instead of a rigid application of statutory designations.<sup>118</sup> In the only policy argument expressly advanced, the majority broadly stated that its interpretation best promoted the goal of curbing short-swing speculation by corporate insiders.<sup>119</sup>

Finally, the panel contended that its approach implemented the objective standard established in the text of section 16(b). After emphasizing the importance of an objective standard for this section, the majority stated that since its approach required no proof of actual abuse of insider information, the objective nature of section 16(b) was served.<sup>120</sup>

Applying the *Colby* approach to the facts of the case, the court concluded that Crotty's appointment as vice-president was essentially honorary in that it was not accompanied by a change in duties or salary.<sup>121</sup> More significantly, the court found that Crotty had no access to inside information before or after the appointment.<sup>122</sup> His complete lack of involvement with and access to the board of directors was the primary reason for such a finding.<sup>123</sup>

The court did admit, however, that the daily revenue receipts to which Crotty had access might constitute inside information.<sup>124</sup> But, because the information was available to major movie exhibitors and distributors and was contained in daily trade publications, it did not

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115. *Crotty*, 878 F.2d at 566.

116. 423 U.S. 232, 251-54 (1976).

117. 411 U.S. 582, 597-604 (1973).

118. *Crotty*, 878 F.2d at 566. Both cases involved a pragmatic or subjective analysis of unorthodox transactions. In *Foremost*, the Supreme Court held that the purchase making a person a 10% shareholder cannot be matched against a subsequent sale to create liability. 423 U.S. at 235. *Kern* involved a defeated tender offerer which was forced to exchange its shares because it had insufficient votes to prevent the merger from proceeding. 411 U.S. at 588-90. See *supra* text accompanying notes 12-15.

119. *Crotty*, 878 F.2d at 566-67.

120. *Id.* at 567.

121. *Id.*

122. *Id.*

123. *Id.*

124. *Id.*

provide Crotty an advantage over other investors.<sup>125</sup> Since Crotty's duties did not give him access to inside information, the court held that the district court's ruling was not clearly erroneous.<sup>126</sup>

### B. *The Dissenting Opinion*

Judge Meskill, in dissent, contended that the plain language of both section 16(b) and rule 3b-2 required, as a matter of law, a finding that Crotty, as a vice president, was within the purview of the strict liability statute.<sup>127</sup>

Although agreeing that the statute and regulation permitted liability for a non-officer who was in substance an officer, Judge Meskill interpreted the provisions as not permitting the reverse inference.<sup>128</sup> Asserting that the language of the statute was clear and unambiguous, the dissent found any extraneous consideration irrelevant to the statute's meaning.<sup>129</sup> The dissent stated that although a pragmatic approach might be proper for interpreting the outer reaches of section 16,<sup>130</sup> officer status cases were routine, therefore, a pragmatic or subjective approach was unnecessary.<sup>131</sup>

Because the 1981 and 1988 SEC releases, which the majority used to establish the flexible nature of rule 3b-2, were only proposals and were not yet in effect, Judge Meskill discounted the release as not necessarily representative of the agency's interpretation of "officer."<sup>132</sup> Furthermore, proposed regulations were not necessarily reflective of an agency's views.<sup>133</sup> Judge Meskill concluded his plain language defense of rule 3b-2 by claiming that the majority holding wrote the term "officer" out of the statute.<sup>134</sup> He argued that "[a]t the very least, the statute should create a presumption that an officer has access to inside information."<sup>135</sup>

125. *Id.*

126. *Id.*

127. *Id.* at 568 (Meskill, J., dissenting).

128. *Id.*

129. *Id.*

130. The dissent was obviously referring to the "unorthodox transactions" cases, as cited by the majority. See *supra* text accompanying notes 115-19.

131. *Crotty*, 878 F.2d at 568.

132. *Id.*

133. *Id.* at 568-69 (quoting *Commodity Futures Trading Comm'n v. Schor*, 478 U.S. 833, 845 (1986)).

134. *Id.* at 568.

135. *Id.*

The second prong of the dissent's attack was that even under the majority's interpretation, Crotty was an insider.<sup>136</sup> Crotty apparently had complete and autonomous control of 15% to 18% of United Artists' revenue. Because this gave Crotty responsibility over and knowledge of the company's financial affairs, Judge Meskill believed Crotty had access to invaluable information for trading in United Artists stock.<sup>137</sup> The dissent illustrated that knowledge of the number of contracts being negotiated and the percentage cut from each contract would be indicative of any changes in United Artists' fortunes.<sup>138</sup> Consistent with a focus on Crotty's functions and not on the information to which he had access, Judge Meskill ignored the majority's concern with Crotty's access to daily revenue receipts.<sup>139</sup>

Judge Meskill found the *Crotty* majority naive in assuming that only formal interaction with the board of directors provided access to inside information.<sup>140</sup> For the dissent, informal contact, such as the opportunity to discuss board meetings personally with individual directors, qualified as access to inside information.<sup>141</sup> Thus, Judge Meskill concluded that Crotty's functions, being executive in nature, gave him access to inside information, regardless of whether he actually received it.<sup>142</sup>

Finally, the dissent attacked the majority's contention that Crotty's title was merely honorary because it was unaccompanied by changes in salary or duties.<sup>143</sup> It was possible that Crotty was performing the duties of an officer before the appointment to vice president and that the appointment was simply *de facto* recognition.<sup>144</sup> Judge Meskill supported this argument by pointing to the lack of evidence presented that the title was honorary.<sup>145</sup>

## V. WILL THE BATTLE RAGE ON?

### A. *The Subjective Difference*

The standard adopted by the Second Circuit in *Crotty* highlighted the differences between the approaches of the Second Circuit, Ninth

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136. *Id.* at 569.

137. *Id.* at 569-70.

138. *Id.*

139. *Id.* at 569.

140. *Id.* at 570.

141. *Id.*

142. *Id.*

143. *Id.*

144. *Id.*

145. *Id.*

Circuit and the SEC in determining who is an officer for purposes of section 16(b). In *Crotty*, the focus on the employee's access to inside information was reflected by the court's emphasis on access in the holding, as well as in its application of the holding to the facts.<sup>146</sup>

The Second Circuit test is clearly subjective, because it prompts fact-oriented inquiries into which avenues of information the employee had access, and whether this information constituted inside information. Such inquiries will vary from court to court; how access is defined will depend on intangibles, such as political preferences and past experiences. Representative of this is the disagreement between the *Crotty* majority and the dissent about whether *Crotty's* position gave him access to the board of directors. The majority, refusing to make any inferences favorable to the plaintiff, considered only formal avenues of access, while the dissent considered informal avenues of access. Similar illustrations of the subjectivity of an inquiry into access are the vague definitions that courts have offered. This is primarily because such a definition varies according to each fact situation.<sup>147</sup>

The second discernable difference in the approaches is that the Second Circuit requires the plaintiff to establish by a preponderance of the evidence that the defendant employee's duties gave him or her access to inside information. Besides a subjective query, the Second Circuit places the burden of proof on the plaintiff. The holdings of other courts place the burden on the defendant.<sup>148</sup>

In contrast to the Second Circuit, the Ninth Circuit, in both *Livingston* and *Small*, held that an officer title raised an inference that the officer had executive duties and access to inside information. To overcome this inference, the defendant, as opposed to the plaintiff in the Second Circuit, must prove the title was merely honorary. Determination of honorary status depends on whether the officer had access to

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146. After a brief discussion of the honorary nature of *Crotty's* appointment to vice president, the court launched into a lengthy discussion of whether the daily revenue receipts constituted inside information. *Id.* at 567.

147. Each court, depending on its view of section 16(b), will either broadly or narrowly define inside information. Both the Second and Ninth Circuits appear to focus on information giving the trader an advantage over other investors. *Crotty* referred specifically to financial or operational plans of the company that gave the individual an advantage. *Id.* The Ninth Circuit in *Merrill Lynch, Pierce, Fenner & Smith v. Livingston* stated that inside information must be more than just non-public information. 566 F.2d 1119, 1123 (9th Cir. 1978).

148. *Crotty*, 878 F.2d at 567; see *Livingston*, 566 F.2d at 1122; *Winston v. Federal Express Corp.*, 853 F.2d 455, 457 (6th Cir. 1988). The SEC offers no indication of who has the burden of establishing compliance (or noncompliance) with the definition. Perhaps no guidance is offered because the nature of a definition simply requires application.

inside information. *Small*, however, requires evidence that the title is honorary before inquiring into access. Hence, although the Ninth Circuit imposes the burden on the defendant, the analysis still involves a subjective inquiry. In *Crotty*, the Ninth Circuit probably would have reached the same result as the Second Circuit. The *Crotty* majority viewed Crotty's title as honorary and decided that he had no access to confidential information. In the Ninth Circuit, the defendant would have overcome the inference of access, as the court likely would have found that Crotty had an honorary title because of his lack of access to inside information.<sup>149</sup>

Although the Sixth Circuit in *Winston* embraced a similar approach as the Ninth Circuit, the presumption of access when the employee is titled an officer is weightier in the Sixth Circuit. The defendant must present substantial evidence that there was no possibility of access to inside information. This rigorous approach, however, might be attributable to the uniqueness of the facts in *Winston*: Winston admitted he had access and that his title was not honorary. He only contended that once he stopped working—before the short-swing transaction was completed—he no longer had access to inside information.<sup>150</sup> Hence, it is possible the Sixth Circuit would require less from a defendant in a more routine fact situation.

Representing the objective approach to determining officer status under section 16(b) is the Commission's proposal to redefine officer according to executive policy-making functions. Although the revision reflects the adoption by the SEC of a more flexible approach to officer determinations, the approach is still objective in comparison to the access-oriented inquiry performed by the courts.<sup>151</sup> The revised rule apparently assumes that, when the employee has executive policy-making functions, there is access to inside information. This conclusion is forced by the lack of reference in the definition to access, and the Commission's statement that "[t]hose exercising a policy-making function . . . have routine access to material non-public information."<sup>152</sup>

The SEC's proposed definition of officer appears to operate as a conclusive presumption, in that if the plaintiff establishes that the

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149. The district court in *Crotty*, when denying Crotty's dismissal and summary judgment motions, indicated that Crotty might be an insider under the Ninth Circuit approach as set forth in *Livingston*. *Crotty*, 663 F. Supp. at 447.

150. *Winston*, 853 F.2d at 457.

151. The conflict between the Commission and the courts was originally "title versus function." See *supra* text accompanying notes 47-60, discussing rule 3b-2 and *Colby*. The conflict has moved to a lower, more subjective ground, and now involves the performance of duties versus access to inside information.

152. 1988 Proposal, *supra* note 2 at 50,000.



defendant's duties are of an executive nature, then it is conclusively presumed that the defendant is an officer for section 16(b) purposes. If the plaintiff fails to establish duties of an executive type, then the presumption never arises, and section 16(b) liability cannot be imposed. Of course, this analysis, that the proposed definition of officer assumes access and operates as a conclusive presumption, is merely speculative.<sup>153</sup> However, such an assessment is consistent with both the Commission's hesitancy toward inquiring into an officer's access to inside information, and the SEC's desire for an objective definition that offers certainty in application.

The SEC approach is objective because certain officers<sup>154</sup> are automatically deemed liable solely because of their titles. In this situation, any factual analysis is irrelevant. A second reason for deeming the SEC approach objective is because it avoids inquiring into access to information and resolving whether information is inside information. Determining job functions is easier and requires fewer inferences than deciding whether information is confidential. For example, determining whether gross daily revenue receipts is the type of information that gives a trader a significant advantage over other investors is an extremely difficult task. On the other hand, job functions and policy-making roles usually are identified easily and understood. Indeed, deciding whether an employee has access to insider information, as opposed to labeling job functions, involves a greater exercise of discretion by the trier of fact.

The SEC offers no indication of what evidence is required to prove that an officer did engage in policy-making functions to impose the conclusive presumption that he or she was an officer with access to inside information. The only indication available is that the dissenting judge in *Crotty*, who adopted a similar approach of presuming access to inside information if the duties were of an executive flavor, willingly found that Crotty's duties were of a nature providing access to inside information.<sup>155</sup> The dissent viewed Crotty's duties in a manner favorable to imposing liability. Judge Meskill argued that Crotty's

153. Rule 3b-7, the origin of the proposed officer definition, provides no indication of how the definition operates in application. The rule, which defines "executive officer," is used for various filing determinations. 1988 Proposal, *supra* note 2, at 50,000.

154. The revised rule states that "officer" means an issuer's "president, principal financial officer, controller or principal accounting officer, and any vice-president in charge of a principal business unit, division or functions such as sales, administration or finance." 1989 Revised Proposal, *supra* note 2, at 1343.

155. For example, the dissent viewed Crotty's involvement with and knowledge of United Artists' contract negotiations as a duty providing access to valuable information. See *supra* text accompanying notes 136-39.

appointment might simply have been recognition of officer duties he already was performing. The majority was unwilling to imply such a fact. If the dissenting approach is indeed an indication of the Commission's new position, the SEC apparently will require substantial evidence of the non-executive nature of a defendant's duties. This is in sharp contrast to the Second Circuit standard which imposes on the plaintiff the burden of proving that the defendant's position provided access to confidential information.

### *B. The Future of the Revised Definition*

*Crotty* represents the established pattern among the courts of using the subjective approach to determine officer status. The Commission, by proposing a less objective definition of officer, obviously is attempting to accommodate the policies served by a subjective approach.<sup>156</sup> Despite a valiant effort by the SEC, there are still significant differences between the two approaches. Although agreeing to a single definition would advance the goals of section 16(b), it is unlikely, for reasons outlined below, that such an agreement between the courts and the SEC will be reached.

Several benefits would be gained by resolving the objective and subjective differences and adopting a uniform approach to determining officer status. The confusion generated by having two approaches creates uncertainty, and results in inconsistent section 16(a) reporting positions by officers of different corporations. The uncertainty might even cause differing liability results under section 16(b).<sup>157</sup> The lack of clarity contributes to the high rate of delinquency in filing under section 16(a).<sup>158</sup> Furthermore, unnecessary litigation could be avoided if parties were certain of the standard applied by the courts. Easier and more consistent enforcement by the SEC would result if there was less confusion associated with officer liability.<sup>159</sup>

Each of these reasons alone can strengthen the operation of section 16(b). The section was designed to curb the abuse of confidential

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156. 1988 Proposal, *supra* note 2, at 50,000. It is ironic that it is the SEC attempting to accommodate the courts, given the Commission's apparent authority to issue a rule defining officer. *See infra* notes 171-73 and accompanying text for discussion of the authority of the SEC to define officer.

157. *Committee on Federal Regulation of Securities, supra* note 11, at 1107.

158. In 1988, 37% of required transaction reports were delinquent. 1988 Proposal, *supra* note 2, at 50,000.

159. The Division of Corporation Finance of the SEC receives more requests for interpretive and no-action advice concerning section 16 than in any other area. *Id.* at 49,999.

information by corporate insiders.<sup>160</sup> Although each approach is claimed to be better than the other at implementing this purpose,<sup>161</sup> the goal of combating insider trading would be served most effectively by resolving the differences. Both approaches obviously achieve certain objectives, but the conflict negates the advancement of any policy. It is unlikely, however, for several reasons, that the courts will alter their position to adopt the Commission's proposed definition.<sup>162</sup>

The validity of rule 3b-2 would probably never have been doubted but for the "momentary assumption" of invalidity by *Colby*.<sup>163</sup> Instead, the courts have given only lip-service to the position of the SEC on determination of officer status. The Commission's 1981 release, which supported focusing on job functions instead of job titles, went unmentioned in the opinions of the Ninth and Sixth Circuits in *Small* and *Winston*. Although the Second Circuit in *Crotty* recognized the 1981 and 1988 SEC releases, it did so only to justify the assertion that rule 3b-2 was a flexible guideline. Other courts have construed *Colby* almost as if it had held the rule invalid.<sup>164</sup> Armed with precedent ignoring the Commission's rule-making authority on the issue, future courts have even less incentive to consider Commission positions. Any revision of the definition of officer, even one attempting to accommodate the values of the courts, is likely to be unnoticed and receive the same treatment as rule 3b-2.

Because courts generally disapprove of the harshness associated with section 16(b) liability, they are unlikely to adopt the straightforward and objective definition of officer proposed by the SEC. According to the Committee on Federal Regulation of Securities:

By taking an unabashedly prophylactic approach, section 16 imposes liability on many transactions that contain no elements of the abuses that Congress sought to eliminate. It can create unwarranted restrictions for insiders who arbitrarily are prevented from trading

160. See *supra* note 5 and accompanying text.

161. For policy reasons supporting implementation of the SEC executive officer definition, see *Committee on Federal Regulation of Securities, supra* note 11, at 1105-07; A.L.I., FED. SEC. CODE § 269 (Tent. Draft I 1972). See *Wentz, supra* note 15, at 253-55 for arguments favoring the subjective approach.

162. Because the 1989 proposal was a republication of the 1988 proposal, and because it had very few changes, the definition as proposed in 1989 likely will be enacted in 1990.

163. Comment, *supra* note 13, at 752.

164. *Morales v. Holiday Inns, Inc.*, 366 F. Supp. 760, 762 (S.D.N.Y. 1973) (statute as interpreted by rule 3b-2 "clear," but *Colby* put "gloss" on meaning of "officer" requiring factual inquiry); *Selas Corp. of America v. Voogd*, 365 F. Supp. 1268, 1270 (E.D.Pa. 1973) (validity of rule "has not been clearly established").

even when they do not possess information that is confidential . . . .<sup>165</sup>

Section 16(b) has been attacked also on economic grounds. Many economists contend that "speculative trading by insiders may be beneficial in an 'economic' sense."<sup>166</sup> It has been argued that section 16(b) is ineffectual in preventing insider trading and does not even address all the ways in which insider trades can be perpetrated. Finally, courts and critics who dislike section 16(b) contend that the development of the insider trading doctrine under rule 10b-5 of section 10 has rendered section 16(b) obsolete.<sup>167</sup>

This disapproval of section 16(b) has been a primary reason for adopting a subjective approach. The courts believe such a test more effectively and more fairly curbs insider trading.<sup>168</sup> A subjective, access-oriented inquiry is more flexible and allows for more discretion; the courts use this discretion to shape section 16(b) to their liking. Although the proposed revisions may accommodate some of the complaints registered by the courts, it must be assumed that the distaste of the judiciary for section 16(b) will persist.<sup>169</sup> Thus, the revised definition will meet with skepticism, and given its objective

165. *Committee on Federal Regulation of Securities*, *supra* note 11, at 1090-91 (footnote omitted).

166. Wu, *An Economist Looks at Section 16 of The Securities Exchange Act of 1934*, 68 COLUM. L. REV. 260, 269 (1968); *see also* H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966); Hetherington, *Insider Trading and the Logic of the Law*, 1967 WIS. L. REV. 720.

Needless to say, however, the economists are not of one persuasion. *See, e.g.*, Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School"*, 1986 DUKE L.J. 628; Mendelson, *The Economics of Insider Trading Reconsidered*, 117 U. PA. L. REV. 470 (1969). Compare Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547 (1970) with Ferber, *The Case Against Insider Trading: A Response to Professor Manne*, 23 VAND. L. REV. 621 (1970) with Manne, *A Rejoinder to Mr. Ferber*, 23 VAND. L. REV. 627 (1970).

167. A.L.I., *supra* note 161, at 751-52.

168. According to the majority in *Crotty*, the subjective approach "best serves the congressional purpose of curbing short-swing speculation by corporate insiders." *Crotty*, 878 F.2d at 566-67 (quoting *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 424 (1972)).

169. As evidence of this assumption, consider the Second Circuit's reaction in *Crotty*. The revisions released in 1988 were cited by the court. *Crotty*, 878 F.2d at 565-66. Nevertheless, the court did not consider the substance of the revisions, but relied only on the revisions to justify not applying rule 3b-2. *See supra* text accompanying notes 107-08.

flavor, repropoed rule 16a-1(f)<sup>170</sup> probably will not be adopted by the courts.

## VI. CONCLUSION

*Crotty* represented an opportunity to resolve the differences existing between the approaches of the SEC and the courts in determining officer status for purposes of section 16(b). The Second Circuit, however, chose instead to apply a subjective approach in determining *Crotty's* officer status. By focusing on *Crotty's* lack of access to inside information, the court found him outside the scope of section 16(b), and therefore, not liable. The SEC responded to *Crotty* by revising its definition of officer. Although the revision is less objective than rule 3b-2, it still differs significantly from and is more objective than the approach of *Crotty*. Because of both dislike for section 16(b) and precedent, it is unlikely that courts will adopt the more objective approach advocated by the SEC. For reasons unrelated to the policy of uniformity, the courts should take the opportunity to adopt the new SEC definition of officer.

Although the courts have ignored the rule-making authority of the SEC in the past, Congress did specifically grant the Commission the power to define a term such as officer. This conclusion can be drawn from both section 3(b) and section 23(a)(1) of the Act.<sup>171</sup> Louis Loss, in his treatise on securities regulation, stated: "It seems difficult to understand how there could be any serious question about the validity of the Commission's rule [3b-2], or the near-binding effect of its interpretation of the rule under orthodox principles of administrative law."<sup>172</sup> It would appear that Congress implicitly intended to leave to the SEC the power to determine the definition of officer. As one commentator has noted:

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170. See *supra* notes 94-105 and accompanying text.

171. See *supra* note 16.

172. 2 L. LOSS, SECURITIES REGULATION 1094 (2d ed. 1961) (footnote omitted). In *SEC v. Wall Street Publishing Inst. Inc.*, 591 F. Supp. 1070, 1081 (D.D.C. 1984) (quoting *United States v. Rutherford*, 442 U.S. 544, 553-54 (1978)), the court stated:

It is important to note that the Commission's interpretation of its statutes and regulations are entitled to substantial deference. The Supreme Court has long held that "[s]uch deference is particularly appropriate where . . . Congress has not acted to correct any misperception of [an agency's] status or objectives. Unless and until Congress does so we are reluctant to disturb a longstanding administrative policy that comports with the plain language, history, and prophylactic purpose of the Act."

That this was a conscious decision is supported by the fact that Congress did take care to define other terms, for example "director," in the Exchange Act. Further, Congress left the definition of officer to the SEC under other securities statutes, supporting the inference that the omission of the definition from the statute was consciously intended by the drafters and Congress. Evidence that the SEC took care to follow the purpose and spirit of the statute is given by the structure and language of the rule which closely follows the statutory definition of director. It therefore is reasonable to assert that the rule is within the power of the SEC under the Exchange Act, that it follows the intent of Congress, and thus, is a legally binding rule.<sup>173</sup>

A second reason the courts should follow the objective definition proposed by the SEC is that the definition can effectively and fairly combat insider trading. The revised definition is the result of compromising the Commission's rigid objectivity with the subjectivity urged by the judiciary. The new rule mitigates much of the harshness of section 16(b) complained of by the courts, while still providing the certainty favored by the SEC. Many companies already look to the executive officer definition in determining officer status for section 16 purposes.<sup>174</sup> Employees exercising a policy-making function, by the very nature of that responsibility, have routine access to confidential information; hence, the substance of the courts' test is satisfied. The revision is a compromise, and given the dangers associated with a nonuniform approach, adoption of the proposal is clearly the desirable result.

The revisions offered by the SEC represent a renewed effort to combat insider trading by corporate insiders. Indeed, the proposals stand for the proposition that section 16 "occupies an important place in the arsenal of weapons provided by Congress to combat insider trading abuse and speculation."<sup>175</sup> If the courts respect the judgment of the SEC with regard to issues such as the definition of officer, section 16 can continue to fight in the war against insider trading.

PHILIP J. BOECKMAN

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173. Comment, *supra* note 13, at 752-53 (footnotes omitted).

174. See *supra* note 102.

175. *Committee on Federal Regulation of Securities, supra* note 11, at 1135.

