

TEACHING AN OLD LAW NEW TRICKS: RETHINKING SECTION 16

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I. INTRODUCTION.....	1316
II. SECTION 16: PURPOSE AND OPERATION.....	1319
A. Legislative History.....	1319
B. Statutory Scheme: 16(a) Reporting and 16(b) Liability.....	1320
C. Problems with Scope of Coverage.....	1322
D. Benefits of Section 16.....	1326
III. SECTION 16(b) AND OTHER LAWS TO COMBAT INSIDER TRADING.....	1328
A. Federal Securities Laws.....	1328
1. Section 10(b) and Rule 10b-5.....	1328
2. Section 14(e) and Rule 14e-3.....	1333
3. Section 13(d) and Schedule 13D.....	1334
4. Restricted Stock and Rule 144.....	1335
B. Other Federal Laws.....	1337
1. Mail and Wire Fraud Statutes.....	1337
2. RICO.....	1338
3. Other Laws.....	1340
C. State Laws.....	1340
1. Blue Sky Laws.....	1340
2. Common Law Actions Based on Fraud, Agency, or Breach of Fiduciary Duty.....	1343
D. Section 16(b) Liability Should Be Eliminated.....	1348
IV. SECTION 16(a) AND THE VALUE OF REPORTED INFORMATION.....	1349
A. Market Efficiency.....	1349
B. Section 16(a) Reporting.....	1350
1. Why Section 16(a) Information Is Valuable to the Market.....	1350
a. Stock Sales.....	1351

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b. Stock Purchases..... 1352

2. Decrease in Value of Information Because
of Delay..... 1353

3. Availability of EDGAR to Solve Problem of
Delay 1354

4. Recommendations for Revision of Section
16(a)..... 1355

V. CONCLUSION..... 1358

I. INTRODUCTION

Thanks in part to several recent well-publicized cases,¹ the public has become very familiar with the notion that insider trading is prohibited; that is, that corporate insiders may not use material, nonpublic information to help them profit from buying and selling their company’s securities. Those familiar with the securities laws also know that whenever insiders of publicly held companies buy or sell their company’s securities, they must file reports with the Securities and Exchange Commission (“SEC”) that disclose their trades to the public, whether or not the trades are based on inside information. If insiders profit from a purchase and sale of their company’s securities within six months, they must return the profit to the company. This Article examines the disclosure/disgorgement obligation from several angles. It considers the rationales for the obligation and determines that the statute requiring insiders to disclose their trades and disgorge their profits does not fulfill its stated objectives. It then queries whether the statute does or could fulfill other objectives, and it suggests how the law might be improved.

The Securities Act of 1933 (the “1933 Act”)² prescribes a system of registration and disclosure in connection with issuances of securities, and the Securities Exchange Act of 1934 (the “1934 Act”)³ prescribes a registration system for classes of securities and periodic mandatory disclosure by issuers of such securities. Companies that offer securities to the public must register those securities under the 1933 Act in a filing with the SEC that includes specified information about the company and its business, management, and finances.⁴ Companies that meet certain size criteria or whose securities trade on national exchanges must also register their publicly traded securities with the SEC under the 1934 Act.⁵ Companies with securities registered under the 1934 Act are

1. The most recent case, which broadens the government’s ability to prosecute persons unaffiliated with the issuing company who trade on nonpublic information, was handed down by the United States Supreme Court in late June, 1997. *United States v. O’Hagan*, 117 S. Ct. 2199 (1997); see *infra* notes 61–68 and accompanying text.

2. Securities Act of 1933, 15 U.S.C. §§ 77a–77bbbb (1994).

3. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78kk (1994).

4. See Securities Act of 1933, §§ 5–7, 10, 15 U.S.C. §§ 77e–77g, 77j (1994).

5. See Securities Exchange Act of 1934, § 12, 15 U.S.C. §78l (1994).

required to file reports with the SEC at the end of each year and each quarter, publicly disclosing on an ongoing basis information similar to that provided in securities registration statements.⁶

Section 16 of the 1934 Act⁷ is intended to discourage insider trading, that is, trading on the basis of material nonpublic information acquired through the insider's relationship with a company. The statute does not directly prohibit insider trading, but instead removes the profit from, and thus the incentive for, a class of transactions deemed likely to involve the use of inside information.⁸ Under section 16, officers, directors, and major shareholders of publicly held companies must report their trades in their company's securities to the SEC and to the exchanges on which the securities trade.⁹ If the reports disclose that an insider has profited from a purchase and sale within a six-month period, either the company or any of its security holders may bring an action to compel the insider to disgorge the profit and return it to the company.¹⁰

Two quirks in the statute ensure that its net ensnares the largest possible group of trades. First, it is irrelevant whether the purchase precedes the sale or the sale precedes the purchase. As long as the purchase price is less than the sale price, section 16(b) deems that there is a recoverable profit.¹¹ Second, the statute does not bundle together all transactions within a six-month period to determine whether the insider has a cumulative profit. Instead, it matches the lowest purchase price with the highest sale price to require disgorgement of the largest possible "profit." As a result, an insider could actually have a cumulative loss resulting from a series of trades within a six-month period and still be required to disgorge "profits" back to his or her company.¹²

In addition to these quirks, section 16(b) makes no inquiry into whether inside information was a factor motivating a transaction that resulted in a profit for the trader. It operates instead on the irrebuttable presumption that any transaction that falls within its prohibition and results in a profit to the trader, as section 16

6. *See id.* § 13, 15 U.S.C. §78m (1994).

7. *Id.* § 16, 15 U.S.C. § 78p (1994).

8. *See id.* § 16(b).

9. *Id.* § 16(a).

10. *Id.* § 16(b).

11. For example, CEO buys 100 shares of her company's stock at \$30 and sells them a month later at \$40. She has a \$1,000 profit, and section 16(b) will require her to disgorge the profit and return it to her company. If instead, she sells 100 shares at \$40 and buys 100 shares a month later at \$30, section 16(b) will still apply, because the sale price was higher than the purchase price. It will require her to disgorge her profit of \$1,000—the \$10 difference between the purchase price and the sale price, times the number of shares.

12. For instance, CEO might purchase 500 shares at \$50 per share in March, sell 500 for \$40 per share in April, purchase 500 for \$30 in May, and sell 500 for \$20 in June. Although CEO is clearly not a successful investor (with a cumulative loss of \$10,000), section 16(b) would impose liability of \$5,000 for the "profit" of \$10 per share between the May purchase price of \$30 and the April sale price of \$40.

defines profit, will create liability and require disgorgement of the profit back to the issuer.

This Article concludes that section 16(b) should be repealed and section 16(a) should be modified. Section 16(b) should be repealed for several reasons. First, it is ineffective at preventing or punishing insider trading.¹³ Its bright-line rule both punishes transactions not based on improper use of inside information and fails to punish transactions based on such information.¹⁴ Second, it is unfair, because its ineffectiveness means that those who do in fact trade on inside information, and thus should have to pay, may escape section 16(b) liability, while those who are merely uninformed or unwary may be caught by the statute's irrebuttable presumption.¹⁵ Third, it is expensive, because it requires both corporations and insiders to govern their conduct by complex rules unrelated to the actual misuse of inside information.¹⁶ And fourth, it is unnecessary, because there

13. See *infra* Part II.C.

14. In a recent article, Professor Marc Steinberg and Daryl Landsdale posit that both courts and regulators have recently taken steps to weaken the enforcement of section 16(b). The authors note that language in a recent decision may narrow the class of potential parties who have standing to bring suit, that recent decisions pose the risk that courts will restrictively interpret the limitations period applicable to section 16(b) claims, and that the SEC itself has promulgated rules that remove some transactions in derivative securities from the purview of the statute. The authors believe that these developments are all in contravention of the statute's broad remedial purpose. See Marc I. Steinberg & Daryl L. Landsdale, Jr., *The Judicial and Regulatory Constriction of Section 16(b) of the Securities Exchange Act of 1934*, 68 NOTRE DAME L. REV. 33 (1992). This reluctance to vigorously enforce section 16 may result at least in part from the widely held perception that it is frequently overbroad.

15. See S.S. Samuelson, *The Prevention of Insider Trading: A Proposal for Revising Section 16 of the Securities Exchange Act of 1934*, 25 HARV. J. ON LEGIS. 511 (1988).

A half century of experience with Section 16 and recent analysis by economists of insider trading reveal that the Act has not prevented insiders from profiting at the expense of other shareholders and the general public. The evidence also suggests that corporate officials not only earn a higher return than the market when trading stock of their own companies, but that insiders frequently trade while in possession of secret, material information. Indeed, since the statute only regulates round-trip trading, it does not prohibit single trades based on secret information. At the same time, Section 16 imposes a heavy burden on corporate insiders by preventing many legitimate trades (i.e., those made without inside information). The reporting requirements often snag not the guilty but the unwary.

Id. at 512 (footnotes omitted).

16. See *infra* Part III.D; see also Merrit B. Fox, *Insider Trading Deterrence Versus Managerial Incentives: A Unified Theory of Section 16(b)*, 92 MICH. L. REV. 2088, 2201 (1994) ("Critics assert that [section 16(b)] is totally ineffective in combatting insider trading because all that an insider needs to do to avoid its bite is to wait six months before reversing the trade.").

is an abundance of other laws and rules that either are intended to combat insider trading or may be used for that purpose.¹⁷

Section 16(a), unlike section 16(b), serves a useful purpose and thus should not be repealed. Section 16(a) reports provide valuable information to the market, even though the meaning of the information is not always clear. The fact that insiders have bought or sold their company's securities may provide insights into their opinions of the company's prospects. This information will tend to make securities prices more accurate, in the sense that the prices will include more information. However, section 16(a) currently allows much too long a delay between the time an insider trades and the time the trade must be reported. Therefore, this Article recommends that the section be amended to require a filing concurrent with the trade and suggests that the concurrent filing can be implemented easily through use of the SEC's EDGAR system.¹⁸

II. SECTION 16: PURPOSE AND OPERATION

A. Legislative History

As the Great Depression reached its nadir in the years following the stock market crash of 1929, Congress enacted the 1933 and 1934 securities acts. These laws were intended in part to restore public confidence in the fairness of the markets. Confidence was low because the public believed the stock markets were "rigged" in favor of those who had access to inside information about the companies whose stock was traded. Investors without inside information were thus reluctant to risk their money in the market. Their reluctance to invest, in turn, made it more difficult for companies to raise the capital needed to stay afloat during the hard times of the Great Depression. Congress believed that by increasing the public's access to information, it could reduce both the perception and the reality that the playing field was slanted. Therefore, the securities laws

17. See *infra* Part III. The Supreme Court's recent *O'Hagan* decision reinforces the position that the government has a heavy arsenal of weapons with which to combat insider trading. *O'Hagan* stands for the proposition that someone who acquires material nonpublic information in a confidential relationship, even if that relationship is with someone other than the issuer, may be prosecuted for "misappropriating" that information and trading on it for his or her own benefit. See *United States v. O'Hagan*, 117 S. Ct. 2199 (1997).

18. EDGAR, the Electronic Data Gathering, Analysis, and Retrieval system, is the SEC's system for both receiving and disseminating information electronically. Companies file their registration statements and periodic reports electronically, using the telephone lines, and both the SEC and the public can access the filed information. See *infra* Part IV.B.3 for more information about EDGAR.

were designed to increase investment by requiring disclosure of certain information.¹⁹

B. Statutory Scheme: 16(a) Reporting and 16(b) Liability

Section 16 has three subsections that set out its requirements and two additional subsections that limit its scope. Section 16(a) requires certain statutorily defined “insiders”²⁰ to report their beneficial ownership²¹ of and their transactions in their company’s securities both to the SEC and to the stock exchanges on which the securities are listed. Insiders must file an initial report when their company’s securities are registered under section 12 or within ten days after becoming statutory insiders.²² This provides baseline information on securities ownership. Following the initial report, insiders must file transaction reports by the tenth day of the month following any month in which there has been a substantial²³ change

19. See, e.g., S. REP. NO. 73-792, at 3-5 (1934):

The unfair methods of speculation employed by large operators and those possessing inside information regarding corporate affairs, and the failure of corporations to publish full and fair reports of their financial conditions, have also been contributing causes of losses to investors.

....

The three principal problems with which the bill deals are the excessive use of credit for speculation, the unfair practices employed in speculation, and the secrecy surrounding the financial condition of corporations which invite the public to purchase their securities.

20. Section 16(a) defines those insiders subject to its requirements as “[e]very person who is directly or indirectly the 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 [(section 12 of the Securities Exchange Act of 1934)], or who is a director or an officer of the issuer of such security.” Securities Exchange Act of 1934 § 16(a), 15 U.S.C. § 78p(a) (1994).

21. “Beneficial ownership” is used in two senses in section 16. One sense relates to the opportunity to realize pecuniary benefit from securities ownership, and the other relates to the power to control the voting and disposition of the securities. A person becomes an insider required to file reports under section 16(a) if he or she meets the control tests set out in section 13(d) and the rules promulgated thereunder. See 15 U.S.C. § 78m(d) (1994); 17 C.F.R. § 240.13d-3 (1997); *id.* § 240.16a-1(a)(1). But for other purposes, including liability under section 16(b), beneficial ownership refers to a person’s pecuniary interest in the securities. See *id.* § 240.16a-1(a)(2).

22. Securities Exchange Act of 1934 § 16(a).

23. Rule 16a-6 permits insiders to delay filing reports of their securities acquisitions that total \$10,000 or less until the next time they are otherwise required to file a monthly report on Form 4 or an annual report on Form 5, subject to certain conditions. 17 C.F.R. 240.16a-6.

in their ownership,²⁴ and they must also file annual statements of beneficial ownership.²⁵

Section 16(b) states that it was enacted “[f]or the purpose of preventing the unfair use of information which may have been obtained by...[a statutory insider] by reason of his relationship to the issuer.”²⁶ It prohibits insiders from

24. See Securities Exchange Act of 1934 § 16(a). Rules 16a-1 through 16a-10 provide explanations and exemptions from reporting for some transactions that the SEC has determined do not pose the dangers of insider trading that Section 16 is designed to forestall. For instance, Rule 16a-9 provides that stock splits and stock dividends are not reportable transactions, and Rule 16a-6 permits small transactions to be reported at the end of the fiscal year rather than on a monthly basis. See 17 C.F.R. §§ 240.16a-1 to 240.16a-10.

25. The initial statement of beneficial ownership is filed on SEC Form 3, the statement of changes in beneficial ownership is filed on Form 4, and the annual statement is filed on Form 5. See 17 C.F.R. § 240.16a-3(a) (1997). The annual report on Form 5 must be filed by the 45th day after the end of the issuer’s fiscal year and must disclose the following if not reported previously on Forms 3, 4, or 5:

(i) all transactions during the most recent fiscal year that were exempt from Section 16(b) of the Act, except:

(A) Exercises and conversions of derivative securities exempt under either § 240.16b-3 or § 240.16b-6(b) (these are required to be reported on Form 4);

(B) Transactions exempt from Section 16(b) of the Act pursuant to § 240.16b-3(c), which shall be exempt from Section 16(a) of the Act; and

(C) Transactions exempt from Section 16(a) of the Act pursuant to another rule;

(ii) Transactions that constituted small acquisitions pursuant to § 240.16a-6(a);

(iii) All holdings and transactions that should have been reported during the most recent fiscal year, but were not; and

(iv) With respect to the first Form 5 requirement for a reporting person, all holdings and transactions that should have been reported in each of the issuer’s last two fiscal years but were not, based on the reporting person’s reasonable belief in good faith in the completeness and accuracy of the information.

Id. § 240.16a-3(f). Insiders need not file Form 5 if they have already reported all transactions that would otherwise be reported on Form 5. *Id.*

26. Securities Exchange Act of 1934 § 16(b). *But see* Karl Shumpei Okamoto, *Rereading Section 16(b) of the Securities Exchange Act*, 27 GA. L. REV. 183 (1992) (proposing that section 16, its preamble to the contrary, was not in fact intended to prevent insider trading, but was instead intended to prevent market manipulation). “[B]oth as a matter of finance theory and of history, insiders have the ability to artificially move stock prices simply by trading. Section 16(b) addresses this opportunity for abuse.” *Id.* at 186; *cf.* Steve Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 HASTINGS L.J. 393 (1991) (noting that section 16(b) has value outside its insider trading function because its six-month holding period tends to align managerial incentives with long-term profitability).

making a profit on transactions in their company's securities when the purchase and sale of the securities both occur within a six-month period. Insiders must disgorge any profit realized in this kind of "short swing" transaction and return it to the company. The remainder of section 16 is not dealt with in this Article. Section 16(c) prevents insiders from profiting from downturns in the price of their company's securities by prohibiting short sales and sales "against the box."²⁷ Subsections (d) and (e) exempt certain transactions from the coverage of section 16.²⁸

C. Problems with Scope of Coverage

Section 16 has been criticized as being both underinclusive and overinclusive.²⁹ The persons, companies, and transactions to which it applies are defined by arbitrary, bright-line classifications rather than by an inquiry into whether inside information was in fact used in a particular trade. This is perhaps understandable in light of the congressional aim to remove the perception of unfairness from the capital markets, but perception may belie reality: the statute's net may fail to catch genuine miscreants more often than not.

27. Securities Exchange Act of 1934 § 16(c). In a short sale, the seller does not actually own the stock. Instead, the seller borrows stock, generally from his or her broker, and sells it in the market. The seller must at some later time replace the borrowed securities by purchasing replacement securities in the market. Sellers engage in short selling in the hope and/or expectation that the market price will decline. Then the replacement securities may be purchased at a lower price than that received in the sale of the borrowed securities, thus creating a profit from the transaction.

Sales "against the box" are similar to short sales, in that they involve the use of borrowed securities. However, in a sale "against the box," the seller owns securities substantially identical to those sold, but chooses to deliver borrowed securities instead.

28. *Id.* § 16(d), (e).

29. *See, e.g.,* Thel, *supra* note 26.

It is hornbook law that the purpose of section 16 is to keep corporate insiders from trading on the basis of inside information; the statute says almost as much. The problem is that section 16 does not always keep those who possess inside information from trading, and the people it does keep from trading do not always possess inside information. Robert Clark has captured the conventional criticism: "Section 16(b) catches defendants who did not violate the policy decision underlying the rule (here, the decision that trading on inside information is unfair), and it fails to catch other defendants who did violate it."

Id. at 396-97 (footnotes omitted). Professor Thel's article goes on to suggest that this understanding of section 16's purpose is incorrect, or at least too limited. Instead, he posits that section 16 is quite effective at encouraging those who control public companies to operate them efficiently because it deters them "from manipulating corporate affairs for their own ends, and it encourages them to acquire a personal interest in the long-term success of those corporations." *Id.* at 393.

Section 16 regulates the trades of a defined group of officers, directors, and substantial stockholders.³⁰ This group of insiders recognized by the statute may be underinclusive in any particular case because it does not necessarily include all corporate employees who have valuable inside information. It may also be overinclusive, because it applies to the defined group of insiders regardless of whether they in fact have (or even have access to) inside information.

Section 16's requirements apply only to insiders of companies with equity securities registered under section 12 of the 1934 Act.³¹ Section 12 companies are fairly large, publicly held companies.³² Many companies are not registered or required to register under section 12. Section 16 does nothing to discourage insider trading by persons outside its defined class of insiders or by persons who fit within the insider definition but are affiliated with companies not registered under section 12.

The most obvious scope problem, however, is not with the group of persons or companies covered but with the transaction period. Section 16(b) applies only to purchase/sale or sale/purchase transactions in which both the purchase and sale occur within a six-month period.³³ It does not inquire whether a trader in fact used inside information but instead sets an arbitrary time period during which profits are prohibited. It is thus overinclusive because it requires disgorgement of profits realized on trades within the six-month limit, even when the trades were not motivated by inside information. This overinclusiveness is harmful, not just neutral. First, it discourages insiders from owning securities in their companies, and securities ownership by insiders is generally beneficial

30. Securities Exchange Act of 1934 § 16(a). See *supra* note 20 for the statutory definition of insiders. It is generally fairly clear who are the directors (although there may be some question about honorary or emeritus directors) and 10% shareholders of an issuer, but the scope of the "officer" classification is not as clear. Lower level employees, even if they are titled "officers," are less likely to have access to material inside information, and thus are less likely to engage in the insider trading that section 16 is intended to deter. Consequently, Rule 16a-1(f) defines officer to include "an issuer's president, principal financial officer, principal accounting officer [or controller], any vice-president...in charge of a principal business unit, division or function..., any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer." 17 C.F.R. § 240.16a-1(f). Officers of related corporations or partners or employees of related partnerships may also be considered officers of the issuer if they "perform such policy-making functions for the issuer." *Id.*

31. Securities Exchange Act of 1934 § 16(a).

32. An issuer must register its securities under section 12 in either of two instances. Section 12(b) requires registration when a security becomes listed on a national securities exchange, and section 12(g) requires registration when the issuer has more than \$1,000,000 in assets and at least 500 shareholders. Securities Exchange Act of 1934 § 12(b), (g), 15 U.S.C. § 78l(b), (g) (1994). Rule 12g-1 modifies section 12(g)(1) to exempt from the registration requirement any issuer with assets not exceeding \$10,000,000. 17 C.F.R. § 240.12g-1.

33. Securities Exchange Act of 1934 § 16(b).

because it decreases agency costs by aligning managerial and shareholder incentives.³⁴ Second, it discourages insider transactions altogether, which keeps valuable information out of the market. But section 16(b) is not only overinclusive, it is also underinclusive. It has no impact on transactions outside the six-month period, even if they were in fact based on the improper use of inside information. Therefore, it would not require disgorgement of profits that were admittedly achieved by relying on inside information as long as the trades were spaced more than six months apart.

There is no sound basis for the statute's use of a six-month period rather than six weeks or six years, other than the intuition that inside information is likely either to lose its inside character and become public or to lose its trading value within a reasonably short period. In 1934, Congress apparently believed that the six-month period would capture a fairly large proportion of the transactions in which there might be an opportunity to profit from the use of inside information.³⁵ Were the issue to be revisited today, legislators might conclude that the short-swing period could be considerably shorter. Since 1934, there have been vast increases in the speed of communication and transportation. There is currently a large corps of market analysts who are vigilant in their search for information about the companies they follow. These developments, together with the SEC's trend toward encouraging companies to provide more forward-looking, "soft" information, might make it substantially more difficult to keep information secret for as long as six months. Therefore, Congress, were it enacting section 16(b) today, might well choose a shorter period.

A final problem with section 16 has to do with its enforcement. If an insider makes a short-swing profit as defined in section 16, any shareholder of the issuer may ask the issuer to require the insider to disgorge the profit.³⁶ If the company fails to do so within sixty days, the shareholder may file suit to compel

34. See generally Fox, *supra* note 16 (commenting that section 16(b) does reduce trades based on inside information, but that it also makes it less attractive for managers to own stock in their companies, which increases the agency costs of monitoring managers to make sure that they act in the best interests of shareholders).

There are strong theoretical reasons to believe that it is good social policy to encourage practices that increase managerial wealth when share price increases. A manager faced with a choice between an action that would increase shareholder wealth and one that would not is more likely to choose the one that does if that choice would increase her personal wealth as well. This flows from the most fundamental proposition in economics—that people are rational maximizers of their own wealth.

Id. at 2100.

35. See *Report of the Task Force on Regulation of Insider Trading, Part II: Reform of Section 16*, 42 BUS. LAW. 1087, 1130 (1987) [hereinafter *Report of the Task Force*].

36. Securities Exchange Act of 1934 § 16(b).

disgorgement.³⁷ Plaintiffs' attorneys are permitted to recover their fees in these actions,³⁸ so a "section 16 bar" has developed to handle disgorgement cases.³⁹ Attorneys who specialize in this work regularly examine filings made pursuant to section 16(a) in order to discover potential short-swing profits. They then procure a shareholder of the company to act as the nominal plaintiff, but the suit is often motivated by attorney fees rather than by any shareholder concern.⁴⁰ The nominal plaintiff need not even have been a shareholder at the time of the section 16(b) violation.⁴¹ The SEC has commented in favor of private actions, noting that they

37. Interestingly, the SEC itself has no authority to enforce section 16. 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....

Id.

38. Although the statute itself does not mandate recovery of attorney fees, courts have consistently allowed their recovery based on equitable considerations. *See, e.g.,* *Gilson v. Chock Full O'Nuts Corp.*, 326 F.2d 246, 248 (2d Cir. 1964), *modified in banc*, 331 F.2d 107 (2d Cir. 1964). One court has noted that, "[s]ince in many cases such as this the possibility of recovering attorney's fees will provide the sole stimulus for the enforcement of § 16(b), the allowance must not be too niggardly." *Smolowe v. Delendo Corp.*, 136 F.2d 231, 241 (2d Cir. 1943).

39. *See* Edward F. Giltenan, *A Frustrating Experience*, *FORBES*, Apr. 2, 1990, at 138 (describing an unsuccessful section 16 suit from the defendant's perspective); *see also* John C. Coffee, *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 *COLUM. L. REV.* 669 (1986) (suggesting that collusive or extortionate litigation might be reduced by shifting compensation for plaintiffs' attorneys away from hourly billing toward a percentage of the recovery).

40. In one case, if plaintiff won, his pro rata share of the corporation's recovery amounted to only \$1.10. Although plaintiff's attorney asserted that plaintiff had orally agreed to pay his fees if the suit was unsuccessful, the defendants claimed the suit was champertous, claiming that it was unreasonable to believe that, for such a negligible recovery, the plaintiff would risk being obligated for substantial attorney fees and costs if he lost. The court refused to allow the defendants to assert the defense of champerty, opining that

even if...[champerty] were fully capable of proof, it would be insufficient in law to defeat the suit. The action is brought on behalf of the corporation to protect the rights of stockholders and of the public. The relationship between his attorney and the plaintiff, who is the mere vehicle of recovery, cannot defeat the rights of the corporation and other stockholders, to whom the recovery accrues.

Magida v. Continental Can Co., 231 F.2d 843, 848 (2d Cir. 1956).

41. *See, e.g.,* *Jammies Int'l, Inc. v. Lazarus*, 713 F. Supp. 83 (S.D.N.Y. 1989) (plaintiff owned a single share of stock, which was purchased after the alleged short-swing trading). *See also* *Blau v. Rayette-Faberge, Inc.*, 389 F.2d 469 (2d Cir. 1968), in which an attorney was allowed to recover fees for his work in investigating and discovering a section 16(b) violation, even though no suit was filed—the corporation was able to persuade the

have the capacity to aid its enforcement of the securities laws and provide more protection to the public than it could on its budget alone.⁴² But even if private plaintiffs can in theory be a useful aid to the SEC in enforcing the securities laws, they pose some troubling issues in the section 16 context.

One issue is that the company may recover nothing, yet the plaintiff's attorney must still be paid out of company funds.⁴³ Another is that even if the insider is forced to disgorge a profit to the company, section 16 does not ensure that the profit was garnered by wrongfully using inside information. Since the statute provides a prophylactic, bright-line rule that depends on form rather than substance, no deliberate wrongdoing need be proven, and, in fact, may not exist. Therefore, the equities of allowing private enforcement of section 16 seem suspect; although the action is ostensibly to recover ill-gotten gains for the company, the gains may not be ill gotten in the sense of involving any conscious wrongdoing: the company may recover nothing, and the plaintiff's attorney may be the only one who gains—at the expense of the company the suit was nominally intended to benefit.

D. Benefits of Section 16

Although its shortcomings are obvious and plentiful, section 16 may provide some benefits. First, it may in some instances prevent trades based on inside information.⁴⁴ Insiders of large companies are routinely instructed by

insider to disgorge his profits without legal action. The *Blau* court noted that such fees should not be allowed for attorney efforts immediately following disclosure of such trades because it believed that corporations should have some incentive to uncover violations and pursue illegal profits on their own. “[O]nly when it is likely that the corporation would have done nothing” is it appropriate for a court to require the corporation to pay for an attorney's efforts in discovering a violation. *Id.* at 474.

42. In 1995, Arthur Levitt, Chairman of the SEC, testified before a House subcommittee in connection with passage of legislation that eventually was enacted as the Private Securities Litigation Enforcement Act of 1995. Chairman Levitt noted:

Besides serving as the primary vehicle for remedies against securities fraud, private actions also provide a “necessary supplement” to the Commission's own enforcement activities by serving to deter securities law violations. Private actions are crucial to the integrity of our disclosure system because they provide a direct incentive for issuers and other market participants to meet their obligations under the securities laws.

141 CONG. REC. D175-76 (daily ed. Feb. 10, 1995) (footnote omitted) (testimony of Arthur Levitt, Chairman of SEC); *see also* 141 CONG. REC. D273 (daily ed. Mar. 2, 1995) (testimony of former SEC member J. Carter Beese, Jr.) (“If we were to wholly eliminate private rights of action, as some commentators have suggested and rely solely on state law and the SEC's limited resources for enforcement of the federal securities laws, we run the risk of encouraging misconduct by market participants.” (footnote omitted)).

43. *See Gilson*, 326 F.2d 246; *Smolowe*, 136 F.2d at 241.

44. Henry Manne and others would argue that preventing such trades is not necessarily a benefit. *See, e.g.*, HENRY MANNE, INSIDER TRADING AND THE STOCK MARKET

company counsel about their section 16(a) obligations to file and the section 16(b) prohibitions on short-swing profits.⁴⁵ To the extent that insiders are aware of the strictures of section 16, they will doubtless try to avoid trades that create liability. This, of course, will eliminate both innocent and guilty trades—whether or not an insider is in possession of material nonpublic information, he or she will attempt to avoid a prohibited short-swing profit.

Second, the prohibition on short-swing profits tends to align insiders' incentives with creating long-term, rather than short-term, gain. Section 16(b) encourages insiders to hold their company's securities for longer than six months, at least if the market for those securities is rising. As a result, interest in maximizing the value of their own investments should encourage insiders to focus on achieving longer-term growth and profitability for their companies. Section 16(b) should thus have at least a slight tendency to encourage managers to invest company resources in research, development, invention, and innovation rather than in opportunities that provide quick profits but have less long-term value.

Section 16's most valuable contribution, however, is the information provided to the market in the form of section 16(a) reports. As discussed in greater detail below in Part IV.B, the news that insiders have bought or sold their company's securities has informational value. Even if trades by insiders are not based on specific nonpublic information, they are likely to be based on the most informed opinions available regarding the company's prospects. Therefore, section 16(a) reports provide insights into valuation that can inform the market as a whole.

(1966); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 861 (1983) (suggesting that allowing insider trading "may be an efficient way to compensate corporate managers").

45. See, e.g., ROBERT W. HAMILTON, CASES AND MATERIALS ON CORPORATIONS, INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS 1057 (5th ed. 1994).

Today, general counsel of issuers of registered securities regularly distribute cautionary memoranda to directors, officers, large shareholders, and employees who may have access to nonpublic material information. Since 1988, these memoranda have been virtually required by ITSFEA [the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677], but even before the enactment of that statute, such memoranda were widely used. They universally described the possible application of section 16(b), cautioning the reader of the dangers of inadvertent violations from innocent transactions and recommending that officers, directors, and ten percent shareholders obtain legal advice before exercising employee stock options, making gifts of securities, exercising conversion privileges, or generally acquiring or disposing of equity securities when any possible offsetting transactions exist.

Id.

III. SECTION 16(b) AND OTHER LAWS TO COMBAT INSIDER TRADING

Although section 16(a) provides valuable information to the market, section 16(b) may be unnecessary, both for the reasons already discussed, and because its function is duplicated or better accomplished by other laws. Several statutes and rules directly or indirectly prohibit the use of material nonpublic information in securities trading. Some of these are much more clearly focused on that problem than section 16. As a result, the limited role that section 16 could play in controlling the use of inside information in securities trading is already performed more fairly and efficiently by other regulation. The following sections identify some of these other provisions and briefly outline how each operates to deter insider trading.

A. Federal Securities Laws

1. Section 10(b) and Rule 10b-5

Section 10(b) is a general fraud provision that, like section 16, is part of the Securities Exchange Act of 1934. Rule 10b-5⁴⁶ was promulgated in 1943.⁴⁷ Although the rule covers all kinds of fraud in connection with securities transactions, it has frequently been employed in insider trading cases.⁴⁸ The cases make it clear that Rule 10b-5 prohibits the use, in connection with the purchase or

46. 17 C.F.R. § 240.10b-5 (1997). The Rule states:

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,

(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.

Id.

47. See *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967) (comments of Milton Freeman). These comments indicate that Rule 10b-5 was drafted in response to a situation in which a company president told shareholders the company was doing poorly, when it in fact was doing very well, in order to buy their stock at discounted prices.

48. See, e.g., *United States v. O'Hagan*, 117 S. Ct. 2199 (1997); *Carpenter v. United States*, 484 U.S. 19 (1987); *Dirks v. SEC*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980); *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (in banc); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

sale of securities, of material⁴⁹ information acquired by an officer or director of the company as a result of his or her relationship with the company⁵⁰ until that information has been effectively disseminated to the public.⁵¹ Section 10(b) and Rule 10b-5, unlike section 16, do not apply only to section 12 companies⁵² but are

49. "Materiality" for purposes of Rule 10b-5 was defined by the Supreme Court in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). Justice Blackmun noted that the Court had previously defined a standard of materiality in the case of *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), which involved a proxy solicitation. Adapting this standard to the Rule 10b-5 context, the Court held that "[a]n omitted fact is material if there is a substantial likelihood that a reasonable [investor] would consider it important" in making an investment decision. *Basic*, 485 U.S. at 231 (quoting *TSC Industries*, 426 U.S. at 449).

Recognizing that materiality can vary with the circumstances, the *Basic* Court approved the balancing approach for determining materiality set forth in *SEC v. Texas Gulf Sulphur Co.*, holding that, "with respect to contingent or speculative information or events,...materiality 'will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.'" *Id.* at 238 (quoting *Texas Gulf Sulphur*, 401 F.2d at 849).

50. See *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961) (an administrative proceeding by the SEC against a broker who had traded on information acquired from an insider). The SEC found that trading on inside information violated Rule 10b-5. It noted that the obligation to refrain from trading on inside information

rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.

Id. at 912.

51. See, e.g., *Texas Gulf Sulphur*, 401 F.2d 833. The court found TGS director Coates liable for insider trading even though he did not purchase the TGS securities until after the material inside information had been announced to the public.

The reading of a news release, which prompted Coates into action, is merely the first step in the process of dissemination required for compliance with the regulatory objective of providing all investors with an equal opportunity to make informed investment judgments. Assuming that the contents of the official release could instantaneously be acted upon, at the minimum Coates should have waited until the news could reasonably have been expected to appear over the media of widest circulation, the Dow Jones broad tape, rather than hastening to insure an advantage to himself and his broker son-in-law.

Id. at 854.

52. Section 10(b) provides that it is unlawful

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may

instead applicable to virtually all securities transactions.⁵³

Rule 10b-5 is limited by the concept of fiduciary duty.⁵⁴ One who trades on material nonpublic information without making any affirmative misstatement does not violate rule 10b-5 unless he or she has a duty to disclose the information before trading.⁵⁵ Classically, the plaintiff or prosecutor had to show that the defendant trader owed a fiduciary duty to the issuer. A recent United States Supreme Court opinion describes this understanding of Rule 10b-5:

Under the "traditional" or "classical theory" of insider trading liability, § 10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information.... The classical theory applies not only to officers, directors, and other permanent insiders of a corporation, but also to attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation.⁵⁶

Using this traditional theory, the United States Supreme Court held in 1980 that the employee of a financial printer who traded on nonpublic information he gleaned from his job had no liability under Rule 10b-5 because he had no relationship with the issuer or its shareholders that would create a duty to disclose.⁵⁷ Similarly, the Court held in the 1983 *Dirks*⁵⁸ case that a "tippee"—one

prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1994) (emphasis added).

53. The federal securities laws apply only when there is some use of the means of interstate commerce. A simple telephone call or use of the U.S. mail, however, will satisfy that jurisdictional requirement. As a result, nearly all securities transactions will be subject to Rule 10b-5.

54. See *In re Cady, Roberts & Co.*, 40 S.E.C. 907.

55. "[S]ilence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b).... But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction." *Chiarella v. United States*, 445 U.S. 222, 230 (1980).

56. *United States v. O'Hagan*, 117 S. Ct. 2199, 2207 (1997); see also, *United States v. Chestman*, 947 F.2d 551, 564-65 (2d Cir. 1991) (in banc).

57. *Chiarella*, 445 U.S. at 235. The Court noted that "a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information." *Id.*

[O]ne who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information "that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them."

Id. at 228 (alteration in original) (footnote omitted) (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)). Although the *Chiarella* decision confined its fiduciary duty inquiry, the recent *O'Hagan* case broadened the inquiry to ask whether the trader had misappropriated nonpublic information. Under the misappropriation theory, *Chiarella* would probably be found guilty today. See *O'Hagan*, 117 S. Ct. 2199.

58. *Dirks v. SEC*, 463 U.S. 646 (1983).

who receives material nonpublic information from an insider—does not violate Rule 10b-5 by trading on that information unless the insider “tipper” breached a fiduciary duty to the issuer in passing the information to the tippee.⁵⁹ These cases illuminated a sizeable gap in Rule 10b-5’s prohibition of trading on inside information. The SEC and many others felt considerable discomfort that persons like Chiarella, who had deliberately violated his employer’s rules by trading, could profit legally from using inside information.⁶⁰ This discomfort was eased when the Court decided the 1997 case of *United States v. O’Hagan*.⁶¹ In *O’Hagan*, the Court adopted the broader reading advocated by Chief Justice Burger in *Chiarella*,⁶² holding that Rule 10b-5 may be employed to prosecute persons who trade on nonpublic information, even if those persons have no relationship to the issuer, if they “misappropriated” the information.⁶³

O’Hagan arose out of the tender offer by Grand Metropolitan PLC for the stock of the Pillsbury Company. Grand Metropolitan retained Dorsey & Whitney, the Minneapolis law firm of which O’Hagan was a member, to represent it. Although O’Hagan did not work on the project (and his law firm actually resigned from the representation before the tender offer occurred), he became aware that the tender offer was contemplated. He purchased stock and call options for Pillsbury stock, and when the tender offer was announced, reaped profits exceeding \$4.3 million. He was prosecuted in federal court, was convicted on 57 counts of mail fraud, securities fraud, and money laundering, and was sentenced to prison. He appealed, and the Eighth Circuit reversed the lower court on all counts, finding, among other things, that because O’Hagan had no relationship to Pillsbury (the company whose securities he traded) he was not guilty of violating Rule 10b-5.⁶⁴

59. In *Dirks*, Ron Secrist, an employee of Equity Funding of America, a large insurance company, disclosed to Dirks that his company was involved in fraud of massive dimensions. *Id.* at 649. Dirks investigated Secrist’s charges and tried to convince the *Wall Street Journal* to publicize the story, but it declined for fear of libel actions. *Id.* at 649–50. Dirks owned no Equity Funding stock himself, but he advised his clients to sell their Equity Funding stock. *Id.* at 651. In an action against Dirks for trading on the nonpublic information, the Court held that Secrist had breached no duty to Equity Funding when he disclosed the wrongdoing, so Dirks had not violated Rule 10b-5 by trading on the information. *Id.* at 667.

60. Indeed, in a dissenting opinion, Chief Justice Burger advocated for a broader reading of § 10(b) and Rule 10b-5 “to mean that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or refrain from trading.” *Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting). However, the majority opinion noted that this “misappropriation” theory was not submitted to the jury, and thus could not be the basis for affirming *Chiarella*’s criminal conviction. *Id.* at 235–36.

61. 117 S. Ct. 2199 (1997).

62. See *supra* note 60.

63. *O’Hagan*, 117 S. Ct. at 2210–11.

64. *United States v. O’Hagan*, 92 F.3d 612 (1996), *rev’d*, 117 S. Ct. 2199 (1997).

The Supreme Court granted certiorari and reversed the appellate court. Writing for the majority, Justice Ginsburg noted that even though O'Hagan had no relationship with Pillsbury that would give rise to a fiduciary duty, he did have such a relationship with his employer, Dorsey & Whitney.

The "misappropriation theory" holds that a person commits fraud "in connection with" a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.... In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information.⁶⁵

Although the Supreme Court had been asked twice previously to rule on the validity of the misappropriation theory as a basis for Rule 10b-5 liability, it had determined that the issue was not appropriately before it in *Chiarella*,⁶⁶ and had split evenly on the theory's validity in *Carpenter v. United States*.⁶⁷ In *O'Hagan*, however, the Court finally settled the question by holding that the misappropriation theory as described above "satisfies § 10(b)'s requirement that chargeable conduct involve a 'deceptive device or contrivance' used 'in connection with' the purchase or sale of securities."⁶⁸

Rule 10b-5 differs substantially from section 16 in that it focuses on individual securities transactions rather than on regulating a whole class of transactions. This tighter regulatory aim has both positive and negative consequences. As with any bright-line rule, section 16 is overbroad and generalized in application, while Rule 10b-5 is able to distinguish between facially similar situations to consider the merits of a particular case. However, this makes liability more difficult to prove under Rule 10b-5 than under section 16, making it a more expensive, if more just, avenue for litigation.

Rule 10b-5 has a broader reach than section 16, because it is not limited to either statutorily defined insiders or to section 12 companies. It focuses directly on insider trading that meets its fraud regime, rather than using the position of the trader and the timing of the transactions as proxies for an inquiry into the facts. But Rule 10b-5 may also be narrower than section 16 in one sense because it does not impose liability for trading on inside information without disclosing the information to the other party to the trade unless there is a breach of fiduciary duty.

65. *O'Hagan*, 117 S. Ct. at 2207.

66. *See supra* note 60.

67. 484 U.S. 19 (1987).

68. *O'Hagan*, 117 S. Ct. at 2208.

2. *Section 14(e) and Rule 14e-3*

Section 14(e) of the Securities Exchange Act of 1934 is designed to prevent fraud in connection with tender offers.⁶⁹ Pursuant to section 14(e), the SEC promulgated Rule 14e-3⁷⁰ in 1980, which is similar to, but both broader and narrower than, Rule 10b-5. Rule 14e-3 deems it a "fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e)" for any person

in possession of material information relating to [a] tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from (1) the offering person, (2) the issuer of the securities sought...by such tender offer, or (3) any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell...any of such securities..., unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed....⁷¹

Rule 14e-3 is narrower than Rule 10b-5 in that it applies only to tender offers, not to all securities transactions. But Rule 14e-3 is broader than Rule 10b-5 in that it does not require that any relationship exist that would create a duty to disclose the information or abstain from trading.⁷² Until recently, there had been considerable discussion in the courts as to whether the SEC exceeded its rulemaking authority when it promulgated Rule 14e-3, but the United States Supreme Court has now held that the rule is valid.⁷³

69. Section 14(e) provides:

It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

Securities Exchange Act of 1934 § 14(e), 15 U.S.C. § 78n(e) (1994).

70. 17 C.F.R. § 240.14e-3 (1997).

71. *Id.*

72. *See* United States v. Chestman, 947 F.2d 551, 557 (2d Cir. 1991) (in banc).

73. *O'Hagan*, 117 S. Ct. at 2214. Before the *O'Hagan* decision, three appeals courts had found that the SEC did not exceed its rulemaking authority. *See* SEC v. Maio, 51 F.3d 623, 634-35 (7th Cir. 1995); SEC v. Peters, 978 F.2d 1162, 1165-67 (10th Cir. 1992); *Chestman*, 947 F.2d 551. However, one appeals court had found that the SEC did exceed its authority by redefining fraud to exclude the requirement of breach of fiduciary duty. *United States v. O'Hagan*, 92 F.3d 612 (8th Cir. 1996), *rev'd*, 117 S. Ct. 2199 (1997).

When compared with sections 16 and 10(b), does Rule 14e-3 provide additional deterrence of insider trading, or is it merely duplicative? For officers and directors, Rule 14e-3 does not appreciably expand the scope of their liability to their shareholders because they already owe fiduciary duties to those shareholders, so Rule 10b-5 would apply. Rule 14e-3 might provide additional liability in a situation in which officers and directors of one company trade in the securities of another company, on the theory that they would not owe fiduciary duties to the security holders of the other company. The other section 16 insiders, 10% shareholders,⁷⁴ would not generally owe fiduciary duties to the issuer's other shareholders unless they are considered "controlling" shareholders.⁷⁵ Thus, they would not be subject to Rule 10b-5 liability for nondisclosure of material inside information.⁷⁶ Therefore, Rule 14e-3 should provide additional deterrence of insider trading by noncontrolling 10% shareholders.

3. Section 13(d) and Schedule 13D

Subsection (d) of section 13 of the 1934 Act⁷⁷ was added in 1968 as part of the Williams Act.⁷⁸ The Williams Act was intended to regulate tender offers and to provide more information to shareholders of target companies, but its application is broad enough to require substantial purchasers to provide information on their acquisitions, even if the purchasers are not contemplating tender offers. Specifically, section 13(d) requires any person or group who acquires more than 5% of a class of equity securities registered under section 12 to report the acquisition to the SEC, the issuer, and the exchanges on which the security trades.⁷⁹ The report, on Schedule 13D, must disclose information about

74. Securities Exchange Act of 1934 § 16(a), 15 U.S.C. § 78p(a) (1994).

75. See, e.g., *Freese v. Smith*, 428 S.E.2d 841, 847 (N.C. Ct. App. 1993) ("As a general rule, shareholders do not owe a fiduciary duty to each other or to the corporation. However, this rule is not without exception." (citation omitted)); *Zahn v. Transamerica Corp.*, 162 F.2d 36, 43 (3d Cir. 1947) (The court held that, whether they are directors or controlling stockholders, "those in charge of a corporation stand in a fiduciary relation to its minority stockholders."); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971) (holding that, as a controlling shareholder, Sinclair owed a fiduciary duty to its majority-owned subsidiary, Sinclair Venezuelan Oil Company ("Sinven"), and that, when it engaged in a transaction with Sinven that permitted Sinclair to receive a benefit to the exclusion and detriment of Sinven's minority shareholders, it had an obligation of "intrinsic fairness," that is, the burden of proof that its transactions with Sinven were objectively fair).

76. That is, unless they misappropriated the information, see *O'Hagan*, 117 S. Ct. 2199 (holding that a lawyer who traded on misappropriated information acquired from his firm's client was guilty of Rule 10b-5 violations), or breached a duty in using it, see *Chiarella v. United States*, 445 U.S. 222 (1980) (holding that the employee of a financial printer was not liable under Rule 10b-5 for trading on material nonpublic information because he owed no fiduciary duty to the issuer or its shareholders).

77. Securities Exchange Act of 1934 § 13(d), 15 U.S.C. § 78m(d) (1994).

78. Pub. L. No. 90-439, § 2, 82 Stat. 454, 454-55 (1968).

79. Securities Exchange Act of 1934 § 13(d)(1).

the acquiring person or group, the funds used to make the acquisitions, and the acquirer's purpose in acquiring the securities.⁸⁰ It must be filed within ten days after the acquirer's beneficial ownership exceeds 5% of the class of securities,⁸¹ and it must be "promptly" amended⁸² whenever there is any material change in its contents. A material change in ownership is defined as one that increases or decreases the filer's holdings by 1% or more.⁸³

The reporting requirements of section 13(d) operate much as the reporting requirements of section 16 do, in that they publicize trading activity. As section 13(d) requires a report within ten days after the filer becomes a 5% beneficial owner, it requires a filing much sooner than section 16. It requires filings of smaller holders (5%) than section 16 (10%), so it casts a wider net for substantial beneficial owners. However, section 13(d) does not require officers and directors who are not 5% holders to file reports of their trades, so it does not provide the publicity with respect to those trades that section 16 does. This is a significant shortcoming because management trades are generally better information regarding company value than are substantial outsider trades, unless the outsiders are planning a coup. Managers have better information than outsiders do, both quantitatively and qualitatively, and they also have much greater capacity to be instrumental in their company's future than a nonemployee, 5% shareholder.

4. *Restricted Stock and Rule 144*

The 1933 Act generally prohibits the offer or sale of securities without registration, but provides exemptions from the registration requirements for various transactions or types of securities. Corporate employees frequently acquire unregistered securities from their companies as part of their compensation. Although the initial transfer from the company to the employee may be exempt from registration, these securities are "restricted" because they cannot be resold by the employee without either registration or an exemption from registration. Both sales by "affiliates"⁸⁴ of either registered or restricted securities and sales by

80. *Id.* § 13(d)(1)(A)-(E).

81. *Id.* § 13(d)(1).

82. 17 C.F.R. § 240.13d-2(a) (1997).

83. *Id.*

84. "An 'affiliate' of an issuer is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer." 17 C.F.R. § 230.144(a)(1) (1997). "Control" is defined in Rule 405 to mean "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." *Id.* § 230.405 (1997). Whether an officer, director, or 10% shareholder has "control" sufficient to be an "affiliate" is a question of fact, but the general view is that there is a presumption that such persons are affiliates unless they prove otherwise. See 3 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3D.2.a.(i), at 1514 (3d ed. 1995). The SEC commented in a 1972 letter:

[A] person's status as an officer, director, or owner of 10% of the voting securities of a company is not necessarily determinative of whether such

nonaffiliates of restricted securities may be accomplished without registration through the safe harbor of Rule 144.⁸⁵ Rule 144 provides a mechanism for the seller to avoid classification as an "underwriter"⁸⁶ and thereby makes available the exemption from registration provided by section 4(1) of the 1933 Act.⁸⁷

Although the adoptive release for Rule 144 does not specify the restriction of insider trading as one of the rule's purposes, it does include the prevention of fraud,⁸⁸ and the rule's effect is in some ways similar to that of section 16(b). Rule 144 requires that restricted securities, or any securities sold by affiliates, be held for at least one year.⁸⁹ Even after the holding period is satisfied, the securities may be sold only in quantities unlikely to affect the market price until they have been held for at least two years, at which time nonaffiliates may sell without regard to volume limitations.⁹⁰

These holding period and "trickle-out" provisions, even if not enacted for the same reasons, are likely to mirror some of the consequences of section 16's six-month profit prohibition. They should also create some of the same incentive effects as section 16(b). Insiders who must hold their securities for a significant period and who, thus, cannot sell them into the market quickly have an increased incentive to work for the long-term profitability of their company. The sales restrictions are also likely to diminish trading based on nonpublic information

person is a control person.... [S]tatus as a control person...must be determined by considering other relevant facts in accordance with the test set forth in Rule 405....

American-Standard, [1972-73 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,071 (Oct. 11, 1972).

85. 17 C.F.R. § 230.144.

86. Underwriter is defined very broadly in section 2(11) of the 1933 Act to include anyone who acquires securities from the issuer "with a view to, or offers or sells for an issuer in connection with,...or participates or has a direct or indirect participation in" their distribution. *See* Securities Act of 1933 § 2(11), 15 U.S.C. § 77b(11) (1994).

87. Section 4(1) exempts from the registration requirement "transactions by any person other than an issuer, underwriter, or dealer." *Id.* § 4(1), 15 U.S.C. § 77d(1) (1994).

88. *See* Notice of Adoption of Rule 144, Securities Act Release No. 33-5223 (Jan. 11, 1972), available in 1972 WL 18134.

Rule 144 is designed to implement the fundamental purposes of the Act as expressed in its preamble: "To provide full and fair disclosure of the character of the securities sold in interstate commerce and through the mails, and to prevent fraud in the sale thereof...." The rule would also operate to inhibit the creation of public markets in securities of issuers concerning which adequate current information is not available to the public.

Id.

89. 17 C.F.R. § 230.144(d).

90. *Id.* § 230.144(k). Note that the one-year and two-year holding periods referred to here were amended in 1997; prior to that time, the holding periods were two and three years, respectively. *See* Revision of Holding Period Requirements in Rules 144 and 145, Securities Act Release No. 33-7390, 62 Fed. Reg. 9242, 9244-45 (1997) (to be codified at 17 C.F.R. pt. 230).

whose value is limited in time because they limit insiders' abilities to time their sales.

B. Other Federal Laws

1. Mail and Wire Fraud Statutes

The federal mail fraud⁹¹ and wire fraud⁹² statutes have proven to be helpful in criminal prosecutions of insider trading.⁹³ In a celebrated case, a *Wall Street Journal* reporter named Foster Winans collaborated with several others to trade on information he created for an investment advice column⁹⁴ before it was published.⁹⁵ He was prosecuted under section 10(b) of the 1934 Act and Rule 10b-5 but also under the mail fraud and wire fraud statutes. The District Court convicted Winans on all charges,⁹⁶ and the Second Circuit affirmed,⁹⁷ finding section 10(b) violations based on a misappropriation theory.⁹⁸ The United States

91. 18 U.S.C. § 1341 (1994) provides:

Whoever, having devised or intending to devise any scheme or artifice to defraud,...for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service,...or takes or receives therefrom, any such matter or thing,...shall be fined under this title or imprisoned not more than five years, or both.

92. 18 U.S.C. § 1343 (1994) provides:

Whoever, having devised or intending to devise any scheme or artifice to defraud,...transmits or causes to be transmitted by means of wire, radio, or television communication in interstate or foreign commerce, any writings, signs, signals, pictures, or sounds for the purpose of executing such scheme or artifice, shall be fined under this title or imprisoned not more than five years, or both.

93. Neither the mail fraud nor the wire fraud statutes provides an express, or gives rise to an implied, private right of action. *See, e.g.,* Ryan v. Ohio Edison Co., 611 F.2d 1170, 1179 (6th Cir. 1979) ("The paucity of legislative intent or any other kind of evidence indicating intent to create a private cause of action forces this court to conclude Congress did not intend to create a private cause of action for plaintiffs under the Mail Fraud Statute."); Napper v. Anderson, Henley, Shields, Bradford & Pritchard, 500 F.2d 634, 636 (5th Cir. 1974) (holding no private cause of action under Wire Fraud Act, 18 U.S.C. § 1343).

94. There is some irony in prosecuting Winans for leaking information that would be published in a column entitled *Heard on the Street*.

95. Carpenter v. United States, 484 U.S. 19 (1987).

96. United States v. Winans, 612 F. Supp. 827 (S.D.N.Y. 1985), *rev'd in part sub nom.* United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986).

97. United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987).

98. The misappropriation theory permits courts to find violations of Rule 10b-5 in the absence of a fiduciary relationship between the trader and the issuer by locating a

Supreme Court affirmed the mail and wire fraud convictions.⁹⁹ The Court split evenly on the securities law claims, so the Second Circuit's decision on those claims was left intact.¹⁰⁰ It was therefore not clear until recently whether the Supreme Court would recognize misappropriation as a valid theory of liability under section 10(b).¹⁰¹ It was clear, however, that the mail and wire fraud statutes could provide alternative means for prosecuting insider trading.¹⁰² The viability of mail and wire fraud as causes of action to deter insider trading was affirmed by the United States Supreme Court in *O'Hagan*, a closely watched 1997 decision.¹⁰³

2. RICO

The Racketeer Influenced and Corrupt Organizations Act ("RICO")¹⁰⁴ is a broad umbrella statute allowing criminal prosecution and civil proceedings by

breach of fiduciary duty elsewhere. *See supra* text accompanying note 65. In *Carpenter*, Winans owed a duty to his employer, the *Wall Street Journal*, which had an explicit policy forbidding the disclosure of information before its publication. Winans was aware of the policy and in fact had reported occasional leaks in the past. The appeals court found that Winans' breach of duty to his employer constituted a breach of fiduciary duty upon which a Rule 10b-5 action could be based. *Carpenter*, 791 F.2d at 1034.

99. *Carpenter*, 484 U.S. at 27.

100. *Id.* at 24.

101. It is now clear that misappropriation is a valid theory for criminal liability under Rule 10b-5. *See* *United States v. O'Hagan*, 117 S. Ct. 2199 (1997); *supra* notes 61-68 and accompanying text.

102. Mail fraud was also used in *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (in banc). *Chestman* was another insider trading case in which Rule 10b-5 was problematic. *Chestman*, a stock broker, received inside information from a customer that the customer had received from his wife. The court found that the customer owed no fiduciary duty to his wife, and hence had not breached a duty by disclosing the information to *Chestman*. *Id.* at 570-71. Under the holding in *Dirks v. SEC*, 463 U.S. 646 (1983), a tippee breaches a fiduciary duty only when the tipper breached a duty in disclosing the information to the tippee. Therefore, *Chestman* was not liable under Rule 10b-5 or under the mail fraud statute. *Chestman*, 947 F.2d at 571.

The same fraudulent scheme that underlay the Rule 10b-5 convictions also was the basis for the mail fraud convictions. A scheme to misappropriate material nonpublic information in breach of a fiduciary duty of confidentiality may indeed constitute a fraudulent scheme sufficient to sustain a mail fraud conviction.... However, whatever ethical obligation...[the customer owed to his family], it was too ethereal to be protected by either the securities or mail fraud statutes.

Id. *Chestman*'s Rule 14e-3 conviction was affirmed because it did not require a showing of any breach of fiduciary duty. *See infra* Part III.A.2.

103. *United States v. O'Hagan*, 117 S. Ct. 2199 (1997). As in *Chestman*, the *O'Hagan* appellate court had struck down the mail fraud, wire fraud, and Rule 10b-5 convictions, *United States v. O'Hagan*, 92 F.3d 612, 628 (8th Cir. 1996), *rev'd*, 117 S. Ct. 2199 (1997), but the Supreme Court reinstated them, *O'Hagan*, 117 S. Ct. at 2220.

104. 18 U.S.C. §§ 1961-1968 (1994).

the Attorney General¹⁰⁵ as well as private rights of action¹⁰⁶ against persons who engage in a pattern of racketeering activity¹⁰⁷ involving violations of specified state or federal statutes that constitute “predicate offenses.”¹⁰⁸ To prove a RICO case, the prosecutor or plaintiff must allege one or more of four categories of “prohibited activities.”¹⁰⁹ These prohibited activities include investing ill-gotten gains in any enterprise which is engaged in or whose activities affect interstate or foreign commerce, acquiring an interest in such an enterprise through a pattern of racketeering activity, conducting the affairs of such an enterprise through a pattern of racketeering activity, or conspiring to violate any of these prohibitions.¹¹⁰ Securities fraud is listed among the offenses that are predicate offenses for RICO liability.¹¹¹ However, when Congress passed the Private Securities Litigation Reform Act of 1995,¹¹² it limited private plaintiffs’ resort to RICO by eliminating securities fraud as a predicate offense for private actions unless the securities fraud has resulted in a criminal conviction of the defendant.¹¹³ Outside the context of a

105. *Id.* §§ 1963–1964.

106. *Id.* § 1964. Note that plaintiffs may use RICO to bring actions for violations of other statutes that themselves do not provide a private right of action. *See, e.g.,* Delta Educ., Inc. v. Langlois, 719 F. Supp. 42, 50 (D.N.H. 1989) (“RICO specifically provides for a private cause of action, see 18 U.S.C. § 1964(c), and its existence does not affect the availability of an implied private cause of action for mail fraud. The plaintiff may allege mail fraud as the predicate acts for its RICO claim, but the mail fraud allegations themselves do not state a separate cause of action.”).

107. 18 U.S.C. § 1961(5). The “pattern of racketeering activity” element requires that the defendant have engaged in at least two acts defined as predicate offenses and that the acts establish a threat of continued racketeering activity. *See, e.g.,* Fujisawa Pharm. Co. v. Kapoor, 115 F.3d 1332, 1338 (7th Cir. 1997) (discussing the meaning of “pattern” under RICO); *In re Motel 6 Sec. Litig.*, [1997] Fed. Sec. L. Rep. (CCH) ¶ 99,454 (S.D.N.Y. 1997), available in 1997 WL 154011, at *4 (“Whether...[predicate] acts establish a threat of continued racketeering activity depends on the facts of each case....” (citation omitted)).

108. The predicate offenses are listed under the definition of “racketeering activity.” Several have been useful in dealing with insider trading. “As used in this chapter...‘racketeering activity’ means...(B) any act which is indictable under any of the following provisions of title 18, United States Code:...section 1341 (relating to mail fraud), section 1343 (relating to wire fraud),...(D) any offense involving...fraud in the sale of securities....” 18 U.S.C. § 1961 (1994).

109. *Id.* § 1962.

110. *Id.*

111. *See generally* Arthur F. Mathews, *Shifting the Burden of Losses in the Securities Markets: The Role of Civil RICO in Securities Litigation*, 65 NOTRE DAME L. REV. 896, 943 (1990) (discussing the availability of RICO in securities fraud cases).

112. Pub. L. No. 104–67, 109 Stat. 737 (1995).

113. *See* 18 U.S.C.A. § 1964(c) (West Supp. 1997).

Any person injured in his business or property by reason of a violation of section 1962 of this chapter may sue therefor in any appropriate United States district court and shall recover threefold the damages he sustains and the cost of the suit, including a reasonable attorney’s fee, except that no person may rely upon any conduct that would have been

private action, however, securities fraud remains available to prosecutors as a RICO predicate offense.

3. *Other Laws*

Although the statutes and rules mentioned above are perhaps the most often employed means of deterring trading on material nonpublic information, there are no doubt other laws that could be pressed into service, given appropriate facts. For instance, in addition to mail fraud, wire fraud, and Rule 10b-5 counts, the federal conspiracy statute¹¹⁴ was successfully used to prosecute Foster Winans and David Carpenter when they entered into a scheme to trade on information developed for Winans' *Heard on the Street* column before the column was published in the *Wall Street Journal*.¹¹⁵ James O'Hagan was prosecuted not only under Rules 10b-5 and 14e-3 but also under the federal mail fraud¹¹⁶ and money laundering¹¹⁷ statutes.¹¹⁸

C. *State Laws*

1. *Blue Sky Laws*

Some states' securities laws provide for criminal and/or civil liability for insider trading. One such state is California, which provides for civil liability against any insider who purchases or sells a security when the insider is in possession of material nonpublic information about the issuer that would

actionable as fraud in the purchase or sale of securities to establish a violation of section 1962. The exception contained in the preceding sentence does not apply to an action against any person that is criminally convicted in connection with the fraud, in which case the statute of limitations shall start to run on the date on which the conviction becomes final.

Id.

114. 18 U.S.C. § 371 (1994).

115. *Carpenter v. United States*, 484 U.S. 19 (1987).

116. 18 U.S.C. § 1341 (1994).

117. *Id.* §§ 1956(a)(1)(B)(i), 1957 (1994).

118. *United States v. O'Hagan*, 117 S. Ct. 2199 (1997). O'Hagan was convicted of money laundering, as well as mail fraud and securities fraud, but the money laundering convictions were reversed by the Eighth Circuit because it concluded that the securities fraud counts on which the money laundering charges were based were insupportable. *See United States v. O'Hagan*, 92 F.3d 612, 614 (8th Cir. 1996) ("The mail fraud counts are structured in the indictment to hinge on the validity of the securities fraud counts, and the money laundering counts in turn are dependent upon the mail fraud or securities fraud counts. Accordingly, we vacate all of O'Hagan's convictions."). The Supreme Court has now reinstated the securities law and mail fraud convictions, but the United States did not seek review of the money laundering convictions, so the Supreme Court did not reinstate those convictions. *O'Hagan*, 117 S. Ct. at 2219 n.24.

significantly affect the security's market price.¹¹⁹ An insider is defined to include the issuer itself or any officer, director, or controlling person or other person whose relationship to the issuer provides access to information about the issuer that is not generally available to the public.¹²⁰ Damages for violation of these provisions are measured by the difference between the price paid and the value of the securities if the market had processed the nonpublic information in advance of the trade.¹²¹ California also provides for recovery by the issuer from the inside trader of up to three times the difference between the transaction price and the market value of the securities if the market had incorporated the inside information.¹²²

119. California's statute includes the following provisions:

It is unlawful for an issuer or any person who is an officer, director or controlling person of an issuer or any other person whose relationship to the issuer gives him access, directly or indirectly, to material information about the issuer not generally available to the public, to purchase or sell any security of the issuer in this state at a time when he knows material information about the issuer gained from such relationship which would significantly affect the market price of that security and which is not generally available to the public, and which he knows is not intended to be so available, unless he has reason to believe that the person selling to or buying from him is also in possession of the information.

CAL. CORP. CODE § 25402 (Deering 1996).

Any person who violates Section 25402 shall be liable to the person who purchases a security from him or sells a security to him, for damages equal to the difference between the price at which such security was purchased or sold and the market value which such security would have had at the time of the purchase or sale if the information known to the defendant had been publicly disseminated prior to that time and a reasonable time had elapsed for the market to absorb the information, plus interest at the legal rate, unless the defendant proves that the plaintiff knew the information or that the plaintiff would have purchased or sold at the same price even if the information had been revealed to him.

Id. § 25502 (Deering 1996).

120. *Id.* § 25402.

121. *Id.* § 25502.

122. *Id.* § 25502.5. This liability will be reduced by any amounts paid by the defendant pursuant to an SEC proceeding under the Insider Trading Sanctions Act of 1984. *Id.* § 25502.5(b). The section also provides that the defendant is liable for reasonable costs and attorney fees. *Id.* § 25502.5(a). The action may be brought either directly by the issuer or derivatively by a shareholder of the issuer. *Id.* Section 25502.5 applies only to issuers with more than \$1,000,000 in assets and a class of equity securities held by at least 500 persons. *Id.* § 25502.5(d).

Another Blue Sky Law cause of action is available in states that have adopted the Uniform Securities Act.¹²³ Section 501 of the Uniform Securities Act¹²⁴ is nearly identical to Rule 10b-5, and section 605¹²⁵ of the Act provides an express private right of action for violation of section 501(2).¹²⁶ One such state is Washington.¹²⁷ Cases arising in Washington have limited the right to sue to the

123. UNIF. SEC. ACT (1956) (superseded 1985), 7B U.L.A. 509 (1985). The Uniform Securities Act was drafted by the National Conference of Commissioners on Uniform State Laws and originally released for adoption by the states in 1956. It requires issuers to register or seek an exemption from registration for their securities offerings, *id.* § 301; it requires securities professionals to register, *id.* § 201; it creates civil and criminal liability for fraud and other violations, *id.* §§ 409-410; and it establishes an agency to administer the Act, *id.* § 406. Thirty-nine states have adopted the Act in part or in its entirety; two major exceptions are New York and California. See LOUIS LOSS, COMMENTARY ON THE UNIFORM SECURITIES ACT (1976), for an analysis of the Act. The Act was substantially revised in 1985, but the revised version has not received wide acceptance. See Mark A. Sargent, *Some Thoughts on the Revised Uniform Securities Act*, 14 SEC. REG. L.J. 62 (1986). Although the Act is called a "uniform" act, in fact, many states have adopted it with substantial variations. *See id.* at 74.

124. UNIF. SEC. ACT (1985) § 501 (amended 1988), 7B U.L.A. 144 (Supp. 1997).

In connection with an offer to sell, sale, offer to purchase, or purchase, of a security, a person may not, directly or indirectly:

(1) employ a device, scheme, or artifice to defraud;

(2) make an untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made not misleading, in the light of the circumstances under which they are made; or

(3) engage in an act, practice, or course of business that operates or would operate as a fraud or deceit upon a person.

Id.

125. *Id.* § 605, 7B U.L.A. 151 (Supp. 1997).

(a) A person who offers to sell or sells a security in violation of Section...501(2)...is liable to one who purchases the security from that person. Upon tender of the security, the purchaser may recover the consideration paid...and interest at the legal rate...from the date of payment, costs, and reasonable attorney's fees as determined by the court, less the amount of income received on the security.... A purchaser who no longer owns the security may recover damages.

Id. § 605(a).

126. Note that the Act only permits a purchaser to sue a seller; it does not provide for a cause of action by the seller when the *purchaser* acts in violation of section 501. *See id.* § 605.

127. Washington's counterpart to section 501 of the Uniform Security Act is found at section 21.20.010 of the Washington Revised Code, and its counterpart to section 605 of the Uniform Securities Act is at section 21.20.430 of the Washington Revised Code. § 21.20.010. Unlawful offers, sales, purchases

express private right of action provided.¹²⁸

2. Common Law Actions Based on Fraud, Agency, or Breach of Fiduciary Duty

As it has been used to handle insider trading, Rule 10b-5 is similar to a common law fraud cause of action.¹²⁹ For fraud, the plaintiff must prove that (1) the defendant acted with scienter¹³⁰ in misrepresenting the truth to the plaintiff (or

It is unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly:

(1) To employ any device, scheme, or artifice to defraud;

(2) 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 are made, not misleading; or

(3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

WASH. REV. CODE § 21.20.010 (1989).

§ 21.20.430. Civil liabilities—Survival, limitation of actions—Waiver of chapter void—Scienter

(1) Any person who offers or sells a security in violation of any provisions of RCW 21.20.010...is liable to the person buying the security from him or her, who may sue either at law or in equity....

(2) Any person who buys a security in violation of the provisions of RCW 21.20.010 is liable to the person selling the security to him or her, who may sue either at law or in equity....

WASH. REV. CODE § 21.20.430 (1989).

128. See *Wade v. Skipper's, Inc.*, 915 F.2d 1324 (9th Cir. 1990); *Ludwig v. Mutual Real Estate Investors*, 567 P.2d 658 (Wash. Ct. App. 1977), *overruled en banc on other grounds by Kittilson v. Ford*, 608 P.2d 264 (Wash. 1980).

129. Chapter 22 (Misrepresentation and Nondisclosure Causing Pecuniary Loss) of the RESTATEMENT (SECOND) OF TORTS (1976) outlines the various causes of action and criteria for proving a *prima facie* case in tort for fraud. The principal liability provision is section 525 (Liability for Fraudulent Misrepresentation).

One who fraudulently makes a misrepresentation of fact, opinion, intention or law for the purpose of inducing another to act or to refrain from action in reliance upon it, is subject to liability to the other in deceit for pecuniary loss caused to him by his justifiable reliance upon the misrepresentation.

Id. § 525.

130. The RESTATEMENT (SECOND) OF TORTS defines a "fraudulent" misrepresentation as one in which its maker:

(a) knows or believes that the matter is not as he represents it to be,

(b) does not have the confidence in the accuracy of his representation that he states or implies, or

(c) knows that he does not have the basis for his representation that he states or implies.

in failing to disclose information, if the defendant had a duty to the plaintiff to make such disclosure),¹³¹ (2) the defendant intended the plaintiff to rely on the misrepresentation, (3) the plaintiff did in fact rely on the misrepresentation, and (4) the plaintiff suffered pecuniary harm as a result.¹³²

One problem with common law fraud as a basis for an insider trading suit is that the defendant generally has not made *any* representation to the plaintiff, true or false. In a normal market trade, the defendant places an order with his or her broker to buy or sell securities. The plaintiff independently places an order with his or her broker to buy or sell securities, and the fact that the two orders result in a matched trade is sheer happenstance.

Even if the defendant makes no affirmative misstatement, however, the plaintiff may be able to prevail under a common law fraud theory. A misrepresentation may be understood to include an omission when there is a duty to speak.¹³³

Under agency or fiduciary duty theories, the plaintiff would assert that the defendant's status as an officer, director, or controlling shareholder creates a duty to act solely for the benefit of the corporation and its shareholders, and not for the insider's own benefit. This duty would obligate the insider to disclose any nonpublic information that provided a bargaining advantage to the insider before he or she traded in the company's securities. Therefore, the fiduciary relationship would create a duty to disclose, and failure to disclose would then fulfill the "misrepresentation" element of a fraud action.

*Goodwin v. Agassiz*¹³⁴ was a case brought under this theory. Agassiz was the president and director of Cliff Mining Company; his codefendant

Id. § 526. The concept defined here is the same as what the courts call scienter. *See id.* § 526 cmt. a.

131. *See infra* note 133 and accompanying text.

132. *See* RESTATEMENT (SECOND) OF TORTS § 525.

133. *See id.* § 551.

(1) One who fails to disclose to another a fact that he knows may justifiably induce the other to act or refrain from acting in a business transaction is subject to the same liability to the other as though he had represented the nonexistence of the matter that he has failed to disclose, if, but only if, he is under a duty to the other to exercise reasonable care to disclose the matter in question.

(2) One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated,

(a) matters known to him that the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them; and

(b) matters known to him that he knows to be necessary to prevent his partial or ambiguous statement of the facts from being misleading....

Id.

134. 186 N.E. 659 (Mass. 1933).

MacNaughton was a director and general manager. They were aware of a geologist's theory that the company's land might contain copper deposits, and they believed that, if the theory proved accurate, the company's value would increase substantially. Consequently, they bought shares of the company's stock through the Boston Stock Exchange. Goodwin, a Cliff shareholder, sold his shares in response to a newspaper article indicating that the company had ceased certain exploratory operations. There was no evidence that the defendants were responsible for the article or had any awareness that they were purchasing stock formerly owned by Goodwin. However, Goodwin alleged that the defendants had breached a duty to him as a company shareholder when they purchased his stock without disclosing to him the information that led them to believe that the company had good prospects. The case was decided before Congress passed the 1934 Act. The plaintiff lost, in part because there was no contact between the plaintiff and defendant and the trade was accomplished on an open, impersonal exchange¹³⁵ and in part because the court seemed to believe that the information was too speculative to require disclosure.¹³⁶

In *Strong v. Repide*,¹³⁷ however, the plaintiff was able to state a cause of action without an affirmative misrepresentation. Repide, a director and the majority shareholder of a corporation, bought shares from Strong, another shareholder. He used a series of intermediaries to make the purchase in order to hide his identity; as a result, he made no misrepresentations to her. Repide was negotiating the sale of some of the company's real estate, and he knew the sale would substantially increase the value of the stock. In fact, the price he paid for Strong's shares was only about one-tenth of the value of the company's stock shortly after the sale was accomplished. Strong sued, and the United States

135.

The stock...was bought and sold on the stock exchange. The identity of buyers and sellers...was not known to the parties and perhaps could not readily have been ascertained. The defendants caused the shares to be brought through brokers.... They said nothing to anybody as to the reasons actuating them. The plaintiff was no novice. He was a member of the Boston stock exchange.... He acted upon his own judgment.... He made no inquiries of the defendants or of other officers of the company.

Id. at 661-62.

136.

The only knowledge possessed by the defendants not open to the plaintiff was the existence of a theory formulated...by a geologist as to the possible existence of copper deposits.... Whether that theory was sound or fallacious, no one knew.... At the annual meeting of the stockholders..., no reference was made to the theory. It was then at most a hope, possibly an expectation. It had not passed the nebulous stage.... Disclosure of the theory, if it ultimately was proved to be erroneous or without foundation in fact, might involve the defendants in litigation with those who might act on the hypothesis that it was correct.

Id. at 661.

137. 213 U.S. 419 (1909).

Supreme Court concluded that she had stated a cause of action.¹³⁸ The Court found that even if Repide was under no duty to disclose his general knowledge regarding the stock's value, the "special facts" of this case,¹³⁹ including Repide's position as a director, principal shareholder, and negotiator in the sale, created a duty to disclose the information or abstain from trading in the stock.¹⁴⁰

Aside from the general common law principals that impose fiduciary duties of loyalty and good faith on officers, directors, and controlling shareholders, federal securities laws and jurisprudence have also made it clear that insiders have a duty to effectively disclose material nonpublic information before they trade on it.¹⁴¹ States have adopted similar or identical standards of disclosure and materiality. Therefore, breach of a duty to disclose may assist plaintiff in establishing a prima facie case, and lack of an affirmative misrepresentation may not be a serious bar to plaintiff's ability to state a cause of action in fraud under state law.¹⁴²

138. *Id.* at 434-35.

139. *Id.* at 431.

140. *Id.* at 432-33; *see also* *Bailey v. Vaughan*, 359 S.E.2d 599, 605 (W. Va. 1987) ("[W]e are drawn to the conclusion that a director, who solicits a shareholder to purchase his stock and fails to disclose information not known to the shareholder that bears upon the potential increase in value of the shares, shall be liable to the shareholder either to have the sale rescinded or to respond in damages.").

141. *See, e.g., SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

[A]nyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.

Id. at 848.

142. *See, e.g., Zirn v. VLI Corp.*, 681 A.2d 1050 (Del. 1996) In *Zirn*, VLI shareholders asserted that the VLI directors had failed to make full disclosure in federal tender offer materials, impairing shareholders' ability to make an informed decision as to whether to tender, and giving rise to a state law claim for "equitable fraud." (The Delaware Supreme Court had previously noted that "the only difference between common law fraud and equitable fraud is 'Chancery's willingness to provide a remedy for negligent or innocent misrepresentation.'" *Gaffin v. Teledyne, Inc.*, 611 A.2d 467, 472 n.4 (Del. 1992) (quoting *Stephenson v. Capano Dev., Inc.*, 462 A.2d 1069, 1074 (Del. 1983)).) The *Zirn* court discussed the duty of directors to disclose information to shareholders, stating that "the duty of disclosure 'represents nothing more than the well-recognized proposition that directors of Delaware corporations are under a fiduciary duty to disclose fully and fairly all material information within the board's control when it seeks shareholder action.'" *Zirn*, 681 A.2d at 1056 (quoting *Stroud v. Grace*, 606 A.2d 75, 84 (Del. 1992)). The court noted that Delaware had adopted the federal securities law definition of materiality as articulated in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976), and continued, "In addition to the traditional duty to disclose all facts material to the proffered transaction, directors are under a fiduciary obligation to avoid misleading partial disclosures." *Zirn*, 681 A.2d at 1056.

The plaintiff may have other avenues of attack, as well. If the defendant did not affirmatively misrepresent facts to the plaintiff, one alternative is a corporate derivative action using an agency theory. When insiders sold their stock before news of declining earnings became public, the court in *Diamond v. Oreamuno*¹⁴³ approved this line of attack to require the insiders to disgorge their profits back to the corporation. The case was allowed to go forward even though the complaint lacked any specific allegation of damages to the corporation. The court itself generously allowed an inference of harm, and even supplied the rationale for the inference, positing that the insider trading might have damaged the corporation's reputation for integrity, harming the "continued public acceptance and marketability of its stock."¹⁴⁴

In *Diamond*, officers and directors of Management Assistance, Inc. knew that the company's earnings had declined substantially. Several of them sold 56,500 shares of the company's stock at an average price of \$28 per share. After the drop in earnings was disclosed to the public, the market price of the stock dropped to \$11, and a shareholder brought a derivative action to compel the insiders to disgorge their profits to the company.¹⁴⁵ The court acknowledged that section 16 was inapplicable, because the insiders had held their stock for longer than six months.¹⁴⁶ It also found section 10(b) to be problematic, because, although plaintiff could allege the elements of a Rule 10b-5 claim, the damages were not individual to the plaintiff, and at the time of this case, the federal courts had not worked out the machinery for class actions under Rule 10b-5.¹⁴⁷ Accordingly, the court believed that the federal securities laws would not help the plaintiff. However, the New York Court of Appeals permitted the shareholder to proceed with the derivative action under state law, even though, as in *Goodwin*, the trades had taken place through the impersonal medium of the market.¹⁴⁸ The court allowed the suit under principals of agency law that require an agent who uses confidential information acquired in the course of employment for the agent's own benefit rather than the principal's benefit to account to the principal for any profits realized.¹⁴⁹ Even though the plaintiff could not allege any particularized

143. See *Diamond v. Oreamuno*, 248 N.E.2d 910 (N.Y. 1969).

144. *Id.* at 912. Other courts have been less expansive. See, e.g., *Schein v. Chasen*, 313 So. 2d 739, 746 (Fla. 1975) (The court required that "actual damage to the corporation must be alleged in the complaint to substantiate a stockholders' derivative action.").

145. *Diamond*, 248 N.E.2d at 911.

146. *Id.* at 914.

147. *Id.* at 914-15.

148. See *id.* at 915; cf. *Goodwin v. Agassiz*, 186 N.E. 659 (Mass. 1933) (discussed *supra* at notes 134-36 and accompanying text).

149. *Diamond*, 248 N.E.2d at 914 (quoting the RESTATEMENT (SECOND) OF AGENCY § 388 cmt. c (1958)). The comment from the restatement states, "if [a corporate officer] has 'inside' information that the corporation is about to purchase or sell securities, or to declare or to pass a dividend, profits made by him in stock transactions undertaken because of his knowledge are held in constructive trust for the principal." RESTATEMENT

pecuniary harm to the company, the court found that the defendants' actions might have harmed the company by damaging its reputation for integrity. "When officers and directors abuse their position in order to gain personal profits, the effect may be to cast a cloud on the corporation's name, injure stockholder relations and undermine public regard for the corporation."¹⁵⁰

D. Section 16(b) Liability Should Be Eliminated

Section 16(b) liability should be eliminated because it is ineffective, unjust, expensive, and unnecessary. As discussed in Part II.C, above, section 16(b) is of very limited usefulness in controlling or punishing insider trading, even in the absence of any other enforcement mechanism. In addition to its general ineffectiveness, it causes unjust results by acting as a trap for the unwary rather than any real deterrent to a determined inside trader. Although it may have some minimal tendency to align insiders' incentives with the long-term profitability of their companies by encouraging them to be long-term holders of their companies' securities, on a cost/benefit balance, its costs outweigh its benefits.

Section 16(b) imposes costs not only on insiders; compliance with the rules promulgated under section 16 imposes significant costs on issuers. Because section 16(b) as written would require reporting of and impose liability for transactions that are unlikely or impossible to involve the use of inside information, the SEC has passed rules that exclude certain transactions deemed not to pose such a threat. The most complex of these is Rule 16b-3, which governs stock option plans.¹⁵¹

Many companies use stock options as incentive compensation for their employees and directors. Giving those persons an ownership stake in the company is intended to align their incentives with those of the other shareholders and thereby encourage them to work harder to make the company profitable.¹⁵² But such plans pose problems under section 16. Is the grant of an option or an exercise of the option a purchase? If the insider is a member of the board committee that grants the options, does that change the answer? If an officer holds stock options for ten years and then, when the market price of the stock is high, exercises them and sells the underlying stock, is the exercise and sale a purchase and sale for purposes of section 16? These and other knotty issues have led to repeated rulemaking and have resulted in complex procedures for corporations to set up their compensation plans to comply with section 16(b). If section 16(b) liability were ended, one collateral benefit would be the decrease in corporations' costs of

(SECOND) OF AGENCY § 388 cmt. c. The *Diamond* court did not deal with how to measure the profit that must be disgorged: the spread between the purchase price and the eventual low point; the spread between the sale price and the eventual low point; the spread between the purchase price and the sale price?

150. *Diamond*, 248 N.E. 2d at 912.

151. 17 C.F.R. § 240.16b-3 (1997).

152. *See supra* note 34.

compliance with the intricate and ever-changing rules promulgated under section 16.

Section 16(b) liability becomes even more unnecessary, and thus even less justifiable, when considered in light of the panoply of federal and state statutes and common law doctrines discussed above¹⁵³ that are available to combat the problems presented by insider trading. Since these other laws are more effective, more narrowly targeted, and produce fairer results than section 16(b) (because they focus on transactions actually motivated by inside information), section 16(b) should be rescinded. If, as some commentators have suggested, section 16(b) provides important benefits in the form of incentive effects and agency cost reductions by encouraging insiders to be long-term security holders,¹⁵⁴ perhaps Congress should replace section 16(b) with a simple holding period, providing that insiders who acquire their companies' equity securities may not sell them for a specified period. But, as discussed above, Rule 144 accomplishes much the same result,¹⁵⁵ so an independent holding period imposed by section 16 is also probably unnecessary.

IV. SECTION 16(a) AND THE VALUE OF REPORTED INFORMATION

A. Market Efficiency

An efficient market is one in which information is rapidly incorporated into the price of goods sold in that market.¹⁵⁶ Generally, markets become more efficient as their size increases and as information costs and transactions costs decrease. As a result, the capital markets in the United States, where millions of shares change hands daily, are relatively efficient.

However, to say that information is rapidly incorporated in the price of stock sold on the New York Stock Exchange says nothing about what kind of information does or is likely to affect stock prices. Factors that make information instrumental in moving prices include its verifiability, its timeliness, and the accuracy with which traders can predict its impact on the issuer's fortunes. In the stock market, information likely to affect the price of a share of stock may include information specific to the company, information about the industry in which the company operates, and information about the economy generally. Market analysts

153. See *supra* Part III.A-C.

154. See *supra* note 29.

155. See *supra* Part III.A.4.

156. See, e.g., Jonathan R. Macey et al., *Lessons from Financial Economics: Materiality, Reliance, and Extending the Reach of* Basic v. Levinson, 77 VA. L. REV. 1017, 1023 (1991) (The authors commented that "one frequently used approach to defining efficient markets focus[es] on the information incorporated in the price of securities." The authors also noted that "the most common definition [of an efficient market] calls it a 'market in which prices fully reflect available information.'" (quoting EUGENE F. FAMA & MERTON H. MILLER, *THE THEORY OF FINANCE* ch. 2 (1972))).

and arbitrageurs constantly search for and trade on information that they believe will affect securities values, and prices adjust in response to that trading activity.

Irrelevant information may also have an impact on market prices; this sometimes is referred to as "noise trading."¹⁵⁷ Noise trading may result from a misperception of the ramifications of relevant information or from a "jump on the bandwagon" approach to following other traders' activities, thus exacerbating the price movements their trading would ordinarily create. It also may result from information unrelated to the value of a particular security, such as trading in response to perceived "patterns" in market movement.

An efficient market carries with it the inference that prices incorporate all available information. If information is quickly incorporated into market prices, then those prices should reach an equilibrium among all traders' perceptions of the significance of the information. When information is withheld from the market and is not incorporated into securities prices, prices may become inaccurate. At least one commentator has posited that efficiency of a market may not be a particularly valuable end itself, as long as the inefficiency that exists is unbiased; that is, as long as the information withheld from the market has an equal tendency to push prices higher as it does to push them lower.¹⁵⁸ This kind of inefficiency would not create an investor perception of "rigged" or unfair markets, in the sense that securities were consistently underpriced or sold at inflated prices. However, to the extent that existing information is undisclosed, those persons in possession of the nonpublic information have the opportunity to profit from it by trading on it before its disclosure impacts securities prices. This perception that insiders can and do take unfair advantage of their access to nonpublic information was exactly what the drafters of the securities acts were trying to dispel by providing for a system of regular, extensive disclosure.

B. Section 16(a) Reporting

1. Why Section 16(a) Information Is Valuable to the Market

The thesis that an insider's trades have informational value is easily defended. First, those in command of the management of a company have access to both the largest quantity of information and the most reliable information about the company's status and prospects. Even without illegally trading on "material" nonpublic information, their regular and ongoing contacts with the company, the industry, and the company's employees put insiders in a much better position than

157. See Andrei Schleifer & Lawrence H. Summers, *The Noise Trader Approach to Finance*, J. ECON. PERSP., Spring 1990, at 19, 23 ("Some shifts in investor demand for securities are completely rational.... But not all demand changes appear to be so rational; some seem to be a response to changes in expectations or sentiment that are not fully justified by information.... We use the term 'noise traders' to describe such investors....").

158. See Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613 (1988).

outsiders to gauge a whole host of intangible factors that may contribute to the company's success or failure. Second, insiders have much greater power than outsiders to actually cause the success or failure of the company. To the extent that they can and will be instrumental in charting the company's future course, their actions with respect to buying or selling the company's securities may at least provide information about their incentives and intentions, if not their capability to ensure their desired outcome.

Information that an insider has bought or sold shares of her company's stock is, in one sense, very dependable information, because it is absolutely factual, historical information, incapable of manipulation or distortion. However, in another sense, it may be very undependable. Disclosure of the *fact* of a transaction without disclosure of the *reasons* for the transaction permits the market to completely misunderstand or misinterpret the significance of the information. It is probably not workable to require insiders to disclose the motivation for their trades, and even if workable, it might be an unjustifiable invasion of their privacy. Even though the information regarding a single insider trade is of uncertain significance, however, insider trades in the aggregate provide valuable information about insiders' predictions of company values. As a consequence, Congress should continue to require insiders to report their trades in their companies' securities.

Does information that insiders have traded constitute information about the company at all? Is the mere fact that an insider has bought or sold stock in her company information that is relevant to the market? If so, it is not the same sort of information as a financial statement reporting the company's income or a news release reporting an impending merger. It is at best secondary information. It may disclose insiders' opinions as to the value of the stock, but it does not disclose the facts upon which those opinions are based. As a general rule, the news that an insider has purchased stock provides more content than the news that an insider has sold stock.

a. Stock Sales

Assume that the president of a small public company sells \$20,000 worth of her \$50,000 investment in her company's stock. As required by section 16, she files a Form 4 reporting the transaction within ten days after the beginning of the month following the trade. Investors now have access to the information that she has sold a significant amount of her holdings in her company's stock. Should they follow her lead and sell their stock in the company? It depends on why she sold.

Perhaps she lacks confidence in the company's prospects. She is not trading on specific nonpublic information, which would be illegal, but rather on opinions and impressions gleaned from her association with her company's industry, its personnel, and the marketplace. Based on her experience, she thinks the price of her company's stock will fall, and she plans to place her money in investments that she believes will have higher returns. If that is why she sold, outside investors are justified in following her lead; after all, her close association

with the company and its management puts her in a much better position than they to judge a whole range of intangibles.

Perhaps she believes that the company is not necessarily going to do badly but that it is likely to be volatile, and she is at a point in her career where she wants to move more of her capital into lower risk investments such as government bonds. If this is her rationale, investors may or may not be justified in following her lead, depending on their individual investment situations and the degree to which they are risk averse.

Perhaps her sale has nothing to do with her company's prospects. Maybe she wants to diversify her investments out of a concentration in her own company's stock. Many officers and directors are partly compensated in stock or stock options. As a result, they may acquire substantial blocks of their company's securities, and over time, their investment portfolios may become heavily weighted in favor of those securities. Lack of diversification, however, is risky. Therefore, even if she believes her company's securities are a sound investment in general, a prudent investor would be likely to sell some of those securities in order to diversify her holdings. An outsider would be mistaken to rely on her sale as an indication that he also should sell his shares unless he, too, happened to be overinvested in that security.

Perhaps the sale reflects a need for liquidity—she needs cash to buy a new car or boat, or to pay her child's college tuition. In these situations, her trades would provide no reliable information to investors who might follow her lead.

Another possibility is that the decision to sell is driven by tax considerations. For instance, if an insider has a loss in one security and a gain in another, the insider may decide to sell both in order to net out the capital gain and loss in a particular year.¹⁵⁹

b. Stock Purchases

The information that an insider has *purchased* company stock should be less subject to misinterpretation. Assuming the insider is a rational investor, a purchase should indicate that the insider believes the company's stock is a better alternative than any other investment. If the insider believes there is more money to be made elsewhere, she is likely to put her money there.

There may be exceptions to this analysis. Some insiders may buy stock to comply with regulatory requirements (for instance, directors of national banks

159. One time that this arises is when a company engages in a cash-out merger. The company's shareholders receive cash instead of stock in the merged company, so they must realize the difference between their basis in the stock given up and the cash received. One way to avoid tax liability if this cash results in a gain is to sell another security whose trading price is lower than the shareholder's basis, and offset the gain in one security with the loss in the other.

must own stock in their banks).¹⁶⁰ Some insiders may be partly compensated in or contractually required to purchase their company's securities, in order to more closely align their interests with those of the shareholders. Some insiders may purchase shares to take advantage of stock options that will soon expire. And there may be purchases by insiders who are not required to purchase, but who believe that it is good public relations to own a significant stake in their companies. However, it seems likely that an insider purchase is a more reliable indicator of an insider's assessment of his or her company's prospects than an insider sale.

The inside information on which insiders can trade with impunity is arguably some of the most valuable information about the company—impressions and opinions built up by long exposure to the details of the day-to-day operations of the company and interactions with its personnel. These "impressionistic" views as to the future vitality of the company's business and earnings are not necessarily event oriented; they may not relate to a specific merger possibility or new product development. However, insider trades based on this "nonmaterial" inside information are a source of valuable information to the market.¹⁶¹

2. *Decrease in Value of Information Because of Delay*

Currently, section 16(a) requires insiders to file reports of their trades by the tenth day of the month after the month in which the trades occur. An insider who trades at the beginning of a month would not be required to report that trade for as long as forty days. If disclosure of trades is required only to permit the identification and capture of short-swing profits, then this delay is unimportant. If, however, the rationale for disclosure is broader, and includes informing the market of the fact of insider trades, then the delay in reporting is very important.

Studies have indicated that the American securities markets are capable of incorporating new information into prices with astounding speed.¹⁶² Every time

160. See 12 U.S.C. § 72 (1994).

Every director must own in his or her own right, either shares of the capital stock of the association of which he or she is a director the aggregate par value of which is not less than \$1,000, or an equivalent interest, as determined by the Comptroller of the Currency, in any company which has control over such association...[unless]...the capital of the bank does not exceed \$25,000,...[in which case the minimum ownership requirement is]...not less than \$500, or an equivalent interest....

Id.

161. Therefore, to the extent that section 16(b) discourages such trades from taking place at all, it prevents information from reaching the market that would assist traders in making informed decisions about securities values.

162. There are numerous studies to this effect. See, e.g., James A. Patell & Mark A. Wolfson, *The Intraday Speed of Adjustment of Stock Prices to Earnings and Dividend Announcements*, 13 J. FIN. ECON. 223 (1984) (noting that information concerning dividends and earnings causes price changes in securities within minutes after the information is

a security price impounds new information, the price becomes a more accurate price, based on an informed consensus of the significance and import of the information. Therefore, to the extent information that would impact prices is withheld from the market, prices are correspondingly "inaccurate."

As mentioned previously, it can be argued that this inaccuracy is unimportant, as long as there is no bias; that is, the withheld information is as likely to result in higher prices as it is in lower prices.¹⁶³ To the extent the inefficiency creates risk, investors can avoid the risk by diversifying their portfolios. This view ignores the costs in diversifying (brokerage fees, information costs to determine whether one is sufficiently diversified, etc.). It also ignores the reality that people prefer to be in control of their environments as much as possible, and that they generally prefer certainty to uncertainty. To the extent that the law encourages market efficiency, it fosters more rational pricing, which should make the market a more attractive option for investors. If the market becomes more attractive, more people are likely to invest. As more people invest, the cost of capital for companies should decrease, and as those costs decrease, so should the prices of goods and services. Therefore, laws that encourage prompt disclosure should have a salutary effect on the market.

3. Availability of EDGAR to Solve Problem of Delay

The SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system is now fully operational.¹⁶⁴ Companies must file all of their registration statements and periodic reports electronically, rather than on paper. Once the information is transmitted to the SEC, it is available to the public over the Internet

released but also noting that price effects may persist for as long as two days); see also Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 821 n.160 (1985) (citations to several empirical studies).

163. See Stout, *supra* note 158, at 701 ("[T]he issues of fraud and efficiency are not the same.... While fraud harms average returns, pricing inefficiency *per se* does not, so long as the investor has an equal chance of gaining or losing.").

164. The EDGAR system has been in development for several years. The SEC began with a test group of filers to develop procedures for electronic filing of documents and developed a schedule that incrementally required companies to switch from paper filings to electronic filings. The system became fully mandatory for all domestic registrants whose filings are subject to the review of the SEC's Division of Corporate Finance on May 6, 1996, when the last group of companies was required to begin making filings on-line. See Securities Act Release No. 33-7369, 63 S.E.C. Docket 869 (Dec. 5, 1996), available in 1996 WL 699505.

Initially, access to EDGAR filings was restricted by a contract the SEC entered into with a private corporation, which digested the information available and charged access fees to those who wanted to view the information. That also has changed. EDGAR filings are freely available to everyone with access to the Internet, and they may also be accessed for a charge through LEXIS/Nexis.

twenty-four hours after the filing date.¹⁶⁵ Reports under section 16 may be, but are not required to be, transmitted over the EDGAR system.

Perhaps one reason that section 16 filings are not yet required to be filed through EDGAR is that they are the individual responsibility of the insiders, rather than the responsibility of the company. While companies and their financial printers may have access to and expertise with the technology and equipment required to make electronic filings, many individuals may not. However, individual filers should be able to rely on their companies to help them secure access to whatever means of communication are necessary to accomplish electronic filings, even if the individuals are not equipped themselves to accomplish the filings.

During EDGAR's development, there was considerable thought and debate over how to authenticate filings, since there would be no way for the officers and directors of companies to physically "sign" the documents electronically transmitted to the SEC. A system of personal identification numbers was developed to allow filers to "sign" filed documents by affixing their PIN. Therefore, individual filers will be able to authenticate their EDGAR filings by including their number.

4. *Recommendations for Revision of Section 16(a)*

Section 16(a) reports provide valuable information to the market¹⁶⁶ and to the SEC. Therefore, insiders should continue to be required to report their trades in their companies' securities. However, section 16(a) reports would be considerably more valuable, both to the market and to the SEC, if the information were available in a more timely fashion. Therefore, the statute should be amended to require trading reports to be filed much sooner.

Insiders currently must report each trade¹⁶⁷ by the tenth day of the month following the month in which their trade occurred,¹⁶⁸ allowing a delay of up to forty days if a trade takes place at the beginning of the month. We can assume reasonably that at least some insider trades are based on assessments related to timing—even if a trade is not based on specific nonpublic material information, it may be based on an insider's conclusion that the company's stock price is currently too high or too low, leading the insider to sell or buy in response to the perceived inaccuracy of the price. Over a forty-day lag between the trade and the report, either the stock price may change or the insider's conclusion as to the

165. EDGAR filings may be viewed on the Internet at either <http://www.sec.gov/edgarhp.htm> or at <http://www.sec.gov/cgi-bin/srch-edgar>. Internet access to filed information is available 24 hours after filing; LEXIS/Nexis access is available simultaneously with filing.

166. *See supra* Part IV.B.1.

167. Although some exceptions do exist for small trades or trades that do not require reports. *See supra* text accompanying notes 23–25.

168. 15 U.S.C. § 78p(a) (1994).

stock's value may change. As a result, the information is a much less trustworthy indication of an insider's value assessment when disclosed to the market after the long delay than it was at the time of the trade.

Section 16(a) reports are valuable to the SEC, as well as to the market. Although this Article recommends that section 16(b) be repealed, section 16 would continue to deter illegal insider trading because the section 16(a) reports can assist in the enforcement of other insider trading laws. Section 16(a) reports enable the SEC to pinpoint insider trades that occur shortly before material disclosures and are thus more likely to have been executed while the insider was in possession of material, nonpublic information. Quicker reporting would thus be beneficial for insider trading enforcement, as well as for informing the market of insiders' opinions of securities values. The sooner such information is in the hands of the SEC, the sooner it can act to enjoin or prosecute insider trading activity. Prompt enforcement of the insider trading laws should promote the effect that Congress intended when it first enacted section 16—that of promoting confidence in the fairness of the securities markets.

There are two ways in which the delay between trading and reporting can be diminished: shortening the time between trading and filing, and using a faster method of transmitting the filing. Congress and the SEC should take advantage of both methods to create the largest benefit to the market.

Several possibilities exist for reducing the time for reporting: the filing could be required sooner after a trade, concurrent with a trade, or even in advance of a trade.¹⁶⁹ The best alternative is the middle ground; filing should be concurrent with trading. Decreasing the time between trading and filing decreases but does not eliminate the decline in value of the information contained in the reports. The earlier the information is available, the more value it has. However, requiring a filing in advance of trading could operate as a significant deterrent to trades by insiders at all because it would reduce their opportunity to profit from their informed conclusions about their companies' value.

Why should we not require pretrade reporting? If, as posited in this Article, insiders' trades have informational content that the market values, then

169. Several commentators have considered these possibilities in the past. See, e.g., Marleen A. O'Connor, *Toward a More Efficient Deterrence of Insider Trading: The Repeal of Section 16(b)*, 58 *FORDHAM L. REV.* 309, 354-55 (1989) (recognizing that "[r]equiring section 16 insiders to file section 16(a) reports on or before the day they trade would take into account the market's sensitivity to the information provided by insider trading upon nonmaterial information" (footnote omitted)); *Report of the Task Force, supra* note 35, at 1102 (noting that Senator Chafee had introduced a bill in 1985 to require insiders "to report their purchases and sales of their companies' stocks on the same day as the transaction" and recommending "that voluntary purchase or sale transactions be reported on form 4 within two business days of the transactions, and that involuntary changes in ownership remain subject to the current monthly reporting requirements"); Samuelson, *supra* note 15, at 523 (proposing that insiders should "report sales or purchases of stock, not after the event, but at least ninety days prior to any trade").

their purchases tend to push prices up, and their sales tend to push prices down. The information on which insiders may trade legally, and which is indirectly disclosed in section 16(a) reports, is not "material" information as that term is used in the securities laws;¹⁷⁰ rather, it is soft or impressionistic information, probably not capable of being disclosed to the public in any cogent manner. Therefore, if this information is not disclosed indirectly through trading reports, it may not be available to the market at all. Requiring insiders to report *before* they trade would allow the market to react to the news before the insider actually made the trade. But if market prices adjust before insiders trade, then insiders cannot reap the benefits of their assessments of their companies' value, based on their experience and knowledge. If insiders must share their insights with the market by prereporting their trades, they will have less incentive to trade. To the extent they are deterred from trading, their valuation conclusions will never be transmitted to the market in the form of trading reports.

Therefore, although requiring a trading report sooner after trading improves the situation, it would not prevent a significant loss in value of the information that insiders have traded. Requiring a pretrade report may decrease the incentive to trade, thus preventing information about insiders' assessments of value from reaching the market at all. Concurrent filing, then, is the best alternative.

Because the SEC's EDGAR system is available to permit concurrent filing, section 16(a) reports can be conveyed immediately to the SEC and to the markets, preserving the maximum value of the information provided by the trading reports. But should section 16(a) also be amended to require the trading reports to provide more information than they do now? As discussed above,¹⁷¹ the information provided by section 16(a) reports is ambiguous because there are reasons other than pure valuation decisions that motivate securities trading. Should insiders be required to report their motivations for trading their companies' securities? No.

First, it is impractical to attempt to require such information because of the nature of the information itself. Instead of being based on quantifiable or factual information (which is largely already available to the market), insiders' trades are merely indications of their conclusions, based on accretions of impressions, opinions, and observations over a period of association with a company. These conclusions frequently cannot be explained in language of the accuracy, specificity, and completeness required under the securities laws to avoid liability for misleading or incomplete statements. Therefore, attempted disclosure of their motivations could subject insiders to liability for material misstatements or omissions.

170. See *supra* note 49 (meaning of materiality as defined by the Supreme Court in *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988)).

171. See *supra* Part IV.B.1.

Second, requiring insiders to disclose their motivations for trading in their companies' securities is an unwarranted invasion of their privacy. Although Congress has determined that insiders do not have the right to keep the fact of their trades in their companies' securities private, the details of their finances are not and should not be public information unless the value of the information to the public significantly outweighs the imposition on insiders.

Does the insider definition in section 16 include the appropriate group, or should it include additional or fewer persons? As presently defined, statutory insiders probably include most persons who are likely to be in a position to develop informed opinions about a company's prospects and to be in a position to influence the company's future performance. There may be exceptions; for instance, persons involved in research and development within a company might in certain circumstances be aware of developments that are not yet "material" but cumulatively portend good or bad things for the company's future. However, such instances of lower-level employees having the breadth of information to make accurate predictions about the company's performance as a whole would be less frequent and less reliable than the opinions of the current group of insiders. Therefore, the definition should not be significantly broadened or narrowed.

How should concurrent filing be accomplished technically? Probably the simplest and most certain method is to require insiders to effect any trades in their companies' securities through the company itself, so that the company would handle both the trade and the report. Section 12 companies are already adept at using the EDGAR system and have access to it, so using the company as a trading and reporting facilitator would lighten the insiders' burden of reporting and provide a single conduit for information about each company's insiders.

In addition, requiring trades and reports to be channeled through the issuer could actually help to prevent illegal insider trading and could also prevent trading that might appear to be illegal. A company could prevent illegal insider trades by refusing to execute an order by an insider known to be in possession of material inside information. It could also prevent trades that are not based on nonpublic information but that may appear to be. For instance, some insiders may be unaware of material developments that have not yet been announced to the public. If the uninformed insider attempts to place a trading order, the company could request or require that the order be postponed until after disclosure of the material information, thus preventing any inquiry into the insider's access to or awareness of the information at the time of the trade.

V. CONCLUSION

Congress should repeal section 16(b). It is both unfair and ineffective in achieving its stated goal of deterring insider trading. It is overinclusive in that it traps unwary investors who are not using inside information, and it is underinclusive in that it permits wary insiders who are using inside information to avoid its penalties by timing their trades to occur outside the six-month period. Other laws deal with insider trading in a much more direct, focused, and effective

manner, so section 16(b) is unnecessary to prevent or sanction insider trading. The private enforcement mechanism is expensive and wasteful, and it does not effectively restore "ill-gotten gains" to the issuer.

Insider trading reports provide valuable information to the market, but the value of that information declines with delay. Therefore, Congress should retain section 16(a) but should modify it to require insiders to file trading reports concurrent with their trades. Concurrent electronic filing is now practical, since the EDGAR system is fully operational. Unlike advance filing, concurrent filing will not create trading disincentives that would keep insiders from sharing their perceptions with the market through their trades. Concurrent filing will permit share prices to react to insider trades more quickly, and it will assist the SEC in detecting illegal insider trades by permitting more timely monitoring.

