The Evolving Role of Section 16(b)

William H. Painter
Villanova University

Follow this and additional works at: https://repository.law.umich.edu/mlr

Part of the Securities Law Commons

Recommended Citation
Available at: https://repository.law.umich.edu/mlr/vol62/iss4/6

This Article is brought to you for free and open access by the Michigan Law Review at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Michigan Law Review by an authorized editor of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.
THE EVOLVING ROLE OF SECTION 16(b)

William H. Painter*

The evils which section 16(b) of the Securities Exchange Act of 1934 was enacted to prevent are well known. As expressed in one of the committee reports, this so-called “short-swing trading” provision was intended “to protect the interests of the public against the predatory operations of directors, officers, and principal stockholders of corporations by preventing them from speculating in the stock of the corporations to which they owe a fiduciary duty.” To curb such speculation, section 16(b) provides for recovery by the corporation, or by one or more stockholders acting in its behalf, of any “profit realized” from purchases and sales of equity securities within a six-month period by directors, officers, or beneficial owners of more than ten percent of any class of equity security of the corporation registered on a national stock exchange. The corporation is thus provided with a method of recouping from insiders profits realized either through purchase of an equity security followed by its sale at a higher price, or from sale of an equity security followed by a purchase at a lower price within the six-month period. Once the statutory conditions have been fulfilled, it is irrelevant that the insider either did not make unfair use of inside information or that he might not have intended, at the time he purchased the security, to sell it within six months.

Section 16(b) has been an effective means of safeguarding the

* Professor of Law, Villanova University.—Ed.
2 S. REP. No. 1455, 73d Cong., 2d Sess. 68 (1934). See also id. at 55: “Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities. Closely allied to this type of abuse was the unscrupulous employment of inside information by large stockholders who, while not directors and officers, exercised sufficient control over the destinies of their companies to enable them to acquire and profit by information not available to others.”
3 For the sake of convenience, such directors, officers, and beneficial stockholders will be hereafter referred to as “insiders,” the term customarily used, and the profits recoverable from them under § 16(b) will be referred to as “short swing” profits.
4 Thus one of the draftsmen of the provision testified before the Senate Committee on Banking and Currency that “you hold the director, irrespective of any intention or expectation to sell the security within 6 months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on the short-swing.” Hearings on S. Res. 84 and S. Res. 56 & S. Res. 97 Before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess. 6557 (1934).
public against those evils which it was designed to prevent. Yet, when considered against the background of the abuses which gave rise to it, it is little more than a halfway measure; perhaps of necessity it is but a "crude rule of thumb." For one thing, its scope is obviously highly restricted. An insider possessed of inside information is free to purchase equity securities of his company, wait for their value to rise, and then dispose of them after the six-month period has elapsed. Similarly, if possessed of information which portends an imminent fall in price, the insider may sell, wait for the six-month period to expire, and then repurchase. To require the insider to wait for six months is scarcely a hardship; tax-wise, it may be to his advantage, since this is also the period for distinguishing short and long-term capital gains and losses. Although the waiting period may have inconvenienced some potential traders, it is equally likely that a considerable volume of trading by insiders is continuing under circumstances which amount to what is in effect an exemption from liability due to the six-month restriction in section 16(b).

In view of the limitations and narrow thrust of the statute, it is not surprising that judicial construction of it has been, to put it mildly, exceedingly liberal in favor of permitting recovery in doubtful situations. Thus, recoveries are maximized wherever possible, and the statute has acquired quasi-penal overtones although, on its face, it purports merely to authorize recovery of "profit realized" by the insider from short-swing trading. Perhaps the best illustration of this is the first case dealing with section 16(b), Smolowe v. Delendo Corp. In the Smolowe case an action was brought against two directors, Seskis and Kaplan, who were also president and vice-president, respectively, of the corporation involved. The action was founded upon a series of transactions, all within a six-month period, which clearly indicated section 16(b) liability.

The transactions involved were as follows (see page 651):

---

5 See note 4 supra.
6 Provided, of course, that he does not purchase the same security within six months of the date of disposition (six months before or after such date), since § 16(b) extends to sales followed by purchases as well as purchases followed by sales.
7 136 F.2d 231 (2d Cir. 1943).
8 The transactions involved were as follows (see page 651):
The defendants in the *Smolowe* case argued that this dilemma should be resolved by a method similar to that authorized by the Internal Revenue Code, *i.e.*, matching purchases and sales of stock if the certificates could be identified, a so-called "identity of certificates" test or, in the absence of such identification, by a rule of "first-in-first-out," based on a presumption that the shares first acquired were the shares first sold. This approach was rejected by the court on the ground that, if adopted, it would permit an insider with a substantial reserve of stock purchased at a date prior to the six-month period to immunize himself from section 16(b) liability merely by taking proper precautions to "cover"

---

### Seskis

<table>
<thead>
<tr>
<th>Date</th>
<th>Purchases</th>
<th>Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/19/40</td>
<td>14,220 shares for $24,245</td>
<td>15,800 shares sold to Kaplan in discharge of $35,550 indebtedness.</td>
</tr>
<tr>
<td>2/28/40</td>
<td>594 shares for $905.20</td>
<td></td>
</tr>
<tr>
<td>4/4/40</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Kaplan

<table>
<thead>
<tr>
<th>Date</th>
<th>Purchases</th>
<th>Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/1/39</td>
<td>5,000 shares for $7,750</td>
<td></td>
</tr>
<tr>
<td>2/5/40</td>
<td>200 shares for $335</td>
<td>200 shares for $308.91</td>
</tr>
<tr>
<td>2/20/40</td>
<td>200 shares for $335</td>
<td></td>
</tr>
<tr>
<td>3/25/40</td>
<td>400 shares for $924</td>
<td></td>
</tr>
<tr>
<td>3/27/40</td>
<td>1,000 shares for $2,560</td>
<td></td>
</tr>
<tr>
<td>4/11/40</td>
<td>300 shares for $768</td>
<td></td>
</tr>
<tr>
<td>4/16/40</td>
<td></td>
<td>15,800 shares previously purchased from Seskis in discharge of $35,550 indebtedness (see above).</td>
</tr>
<tr>
<td>4/19/40</td>
<td>500 shares for $750</td>
<td></td>
</tr>
<tr>
<td>4/22/40</td>
<td>500 shares for $1,312.50</td>
<td></td>
</tr>
<tr>
<td>5/7/40</td>
<td>200 shares for $325</td>
<td></td>
</tr>
<tr>
<td>5/7/40</td>
<td>800 shares for $2,000</td>
<td></td>
</tr>
<tr>
<td>5/10/40</td>
<td>500 shares for $1,040.20</td>
<td></td>
</tr>
<tr>
<td>5/11/40</td>
<td>200 shares for $250</td>
<td></td>
</tr>
<tr>
<td>5/13/40</td>
<td>2,000 shares for $7,779.03</td>
<td></td>
</tr>
<tr>
<td>5/14/40</td>
<td>1,000 shares for $3,889.52</td>
<td></td>
</tr>
</tbody>
</table>

---

8 See Treas. Reg. § 1.1012-1(c) (1958): "If shares of stock in a corporation are sold or transferred by a taxpayer who purchased or acquired lots of stock on different dates at different prices, and the lot from which the stock was sold or transferred cannot be adequately identified, the stock sold or transferred shall be charged against the earliest of such lots purchased or acquired in order to determine the cost or other basis of such stock and in order to determine the holding period of such stock . . . . If, on the other hand, the lot from which the stock is sold or transferred can be adequately identified, the rule stated in the preceding sentence is not applicable . . . ."
his sales with certificates attributable to stock purchased at the earlier date.\textsuperscript{10} In addition, any test based on identity of certificates would render meaningless the express statutory liability for sales followed by purchases. Hence, if the test were adopted, the court said, "the statute would be substantially emasculated."\textsuperscript{11} After thus rejecting both the "identity of certificates" and the "first-in-first-out" tests, the court considered another possibility, that of determining an average purchase price and an average sale price during the six-month period and taking the difference between them as the measure of liability. This would in effect permit the defendant to offset losses sustained during the period against gains, thus reducing his liability for "profit realized" to a net figure. This approach was rejected on the ground that the statutory purpose precluded a setting off of losses, since any contrary rule would tend to stimulate more active trading to reduce the chance of a penalty.\textsuperscript{12} Further, the statute refers to "any" profit, and this, the court thought, indicated that losses were not to be offset.

From the Smolowe decision there arose the basic test for the computation of section 16(b) profit, that of "lowest-in-highest-out," requiring a matching of the lowest purchase against the highest sale, the next lowest purchase against the next highest sale, and so forth. The court reasoned:

"The statute is broadly remedial. . . . We must suppose that the statute was intended to be thoroughgoing, to squeeze all possible profits out of stock transactions, and thus to establish a standard so high as to prevent any conflict between the selfish interest of a fiduciary officer, director, or stockholder and the faithful performance of his duty."\textsuperscript{13}

That the court was correct in rejecting an "identity of certificates" rule under the factual situation presented by the Smolowe case is hardly open to question. However, the apparent rejection of such a rule as inappropriate under any set of circumstances

\textsuperscript{10} Smolowe v. Delendo Corp., 136 F.2d 231, 238 (2d Cir. 1943).
\textsuperscript{11} Ibid.
\textsuperscript{12} Id. at 239. The court observed that "Kaplan, with his more involved trading, benefits by the rule, whereas Seskis, who bought substantially at one time and sold as a whole, does not."
\textsuperscript{13} Ibid., citing Woods v. City Nat'l Bank & Trust Co., 312 U.S. 262 (1941); In re Mountain States Power Co., 118 F.2d 405 (3d Cir. 1941); Otis & Co. v. Insurance Bldg. Corp., 110 F.2d 333 (1st Cir. 1940); In re Republic Gas Corp., 35 F. Supp. 300 (S.D.N.Y. 1936), cases dealing with the disallowance of fees and compensation in bankruptcy and reorganization proceedings due to conflicts of interest.
is more difficult to justify. Smolowe presented a situation in which insiders, endowed with substantial reserves of securities, should not be permitted to draw upon such reserves to cover short-term speculation and thus immunize themselves from 16(b) liability. Does it necessarily follow, however, that the "identity of certificates" rule would be inappropriate if the insiders were possessed of no reserves of stock upon which to draw, where the certificates sold were obviously those acquired during the six-month period? Curiously enough, the legislative history of section 16(b) indicates that the draftsmen were aware of the danger of the statute's possible "emasculaton" in a Smolowe situation and that they attempted to provide against it by proposing an express provision for computing liability by the "lowest-in-highest-out" method. This provision, contained in early drafts of the bill, was for some unknown reason deleted from the final version. However, the intent of the draftsmen is clear. Thus Thomas G. Corcoran, one of the principal draftsmen, testified with regard to the "lowest-in-highest-out" provision, "That is in case he [the insider] said, 'Well, I sold within 6 months after I bought some stock, but the stock I sold was not the stock I bought within a 6 months' period. It was stock I bought a year before.'" Similarly, he testified later that the provision was intended to apply only to a defendant whose previous accumulation of the stock might otherwise allow him to escape liability. Hence it seems that the Smolowe situation, where the insiders had substantial reserves of stock upon which to draw, was uppermost in the minds of the draftsmen. Although, as indicated above, the "lowest-in-highest-out" provision was for some reason deleted from the bill in its final form, the purpose of the statute seems to require an interpretation such as that proposed by Corcoran. In this respect, the Smolowe decision appears to be correct. However, to extend this principle beyond the Smolowe situation to one where the danger referred to by Corcoran is not present, where the insiders had no reserves of

14 See note 11 supra.
15 H.R. 7852 and S. 2693, § 15(b)(1), 73d Cong., 2d Sess. (1934). The deletion of the computation provision was relied upon by the defendant in Smolowe to support its argument that the "lowest-in-highest-out" formula was thus implicitly rejected by Congress, but the court glossed over this seemingly troublesome point by observing that the failure of Congress "to specify a method of computation may well be thought more of a sanction of the formula devised in S. 2693 than an expression of hostility towards it." Smolowe v. Delendo Corp., 196 F.2d 231, 237 (2d Cir. 1943).
16 Hearings on S. Res. 84 and S. Res. 56 & S. Res. 97 Before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess. 6557 (1934).
17 Id. at 6559.
stock upon which to draw, seems unnecessary. Hence the "lowest-in-highest-out" test might have a legitimate application either to situations where the insiders had substantial blocks of stock to begin with (the Smolowe case), or where the purchases and sales could not be matched with corresponding certificates. This approach would permit a court to look at the actual facts of trading within the six-month period and at the same time refuse to recognize an attempt to cover sales made therein with certificates from a block of stock purchased earlier. That this method of computing liability is more realistic than one based on a dogmatic application of the "lowest-in-highest-out" formula may be illustrated by the following example.

Suppose that the following series of transactions takes place, on the assumption that the insider, prior to the first purchase of securities indicated in the table below, is not a stockholder, i.e., he is an insider by virtue of his being a director or officer of the issuer and he has no reserve of securities upon which to draw to cover sales made within the six-month period.

<table>
<thead>
<tr>
<th>Date</th>
<th>Purchases</th>
<th>Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 2</td>
<td>10 shares at $100 per share</td>
<td></td>
</tr>
<tr>
<td>January 15</td>
<td>5 shares at $105 per share</td>
<td></td>
</tr>
<tr>
<td>January 21</td>
<td></td>
<td>15 shares at $110</td>
</tr>
<tr>
<td></td>
<td></td>
<td>per share</td>
</tr>
<tr>
<td>February 5</td>
<td>10 shares at $140 per share</td>
<td></td>
</tr>
<tr>
<td>February 20</td>
<td></td>
<td>10 shares at $150</td>
</tr>
<tr>
<td></td>
<td></td>
<td>per share</td>
</tr>
</tbody>
</table>

If the "lowest-in-highest-out" method of matching sales and purchases is used with respect to the above series of transactions, the section 16(b) liability will amount to $525, computed by first matching the January 2 purchase with the February 20 sale, yielding a profit of $500, then matching the January 15 purchase of 5 shares with the January 21 sale to yield an additional profit of $25. The alternative approach suggested above would yield a profit of only $225, since the January 21 sale must by hypothesis be matched with the earlier purchases of January 2 and January 15, yielding $125 profit, with $100 additional profit resulting
from the subsequent purchase and sale of 10 shares on February 5 and February 20, respectively. The matching of the January 2 purchase with the February 20 sale, required by the "lowest-in-highest-out" formula, would under the suggested alternative approach be rejected because it is, under the assumptions given, a logical impossibility. Thus the Smolowe rule would be inapplicable where the realities of the situation seem to require matching of certificates. Such an approach would not prevent the matching of sales against subsequent purchases at a lower price, since the "identity of certificates" rule is obviously inapplicable here.

It should be apparent from the above discussion that under certain conditions any of the suggested rules of computing section 16(b) liability is bound to result in artificiality. The "lowest-in-highest-out" rule, rigidly applied, may cause recovery of profits which simply do not and cannot logically exist. Similarly, the "identity of certificates" rule obviously cannot be squared with the express statutory mandate to recover profits resulting from a sale followed by a subsequent purchase at a lower price. In view of the limitations of each of the rules, dogmatic adherence to any one of them seems unwise and hardly in accord with congressional intent. The purpose of the statute is not to impose a "penalty" for insider trading, nor to authorize the recovery of amounts which only by the use of legal fiction could be said to have been received by the insider. The statute speaks in terms of "any profit realized," a phrase which refers to an existing state of affairs rather than a construction based on assumptions which are defective as either improbable or logically impossible. As Senator Barkley commented in the hearings already referred to, "It seems to me the simple way would be to charge him [the insider] with the actual profit." This may appear to be a naive oversimplification, but it seems to be precisely what Congress attempted to do. Thus a judicial gloss based on "lowest-in-highest-out" or, for that matter, a dogmatic assertion of any other "rule" for the computation of liability regardless of the circumstances is, to the extent of the resulting artificiality, inconsistent with the purpose of section 16(b).

Despite the above difficulties, the "lowest-in-highest-out" formula has been accepted by virtually every subsequent decision...
and commentator as the exclusive method of computing section 16(b) liability under any given set of facts. The entire problem of profit computation was carefully re-examined by the late Judge Learned Hand in *Gratz v. Claughton*; Judge Hand expressly reaffirmed the *Smolowe* doctrine. The defendant in *Gratz*, being a ten percent stockholder, was in a position similar to that of the defendants in *Smolowe* in having a considerable reserve of stock upon which to draw to cover sales made within the six-month period. This clearly justified the application of the "lowest-in-highest-out" formula to his transactions. However, the language used by Judge Hand was broad enough to include any insider, presumably including one who was not a stockholder at the commencement of the six-month period. According to his analysis, there were but two alternatives: to match purchases and sales in such a way as to reduce profits to the lowest possible figure or to match them so as to produce the maximum possible profit. The latter alternative was of course chosen, based in part on an analogy drawn between this situation and that of surcharging a trustee's account "when damages are at some unascertainable amount below an upper limit and when the uncertainty arises from the defendant's wrong," in which case "the upper limit will be taken as the proper amount." The court concluded by observing, in an oft-quoted phrase, "The crushing liabilities which § 16(b) may impose are apparent; . . . it should certainly serve as a warning, and may prove a deterrent."

A recent, similar decision seems to indicate that one who violates section 16(b), his status being analogous to that of a trustee *ex maleficio*, is not even permitted to submit proof as to the actualities of the situation giving rise to the liability; he must submit to an "arbitrary matching of purchases and sales to achieve the showing of a maximum profit . . . ." Although this case in

---

21 Id. at 51-52, citing, interestingly enough, the "Chimney Sweeper's Jewel Case," *Armory v. Delamirie*, 1 Strange 505 [K.B. 1722].
22 Id. at 52.
23 *Adler v. Klawans*, 172 F. Supp. 502, 505 (S.D.N.Y. 1958), aff'd, 267 F.2d 840 (2d Cir. 1959). The defendant argued that an earlier holding, *Stella v. Graham-Paige Motors Corp.*, 222 F.2d 299 (2d Cir. 1956), concerning the determination of the "purchase price" of stock acquired pursuant to a transfer by an insider of its assets in exchange for stock of the transferee, supported his position that he should be permitted to submit evidence as to the details of the transactions within the six-month period to show his actual profit. Although some of the language of the *Stella* case seems highly suggestive in this regard, the court in *Adler* not only held this approach inapplicable to permit an offset of losses against gains, but strongly implied that the rule of maximizing profits would prevail regardless of any attempt by the insider to submit proof as to the actual facts of the
fact concerned the related but distinct problem of whether the defendant would be permitted an offset of losses against gains sustained during the six-month period, the offset being disallowed in accordance with an express holding on this point in the Smolowe case, the language is suggestive and seems to indicate that the "lowest-in-highest-out" rule has now become solidified as a permanent gloss upon the statute, rewriting it as if the discarded proviso had been expressly adopted. The general effect is to give the statute an almost penal character, rather than construing it merely as authorization for recovery of gains so as to render insider trading unprofitable. For example, that portion of the Smolowe holding which prohibits an offset of losses against profits may result in recovery of "profit realized" despite the insider’s having sustained a net loss during the six-month period.

There are other situations where the insider has received equally harsh treatment. Suppose, for example, that one who is neither a director, officer, nor beneficial owner of more than ten percent of any equity security of an issuer purchases a small amount of common stock and then, a few months later, becomes a director. If the stock were then sold within six months of the date of its purchase, would section 16(b) apply so as to authorize recoupment of profits on the transaction? The last sentence of section 16(b) provides: "This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved . . . ." It can be argued that this language conveys a negative implication that an insider need not be a director both at the time of purchase and at the time of sale, as distinct from the case where his insider status depends upon being a ten percent beneficial owner. On the other hand, where one is neither a director, officer, nor beneficial owner, he is for all practical purposes an outsider and is unlikely to acquire inside information which would motivate a purchase of securities. Merely


25 See text accompanying note 12 supra.

26 This was in fact the case in Gratz v. Claughton, 187 F.2d 46 (2d Cir.), cert. denied, 341 U.S. 920 (1951).
because the sale which takes place after the stockholder has achieved insider status might have been motivated by inside information should not necessarily imply liability, for, as already indicated, the intent of 16(b) seems to envisage that both purchase and sale must take place under the prescribed conditions, i.e., insider status. Yet, in at least two instances it has been held that, to qualify as an insider so as to impose liability based on a subsequent sale, a director need not be such at the time of purchase.

A similar problem arises with regard to the requirement of ten percent beneficial ownership. Suppose that one who is not the beneficial owner of more than ten percent of any equity security of the issuer becomes such by purchase of the requisite number of shares. Although he has now achieved insider status, does section 16(b) liability extend to the securities which, by their purchase, increased the beneficial ownership to more than ten percent? As already indicated, the last sentence of section 16(b) requires that the beneficial owner be "such both at the time of purchase and sale." The narrow problem then becomes one of whether, under these circumstances, the insider was a beneficial owner of more than ten percent "at the time of purchase" even though, immediately prior to the purchase, he was not such a beneficial owner. The situation is analogous to that of the director-officer discussed above, and similar considerations appear applicable, since, prior to the purchase, such a person is not likely to be in a position to acquire inside information. Because of the language of 16(b) referred to above, the case against liability on a subsequent sale of the securities in question is stronger than in the analogous situation of the director-officer. Yet in *Stella v. Graham-Paige Motors Corp.* it was held that liability extends to the securities which by their purchase made the stockholder a ten percent owner. It was thought that, if the rule were otherwise, "it would be possible for a person to purchase a large block of stock, sell it out until his ownership was reduced to less than 10%, and then repeat the process, ad infinitum." This of course is true, except that the hypothetical case referred to raises what

27 See text accompanying note 6 *supra*.
29 See text accompanying note 27 *supra*.
31 Id. at 299-90.
may be a separate problem, namely whether a rule contrary to that adopted by the Stella case might be applied to a purchase followed by a sale rather than a sale followed by a purchase. To put the matter differently, there is nothing inconsistent with the view that, in the hypothetical situation posed by the court in Stella, where because of the insider status of a person owning a large block of stock he is given access to inside information, a sale followed by a purchase which restores him to insider status should result in liability; yet this should not be so in the converse situation, that of a purchase by an outsider followed by a sale within six months. This difficulty and the somewhat rigid approach of the court to it is reminiscent of the problem of computing the extent of liability, where the "lowest-in-highest-out" rule is adhered to as the method of computing "profit realized" regardless of the particular factual situation. The judicial attitude implies that the statute must have but one interpretation and that its construction cannot be made flexible enough to vary with specific situations in order to effectuate its intent. That such a flexible approach is possible is indicated by its having been adopted judicially in construing another phrase in 16(b)—"purchase and sale."

Section 16(b) obviously applies only after an insider has engaged in a "purchase and sale" or "sale and purchase" of an equity security. Although the meaning of these terms is usually clear, difficult problems of construction have arisen with regard to various specialized situations, such as the conversion of preferred stock, the exercise of warrants and pre-emptive rights to subscribe to stock, and exchanges of securities pursuant to mergers and consolidations. Since the statute says nothing specifically about those situations, the problem becomes one of determining whether each type of transaction, such as a conversion of preferred stock, is a "purchase" or "sale."

One of the first cases to consider this problem, Park & Tilford v. Schulke, involved the conversion of redeemable preferred stock. The defendants, owning a majority of the outstanding shares of common stock, were in control of the issuer. In addition, they owned 6,604 shares of preferred which, unlike the common, was not listed on a national securities exchange. The preferred was redeemable on ninety days notice at fifty-five dollars per share, the stockholder having the right to exercise the conversion privilege.

---

82 See Note, 70 Harv. L. Rev. 1312 (1957); Comment, 9 Stan. L. Rev. 582, 588 (1957).
83 160 F.2d 984 (2d Cir. 1947).
until the redemption date. Due to a rumor that the issuer was about to declare a dividend in kind (liquor) on its common stock, the market price of the latter, from late 1943 until May 1944, underwent a spectacular rise. On December 20, 1943, the issuer gave notice that the preferred was to be redeemed and, on January 19, 1944, the defendants exercised their conversion privilege. Within six months after the conversion they sold the common stock acquired as a result thereof. It was held that the conversion was a "purchase" within the meaning of section 16(b), the court observing:

"Whatever doubt might otherwise exist . . . is dispelled by definition of 'purchase' to include 'any contract to buy, purchase, or otherwise acquire'. . . . Defendants did not own the common stock in question before they exercised their option to convert; they did afterward. Therefore they acquired the stock, within the meaning of the Act."

This language is exceedingly broad, and there are some who consider that the Park & Tilford holding was sweeping enough to render any conversion of preferred stock into common a "purchase" within the meaning of 16(b). That this is not so has become obvious with later decisions. In Ferraiolo v. Newman, a Sixth Circuit case, for example, the receipt of common stock of Ashland Oil and Refining Co. in exchange for preferred was held not to be a "purchase," the Park & Tilford case being distinguished on several grounds. It was pointed out that, unlike the defendants in Park & Tilford, those in Ferraiolo were not in control of Ashland Oil and, since the common stock was worth more than the redemption price of the preferred, the conversion of the latter,

---

34 Id. at 987. The court also held that the transaction did not fall within the § 16(b) exemption provided for an acquisition "in good faith in connection with a debt previously contracted" since "the exception is clearly inapplicable to anything except transactions in connection with actual debts. It is a strained concept, indeed, to regard preferred stock convertible into common as a debt here. Ownership of preferred or common stock creates an equity interest, and not a creditor's interest, under these circumstances." Ibid.
36 259 F.2d 342 (6th Cir. 1958).
37 Most of the litigation under § 16(b) has taken place in the Southern District of New York and hence has been appealed to the Court of Appeals for the Second Circuit. One reason is that, due to listing on the New York or American Stock Exchanges in the usual case, venue is properly laid in New York if the sale or purchase is executed there even though the buyer and seller are elsewhere. Grossman v. Young, 70 F. Supp. 970 (S.D.N.Y. 1947). In addition, it should be apparent that courts in the Second Circuit have been liberal toward the plaintiff's position in the matter of statutory construction.
which was about to be redeemed, was for all practical purposes involuntary. In the *Park & Tilford* case, on the other hand, the defendants, because of their control of the company, could have prevented redemption of their preferred; hence the conversion was not involuntary. The court in *Ferraiolo* pointed out that the Ashland convertible preferred was listed and actively traded, and, unlike the *Park & Tilford* preferred, the conversion privilege was protected against "dilution" in the event of issuance of more common. Thus the preferred and common stocks of Ashland were deemed "economic equivalents" and the receipt of one for the other was not the "purchase" of something new. Although the reasoning of the *Ferraiolo* case has been criticized and thought inconsistent with the broad position taken by the Court of Appeals for the Second Circuit in *Park & Tilford*, it demonstrates at least that, with regard to the problem of construing the terms "purchase" and "sale" in section 16(b), the approach has been a flexible one, foregoing any enunciation of what the Second Circuit has referred to as "black-letter rubrics." As one writer has put it, the approach has been pragmatic rather than technical.

---


40 Comment, 11 STAN. L. REV. 358 (1959). For other holdings illustrating the variety of approaches to the problem of defining "purchase" and "sale" in specific situations, see Blau v. Mission Corp., 212 F.2d 77 (2d Cir.), cert. denied, 347 U.S. 1016 (1954) (parent corporation transferred stock of one subsidiary to another in exchange for its stock, which was then distributed in part to parent corporation's stockholders); Roberts v. Eaton, 212 F.2d 82 (2d Cir.), cert. denied, 348 U.S. 827 (1954) (reclassification of securities); Blau v. Hodgkinson, 100 F. Supp. 561 (S.D.N.Y. 1951); Shaw v. Dreyfus, 79 F. Supp. 533 (S.D.N.Y. 1948) (receipt of stock rights evidencing pre-emptive right to subscribe to new issue); Truncale v. Blumberg, 80 F. Supp. 557 (S.D.N.Y. 1946) (receipt of warrants pursuant to employment agreement). The Shaw and Truncale cases also involved the interesting question of whether gifts of stock, to a charity for example, constitute "sales," holding that they do not. See also Truncale v. Blumberg, 83 F. Supp. 623 (S.D.N.Y. 1949). These cases have been criticized as offering a loophole for high income tax bracket stockholders to avoid § 16(b) liability. See Note, 50 COLUM. L. REV. 379 (1950); Note, 62 HARV. L. REV. 706 (1949).

Roberts v. Eaton, supra, is interesting factually and contains a useful summary of most of the cases in this area. There persons owning 45.9% of the outstanding $5 par value common stock of a corporation surrendered their common in a reclassification whereby they received an equal number of $1 par value common shares plus the same number of $7 par value 40-cent cumulative preferred stock. The preferred stock was then sold to two insurance companies and the common to a third purchaser. It was held that the receipt of the securities pursuant to the reclassification was not a "purchase." Although the reasoning of the decision is somewhat obscure, emphasis was placed on a finding that the defendants' interest in the corporation remained proportionately the same, despite the reclassification. Although this was the factor substantially relied upon by the trial court, the circuit court observed that, although "essential for defendants' position . . . we
should be. Yet one wonders why the pragmatic approach has been chosen in this area and a relatively inflexible approach taken in others, such as those discussed above.

Another area in which the pragmatic approach has been adopted, at least tentatively, is that of the liability of partners for short-swing profits of a partnership, or the converse problem of the liability of a partnership for such transactions by a partner. There seems to be little question that, where a partnership engages in short-swing trading, an insider partner at least is liable under section 16(b) to the extent of his distributive share, and it is irrelevant that the partner had no personal knowledge of the transactions or that he did not expressly authorize them. The statute provides for recovery of "any profit realized by him" in the short-swing transaction. Obviously, the question then becomes one of determining the extent of "profit realized" by the insider-partner in a transaction by his partnership. In *Rattner v. Lehman Bros.*, the court answered this by concluding that the partner was liable only for his distributive share of the profits since, "under a literal reading of the statute, he cannot be held liable for profits 'realized' by other partners from the firm's short-swing transactions." The
question of the extent of the partner's liability, had he caused the firm to undertake the transactions, was expressly reserved but, if the reasoning of the case is valid, a literal interpretation of the statute would not extend the insider's liability in this situation unless his distributive share were increased by some special understanding, since the amount of "profit realized" by him remains the same. Yet, in transactions carried out on the advice of the insider partner or, more likely, with the benefit of inside knowledge communicated to the firm by the insider, the purposes of the statute, to discourage short-swing trading by insiders directly, or indirectly by means of partnerships, would perhaps be best fulfilled if the insider partner were held liable for the entire amount of the profit. He might then have recourse to the firm or his fellow partners by indemnity, partnership agreement, or otherwise.

A more baffling question is that of the liability of the firm or of the non-insider partners under section 16(b) where the firm engages in short-swing trading. If there is no evidence that the insider partner caused the firm to make either the purchase or the sale, that the insider partner had knowledge of the transaction, or that the purchase or sale was made as a result of inside information communicated by him to the firm, it seems that the firm cannot be held liable. In the first case concerning this question, Rattner v. Lehman Bros., reliance was placed on the fact that early drafts of section 16(b) provided for liability of persons to whom unlawful disclosure of inside information was made despite their non-insider status, but this theory of liability was eventually abandoned, presumably because of anticipated difficulties regarding burden of proof. The late Judge Learned Hand, concurring, stated: "I wish to say nothing as to whether, if a firm deputed a partner to represent its interests as a director on the board, the other partners would not be liable . . . . The provision eliminated from the earlier drafts of the Act does not seem . . . to throw any light at all on such a situation as that." This reasoning was recently reiterated by a majority of the Supreme Court, Mr. Chief Justice Warren requirement is still contained in the Commission's instructions to its Forms 3 and 4, used for making reports under § 16(a). See Blau v. Lehman, 368 U.S. 403, 413 n.14 (1962).

45 Blau v. Lehman, 368 U.S. 403 (1962); Rattner v. Lehman Bros., 193 F.2d 564 (2d Cir. 1952).
46 Note 45 supra.
47 Id. at 566; see Rattner v. Lehman Bros., 98 F. Supp 1009, 1010 (S.D.N.Y. 1951); Smolowe v. Delendo Corp., 136 F.2d 231, 236 n.9 (2d Cir.), cert. denied, 320 U.S. 751 (1943).
48 Rattner v. Lehman Bros., 195 F.2d 564, 567 (2d Cir. 1952).
and Mr. Justice Douglas dissenting, in *Blau v. Lehman*. There, in a factual situation similar to that of the *Rattner* case, the district court expressly found that the transaction had been effected without the knowledge of or consultation with the insider partner. Hence, even assuming the validity of Judge Hand’s dictum concurring in the *Rattner* decision, there was no evidence that the insider partner had been “deputed” by the firm to represent its interests on the board of directors. Thus the question presented to the Supreme Court was whether liability might exist even though the insider partner was not sitting on the company’s board as a representative of his partnership, and even though the profits made by the latter on the transaction were made on the partnership’s own initiative, independently of any advice or inside knowledge given it by the insider. In affirming the result reached by both the district and circuit courts, the Supreme Court stated that liability would exist if it were found that the partnership “actually functioned as a director” through the insider partner, “who had been deputized by [the partnership] . . . to perform a director’s duties not for himself but for [the partnership] . . . .” Thus the Supreme Court apparently accepted the qualification suggested in the *Rattner* case by Judge Hand. Liability in this area is thus made to depend upon a finding of fact, namely the existence of the requisite “deputization” of the insider partner by the firm to represent its interests.

It has been suggested that the “fact-oriented” or pragmatic approach taken in the *Rattner* and *Blau* holdings is inconsistent with the express purpose of Congress in its enactment of section 16(b), namely the avoidance of a “subjective standard of proof, requiring a showing of an actual unfair use of inside information.” This may be true in a sense, although the use of the term “subjective” is open to question. In the context in which it originated, namely the *Smolowe* case, the emphasis seems to have been upon the lack of any requirement of actual use, or intention to use, inside information, rather than upon the supposedly “objec-

---

49 368 U.S. 403 (1962).
51 See note 48 supra.
53 Id. at 410.
54 See note 48 supra.
55 The terminology is the author’s.
56 Judge Clark, dissenting in *Blau v. Lehman*, 286 F.2d 785, 794 (2d Cir. 1960), aff’d, 368 U.S. 403 (1962), quoting from *Smolowe v. Delendo*, 136 F.2d 231, 235 (2d Cir. 1943).
tive measure of proof" intended by draftsmen. It hardly follows as a logical necessity, however, that Congress intended the application of section 16(b) to be purely mechanical and "automatic" in every respect. Indeed, as we have seen in at least one other area, namely that of the construction of the term "purchase and sale" in section 16(b), the judicial approach has been ad hoc or pragmatic, although hardly for that reason "subjective." Thus the factual inquiry suggested by the Rattner and Blau approaches, as to whether the insider partner has been "deputized" by the firm to perform the duties of a director on its behalf, seems perfectly consistent with the supposedly "objective" thrust of the statute in other respects. If the director has been so "deputized" the firm may be held liable without a showing of actual use or intention to use inside information, but the initial problem of the status of the partner as director vis-à-vis his partnership (i.e., the deputization question) remains a real one and worthy of exploration by a court before imposing liability.

THE SPECIAL STUDY RECOMMENDATIONS

If anything, there is a pressing need in this area for a greater degree of "fact-orientation" or pragmatic analysis. This is graphically illustrated by the Blau and Rattner cases in that, although rightly avoiding an "automatic" or even "arbitrary" approach to the statute, which would render it applicable to all short-swing trading by partnerships encompassing a partner-director, the Supreme Court and the Court of Appeals for the Second Circuit may have failed to appreciate fully the subtleties of the problem. Despite Judge Hand's dictum, the question of "deputization" is at best an oversimplification of the requisite conditions for liability. As shown by the recent Special Study of Securities Markets undertaken by the Securities and Exchange Commission, most broker-dealer directorships do not arise merely from a firm's "deputiza-

57 See text accompanying note 4 supra.
58 See note 40 supra. In defending the opposite view, and extending it to what may perhaps be its logical conclusion, Professor Loss courageously suggests that "the one policy determination which Congress clearly made was that § 16(b) should operate as automatically—indeed, as arbitrarily—as possible, whether the result be to include or exclude. One cannot have both automaticity and equity." 2 Loss, SECURITIES REGULATION 1101-04 (Supp. 1962). With all deference to the consistency of this point of view, the supposedly "automatic" or, worse still, "arbitrary" nature of § 16(b) does not emerge from any reading of its legislative history. All that was said was that there need be no showing of actual use, or intention to use, inside information. See note 4 supra.
59 See note 58 supra.
60 See note 48 supra.
tion” of one of its members to represent its interests on a board of directors for the purpose of acquiring inside information; rather, they usually originate in underwritings of securities. Thus it is commonly agreed, either under the terms of the underwriting commitment or otherwise, that the issuer will use its best efforts to insure the election of one or more representatives of the underwriter as a director. This is justified as a legitimate function of the underwriter in performing its continuing duties to the issuer and to those who have purchased its securities. The underwriter advises the issuer regarding its responsibilities to its shareholders, assuring an adequate flow of information to the latter from the company, as well as compliance with requirements for filing of financial statements with the Commission. In addition, the representative of the underwriter acts as an “outside director” with a broad background of business experience, particularly in the important area of investment banking. In this regard, the Study concluded that “there is no occasion to question the merits of broker-dealer representation on [a] board of directors. . . .” Hence, if it were not for the problems posed by conflicting interests, “deputization” would be, if not a necessity, at least an added safeguard to all interested parties, as well as an invaluable aid to issuers undertaking their first public offering of securities. What, then, are the problems raised by conflicting interests among the various groups which the broker-dealer director allegedly represents?

Essentially, the fundamental conflict is between the director’s duty to the company and its shareholders, and his obligations to his firm and its clients. Suppose, for example, that while performing his duties as a director, a representative of a broker-dealer learns of an impending unfavorable earnings report or a plan to

---


63 Id. at 437-38.

64 Including, of course, the important area of services provided for investment companies or mutual funds. See id. pt. 1, at 438: “For example, if the broker-dealer represented on the board has been a managing underwriter in the flotation of a company’s securities, obligations to customers in the original allotment and to fellow underwriters and their customers may be important. If the same broker-dealer is now making a market, or recommending or selling the securities to retail customers, or has investment advisory clients, additional motivations and obligations may arise and the potentiality for conflict with the director’s obligation to his corporation and its stockholders inevitably widens.”
reduce the dividend. Obviously, he cannot use the inside information to speculate on his own, either directly or through others, such as relatives, friends, or customers as intermediaries. Is it equally clear, however, that he has no duty of disclosure to his firm or to its fee-paying or ordinary brokerage customers who may be entitled to the benefits of whatever specialized knowledge the partners may have? Might he and his firm be liable to customers who buy and sell securities without the benefit of inside knowledge and thus suffer losses which otherwise could have been avoided?

To complete the paradox, if the broker-dealer-director should advise his customers to take advantage of inside information in their securities dealings, may he incur liability to those who deal with the broker-dealer's customers in ignorance of the inside knowledge possessed by the latter?

In view of the conflicting duties arising from the representation of broker-dealers on boards of directors, one might well ask whether the "game is worth the candle," as the expression goes. Apparently it is to some, but not to as many as might be supposed. The Special Study found, in response to questionnaires distributed to every registered broker-dealer in the United States, that, of the 4,964 firms replying to the questionnaire, only 476 stated that their members were directors of one or more companies whose stock was traded on an exchange, and 995 stated that members were.

---


66 See Special Study pt. 1, at 436, indicating the possibility that some "may have purchased stock through a firm just because they were told the firm was represented on the company's board of directors and that therefore they would be advised quickly of developments." As the Special Study pointed out, "In some circumstances ... it may be impossible for a firm to take the position that it has no duty to inform customers of adverse developments of a company which are still confidential, since these customers may have been led to rely on the firm for this kind of information." Ibid.; see Comment, Securities Regulation: Insider Status in Legal Fiction and Financial Fact—A Proposed Revision to Section 16(b), 50 Calif. L. Rev. 500, 506-07 (1962).

67 Through the doctrine of imputed knowledge. See Uniform Partnership Act § 12.

directors of one or more companies whose stock was traded solely over-the-counter. Of this last minority of firms having broker-dealer directors, only 508 firms indicated that they carried on trading over-the-counter in stock of the company while at the same time being represented on its board of directors by an officer, director, partner or employee. As these figures indicate, the problem of broker-dealer representation on boards of directors afflicts only a minority of industry members numerically speaking, although it would be misleading to suppose that the problem is for that reason insignificant in its impact upon the industry, in view of the large number of director-partners in certain influential brokerage and investment firms.

Assuming that the problem is significant in its impact upon securities dealings both on the exchanges and over-the-counter, what, if anything, has been the response of industry members to the problem? If the Special Study is any barometer of attitudes and practices in this area, the responses vary widely. A frequent answer to inquiries concerning firm policies was that, “while the firm may maintain positions in securities of companies of which a member of the firm is a director, the director will not tell his partners any nonpublic information.” Other firms, perhaps with less frequency, withdraw from the market and forbid trading in stocks where confidential information has been received. Still others attempt to draw a somewhat subtle distinction between so-called “hot” or confidential information and other information of a more generalized nature which corporate management is willing to make available upon request to anyone. Finally, a few firms

69 Special Study pt. 1, at 429.
70 Id. pt. 3, at 44.
71 See, e.g., the dissenting opinion in Blau v. Lehman, 368 U.S. 403, 414 (1962), indicating that Lehman Bros. had partners on 100 boards of directors. See also Comment, supra note 66, at 511-14.
72 Special Study pt. 1, at 434. One somewhat humorous illustration of this “insulation” technique was reported to have come from a partner of Carl M. Loeb, Rhoades & Co., who stated: “Kelly [partner in charge of the trading department] is on the 16th floor at the end. I am on the seventh floor. To get to the 16th floor, and you cannot get him on the telephone, you have got to go out, get on the elevator to the 12th floor, change on the 12th floor and go to the 16th floor. If you have ever been in that office, the counterroom, I guarantee you, you cannot discuss anything in there. All the rest of the partners are down on the seventh floor. Geographically, in our firm we do not have much of a problem.” Ibid.
73 Id. at 433-34.
74 Id. at 433. Thus one partner stated: “I ascertain from management in most cases, or in all cases, if I am going to make this information available to anyone. I say, ‘Is this information available generally to any part of the investing public that wants to find it’... If that is the situation, I do not wait 6 months until the public report comes out on the company. If this is not secret information and you are sure this is information...
candidly admit that they consider it their prerogative to make whatever use they wish of confidential information.\textsuperscript{75} 

Aside from the obvious perils of the approach last mentioned—that which considers it the “prerogative” of the broker-dealer director and his firm to make use of inside information—this uninhibited view of the problem is essentially not a solution at all but merely a determination to run the risks of section 16(b) liability. To draw a distinction between “hot” inside information and other forms of information which, although perhaps technically available “upon request” to the investing public, is unknown to them, is doubtful to say the least. Even if the information is available “on the street” in the form of rumor, the insider has the peculiar advantage of being in a position to confirm its accuracy and to act accordingly. Thus, in the final analysis, it is only the first two of the above-mentioned approaches which have a substantial chance of success in avoiding conflict of interest. Insulating the broker-dealer director from trading activities depends for its efficacy upon the extent to which firm members and employees take their obligations seriously.\textsuperscript{76} In addition, the nondisclosure to customers which follows may, as already suggested, involve other risks of liability for breach of fiduciary duty.\textsuperscript{77} The only completely safe solution is that of withdrawal from trading in a security concerning which confidential information has been received. This, although acceptable to some, is no doubt extremely unpalatable and unsatisfactory to others as a solution to the dilemma. The Special Study, in fact, found that, if faced with the alternative of

that would be available in like manner, you do not try to jump the market but, at the same time, you do not want to stand back and look stupid. This is a very difficult area to move in. This is why we have this policy of not tying our trading department’s hands with inside knowledge, because what is inside knowledge to me is already on the street in about 9 cases out of 10. That is why we get the company to release the information as soon as possible, to remove the problem.” \textit{Ibid.}

\textsuperscript{75} \textit{Id.} at 434-35. “There are probably only two alternatives. . . . You can either take the position that a public release of information is necessary before you can act on it, or you can take the position that having been the company’s main underwriter and investment banker you are therefore entitled to that kind of information; that you took a risk in originally offering the stock to the public and therefore can make the best possible use of it.” \textit{Ibid.}

\textsuperscript{76} See \textit{New York Stock Exchange, M.F. Educational Cir. No. 162, June 22, 1962}, apparently endorsing the “insulation” approach.

\textsuperscript{77} See text accompanying note 65 \textit{supra}; \textit{Special Study} pt. 1, at 435: “[I]f a broker-dealer serving as a director has material information, the disclosure of which is necessary to prevent fraud on a customer, or in a transaction in which he participates, it must be disclosed; and that if the broker-dealer believes that he is under a duty to the corporation not to disclose the information, his only alternative is not to participate in transactions in the security until disclosure may be made. [Citing Van Alstyne, Noel & Co., 33 S.E.C. 311 (1959).]”
ceasing trading activities or resigning as directors of the corporations concerned, many broker-dealers would choose the latter course of action. In any event, it is in this direction, toward the ultimate choice of "to trade and not to direct" or "to direct and not to trade" that the recommendations of the Special Study regarding section 16(b) are directed.

The broad range of suggestions and proposals which emerged from the Special Study is beyond the reach of this discussion. Some consideration should nonetheless be given to the impact of the proposals upon section 16(b). Briefly, the broad pattern of the proposals is to extend the protections of sections 13, 14, and 16 of the Securities Exchange Act of 1934 to certain issuers of unlisted securities, designated as "OTC-listed." Aside from issuers voluntarily electing to be included in the "OTC-listed" category, the Special Study proposal included all issuers of unlisted securities having 750 or more equity security holders of record and/or known beneficial holders, and this classification would "as rapidly as feasible" be broadened further to include issuers having 300 or more such security holders, subject to certain exemptions.

The Special Study proposed another important change, namely that section 16(b) be amended "to permit recovery of short-swing profits of a broker-dealer firm where one of the principals is a director, [thereby] 'reversing' Blau v. Lehman." The Commission would, under this proposal, be "empowered to provide limited exemptions [from the operation of section 16(b)] on an affirmative showing both of unique need of the issuer or class of issuers and necessity and appropriateness in the public interest and for the protection of investors." Thus the Special Study found no need for a general exemption applicable to all broker-dealers who "make markets" in securities of issuers on whose boards of directors they are represented. In fact, the Special Study stated, "Entirely apart from the merits of broker-dealers' services on corporate boards generally, the combination of making a market in an issue (as 'sponsor' or otherwise) and representation on the board of the issuer appears to be in most, if not all, circumstances an unnecessary one; and when consideration is given to the potential conflicts

78 See Special Study pt. 5, at 48.
79 Id. at 62. This has been modified in the legislation introduced by the Commission as indicated in the text accompanying note 91 infra.
80 Special Study pt. 5, at 64.
81 Ibid.
of interest inherent in the combination, the balance clearly does not lie in favor of a general and broad exemption."

As indicated previously, one of the supposed justifications for broker-dealer representation on the board of directors of an issuer is to insure an adequate flow of information to the issuer's security holders and to the public. If the other proposed amendments to the Securities Exchange Act of 1934 are adopted, particularly the extension of section 13 (requiring the filing of periodic reports and financial statements) and section 14 (regulating proxy solicitation), this need to inform the public will be largely fulfilled, rendering broker-dealer representation on the board unnecessary. Moreover, the supposed obligation of broker-dealers underwriting securities issues to continue to make the market in such issues can be fulfilled without the necessity of representation on the board of directors. Thus if, as a result of the proposed amendment of section 16(b) to overcome the effect of Blau v. Lehman, broker-dealers are persuaded to forego representation on the board of directors, the public is not likely to suffer greatly and may in fact benefit from reduction of the likelihood of misuse of inside information. To be sure, the issuer would be deprived of the services of its "outside" director, but there are assuredly others of similar background and experience who could fill his shoes without at the same time being obliged to make a market in the company's securities. If a broker-dealer should choose board of directors representation and forego making a market in the issuer's securities, a choice which few broker-dealers are likely to make, his withdrawal from the market as "sponsor" would not in most cases affect the price of the securities adversely, according to statistical findings of the Special Study. Finally, if in some unusual situation it were found necessary for a broker-dealer to be represented on an issuer's board of directors while continuing to act as "sponsor" in making a market in its securities, the Commission would have power to grant a limited exemption.

82 Id. at 63.
83 See text accompanying note 61 supra.
84 See Special Study pt. 3, at 47.
85 Id. at 49.
86 See text accompanying note 79 supra.
87 Except possibly those who, as fee-paying customers of the broker-dealer or otherwise, may hitherto have felt entitled to the benefit of inside information. See note 66 supra. Query, however, whether they should continue to feel entitled to such information if it were not legally permissible for broker-dealers to obtain and act upon it.
88 See note 78 supra.
89 See Special Study pt. 3, at 49-51.
90 See text accompanying note 80 supra; Special Study pt. 3, at 62.
LEGISLATION PROPOSED BY THE COMMISSION

Against the background of the Special Study and its legislative proposals, two substantially identical bills were introduced in Congress at the request of the Securities and Exchange Commission.91 The overall pattern of the legislation resembles the Special Study proposals, except that the portion of the over-the-counter securities industry subjected to regulation has been modified so as to include, ultimately, only issuers having over one million dollars in total assets and a class of equity security (other than an exempted security) held of record by 500 or more persons.92 The only specific change with regard to insider trading would be the addition of a new subsection to section 16 of the Securities Exchange Act of 1934 to read as follows:

“(d) The provisions of subsection (b) of this section shall not apply to any purchase and sale, or sale and purchase, and the provisions of subsection (c) of this section shall not apply to any sale, of an equity security not then or theretofore held by him in an investment account, by a broker or dealer in the ordinary course of his business and incident to the establishment or maintenance of a primary or secondary market for such security. The Commission may, by such rules and regulations as it deems necessary or appropriate in the public interest, define and prescribe terms and conditions with respect to securities held in an investment account and transactions made in the ordinary course of business and incident to the establishment or maintenance of a primary or secondary market.”93

91 H.R. 6789 and S. 1642, 88th Cong., 1st Sess. (1963). The Senate Bill had been passed as of this writing.

92 S. 1642, 88th Cong., 1st Sess. § 3(c) (1963). Initially, only issuers having 750 or more equity security holders of record would be covered, but the lower limit would become effective within 120 days after the last day of an issuer's fiscal year ended after two years from the effective date of the new legislation. The Special Study Group had proposed 300 record and/or known beneficial holders. See text preceding note 79 supra. The so-called Fearn-Fulbright proposal to regulate the over-the-counter market resembled the present legislation in several respects but used different exemptive criteria, i.e., less than $3,000,000 in assets or fewer than 300 security holders. S. 2408, 81st Cong., 1st Sess. (1949).

93 S. 1642, 88th Cong., 1st Sess. § 8(b) (1963). As passed by the Senate, the bill contains three relatively minor clarifying changes of a technical nature. The reference to “broker or” before the term “dealer” in line 5 of the quoted version supra has been deleted. The phrase “by him” has been added after the word “maintenance” in line 7. The following parenthetical reference has been inserted between the words “market” and “for” in lines 7 & 8: “(otherwise than on a national securities exchange or an exchange exempted from registration under section 5 of this title).” The reference to a “broker” in the bill as originally submitted was thought to be misleading since the exemption is available only to a dealer, although a dealer who is also a broker can qualify. Similarly, the other changes clarify the fact that the exemption applies only to over-the-counter market-
The basic effect of this change in section 16 would be provision of an added exemption for brokers or dealers, otherwise within the scope of section 16, who deal in equity securities not held by them in an investment account "in the ordinary course of . . . business and incident to the establishment or maintenance of a primary or secondary market" for the securities. Thus the Commission has endorsed a general exemption for market-making activities of broker-dealers, rather than the limited exemption or ad hoc approach advocated by the Special Study. 94 Non-market-making activities of brokers or dealers, or dealings in securities held in an investment account or not in the ordinary course of business would be left subject to section 16. 95 The Commission would have rulemaking power to prescribe when securities are held in an "investment account" and when transactions would be considered in the ordinary course of business and incident to primary or secondary market-making activities. In general, however, a dealer who is "generally considered by other brokers or dealers having orders to buy or sell a security as the principal source or market for the execution of such orders" would be regarded as making the primary market. Secondary market makers are those who "trade in a security regularly, but on a more limited basis." 96

In view of the rather persuasive arguments advanced by the Special Study against granting a broad exemption for market-making activities of brokers or dealers, 97 the legislation introduced by the Commission is somewhat surprising. The reasons given for the change 98 do not appear particularly convincing. Essentially, they amount to an evaluation of the existing statutory safeguards making and that the dealer who claims the exemption must himself be making the primary or secondary market. See S. Rep. No. 379, 88th Cong., 1st Sess. (1963). Technical changes were also made in § 16(a) of the act by both the SEC-proposed version and by that finally adopted by the Senate, as well as the redesignation of § 16(d) of the present statute as new § 16(e).

94 Special Study pt. 3, at 63; see text accompanying note 82 supra. The stated reason for the departure from the Special Study recommendations is to obviate the necessity of considering applications for exemptions on an ad hoc basis, together with the existing power of the Commission to "curb by alternative means the misuse of inside information" by analysis of reports filed pursuant to § 16(a) of the act, periodic inspections of broker-dealers by Commission staff members, enforcement of the antifraud sections of the 1933 and 1934 Acts, together with the broker-dealer registration revocation power under § 15(b) of the 1934 Act. Statement of the SEC, Hearings on S. 1642 Before a Subcommittee of the Senate Committee on Banking and Currency, 88th Cong., 1st Sess. 401 (1963) [hereinafter cited as Hearings].

95 Technical Statement of the SEC Relating to S. 1642, Hearings 359.

96 Ibid. See also Hearings 71-73.

97 See text accompanying note 81 supra.

98 See note 94 supra.
as adequate protection against the abuses of insider trading by broker-dealers, a conclusion which is in rather striking contrast to the entire import of the Special Study. Perhaps, as implied by the Commission in the statement accompanying the proposed legislation, the necessity for consideration of exemption applications on an ad hoc basis was envisaged as unduly burdensome. In addition, it is possible that there is implicit in the Commission's re-evaluation of the Study proposals a determination that a general ban on market-making activities would have an adverse effect on the liquidity and price activity of many securities, although such a conclusion is inconsistent with the express results of statistical analyses conducted by the Study.

A further illustration of the Commission's departure from the more stringent recommendations of the Study is the former's failure to adopt an express legislative repudiation of Blau v. Lehman. As already stated, the Study recommended that section 16(b) be amended "to permit recovery of short-swing profits of a broker-dealer firm where one of the principals is a director, 'reversing' Blau v. Lehman." The proposed legislation merely provides for an exemption for market-making activities of brokers or dealers and thus, technically speaking, Blau v. Lehman has remained untouched. Hence the question of whether a firm has "deputized" one of its members or employees to represent it on a board of directors remains relevant, if not determinative of its liability, although the Study found the "deputization" test distasteful and urged that it be abandoned. On the other hand, the exemption for market-making activities which the proposed legislation has added to section 16(b) may create a powerful negative inference that non-market-making activities are subject to section 16(b) despite absence of "deputization." This inference is addition-

99 Ibid.
100 See Special Study pt. 3, at 49-51.
101 Id. at 64; see note 80 supra.
102 Special Study pt. 3, at 44 n.87.
103 See Technical Statement of the SEC Relating to S. 1642, Hearings 339: "A broker-dealer making an over-the-counter market for the securities of such a company, who is also one of its officers or directors, is now subject to the provisions of sections 16(b) and 16(c). His market-making transactions would be exempted by the new section 16(d)."

Although the quoted statement was made with regard to closed-end investment companies, to which § 16(b) is made applicable by means of § 30(f) of the Investment Company Act of 1940, it obviously applies to other issuers as well. Note the following additional statement of the Commission concerning the availability of the exemption:

"The exemption is intended only for transactions in the over-the-counter market. The New York Stock Exchange and other exchanges have adopted rules prohibiting a specialist on these exchanges from being an officer or director of a company in
ally strengthened by the highly controversial status of the *Blau v. Lehman* holding, as indicated by the dissents in the Supreme Court and the Court of Appeals for the Second Circuit.

Assuming for the purpose of discussion that the *Blau* case would be legislatively "reversed" if the new statute were adopted, although the question of "deputization" might become irrelevant in the case of non-market-making activities of broker-dealer directors, further opportunities for statutory construction by the courts will arise with regard to the scope of the exemption and such language as "investment account" and "establishment or maintenance of a primary or secondary market." Although the Commission is given power to make rules and regulations in this area, it would be naive to suppose that this will foreclose judicial inquiry.\(^{104}\) In fact, if experience is any guide in this regard, the more elaborate the statute and the greater the proliferation of rules and regulations under it, the more courts will be called upon to construe their meaning and intent. For example, the new exemption for market-making activities raises the question of the status of securities not held in an investment account, as regards computing whether a broker-dealer is a beneficial owner of more than ten percent of a class of equity security. As indicated previously, a person may become an insider under section 16(b) by having such ownership in excess of ten percent, as well as by being an officer or director of an issuer, and this obviously applies to broker-dealers as well. The Commission has already taken the position that, in determining the requisite extent of ownership, securities held in an investment account are to be aggregated with those in whose securities he specializes. The Commission also has power, under section 11 of the act, to prohibit such affiliations.\(^{109}\) The difference between a "specialist" and a "market-maker" may be one of the extent of participation. See the following exchange in the *Hearings* 71:

"Senator Williams: Does this [market-making] compare in any degree to the specialist who makes the market for a stock listed on one of the exchanges?"

"Mr. Haack: [Member, Board of Governors, NASD]. I would say there is a degree of similarity. One difference is that a specialist on the floor of an exchange sees almost all of the traffic in that particular security, whereas a marketmaker might be one of 10 or 15 or 20 people who would be acting as a principal, and he would not be exposed to all of the trading that takes place. But there is a comparability of function."

\(^{104}\) Thus the scope and meaning of the rules may be called into question; in some instances, even their validity may be disputed. See, e.g., the checkered career through the courts of the exemption for certain stock bonus, profit-sharing, and other incentive-type plans of former Rule 16b-3, 17 C.F.R. § 240.16b-3 (1949), in such cases as Greene v. Dietz, 247 F.2d 689 (2d Cir. 1957); Van Aalten v. Hurley, 176 F. Supp. 851 (S.D.N.Y. 1959); Perlman v. Timberlake, 172 F. Supp. 246 (S.D.N.Y. 1959); Continental Oil Co. v. Perlitz, 176 F. Supp. 219 (S.D. Tex. 1959), and the subsequent amendment of the rule to bring it more into accord with judicial concepts of the proper scope of rule-making power under the statute. SEC Securities Exchange Act Release No. 6275, May 26, 1960.
the trading or "market-making" account. 105 This comparatively strict approach to the exemption is probably justified by a literal reading of the statute, since the exemption applies only to purchases and sales of securities not held in an investment account and says nothing about whether they may be used to determine the ownership requirement. In addition, section 16(a), to which section 16(b) refers by its use of the phrase "such beneficial owner," mentions a "beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security)," and the term "exempted security," defined in section 3(a)(12) of the Exchange Act, apparently does not relate to the exemption contained in new subsection 16(d), which is more akin to a transaction exemption, dealing as it does with purchases and sales, etc. Finally, as previously indicated, the Commission would be given power, under the terms of the exemption in section 16(d), to define its scope; thus the Commission's views with regard to the ten percent requirement are likely to be upheld judicially.

Other problems will no doubt arise with regard to the applicability of section 16(b) and its new exemption. Thus, although the recent cases dealing with the question of whether a partnership may become a "director" for the purpose of recovery of short-swing profits have dealt only with partnerships, similar problems are likely to arise with regard to the incorporated brokerage houses which are becoming increasingly popular. Obviously, if a partnership may, under some circumstances, be held liable for short-swing profits, no different result should follow merely from the fact of its incorporation. In fact, it is arguable that, in some cases, the shareholders of an incorporated brokerage house should themselves be held liable. This would be so not merely in those instances where the shareholder, because of corporate "thin-ness" or other factors leading to disregard of the corporate entity, 106 would be held liable for corporate obligations generally, including section 16(b) liability, but also in cases where, because of the extent of the shareholder's interest in the corporation, he might fall directly within the statutory language. Thus section 16(a) refers to "every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security. . . ." If X owns 51 percent of the stock in the brokerage firm and the

firm owns more than 20 percent of the stock of ABC Corp., which is registered on a national securities exchange, or “OTC-listed” under the new legislation, X arguably is “indirectly” the beneficial owner of 51 percent of 20 percent, or more than 10 percent of ABC Corp., and thus is himself an “insider.” The situation has never arisen but, if it should, one could well foresee liability imposed on the assumption that a person owning such a substantial interest in an “insider” corporation is likely to be in possession of information known to the corporation and thus, functionally as well as literally, the statute should apply to him.

It is all too apparent that, despite the continuing elucidation of the purpose and scope of section 16(b), there is a comparatively wide area in which questions have yet to be resolved by the courts and the Commission. In construing the statute, one may hope that the approach will be functional and pragmatic—not rigid, “automatic,” or “arbitrary” in the supposed “objective” or “penal” tradition of Smolowe v. Delendo. If, as one early commentator pointed out, section 16(b) is itself a bed of Procrustes, “imposing an artificial test of liability which bears no true relation to the evil sought to be remedied,” it would seem unwise to add to its artificiality by construing it in a Procrustean manner out of some supposed “objectivity” in the statute.

CONCLUSION

Although the overall intent of the statute is to serve as a “deterrent” and for that reason it may be well in some instances to impose a “crushing liability,” to hypostatize this attitude or emotional bias into an inflexible “rule” to govern all instances, foreclosing inquiry into the facts of the case, would impose extremely harsh liability, doubtfully intended by Congress. As we have seen, the primary if not only reason for the choice of a more or less arbitrary period of six months for the short-swing transaction was the presumed difficulty of proving an actual intent to make use of inside information. The “crude rule of thumb” solution which

107 See text accompanying note 7 supra. See also the related problem of when a person becomes an insider, discussed in text accompanying note 26 supra.
111 See note 4 supra.
Congress adopted to dispense with this difficulty should not constitute an implied mandate to ignore the facts of the case as well. The statute itself has been too much criticized for its overly mechanical approach\textsuperscript{112} to be burdened with a further arbitrary gloss placed upon it by the courts. To put the matter differently, in view of the history and apparent purpose of this legislation, the fundamental consideration in all doubtful cases should be "not whether the defendant actually used inside knowledge to profit, but rather whether the situation was one in which such inside knowledge could have been advantageously used."\textsuperscript{113}

If the function of section 16(b) is at all relevant, and to say that it is not is to discount the whole of the recent development of its construction in the courts as well as the meaning behind the efforts of the Special Study and the spirit of the proposed legislation, the statute should be construed functionally—and not mechanically, like some modern equivalent of the Rule in Shelley's Case. It is indeed fortunate, in view of past judicial excesses in applying section 16(b), that the courts, Congress, and even the Commission\textsuperscript{114} are coming to realize the necessity for a more functional, if not pragmatic, approach to this useful provision.

\textsuperscript{112} See, e.g., the statement of Mr. George Rea, former president of the New York Curb Exchange (now the American Stock Exchange) that "This part of the law has, in truth, burned down the barn in order to kill the rats." 4 Proposed Amendments to the Securities Act of 1933 and to the Securities Exchange Act of 1934, Hearings before House Comm. on Interstate & Foreign Commerce, 77th Cong., 1st Sess. vol. 4, at 1299 (1941). For a summary of further criticism, see 2 Loss, Securities Regulation 1087-90 (2d ed. 1961).

\textsuperscript{113} See Note, 72 Harv. L. Rev. 1392, 1393 (1959).

\textsuperscript{114} See Special Study pt. 1, at 439-46: "The multitude and variety of possibilities of conflict in the securities business make it difficult, if not dangerous, to generalize as to the problems presented or possible remedies."