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An Economic Analysis of Section 16(b) of the Securities Exchange Act of 1934
NOTES

AN ECONOMIC ANALYSIS OF SECTION 16(b) OF THE SECURITIES EXCHANGE ACT OF 1934

Primarily as a reaction to the "Great Crash" of 1929,¹ a plethora of federal statutes² and regulations governing the operation of the securities markets has emerged. In passing the Securities Exchange Act of 1934,³ Congress' primary concern was to curb "corporate insiders'" admitted practice of reaping substantial profits by trading on the basis of information not available to the investing public. In circumscribing the permissible conduct of persons in a position to obtain "inside information," Congress' aim was to provide all investors with equal access to investment information. This Note will not question the legitimacy of federal regulation of insider trading;⁴ rather, it will analyze critically section 16(b)⁵ of the Securities

4. This issue has created vigorous discussion in legal and economic circles. Several commentators argue that regulation of insider trading has had an adverse impact on the market. See H. MANNE & E. SOLOMON, WALL STREET IN TRANSITION (1974); H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966); Wu, An Economist Looks at Section 16 of the Securities Exchange Act of 1934, 68 COLUM. L. REV. 260 (1968). Their contention is based on the classical economic theory that, for the market to operate efficiently, speculation and entrepreneurship must flourish. See J. LORIS & M. HAMILTON, THE STOCK MARKET THEORIES AND EVIDENCE 5-10 (1973); A. SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 490-510 (E. CANNAN ed. 1966); J. SCHUMPETER, THE THEORY OF ECONOMIC DEVELOPMENT (R. OPIE transl. 1934). Because an insider is thought to have both a relatively elastic demand for his company's stock and a disproportionately large influence on the price of that stock, the "outsiders", by observing the market activities of the insiders, receive accurate signals concerning the current value of their shares. Mendelson, Book Review, 117 U. PA. L. REV. 470, 483 (1969); Wu, supra at 266. Finally, some argue that equality of access and the concomitant equality of risk is not desirable. Although to the extent that investors are risk averse (individual's total welfare increases less than proportionately to increases in potential income), risk equalization probably increases aggregate social welfare, many investors do not have this psychological make up. To the extent that investors are risk preferrers (individual's total welfare increases more than proportionately to increases in potential income), therefore, the regulation of insider trading may well tend to decrease aggregate social welfare. H. MANNE & E. SOLOMON, supra at 50; Schotland, Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market, 53 VA. L. REV. 1425, 1430-32 (1967).

Other commentators argue that regulation of insider trading is necessary. See Schotland, supra; Hetherington, Insider Trading and the Logic of the Law, 1967 WIS. L. REV. 721. By increasing investor confidence, governmental restraints on insider trading actually may result
in overall social benefits. J. GALBRAITH, supra note 1, at 174-75. The major premise of federal regulation in this area is to preserve the market as an essential part of the national financial structure by preserving the public's belief that it is a relatively safe place to receive a reasonable return, regardless of one's employment position. To attain maximum public investment, therefore, the market's reputation must be above suspicion. In re Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961).

Moreover, several basic common law notions buttress the theoretical arguments in behalf of federal regulation. During the period immediately preceding the Great Crash Judge Cardozo expressed the rigid fiduciary standard: "Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior." Meinhard v. Salmon, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928). Regulation of insider trading therefore can be viewed as a natural consequence of the common law trend toward a "disclosure philosophy" of fiduciary conduct in which insiders are "held to something stricter than the morals of the marketplace." Id.

Recently, courts have given common law agency principles renewed attention in the area of insider trading. See, e.g., Diamond v. Oreamuno, 24 N.Y.2d 494, 301 N.Y.S.2d 78, 248 N.E.2d 910 (1969) (insiders held liable to employer corporation on agency principles for difference between selling price and eventual declined market value if they had sold shares on over-the-counter market on basis of inside information concerning prospective decrease in corporate earnings); Schein v. Chasen, 478 F.2d 817 (2d Cir. 1973), vacated sub nom., Lehman Bros. v. Schein, 416 U.S. 386 (1974) (extension of Diamond rule to tippees of insiders). See also, Note, From Brophy to Diamond to Schein: Muddled Thinking, Excellent Result, 1 J. CORP. LAW 83 (1975); Comment, Persons Transmitting or Trading on Inside Information Obtained from a Corporate Fiduciary are Liable Under State Law to the Corporation for the Resulting Profits, 87 HARV. L. REV. 675 (1974). If courts are unwilling to apply federal statutes and state blue-sky laws, liability of insiders for use of inside information may be premised on the agency principle that an insider who appropriates information for personal gain should be required to hold all resulting profits in constructive trust for the corporation. RESTATEMENT (SECOND) OF AGENCY § 388, Comment c at 205 (1958).

These arguments demonstrate that the consequences of regulation of insider trading on stock market performance are uncertain, primarily because of difficulties in quantification. Given the public's moral bias against insider trading, however, any further inquiry into the economic rationality of the underlying premise of regulation has only academic value. This Note, therefore, assumes (as Congress has) that the social costs of unfettered insider trading are greater than the resulting benefits.

5. 15 U.S.C. § 78p(b) (1970) provides:

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the
Exchange Act of 1934, one of the means designed by Congress to effectuate its regulatory goals.\(^6\)

**THE "BLACK LETTER RUBRIC" OF THE OBJECTIVE APPROACH**

Not designed to deter all abuses of insider status, section 16(b) is applicable only to a limited class of statutorily defined insiders\(^7\) who are deemed most likely to speculate on the basis of inside information. Congress concluded that the greatest opportunity for insider speculation exists in the so-called "short-swing" transaction, in which it can be presumed justifiably that the insider's intent is to gain short-term profits rather than long term investments. Section 16(b) provides that any profits realized by an officer,\(^8\) director,\(^9\) or beneficial owner\(^10\) of more than ten percent of any class of equity

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Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.


7. Section 16(b) "insiders" are defined in section 16(a) of the Act to include "[e]very . . .beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 78l of this title, or who is a director or an officer of the issuer of such security." 15 U.S.C. § 78p(a) (1970).

8. See 17 C.F.R. § 240.3b-2 (1976) wherein "officer" is defined as "a president, vice-president, treasurer, secretary, comptroller, and any other person who performs for an issuer, whether incorporated or unincorporated, functions corresponding to those performed by the foregoing officers." See, e.g., Lee National Corp. v. Segur, 281 F. Supp. 851 (E.D. Pa. 1968) (officer of wholly owned subsidiary held not to be officer of parent issuer); Lockheed Aircraft Corp. v. Rathman, 106 F. Supp. 810 (S.D. Cal. 1952) (assistant treasurer held not to be an "officer" within the meaning of section 16(b)).

9. The definition of "director" has created controversy by way of the so-called "deputation" theory applicable under which insider status is imputed to an entity whose insider is also an insider of the issuing corporation. See, e.g., Blau v. Lehman, 368 U.S. 403 (1962); Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir. 1969) ("deputation" theory applied to allow recovery, under 16(b), from corporation whose officer sat on the Board of Directors of the issuer). The American Law Institute's proposed codification of the federal securities laws would expressly overrule this "deputation" theory by providing that the term, "director", does not include a person who deputizes another. See ALI FEDERAL SECURITIES CODE § 1413, Comment 4 at 133-34 (Tent. Draft No. 2, 1973).

by virtue of a purchase followed by a sale or a sale followed by a purchase within any six month period, shall be disgorged to the issuing corporation. Effective enforcement of the section depends upon the filing requirements of section 16(a) and the proxy requirements of section 14. Application of the section is restricted to corporations having assets of more than one million dollars, and a class of equity securities held by at least five hundred people. The issuing corporation is the beneficiary of section 16(b).

Should it fail either to sue within sixty days after requested to sue, or to prosecute diligently, any security holder of the issuer may sue in a quasi-derivative posture.

Section 16(b) was intended to be a simple, predictable rule which, by efficiently curbing conspicuous abuses of insider status,


any stock or similar security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of a similar nature and consider necessary and appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security.

The Commission has adopted a regulation that further elaborates on the meaning of "equity security" for purposes of section 16. See 17 C.F.R. § 240.3a11-1 (1976).


15. 15 U.S.C. § 78(l)(1) (1970). See Blau v. Lamb, 314 F.2d 618 (2d Cir. 1963). See also Comment, Insider Trading: The Issuer's Disposition of an Alleged 16(b) Violation, 1968 Duke L.J. 94. Technically the shareholder suit under section 16(b) is not derivative in nature, and there is no requirement that the shareholder allegel ownership at the time the alleged violation occurred, nor comply with any other requirement under Fed. R. Civ. P. 23.1. See R. Jennings & H. Marsh, Securities Regulation, Cases and Materials 1247 (3d ed. 1972). Allegations of champerty are the frequent result of this liberal rule of standing. See notes 98-102 infra & accompanying text. Even though section 16(b) is silent on the subject of attorney fees, courts have been liberal in allowing such awards to provide motivation for maximum private enforcement. See, e.g., Newmark v. RKO General, Inc., 332 F. Supp. 161 (S.D.N.Y. 1971); Lewis v. Wells, 326 F. Supp. 382 (S.D.N.Y. 1971). See generally Kapp & Olson, Recovering Attorneys' Fees in Short-Swing Trading Cases, 2 Sec. Reg. L.J. 214, 223 (1974).

16. The chief proponent of section 16(b), Thomas B. Corcoran, referred to it as "the crude rule of thumb" because of its literal application and its ease of administration. See Hearings on S.97 Before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess., pt. 15, at 6557 (1934) [hereinafter cited as Hearings on S.97].
would tend to equalize the informational positions of all investors.\textsuperscript{17} By choosing a "bright line" rule of liability,\textsuperscript{18} the drafters of section 16(b) rejected the necessity of showing actual use of inside information, in favor of a highly formalistic approach aimed at promoting the statute's \textit{in terrorem} value.\textsuperscript{19} If the defendant's conduct falls within the various "compartments" of the section, liability is automatic. The irrelevance of culpability substantially eases the plaintiff's evidentiary burden:

You hold [the insider liable], irrespective of any intention or expectation to sell the security within six months after, because it will be absolutely impossible to prove the existence of such intention of expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the [insider] intended, at the time he bought, to get out on a short swing.\textsuperscript{20}

In examining section 16(b), a basic policy question is why should its reach be limited to purchases and sales occurring within a six

\begin{itemize}
\item \textsuperscript{17} See S. Rep. No. 1455, 73d Cong., 2d Sess. 55 (1934): Among the most vicious practices unearthed at the hearings . . . 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.
\item \textsuperscript{18} See Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 610 (1973) (Douglas, J., dissenting). See also \textit{Hearings on S.97, supra} note 16, at 6558, in which Thomas Corcoran states: "You have to have a general rule. In particular transactions it might work a hardship, but these transactions that are a hardship represent the sacrifice to the necessity of having a general rule."
\item \textsuperscript{19} See Bershad v. McDonough, 428 F.2d 693 (7th Cir. 1970): The objective standard of Section 16(b) imposes strict liability upon substantially all transactions occurring within the statutory time period, regardless of . . . intent . . . or the existence of actual speculation. This approach maximized the ability of the rule to eradicate speculative abuses by reducing difficulties in proof.
\item \textsuperscript{20} \textit{Hearings on S.97, supra} note 16, at 6557.
\end{itemize}
Perhaps, as one commentator suggests, "the desire was simply to have some relatively short period during which trading by insiders was to be suspended." Temporal proximity is characteristic of short-swing speculation; therefore, the six-month limitation serves as an arbitrary indicator of the probable motives of insiders. The choice of six months is the product, not of any empirical evidence, but of the investing public's general belief that there should be a dividing line so that the regulation of short swing speculation will not interfere with long-term investment activities nor with investment liquidity.

Perhaps the most controversial element of liability under section 16(b) is the method used to compute the profits to be recaptured by the issuing corporation. The statute is silent on the subject; the SEC has chosen not to issue rules on computation of profits. In 1943, however, the Court of Appeals for the Second Circuit, in Smolowe v. Delendo Corp., enunciated the method that has been generally accepted. As the defendants failed to suggest any "reasonable rule," the court developed the unique process of matching the lowest priced purchases against the highest priced sales (lowest in-highest out, or LIHO) within the six month period. The LIHO rule has since been viewed as the optimal method of attaining the statute's crude purpose, that is, "to squeeze all possible profits out of stock transactions." In many cases, however, the liabilities imposed exceed the insider's actual profits and as such are punitive.

The "objective approach," that is, a mechanistic application of the statute in which both the existence of inside information and the existence of scienter are irrelevant, often has resulted in harsh and...
even absurd decisions. In *Volk v. Zlotoff*, the court forced certain officers and directors to disgorge profits even though their intent clearly was to benefit the issuing corporation, by helping it obtain short-term working capital through the exercise of stock options. Conversely, the Supreme Court has noted that one who possesses fraudulent intent, but consciously structures his transactions to avoid liability, does not fall within the ambit of the section. Thus,

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<th>Shares</th>
<th>Price</th>
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<td>buys</td>
<td>10 sh</td>
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<tr>
<td>Feb. 1</td>
<td>buys</td>
<td>5 sh</td>
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<td>March 1</td>
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<tr>
<td>April 1</td>
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<tr>
<td>June 1</td>
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On the face of these transactions, the insider has fallen within the ambit of section 16(b), and, thus, he must disgorge his profits to the corporation. The question is how much must be disgorge. At first glance, it appears that he has realized a gain of $225. However, using the "lowest in-highest out" (LIHO) approach, as in *Smolow*, which ignores transactions that yield net losses, the insider must disgorge $525. For a shocking case, see *Gratz v. Claughton*, 187 F.2d 46 (2d Cir.), cert. denied, 341 U.S. 920 (1951) (insider had an actual loss of $300,000, but was required, pursuant to § 16 (b), to disgorge $300,000 to the issuing corporation under the LIHO method). See also *Lewis v. Wells*, 325 F. Supp. 382 (S.D.N.Y. 1971). At best, such a method has resulted in increased employment for attorneys, accountants and bureaucrats. One commentator has asserted that "the SEC has gotten so fascinated with the algebraic formulae which a fertile mind can conceive under Section 16(b) that it has never walked away a hundred paces and taken a good look at the monstrosity which has been created." Calderwood, *Section 16(b)—Another Noble Experiment Gone Wrong* (address before Am. Soc. of Corp. Secretaries, New York, Apr. 21, 1960) at 32, quoted in L. Loss, *Securities Regulation* 1088 n.212 (2d ed. 1961). Ironically, in 1961, the president of the New York Stock Exchange, overlooking that the section is in fact punitive, contended that Congress should put some teeth into section 16(b) "so that if some insiders do take short-term profits they have to pay some kind of penalty instead of just paying the profits back." *Hearings on H.J. Res. 438 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce*, 87th Cong., 1st Sess. 120 (1961).

Moreover, several requests have been made to the SEC for a rule that would define "profits realized" as "not exceeding the maximum net profit shown by the defendant on his total trading" during the pertinent six month period. In 1964 and 1967, for example, the Committee on Securities Regulation of the Association of the Bar of the City of New York made such requests. D. Ratner, *Securities Regulation* 344 (1975).

28. 285 F. Supp. 650 (S.D.N.Y. 1968). *See also* Western Auto Supply Co. v. Gamble-Skogmo, Inc., 348 F.2d 736 (8th Cir. 1965) (ten percent owner purchased shares to contribute to stock bonus trust fund but within six months after contribution was made sold shares under antitrust consent order and, thus, fell within ambit of § 16(b)).

29. Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418 (1972), in which the court noted: Liability cannot be imposed simply because the investor structured his transaction with the intent of avoiding liability under § 16(b). The question is, rather, whether the method used to "avoid" liability is one permitted by the statute. *Id.* at 422. *See generally* Comment, *Short-Swing Speculation by Corporate Insiders: Widening the Loopholes in Section 16(b)*, 25 U. Fla. L. Rev. 412 (1973).
according to one commentator, "equitable factors have no place in a statute intended to be 'inequitable' on occasion in order to attain what is felt to be a greater good: a stable, fair market in which the public can invest with confidence."  

Both the extensive legislative history of section 16(b), and the majority of court decisions substantiate the view that the statute is to be applied literally and objectively. At least during the two decades following the enactment of the section, the transactions subject to the section were relatively simple, seldom extending beyond the range of transactions contemplated by the drafters. During the last twenty years, however, a variety of sophisticated schemes of business organization and employee compensation has emerged, testing the limits of the objective approach. Not surprisingly, the ease in enforcing this "prophylactic rule" has made it "the most cordially disliked provision" of the regulatory scheme; the arbitrariness in applying it has provoked one judge to describe it as "an extremely crude rule of a most deformed and misshapen thumb."

Exemplary of the objective approach is Smolowe v. Delendo Corp. involving a simple cash transaction—the type of transaction originally contemplated by Congress. The defendants, two officer-directors, were sued by a minority shareholder who had conceded the defendants' good faith. The court, however, in broad terms rejected the defenses of good faith and ignorance of the law, concluding that subjective standards of proof requiring a showing

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31. See Lowenfels, Section 16(b): A New Trend in Regulating Insider Trading, 54 CORNELL L. Rev. 45 (1968), in which the writer notes:
   [It] [has] made little difference whether or not the defendant in question had actually used inside information to his own advantage. Moreover, it was seldom asked whether or not the transaction in question could possibly lend itself to the type of speculative activity that the statute was designed to prevent.
   Id. at 47.
33. 2 L. Loss, SECURITIES REGULATION 1087 (2d ed. 1961).
36. Cash transactions present few problems today unless a collateral issue is involved. See, e.g., Chemical Fund, Inc. v. Xerox Corp., 377 F.2d 107 (2d Cir. 1967).
37. See Note, Reliance Electric and 16(b) Litigation: A Return to the Objective Approach?, 58 Va. L. Rev. 907, 907 (1972) [hereinafter cited as Objective Approach].
of actual unfair use of inside information would render the statute little more of a deterrent than are the common law rules of liability. 38

Reliance Electric Co. v. Emerson Electric Co., 39 a 1972 Supreme Court decision, demonstrates the impact of these early enunciations. An overt attempt by a ten percent beneficial owner to circumvent the statutory purpose of section 16(b) produced the controversy. The respondent, Emerson Electric Co., which owned 13.2% of the petitioner's stock as a result of an unsuccessful tender offer, disposed of its entire holdings in two sales, both of which were within six months of the purchase. The first sale reduced the respondent's holdings to 9.96%, the second disposed of the balance. The dispute concerned the proper treatment under section 16(b) of the profits realized from the second transaction. Unlike an officer or director, a ten percent beneficial owner is subject to section 16(b) liability only when he occupied this status "both at the time of purchase and sale or sale and purchase of the security involved." 40

The district court applied an expansive reading to the phrase, "time of sale," concluding that to comport with reality rather than appearances, the phrase should encompass the whole period during which a series of related transactions take place pursuant to a plan by which a ten percent beneficial owner disposes of his stock holdings. 41 Although apparently conceding that the "split-sale" was inconsistent with the spirit of the statute, the Supreme Court rejected the district court's analysis, holding that the profits realized from the second step were immune from section 16(b). The Court concluded that amendment of the statute is the only way to both prevent such acts, and, at the same time, avoid the necessity of a "judicial search for the will-o'-the-wisp of an investor's 'intent' in each litigated case." 42 As Reliance Electric shows, a formalistic rule of liability, though possessing the virtue of predictability, allows its basic purpose to be easily circumvented. The split sale device is but a logical adaptation to the objective approach. 43 Thus, the conse-

38. See 136 F.2d at 236.
40. See note 5 supra.
42. 404 U.S. at 425.
43. See ALI FED. SECURITIES CODE § 1413(d), Comment 6 at 134-35 (Tent. Draft No. 2, 1973) which provides that while the codification would reject it, Reliance Electric was decided correctly, given the present state of the law. See also N. Leech, FOURTH ANNUAL INSTITUTE ON
quence of applying such a device is a convenient loophole for a culpable shareholder to bail out with partial immunity.\textsuperscript{44}

The Supreme Court recently continued this strict approach in Foremost-McKesson, Inc. v. Provident Securities Co.\textsuperscript{45} Foremost-McKesson concerned the other end of the focal period, that is, "at the time of the purchase." The respondent, Provident Securities Co., had become a ten percent owner in Foremost-McKesson, Inc. by purchasing certain convertible debentures. Within six months of the purchase, it sold $25 million of the Foremost-McKesson debentures. The overriding issue was whether "at the time of purchase" means "prior to" or "simultaneous with." Although prior case law, as developed in the lower courts, favored the latter interpretation,\textsuperscript{46} the Supreme Court concluded that for there to be liability beneficial ownership was required before the purchase.\textsuperscript{47}

Unlike prior Supreme Court decisions concerning section 16(b),\textsuperscript{48} this was a unanimous decision. Foremost-McKesson seems to comport more closely with the statute's purpose than Reliance Electric; because the purchaser in Foremost-McKesson was an "outsider" at the time of the purchase, no inside information could have been

\textbf{Securities Regulation 386-90} (R. Mundheim, A. Fleischer & J. Schupper ed. 1973) wherein it is stated that the "Court [in Reliance Electric] was unable to arrive at any other interpretation in the face of almost compelling statutory language and with no satisfactory legislative history to undercut the words." Id. at 386.

44. As an alternative, Justice Douglas, viewing the majority's interpretation as the demise of the "thorough-going qualities" of the statute, would create a rebuttable presumption that any split-sale is part of a single plan. 404 U.S. at 436-38 (Douglas, J., dissenting).

45. 96 S. Ct. 508 (1976).


[A] shareholder with over ten per cent could gain advance information about a price rise. Acting upon this information, he could sell out to below ten per cent and shortly thereafter repurchase even more shares than he originally held. This sale and purchase, though covered by section 16(b), would likely be inconsequential, since the price of the stock would not yet have risen. It would rise shortly thereafter, but the investor could sell and take his profits with impunity if the repurchase were exempt under section 16(b). . . .

Id. at 600 n.34. The proposed codification of the federal securities laws would incorporate the "simultaneous with" interpretation. ALI FEDERAL SECURITIES CODE § 1413(d) at 129 (Tent. Draft No. 2, 1973).

47. 96 S. Ct. at 518-19.

obtained “by reason of his relationship to the issuer.”

Apparently, Congress felt that to provide this loophole was more equitable than “to suck into a suffocating dragnet many who . . . could not justly be so held.”

Perhaps because of the conclusive presumption included in the statute, a strict view of its applicability is appropriate.

Moreover, the Court in Foremost-McKesson noted the increasing use of other, more suitable, methods of combating the problem of insider trading. For example, rule 10b-5, which has become a major obstacle to insider speculation, is a remedy without the limitations of section 16(b). That rule 10b-5 would fill any void resulting from a narrow reading of section 16(b), undercuts substantially the logic of the argument in favor of an expansive reading of the section.

THE PRAGMATIC APPROACH: DECREASING THE INSIDER’S RISK

Because the courts now apply section 16(b) to transactions not originally envisioned by Congress, the number of approaches used by the federal courts has expanded. Although courts apply the statute literally to a cash transaction, when confronted with an “unorthodox” transaction, the same courts have sought to mitigate the “purposeless harshness” of the objective approach by applying a “pragmatic approach.”

Under the pragmatic approach, the courts deny the existence of any “black letter rubric” in section 16(b) jurisprudence, requiring instead a threshold examination of the facts in each case to determine whether there was the possibility of speculative abuse in the


51. See notes 125-84 infra & accompanying text.

52. See, e.g., Abrams v. Occidental Petroleum Corp., 450 F.2d 157 (2d Cir. 1971) in which Judge Friendly asserted that in the case of “orthodox” translation, “it would be no defense that a person . . . was operating, by sheer intuition, from Antarctica or even from outer space.” Schur v. Salzman, 365 F. Supp. 725 (S.D.N.Y. 1973), Id. at 162.

53. See 2 L. Loss, SECURITIES REGULATION 1069 (2d ed. 1961). The term is applied to stock conversions, mergers, reclassifications and reorganizations. See generally Lang & Katz, Section 16(b) and “Extraordinary” Transactions: Corporate Reorganizations and Stock Options, 49 NOTRE DAME L. REV. 705 (1974).


transaction. If the conclusion is negative, the transaction is deemed not to fall within the purview of the statute. The concept seems laudable in that the substance of the transaction is at least considered. The pragmatic approach, however, appears incompatible with the objective approach. Moreover, it seems redundant in light of the recent expansive readings of rule 10b-5, in which the substance of the transaction also is considered. In 1973, however, the Supreme Court endorsed the pragmatic approach in Kern County Land Co. v. Occidental Petroleum Corp., a decision inconsistent with Reliance Electric and Foremost-McKesson.

In Kern County, Occidental Petroleum had acquired, by a statutory "purchase," shares of Kern in an attempted tender offer. The plan was spoiled by a subsequent defensive merger between Kern and Tenneco, Inc. which locked Occidental in as a minority shareholder of Kern, thus forcing it to exchange the Kern securities for those of Tenneco. Tenneco's receipt, to its benefit, of an option to repurchase its shares from Occidental complicated the situation. Affirming the decision of the Second Circuit, the Supreme Court held that "neither the option nor the exchange constituted a 'sale' within the purview of section 16(b)." After scrutinizing the facts, the Court rejected the contention that Occidental knew that it could sell its stock to the merger partner at a profit if the tender offer failed. Instead, the Court chose to emphasize the involuntary nature of the transaction to support its finding that no opportunity for speculative abuse of inside information existed. Unquestionably,


57. "Cessante ratione legis, cessat it ipsa lex" or, "When the reason for the law ceases, the law itself must also cease."

58. See notes 125-34 infra & accompanying text.
60. See Abrams v. Occidental Petroleum Corp., 450 F.2d 157 (2d Cir. 1971).
61. 411 U.S. at 590-91.
62. The court, applying the pragmatic approach, asserted:
[I]f its takeover efforts failed, it is argued, Occidental knew it could sell its stock . . . at a substantial profit. Calculations of this sort . . . do not represent the kind of speculative abuse at which the statute is aimed, for they could not
Kern County destroyed 16(b)’s predictability, for the “possibility of abuse” test is vague enough to allow divergent conclusions from the same facts. The only certainty is that this judicially conceived approach will increase litigation.

Gold v. Sloan demonstrates the effect of Kern County on subsequent 16(b) litigation. Atlantic Research Corporation (ARC) and Susquehanna Corporation (SC) were merging. The defendants, who were officers or directors as well as stockholders in ARC, received preferred shares of SC in exchange for their holdings in ARC. On an objective reading of the statute, all of the defendants would have been liable because the shares were sold within six months after the merger. The district court, however, initiated an extensive factual

have been based on inside information obtained from substantial stockholdings that did not yet exist.

Id. at 597-98. See also American Standard, Inc. v. Crane Co., 510 F.2d 1043 (2d Cir. 1974), cert. denied, 55 S. Ct. 2397 (1975) (no section 16(b) liability found in a case in which the tender offeror, unlike Occidental, continued to fight control and to prevent defensive merger because of no “possibility of abuse”).

63. The Court’s decision in Kern County was not unanimous. Justice Douglas, who argued for an expansive approach on similar facts in Reliance Electric, see 404 U.S. at 427-42, seems to have rejected that approach in his Kern County dissent. 411 U.S. at 605 (Douglas, J., dissenting). Justice Douglas also noted:

The conclusion seems inescapable that Occidental Petroleum Corporation (Occidental) purchased and sold shares of Kern County Land Company (Old Kern) within a six-month period and that this “round trip” in Old Kern Stock is covered by the literal terms of § 16(b).

Id. Furthermore, as then Circuit Judge Blackmun, who concurred with the majority in Kern County, had espoused:

My own reaction is that either the statute means what it literally says or that it does not; that if the Congress intended to provide additional exceptions it would have done so in clear language; and that the recognized purpose and aim of the statute are more consistently and protectively to be served if the statute is construed literally and objectively rather than non-literally and subjectively on a case-by-case approach. The latter inevitably is a weakening process.


The inconsistent Supreme Court voting pattern in section 16(b) cases has caused many lower courts to struggle for the proper standard. See, e.g., Whiting v. Dow Chem. Co., 386 F. Supp. 1130, 1135 (S.D.N.Y. 1974), aff'd, 623 F.2d 680 (2d Cir. 1975).

For a discussion of the lack of predictability, see 5 L. Loss, SECURITIES REGULATION 3029 (Supp. 1969) in which the author states that the pragmatic cases have a “generalization defying nature [and] . . . will continue to rule us from their graves.” See also Comment, Insiders’ Liability Under Section 16(b) of the Securities Exchange Act for Stock Transfer After Corporate Merger, 15 B.C. IND. & COM. L. REV. 149, 162 (1973).


65. 486 F.2d at 342.
inquiry and exonerated one defendant because he was merely a "titular officer."\textsuperscript{66}

The Court of Appeals for the Fourth Circuit exonerated several other insiders as well, holding only one director liable because he alone was involved intimately in the merger negotiations, and was thus the only one occupying a position of potential speculative abuse.\textsuperscript{67} One defendant was exonerated because he was merely an outside director separated from the actual negotiations and as such was as much an outside observer as was Occidental in \textit{Kern County}\textsuperscript{68}. The court applied similar reasoning to reach the same conclusion regarding two officers of ARC.\textsuperscript{69} Such a factual inquiry moves even farther away from the statutory language and intent of 16(b) than the \textit{Kern County} "possibility of abuse" test. Although in \textit{Kern County} the majority rejected the test based on \textit{actual} possession of inside information, the court in \textit{Gold} concluded that "[t]he \textit{actual} knowledge possessed by an insider at the time of a given 'unorthodox transaction' is an essential element to be considered in determining whether a 16(b) 'purchase' has occurred . . . ."\textsuperscript{70}

In the courts' attempts to adapt to increasingly complex transactions and to ameliorate the harshness of 16(b), the statute has been modified beyond recognition by judicial interpretation. Given the language of the statute, whether a director is active or inactive is usually deemed irrelevant for purposes of establishing liability under section 16(b).\textsuperscript{71} Also, it usually is conclusively presumed that a director is performing his job, and as such is privy to information about his corporation that he could use to his benefit.\textsuperscript{72} Nevertheless, several commentators have asserted that both the statutory language and the legislative history support the pragmatic approach.\textsuperscript{73} In any event, whether or not such support in fact exists, the trend is to apply the pragmatic approach with its reliance on factual analysis.

\textsuperscript{67} 486 F.2d at 351-53.
\textsuperscript{68} Id. at 346.
\textsuperscript{69} Id. at 351.
\textsuperscript{70} Id. at 352-53 (emphasis supplied).
\textsuperscript{72} See Pragmatic Approach at 613-14; Comment, Securities—Section 16(b)—Merger as a "Purchase", 20 WAYNE L. REV. 1415 (1974).
\textsuperscript{73} See Lowenfels, supra note 31, at 57-61; W. CARY, CASES AND MATERIALS ON CORPORATIONS 700 (4th ed. abr. 1970).
ALLOCATIONAL AND DISTRIBUTIONAL EFFECTS OF 16(B)
LIABILITY RULES

Analytical Framework

The remainder of this Note is devoted to an analytical discussion of the consequences of applying both the objective and pragmatic approaches to section 16(b), and to a comparison of these consequences with those resulting from the imposition of liability under rule 10b-5. Primary emphasis will be placed on the effects of the various liability rules both on the individual insider's decision-making behavior and on the cost of enforcement. In addition, notions of distributional equity will be considered.

From a policy perspective, the efficient enforcement of any legal rule depends upon many co-existing variables. The efficient application of a statute such as section 16(b) is a function (sum) of the amount of resources available for enforcement, the method in which these resources are allocated, and the discounted (to the present) values placed by the insider on the costs and benefits of violating the rule. First, it generally is agreed that some quantity of violations greater than zero is optimal; total detection and prevention is too costly. Because enforcement requires the use of scarce resources, the goal of enforcement is "to achieve that degree of compliance with the rule of prescribed (or proscribed) behavior that the society believes it can afford." Thus, one objective in the area of government regulation should be that of minimizing enforcement costs.

The other focal point in this analysis is from the perspective of the insider who is contemplating speculating on inside information. A legal rule is designed to place a cost on a violator, and, to be efficient, that cost should be greater than the cost of imposing it. The inside trader's expected utility (i.e. benefit or return) from violating the securities laws is a function of several variables. First, there are the expected gains and losses, both monetary and psychic. Also, there is an opportunity cost to the inside trader as

74. Although the concept of distribution equity is predictably found in many discussions of public policy, it has eluded any precise definition. See notes 85-87 infra & accompanying text.
75. Stigler, The Optimum Enforcement of Laws, 78 J. Pol. Econ. 526, 526 (1970). This merely states that society will tolerate violations of a legal rule whenever the marginal return from violations prevented has a lower value than the marginal cost incurred.
78. See Ehrlich, The Deterrent Effect of Criminal Law Enforcement, 1 J. Legal Studies
he could be allocating his efforts to the furtherance of a legitimate activity.

Thus, the total amount of proscribed insider activities depends upon the mean income derived from participation in the proscribed activity, the mean income earned from participation in the most attractive available kind of legitimate investment, the mean probability of being detected and ultimately being found liable, and the mean discounted (present) value of the sanction imposed. Common sense dictates that an increase in either or both of the latter pair of variables (hereinafter referred to as the enforcement variables) will cause a decrease in the quantity of violations; the problem, however, is in determining the comparative degree of elasticity (responsiveness to change) of the supply of violations in relation to changes in the quantities of the enforcement variables.

To determine these quantities, the attitude toward risk of those violating 16(b) is a crucial factor. Moreover, the absolute amount of risk to a participant is a function of the quantity and quality of information available to him. Thus, if an inside trader is risk neutral, the elasticity of the supply of violations in relation to changes in either of the enforcement variables will be the same. If he is a

259, 262 (1972). These gains are a function of the violator's time, skill and experience.

79. See Schwartz & Tullock, supra note 76 at 76. "The probability of a sanction's being imposed . . . is a function of the costs incurred in detecting violations, providing data to the tribunal having jurisdiction, and staffing the tribunal." Id. at 77. One significant element that would affect the probability of being held liable is the quality and quantity of legal services available to the defendant.

80. The discounted (or present) value of the sanction is a function of the insider's rate of discounting possible future costs. Thus, a violator of the antitrust laws, who is subject to treble damages, need not by his actions indicate a preference for risk, but simply need demonstrate that such a cost was subjectively deferred. See Ehrlich, supra note 78, at 267. This issue also arises in discussions of the deterrent effects of capital punishment. A person may commit a crime punishable by death not because he is irrational or because he is a risk preferrer but simply because he has a high rate of discounting the future costs. Id. at 266.


82. A risk neutral person is solely interested in the expected value of his prospective gain. Thus, his expected wealth and his expected utility (benefit or return) are the same. Ehrlich, supra note 78, at 265. Insider, j, has a utility function: $U_j = U_j(Y_j).$ Assuming utility is measured in units called "Utiles" (U), a typical utility schedule for a risk neutral insider would be:

<table>
<thead>
<tr>
<th>$Y_j$</th>
<th>$U_j$</th>
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<tbody>
<tr>
<td>$3000$</td>
<td>$3000U$</td>
</tr>
<tr>
<td>$5000$</td>
<td>$5000U$</td>
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<td>$20,000$</td>
<td>$20,000U$</td>
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risk preferrer, however, the elasticity of the supply of violations will be greater with respect to changes in the probability of being held liable than to proportionate changes in the discounted value of the sanction. Conversely, if the insider is a risk averter, the responsiveness of the supply of violations will be greater with respect to changes in the discounted value of the sanction.

The effects upon distributional equity of alternative implementation devices are of major concern. Equity, in a distributional sense, evades precise definition. "Presumably, the term implies that equals should be treated equally, that unequals should be treated unequally, and that the differences in treatment should be 'fair.' "

Basically, there are two concepts of equity; one's view of the distributional effects of a given situation is dependent upon the concept adopted. *Ex ante* equity is achieved when each participant is subjected to equal risks and provided with equal opportunities. *Ex ante* equity is achieved when each participant is subjected to equal risks and provided with equal opportunities.

Assume that a policymaker wants to deter "j" from trading on inside information. He can increase the probability of being held liable by, for example, 20%, or the discounted value of the sanction by 20%. Assuming the cost of both alterations are equal, the optimal change will be the one that reduces the insider's expected gain from the illegitimate activity the most. In the case of a risk neutral person, a 20% change in either of the enforcement variables produces a concomitant decrease in expected utility.

83. A risk preferrer is one whose total utility increases more than proportionately as expected income rises. His utility schedule would show:

<table>
<thead>
<tr>
<th>Yj</th>
<th>Uj</th>
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<tr>
<td>$3000</td>
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<td>5000</td>
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<td>30,000</td>
<td>40,000U</td>
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</tbody>
</table>

He is one who realizes more satisfaction from an increase in income, than suffers from an equal decrease. Should the policymaker have to choose between a 20% increase in either of the enforcement variables, he should opt for the former, assuming equal costs, because such a person assigns a greater value to the gain if he wins than to the sanctions if he loses, so that imposition of heavier losses is not going to deter as much as a like increase in the probability of being held liable. Ehrlich, *supra* note 78, at 265.

84. For a risk averter, the converse of the risk preferrer model applies. In other words, a risk averter is one who realizes less enjoyment (benefit or utility) from an increase in income than he suffers from an equal decrease. Thus, unlike the risk preferrer, a risk averter is more greatly deterred by an increase in the severity of the penalty, than in a proportionate increase in the probability of being held liable.


86. *Id.* at 9. An example of *ex ante* equity is a lottery before the drawing. After the drawing, there will be one winner but many losers, thus producing *ex post* inequity.
post equity is attained when each participant has received the same benefit, and has incurred the same costs.87

Initially it is useful to consider briefly the consequences of an approach that is seemingly consistent with the public's moral bias: an absolute prohibition against all insider investments.88 Clearly such a prohibition, coupled with strict filing requirements, would solve most of the problems of insider trading.89 Although superficially attractive, such an approach would create several problems. Assuming a narrow definition of "insider" as used in section 16(b), an absolute preclusion would create both ex ante and ex post inequity. All investors would have relatively equal opportunities to invest, except the members of this arbitrarily defined group. Such ex ante inequity contributes to a concomitant ex post inequitable distribution of income.

Moreover, not only is this proposal inequitable, but also it results in inefficiency. To allow employees to own stock in the employer tends to maximize efficiency, in that it permits the employee to empathize with the outside stockholders and creates an incentive for that individual to increase his productivity. Thus, total disallowance of such direct compensation would tend to lower the rate of return of the insider's investment in human capital90 which in the long run could create an incentive toward more leisure time.91 For these reasons, outside shareholders support the concept of allowing insiders to invest in their companies.92 Similarly, it appears Con-

87. Id. at 12. The easiest way to attain ex post equity is to tax the winners to compensate the losers. Of course, such a process would require a tradeoff in terms of efficiency because individual initiative would be lessened.

88. Section 16(b) does not preclude insider investments or even prevent an insider from trading on the basis of inside information. Thus, an insider is allowed to recover his investment and required only to disgorge his "profit" to the issuer.

89. Such a scheme would not solve all of the problems associated with insider trading. For example, it is conceivable that an insider, although not owning stock in the corporation himself, could "tip" an outsider who would not be precluded from making such investments.


91. The relationship of progressive income tax rates to incentives is analogous. Although such a tax structure theoretically should provide a disincentive to increase one's income, available empirical evidence seems to demonstrate the opposite tendency because executives find that they must work much harder to "take home" the same income. J. PECHMAN, FEDERAL TAX POLICY 66-67 (rev. ed. 1971).

92. See Munter, Section 16(b) of the Securities Exchange Act of 1934: An Alternative to "Burning Down the Barn in Order to Kill the Rats", 52 CORNELL L. Q. 69, 88 (1966). See also In re Calton Crescent, Inc., 173 F.2d 944 (2d Cir. 1949) in which Judge Learned Hand, dissenting, stated: "I conceive that the law allows [an insider] to increase his stake in the company, because it adds to his incentives to make it succeed . . . ." Id. at 952 (L. Hand, J., dissenting).
gress intuitively concluded that the costs in terms of disincentives outweigh the benefits of a rule of total preclusion.

The Objective Approach

Allocational Effects

That the drafters of 16(b) intended it to serve as a potent deterrent to short-swing insider trading can be discerned from the section's legislative history. Judge Clark, in Smolowe, felt his LIHO method of damage computation was consistent with the statutory purpose. Also Judge Learned Hand observed that 16(b)'s "crushing liabilities . . . should certainly serve as a warning, and may prove a deterrent." The primary consideration, therefore, should be whether the "crude rule of thumb" in 16(b) is as efficient as it is harsh.

The implicit assumption of the drafters was that to maximize its deterrent value, section 16(b) must be easy to administer, must create a high probability of liability, and must have a sanction that, while nominally remedial, is somewhat punitive. This assumption is not irrational. Empirical evidence, however, though equivocal, seems to demonstrate that insider trading still occurs frequently, both on the short-swing and the long-term. This evidence leads to the conclusion that section 16(b) is not in fact a potent obstacle.

From an enforcement standpoint, section 16(b) is largely self-executing, thus reducing administrative costs. Under the objective

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94. Even though several countries have securities laws patterned after the American model, the harsh operation of section 16(b) is indigenous to the United States. See Munter, supra note 92, at 70-71.

95. See Lorie & Niederhoffer, Predictive and Statistical Properties of Insider Trading, 11 J. Law & Econ. 35 (1968) in which the writers state that "[w]hen insiders accumulate a stock intensively, the stock can be expected to outperform the market during the next six months. Insiders tend to buy more often than usual before large price increases and to sell more than usual before price decreases." Id. at 52. See also Jaffe, The Effect of Regulation Changes on Insider Trading, 5 Bell J. Econ. 93 (1974).

96. Still, the consequence of any legal rule is that it creates litigation. To the extent that enforcement of section 16(b) is a public good, however, it is obviously appropriate for the public to bear some of the burdens so as to "internalize" what would otherwise be external benefits. See Schwartz & Tullock, supra note 76, at 81 in which the authors note:

If indeed the capacity for correct decision making purchased with fixed enforcement costs is a public good of all people benefitting from compliance with the laws then it would be inefficient to finance these exclusively through user charges . . . . This notion provides justification for the present practice of not charging the litigants for the full opportunity cost of judges and physical facilities utilized in litigation.

Id.
approach, the costs of litigation are low, as extensive factual analy-
sis is usually unnecessary. Also, the use of private enforcement,
coupled with the insider’s knowledge of the liberal attorney fee
awards, tends to conserve judicial resources by promoting settle-
ments. As liability is conclusive, both parties can predict accurately
the outcome without going to court. This is not to suggest, however,
that the settlement will be for an amount less than the “normal”
measure of damages.77

Because of the liberal standing requirements under section 16(b),
champerty has been a recurring subject of controversy.98 As recov-
ery goes to the issuing corporation, the benefit to an individual
shareholder of bringing a 16(b) action is likely to be insignificant;
thus, the sole stimulus to maintaining an efficient level of enforce-
ment is the prospect of large attorney fees. Champerty is a social
cost, at least in psychic terms, because it reduces the integrity of
the market. Apparently, however, Congress believes that public
benefits realized from vigorous (albeit self-interested) private en-
forcement outweigh any social costs resulting from champerty.99
Loss100 has argued, and others have concurred,101 that the SEC
should be substituted as the proper plaintiff in 16(b) suits. Such a
change, however, seems unnecessary. The private enforcement
mechanism has provided effective enforcement, as well as signifi-
cant deterrent value, and it is certainly “rare good fortune when
controls can be self-executing, without governmental interposi-
tion.”102 On balance, therefore, the objective approach tends to effi-
ciently conserve judicial and administrative resources.

From the standpoint of an insider facing section 16(b) liability,
presumably, all other things being equal, the more expected income
to be derived from the short-swing, the more likely it is that the
insider will trade. Thus, the purpose of section 16(b) is to reduce the
insider’s expected return by allocating resources so that both en-
forcement variables will be used efficiently. Under the objective
approach, the probability of being detected is high because section

77. See Lewis v. Wells, 325 F. Supp. 382 (S.D.N.Y. 1971) (court rejected a settlement
equal to 82% of the profits realized by the insiders, and required full recovery by the corpora-
tion to further the purpose of the statute).
78. For conflicting views on the policy of private enforcement, compare 2 L. Loss, Securi-
80. 2 L. Loss, Securities Regulation 1053-54 (2d ed. 1961).
81. See, e.g., Munter, supra note 92, at 96-99.
82. Cary, supra note 98, at 860.
16(a) requires insiders to file information concerning any changes in ownership of their stock, and the prices of any such transfers. These disclosures are the primary source of litigation and settlement pursuant to section 16(b). The prospect of disclosure to the investing public should serve as a deterrent in itself, because it provides for the "rapid communalization of rewards" that would otherwise have been realized from the short-swing trading.

Various evidentiary rules (presumptions and burden of proof) affect the probability of being held liable under section 16(b). Because the objective approach provides a per se rule of liability, the probability of the insider being required to disgorge his profits is high, once detection has been made. In fact, the only question is whether the insider falls within the statutory limitations. The narrower the class of potential defendants, the greater the probability of holding insiders liable. To this extent, an arbitrarily narrow rule such as section 16(b), when literally applied, tends to produce inaccurate conclusions concerning its efficiency. Because a rigid rule allows for easy avoidance, the probability of holding an insider liable under the objective approach could be much lower than it actually appears. Thus the actual effect of such an irrebuttable per se rule, is, at best, uncertain. In addition, as noted above, even if such probabilities are relatively high, the deterrent effect on insider behavior is ultimately dependent upon that person's attitude toward risk. A high probability of being held liable should deter risk preferrers more efficiently than a proportionately high value of the sanction imposed. Nevertheless, because inside traders are presumed to be betting on a "sure thing" (characteristic of risk averters) in that they have access to accurate information, enforcement resources are not being optimally allocated.

An insider should know, either from the case law or by word of mouth, that the profits subject to disgorgement under section 16(b) are not limited to the actual profits realized during the six-month

103. See note 14 supra & accompanying text.
105. Such disclosure requirements are not necessarily inconsistent with the contention by some economists that insider trading contributes to the overall efficiency of the stock market. See generally H. Manne, supra note 4. The proper equilibrium level for the stock will be reached most swiftly when the investment community has access to information that will "permit valid inferences regarding future movements in the prices of stocks." Lorie & Niedenhoffer, supra note 95, at 35. To the extent that this principle is correct, section 16(a) encourages the process.
period. Theoretically, increasing the discounted value of the sanction through this "quasi-punitive" liability should tend to decrease the number of violations, especially if insiders are risk averse. From the standpoint of deterrence maximization, the LIHO method of damages is appropriate; if recovery were simply limited to actual profits, no real cost would be imposed on the insider (except for opportunity costs and possible social stigma) because he merely would be returned to his financial status quo. Thus, the "purposeless harshness" of the objective approach in fact has a purpose, but the attainment of that purpose is dependent upon the effect that an increase in harshness has upon the number of violations. To the extent that insiders are risk averse, such increases should cause significant decreases in the expected benefit from trading on the short-swing.

Theoretically, the 16(b) scheme apparently tends to be an efficient deterrent. If this is so, however, why is it that much

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106. Of course, any analysis of the deterrent value of the sanction imposed under section 16(b) would be incomplete without a consideration of the tax consequences to the insider of such disgorgements. There are four basic possible tax treatments of section 16(b) liability: no favorable treatment, an ordinary deduction, a capital loss, and an increase in the tax basis. Davis, Tax Treatment of Section 16(b) Payments, 27 STAN. L. REV. 143 (1974); Note, Tax Consequences of Repayments by Insiders in Satisfaction of Section 16(b) of the Securities Exchange Act of 1934, 40 Mo. L. Rev. 195 (1975). During the early 1950's, the policy supported by the Commissioner and adopted by the Tax Court was to reject any type of favorable tax treatment because such treatment "would frustrate the public policy expressed in [section 16(b)]." See William F. Davis, Jr., 17 T.C. 549, 556 (1951); I.T. 4069, 1952-1 CUM. BULL. 28. Cf. Tank Truck Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958). Because section 16(b) liability was considered a penalty, it was felt that any favorable tax treatment would frustrate the policy of deterrence. Since 1956, however, the 16(b) payment has been deductible as "an ordinary and necessary business expense." See Laurence M. Marks, 27 T.C. 464 (1956). In 1961, the Commissioner reversed his prior stand by concluding that:

[The] purpose [of § 16(b)] is not frustrated by the allowance of a tax deduction for amounts paid by reason of section 16(b); but, rather, the allowance of the deduction is consistent with the purpose of the statute in returning the insider to his original position.

litigation and many settlements still occur? The American Law Institute has noted that "section 16(b) should afford sufficient deterrence to those who are aware of it . . . ." Perhaps to a great degree, therefore, section 16(b) is merely a trap for the unwary. The foregoing discussion, for example, has assumed that insiders are rational individuals who have access to adequate information. As access to information decreases, however, the rationality of the insider's decision-making decreases. Although uncertainty is greater under the pragmatic approach, it has been observed that, even as to common transactions, "few insiders consciously engage in [inside] trading." Rather, although quantification is impossible, many insiders trade because of financial necessity. Moreover, to the extent that the enforcement variables are not known by the insider, the optimal amount of deterrence will not be attained, except by chance.

Any favorable tax treatment seems contrary to the true policy of section 16(b). The judicial confusion concerning the tax consequences of 16(b) payments is simply another example of the tendency to mitigate the harshness of the statute. Certainly, the LIHO method of computing damages appears just as inconsistent as a policy of denying favorable tax treatment with the purported purpose of the statute to return the insider to his original position. Rev. Rul. 61-115, 1961-1 Cum. Bull. 46, 48. As statutory insiders are probably in upper income brackets, such allowances, especially an ordinary deduction, tend to mitigate any deterrent value that the section might otherwise possess. Both opponents and proponents of ordinary deductibility have found support in the language of § 162 which disallows such a deduction for any "fine or similar penalty paid to a government for violation of any law." I.R.C., § 162(f). The proponents note that the legislative history states that the enumerated disallowances are all inclusive and, thus, as profits are disgorged to a corporation, it does not come within the statutory language. See S. Rep. No. 91-552, 91st Cong., 1st Sess. 279 (1969). For the opposite view, see Nelson, Tax Deductibility of Insider Profit Repayments: Resolving an Apparent Conflict, 24 Case W. Res. L. Rev. 330 (1973). Obviously, to the extent that insiders are risk averse, this mitigation effect will be exacerbated because the number of offenses is greatly responsive to changes in the discounted value of the sanction, one of the two enforcement variables.


108. See 3A H. BLOOMENTHAL, FEDERAL SECURITIES AND CORPORATE LAW § 10.01(4) at 10-5 (1975); Deitz, A Practical Look at Section 16(b) of the Securities Exchange Act, 43 FORDHAM L. REV. 1 (1974).


110. One possibility is for the insider to pledge his shares, but this solution entails problems as well. First, a person cannot receive 100% of the fair market value for his pledged securities. Also, there is still a chance that he will ultimately be held liable under section 16(b), if the bank should sell the shares. See, e.g., Alloys Unlimited, Inc. v. Gilbert, 319 F. Supp. 617 (S.D.N.Y. 1970).
Distributional Effects

The goal of regulation of insider trading is to promote \textit{ex ante} equality of access to investment information thus providing an equal opportunity to every member of the investing public. Unfortunately, however, inequity seems to be the consequence of section 16(b)'s arbitrarily limited application. Although the six-month rule separates the liable from the non-liable, it does not separate the users of inside information from the non-users.\textsuperscript{111} Consequently, the rule in effect rewards an insider for his astuteness in evading the reach of the statute;\textsuperscript{112} this clearly is not an acceptable public policy, especially since the tax laws provide an incentive for him to do so anyway.\textsuperscript{113}

There is a similar problem in the arbitrary definitions of officer, director, and ten percent beneficial owners. The dangers of insider manipulation are present even if all members of these groups were completely prevented from trading, for section 16(b) exonerates a significant number of insiders who have access to valuable information. To illustrate, in corporations with extremely diverse ownership, a five percent stockholder might be as much an insider as an officer or director\textsuperscript{114} and as such, generally has as much access to inside information as a ten percent owner. Yet the five percent owner is immune to liability under 16(b).

In light of the total class of insiders (not limited to the 16(b) definition), the objective approach fails to achieve either \textit{ex ante} or \textit{ex post} equity. The objective approach exposes an arbitrarily designated group of insiders to liability, while those falling outside the statutory limits avoid all such costs.\textsuperscript{115} This \textit{ex ante} inequity will produce an \textit{ex post} inequitable distribution of the benefits of having access to inside information. Furthermore, because many defen-

\textsuperscript{111}. One court has noted that "[o]ne can speculate on whether the moral or ethical values are altered by the passage of 24 hours but the statute makes an honest if not honorable man out of the insider in that period." Adler v. Klawans, 267 F.2d 840, 845 (2d Cir. 1959).

\textsuperscript{112}. See R. Jennings & H. Marsh, supra note 15, at 1031, in which the editors state that "any moderately bright manipulator should be able in many cases to string out his activities over a period of more than six months and thus escape any penalty under the section. He would probably want to do that anyway for tax purposes."

\textsuperscript{113}. See I.R.C. §§ 1201, 1211, & 1222.

\textsuperscript{114}. Hearings on S. Res. 84, S. Res. 56 & S. Res. 97, 73d Cong., 1st Sess., pt. 15, at 6556 (1934).

\textsuperscript{115}. This is not to say that such persons are immune to suit under rule 10b-5 or state common law. These remedies, however, appear to be more equitable for the defendant, though more burdensome for the plaintiff. See notes 125-84 infra & accompanying text.
ECONOMIC ANALYSIS OF 16(b)

dants in section 16(b) litigation are corporations that are members of relatively concentrated industries, the application of section 16(b) ultimately will be felt, at least in part, by the consumers of these corporations' products, thus magnifying ex post inequity.

Furthermore, distributional equity (both ex ante and ex post) should be viewed in relation to the culpability of the insiders. Non-culpable parties have fallen victim to the blind application of section 16(b) under both the objective and subjective approaches. Consequently, inequities frequently result. Because non-culpable parties are detected more easily, their ex ante risk of liability is greater than that of a more culpable, and more cunning, insider. Moreover, even if the ex ante risks of all insiders were equal, ex post inequity still would result because equal treatment of persons who are not in an equal position tends to be inequitable. As will be seen, such problems are exacerbated when the pragmatic approach is applied concurrently with the objective approach.

The Pragmatic Approach

Allocational Effects

Because the objective and pragmatic approaches have many similarities, this subsection will emphasize the ways in which the pragmatic approach alters the conclusions reached above.

The pragmatic approach was adopted to mitigate the inequalities of the objective approach in cases involving unorthodox transactions. The "possibility of abuse" test, with its subjective inquiry and its detailed factual examination, has undermined the simple prophylactic rule that Congress intended. If the goal is to curb insider short-swings at the lowest social cost, the pragmatic approach is not the appropriate tool, for such a rule encourages litigation and subsequent appeals, while discouraging settlements. Such results, coupled with the opportunity cost to the judicial system, suggest that

116. Cf. J. Pechman, supra note 91, at 111-15. If "shifting" to the consumers is not possible, the burden will fall instead on the shareholders and/or employees.

117. Holding constant the level of technology of detection and enforcement, the further one moves along the spectrum in the direction of higher fines, but lower risk of punishment . . . the greater will [be] the ex post inequity placed on those who happen to get caught.

Pauly & Willett, supra note 85, at 15.

118. See notes 52-73 supra & accompanying text.


120. Like other resources, judicial and enforcement resources are scarce; as a result, an
the pragmatic approach is contrary not only to the legislative history of section 16(b), but also to the social policy of conserving resources. As Justice Douglas has noted: "Instead of a section that is easy to administer and by its clearcut terms discourages litigation, we have instead a section that fosters litigation, because [the pragmatic approach] holds out the hope for the insider that he may avoid §16(b) liability."  

Not only are the costs in terms of judicial resources great, but also such an ad hoc approach has adverse consequences on overall market performance, as well as on the deterrent value of the section. In considering an insider's decision-making process, it usually is assumed that the two enforcement policy variables act independently of each other. Under the present state of section 16(b) remedies, however, this assumption is false. Because of the harsh calculation of "profits," the courts resorted to the pragmatic approach, and by so doing, indirectly decreased the probability of holding the insider liable. In fact, if such a harsh penalty deters more courts from holding a defendant liable than deters insiders from speculating, it actually may increase the number of violations, especially if the insiders are risk preferrers. In addition, the incentives to litigate, as opposed to settling, provided to the insider create a concomitant disincentive to the issuing corporation (and more importantly to the shareholders thereof) to bring suit. Although possibly lessening the risk of champerty, such a tendency results in an even greater decrease in the probability that insiders will be held liable.

**Distributional Effects**

The apparent interrelationship of the enforcement variables re-
sults in a direct relationship between equity and efficiency. As the probability of holding inside traders liable decreases, overall efficiency decreases and equity, both \textit{ex ante} and \textit{ex post}, tends to decrease. From an \textit{ex ante} view, the pragmatic approach arbitrarily segregates section 16(b) suits according to the type of transaction involved. The insider covered by the section because of a cash purchase and sale faces a conclusive presumption, while the same insider would have a greater "chance" if he happened to participate in an unorthodox transaction such as a tender offer, or if he were only a "titular director." Hence \textit{ex ante} inequity results. As one commentator has noted: "If the defendant is to be relieved of liability because he could not have abused his insider status, he should be relieved whether he has traded his securities for other securities pursuant to a merger or simply sold them for cash."\textsuperscript{124} If the goal of 16(b) regulation is to achieve \textit{ex ante} equity, an equal access to information for all investors, it is inconsistent to make a factual inquiry into the "possibility of abuse" in one type of transaction and not in the other. Thus, the \textit{ex post} inequity existing under the objective approach is exacerbated under the pragmatic approach, in that even fewer insiders are required to disgorge their section 16(b) profits.

The attempt of the courts, via the pragmatic approach, to consider the substance of the transactions is commendable. Unfortunately, however, because this inquiry is made only in a limited number of insider activities, the consequences tend to be what neither Congress nor the courts intended. To be equitable, such an approach should be extended to include orthodox cash transactions as well. Under its present status, therefore, section 16(b) has lost its predictability and simplicity, yet has gained little in terms of equity.

\textbf{Rule 10b-5: A More Equitable Alternative}

\textit{Overview}

Perhaps the most significant development in the field of securities regulation has been the expansive application of rule 10b-5,\textsuperscript{125} pro-

\begin{itemize}
\item \textsuperscript{124} Pragmatic Approach, supra note 46, at 623.
\item \textsuperscript{125} 17 C.F.R. § 240.10b-5 (1976):
\begin{quote}
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
\end{quote}
mulgated pursuant to section 10(b) of the Securities Exchange Act. Adopted by the SEC in 1943, rule 10b-5 was written broadly, possessing none of the inherent restrictions of section 16(b) other than a fairly rigid standing requirement. Congress intended section 10(b) to serve as "a general prohibition of a relatively wide variety of deceitful or manipulative practices . . . both on and off the exchanges." Rule 10b-5 effects this aim by proscribing any fraudulent conduct "in connection with the purchase or sale of any security." Such broad language permits flexible application so that "loopholes" that might arise in other provisions may be closed. Because the plaintiff must overcome several procedural and substantive obstacles to obtain relief under rule 10b-5, however, plaintiffs in effect are encouraged to pursue 16(b) relief with its liberal standing and evidentiary standards.

Either the SEC or a private party may sue under rule 10b-5, the common-law privity requirement is abolished, and the class of defendants is not limited to insiders as defined in section 16(a). In SEC suits for injunctive relief, the Commission normally names as defendants any person or entity that was connected with the alleged violation. In private actions, the defendant need not be a purchaser or seller of securities so long as his conduct is connected with such a purchase or sale. Thus, if one party to the transaction

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(a) To employ any device, scheme, or artifice to defraud,
(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

127. See notes 142-51 infra & accompanying text.
134. See, e.g., Rogen v. Ilikon Corp., 361 F.2d 260 (1st Cir. 1966); List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir. 1965), cert. denied, 382 U.S. 811 (1965); Kohler v. Kohler Co., 319
occupies a fiduciary position to another, rule 10b-5 imposes on the former an affirmative duty of disclosure of any material facts known to him and unknown to the other party.\textsuperscript{135} Similarly, those who aid in the breach of such a fiduciary duty are potential defendants both in SEC\textsuperscript{136} and in private suits.

"Tipping" is a major area in which rule 10b-5 is applied. The basic principle of tippee liability is that a tippee, who is otherwise an "outsider," becomes liable under rule 10b-5 when he purchases or sells to another on the basis of inside information received from an insider-tipper, without disclosing such information to the other party. One court has held that tippees are liable to the same extent as insiders.\textsuperscript{137} The SEC has adopted a similar approach,\textsuperscript{138} although in many situations its available sanction is limited to censure.\textsuperscript{139} Effective application of 10b-5 to tipping, however, is hampered by the difficulty of identifying the tippee and his source. Moreover, the scope of liability remains unclear.\textsuperscript{140} At least one court has held that, to develop a strong deterrent to tipping, the best policy is to place the liability on the tipper for his profits as well as for the profits of his immediate tippees.\textsuperscript{141}

Perhaps the most controversial issue under rule 10b-5 is the plaintiff's standing to bring a private action. To have standing, the plaintiff, unlike the defendant, must be a purchaser or a seller. As such, this "Birnbaum doctrine"\textsuperscript{112} precludes standing for persons who merely refrained from purchasing or selling in reliance on the fraud. Via the principle of \textit{expressio unius est exclusio alterius},\textsuperscript{143} the

\textsuperscript{135} SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 861 (2d Cir. 1968).
\textsuperscript{142} The rule was first handed down in Birnbaum v. Newport Steel Corp., 193 F.2d 461 (1952), cert. denied, 343 U.S. 956 (1952).
\textsuperscript{143} Id. at 464.
court in Birnbaum reasoned that because section 16(b) expressly gives the shareholder a right of action, "[t]he absence of a similar provision in section 10(b) strengthens the conclusion that that section was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs . . . ."\textsuperscript{144} Such an interpretation is not mandated by statutory language, but rather by judicial policy.\textsuperscript{145} The overriding concern of the courts in sustaining this artificial rule is that otherwise there would be a flood of litigation, especially nuisance litigation.\textsuperscript{146} In defense of this policy, the courts contend that a person who refrains from participating in a trade has the subsequent option of selling his stock,\textsuperscript{147} or of bringing a common law action.\textsuperscript{148} The Supreme Court recently reaffirmed the Birnbaum doctrine in Blue Chip Stamps v. Manor Drug Stores,\textsuperscript{149} despite criticism from both the SEC\textsuperscript{150} and the lower courts.\textsuperscript{151}


\textsuperscript{145} Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 748-49 (1975). See also Comment, Securities Law—Fraud—Standing of Nonpurchasers and Nonsellers Under Section 10(B) of the Securities Exchange Act of 1934, 1976 Wis. L. Rev. 256, wherein the writer rejects the Blue Chip Stamps rationale.

\textsuperscript{146} The very real risk in permitting those [who refrain from purchasing or selling] to sue under Rule 10b-5 is that the door will be open to recovery of substantial damages on the part of one who offers only his own testimony to prove that he even consulted a prospectus of the issuer . . . . Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 746 (1975). See also, McClure v. Borne Chem. Co., 292 F.2d 824 (3d Cir. 1961).

\textsuperscript{147} See Note, The Purchaser-Seller Limitation to SEC Rule 10b-5, 53 CORNELL L. REV. 684 (1968). Should the investor subsequently sell and incur a loss, his damages would be partially mitigated by capital loss treatment on his tax return. See INT. REV. CODE OF 1954, §§ 1211, 1221. One commentator has suggested that such a loss be given more favorable treatment under section 165 as a theft loss deduction. See Note, Extension of the Internal Revenue Code Theft Loss Deduction to Victims of Securities Frauds, 48 S. CAL. L. REV. 1388 (1975).

\textsuperscript{148} See note 4 supra.

\textsuperscript{149} 421 U.S. 723 (1975). See notes 144-46 supra & accompanying text.

\textsuperscript{150} Prior to Blue Chip Stamps, the SEC had submitted amicus briefs in sever\textsuperscript{1} cases proposing a judicial relaxation of Birnbaum. See, e.g., Mount Clemens Indus., Inc. v. Bell, 464 F.2d 339, 341 (9th Cir. 1972); Levine v. Seilon, Inc., 439 F.2d 328, 332 (2d Cir. 1971).

The materiality of the misrepresentation or omission, and the reliance thereon are relatively straightforward elements of a rule 10b-5 action. Determining whether the defendant possessed a culpable state of mind, however, is problematic. The state of mind requirement usually relates only to private suits for monetary recovery; in suits for injunctive relief brought by either a private party or the SEC, the defendant’s state of mind is irrelevant. Innocent conduct generally is not within the purview of the rule’s application, whereas, conversely, an intent to deceive always falls within its bounds. Between these two extremes lie “negligence” and “reckless disregard,” two concepts of uncertain significance. Recently, the Supreme Court endorsed the more frequent rule in the circuit courts, that mere negligence is insufficient to invoke rule 10b-5 liability.

Upon determining that the above elements of material misrep-
sentation or omission, reliance, and culpable state of mind exist, the court then must determine the appropriate measure of 10b-5 liability. Although there is no black letter law of remedies under rule 10b-5, the common denominators of 10b-5 remedies include a policy of deterrence, a goal of making the plaintiff “whole,” and a goal of equal compensation to all equally harmed investors. Neither punitive damages, nor attorney’s fee are awarded, but litigation costs are allowed.

One ad hoc approach in determining the correct measure of liability is to award rescissory damages computed with reference, not to the date of the transaction, but to some post-transaction date so that it is less likely that the defendant will be unjustly enriched. Applying such a remedy in the absence of privity may well produce substantial liability for the defendant, liability that far exceeds his related benefits. For this reason, the court in Mitchell v. Texas Gulf Sulphur Co. rejected this rule in favor of a “cover-type” award. Under this approach, the court concluded that damages should be the difference between the highest price of the stock during the nine days following the misrepresentation, and the selling price of the shares. Several other courts have adopted an “out-of-pocket” measure of damages that represents “the difference between the contract price, or the price paid, and the real or actual value at the date of the sale, together with such outlays as are attributable to the defendant’s conduct.” At least one court has suggested that as this theory, in which expectancy gains of the


162. Basically, this is the monetary value of what the defrauded seller would have received had specific restitution been available, or, in other words, the difference between the value of the consideration exchanged by the defrauded seller or buyer. See, e.g., Gottlieb v. Sandia Am. Corp., 304 F. Supp. 980 (E.D. Pa. 1969), aff’d in part, rev’d in part on other grounds, 452 F.2d 510 (3d Cir. 1971), cert. denied, 404 U.S. 938 (1971).


164. Janigan v. Taylor, 344 F.2d 781 (1st Cir. 1965), cert. denied, 382 U.S. 879 (1965): “It is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them.” Id. at 786.

165. See Measure of Damages, supra note 163, at 373-74.

166. 446 F.2d 90 (10th Cir. 1971), cert. denied, 404 U.S. 1004 (1972).

167. Id. The court in Mitchell noted that “the measure of damages used should award the reasonable investor the amount it would have taken him to invest in the TGS market within a reasonable period of time after he became informed [of the true facts].” Id. at 105.

168. Id. at 105.

plaintiff are irrelevant, is the most precise measure of damages in open market transactions, it should provide the upper limit of liability.\textsuperscript{170}

\textit{Allocational and Distributional Effects}

In maximizing the efficient use of administrative and judicial resources, rule 10b-5 presents greater difficulties than does section 16(b), because of both the different role played by the SEC and the additional evidentiary hurdles. Unlike section 16(b), rule 10b-5 increases administrative costs because it mandates that the Commission actively participate in bringing suit against violators. Also, because of the complex factual issues in both private and SEC actions, litigation costs are generally high, exceeding those resulting from the application of the pragmatic approach under 16(b). Moreover, although application of the \textit{Birnbaum} doctrine restricts “nuisance” litigation under 10b-5,\textsuperscript{171} it also precludes recovery for many persons who have been injured.\textsuperscript{172} To the extent this occurs, a suboptimal supply of enforcers results. A more liberal standing rule thus would be more efficient; for, as attorney fees generally are not allowed under rule 10b-5,\textsuperscript{173} the risk of champerty still would be negligible.

From the insider’s perspective, the first enforcement variable, the probability of holding inside traders liable, is affected, not only by the quantity of potential plaintiffs and by the amount of SEC resources available, but also by the substantive requirements of the rule. Because rule 10b-5 is complicated substantively, the probability of finding a defendant liable is low although use of judicial resources is extensive. Even though sections 14 and 16(a) are utilized to detect fraudulent trading, detection is more difficult under rule 10b-5, especially in the area of tipping. “A prohibition on tippee

\textsuperscript{170} \textit{See Measure of Damages, supra} note 163, at 385. The author notes that “[t]he economic reality of how much an investor actually suffers needs to be balanced against the detrimental impact on corporate existence and on remaining, innocent shareholders. An open-market trader should receive no more than his out-of-pocket loss.” \textit{Id.} at 396.

\textsuperscript{171} Notably, however, several members of the judiciary have indicated that the argument that a flood of litigation would result if the rule enunciated in \textit{Birnbaum} were relaxed, is specious. \textit{See, e.g.}, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (Blackmun, Douglas & Brennan, J.J., dissenting); Eason v. General Motors Acceptance Corp., 490 F.2d 654 (7th Cir. 1973) (Judge, now Justice, Stevens writing for the majority).


\textsuperscript{173} \textit{See} Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir. 1971).
trading is difficult to enforce, for the universe of potential tippees is virtually unlimited and detection is likely to occur only in the most obvious of cases. 174 Apparently the "most obvious" tippee suits are the ones in which the cost to the Commission or private party is minimal. On a cost-benefit analysis, suit should be brought, not merely in the easy cases (in which the SEC can inflate its record), but against both frequent violators and the not-so-frequent violators who cause extensive damage. 175 To the extent that such a policy is not pursued, the probability of holding an insider liable is decreased, so that even as to risk averse insiders, the deterrent value of rule 10b-5 is minimized.

As for the second enforcement policy variable, the discounted value of the sanction, the available empirical evidence apparently supports the view that the liability imposed pursuant to rule 10b-5 is of limited deterrent value. Analyzing insider reactions to three significant events in the evolution of the rule, In re Cady, Roberts & Co., the Texas Gulf Sulphur indictment, and SEC v. Texas Gulf Sulphur, one commentator concluded that "[t]here appeared to be few changes in the characteristics of trading." 176 Such evidence nonetheless is hardly unequivocal.

If the requirement of privity is relaxed so that plaintiffs may sue on open market transactions, the deterrent value of rule 10b-5 is enhanced in that the potential recovery is increased. The same is true if a tipper is held liable for profits made by all subsequent tippees. 177 Yet, as noted above, the deterrent effect of rule 10b-5 is questionable under its present application. As the stakes usually are high the incentive to violate the law is great. Nevertheless, the possibility exists that the psychic costs (non-monetary costs, e.g., social stigma) to the defendant act as some deterrence. Also, even


175. See Stigler, supra note 75, at 533.

176. Jaffe, The Effect of Regulation Changes on Insider Trading, 5 BELL J. ECON., 93, 114 (1974). Jaffe also notes: "Only the Texas Gulf Sulphur decision seems to have had even a slight effect on the profitability of insider trading . . . . Furthermore, the data do not suggest that the regulatory changes affected the volume of insider trading. The volume actually increased slightly after each of the three events. . . ." Id.

177. See SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301 (1971), cert. denied, 404 U.S. 1005 (1971): "As to the requirement that [the tipper] make restitution for the profits derived by his tippees, admittedly more of a hardship is imposed. However, without such a remedy, insiders could easily evade their duty to refrain from trading on the basis of inside information." Id. at 1308.
though punitive damages are not allowed, one court has chosen to compute damages by a method analogous to that under section 16(b). Likewise, injunctions obtained through SEC suits produce an increase in the discounted value of the sanction. One commentator has asserted, however, that injunctions obtained through the process of consent decrees have mitigated much of the harshness.

The disadvantages of the present application of rule 10b-5 in terms of efficiency, are more than compensated for in terms of equity. Like section 16(b), the underlying premise of rule 10b-5 is ex ante equality of access to information by all members of the investing public. Unlike section 16(b), however, rule 10b-5 is an equitable means to an equitable end. In terms of culpability, greater ex ante and ex post equity are generally achieved because the rule distinguishes between the innocent and the less-than-innocent. Thus, the language of rule 10b-5 allows the result that the pragmatic approach under 16(b) can attain only by twisting the plain language and the legislative history of the section.

For example, because rule 10b-5 applies to every situation involving fraud "in connection with the purchase or sale of any security," everyone is similarly situated should they violate the rule. Admittedly, to the extent that the probability of holding insiders liable is reduced, causing more violators to escape liability, ex post inequity will be the result. But because increasing this probability is costly, such a trade-off may be necessary. In terms of equity, the major weakness in rule 10b-5 is the uncertain method of measuring damages. Because ex post equity is achieved only when similarly situated defendants bear similar costs, one method of computing damages is required, so as to insure that damages are commensurate with liability. Moreover, if the method used to detect, and ulti-


179. SEC v. Shapiro, 494 F.2d 1301 (2d Cir. 1974) (defendant made to disgorge his paper profits computed by reference to the highest market value subsequent to the defendant's purchase and prior to his sale).


182. Id. at 578. Such decrees are used by the Commission both in the federal courts and in administrative proceedings. In consenting, the defendants do not admit wrongdoing.

183. Pauley & Willett, supra note 85, at 15.
mately to find liability, is random,\textsuperscript{184} ex ante equity still can be attained. As this is the salient goal of the anti-fraud provisions, such an approach is apparently appropriate.

**Conclusion and a Proposal**

The purpose of this Note has been to illustrate the inherent deficiencies of both the objective and the pragmatic approaches to section 16(b), while, at the same time, emphasizing the advantages of rule 10b-5. The implications of the foregoing analysis suggest that a rule of law of general application, such as rule 10b-5, tends to achieve an optimal degree of both equity and efficiency. As a statute becomes more specific in its application, efficiency and equity are minimized. The constructions of Kern County, Reliance Electric and Foremost-McKesson have steadily eroded section 16(b); the applicability of rule 10b-5 has been increasingly expanded.\textsuperscript{185}

Ironically, section 16(b), a statute apparently premised on equitable notions, has become generally inequitable in its application. The ad hoc policymaking of the pragmatic approach has led to perplexing consequences. Although most commentators think section 16(b) continues to serve a necessary function,\textsuperscript{186} it appears that Congress should reconsider the validity of this statute. Lowenfels contends that “Congress has many more pressing and important problems than the fate of one comparatively obscure provision of the federal securities laws.”\textsuperscript{187} Yet the courts also have more pressing concerns than struggling with the inconsistent decisions under 16(b). In short, the pragmatic approach is no longer the solution to the harshness of section 16(b); rather, such an approach has itself created serious confusion.

If Congress would consider the concurrent development of section 16(b) and rule 10b-5, it would be clear that the continued existence of 16(b) is unjustified. Prior to Texas Gulf Sulphur, which represented the advent of rule 10b-5 as a useful tool in retarding insider trading, the courts seemingly were justified in expanding the application of section 16(b), even though such a policy affected transac-

\textsuperscript{184} Total randomness is virtually impossible; thus, some bias is inevitable.


\textsuperscript{186} See, e.g., 2 L. Loss, Securities Regulation 1089 (2d ed. 1961); Lowenfels, supra note 31, at 64.

\textsuperscript{187} Lowenfels, supra note 31, at 64.
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itions not contemplated in the legislative history. The courts were confronted with two undesirable choices: they could apply the objective approach that Congress apparently intended, and reach absurd results in unorthodox situations, or they could develop their own approach and merely pay lip service to the intent of Congress. Even given the rapid expansion of rule 10b-5, these same courts now find the hands of equity bound by anachronistic precedents. 188

Today the distinction between section 16(b) and rule 10b-5 has been almost eliminated. Fortunately, even the courts have begun to realize the obsolescence of section 16(b). The Supreme Court in Foremost-McKesson noted, “Rule 10b-5 has been held to embrace the evils that Foremost urges its [broad] construction of §16(b) is necessary to prevent.” 189 There is no reason why rule 10b-5 cannot accomplish even more than section 16(b). The policies underlying both are the same. Also, the pragmatic approach to section 16(b) requires the same factual inquiries as does rule 10b-5. 190 The only difference is the degree of proof required to impose liability. The pragmatic approach allows imposition of harsh liability on a showing of a mere “possibility of abuse,” a test that theoretically does not require any showing of actual use of inside information. Rule 10b-5 requires a showing by a preponderance of the evidence that there was an actual abuse of inside information. 191 Although rule 10b-5 is procedurally more burdensome to the plaintiff, this burden could be eased by evidentiary rules and presumptions without decreasing the equitable effects of the rule.

Even if section 16(b) were not redundant, however, it still should be eliminated because of its gross inequity. Prior to Texas Gulf Sulphur, one commentator proposed that section 16(b) be amended to require a two-year focal period with merely a rebuttable presumption of insider trading, 192 a then reasonable and workable suggestion. In the aftermath of Texas Gulf Sulphur, however, such an amend-

188. See ALI FEDERAL SECURITIES CODE § 1413, Comment 1 at 133 (Tent. Draft No. 2, 1973).
191. See Objective Approach, supra note 37, at 928-29. See also Weinstock, Section 16(b) and the Doctrine of Speculative Abuse: How to Succeed in Being Subjective Without Really Trying, 29 BUS. LAWYER 1153, 1175-76 (1974) where the writer emphasizes that “the distinction [between the factual inquiries of the pragmatic approach and of rule 10b-5 is] more apparent than real. . . .”
192. See Munter, supra note 92, at 89-101.
ment seems inadvisable; repeal of section 16(b) by Congress is the only appropriate course.

Rule 10b-5, however, requires modification, either by judicial interpretation, administrative rule, or statutory amendment, to increase its effectiveness. As noted, the deterrent value of the rule must be increased without sacrificing its basic equitable nature. To accomplish this, the Birnbaum doctrine should be abolished. Although the probability of increasing nuisance litigation by relaxing the standing requirement is merely speculative, the benefits are readily apparent.

The inflexibility of Birnbaum precludes regulatory adaptation to the expanding variety of fraudulent securities transactions. By repudiating Birnbaum the probability of imposing liability on a violator would increase because there would be more potential plaintiffs who could negotiate successfully the substantive obstacles of the rule. Similarly, the discounted value of the sanction would be increased in that the defendant potentially would be liable to more plaintiffs, although his expected gain would remain the same. Thus, such action would increase the deterrent effect to both risk averters and risk preferrers.

The equitable arguments in favor of a relaxed standing requirement are equally compelling. It is inequitable to preclude an investor from bringing suit merely because he did not purchase or sell his shares. Certainly, that person still could be injured greatly by refraining from such action in reliance on fraudulent conduct. From an *ex ante* viewpoint the abolition of Birnbaum would increase equity by equalizing the liability risks of a greater number of defrauders. Concomitantly, *ex post* equity would be increased because all defendants would be subject to liability directly related to the amount of damage caused, regardless of whether the injured party relied by purchasing or selling, or by refraining from doing so.

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> [T]he Court, in my opinion, unfortunately mires itself in speculation and conjecture not usually seen in its opinions. . . .

> Certainly, this Court must be aware of the realities of life, but it is unwarranted for the Court to take a form of attenuated judicial notice of the motivations that defense counsel may have in settling a case, or of the difficulties that a plaintiff may have in proving his claim.

*Id.* at 769-70 (Blackmun, J., dissenting).

Theoretically, courts could achieve similar results without an express rejection of *Birnbaum* merely by reading "purchase" and "sale" expansively. As Justice Blackmun argued in *Blue Chip Stamps*, "the word 'sale' ordinarily and naturally may be understood to mean not only a single, individualized act . . . but also the generalized event of public disposal of property through advertisement, auction, or some other market mechanism." In view of possible problems resulting from an artificially expansive reading, however, express judicial rejection of *Birnbaum* is the better approach. *Eason v. General Motors Acceptance Corp.* evinces a significant recent departure from *Birnbaum*. There the Court of Appeals for the Seventh Circuit applied a "nexus rule" so that any investor, regardless of whether he purchased or sold, who has suffered significant injury as a direct result of fraudulent conduct has standing. Dissenting in *Blue Chip Stamps*, Justice Blackmun argued that under this approach, "[s]ensible standards of proof and of demonstrable damages would evolve and serve to protect the worthy and shut out the frivolous."

Remedies is the other area of rule 10b-5 that needs modification. That similarly situated defendants will incur the same liability should be the overriding objective in the application of rule 10b-5. Because increasing the discounted value of the sanction is virtually costless, and in the case of rule 10b-5 would involve no trade-off in terms of equity, a policy of allowing merely out-of-pocket damages should be rejected. Moreover, punitive damages should be permitted in appropriate cases. To be an effective deterrent, a remedy must do more than require the wrongful party to return what he has gained. Even if liability were certain, there is no deterrent effect in the policy of allowing out-of-pocket damages, except possible social stigma and the opportunity cost.

Admittedly, the regulation of insider trading is still necessary,
for if *ex ante* equality of access to information exists, the investing public is likely to accept any resulting *ex post* inequality in income derived from such information. The appropriate means to achieve this valid end, however, lies not in a 16(b) type statute that merely decreases confidence in the market and maximizes investor cynicism, but in rule 10b-5 and its future evolution.