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The Genius of Section 16: Regulating the Management of Publicly Held Companies

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Section 16 of the Securities Exchange Act[1] (Exchange Act) is probably the most criticized provision of the federal securities statutes. Critics typically disapprove of the approach section 16 takes to ensuring that no person trading common stock has superior access to relevant information emanating from the corporation that issued the stock. They complain that section 16 permits many corporate insiders to use nonpublic corporate information to trade stock profitably at the same time that it keeps many people who do not possess inside information from trading at all.

This Article offers a different way of thinking about section 16. It suggests that section 16 is better understood as a tool for promoting the efficient operation of publicly held corporations. Section 16 deters those who control publicly held corporations 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. This explanation recognizes in section 16 an elegance it is usually thought to lack. It also suggests that most courts and commentators have underestimated the reform that the Exchange Act was designed to achieve.

I. Introduction

A. Two Explanations of Section 16

Section 16 requires the officers, directors, and principal stockholders of most publicly held companies to disclose how much of the

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1. Securities Exchange Act of 1934, Pub. L. No. 73-291, § 16, 48 Stat. 881 (codified as amended at 15 U.S.C. § 78p (1988)). For the text of § 16, see Appendix, *infra*. For a summary of criticism of § 16, see *infra* notes 8-14 and accompanying text.

equity securities of those companies they beneficially own at the time they become affiliates and to report any change in ownership thereafter. It also forbids them to sell such securities short and requires them to forfeit to the issuers any profits they realize in short-swing transactions in such securities. These provisions interfere with the prerogatives of some of the most influential people in America, and not surprisingly they and others have attacked section 16. While section 16 was bound to receive criticism, the nature of that criticism is remarkable.

Commentators often take issue with the goals of statutes, including the federal securities statutes. Those who find section 16 wanting, however, have generally expressed sympathy with what they take to be its end—preventing corporate insiders from trading stock on the basis of important, nonpublic corporate information.[2] Perhaps precisely because they find this end so attractive, many people have complained that section 16 fails to achieve it. Almost alone among the provisions of the federal securities statutes, section 16 is consistently criticized for the way it works.

Section 16 is not the only provision of the federal securities laws that regulates insider trading. In fact, most of the highly publicized insider trading cases of the past few years have been brought under rule 10b-5.[3] Just what rule 10b-5 prohibits is not entirely clear, but the rule can be stretched to cover a wide variety of insider trading practices that are beyond the scope of section 16.[4] Largely because of

2. *Cf.* 2 L. Loss, Securities Regulation 1088 (2d ed. 1961) ("The purpose of § 16(b)—prevention of the unfair use of information by corporate insiders—does not, of course, admit of dispute."); Wu, *An Economist Looks at Section 16 of the Securities Exchange Act of 1934,* 68 Colum. L. Rev. 260, 261 (1968) ("Although Section 16 has many shortcomings and has been subject to substantial criticisms, its fundamental purpose has never been seriously questioned." (footnote omitted)). Some writers argue that there is nothing wrong with insiders trading while in possession of important nonpublic information, but their arguments are usually directed at Securities and Exchange Commission (SEC) rule 10b-5, 17 C.F.R. § 240.10b-5 (1988). *See infra* notes 14, 18.

3. 17 C.F.R. § 240.10b-5 (1988). Although § 16 may be the most criticized provision of the federal securities statutes, 2 L. Loss, *supra* note 2, at 1087-88, rule 10b-5 is surely the most controversial. In exploring what § 16 is about, it is important to remember that rule 10b-5 was not enacted by Congress. It was promulgated by the SEC pursuant to § 10(b) of the Exchange Act, 15 U.S.C. § 78j (1988), and there is no reason to think that Congress intended § 10(b) to be used to deal with insider trading in particular. *See infra* note 5 and accompanying text.

4. *See* Aldave, *The Insider Trading and Securities Fraud Enforcement Act of 1988: An Analysis and Appraisal,* 52 Alb. L. Rev. 893, 896-905 (1988) (discussing clarity and coherence of case law); *Symposium: Defining "Insider Trading,"* 39 Ala. L. Rev. 337 (1988). *See generally* R. Clark, Corporate Law 264 (1986) (definitions); D. Langevoort, Insider Trading Regulation 3-4 (1988). The Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended at 15 U.S.C. §§ 78*o*, 78t(d), 78u(d)(2), 78ff(a) (1988)),

this, the strictures of section 16 have generally been ignored in recent debate over the propriety and legality of insiders trading on the basis of nonpublic information.[5] Section 16 continues to draw criticism, however,[6] and it is still well known—especially among those who control publicly held companies—for requiring officers, directors, and principal stockholders of publicly held companies to disclose their trading in the stock of the companies with which they are affiliated and to disgorge their profits if they buy and sell stock within any six-month period.

"The most distinctive feature" of section 16 is that none of its provisions turns on whether insiders actually possess material, non-public information when they trade.[7] This simplifies enforcement and makes it easier to predict legal outcomes, but many people find the price for simplicity and certainty much too high.[8] According to its

and the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (codified in part at 15 U.S.C. §§ 78*o*, 78t-1, 78u(a), 78u(d), 78u-1, 78ff(a), 78kk(c), 80b-4a (1988)), amended the Exchange Act to add sanctions against insider trading. These amendments had substantive implications, but they did not define the offense directly.

5. *See* FEDERAL SECURITIES CODE § 1714 comment 1 (1980) (stating argument that § 16(b) should be repealed because rule 10b-5 jurisprudence renders it obsolete); D. LANGEVOORT, *supra* note 4, at 331 ("[T]heories of liability for insider trading under the antifraud provision of the federal securities laws . . . are the most visible weapons against unlawful trading activity . . . ."); Aldave, *supra* note 4, at 897 ("The current body of law regulating insider trading has developed gradually, primarily through a process of judicial interpretation of rule 10b-5 . . . ."); Dooley, *Enforcement of Insider Trading Restrictions,* 66 VA. L. REV. 1, 3 (1980); Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts,* 68 VA. L. REV. 117, 117 n.1 (1982) ("Most of the law in this area [i.e., the regulation of insider trading] derives from Rule 10b-5."); Morgan, *Insider Trading and the Infringement of Property Rights,* 48 OHIO ST. L.J. 79, 82 (1987) ("Although Section 16 is Congress' specific response to the problem of insider trading, it is another section of the Securities Exchange Act—Section 10b [sic]—that has formed the basis for most of the administrative and judicial attempts to regulate actual insider trading." (footnotes omitted)); Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy,* 9 J. LEGAL STUD. 801 (1980); *cf.* Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading,* 13 HOFSTRA L. REV. 9, 9 n.1 (1984) ("Because of the extremely limited scope of section 16(b), this Article will focus . . . on Rule 10b-5.").

6. *See, e.g.,* Exchange Act Release No. 26,333, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,343, at 89,600 (Dec. 2, 1988) ("The staff of the Division of Corporation Finance receives more requests for interpretive and no-action advice concerning the Section 16 rules than any other area."); Exchange Act Release No. 27,148, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,439, at 80,383 (Aug. 18, 1989) (271 comment letters received on proposed rule changes); Block & Barton, *Section 16(b) of the Exchange Act: An Archaic Insider Trading Statute in Need of Reform,* 12 SEC. REG. L.J. 203 (1984); O'Connor, *Toward a More Efficient Deterrence of Insider Trading: The Repeal of Section 16(b),* 58 FORDHAM L. REV. 309 (1989).

7. Committee on Federal Regulation of Securities, *Report of the Task Force on Regulation of Insider Trading—Part II: Reform of Section 16,* 42 BUS. LAW. 1087, 1089-90 (1987) [hereinafter *Task Force Report*].

8. According to Jennings and Marsh, "[j]udging solely from the facts stated in the

critics, section 16 is more than simple and clear; it is crude[9] and arbitrary.[10]

Anyone who has read this far can probably recite the shortcomings of section 16.[11] It is hornbook law that the purpose of section 16 is to keep corporate insiders from trading on the basis of inside information;[12] the statute says almost as much.[13] The problem is that

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opinions in the decided cases, the function of Section 16(b) would appear to be to impose unjust liability upon entirely innocent persons." R. JENNINGS & H. MARSH, SECURITIES REGULATION—CASES AND MATERIALS 1402 (6th ed. 1987). They support this conclusion by quoting from Western Auto Supply Co. v. Gamble-Skogmo, Inc., 348 F.2d 736, 743 n.7 (8th Cir. 1965), *cert. denied,* 382 U.S. 987 (1966), in which the court said that the ethical positions of the parties were not relevant. "[I]n other words, justice has nothing whatever to do with Section 16(b)." R. JENNINGS & H. MARSH, *supra,* at 1402 n.2.

9. Provident Sec. Co. v. Foremost-McKesson, Inc., 331 F. Supp. 787, 791-92 (N.D. Cal. 1971), *aff'd,* 506 F.2d 601 (9th Cir. 1974), *aff'd,* 423 U.S. 232 (1976), *quoted in* R. JENNINGS & H. MARSH, *supra* note 8, at 1402 n.1, *and in* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 547 n.17 (2d ed. 1988); *see also* Halleran & Calderwood, *Effect of Federal Regulation on Distribution of and Trading in Securities,* 28 GEO. WASH. L. REV. 86, 115 (1959) ("almost unprecedented chaos"); Wentz, *Refining a Crude Rule: The Pragmatic Approach to Section 16(b) of the Securities Exchange Act of 1934,* 70 NW. U.L. REV. 221 (1975).

10. Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418, 422 (1972) (quoting Bershad v. McDonough, 428 F.2d 693, 696 (7th Cir. 1970)); FEDERAL SECURITIES CODE § 1714 comment 1 (stating argument that § 16(b) is arbitrary); R. JENNINGS & H. MARSH, *supra* note 8, at 1402 n.3 ("wholly arbitrary").

11. If not, the imprecision of § 16 was succinctly described in a recent report on insider trading:

> [S]ection 16 imposes liability on many transactions that contain no elements of the abuses that Congress sought to eliminate. It can create unwarranted restrictions for insiders who arbitrarily are prevented from trading even when they do not possess information that is confidential and material, as well as anomalies for tender offerors . . . .
>
> While in certain circumstances the scope of section 16 is too broad, it also has several limitations. Most importantly, by primarily focusing upon so-called "short-swing" profits, section 16 provides no protection for abuses of insider status involving only a purchase or only a sale. Moreover, it is limited to trading of equity securities by officers, directors, and ten percent shareholders and therefore does not reach all insiders. In addition, it has no application to tipping by insiders.

Task Force Report, supra note 7, at 1090.

12. W. CARY & M. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 844-48 (5th ed. 1980); R. CLARK, *supra* note 4, at 293-96; 2 T. HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 12.3, at 20, 27 (2d ed. 1990); L. SODERQUIST, UNDERSTANDING THE SECURITIES LAWS 273 (1987); *see also* C. MEYER, THE SECURITIES EXCHANGE ACT OF 1934 ANALYZED AND EXPLAINED 20-21, 111 (1934). Since 1934, over 150 law review articles, comments, and notes devoted to § 16 have been published. These typically have developed one or another complexity or inadequacy of § 16, and almost all of them take as a premise that the purpose of § 16 is to prevent corporate insiders from trading on the basis of inside information. *See, e.g.,* Cole, *Insiders' Liabilities Under the Securities Exchange Act of 1934,* 12 SW. L.J. 147, 147-48 (1958); Cook & Feldman, *Insider Trading Under the Securities Exchange Act,* 66 HARV. L. REV. 385, 386 (1953); Halleran & Calderwood, *supra* note 9, at 114-17; Hamilton, *Convertible Securities and Section 16(b): The End of an Era,* 44 TEX. L. REV. 1447, 1447-48 (1966); Jacobs, *An*

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."[14]

Section 16 is ill-tailored for the task of preventing insiders from taking advantage of inside information. The best proof is probably the fact that the recent crusade against insider trading has been mounted on rule 10b-5,[15] but there is also a staggering body of commentary expounding the section's various inadequacies.[16] The critics essentially complain that the legislature failed in creating section 16 because of lack of skill.[17] They do not argue that statutes are always imprecise

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Analysis of Section 16 of the Securities Exchange Act of 1934, 32 N.Y.L. SCH. L. REV. 209, 209-10 (1987); Kaplan, Wolf v. Weinstein: *Another Chapter on Insider Trading,* 1963 SUP. CT. REV. 273, 301; Lowenfels, *Section 16(b): A New Trend in Regulating Insider Trading,* 54 CORNELL L. REV. 45, 57-61 (1968); Meeker & Cooney, *The Problem of Definition in Determining Insider Liabilities Under Section 16(b),* 45 VA. L. REV. 949, 950 (1959); Munter, *Section 16(b) of Securities Exchange Act of 1934: An Alternative to "Burning Down the Barn in Order to Kill the Rats,"* 52 CORNELL L.Q. 69, 70 (1966); Painter, *The Evolving Role of Section 16(b),* 62 MICH. L. REV. 649, 649 (1964); Ribstein, *The Application of Section 16(b) of the Securities Exchange Act of 1934 to Tender Offers,* 31 SW. L.J. 503, 503 (1977); Rubin & Feldman, *Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders,* 95 U. PA. L. REV. 468, 468-70 (1947); Seligman, *Problems Under the Securities Exchange Act,* 21 VA. L. REV. 1, 3 (1934); Tomlinson, *Section 16(b): A Single Analysis of Purchases and Sales—Merging the Objective and Pragmatic Analyses,* 1981 DUKE L.J. 941, 941; Wu, *supra* note 2, at 261.

13. *See* Exchange Act § 16(b), 15 U.S.C. § 78p(b) (1988). *But see infra* notes 318-352 and accompanying text (purpose clause an afterthought intended to legitimate SEC exemptive authority).

14. R. CLARK, *supra* note 4, § 8.6, at 295.

15. *See supra* note 5 and accompanying text. Further proof may lie in the fact that insiders subject to § 16 continue to trade profitably. In fact, their trading is abnormally profitable. R. BREALEY & S. MYERS, PRINCIPLES OF CORPORATE FINANCE 288 (3d ed. 1988); W. KLEIN & J. COFFEE, BUSINESS ORGANIZATION AND FINANCE—LEGAL AND ECONOMIC PRINCIPLES 362 (4th ed. 1990); Carney, *Signalling and Causation in Insider Trading,* 36 CATH. U.L. REV. 863, 878 (1987); 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, 517 (1988). Insiders may be able to realize abnormal trading profits without taking advantage of corporate information, *see* Carney, *supra,* at 878-79; Givoly & Palmon, *Insider Trading and the Exploitation of Inside Information: Some Empirical Evidence,* 58 J. BUS. 69, 85-86 (1985), but whatever explains the profits, the fact remains that § 16 does not stand in the way of profitable trading. *Cf.* Dooley, *supra* note 5, at 3 (difficulty of enforcing rule 10b-5).

16. *See supra* notes 5, 7, 10-11.

17. *See* Dooley, *supra* note 5, at 57 ("It is sometimes implied that the narrow scope of [§ 16] is attributable to a failure of imagination, subsequently remedied by the creative development of rule 10b-5 . . . ."). *But see* R. CLARK, *supra* note 4, § 8.7, at 306 (ambiguities of § 16(b) result from drafters' inevitable uncertainty about the future).

or arbitrary; on the contrary, section 16 bothers them because they find it a peculiarly inadequate statute. Their judgment presupposes that Congress thought it was wrong to trade stock on the basis of nonpublic corporate information and enacted section 16 because it wanted to prevent insiders from doing so. The problem with section 16, however, may lie not in the statute but in the premise of its critics: that section 16 was created to keep people from taking advantage of nonpublic information. In other words, section 16's well-known shortcomings actually may show that it was intended to serve some purpose other than preventing people from taking advantage of inside information.

Few critics seem to have even considered the possibility that Congress was trying to do anything but stop insiders from trading on the basis of inside information.[18] Here again, Clark has captured the con-

18. A few commentators have recognized that § 16 may serve policies other than informational equality, but usually as an aside in discussion of rule 10b-5 and without much development of the point. *See* V. BRUDNEY & M. CHIRELSTEIN, CASES AND MATERIALS ON CORPORATE FINANCE 1023, 1028 (3d ed. 1987); H. MANNE, INSIDER TRADING AND THE STOCK MARKET 9-10 (1966); *id.* at 30 (stating that "§ 16(b) can be rationalized as an antimanipulation device but not as an effective prohibition of insider trading. . . . Neither legislative history nor the subsequent literature . . . has viewed Section 16 as another of the antimanipulation devices Congress included in the 1934 Act."); Brudney, *Insider Securities Dealings During Corporate Crises,* 61 MICH. L. REV. 1, 8-9 (1962); Dooley, *supra* note 5, at 56-59 (legislative history and statutory language show § 16 to be directed at manipulation); Easterbrook & Fischel, *Trading on Inside Information,* 36 LAW SCH. REC. 10, 17 (1990); *see also Task Force Report, supra* note 7, at 1092 (§ 16(b) "is aimed at three specific types of insider trading abuses, only one of which involves abuse of inside information"); Yourd, *Trading in Securities By Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act,* 38 MICH. L. REV. 133, 143-44, 147-48 (1939) ("behind this purpose [prevention of insider trading] lies the larger and predominant design to protect the securities market from untoward influences"). *But see* H. MANNE, *supra,* at 26 (§ 16 "was designed only to prevent insiders from profiting from inside information").

The failure of most critics of § 16 to consider the possibility that it was addressed to something other than insiders taking advantage of corporate information is probably explained by a number of factors. The language of § 16(b) suggests that the reason affiliates are required to forfeit short-swing profits is that forfeiture will prevent them from making unfair use of inside information, but the conventional wisdom on § 16 may have been influenced even more profoundly by the fact that for 30 years after the Exchange Act was enacted, there was no real debate about insider trading. Until Henry Manne called attention to the incentive effects of insiders trading on the basis of nonpublic information, *see infra* note 65 and accompanying text, two sides to the issue did not exist: insider trading was criticized, but not defended. So long as everyone agreed that trading on the basis of inside information was immoral, it would have been hard to discuss or to justify § 16 in the relatively mundane terms of efficiency or incentive. By the time the propriety of insider trading was carefully considered, every aspect of § 16 had already been discussed extensively. Moreover, the debate had shifted from § 16 to rule 10b-5; the operation of § 16 was relatively settled, while many important questions under rule 10b-5 were still open. *See supra* notes 3, 5 (rule 10b-5 dominates recent discussion of federal regulation of insider trading). Finally, anyone who thinks insiders should not be allowed to trade on inside information is hard pressed to concede some other purpose in §

ventional—if generally unarticulated—wisdom: "Did Congress decline to make the rule turn on the insider's knowledge and intent because it thought these things to be theoretically irrelevant? Because it was interested in some evil other than insider trading? The answer to both questions is no, of course."[19]

This Article reaches a different conclusion. Section 16 does much more than regulate the use of corporate information; it discourages those who control publicly held corporations from manipulating corporate affairs to create opportunities to trade corporate stock profitably. If widely held assumptions about the way corporations work are true, section 16 is an extraordinarily precise measure for getting those in charge of publicly held companies to operate them in ways that will benefit the general public. Those who secured the enactment of section 16 knew this, and they were probably more concerned with reforming the way publicly held corporations conduct their business than with the interests of security traders.

After outlining the mechanics of section 16 more fully, this Article proceeds in Part II to show how section 16 regulates the operation of publicly held corporations. The key is that publicly held companies are managed by people who do not own them. The separation of management from ownership that defines publicly held companies has disturbing implications for the way they do business, calling into question the legitimacy of large-scale corporate enterprise. By moving the interest of those who control corporations into alignment with the interest of stockholders, section 16 addresses a distracting and destructive opportunity that the separation problem creates, and in so doing it encourages those in control to run publicly held companies in the public interest. If the separation of ownership and control really is a problem, section 16 cannot solve it of course; if corporate managers can shirk and steal, they can do so without trading stock. Nonetheless, section 16 is calculated to improve the way publicly held corporations operate and to prevent many abusive management practices.

People who ought to know have called section 16 "[t]he most subtle and least understood" provision of the Exchange Act.[20] None-

16, for if Congress was concerned with something other than informational equality in § 16, the legitimacy of regulating insider trading under rule 10b-5 is open to question. It is instructive that Dooley, Easterbrook and Fischel, and Manne suggested the possibility of explaining § 16 as an antimanipulative provision while they were engaged in extensive and more general criticism of rule 10b-5. (Brudney on the other hand has recognized the antimanipulative function of § 16 and also championed informational equality.).

19. R. CLARK, *supra* note 4, § 8.6, at 295.

20. Cook & Feldman, *supra* note 12, at 386; *see also* Meeker & Cooney, *supra* note 12, at 949 (quoting Cook & Feldman) (Donald Cook and Thomas Meeker were, respectively, Chairman and Special Counsel of the SEC when they made these observations).

theless, section 16 works in a relatively straightforward manner on one aspect of the management process. It regulates the way publicly held corporations are managed by manipulating the incentives that operate upon those who control these corporations. The several provisions of section 16 work together to tie the personal fortunes of directors, officers, and principal stockholders more closely to long-term appreciation of stock prices and to discourage them from arranging corporate affairs to suit their personal ends at the expense of corporate profit.

Section 16 makes it likely that those whose affairs it regulates will profit when stock prices rise over the long term. It encourages officers and directors to buy and hold stock in their companies by requiring them to disclose how much stock they own and by discouraging frequent trading. Officers, directors, and principal stockholders are left with an incentive to pursue corporate policies that will cause stock prices to rise, since they are allowed to trade profitably while prices are rising, even if they trade on the basis of nonpublic corporate information. Finally, by requiring those it regulates to disclose their trading and to disgorge their profits from short-swing trading and by forbidding them to sell short, section 16 makes it difficult for those in charge of publicly held companies to profit when stock prices fall steadily or fluctuate rapidly.

Section 16's technique of manipulating private incentives with simple, statutorily enunciated rules is uncharacteristic of the Exchange Act. Commentators consistently have considered administrative discretion to be the hallmark of the Exchange Act, and taken as a whole the Act reflects tremendous confidence in administrative expertise.[21] Almost every substantive provision of the Act provides for regulation of some set of practices by an administrative agency, typically the Securities and Exchange Commission (SEC), which is supposed to perfect the regulatory scheme in light of experience and changing circumstances. Administrators, however, play a minimal role in section 16. Instead of providing for continuing bureaucratic oversight, section 16 adjusted the management system once, in hopes of making the system work correctly for a long time. This approach gave section

21. *See* J. Brooks, Once in Golconda: A True Drama of Wall Street 1920-1938, at 204-05 (1969); R. DeBedts, The New Deal's SEC 81 (1964); J. Flynn, Security Speculation 1 (1934); M. Parrish, Securities Regulation and the New Deal 143 (1970); J. Seligman, The Transformation of Wall Street 99-100 (1982); R. Vernon, The Regulation of Stock Exchange Members 132-34 (1941); Hoffman, *Securities Exchange Act of 1934,* in The Security Markets: Findings and Recommendations of a Special Staff of the Twentieth Century Fund 700, 700 (1935) [hereinafter The Security Markets]; Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act,* 42 Stan. L. Rev. 385, 419-24 (1990); D. Levin, Regulating the Securities Industry 403-04 (1969) (Ph.D. dissertation, Political Science, Columbia University).

16 a rigidity that may be unfortunate, but at the same time it made the section politically palatable.

The idea that section 16 was designed to encourage those in control of a publicly held company to devote themselves to raising the price of its common stock is somewhat at odds with prevailing wisdom about the purpose of section 16 and of the Exchange Act generally. Part III of this Article shows that the people responsible for the enactment of section 16 intended to influence the way publicly held corporations are managed. The regulation of corporate management had long been a goal of those who pressed for stock exchange reform, and management regulation seemed imperative during the crisis that led to enactment of the Exchange Act. The model of the publicly held corporation implicit in section 16 comports with thinking at that time, and the record of public and private deliberations on the Exchange Act shows that the drafters and sponsors of section 16 intended to regulate corporate management.

Some of the implications of the explanation of section 16 offered here are outlined in Part IV. The courts and the SEC regularly refer to congressional intentions to justify the way they construe and administer the federal securities statutes, and some of their decisions are inconsistent with the congressional intentions implicit in the vision of section 16 offered here. Measuring recent judicial and administrative initiatives against those intentions leads to the conclusion that federal securities regulation has evolved in a way that would have surprised and perhaps disappointed those involved in enacting the Exchange Act.

It may be appropriate that the intentions of the drafters of the Exchange Act have not been realized. Nonetheless, the startling difference between what the drafters saw and what we see today says something important about the way statutes are written and understood. By and large, section 16 still works as the drafters intended: it is effective largely because the courts and the SEC rarely have to delve into its underlying purpose. Intentionally or not, wisely or naively, the drafters of section 16 coordinated the interests of management and stockholders of publicly held corporations. In doing so, they codified the best business practices and fundamentally changed, without challenge, the system under which corporate managers work. Those who want to understand the federal securities statutes or to reform big business should study section 16 carefully.

B. The Mechanics of Section 16

The Exchange Act provides for pervasive regulation of the operations of stock exchange members and others continuously engaged in the securities business.[22] It also provides for less extensive regulation of the affairs of industrial and commercial firms whose securities are owned by the public.[23] When the Exchange Act was first enacted, the provisions governing security issuers did not come into play until a business registered its securities on a national securities exchange pursuant to section 12 of the Act.[24] Section 16 did not apply unless an issuer registered a class of its equity securities.[25] Registration was voluntary, and although issuers might have been under substantial pressure to register,[26] an issuer could have avoided most provisions of the Exchange Act, including section 16, by not registering.

The reach of section 16 was extended when the Exchange Act was amended in 1964.[27] Although companies still trigger section 16 by registering their equity securities under section 12, section 12 now requires them to register most publicly held equity securities with the SEC if they are not registered on an exchange.[28] As a result, almost all pub-

22. *See* Exchange Act §§ 8, 15 U.S.C. § 78h (1988) (borrowing by exchange members, brokers and dealers), 11, 15 U.S.C. § 78k (1988) (segregation of broker and dealer functions), 15, 15 U.S.C. § 78*o* (1988) (regulation of over-the-counter market), 17, 15 U.S.C. § 78q (1988) (accounts and records).

23. *See* Exchange Act §§ 12, 15 U.S.C. § 78*l* (1988) (registration of securities), 13, 15 U.S.C. § 78m (1988) (reporting), 14, 15 U.S.C. § 78n (1988) (solicitation of proxies).

24. *See* Exchange Act § 12(b), 15 U.S.C. § 78*l*(b) (1988) (registration); *see also* Exchange Act §§ 13, 15 U.S.C. § 78m (1988) (periodic reporting), 14, 15 U.S.C. § 78n (1988) (regulation of proxy solicitation).

25. *See* Exchange Act § 16(a), 48 Stat. 881, 896-97 (codified as amended at 15 U.S.C. § 78p(a) (1988)). The reporting requirements of § 16(a) are tied to an issuer's registering a class of its equity securities pursuant to § 12 of the Exchange Act, and the rest of § 16 builds on § 16(a). *See, e.g., id.* § 16(b), 15 U.S.C. § 78p(b) ("such security").

26. Registration is a condition of participating in the exchange market, since exchange members, brokers, and dealers cannot effect transactions in a security on an exchange unless the security is registered. *Id.* § 12(a), 15 U.S.C. § 78*l*(a) (1988). *See generally* 2 L. Loss, *supra* note 2, at 406-12.

27. Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565 (codified as amended in scattered sections of 15 U.S.C.). The scope of § 16 was expanded by changing § 12 to require the registration of many equity securities traded over-the-counter. The language of § 16 was changed in 1964 to accommodate the change in § 12 and to provide an exemption for market makers. These are the only changes that have been made in § 16 since it was first enacted in 1934.

28. With a few exceptions, any security traded on a national securities exchange and any equity security held of record by 500 persons issued by a company with $5,000,000 or more in assets must be registered pursuant to § 12. Exchange Act § 12(a), (g), 15 U.S.C. § 78*l*(a), (g) (1988); rule 12g-1, 17 C.F.R. § 240.12g-1 (1988). An issuer must register an equity security under § 12(g) within 120 days after the last day of its first fiscal year on which such security is held of record by 500 or more persons. Issuers may also register their securities under § 12 voluntarily. Exchange Act § 12(g), 15 U.S.C. § 78*l*(g) (1988); *see* 2 L. Loss, *supra* note 2, at 411-12. Since brokers and dealers may not make a market in a security unless they have extensive information about the issuer's operations, rule 15c2-11, 17 C.F.R. § 240.15c2-11 (1988), even issuers that are not required to register their securities are under considerable

licly held equity securities are registered under section 12, and accordingly section 16 now influences the way almost all publicly held companies do business.[29]

Relatively few people are subject to section 16, but they are generally prosperous and influential people: the directors and officers of issuers of equity securities registered under section 12 and what the caption for section 16 refers to as "principal stockholders" (persons who, directly or indirectly, beneficially own more than ten percent of any class of any equity security registered under section 12).[30] These principal stockholders,[31] directors, and officers[32] control publicly held

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pressure to register them if they want to foster a trading market. *See also* National Association of Securities Dealers, Inc., By-Laws, Schedule D § 1, NASD Manual (CCH) ¶ 1803.

29. *See* R. CLARK, *supra* note 4, at 294; *cf.* SEC, DIRECTORY OF COMPANIES REQUIRED TO FILE ANNUAL REPORTS WITH THE SECURITIES AND EXCHANGE COMMISSION UNDER THE SECURITIES EXCHANGE ACT OF 1934 (1988) (listing 14,620 companies registered under § 12 or required to file reports pursuant to § 15(d) of the Exchange Act, 15 U.S.C. § 78*o*(d) (1988)).

30. A § 12 registration now covers a whole class of securities, but at one time specific securities were registered. *See* Exchange Act § 12(g)(1), 15 U.S.C. § 78*l*(g)(1) (1988) (class registration); rule 12d1-1, 17 C.F.R. § 240.12d1-1 (1988) (applications under § 12(b) and (c) deemed to apply for whole class); 2 L. Loss, *supra* note 2, at 407-08. This history accounts for § 16's reference to "any class of any equity security that is registered," rather than simply any class of equity security that is registered.

31. When stock is widely held, a substantial stockholder can often control the corporation with less than a majority of the outstanding stock. *Stock Exchange Practices: Hearings Before the Committee on Banking and Currency, United States Senate on S. Res. 84 (72nd Congress) and S. Res. 56 and S. Res. 97 (73d Congress),* 73d Cong., 1st Sess. 6556 (1934) [hereinafter *Stock Exchange Practices*] (testimony of Thomas Corcoran) ("Five percent is a lot in a modern corporation. Many corporations are controlled by 5 percent or 10 percent."), *reprinted in* 6 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, item 22 (J. Ellenberger & E. Mahar eds. 1973) [hereinafter LEGISLATIVE HISTORY]; 4 L. Loss & J. SELIGMAN, SECURITIES REGULATION 1703 (1990) ("It has been generally recognized, back far further than 1933, that practical control of a corporation does not require ownership of 51 percent of its voting securities—or anything like that amount."); *see also Report of the Committee Appointed Pursuant to House Resolutions 429 and 504 to Investigate the Concentration of Control of Money and Credit,* H.R. REP. No. 1593, 62d Cong., 3d Sess. 145-46 (1913) ("a small fraction [of outstanding stock] is able to control a corporation if the holdings are widely scattered"), *reprinted in part in* Sheldon, *The Pujo Committee,* in 3 CONGRESS INVESTIGATES: A DOCUMENTED HISTORY 1792-1974, at 2356-81 (A. Schlesinger, Jr. & R. Burns eds. 1975) [hereinafter CONGRESS INVESTIGATES]; H.R. REP. No. 1383, 73d Cong., 2d Sess. 3 (1934) ("Not only is nearly one half of the entire national wealth of the country represented by corporate stocks and corporate and Government bonds, but nearly one half of that corporate wealth is vested in the 200 largest nonbanking corporations which, piercing the thin veil of the holding company and disregarding a relatively few notable exceptions, are . . . controlled by those owning only a very small proportion of the corporate stock"), *reprinted in* 5 LEGISLATIVE HISTORY, *supra,* item 18; W. RIPLEY, MAIN STREET AND WALL STREET 95 (1927). *See also* A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932); Berle, *"Control" in Corporate Law,* 58 COLUM. L. REV. 1212 (1958); Sommer, *Who's "In Control"?—SEC,* 21 BUS. LAW. 559 (1966).

32. State corporate law typically provides that the affairs of a business corporation are to be managed by the board of directors or by officers under the direction of the board, *see,*

companies, and section 16 has more pervasive implications for their personal affairs than any other provision of the securities laws.

Directors, officers, and principal stockholders become subject to the reporting requirements of section 16(a) as soon as they take their companies public or become affiliated with publicly held companies.[33] Section 16(a) requires them to disclose beneficial ownership of any equity securities, registered or not, issued by the companies with which they are affiliated. In addition to reporting their initial holdings, they must report any change in ownership to the SEC and to any stock exchange on which their companies have equity securities registered.[34]

Section 16(b) is the provision that most complicates the personal affairs of those in control of publicly held companies, and it is also the most maligned part of section 16. Broadly speaking, it provides that if anyone subject to section 16(a) buys and sells, or sells and buys, any equity security issued by the company with which she is affiliated within a period of less than six months, the company is entitled to recover any profits she realizes from the transactions.[35] If the company fails to pursue such profits, its security owners may do so in its behalf. The courts have given section 16(b) teeth by computing profit so as to maximize the forfeiture and by awarding attorneys fees when security owners prosecute section 16(b) suits in behalf of issuers.[36]

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e.g., CAL. CORP. CODE § 300(a) (West 1977 & Supp. 1990); DEL. CODE. ANN. tit. 8, § 141(a) (Supp. 1978); N.Y. BUS. CORP. LAW § 701 (McKinney 1986); REVISED MODEL BUSINESS CORP. ACT § 8.01(b) (1985); PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3.01, at 61, § 3.02, at 66 (Tent. Draft No. 2, 1984) [hereinafter CORPORATE GOVERNANCE], with stockholders electing the board of directors, *see, e.g.*, CAL. CORP. CODE § 708 (West 1977 & Supp. 1990); DEL. CODE ANN. tit. 8, § 211 (1975); N.Y. BUS. CORP. LAW § 703 (McKinney 1986); REVISED MODEL BUSINESS CORP. ACT §§ 8.03, 8.04.

33. Directors, officers, and principal stockholders must report when the issuer with which they are affiliated registers an equity security. Persons who become directors, officers, or principal stockholders of issuers with registered equity securities have 10 days to file. Transactions effected before a company registers equity securities under § 12 or before a person becomes an officer or director of a company with registered equity securities can have implications under § 16(b). An officer or director's trade can be matched with an earlier trade made before the trader became an officer or director. *See* Jacobs, *supra* note 12, at 380-89. A purchase or sale made prior to the effective date of a § 12 registration may be matched with a sale or purchase occurring after registration but within six months of the first transaction. Perfect Photo, Inc. v. Grabb, 205 F. Supp. 569 (E.D. Pa. 1962); *see* Jacobs, *supra* note 12, at 265-66; Sargent, *The Securities Acts Amendments of 1964: Background, Effect and Practicalities*, 20 SW. L.J. 434, 452 (1966).

34. An issuer that has equity securities registered on more than one exchange may designate one of them as the only one with which § 16(a) reports need be filed. Rule 16a-1(c), 17 C.F.R. § 240.16a-1(c) (1988).

35. The statute uses the male form of the pronoun but presumably applies to women as well.

36. Smolowe v. Delendo Corp., 136 F.2d 231, 237-38 (2d Cir. 1943), *cert. denied*, 320 U.S. 751 (1943) (adopting lowest-in, highest-out measure of profit and awarding attorney fees

There has been very little litigation or commentary on the other parts of section 16, and accordingly they are less well known than sections 16(a) and 16(b). Section 16(c) imposes two limitations on activities of those subject to section 16 (again, directors and officers of issuers of registered equity securities and beneficial owners of more than ten percent of any class of registered equity security). First, it makes it unlawful for them to sell stock short—they cannot sell equity securities issued by the companies with which they are affiliated if they do not own the securities. Second, it forbids them to sell such securities against the box—if they sell stock that they do own, they must deliver to the buyer promptly. In declaring short sales and delayed deliveries illegal, section 16(c) is markedly different from section 16(b), which provides for the disgorgement of short-swing profits but does not forbid anything.

The rest of section 16 limits the scope of the first three parts.[37] Section 16(d), which was added in 1964, exempts market makers from section 16(b) and section 16(c).[38] Section 16(e) provides that no part of section 16 will apply to arbitrage transactions unless they contravene such rules as the SEC "may adopt in order to carry out the purposes of [the] section."[39]

II. Section 16 and the Regulation of Corporate Management

By regulating the affairs of the officers, directors, and principal stockholders of publicly held corporations, section 16 influences the

to the plaintiff-securityholder out of the amount forfeited); *cf.* 2 L. Loss, *supra* note 2, at 558 (*Smolowe* "has reigned supreme."). *See generally* W. Cary & M. Eisenberg, *supra* note 12, at 597-98 (computation of profits).

37. The operative provisions of § 16 also include limitations. "Exempted securities" are excluded from each of them. Section 16(b) does not apply when the traded security "was acquired in good faith in connection with a debt previously contracted," and it does not "cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved." The SEC is granted further exemptive power in § 16(b) ("This subsection [16(b)] shall not be construed to cover . . . any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."), and § 12(h) ("The Commission may . . . exempt from section 16 any officer, director, or beneficial owner of securities of any issuer, any security of which is required to be registered pursuant to subsection [12(g)] . . . if the Commission finds . . . that such action is not inconsistent with the public interest or the protection of investors."). The § 12(h) exemptive authority with respect to certain types of regulated financial institutions is vested in different regulatory agencies. Exchange Act § 12(i), 15 U.S.C. § 78*l*(i) (1988).

38. *See generally* Painter, *Section 16(d) of the Securities Exchange Act: Legislative Compromise or Loophole?,* 113 U. Pa. L. Rev. 358 (1965) (discussing the legislative and judicial history of § 16(d)).

39. Old § 16(d) was redesignated § 16(e) when the present § 16(d) was added to the Exchange Act in 1964.

way publicly held corporations are managed. Although section 16 regulates the business affairs of publicly held corporations indirectly, an examination of the way it does so reveals a coherent scheme for the regulation of corporate management. That regulatory scheme seems to envision a publicly held corporation as one which "should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain,"[40] and one which is owned by its stockholders.[41] It follows from these propositions that the people in charge of corporations should devote themselves to producing profits and causing stock prices to rise.[42] The problem with publicly held corporations is that managers who do not own the corporations they manage may have less incentive to maximize stockholder wealth than do managers who are owners.[43]

This conception of the corporation has its critics,[44] and a variety of mechanisms minimize the actual conflict between stockholders and managers of publicly held corporations.[45] No doubt a more sophis-

40. CORPORATE GOVERNANCE, *supra* note 32, § 2.01.

41. *See* A. BERLE & G. MEANS, *supra* note 31, at 120; *cf.* Fama & Jensen, *Separation of Ownership and Control,* 26 J.L. & ECON. 301 (1983) (ownership as residual risk-bearing) (explaining "the survival of organizations characterized by separation of 'ownership' and 'control'").

42. CORPORATE GOVERNANCE, *supra* note 32, § 3.02(a)(2) (Directors of a publicly held corporation should oversee its business with a view to evaluating whether it is being managed consistently with § 2.01.). Although some critics contend that managers should concern themselves with non-stockholder constituencies, it is fair to say that those who concern themselves with the Exchange Act generally agree that stockholder welfare should be at least an important goal of corporate managers. *Cf.* Douglas, *Directors Who Do Not Direct,* 47 HARV. L. REV. 1305, 1322 (1934) (stating that "the board is to be employed as a medium for the protection and enhancement of the interests of the corporation and the stockholders . . ."); Palmiter, *Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence,* 67 TEX. L. REV. 1351, 1367-68 (1989) (explaining fiduciary model of directors' duties in terms of stockholder wealth maximization). *Compare* Berle, *For Whom Corporate Managers Are Trustees: A Note,* 45 HARV. L. REV. 1365 (1932) *and* Berle, *Corporate Powers as Powers in Trust,* 44 HARV. L. REV. 1049 (1931) *with* Dodd, *For Whom Are Corporate Managers Trustees?,* 45 HARV. L. REV. 1145 (1932).

43. Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract,* 85 COLUM. L. REV. 1403, 1406-07 (1985); Fama & Jensen, *Agency Problems and Residual Claims,* 26 J.L. & ECON. 327, 331 (1983); Fischel, *The Corporate Governance Movement,* 35 VAND. L. REV. 1259, 1262-63 (1982) [hereinafter Fischel, *Corporate Governance*]; Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law,* 76 NW. U.L. REV. 913 (1982) [hereinafter Fischel, *Race to the Bottom*].

44. *Cf.* Brudney, *supra* note 43; Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web,* 85 MICH. L. REV. 1, 25-40 (1986) (surveying theories); Fischel, *Race to the Bottom, supra* note 43, at 917 (criticizing model as based on shareholder irrationality); *Contractual Freedom in Corporate Law,* 89 COLUM. L. REV. 1395 (1989) (discussing debate on corporate contractual freedom).

45. *See* R. WINTER, GOVERNMENT AND THE CORPORATION (1978); Coffee, *supra* note 44, at 25-28 (summarizing literature); Dent, *Toward Unifying Ownership and Control in the Public*

ticated and qualified model is needed to determine whether section 16 makes the world a better place and whether it in fact helps to align management and stockholders interests. Nonetheless, whatever its limitations in reflecting the way publicly held corporations actually work, the simple model does help make sense of section 16.

Even if the market and state law constraints are adequate to the challenges posed by the separation of management and ownership in publicly held corporations, the fact remains that many people think these constraints are inadequate. The Exchange Act was written and debated in the light—some might say the glare—of *The Modern Corporation and Private Property,* in which Adolf A. Berle, Jr. and Gardiner C. Means undertook to show that ownership and control had been separated in large corporations.[46] Section 16 should be recognized as an early response to this problem.

One can appreciate that section 16 may have been a response to a perceived problem of separation of ownership from control without agreeing that the separation is in fact a problem. To understand section 16, however, it is necessary to understand why people worried about the separation in 1934.[47] Scholars have been preoccupied with the implications of Berle and Means's thesis since 1932, and perhaps the theme of separation now carries some connotations that Berle and Means did not identify.[48] Those who are troubled by the separation

Corporation, 1989 WIS. L. REV. 881, 884-85 (summarizing literature); Manne, *The "Higher Criticism" of the Modern Corporation,* 62 COLUM. L. REV. 399 (1962); Werner, *Management, Stock Market and Corporate Reform: Berle and Means Reconsidered,* 77 COLUM. L. REV. 388 (1977) (financial markets cause modern corporate management to pursue constantly increasing corporate earnings); Williamson, *Corporate Governance,* 93 YALE L.J. 1197 (1984); McCraw, In Retrospect: Berle and Means, Reviews in American History, (forthcoming; manuscript at 15) (describing "the sociology of professional management[:] executives' submergence in a corporate culture obsessed with competitive market performance, their keen identification of the self with the company"). It may be noteworthy that the co-author of the most extensive discussion of the way that § 16 aligns stockholder and manager interests, Carlton & Fischel, *The Regulation of Insider Trading,* 35 STAN. L. REV. 857, 891-94 (1983), is also one of the most vigorous proponents of the view that the separation of ownership and control does not pose problems justifying substantial law reform. *See, e.g.,* Fischel, *Corporate Governance, supra* note 43, at 1291-92; Fischel, *Race to the Bottom, supra* note 43, at 918.

46. A. BERLE & G. MEANS, *supra* note 31. On the influence of this work see J. SCHWARZ, LIBERAL: ADOLF A. BERLE AND THE VISION OF AN AMERICAN ERA 59-68 (1987); *Corporations and Private Property: A Conference Sponsored by the Hoover Institution,* 26 J.L. & ECON. 235 (1983); Werner, *supra* note 45, at 395-97; McCraw, *supra* note 45.

47. S. BRUCHEY, ENTERPRISE: THE DYNAMIC ECONOMY OF A FREE PEOPLE 452 (1990) ("Men and women can attend only to what they understand to be the exigencies of their time."); *id.* at 421-22 ("the historian's insistence that the past be viewed . . . in the light of what contemporaries believed about their situation and about themselves").

48. *See* W. KLEIN & J. COFFEE, *supra* note 15, at 160 (The Berle and Means thesis "has remained the point of departure for most modern commentary about the publicly held

today often argue that something should be done to protect stockholders from selfish managers; their case is essentially for investor or stockholder protection. If the separation of ownership from control is of consequence at all, however, it has consequences for people who are neither owners nor managers.

The Modern Corporation was provocative because it treated the separation of ownership and control in large publicly held corporations in the broadest terms of public welfare. When corporate managers failed to pursue profits, according to Berle and Means, business stopped working in the public interest.[49] Their ultimate aim was to reform big business. They were not interested in publicly held corporations without substantial assets or sales. Almost all big businesses were publicly held corporations though, and big businesses dominated the economy. According to Berle and Means, a relatively small number of publicly held companies formed "the very framework of American industry. The individual must come in contact with them almost constantly. He may own an interest in one or more of them, he may be employed by one of them, but above all he is continually accepting their service."[50]

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corporation."); R. WINTER, *supra* note 45, at 16 ("With a few exceptions, the legal literature is single-mindedly concerned with the discretion corporate management can exercise as a result of the 'separation of ownership and control' popularized by Berle and Means."); Coffee, *supra* note 44, at 15; DeMott, *Foreword: Reweaving the Corporate Veil,* 41 LAW & CONTEMP. PROBS., No. 3, at 1 ("In the past fifty years, writing about corporation law has pursued several distinct lines of inquiry. One such line of analysis began with Berle and Means' demonstration that ultimate legal ownership was separate from effective control in large publicly held corporations."); Dent, *supra* note 45, at 881; Fischel, *Race to the Bottom, supra* note 43, at 913-15; Scott, *Corporation Law and the American Law Institute Corporate Governance Project,* 35 STAN. L. REV. 927, 927 (1983) ("A central intellectual theme of the analysis of corporation law in the twentieth century has been the separation of ownership and control in the modern publicly-held corporation . . . ."); Williamson, *supra* note 45, at 1199; *cf.* 2 L. LOSS & J. SELIGMAN, *supra* note 31, at 23.

49. *See* Berle, *High Finance, Master or Servant?,* 23 YALE REV. 20, 43 (1933). In its focus on the public interest, as distinct from investor interest, the argument differs in important respects from recent arguments for federal corporate law standards. *See* R. WINTER, *supra* note 45, at 9 (characterizing Cary's argument for federal standards: "This last claim, it is absolutely critical to note, is not that an overriding social goal is sacrificed by state law but that Delaware is preventing *private* parties from optimizing their *private* arrangements."). In Berle's argument, private ordering is appropriate when private parties pursuing their own interests arrange their affairs in a way that contributes to the public good, but when they fail to do so they injure a public interest independent of their own.

Many proponents of corporate law reform also are concerned more with average citizens than with stockholders and other investors. *See, e.g.,* R. NADER, M. GREEN & J. SELIGMAN, TAMING THE GIANT CORPORATION (1976).

50. A. BERLE & G. MEANS, *supra* note 31, at 24:

> Corporations have ceased to be merely legal devices through which the private business transactions of individuals may be carried on. . . . The corporation has, in

Berle and Means focused on corporate structure because they believed that corporate structure determines the way big business works. The separation of ownership from control was important because it defined the framework of industry and brought the fundamental justification for private property into question:

> [S]elf-interest has long been regarded as the best guarantee of economic efficiency. It has been assumed that . . . [the individual's] desire for personal gain, for profits, can be relied upon as an effective incentive to his efficient use of any industrial property he may possess.
>
> In the quasi-public corporation, such an assumption no longer holds.[51]

Investors had reason to be concerned, but the explosive implication of separating the control of industrial assets from ownership was that it seriously undermined the legitimacy of big business. "It requires little analysis to make plain the fact that private property, as understood in the capitalist system, is rapidly losing its original characteristics. Unless the law stops the wide open gap which the corporate mechanism has introduced, the entire system has to be revalued."[52]

It may be hard to believe that many Americans, let alone members of Congress, actually questioned the legitimacy of big business or private property in 1934, or that they were moved to do so by a technical analysis of industrial structure and corporate law. Nonetheless, even if the tone of *The Modern Corporation* was overblown,[53] the argument

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> fact, become both a method of property tenure and a means of organizing economic life. Grown to tremendous proportions, there may be said to have evolved a "corporate system"—as there was once a feudal system—which has attracted to itself a combination of attributes and powers, and has attained a degree of prominence entitling it to be dealt with as a major social institution.

Id. at 1; *see also* J.W. HURST, LAW AND SOCIAL ORDER IN THE UNITED STATES 242 (1977) [hereinafter J.W. HURST, LAW AND SOCIAL ORDER] ("Great practical power over resource allocation and over the social and political values it affected had come to rest in modern corporate management."). For a recent statement of the argument that the importance of corporate operations justifies public intervention in corporate affairs, see R. NADER, M. GREEN & J. SELIGMAN, *supra* note 49, ch. 1.

51. A. BERLE & G. MEANS, *supra* note 31, at 8-9.

52. *Id.* at 247.

53. Other commentators have also stated the issue in terms of legitimacy. *See* J.W. HURST, LAW AND SOCIAL ORDER, *supra* note 50, at 242 ("At mid-twentieth century public policy thus emerged with a patchwork of consensus and conflict that left unresolved questions of the political and social legitimacy of the big business corporation. The issue of legitimacy was real and urgent."); J.W. HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION 84-85 (1970) [hereinafter J.W. HURST, LEGITIMACY] ("The conventional view assigned the stockholder two roles in legitimating corporate power. . . . In both respects, the shareholders' involvement would insure that those immediately in charge of the enterprise would be held to a profit-seeking performance, which under market discipline would make the firm an acceptably productive contributor to the economy."); W. RIPLEY, *supra* note 31, at 83 ("Veritably the

was compelling. During the Great Depression it was clear that "something had gone terribly wrong with unfettered capitalism."[54]

Although the New Deal securities statutes are conventionally viewed as a program of investor protection, the Exchange Act was directed as much to protecting the general public as to protecting investors.[55] Stockholders took a terrible beating in the early 1930s, but in 1934 their problems paled in comparison to the problems of just about everyone else. Congress recognized that corporate structure and the securities markets affect people who do not own securities. The Exchange Act responded to the perceived problem of the separation of ownership from control in a variety of ways.[56] Most obviously, it provided for the reorganization of proxy machinery so that stockholders could assert control.[57] Section 16 responded by regulating the personal finances of those who control publicly held corporations.

Section 16 reinforces incentives that will encourage directors, officers, and principal stockholders who control the operations of pub-

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institution of private property, underlying our whole civilization, is threatened at the root unless we take heed" of absentee ownership and involved corpôrate financial structures.); *cf. id.* at v ("Property should never be allowed to degenerate into an instrument of oppression. . . . This, then, is really a study in the relation of property to civilization."); *id.* at 99-100 (trend of corporate law to lessen responsibility and accountability of property owners). Ripley's book, first published in 1927, had explored the failure of stockholders to control corporate policy, *id.* at 78-117, and Berle and Means acknowledged that Ripley had "pioneered this area." A. BERLE & G. MEANS, *supra* note 31, at ix.

54. McCraw, *supra* note 45, at 22.

55. On introducing the bill that became the Exchange Act, Senator Duncan Fletcher explained that it was

> made necessary by the misfortunes of great numbers of our people who have lost part, or all, of their savings through unregulated stock exchanges. Still more, this bill has been made neçessary by the needs of the entire American public that the operation of the securities exchanges shall never again intensify a business depression, or help precipitate a business depression.

78 CONG. REC. 2270 (1934).

Section 2 of the Exchange Act, 15 U.S.C. § 78b (1988), expressly enumerates the reasons that pervasive regulation was necessary, and while it mentions that stock market practices establish prices for investors, it focuses on the effect such practices have on the underlying economy. *See, e.g., id.* § 2(4), 15 U.S.C. § 78b (1988) ("National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation . . . ."). *See generally* Thel, *supra* note 21, at 426-28 ("manipulation of security prices and excessive speculation can cause not only depressions but also unreasonable price fluctuations which interfere with the supply of credit, the calculation of taxes, and the proper functioning of financial institutions.").

56. *Cf.* Karjala, *An Analysis of Close Corporation Legislation in the United States,* 21 ARIZ. ST. L.J. 663, 666 (1989) ("In a very meaningful sense, federal securities regulation has thus created a public company law, leaving 'pure' state corporation law as a kind of private company law.").

57. Exchange Act § 14, 15 U.S.C. § 78n (1988). *See* H.R. REP. No. 1383, *supra* note 31, at 3, 5, 13-14; Dent, *supra* note 45, at 895-96; Manne, *supra* note 45, at 408.

licly held companies to manage those companies in ways that will cause steady appreciation of stock prices, while at the same time it deprives them of trading opportunities that might lead them to manage corporate affairs in ways that will cause prices to fluctuate or decline. By so refining the incentives under which they operate, section 16 may cause those in control to manage publicly held companies in ways that will benefit others legitimately interested in corporate affairs, including stockholders and the public at large.

If corporate stock prices are directly correlated with issuer profits, then the section 16 incentive structure should work to improve the way publicly held companies do business. In looking for coherence in the statute, conventional wisdom about the relationship between stock prices and issuer profits may be more important than the actual relationship, and the conventional wisdom is that prices tend to rise and fall with corporate profitability, at least over the long run.[58] In 1934 there was evidence that corporate earnings were an important determinant of stock prices,[59] and even the skeptical Keynes recognized that earnings were influential (although he thought other factors were likely to be overbearing).[60] Aside from what people thought actually determined prices, prevailing sentiments that security prices should reflect corporate profitability also played a large role in the way the Exchange Act was written,[61] and at the time there was widespread agreement that security prices should reflect corporate profitability.[62]

58. *See* Basic v. Levinson, 485 U.S. 224, 244 (1988) ("The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price.") (quoting *In re* LTV Securities Litigation, 88 F.R.D. 134, 143 (N.D. Tex. 1980)); R. Brealey & S. Myers, *supra* note 15, at 882 ("security prices reflect the true underlying values of assets"); Mendelson, *The Economics of Insider Trading Reconsidered,* 117 U. Pa. L. Rev. 470, 470 (1969) (reviewing H. Manne, *supra* note 18) ("[T]he capital markets do a reasonably good job of keeping the prices of securities in line with their earning power and riskiness . . . ."); Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation,* 87 Mich. L. Rev. 613 (1988); Wang, *Some Arguments that the Stock Market Is Not Efficient,* 19 U.C. Davis L. Rev. 341 (1986).

59. J. Burk, Values in the Marketplace: The American Stock Market Under Federal Securities Law 56-57 (1988).

60. J. Keynes, The General Theory of Employment, Interest and Money 156-58 (1936).

61. *See* J. Burk, *supra* note 59, at 45-47.

62. *See, e.g.,* S. Rep. No. 1455, 73d Cong., 2d Sess. 68 (1934), *reprinted in* 5 Legislative History, *supra* note 31:

> It is universally conceded that adequate information as to the financial structure and condition of a corporation is indispensable. . . . The concept of a free and open market for securities necessarily implies that the buyer and seller are acting in the exercise of an enlightened judgment as to what constitutes a fair price.

Id. at 30; H.R. Rep. No. 1383, *supra* note 31, at 5 ("The causes of dangerous speculation in

To the extent stock prices are a function of corporate profitability, section 16 may serve the interests of both stockholders and the general public by causing managers to focus on producing sustained price increases. Higher stock prices benefit stockholders, and attending to the interests of stockholders was (and probably still is) widely regarded as management's primary responsibility. Consumers and workers also benefit if steadily rising stock prices are a result of rising corporate profits. Companies ordinarily profit by producing goods and services efficiently, and profitable companies presumably provide more employment than failing companies. In trying to make sense of the Exchange Act, it helps to remember that in 1934 Congress was concerned far more with increasing employment than with protecting investors or stock-market speculators.

A. Management Conduct that Causes Stock Prices to Rise

If stock prices reflect issuer profits, it may be possible to inspire the profitable operation of publicly held corporations by giving those in charge a personal stake in stock prices.[63] One obvious way to do this is to encourage corporate managers to own corporate stock.[64]

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the securities markets . . . include inadequate corporate reporting which keeps in ignorance of necessary factors for intelligent judgment of the values of securities a public continually solicited to buy. . . ."); *id.* at 11; J. KEYNES, *supra* note 60, at 152 (characterizing conventional view); Moore & Wiseman, *Market Manipulation and the Exchange Act,* 2 U. CHI. L. REV. 46, 51 n.26 (1934); *Legislation,* 21 VA. L. REV. 103, 108 (1934); *see also* J. BURK, *supra* note 59, at 45-70; Danielian, *The Functions of an Ideal System of Exchanges,* in THE SECURITY MARKETS, *supra* note 21, at 19; Thel, *Regulation of Manipulation Under Section 10(b): Security Prices and the Text of the Securities Exchange Act of 1934,* 1988 COLUM. BUS. L. REV. 359, 405-15 (provisions of the Exchange Act designed to discourage speculation).

63. This incentive argument only applies to those who can affect corporate profits and thus stock prices. *See* Carlton & Fischel, *supra* note 45, at 877-78; Levmore, *supra* note 5, at 149; Scott, *supra* note 5, at 809; *cf.* R. CLARK, *supra* note 4, §6.2, at 201 (Incentive compensation schemes "are often, though not always, limited to upper and middle-level executive personnel."). Robert Haft has argued that corporate employees may delay the transfer of information to their superiors so that they can trade on it. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation,* 80 MICH. L. REV. 1051, 1054-55 (1982). If this is a problem, the solution may lie in regulating trading by subordinate employees. Easterbrook, *Insider Trading as an Agency Problem,* in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 81, 85 (J. Pratt & R. Zeckhauser eds. 1985) [hereinafter PRINCIPALS AND AGENTS]. *But see* Haft, *supra,* at 1060-64 (Allowing insider trading, even with fiduciary duties imposed on directors *inter se,* would return the board to hierarchical decision-making and would undermine peer group decision-making superiority.).

64. *See* NYSE Listed Company Manual ¶ 309.00 ("Many shareholders feel that directors and officers should have a meaningful investment in the companies they manage. . . . As shareholders themselves, directors are more likely to represent the viewpoint of other shareholders whose interests they are charged with protecting. Similarly, officers—the executive management group—may well perform more effectively with the incentive of stock options or

Some commentators go further and argue that the best way to motivate corporate managers is to allow them to buy stock on the basis of inside information. If managers can trade, the argument goes, they will have a powerful incentive to maximize corporate profits toward the end of causing share prices to increase.[65]

Of course, many people think it is profoundly unfair for corporate insiders to buy common stock when they are aware of favorable corporate developments of which the public is ignorant.[66] Nor is it clear that permitting insiders to trade while in possession of nonpublic corporate information will improve corporate performance; the profits of trading based on advance knowledge of good news may be unnecessary, imprecise, or counterproductive incentives for corporate managers.[67]

Even if critics of insider trading are right, however, it may not be a good idea to try to prevent it.[68] Legal sanctions are imprecise, and any effort to prevent insiders from buying stock on the basis of inside information risks discouraging insiders from buying stock at all.

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a share in the equity ownership of the company."), *reprinted in* 4 FED. SEC. L. REP. (CCH) ¶ 26,100, at 19,103; *see also* R. CLARK, *supra* note 4, § 6.2.1, at 202:

> Incentive compensation plans usually seek to give the executive a long-term reward that is linked to some measure of company performance. The performance measure might be the market price of the company's stock or the operating results . . . of the company or of the particular subsidiary or unit for which the executive works.

See also Fischel, *Race to the Bottom, supra* note 43, at 919; Mendelson, *supra* note 58, at 492 n.49 (recommending caution in curtailing long-term insider trading); Samuelson, *supra* note 15, at 523; *cf.* Lieberman v. Becker, 38 Del. Ch. 540, 155 A.2d 596 (1959) (upholding compensation plan).

65. The leading exponent of this view is Henry Manne. *See* H. MANNE, *supra* note 18, at 138-41; Manne, *Economic Aspects of Required Disclosure Under Federal Securities Laws,* in WALL STREET IN TRANSITION 21 (1974) [hereinafter Manne, *Economic Aspects*]; Manne, *Insider Trading and the Law Professors,* 23 VAND. L. REV. 547, 578-79 (1970); *see also* Carlton & Fischel, *supra* note 45, at 869-82 (discussing advantages and disadvantages of allowing corporate managers to buy stock on the basis of inside information).

66. 2 L. Loss, *supra* note 2, at 544-45; *cf.* R. POSNER & K. SCOTT, ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION 119 (1980) ("Much, if not most, of the judicial discussion of insider trading has been in terms of fairness and equal treatment of all investors . . . ."); Carlton & Fischel, *supra* note 45, at 880 ("the most common argument against insider trading—that it is unfair or immoral"); Dooley, *supra* note 5, at 55 (Even though enforcement of insider trading restrictions is unwise, insider trading "is behavior that falls below a standard of conduct to which many, including the author, aspire."). *See generally* Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information,* 1981 SUP. CT. REV. 309, 323-30 (discussing "fairness as the source of the obligation to disclose"); Lawson, *The Ethics of Insider Trading,* 11 HARV. J.L. & PUB. POL'Y 727 (1988) (in-depth treatment of the moral issues arising from insider trading).

67. R. CLARK, *supra* note 4, § 8.3, at 277-80; Levmore, *supra* note 5, at 149-50; Mendelson, *supra* note 58, at 486-90; Schotland, *Unsafe At Any Price: A Reply to Manne, Insider Trading and the Stock Market,* 53 VA. L. REV. 1425 (1967).

68. *See* Dooley, *supra* note 5.

If insider stock ownership creates appropriate incentives, any program that regulates trading on the basis of inside information must justify the incidental burden placed on insider stock ownership. The ultimate evaluation of such a program involves balancing the value of preventing insider trading against any damage to management incentives. That balance will shift with changes in the overall health of business.

During the Great Depression incentive problems were quite pressing, and section 16 in fact seems to be directed at encouraging corporate managers to hold stock for the long term. Some parts of section 16 work to discourage insiders from buying stock, but not so much from buying on inside information as from buying on speculation. There is no reason to believe that the drafters thought that buying on inside information is good, but neither do they seem to have been willing to compromise appropriate management incentives to prevent such buying.

The presumption that section 16 was supposed to prevent insiders from trading on the basis of inside information is hard to square with the fact that section 16 permits insiders to buy or sell on the basis of inside information.[69] Under the scheme Congress put in place with section 16, corporate managers are free to trade on the basis of information they acquire in the course of their work if they are prepared to wait to convert their profits to cash.[70]

The automatic forfeiture provision of section 16(b) is usually treated as the heart of section 16. Section 16 works to focus the attention of corporate managers on corporate business. Automatic forfeiture of short-swing profits eliminates the incentive to speculate for the short swing, and thus helps to keep corporate managers from being

69. *Cf.* H. MANNE, *supra* note 18, at 30 ("Section 16(b) can be rationalized as an antimanipulation device but not as an effective prohibition of insider trading.").

70. Of course rule 10b-5 also regulates insider trading, but rule 10b-5 was promulgated by the SEC, not by Congress. *See* 2 L. Loss, *supra* note 2, at 543 ("It is interesting that the only explicit answer of Congress to the insider trading problem was § 16, not some sort of provision . . . along the lines of the vast jurisprudence that ultimately developed under Rule 10b-5 . . . ."); *supra* notes 3, 5 and accompanying text. The Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA) more or less ratified the insider trading law that had developed under rule 10b-5. Pub. L. No. 100-704, § 2, 102 Stat. 4677 (codified following 15 U.S.C. 78u-1 (1988) under caption "Congressional Findings") ("The Congress finds that . . . the [SEC] has, within the limits of accepted administrative and judicial construction of [its rules and regulations governing trading while in possession of material, nonpublic information], enforced such rules and regulations vigorously, effectively, and fairly . . . ."); *see also* Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended in scattered sections of 15 U.S.C.) (authorizing the SEC to bring civil actions for insider trading and allowing for treble damages); H.R. REP. No. 910, 100th Cong., 2d Sess. 35 (findings in ITSFEA of 1988 "are intended as an expression of congressional support for [SEC] regulations"), *reprinted in* 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6072.

distracted from the business of running publicly held companies.[71] Moreover, since officers and directors cannot profit from being stockholders unless they hold for at least six months, when they do buy stock they acquire interests similar to those of long-term public stockholders.

Section 16(b) influences those it governs in subtle ways. Officers, directors, and principal stockholders cannot be held accountable under section 16(b) unless prices change for the better after they trade, and even then they are accountable only to the extent that they return to their original positions by effecting countervailing trades within six months; they can avoid forfeiture if they can delay their profitable offsetting trades for six months. Because of the short-swing trigger, section 16(b) tends to burden short-term speculations while leaving long-term investments alone. Specifically, section 16(b) will deter insiders from trading in two situations: (1) when they hope to make offsetting trades at better prices within six months; or (2) when they have made countervailing trades at better prices in the preceding six months (that is, a previous purchase may deter a sale, and vice versa).

If section 16(b) sometimes produces unfair results, it is in the second situation. When the second of two trades matched under section 16(b) is entirely independent of the first except for the fortuity of time, section 16(b) forfeiture may not serve any constructive purpose. Any time those subject to section 16 trade, they give up their right to make profitable trades in the other direction during the next six months. If the first trade is effected with no intention of making an offsetting trade, however, the burden of section 16(b) is unpredictable and not likely to deter trading on inside information or to encourage efficient corporate management. If an insider trades stock for the long term and subsequently decides to effect an offsetting trade within six months, section 16(b) will cause a problem only on the happenstance that prices have changed favorably since the first trade. In that event, the prospect of forfeiture may discourage the insider from making an offsetting trade, but it will do so irrespective of whether the insider possesses

71. *See* S. REP. No. 1455, *supra* note 62, at 186-87 ("Officers of commercial banking institutions, who were most substantially compensated to devote their time and energy to the performance of their essential duties, . . . encouraged and participated in speculative ventures [in the stock of their banks] for their own personal gain."); R. CLARK, *supra* note 4, § 8.3, at 280; Schotland, *supra* note 67, at 1451-52 (insiders "trading in the shares, as differentiated from investing in them, raises the danger that they may be distracted from single-minded devotion to their work for the corporation"); Werner, *supra* note 45, at 391 ("'[S]tock gambling' or speculation—trading to realize a quick profit from fluctuations in stock prices . . . was a mania that 'causes unutterable woe and ruin' to its practitioners, Cook said, and 'unsettles the minds of men and unfits them for serious earnest business.'") (footnote omitted) (quoting W.W. COOK, THE CORPORATION PROBLEM 71-72 (1891)).

nonpublic information at the time of the second trade. Moreover, the threatened forfeiture is not calculated to deter the insider from trading on inside information acquired after the first trade. The amount the insider will forfeit is determined by how the market has responded to information made available since the first trade, while the insider's profit from the offsetting trade will be determined by the way the market reacts when the inside information is released, which by hypothesis will not occur until after the offsetting trade is complete.[72]

Those responsible for section 16 were concerned with matched trades that were related by more than proximity in time. They wanted to keep corporate affiliates from entering into transactions with the intention of effecting offsetting transactions in the near future.[73] They

72. In other words, insofar as forfeiture is a function of the difference of price between two matched trades, it is not calculated to deter the use of inside information acquired after the original trade. An insider who learns nonpublic information after the original trade and is trying to decide whether to make an offsetting trade is concerned with what will happen to prices after the offsetting trade, while the amount of the § 16(b) forfeiture is a function of what has happened to prices between the time of the original and offsetting trade.

Consider an insider who buys stock without inside information and within six months learns negative information the disclosure of which she knows will depress share prices. She can sell all of her stock before the information is disclosed, and she will not have to make good the loss she has avoided by virtue of her possession of inside information. If the price has risen in the interim she will have to forfeit any profit she made on her purchase (but not profit she made on purchases made more than six months before), but by hypothesis she did not make that profit on the basis of inside information. She will sell if, but only if, the loss she hopes to avoid by selling on the basis of inside information exceeds the amount of the forfeiture. That is, she will sell if she expects the price to fall below her purchase price. In any case, the amount of the forfeiture is not tied to the value of nonpublic information but to the value of information released since the original purchase. In fact, the forfeiture is less likely to deter the offsetting sale when the nonpublic information is particularly important, for it is in those cases that the loss likely to be avoided is greatest.

Conversely, forfeiture is not particularly effective at discouraging an insider who sells stock from buying on the basis of positive inside information she learns after she sells. She can buy on the basis of the positive information. When the information subsequently becomes public, the price of the newly acquired stock will rise, but she will be able to keep the appreciation, which is the only profit she made on the basis of the inside information—that profit will be forfeited only if she sells again within six months. If the market price rose during the period between the original sale and the purchase, she will have to make good any loss she avoided by selling, but that is not a loss she avoided by using inside information; she avoided the loss by selling in the first place, and the original sale was not based on inside information. Once again, § 16(b) may require a forfeiture, but not the forfeiture of profits based on inside information.

73. As first introduced by Senator Fletcher and Representative Rayburn, the Exchange Act made it illegal for control persons to trade "with the intention or expectation of" effecting an offsetting transaction within six months, and provided for the forfeiture of any profits from such an offsetting transaction, regardless of the trader's intentions on entering the original transaction. S. 2693, 73d Cong., 2d Sess. § 15(b) (1934), *reprinted in* 11 LEGISLATIVE HISTORY, *supra* note 31, item 34; H.R. 7852, 73d Cong., 2d Sess. § 15(b) (1934), *reprinted in* 10 LEGISLATIVE HISTORY, *supra* note 31, item 24 [S. 2693 and H.R. 7852 were identical, and

may not have recognized that section 16(b) can effectively freeze insiders out of the market for six months after they trade, and they might not have cared. While section 16(b) limits the options available to managers who trade, it does so regardless of whether they have inside information; they simply cannot trade at a profit for six months. Section 16(b) is structured to ensure that when affiliates trade, they trade for the long haul.

Section 16(b) was intended to deter affiliates from trading except on the basis of long-term (almost permanent) investment decisions. Its most powerful and constant force is on officers, directors, and principal stockholders who would trade with the intention or expectation of effecting offsetting trades within six months—that is, the burden it places on speculation for the short term. They must recognize that if they make offsetting trades within six months, for whatever reason, they will have to forfeit any profits they realize. In sum, section 16(b) burdens short-term trading, not trading on inside information.

Section 16(b) is not calculated to keep insiders from trading stock on the basis of inside information. Insiders who have not traded for six months are free to buy or sell on the basis of inside information. To be sure, they will be unable to effect profitable offsetting trades

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hereinafter are referred to jointly as the Fletcher-Rayburn bill].

The intention element disappeared when the prohibitory portion of the provision was eliminated, but it is clear from the way the drafters explained the intention element in early hearings on the bill that their primary concern was influencing the first trading decision. Thomas Corcoran explained § 15(b)(1) of the Fletcher-Rayburn bill, which was the predecessor of § 16(b) of the Exchange Act. After reading the sentence that declared intentional short-swing trading illegal and provided for the forfeiture of short-swing profits irrespective of intention, he explained:

> That is to prevent directors receiving the benefits of short-term speculative swings on the securities of their own companies, because of inside information. The profit on such transaction [sic] under the bill would go to the corporation. You hold the director, irrespective of any intention or expectation to sell the security within 6 months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing.

Stock Exchange Practices, supra note 31, at 6556-57; *see* Comment, *Section 16(b): An Alternative to the Six Month Limitation Period,* 20 UCLA L. Rev. 1289, 1294-1300 (1973).

This testimony is frequently said to show that the drafters intended § 16(b) to prevent control people from trading on the basis of inside information. *See, e.g.,* Jacobs, *supra* note 12, at 357. Yet, while Corcoran did mention inside information, it is clear that his precise concern was with preventing insiders from engaging in short-term trading. *See also* Lowenfels, *supra* note 12, at 61. Section 16(b) still says that profits are to be forfeited "irrespective of any intention on the part of [the trader] in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months." This language is a vestige of the Fletcher-Rayburn bill, in which criminal punishment depended on intent but the forfeiture provision did not. *See infra* notes 284-285 and accompanying text.

for six months, but if the information relates to the corporation's long-term prospects, they will be able to wait before effecting offsetting trades. Consider, for example, officers who learn that the corporation they run has discovered very valuable mineral deposits. They can buy the corporation's stock on the market while they keep the information secret. When the information is made public, the price of the stock will climb. Inasmuch as the new price reflects future corporate income previously unknown to the market, the price is permanent.[74] The insiders' holdings will be much more valuable, and the insiders will be wealthier.[75] Regardless of whether they sell, they will have made all the money they can on the inside information, and there is no extra profit to be made by returning to their original positions.[76] The insiders

74. Section 16(b) will deter insiders from trading in hopes of profiting from temporary fluctuations in prices. This is in fact its primary effect. This subject is considered more fully in the next part, but it may be enough here to suggest that the publication of inside information is likely to have a permanent effect on prices.

The ABA Task Force recommended shortening the six-month period in § 16(b) because today information is disseminated more quickly than it was when the Exchange Act was enacted. *Task Force Report, supra* note 7, at 1130-31. The Task Force presumed that the drafters of § 16(b) chose the six-month period because they "believed that inside information . . . would lose its vitality after six months and, in the usual case, would no longer provide the basis for improper trading activities." *Id.* at 1130. The recommendation reflects a confusion of the life of a secret, which is usually short, with the life of the underlying fact, which can be quite long. *See* H. MANNE, *supra* note 18, at 84; Lawson, *supra* note 66, at 764; *cf.* Dooley, *supra* note 5, at 58 ("Because most manipulations occur within a short period, the purposes of section 9 [of the Exchange Act] are advanced by denying insiders short-swing profits."); Easterbrook & Fischel, *supra* note 18, at 17 ("Manipulation is a short-run or one-shot phenomenon.").

In the example in the text, the price of the corporation's stock will rise as the market learns of the ore discovery, and the price will stabilize when the market knows everything there is to know about the discovery. The price of the stock will change again with the release of new information, whether about the mine or other corporate operations. The fact that prices may change in the future does not mean that the information about the original discovery had only a short-term value, however. That information had real value that lasted a long time in the sense that it allowed the officers and directors to reap a permanent financial gain. The stock they bought was in fact worth more than what they paid for it, and the price at which it traded after disclosure was as correct as market prices can be. What had only short-term value was the secret. The officers and directors had to act quickly, before news of the discovery leaked, but once they acted they had long-term (i.e., permanent) wealth.

This is not to say that changing the length of the short-swing period in § 16 will not fundamentally change the sort of trading insiders engage in. As developed below, *infra* Part II.B., § 16(b) keeps insiders from trading on the basis of information that has short-lived implications. Shortening the six-month period will permit managers to take advantage of developments with shorter-term implications. This might encourage them to devote their energies to achieving transient results.

75. The facts are drawn from SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 839-47 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969), which arose under rule 10b-5.

76. *See* Manne, *Economic Aspects, supra* note 65, at 58, 75-79. The same is true of sales made before a price decline in order to avoid taking a loss on a previously held position. A

will not have cash until they sell, but in that the price rise is permanent, they can wait to sell.

If they do not sell immediately, their investment in the stock will continue to be at risk of course. This risk is tied to the fortunes of the business and the market; anything that happens during the next six months will affect them. The risk of a price fall will sometimes keep insiders from trading on nonpublic information, but not always. Section 16(b) does not prevent insiders from trading profitably on good news; it just makes holding stock for six months, risking a price fall, the price of buying the stock on the basis of nonpublic information. By putting a six-month quarantine on insider profits instead of forbidding them, section 16(b) works to align management and stockholder interests. In a sense, it holds out the reward of profits based on nonpublic information to affiliates who will tie their interests to those of their stockholders by holding an equity position for six months.

The reporting requirements of section 16(a) were supposed to discourage insiders from trading on inside information: insiders may not trade on inside information if they have to expose their trades to the public.[77] Embarrassment attendant to post-trading disclosure, how-

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principal stockholder may want to repurchase her stock as soon as the price falls, *see infra* note 265, but if she repurchases, it is because she values control, not because she has inside information that causes her to expect the market price to increase in the future.

77. *See* H.R. REP. No. 1383, *supra* note 31, at 13, 24. The predecessor of § 16 in the version of the Exchange Act that the House of Representatives sent to conference required control persons to report their trades and forbade them to sell short, but it did not restrict their short-term trading. H.R. 9323, 73d Cong., 2d Sess. § 15 (1934), *reprinted in* 10 LEGISLATIVE HISTORY, *supra* note 31, item 30. The committee report on this bill suggested that the reporting provisions might "bring these practices [i.e., insider trading] into disrepute and encourage the voluntary maintenance of proper fiduciary standards by those in control of large corporate enterprises whose securities are registered on the public exchanges." H.R. REP. No. 1383, *supra* note 31, at 13; *see also Task Force Report, supra* note 7, at 1099 ("Such publicity [public disclosure of changes in beneficial ownership] was designed to encourage voluntary compliance with proper fiduciary standards by subjecting insider trades to public scrutiny.").

Although Congress hoped that the publicity created by trading reports would change management practices, it presumably recognized that post-trading disclosure was not likely to shame insiders into refraining from trading on inside information. Congress knew that many executives thought that insider trading was entirely appropriate. "Prior to the enactment of the Securities Exchange Act, profits from 'sure thing' speculation in the stocks of their corporations were more or less generally accepted by the financial community as part of the emolument for serving as a corporate officer or director notwithstanding the flagrantly inequitable character of such trading." 10 SEC ANN. REP. 50 (1944), *quoted in* 2 L. Loss, *supra* note 2, at 541; *see also* H. MANNE, *supra* note 18, at 2 (citing 1915 survey) ("90% of business executives interviewed admitted to trading regularly in their own company's shares"); Painter, *supra* note 12, at 668-69 (citing REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. No. 95, 88th Cong., 1st Sess. pt. 1, at 433-35 (1963)) (While some firms attempt to draw a distinction between confidential and general information, "a few firms candidly admit that they consider it their prerogative to ever, is about the only price section 16 imposes on insiders who take advantage of favorable buying opportunities. Since insiders need not report until after they trade, section 16 reports do not alert the market to the insiders' views soon enough to cause prices to change before they trade.[78] Outside investors who sell before favorable developments are disclosed may be upset when they later learn that insiders were buying at the same time they were selling, but they will be powerless to do anything about it. Neither the Exchange Act nor the common law at the time the Act was adopted gave outside sellers any redress in court.[79] Because these outside sellers have sold their stock, they cannot even vote to throw the insiders out. Continuing stockholders who do have power to change directors will also learn of the insiders trading. But post-trading reports are not at all certain to move continuing stockholders to remove officers and directors who have traded on inside information. Insider trading may hurt continuing investors,[80] yet

make whatever use they wish of confidential information."). Even if that perception was changing, section 16 was hardly calculated to stop them, at least not if corporate managers were more interested in money than in their reputations, as must have seemed the case in 1934.

78. Section 16(a) requires those subject to it to file reports "within ten days after the close of each calendar month . . . , if there has been a change in [beneficial] ownership during such month." Some commentators have recommended that insiders be required to report before trading. *See, e.g.*, Samuelson, *supra* note 15, at 523-28; *see also Task Force Report, supra* note 7, at 1102 (noting suggestions for pre-transaction reporting). While the Exchange Act was under consideration, the drafters considered requiring affiliates to report before trading, but decided against it. *See* I.N.P. Stokes' master draft of comments on Fletcher-Rayburn bill at § 15 (handwritten comment: "Should they [i.e., affiliates] give notice in advance?") (James M. Landis, who helped draft the Exchange Act, *see infra* Part II.B., collected and bound most of the drafts of the Act as well as related materials. [The collection is hereinafter referred to as the DOCUMENTARY HISTORY COLLECTION.] I.N.P. Stokes' master draft is in 4 DOCUMENTARY HISTORY COLLECTION item 2. Copies of the collection are in the James McCauley Landis Papers in the Manuscript Collection of the Harvard Law School Library and in the SEC Library. For bibliographic information useful in locating the collection in the SEC Library, see Thel, *supra* note 21, at 391 n.28).

79. *See* Smolowe v. Delendo Corp., 136 F.2d 231, 235 (2d Cir.) ("By the majority rule, aggrieved stockholders had no right to recover from the insider in such a situation."), *cert. denied*, 320 U.S. 751 (1943); Cook & Feldman, *supra* note 12, at 408-09 (surveying cases and literature as of 1934); Yourd, *supra* note 18, at 139-43 (same); Annotation, *Duty of Officer or Director of Corporation Toward One From Whom He Purchases Stock,* 84 A.L.R. FED. 615-35 (1933) (same). *See generally* Ash, *State Regulation of Insider Trading—A Timely Resurgence?,* 49 OHIO ST. L.J. 393 (1988) (discussion of the development of common law regulation and its resurgence); Hazen, *Corporate Insider Trading: Reawakening the Common Law,* 39 WASH. & LEE L. REV. 845 (1982) (discussion reconciling the recent federal decisions and the common law of fiduciary responsibility).

80. *Compare* Carlton & Fischel, *supra* note 45, at 858-59 ("it is generally believed that firms have made little, if any, attempt to prohibit insider trading"), 866-72 (discussion entitled "Why Firms Might Want to Allocate the Property Rights in Valuable Information to Managers as Opposed to Shareholders") *with* R. CLARK, *supra* note 4, § 8.2.4, at 274 (rational stock-

stockholders may see little reason to protect themselves from insiders who have presided over an increase in the value of their stock.[81]

Whatever effect the reporting requirements of section 16(a) have on insiders buying on the basis of inside information, their overall effect is to encourage directors and officers to buy and hold stock in the companies they manage. Section 16(a) is more than an adjunct to section 16(b) serving to reveal transactions that might give rise to forfeiture. Periodic reports of change in ownership are the key to an effective forfeiture scheme,[82] but section 16(a) reports were to have an independent role in regulating the behavior of corporate managers.[83] By requiring insiders to report their trades, section 16 was supposed to alert the market to the predictions of insiders,[84] albeit perhaps in a potentially misleading fashion.[85] Trading, moreover, is only one of the things control persons have to report. Section 16(a) also requires them to disclose their initial positions and to keep that disclosure current.[86]

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holders would not approve of insiders trading on nonpublic information) *and* Clark, *Agency Costs Versus Fiduciary Duties* in PRINCIPALS AND AGENTS, *supra* note 63, at 55, 75 (rules against insider trading are particular example of general rule against fiduciaries making secret profits).

81. R. CLARK, *supra* note 4, at 276 (firms may not have sufficient incentive or ability to curb destructive insider trading); Easterbrook, *supra* note 63, at 90-95 (survival of insider trading does not mean it benefits investors). Even if disposed to act, continuing stockholders cannot use their residual power over corporate management to discipline non-manager principal stockholders who buy on the basis of inside information.

82. *See* 2 T. HAZEN, *supra* note 12, § 12.2, at 19-20.

83. The version of the Exchange Act that the House of Representatives sent to conference with the Senate contained a reporting provision but no provision analogous to § 16(b). It would also have required issuers to report on trading by officers and directors in their periodic reports to stockholders. H.R. 9323, *supra* note 77, § 15(a); *see infra* note 358 and accompanying text.

84. H.R. REP. No. 1383, *supra* note 31, at 13, 24.

85. *See Stock Exchange Regulation: Hearing Before The House Committee on Interstate and Foreign Commerce on H.R. 7852 and H.R. 8720,* 73d Cong., 2d Sess. 488, 917 (1934) [hereinafter *House Hearings*], *reprinted in* 8 & 9 LEGISLATIVE HISTORY, *supra* note 31, item 23; H.R. REP. No. 1383, *supra* note 31, at 24; *Letter from the Counsel for the Committee on Banking and Currency Under S. Res. 84,* 73d Cong., 1st Sess. 31 (Comm. Print 1933) [hereinafter *Letter from the Counsel*], *reprinted in* 5 LEGISLATIVE HISTORY, *supra* note 31, item 15; *see also* Carney, *supra* note 15, at 889-91; Samuelson, *supra* note 15, at 519-20 ("Insiders profit from making the required disclosures because the market mimics their transactions."); Thel, *supra* note 62, at 401-02 (While trades "convey the predictions of the traders" these "reports can create erroneous impressions."); *infra* note 361 and accompanying text (floor debate in House).

86. *See also* Exchange Act § 12(b)(1)(D), 15 U.S.C. § 78*l*(b)(1)(D) (1988) (application for registration with exchange must disclose interests of officers, directors, and principal stockholders in issuers securities); Exchange Act §§ 12(b)(1)(D), 12(g)(1), 13(a)(1), 15 U.S.C. §§ 78*l*(b)(1)(D), 78*l*(g)(1), 78m(a)(1) (1988) (issuers required to report interests of officers, directors, and security holders of record holding more than 10 percentum of any class of any equity

The requirement that officers and directors disclose their equity security holdings has the potential for encouraging managers to acquire equity positions, and thus interests similar to those of stockholders. Berle and Means made a powerful case for the proposition that stockholders are better off if corporate managers own stock in the companies they manage.[87] They argued that non-owner managers pursued their own interests to the detriment of stockholders, convincing at least some members of Congress. Opponents of the Exchange Act also emphasized the importance of corporate managers holding stock in the companies they manage.[88] The consensus on the desirability of managers owning stock was underscored by the critics' argument that section 16 would have the unintended effect of discouraging officers and directors from owning stock at all.[89] Even if investors think they are injured when insiders trade on inside information, they may be reluctant to entrust their financial interests to managers who are unwilling to participate in the common enterprise by owning stock.[90] Managers who hold substantial amounts of stock have a powerful incentive to work effectively.[91]

Prior to the enactment of section 16(a), it would have been difficult for stockholders to determine what interest officers and directors had in the companies they ran.[92] Stockholder lists and information

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security of the issuer (other than an exempted security)); Regulation S-K, item 403, 17 C.F.R. § 229.403 (1988) (information on equity securities beneficially owned by management to be reported on Exchange Act forms); Regulation 14A, item 8, 17 C.F.R. § 240.14a-101 (1988) (reporting in proxy statements).

87. *See supra* notes 46-54 and accompanying text.

88. *House Hearings, supra* note 85, at 917 (Memorandum of National Automobile Chamber of Commerce) ("That it is in the interest of the stockholders of a corporation to have those charged with the responsibility of management own a substantial interest in the corporation has long been recognized.").

89. *Id.*; *see also infra* notes 312-317 and accompanying text (Sachs Memorandum).

90. Munter, *supra* note 12, at 87-88.

91. *See* Werner, *supra* note 45, at 404; *see also supra* note 63 and accompanying text (incentive compensation); *cf. In re* Calton Crescent, Inc., 173 F.2d 944, 952 (2d Cir.) (L. Hand, J., dissenting) ("I conceive that the law allows a director to increase his stake in the company, because it adds to his incentive to make it succeed; the greater the prize, the greater the effort . . . ."), *aff'd sub nom.* Manufacturers Trust Co. v. Becker, 338 U.S. 304 (1949); Carlton & Fischel, *supra* note 45, at 893 n.114 (employment contracts may implicitly forbid managers to sell short excessively); Easterbrook & Fischel, *supra* note 18, at 12 ("Better managers signal their quality by willingness to tie a higher proportion of their compensation to stock performance."). *See generally* Stigler & Friedland, *The Literature of Economics: The Case of Berle and Means*, 26 J.L. & ECON. 237, 254-58 (1983) (analyzing the effect of owner-controlled versus management-controlled corporations on profits and investment).

92. In fact, stockholders may not have been interested. Although there has been a great deal of academic interest in the separation of management and control, stock market participants do not seem to care whether managers are stockholders. While many investors and analysts follow management trading, management ownership is not widely followed. The

about management holdings generally were not available.[93] As a result, it was charged, "Insiders having little or no substantial interest in the properties they manage have often retained their control without an adequate disclosure of their interest and without an adequate explanation of the management policies they intend to pursue."[94] The information made available by section 16(a) reports enabled stockholders to protect themselves, and indirectly the public, from uninterested managers by selling their stock or by electing new directors.[95]

The ability of managers to disassociate themselves from declines in the value of their companies' stock is also undercut by section 16(c), which requires directors, officers, and principal stockholders who sell any equity securities to deliver them promptly. Prior to enactment of section 16(c), managers could deliver borrowed securities against their sales. They sometimes used this practice, known as selling against the box,[96] to dispose of their holdings while delaying or even altogether avoiding disclosure of their sales.[97] Moreover, those who were short

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market may be uninterested because other incentives under which managers operate are so powerful that increased stock ownership would have little impact on management behavior. Berle and Means suggested that separation would be a problem even if managers were stockholders, so long as managers did not own all outstanding stock. A. BERLE & G. MEANS, *supra* note 31, at 343-44.

93. *See id.* at 90-118 (describing sources of ownership information); *see also* 78 CONG. REC. 8038 (1934) (debate on making public the names of shareholders in corporations registered on national securities exchanges); *cf.* S. 4939, 72d Cong., 1st Sess. (1932) (proposing to require corporations with capital stock of $200,000 or more to make available financial statements and stock holdings of officers and directors).

94. H.R. REP. No. 1383, *supra* note 31, at 13-14; *see also id.* at 3 ("Ownership and control are in most cases largely divorced."); *House Hearings, supra* note 85, at 139-41; *Stock Exchange Practices, supra* note 31, at 6543-45.

95. Managers may manage their companies in the best interest of stockholders even if they do not have any equity in the companies they manage. Perhaps in recognition of this, § 16(a) requires managers to disclose what they own, but leaves it to investors to insist that managers have an equity interest in the companies they manage.

Once again, investors will not be able to do anything to discipline a substantial stockholder who sells. *Cf. supra* note 81 and accompanying text (principal stockholders buying on good news). Unlike sales by directors and officers, however, sales by principal stockholders do not create a risk of uninterested management, inasmuch as principal stockholders lose their power to influence management when they sell. *See infra* note 170 (principal stockholders will not create short-lived price rises).

96. "In a sale against the box, the seller owns enough securities to deliver the shares that have been sold but chooses to borrow securities in order to make the delivery. Subsequently, the seller completes the transaction by buying stock or using his own stock in order to repay the lender." *Task Force Report, supra* note 7, at 1098; *see also* F. MACAULAY, SHORT SELLING ON THE NEW YORK STOCK EXCHANGE 14 (1951) ("Selling against the box occurs when, for some reason, the seller prefers to deliver borrowed stock rather than his own.").

97. *See* S. REP. No. 1455, *supra* note 62, at 52 ("This is a devise [sic] which can be employed by corporate officials and insiders who desire to sell their corporation's stock short without disclosing such short selling."); H.R. REP. No. 1383, *supra* note 31, at 25; *Letter*

against the box retained the corporate control attendant to record ownership of stock even though by selling they abandoned any interest in the income from the stock.[98] Indeed, they never gave up control if they covered their short positions with purchases in the market.[99] With the enactment of section 16(c), those in control of publicly held companies must accept the full consequences when they sell their stock.

In sum, section 16 encourages those in control of publicly held companies to hold stock. It also permits them to buy stock on the basis of confidential information they learn through their corporate affiliation, even if they know they will profit once the public learns that information and bids up the price of the stock. While section 16 did not do much to discourage insiders from buying on the basis of inside information, it did refine the incentive system under which corporate managers operate in a way that makes them more likely to pursue corporate policies that will cause stock prices to rise.

When section 16 was enacted, the incentive system it put into place may have seemed much more attractive than it does now.[100] By 1934, the perspective of the nation had been jarred by two interrelated developments that surely shaped the Exchange Act. One was a growing consensus that something had to be done about large corporations that were not managed by their owners. The other, and far more important, was the Great Depression. The Exchange Act was passed in terrible times, and those who enacted it desperately wanted to get people

from the Counsel, supra note 85, at 7, 32; F. MACAULAY, *supra* note 96, at xii, 2-3; Hoffman, *Short Selling,* in THE SECURITY MARKETS, *supra* note 21, at 362 ("If the seller is a large stockholder, . . . the practice [of selling against the box] at best is deceptive. In its worst setting it may be done by a director or official of the corporation presenting a front of good faith and confidence and through the rear door getting out from under or even going short.").

98. F. MACAULAY, *supra* note 96, at xi-xii ("Sometimes the reason [for selling against the box] was merely to preserve a voting privilege."); Hoffman, *Short Selling, supra* note 97, at 362 ("To the advocates of short selling this [i.e., selling against the box] is a desirable practice since it permits the seller to maintain control over his actual shares while at the same time 'hedging' against the possibility of a decline in price."); *see also* J. MEEKER, SHORT SELLING 26-27 (1932) ("In the widespread distribution of stocks effected in recent years, this practice of hedging [with sales against the box] has provided the means whereby many types of individual and institutional investors could avoid capital losses. Companies which before the stock panic of 1929 inaugurated 'employee stock ownership' plans have also been provided with facilities for protecting employee-investors. . . . How far such a use of the hedging short sale has actually been used is uncertain, but a good argument could be made to the effect that it should have been done."); Yourd, *supra* note 18, at 157 n.78 ("This is said, by the advocates of short selling, to be desirable practice because it permits the seller to maintain control over his actual securities while at the same time hedging against a decline in price.").

99. F. PECORA, WALL STREET UNDER OATH 157 (1939 & reprint 1968); *see also* S. REP. No. 1455, *supra* note 62, at 52 ("It is plain, however, that where a person initially makes a sale 'against the box' but subsequently changes his mind, there is nothing to prevent him from covering in the open market. In such case he is indistinguishable from any other short seller.").

100. *See supra* note 66 and accompanying text (unfairness of insider trading).

back to work. It is no wonder that as originally enacted the Exchange Act encouraged corporate managers to buy stock and did not stand in the way of their buying on the basis of inside information. When the Exchange Act was written, there was little immediate prospect of the stock market achieving a sustained advance. Under the circumstances, it would have seemed irresponsible to have made it illegal to take advantage of good news.[101]

B. Management Conduct that Causes Stock Prices to Fall

To the extent that section 16 interferes with the trading opportunities of those who control publicly held companies, its impact is much greater when stock prices are falling than when they are rising. Here again, though, section 16 does not so much prevent insiders from taking advantage of corporate information as it regulates the way managers run corporations. Directors, officers, and principal stockholders are largely free to take advantage of inside information to protect themselves from losses. They may sell any stock they own before they disclose corporate information that is likely to cause stock prices to fall.[102] Section 16 does not keep insiders from using infor-

101. *See also* S. BRUCHEY, *supra* note 47, at 458 ("Many critics . . . believed that both the Securities Act and the Securities Exchange Act inhibited recovery by increasing the costs and risks of new flotations and by making officers of issuing companies and underwriters reluctant to assume risks for fear of incurring civil and criminal penalties."); *cf.* 1 L. LOSS & J. SELIGMAN, *supra* note 31, at 380; Carlton & Fischel, *supra* note 45, at 881 ("[I]f insider trading is a desirable compensation scheme, it benefits insiders and outsiders alike. Nobody would argue seriously that salaries, options, bonuses, and other compensation devices allow insiders to profit at the expense of outsiders . . . ."). Samuel Williston may be too closely associated with reaction to credit him with holding popular or common views, but his revealing autobiography is little enough known that it may well be mentioned. He described a commencement address delivered in 1923 in which a student challenged the people of New England for not freeing their "wage slaves." Several years into the Depression, Williston wrote that the address "does not seem so pertinent now, when jobs are not too abundant and when capitalists are reproached for not initiating more enterprises that will give employment." S. WILLISTON, LIFE AND LAW: AN AUTOBIOGRAPHY 180 (1941).

102. Since managers will have to disclose their sales, they may be reluctant to sell for fear that stockholders will dismiss them for their failure to act in the stockholders' interests. *See supra* note 95 and accompanying text. This sanction is not calculated to discriminate between sales based on inside information and other sales; it works against all insider sales equally. *See also supra* note 92 (stockholders may not care).

Section 16(c)'s prohibition of sales against the box, discussed *supra* text accompanying notes 96-99, may keep managers from locking in current stock prices and hedging against price declines. *See* Yourd, *supra* note 18, at 157 ("[A] sale against the box is, at best, a hedge against [the insider's] bad management."). But selling against the box is a sale, not a hedge, and the seller does not participate in any gains if the price of the stock rises before she covers. *See* Hoffman, *Short Selling, supra* note 97, at 362 ("This practice is obviously not a hedge since the short sale of borrowed shares is not a closely allied subject matter but the same mation about unfavorable corporate developments that will depress share prices, but it does makes it difficult for them to profit by creating unfavorable developments.

One objection to managers trading the stock of their corporations is that since it is possible to profit from bad news as well as good, insider trading may create perverse incentives, possibly even an incentive to run companies badly in order to depress share prices.[103] Everyone presumably agrees that corporate managers should not manipulate corporate affairs to depress share prices,[104] but one might wonder whether managers would ever have an incentive to do so. Clark dismisses the possibility that managers will mismanage their companies in order to depress security prices so that they can buy stock cheaply. As he explains, the stock they buy at depressed prices will be worth only the depressed price they pay.[105] Moreover, if they mismanage corporate affairs, managers may destroy part of the value of any securities they already own. Thus, in the usual case it would be irrational for corporate managers to act against corporate interests intentionally. There is no reason to think that the drafters of the Exchange Act thought that corporate managers were irrational, and no one ever suggested that managers should be forbidden to sell their holdings.[106]

subject matter as that being held."). If a manager is certain that the market price is about to fall, she can always simply sell her stock outright. The prohibition of sales against the box does not deter insiders from selling on bad news except insofar as it may trigger the disclosure requirements of § 16(a) and thereby discourage managers from selling at all.

103. R. CLARK, *supra* note 4, § 8.2.1, at 267; H. MANNE, *supra* note 18, at 150-51; Carlton & Fischel, *supra* note 45, at 873-75; Easterbrook & Fischel, *supra* note 18, at 13; Levmore, *In Defense of the Regulation of Insider Trading,* 11 HARV. J.L. & PUB. POL'Y 101, 104-05 (1988); Levmore, *supra* note 5, at 149; Schotland, *supra* note 67, at 1453.

104. Some critics who argue that stockholders will benefit by permitting management to trade on the basis of inside information suggest that managers should be able to trade while prices are declining, but they do not argue that insiders should have an incentive to depress stock prices. On the contrary, they argue that it is extremely unlikely that managers will successfully pursue corporate projects that they know are bad. Carlton & Fischel, *supra* note 45, at 873-74. They simply argue that allowing managers to trade on bad news will reduce the cost of managers to stockholders or will encourage managers to undertake risky enterprises that stockholders would find attractive but managers would avoid because of the career risks they entail. *Id.* at 872. *See generally* Coffee, *supra* note 44 (managers more risk averse than stockholders).

These arguments suggest that the § 16(c) prohibition against short-selling by insiders may in some cases destroy an appropriate incentive. *See* Carlton & Fischel, *supra* note 45, at 872, 893-94. This does not substantially undercut the theory that § 16 was intended to align the interests of managers with those of stockholders, however. Section 16 still allows insiders to sell stock on the basis of inside information; thus, they are able to reduce their exposure to losses from risky projects to at least some extent. In any case, no one appears to have defended insider short selling while the Exchange Act was being considered. *Cf.* Schotland, *supra* note 67, at 1453 ("novel twist").

105. R. CLARK, *supra* note 4, § 8.2.1, at 267.

106. Clark's observation, that a manager who ran her company badly in order to depress

Nonetheless, as Clark himself elsewhere recognizes, managers can profit by depressing share prices if they are allowed to sell short.[107]

Short sellers borrow securities to make delivery of what they sell and subsequently purchase securities to repay the loan. They profit if prices fall between the time they sell and the time they cover, and lose if prices rise. Professor Loss has observed that "legislators in different ages and different lands [have shared the feeling] that the very idea of a person's selling something he does not own, in the hope of buying it back later at a lower price, is essentially immoral."[108] While popular criticism of short-selling often reflects little more than a distaste for those who would profit from the misfortunes of others, short selling by corporate managers poses more concrete problems. Corporate managers can help effectuate a fall in stock prices, and while they are in a short position they have a great incentive to do so. Congress was presumably troubled by this possibility. It could not decide what to do about the general issue of short-selling, which it simply delegated to the SEC,[109] but it took a hard line against short selling by those in control of publicly held companies.[110]

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stock prices would shoot herself in the foot (cut off her nose to spite her face would be better), actually underscores how well-suited § 16 is to encouraging managers to maximize stockholder welfare. Since managers who cannot sell short cannot produce trading opportunities by hurting the long-term value of their companies, the problem of managers purposely destroying corporate profit opportunities to create trading opportunities is solved without forbidding all insider sales.

107. R. Clark, *supra* note 4, § 8.2.4, at 274 n.15, § 8.3.1, at 278; *see also* Carlton & Fischel, *supra* note 45, at 873, 893-94 ("[S]hort selling may have benefits . . . if it induces managers to invest in a way that maximizes the value of the firm."); Easterbrook & Fischel, *supra* note 18, at 17 ("The perverse incentives created by the ability to trade are most acute when insiders engage in short selling."). Another way managers may be able to create profitable trading opportunities is by manipulating corporate affairs to depress prices temporarily. *See infra* Part II.C.

108. 2 L. Loss, *supra* note 2, at 647. *See generally* S. Rep. No. 1455, *supra* note 62, at 50-54; J. Meeker, *supra* note 98, at 45 ("Assertions that short selling is immoral proceed, not from refined ethical sensibilities, but merely from misunderstanding."); Hoffman, *Short Selling, supra* note 97, at 356-401.

109. Exchange Act § 10(a), 15 U.S.C. § 78j(a) (1988); *see* 2 L. Loss, *supra* note 2, at 648-49.

110. The singular rigidity of § 16(c)'s prohibition is noteworthy even in the context of the generally severe federal regulation of short selling. *See* Macey, Mitchell & Netter, *Restrictions on Short Sales: An Analysis of the Uptick Rule and Its Role in View of the October 1987 Stock Market Crash,* 74 Cornell L. Rev. 799, 812 n.52 (1989). In the extensive congressional hearings on short selling held during 1932, no one suggested that short selling by insiders caused unique problems. *See Short Selling of Securities: Hearing Before the House Committee on the Judiciary on H.R. 4, H.R. 4604, H.R. 4638, H.R. 4639,* 72d Cong., 1st Sess. (1932). Thus § 16(c) seems to be directed not at particularly demoralizing short selling but at particularly reprehensible manipulative practices. *See* J. Meeker, *supra* note 98, at 74-75; Hoffman, *Short Selling, supra* note 97, at 401.

Corporate managers have a great personal stake in the success of the companies they manage, entirely apart from any profits they might make in the stock market, since corporate failure is likely to lead to career failure. Thus it may well be that few corporate insiders will mismanage the corporations they run in order to make it possible to trade profitably.[111] Nonetheless, an agent who intentionally fails her principal for personal profit is "distinctly reprehensible."[112] It is not surprising that the public and their representatives in Congress were moved to act against the danger of managers intentionally mismanaging corporate affairs on the basis of even one well-publicized example of a manager selling short while stock prices were falling.

While the Exchange Act was being debated, the set of provisions that evolved into section 16 were identified with Albert Wiggin.[113] Wiggin was one of the most influential and respected financiers in American until 1933, when he testified before the Senate Banking and Currency Committee as part of its investigation of stock exchange practices. Wiggin had been chairman of the board of directors of the Chase National Bank, the largest bank in the country, and he admitted that he had traded extensively in the stock of the bank while affiliates of the bank alternatively bought and sold huge quantities of the stock to manipulate its price. He made immense personal profits by selling while the price of bank stock plummeted with the stock market late in 1929.[114]

The public disapproved of much that Wiggin had done,[115] but not particularly his selling of bank stock on the basis of inside infor-

111. H. MANNE, *supra* note 18, at 150-51; Carlton & Fischel, *supra* note 45, at 872, 873-75; Schotland, *supra* note 67, at 1453; *see also supra* note 45 (constraints on management discretion).

112. Yourd, *supra* note 18, at 157.

113. H.R. REP. No. 1383, *supra* note 31, at 13; *House Hearings, supra* note 85, at 134, 937; *Stock Exchange Practices, supra* note 31, at 6555, 7741.

114. F. PECORA, *supra* note 99, at 148-52; *see also* S. REP. No. 1455, *supra* note 62, at 62-63, 173-83. Not surprisingly, these revelations ruined Wiggin's reputation. *See* 78 CONG. REC. 8037 (1934) (Rep. Fish) ("[A]lthough I come from New York, I am not taking this floor to defend Albert Wiggin, as I believe he and those like him, in selling short and in mulcting the public and deceiving the members of his own bank and his own stockholders, has done more to create communism in America than all the reds combined. [Applause.]"); D. Levin, *supra* note 21, at 322; ("The enormity of the malpractices perpetrated by Albert H. Wiggin demands attention."); *see also* F. PECORA, *supra* note 99, at 160-61 ("For his own part, Mr. Wiggin professed to see nothing wrong in his own short selling of Chase Bank stock. . . . [T]he new management of the Bank, and the country at large, thought otherwise."); Yourd, *supra* note 18, at 134 n.2 ("Sometimes those thought to be most exemplary in conduct turn out to be the ones who have taken greatest undue advantage of a trust.").

115. Wiggin also sold stock of another company with which he was affiliated on the basis of inside information (the Brooklyn Manhattan Transit Corporation), but despite occasional

mation.[116] What Wiggin did that seemed so wrong was to manipulate the price of the stock while selling it short.[117] Ferdinand Pecora, who led the investigation that uncovered Wiggin's activities,[118] later explained that Wiggin made $4,008,538 by trading Chase National Bank stock

> in the amazingly short period between September 19, 1929 and December 11, 1929, and in the very midst of the great Wall Street crash. To make four million dollars at any time is considered a brilliant achievement; to make that much money, in less than three months, and during the greatest collapse in the history of the stock market, would seem to call for a mysterious genius. But, like other mysteries, the answer, once found, was quite simple. Mr. Wiggin made all that money by selling Chase National Bank stock short.[119]

Although "Congress viewed the prohibitions against short sales . . . as a core prohibition of" section 16,[120] section 16(c) is ignored in most analyses of section 16.[121] This may be because section 16(c)

suggestions to the contrary, *see, e.g.*, W. PAINTER, FEDERAL REGULATION OF INSIDER TRADING 1-2 (1968); Comment, *Section 16(b): Re-Evaluation Is Needed*, 25 U. MIAMI L. REV. 144, 145 (1970), this was not the reason that § 16 was named after him. The context in which Wiggin's name was used in congressional hearings indicates that his trading bank stock was the problem. *See* 1 L. LOSS & J. SELIGMAN, *supra* note 31, at 204 n.81; Dooley, *supra* note 5, at 57 n.239; Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 29 (1983). Moreover, the final report of the Senate investigative committee focused on that trading, S. REP. No. 1455, *supra* note 62, at 62-63, 173-83, as did the counsel for the committee when he subsequently wrote a book about the investigation. F. PECORA, *supra* note 99, at 148-53.

116. *Cf.* Dooley, *supra* note 5, at 57-58.

117. While Wiggin traded, unbeknownst to the public the bank was manipulating the price of the stock. Thus he was both taking advantage of inside information and manipulating corporate affairs to cause price fluctuations that would allow him and his associates to trade profitably. The Senate Banking and Currency Committee's report on the bill that became the Exchange Act discusses the provision that became § 16 of the Act under the heading "Manipulative Practices." S. REP. No. 792, 73d Cong., 2d Sess. 7-9 (1934), *reprinted in* 5 LEGISLATIVE HISTORY, *supra* note 31.

118. See *infra* note 140 and accompanying text.

119. F. PECORA, *supra* note 99, at 153; *see also* S. REP. No. 1455, *supra* note 62, at 186-92. Wiggin financed his trading with loans from the bank, and while he was short the bank was buying its own stock to support the price. "To the extent that this was successfully accomplished, it of course helped Mr. Wiggin by tending to hold up this market, while he was selling short." F. PECORA, *supra* note 99, at 155; *see also* Ritchie, *The Pecora Wall Street Exposé 1934*, in 4 CONGRESS INVESTIGATES, *supra* note 31, at 2555, 2571-73 (detailed description of Wiggin's transgressions). Wiggin's testimony is extensively quoted in Ritchie. *See id.* at 2698-2707.

The whole time Wiggin was selling short he held substantial positions in bank stock, so that his sales were actually sales against the box, and thus he had no incentive to depress the price permanently. This defense was ignored, however, in the Senate Report on Wiggin's trading. *See* S. REP. No. 1455, *supra* note 62, at 186-92.

120. *Task Force Report*, *supra* note 7, at 1096; *see also* Dooley, *supra* note 5, at 57 (noting that there was more interest in prohibiting short sales by insiders than in providing for the issuer's recovery of short-swing profits).

121. *See, e.g.*, W. PAINTER, *supra* note 115.

does not fit into a scheme directed at preventing insiders from trading on inside information.[122] Section 16(c) keeps those who control publicly held companies from profiting personally when they fail as managers.

Section 16(c) takes a particularly hard line on short sales. Whereas the reporting requirements of section 16(a), supplemented by section 16(c)'s prohibition of sales against the box, leave it to investors to insist that managers hold an equity stake, and section 16(b) only takes the profit out of managers' short-swing trading, section 16(c) makes management short sales illegal. Someone who has undertaken to work on another's behalf should not intentionally fail so that she may profit personally. Moreover, any management short sale, even one effected by a manager trying to protect herself from the personal cost of the failure of a reasonable corporate endeavor,[123] looks a lot like a distasteful bet against the agent's own success.[124] Section 16(c) forbids corporate managers to sell short, and by doing so it reduces any temptation they might have to act against stockholder interests.[125]

122. Smith, *Section 16(b): Too Much or Too Little?*, N.Y.L.J., Apr. 6, 1989, at 5, col. 1. One could argue that no insider will sell stock short unless she possesses inside information, and thus that § 16(c) does deal with the abuse of inside information. But this argument proves too much; by this same logic, no insider will buy (or sell) stock unless she has inside information, and yet insider buying (and selling) is neither made illegal nor effectively constrained by § 16. Insider short selling may be more analogous to insider buying on margin, since margin buying and short selling are each forms of trading on credit and both couple the risk of price changes with fixed repayment obligations. The Exchange Act does not forbid insiders to buy on margin either. *Cf.* Seligman, *supra* note 12, at 23-24 (section 16(c) involves no real hardship, so categorical prohibition on those with access to inside information can be justified).

123. *See supra* note 104.

124. *See* Schotland, *supra* note 67, at 1453; *Task Force Report, supra* note 7, at 1098 ("The purpose of the section 16(c) prohibition is to prevent insiders from in effect betting against the performance of their own company."); Yourd, *supra* note 18, at 157 ("In a sense, a short sale by one in control is a bet against his successful management . . . ."); *cf.* Easterbrook & Fischel, *supra* note 18, at 17 ("Any corporate manager caught with a large net short position would be fired. Section 16's prohibition against short selling enforces these enduring patterns.") Dennis Carlton and Daniel Fischel restate the argument that short selling may lead to perverse incentives in an intriguing way in their article on insider trading as management compensation:

> Many commentators have argued that insider trading is harmful because it creates a moral hazard by allowing insiders to profit on bad news. At the extreme, they claim that allowing insiders to profit on bad information makes managers indifferent between working to make the firm prosperous and working to make it bankrupt.

Carlton & Fischel, *supra* note 45, at 873 (footnote omitted). What they call the extreme claim seems to ignore the possibility that trading profits may actually lead insiders to engineer business failures. Maybe they mean to cover that possibility or maybe they think that there is no practical possibility that trading profits would lead managers to undermine corporate success (which may well be true). Nonetheless, they consider the possibility in their discussion, and perhaps their statement simply reflects common revulsion to the idea of an agent purposely damaging her principal in order to further her own ends.

125. Easterbrook, *supra* note 66, at 319 n.50.

C. Management Conduct that Causes Stock Prices to Fluctuate

When the Exchange Act was enacted, many people attributed the Great Depression to the bull market of the 1920s and the stock market collapse that ended it.[126] In this atmosphere, stock market volatility was considered harmful.[127] Congress went so far as to state its misgivings about volatility in the text of the Act. In section 2 of the Act, a sort of preamble, Congress explained why it was necessary to regulate all aspects of the stock market, including specifically transactions by officers, directors, and principal security holders.[128] All of the reasons section 2 gives for taking control of the market come down to excessive volatility: as Congress saw it, or at least as Congress said it saw it, prices in the public securities market are susceptible to being controlled and manipulated, which gives rise to excessive speculation, which in turn results in unreasonable price fluctuations.[129] All of this might have damaged investors, but Congress did not refer to the interests of investors in section 2.[130] The problem with speculation, manipulation, and volatility, according to Congress, is that it leads to widespread unemployment and its accompanying commercial and industrial dislocations.[131]

The whole Exchange Act was a response to the problem of volatility.[132] Part of the response was to reorganize the market in a way that would make it possible for investors to focus on issuer earnings instead of speculating on future stock prices.[133] Another part of the

126. *See* J. SELIGMAN, *supra* note 21, at 76 ("Like Herbert Hoover, [Franklin] Roosevelt accepted the conventional wisdom that 'unregulated speculation in securities . . . [was] one of the most important contributing factors in the artificial and unwarranted "boom" which had so much to do with the terrible conditions in the years following 1929.'") (quoting Letter from President Roosevelt to Sam Rayburn (March 26, 1934), *reprinted in* H.R. REP. No. 1383, *supra* note 31, at 2); *see also* Thel, *supra* note 21, at 407-10 (discussing how the rise and fall of the market shaped public and congressional perceptions).

127. *See* Thel, *supra* note 21, at 407-10; *cf.* H.R. 3657, 101st Cong., 2d Sess. § 3 (1990) (proposing to add § 9(h)(1) to the Exchange Act, which would authorize the SEC to regulate practices contributing to extraordinary volatility); H.R. REP. No. 477, 101st Cong., 2d Sess. 33 (1990) (in recommending H.R. 3657, *supra,* "the Committee recognizes that price movement in our capital markets is not damaging *per se.*"). *See generally* R. SHILLER, MARKET VOLATILITY (1989).

128. Exchange Act § 2, 15 U.S.C. § 78b(3) (1981).

129. *Id.* § 2(3), 15 U.S.C. § 78b(3) (1981).

130. Section 2 does say that reform was necessary "to insure the maintenance of fair and honest markets." *Id.* § 2, 15 U.S.C. § 78b (1981).

131. *Id.* § 2(4), 15 U.S.C. § 78b(4) (1981); *see also id.* § 2(3), 15 U.S.C. § 78b(3) (national credit, tax and banking systems).

132. *See* Thel, *supra* note 62, at 374-82.

133. Practices used to manipulate prices were outlawed or subjected to regulation in §§ 9 and 10, 15 U.S.C. §§ 78i, 78j (1988), and §§ 12 and 13, 15 U.S.C. §§ 78*l*, 78m (1988), which

response was to make it difficult for those who wanted to speculate on price changes to participate in the market, at least on the scale that they had in the past.[134] Still, the Exchange Act does not as a general matter stop people from trading securities in anticipation of changing market prices, and as the preceding discussion shows, section 16 does not stop insiders from trading in anticipation of price changes either. Section 16(b) does interfere, however, with the plans of directors, officers, and principal stockholders who would trade in anticipation of imminent, short-lived price changes.

Those who trade in anticipation of long-lived price changes and thus do not trade during the requisite six month period are not subject to the provisions of section 16(b). By requiring forfeiture of profits from six-month in-and-out trading, however, section 16(b) foils those who would trade on rapid price fluctuations. A trade made in anticipation of a temporary fluctuation in prices will be profitable only if an offsetting trade is made in the limited period of time during which the new price is available. This is the situation in which section 16(b) substantially impedes directors, officers, and principal stockholders who would effect the essential offsetting trades.[135] They cannot realize their profits until they effect offsetting trades, and because they must forfeit short-swing profits, they cannot hope to realize profits unless they expect different prices to prevail six months or more in the future.[136]

Whatever else it may accomplish, then, section 16(b) is precisely calculated to keep those in control of publicly held companies from trading in anticipation of imminent temporary price changes. This is exactly what those responsible for the enactment of section 16 wanted

required issuers of exchange-traded securities to release information about their earnings. *See generally* J. Burk, *supra* note 59, ch. 3 (arguing that the disclosure requirements of the Securities Act and the anti-manipulation provisions of the Exchange Act restructured the stock market in a way that reflected a belief that stock prices will be determined by corporate earnings); Thel, *supra* note 62, at 396-415 (discussing issuer disclosure requirements and the effects of disclosure on the price of the issuer's stock).

134. For example, to the extent that the regulation of margin trading and short selling provided for in §§ 7 and 10(a) of the Exchange Act, 15 U.S.C. §§ 78g, 78j(a) (1988), makes it difficult to buy or sell stock on credit, the Act discourages speculators who anticipate profits from price changes from participating in the market.

135. *See supra* notes 74-75 and accompanying text (deterrent effect of § 16(b)).

136. A director, officer, or principal stockholder can expect a trade to lead to profits from future price changes (as opposed to profits from issuer distributions) only if she expects post-trade price changes either to last for more than six months or not to occur for six months. Dividends are sometimes included in profit realized for purposes of § 16(b). *See* Western Auto Supply Co. v. Gamble-Skogmo, Inc., 348 F.2d 736 (8th Cir. 1965) (forfeiture of dividends), *cert. denied,* 382 U.S. 987 (1966); Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959) (no forfeiture of dividends); 2 L. Loss, *supra* note 2, at 561; Jacobs, *supra* note 12, at 544-48.

it to accomplish. In the words of Duncan Fletcher, who sponsored the Exchange Act in the Senate, section 16(b) effectively forbids "directors, officers, and principal stockholders . . . to speculate in the securities of the corporation" with which they are affiliated.[137]

The key to understanding section 16(b) is understanding why management speculation for the short-swing was treated more harshly than other speculative activity. One problem with insiders trading for the short-swing is that the possibility of realizing trading profits may be an incentive to manipulate corporate affairs to create short-term price fluctuations and their attendant trading opportunities. Section 16 destroys this incentive by depriving managers of the ability to profit from short-term price fluctuations.[138] It encourages those in control of publicly held corporations to manage in a way that pushes security prices up, and it discourages them from managing in a way that pushes prices down. Most of all, though, it discourages management practices that cause prices to go up and down.[139]

The Exchange Act was written and enacted against the background of the Senate Banking and Currency Committee's hearings on stock exchange practices, the so-called Pecora Hearings.[140] The extensive record of those hearings is replete with instances of managers causing their companies to undertake unwise operations for no reason other than to produce price changes that would allow them to trade profitably.[141] For example, Albert Wiggin, whose identification with

137. Digest presented by Sen. Fletcher to accompany the introduction of S. 2693, 78 CONG. REC. 2270, 2271 (1934); *see also supra* note 73 (Corcoran testimony in Senate); *cf.* Principal Changes Embodied in New Draft for National Securities Exchange Act of 1934, at 2 (undated memorandum) (stating that the predecessor of § 16(b) made the profits of short-term speculation recoverable by the issuer) (copy in 3 DOCUMENTARY HISTORY COLLECTION, *supra* note 78, item 13) (The provenance of this memorandum is discussed in Thel, *supra* note 21, at 446 n.275.).

138. A secondary benefit of stopping managers from speculating to focus the attention of management on their jobs rather than on market speculation. *See supra* note 71 and accompanying text.

139. *See* Easterbrook & Fischel, *supra* note 18, at 16.

140. *Stock Exchange Practices, supra* note 31.

141. *Letter from the Counsel, supra* note 85, at 32 ("Among the various subjects touched upon in the testimony produced before the committee are short selling; syndicates or pools for the purpose of conducting operations in stocks; the manipulations of the affairs of corporations by those in control . . . ."); *see also* Exchange Act Rel. No. 18,114, 4 FED. SEC. L. REP. (CCH) ¶ 26,062, at 19,063-3 (Sept. 23, 1981) ("On occasion, insiders actually manipulated the market price of their stock by causing a corporation to follow financial policies calculated to produce sudden changes in market prices in order to obtain short swing profits."); Exchange Act Rel. No. 26,333, *supra* note 6, ¶ 89,599 ("In some cases, insiders manipulated the market price of their stock and caused the company to follow financial policies calculated to produce sudden changes in market prices."); C. DICE, THE STOCK MARKET 439 (1926) ("A generation ago the standards of business permitted boards of directors and officers of corporations to manipulate earnings, dividends, and the property of their

section 16 has already been mentioned, furthered his personal trading schemes by causing the bank he controlled to be managed in a way that contributed to changes in the price of its stock.[142] The Senate Banking and Currency Committee report, which was the only committee report that discussed the forfeiture provision that became section 16(b),[143] cited another case of trading coupled with mismanagement as a "glaring instance" of the sort of misconduct that it said section 16(b) addressed.[144]

Any example of misconduct cited to justify section 16(b) was bound to involve questionable management decisions; anything else would have made patent the section's shortcomings as a provision for preventing insiders from trading on the basis of nonpublic information. Obviously, the provision could not have been explained with examples of insiders who simply traded before they announced important corporate news with long-term implications, since such insiders can avoid forfeiture by the simple expedient of holding for six months. Nor could the section have been justified with an example of trading in antic-

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company in such a manner as to cause great fluctuations in the price of the stock of the concern."); H. MANNE, *supra* note 18, at 6-7; *id.* at 8 ("Certainly this relationship [between insider trading and the danger of manipulation of corporate affairs] was frequently alluded to in the congressional hearings on the Securities and Exchange Act of 1934.") (citing *Stock Exchange Practices, supra* note 31); Brudney, *supra* note 18, at 8 n.27; Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws,* 93 HARV. L. REV. 322, 335 n.50 (1979) ("Evidence of the connection of insider trading with such manipulation of corporate affairs was frequently alluded to in congressional hearings."); Dooley, *supra* note 5, at 56 ("The hearings . . . focused on insiders' participation in pools designed to manipulate their corporation's stock. . . . The few questions pertaining to inside information were only incidental to inquiries regarding the manipulations in which the information had been used, which were Congress's primary concern." (footnotes omitted)); Samuelson, *supra* note 15, at 514-31; Steiner, *Security Markets and Business,* in THE SECURITY MARKETS, *supra* note 21, at 154, 199 ("Some corporations, in fact, seem to have been operated by their managements as an aid to personal stock market profits, rather than to earn business profits for the shareholders. Moreover, the corporation may be used to 'bail out' speculative directors."); *cf.* Brief for the SEC as Amicus Curiae at 11-12, Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418 (1972) (No. 70-79) ("Congress had uncovered many instances where those in control of large corporations . . . had manipulated the affairs of their corporations to profit from short-term speculative trading in their corporations' securities.").

142. While he traded for his own accounts, Wiggin caused affiliates of the bank to expend a tremendous amount of money trading stock of the bank in order to manipulate its price. *See supra* note 114 and accompanying text.

143. The version of the Exchange Act that the House passed and sent to conference, H.R. 9323, 73d Cong., 2d Sess. (1934), *reprinted in* 10 LEGISLATIVE HISTORY, *supra* note 31, item 31, did not contain any provision analogous to § 16(b) of the Exchange Act. *See* H.R. REP. No. 1838, 73d Cong., 2d Sess. 35-36 (1934) (discussion of §16 in conference report), *reprinted in* 5 LEGISLATIVE HISTORY, *supra* note 31, item 20.

144. S. REP. No. 792, *supra* note 117, at 9, *reprinted in* 5 LEGISLATIVE HISTORY, *supra* note 31, item 17; *see also infra* notes 163, 241 (discussing the General Asphalt pool, to which the Senate committee report was probably referring).

ipation of a short-term price change for which the trader was not responsible; if the problem is the unfairness of trading on the basis of nonpublic information, there is no reason to draw lines on the basis of the duration of the information's effect on the market (and if a line had to be drawn, it seems that information with long-term implications is more important).

A trader can predict a security price that will be short lived if she is aware that the movement to a new equilibrium price will be irregular.[145] For example, a deviant price may reflect an inappropriate market response to new information—overreaction to the truth or acceptance of falsehood—that will be corrected over time.[146] Insider trading in anticipation of short-lived price changes has greater practical implications than other trading on the basis of nonpublic information because insiders will have an incentive to create price volatility if they can profit from it, and price volatility is itself objectionable. Those in control of publicly held corporations are uniquely situated to produce price fluctuations by manipulating either corporate income-producing operations or the public's perception of corporate prospects.

Managers are much more likely to manipulate corporate affairs to produce transient trading opportunities than they are to mismanage corporations in order to depress share prices permanently. If managers can depress prices temporarily, they can create opportunities to trade profitably without destroying the value of what they buy. Thus, substantial stockholders who would never want to create permanent price drops can profit from short-lived ones. Moreover, short-lived manipulations are less likely to have the devastating personal consequences for officers and directors that will attend sustained price drops.[147]

The easiest way that managers can temporarily influence stock prices is to manipulate the flow of corporate information to the public.[148] Even if businesses cannot keep secrets forever, corporate management often has broad discretion about when and how to disclose important information, and corporate disclosure practices can

145. *Cf.* Niederhoffer & Osborne, *Market Making and Reversal on the Stock Exchange,* 61 J. Am. Statistical A. 897 (1966) (examination of price fluctuation in the stock market); Thel, *supra* note 62, at 415-38 (disruptive trading).

146. Manipulation by misrepresentation "is inherently a short run phenomenon," since market prices will bounce back with the passage of time as statements or acts are shown to have been misleading. Carlton & Fischel, *supra* note 45, at 892; Mendelson, *supra* note 58, at 474 ("[W]hen mispricing occurs, it is relatively quickly eliminated.").

147. *See supra* notes 105-111 and accompanying text (personal damage to affiliates from declining stock prices).

148. *Cf.* Haft, *supra* note 63, at 1053-60 (lower-level employees may conceal information from superiors in order to preserve their own trading opportunities).

be manipulated to create or preserve trading opportunities.[149] Since the goal is only to change the public's perception of corporate income, managers need not tamper with corporate business activities that directly produce income. Their deception may injure non-trading stockholders, nonetheless, for its revelation will injure corporate credibility, a valuable asset.[150] Other forms of manipulation, however, may damage the interests of long-term stockholders even more than corporate deception.

Managers may be able to profit personally if they undertake corporate practices that will depress corporate earnings, buy stock at prices reflecting those lower earnings, and then reverse those practices and sell at a profit after prices rise again. This will work only if the market believes that the unprofitable corporate practices will not be changed, and the market will of course be trying to figure out management's plans. Management might hide its plans or even try to mislead the market about them, in which case the scheme might be said to be deceptive, but a business manipulation might succeed even if fully disclosed. If the market recognizes that the interests of management and public stockholders diverge, stock prices may fall even though the public is fully aware that the managers will change business practices after trading.[151]

Even if it is possible for managers to create short-swing trading opportunities by manipulating corporate business operations, they may in fact be unlikely to do so very often. Aside from the effects of market discipline and judicially administered rules against fraud and self-dealing, even managers who would delay corporate announcements in order to trade might find it difficult to rationalize abandoning valuable corporate opportunities for selfish ends. A proscription of trading may be too broad a tool for controlling a rare problem.[152] In trying to make sense of the Exchange Act, however, it is wise to remember that it was the product of very unusual circumstances. What might now pass as unexceptional confidence in the efficacy of ordinary incentives to prevent management manipulation would have seemed horribly mis-

149. *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). *See generally* H. MANNE, *supra* note 18, at 6-7, 151-52 (delay in disclosures).

150. *See* Diamond v. Oreamuno, 24 N.Y.2d 494, 499, 248 N.E.2d 910, 912-13, 301 N.Y.S.2d 78, 81-82 (1969).

151. Berwald v. Mission Development Co., 185 A.2d 480 (Del. 1962), may be an example of managers manipulating corporate affairs to allow them to trade profitably. *See, e.g.*, J. HOCKENBERRY & T. HARDY, TEACHER'S MANUAL TO ACCOMPANY BRUDNEY & CHIRELSTEIN'S CASES AND MATERIALS ON CORPORATE FINANCE 65-67 (1972).

152. H. MANNE, *supra* note 18, at 8.

placed in the extraordinarily terrible times in which section 16 was enacted.

Ordinary market and legal restraints on management behavior may be ineffective in controlling the behavior of managers during a corporate crisis. Managers may not know the best way to maximize stockholder value in difficult and unusual situations, yet such situations are peculiarly likely to result in management abuse or error, offering as they do both wonderful trading opportunities and the threat of ruined careers. When the Exchange Act was passed, the public had reason to doubt the judgment of business executives, especially those who were active in the stock market. In the circumstances, there was little reason to be confident that managers faced with a choice between personal interest and fiduciary obligations would recognize the conflict or act responsibly if they did.

Insider trading restrictions that would ordinarily be rejected as excessive appear to be appropriate when they are applied to corporations in crisis. Especially severe restrictions on insider trading during corporate reorganizations have been justified by the potential conflict between management and stockholder interests.[153] The Supreme Court has on several occasions upheld trading rules that were said to be justified by the risk of management's manipulating the reorganization process to create trading opportunities. In *Wolf v. Weinstein*,[154] the Court emphasized the danger of officers misusing their power over corporate affairs to enhance their trading profits as it expansively construed rules on trading during the pendency of reorganization proceedings under the old Bankruptcy Act. The Court recognized the link between the unfair use of inside information and the manipulation of corporate affairs, and went so far as to suggest that section 16 of the Exchange Act was directed at preventing both.[155]

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153. *See* Bandler, *Securities Trading and Fee Sharing Under Chapter X of the Bankruptcy Act*, 15 REC. N.Y.C.B.A. 230 (1960); Brudney, *supra* note 18; Douglas, *Improvement in Federal Procedure for Corporate Reorganizations*, 24 A.B.A. J. 875, 877-78 (1938); Ferber, Blasberg & Katz, *Conflicts of Interest in Reorganization Proceedings Under the Public Utility Holding Company Act of 1935 and Chapter X of the Bankruptcy Act*, 28 GEO. WASH. L. REV. 319, 330, 376-377 (1959); Gerdes, *Corporate Reorganizations: Changes Effected by Chapter X of the Bankruptcy Act*, 52 HARV. L. REV. 1, 38-39 (1938); Kaplan, *supra* note 12, at 276-77; Note, *Conflict of Interests as a Factor in the Allowance of Representatives' Claims in Insolvent Corporate Reorganizations*, 106 U. PA. L. REV. 1139, 1148-61 (1958); *see also* 2 L. Loss, *supra* note 2, at 1124-30.

154. 372 U.S. 633 (1963).

155. Access to inside information or strategic position in a corporate reorganization renders the temptation to profit by trading in the Debtor's stock particularly pernicious. The particular dangers may take two forms: On the one hand, an insider is in a position to conceal from other stockholders vital information concerning the

The Court also dealt with the issue of management manipulation in one of the best known cases arising under the federal securities laws. The Court's two opinions in *SEC v. Chenery* are remembered mainly for their holdings on the role of adjudication in administrative decision-making and the scope of judicial review of administrative orders.[156] Nonetheless, underlying the dispute in *Chenery* was the SEC's concern about corporate managers manipulating corporate affairs during reorganizations to produce profitable trading opportunities.[157]

Chenery involved the reorganization of a holding company under the Public Utility Holding Company Act,[158] which required that reorganization plans be fair and equitable and not detrimental to the public interest or the interest of investors. The SEC objected to a series of reorganization plans that would have allowed managers to receive common stock of the reorganized company on the basis of preferred stock they had purchased in the market while various reorganization plans were under consideration.[159] The SEC reasoned that by virtue of its control of the holding company's business, management could affect the market price of outstanding securities and had "a formidable battery of devices that would enable it, if it should choose to use them selfishly, . . . to influence the market for its own gain."[160] The SEC concluded that it would have been inconsistent with the statutory standards to allow managers to receive common stock in the reorganized company on the basis of securities they bought at prices

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> Debtor's financial condition or prospects, which may affect the value of its securities, until after he has reaped a private profit from the use of that information. On the other hand, one who exercises control over a reorganization holds a post which might tempt him to affect or influence corporate policies—even the shaping of the very plan of reorganization—for the benefit of his own security holdings but to the detriment of the Debtor's interests and those of its creditors and other interested groups.
>
> Congress enacted two distinct types of sanctions to prevent these possible practices. One appears in § 16(b) of the Securities Exchange Act . . . . The other sanction, directed at preventing insider trading during insolvency or reorganization, appears in § 249 [of the Bankruptcy Act (repealed 1978)]; it denies to a "fiduciary" or "representative" any compensation or reimbursement if at any time during the proceeding he trades in the Debtor's stock.

Id. at 642-43 (footnote omitted).

156. SEC v. Chenery Corp., 332 U.S. 194 (1947); SEC v. Chenery Corp., 318 U.S. 80 (1943).

157. *See also* 318 U.S. at 91-92 (short-swing trading proscription of Public Utilities Holding Company Act is not the limit of SEC power over conduct of holding company management); *cf.* Rubin & Feldman, *supra* note 12, at 499 n.102 (SEC saw *Chenery* as equivalent to § 16).

158. Public Utility Holding Company Act of 1935 §§ 7, 11 (codified as amended at 15 U.S.C. §§ 79g, 79k (1988)).

159. 332 U.S. at 197-99; *see also* 318 U.S. at 81-85.

160. 332 U.S. at 205 (quoting SEC order, Holding Company Act Release No. 5584).

possibly influenced by the way they managed the business or shaped the reorganization process.[161] As is well known, the Court sustained the SEC once it explained itself.

The "notorious market pools"[162] that figured so prominently in the debate over the Exchange Act were charged with manipulating both corporate announcements and underlying corporate business activities.[163] The pools were trading syndicates that used whatever tools

161. 332 U.S. at 204-05. The SEC "was led to this result 'not by proof that [the holding company's management] committed acts of conscious wrongdoing but by the character of the conflicting interests created by [their] program of stock purchases carried out while plans for reorganization were under consideration.'" *Id.* at 204; *see also id.* at 197 ("It was also plain that there was no fraud or lack of disclosure in making these purchases."); 318 U.S. at 85 ("The Commission did not find fraud or lack of disclosure . . . .").

162. 2 L. Loss, *supra* note 2, at 844. *But see* H. Manne, *supra* note 18, at 66 (pools as device for sharing information).

163. The Senate Banking and Currency Committee, which was responsible for keeping the § 16(b) forfeiture provision in the Exchange Act, seems to have been particularly concerned with manipulation of financial policy and business operations, as opposed to manipulation of reports of those activities. As noted above, this committee's report was the only one that discussed the provision that became § 16(b). *See* S. Rep. No. 792, *supra* note 117. It gave two examples of the sort of misconduct that § 16(b) would prevent, both involving the manipulation of dividend policy. *Id.* at 9.

A change in dividend policy might lead to a change in stock prices in two ways. Dividend policy may somehow determine the amount stockholders will receive from the issuer over time, or it may reveal information about the issuer's operations. Even if stockholders are indifferent between receiving corporate income as dividends or capital gains, changes in dividend payout may affect security prices if they give the market some signal (correct or not) about corporate income. Managers may be able to manipulate this signal to create trading opportunities. R. Clark, *supra* note 4, at 267. Managers can also manipulate dividend policy to favor one class of securityholders over another in the distribution of corporate wealth, but like the manipulation of dividend signals, inter-class manipulation need not affect actual corporate operations. *See, e.g.,* Pittsburgh Terminal Corp. v. Baltimore & Ohio R.R., 680 F.2d 933 (3d Cir.), *cert. denied,* 459 U.S. 1056 (1982); Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919).

Stockholders may be indifferent to corporate dividend policy. *See* R. Brealey & S. Myers, *supra* note 15, at 357-81; R. Clark, *supra* note 4, § 14.1, at 594-602; W. Klein & J. Coffee, *supra* note 15, at 348-50. Nonetheless, many people still assume that dividend rates actually affect corporate earning power, or at least stock prices, and this seems to have been the prevailing wisdom in 1934. The Senate committee seems to have been particularly concerned with this aspect of dividend policy. Consider one of its cases:

> In a particularly glaring instance, the chairman of the executive committee and another director participated in a pool organized in [sic] trade in the stock of their company when the stock was paying no dividends. During the operation of the pool, which continued for a period of 2 years, they caused the company to resume the payment of dividends, more than 25 percent of which were received by the pool participants. These dividends were paid during the pool's operation in spite of the fact that the company's earnings were not sufficient to meet them and part of its surplus had to be diverted for that purpose.

S. Rep. No. 792, *supra* note 117, at 9.

According to the Senate committee, the directors and their cronies simply bought stock, took dividends, and sold the stock. The scheme did not turn on misleading the public and the directors did not take advantage of inside information. The pool simply coupled corporate were available to move market prices to their own advantage.[164] Corporate officers and directors frequently participated in pools in the stock of their companies,[165] sometimes conducting corporate affairs to manipulate corporate stock prices.[166] For example, the issuers of stocks that were the subject of pool manipulations were often themselves the source of the stock options that the pools used to limit their risks.[167] Issuers managed by pool participants often released misleading information about corporate operations.[168] Finally, managers could direct the corporation's assets into the stock market to manipulate prices by trading.[169] Together with sections 9 and 10 of the Exchange Act, section 16 was directed at eliminating manipulative pools.[170]

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control with stock trading to gain control of corporate assets. It may well be that managers cannot realize a disproportionate share of corporate income by coordinating their trading and dividend decisions; corporate dividend payments are presumably followed instantaneously by offsetting declines in stock prices. It seems, however, that this is precisely the possibility that worried the Senate committee. The pool's profit in the example did not come from fooling the market; it came from bleeding the company. (Interestingly, this scheme would not seem even to implicate § 16(b), inasmuch as, so far as appears in the report, the insiders held their stock for two years. *Cf. supra* note 136 (forfeiture of dividends). The example is based, however, on an actual pool that traded frequently, and in which the participants lost money. S. REP. No. 1455, *supra* note 62, at 66-68.)

164. S. REP. No. 1455, *supra* note 62, at 30-46; 78 CONG. REC. 8165-74 (1934); Jones & Lowe, *Manipulation*, in THE SECURITY MARKETS, *supra* note 21, at 462-99 (techniques and examples).

165. S. REP. No. 1455, *supra* note 62, at 55-68 (discussing participation of directors, officers, and principal stockholders in pools and describing § 16 as a remedy); THE SECURITY MARKETS, *supra* note 21, at 690; Dooley, *supra* note 5, at 56 ("The hearings that preceded the 1934 Act . . . focused on insiders' participation in pools designed to manipulate their corporation's stock.").

166. *See, e.g.*, S. REP. No. 1455, *supra* note 62, at 67 ("It is difficult to believe that the conduct of [a director and the chairman of the executive committee of General Asphalt Co.] was not influenced by their interest in the pool, when as directors they approved the payment of an initial dividend . . . and the payment of subsequent dividends while the company was showing a deficit."); *see also supra* note 141 (manipulation of corporate affairs).

167. S. REP. No. 1455, *supra* note 62, at 37; Jones & Lowe, *supra* note 164, at 447, 463-64 (option pools), 452-56 (source of options); *see also* S. REP. No. 792, *supra* note 117, at 9 (Options "are indispensable concomitants of every pool operation designed to distribute stock at an increased price."); H.R. REP. No. 1383, *supra* note 31, at 10 ("The granting of options to pools and syndicates has been found to be at the bottom of most manipulative operations . . . .").

168. Comment, *Market Manipulation and the Securities Exchange Act*, 46 YALE L.J. 624, 626-27 (1937) ("The directors of the corporation whose stock is being manipulated, who may be members of the pool, issue favorable, but not wholly true, statements concerning the corporation's prospects . . . .").

169. Steiner, *supra* note 141, at 199; *see also supra* notes 117-123 and accompanying text (Wiggin's bank trading).

170. S. REP. No. 792, *supra* note 117, at 9 ("Such a provision will render difficult or impossible the kind of transactions which were frequently described to the committee, where directors and large stockholders participated in pools trading in the stock of their own companies . . . ."); S. REP. No. 1455, *supra* note 62, at 68; H. MANNE, *supra* note 18, at 66;

The principal effect of section 16(b), then, is to discourage affiliates of publicly held corporations from speculating on short-term swings in stock prices. While the forfeiture provision does not remove the incentive to trade on inside information, it does remove much of the incentive for corporate managers to manipulate corporate affairs to create short-lived price changes,[171] without seriously undermining the incentive to keep prices rising.

D. Management Regulation and the Anomalies of Section 16

Perhaps what is most satisfying about the interpretation of section 16 offered here is that it explains the anomalies presented by the conventional equal-access-to-information interpretation. The anomalies most frequently discussed in the literature arise from the short-swing trading limitation of section 16(b), which is calibrated to make section 16 an effective device for regulating the way businesses are run. As the reader may have recognized, the management-control interpretation also goes a long way toward explaining other anomalies as well. In fact, most of the features of section 16 that undercut its effectiveness in assuring all traders equal access to inside information are precisely keyed to its function as a device to prevent manipulation and

Dooley, *supra* note 5, at 59; Mathias, *Manipulative Practices and the Securities Exchange Act* (pt. 2), 3 U. PITT. L. REV. 104, 110 (1936).

171. Since § 16(b) forfeiture is triggered only by matched trades, managers may be able to profit from short-lived changes in stock prices by selling long-held positions on a price spike. The point is not that § 16(b) makes it impossible for managers to profit from volatility, but rather that it undercuts any incentive they may have to create such volatility. It does this by making the price of trading a six-month change of position, and this price is likely to be high enough to discourage managers from manipulating temporary price changes. For example, a manager without a position in the stock of her company might buy with a view to creating a temporary selling opportunity in six months, but this would require her to tie up her funds and assume an investment risk for six months, during which she would have interests similar to those of public stockholders. More importantly, if a director, officer, or principal stockholder sells on a price spike, she will have to forfeit her profit if she buys the stock back at a lower price within six months. Since the price will fall back to previous levels as soon as the temporary effect of the manipulative corporate action wears off, managers will not be able to take advantage of temporary price rises unless they are able to do so without repurchasing the stock they sell.

Principal stockholders are particularly likely to be interested in promptly repurchasing what they sell, since they risk losing control of the companies with which they are affiliated if their sales are large. *See* S. REP. No. 792, *supra* note 117, at 9 (brothers who controlled company with a little over 10% of the stock disposed of stock before passing dividend and later repurchased stock for $9,000,000 less). Yet principal stockholders will not be able to buy their stock back for six months without surrendering their profits. This will be a problem only if prices spring back after the sale, but a principal stockholder has no incentive to depress prices permanently. *See supra* notes 105-106 and accompanying text.

to align the interests of management and stockholders in publicly held corporations.

(1) The Limitation to Publicly Held Companies

When section 16 was enacted in 1934, its provisions were limited to affiliates of issuers that registered equity securities on national stock exchanges. Although the compass of the section was expanded to virtually all publicly held companies in 1964, it still does not reach trading in the stock of closely held companies. This would be an important defect in a statute designed to ensure that insiders do not take advantage of their access to inside information. Yet, it is an entirely appropriate limitation in a statute designed to channel the energies of non-owner managers into the pursuit of appropriate corporate business activities.

It is hard to see why Congress would have limited section 16 to exchange-registered companies if its primary concern was assuring that all traders had equal access to corporate information. To be sure, there are fewer investors to worry about when the insiders of closely held companies take advantage of their access to inside information, but if it is unfair for insiders to trade stock on the basis of corporate information, it is unfair even if the issuer is closely held. If anything, insider trading in the stock of closely held companies seems even more unfair,[172] and it is also more likely to involve deceit and the sort of injury to outside investors that would justify a legal proscription.[173] In sum, a limitation to the stock of publicly held companies is inconsistent with the policies that would underlie an equal-access regime.

The limitation of section 16 to publicly held companies cannot be explained by the Exchange Act's preoccupation with public markets either. Once section 16 is triggered by the registration of a class of a corporation's equity securities on an exchange, it governs trading

172. *Cf.* Yourd, *supra* note 18, at 146. Those who defend insider trading as an appropriate incentive device usually confine their arguments to publicly held companies, and some recognize that closely held companies present much more difficult issues. *See* Carlton & Fischel, *supra* note 45, at 861 n.19; *cf.* Easterbrook & Fischel, *supra* note 18, at 14-15.

173. When the Exchange Act was being debated, the majority common law rule was that insiders could trade on the basis of inside information, but the few cases that held insider trading actionable involved negotiated transactions in closely held companies. *See supra* note 79. Since 1934, some courts have held that publicly held companies can recover from insiders who trade on inside information. *See, e.g.*, Brophy v. Cities Service Co., 31 Del. Ch. 241, 70 A.2d 5 (1949); Diamond v. Oreamuno, 29 A.D.2d 285, 287 N.Y.S.2d 300 (1st Dept. 1968). Even those who argued that the common law was moving toward forbidding insiders to trade on the basis of corporate information acknowledged that the progressive movement was limited to securities that were not publicly traded. *See, e.g.*, Yourd, *supra* note 18, at 146.

in all of the corporation's equity securities, including equity securities that are not traded in any public market. The limitation may reflect a narrow conception of federal constitutional power to regulate stock trading that prevailed in 1934, but even this seems unlikely. If section 16 was addressed to unfairness or fraud, it could have tied regulation to the insiders' use of the mails or instrumentalities of interstate commerce.[174] Congress used that tie in broad provisions of the Securities Act and the Exchange Act that address fraud, extending coverage to all securities and basing jurisdiction on the trader's activities rather than the issuing corporation's activities.[175]

Congress may have made an issuer's act of registering securities trigger section 16 for administrative convenience or because of a narrow conception of the constitutional basis for federal intervention, but it left out some trading that could have been reached conveniently and constitutionally.[176] Section 16 does not reach any trading in equity se-

174. The drafters apparently rejected a suggestion that insiders of all issuers should be forbidden to use the mails or means of interstate commerce for short-swing trading. I.N.P. Stokes' master draft of comments on Fletcher-Rayburn bill, *supra* note 78, at § 15(b) (handwritten comment). At the time this suggestion was made, the predecessor of § 16 under consideration would have prohibited intentional short-swing trading by certain affiliates of companies with exchange-registered securities. *See infra* note 284 and accompanying text. Had the drafters wanted to require forfeiture of short-swing trading profits, they would have had to restructure § 16. Enforcement of the forfeiture provision depends on trading reports, and it would have been impracticable to have had insiders of all corporations report their trades to the SEC. Insiders of privately held companies might have been required to report their trades to the company or directly to stockholders.

175. *See* Securities Act § 17(a), 15 U.S.C. 77q(a) (1988); *id.* § 10(b), 15 U.S.C. §78j(b) (1988). The fact that § 16 governs only publicly traded companies does not necessarily mean that Congress was concerned with a problem unique to such companies of course. The limitation may have been merely an oversight. When the Fletcher-Rayburn bill was introduced, the provision that became § 10(b) of the Exchange Act was also limited to exchange-registered securities. Fletcher-Rayburn bill, *supra* note 73, § 9. The first introduced revision extended the reach of what became § 10(b) to "any security registered on a national securities exchange or any security not so registered." H.R. 8720, 73d Cong., 2d Sess. § 9(c) (1934), *reprinted in* 10 LEGISLATIVE HISTORY, *supra* note 31, item 28; *see* Thel, *supra* note 21, at 443-44. The House drafters may have forgotten § 16 when they effectively extended the reach of what became § 10(b) to all securities. This seems unlikely, though, for at the same time they were expanding what became § 10(b), they were contracting what became § 16. The predecessor of § 16 in the original bill was triggered by an issuer's registration of any security, Fletcher-Rayburn bill, *supra* note 73, § 15, and the first revision narrowed the scope to the registration of equity securities, which was the form in which § 16(a) was ultimately adopted. H.R. 8720, *supra,* § 15.

176. The drafters were concerned with convenient administration of the forfeiture provision, but this concern does not explain their keying § 16 to registered securities. *See infra* notes 179-180 and accompanying text. A distinct emphasis on publicly held corporations was apparent in the first introduced version of what became § 16, which absolutely prohibited intentional short-swing trading. Fletcher-Rayburn bill, *supra* note 73, § 15(b)(1). That prohibition was apparently written without concern for enforcement, and it was still limited to trading in publicly held securities.

curities of issuers that have registered only debt securities, and it leaves principal holders of unregistered securities (debt or equity) free to trade registered (that is, publicly held) equity securities.[177] The drafters would hardly have left these holes if they had wanted to ensure everyone trading in the public market equal access to corporate information. They could easily have filled the holes by triggering the section with the registration of any class of security, equity or debt, which is just what the provision did when it was first introduced.[178]

On the other hand, there was no need to reach companies outside of section 16 in order to align the interests of management and stockholders. Section 16 applies to all issuers with registered equity securities, so if section 16 does not apply, it is because all a company's equity securities are closely held. In that situation the ownership and control of the corporation probably are not split, and conventional incentives are likely to ensure that the corporation's affairs are not mismanaged. If the managers of a closely held corporation do not own it themselves, ownership will at least be concentrated in a few stockholders with the ability and incentive to insist that managers vigorously pursue corporate profit.[179]

One of the reasons section 16 is so long and hard to read is that it sometimes refers to registered equity securities and sometimes to any equity securities, registered or not. The distinction introduces a numbing complexity to section 16, but in the end it determines what section 16 accomplishes.[180] As has just been explained, since the trigger of section 16 is the registration of equity securities, section 16 does not reach all corporations or even all corporations having publicly held securities. If a corporation has publicly held equity securities, however, section 16 reaches affiliate trading in all its equity securities, publicly held or not. Section 16(b) requires affiliates of companies with registered equity securities to forfeit their profits from trading any equity security, registered or not, and section 16(c) forbids them to sell any equity security short or against the box, once again, whether it is registered or not.

It is not likely that section 16 covers trading in all equity securities of publicly held corporations in order to achieve equality of infor-

177. *See* 2 L. Loss, *supra* note 2, at 605-06.

178. Fletcher-Rayburn bill, *supra* note 73, § 15. The redrafting of the predecessor to § 16 alluded to above, *supra* note 173, strongly suggests both that the drafters saw the holes and knew how to fill them.

179. *See House Hearings*, *supra* note 85, at 135.

180. The distinction was not inadvertent. Broadly speaking, over the course of the amendment of § 16 references to registered securities became references to any securities, and vice versa. *See infra* Part III.B.

mation. If Congress was unwilling to extend protection to the stockholders of closely held corporations, there is no reason to think that it would have wanted to ensure equal access to corporate information to the few holders of a closely held class of equity securities just because the issuer has a class of publicly held equity. It is even harder to explain the extension of section 16(c) in terms of traders' access to information. On the other hand, the extension is natural for a provision addressed to problems created by the separation of ownership from control. If affiliates of publicly held companies were free to trade nonpublicly held securities as they wished, they would be able to manipulate corporate affairs to shift wealth among holders of registered and unregistered equity and then trade accordingly. The best explanation for the decision to extend the reach of section 16 to trading in all equity securities of publicly held companies is the same as the explanation for the decision to limit section 16 to publicly held companies in the first place: the drafters were intent on controlling the way corporations are managed.

(2) The Limitation to Control Persons

Section 16(b) is usually called an insider trading provision, but relatively few corporate insiders are within its scope. It covers only directors, officers, and principal stockholders, leaving lower level employees, substantial holders of debt securities, and tippees free to trade on the basis of inside information. Thus the vast majority of people who have access to nonpublic information about publicly held corporations are not subject to section 16 at all. Section 16 governs the conduct of only those people who ought to be covered by a management-control provision—the people who control corporations.

Subordinate employees should not be exempt from an equality-of-information regime, and the courts and the SEC do not seem disposed to exempt them.[181] One might argue that section 16 excludes non-managerial employees because only directors, officers, and principal stockholders regularly learn corporate secrets. Yet people without control of corporate activities have ample opportunity to trade on the basis of nonpublic information. To the extent that section 16 burdens insiders even when they trade without an intent to profit on inside information, it might be considered inappropriate to include presumably

181. *Cf.* Carpenter v. United States, 484 U.S. 19 (1987) (Wall Street Journal employee); Chiarella v. United States, 445 U.S. 222 (1980) (financial document printer employee). Indeed, the argument can be made that trading by subordinate employees is especially damaging to firms. *See* Haft, *supra* note 63, at 1053-56.

low-paid non-management employees. The burden of section 16, however, would not justify an exemption for lower-level employees either. If they are deserving of special consideration at all, it is because they will seldom trade very extensively, and if this is so then section 16 will not have much effect on them. The activities that section 16 burdens are not attractive ones in any case. In 1934, public and congressional sentiment was strongly against all short-swing, in-and-out trading, and there is no evidence that Congress wanted to protect employee-speculators and no reason to think that it would have been impressed with their desire to speculate.[182]

In any case, even if the drafters had wanted to protect the legitimate trading activities of lower-level employees, they would not have seen any reason to limit section 16 to managers, for they did not think section 16(b) imposed a burden on anyone. As they saw it, the section does not provide for the punishment of short-swing trading; it simply takes away the profits. Courts typically compute profits in a way that can punish active traders,[183] but the drafters thought that the section simply removed the profits from short-swing trading. As Thomas Corcoran told the Senate Banking Committee when he was asked whether the provision might work a hardship on those who needed their money: "Let him get out what he put in, but give the corporation the profit."[184]

Another reason that section 16 is too narrow to achieve informational equality is that it does not cover trading by outsiders who acquire inside information. An equality-of-information regime has to deal with the possibility that insiders who cannot trade will give inside information to outsiders, perhaps in exchange for inside information about other companies, yet section 16 leaves tippees free to trade.[185]

182. On the contrary, the liberal inclination was to prevent those without substantial wealth from speculating at all. *See* Message from President Roosevelt to Congress (Feb. 9, 1934), *reprinted in* H.R. REP. No. 1383, *supra* note 31, at 1-2 ("[N]aked speculation has been made far too alluring and far too easy for those who could and for those who could not afford to gamble."); Letter from President Roosevelt to Sam Rayburn (March 26, 1934), *reprinted in* H.R. REP. No. 1383, *supra* note 31, at 2; C. DICE, *supra* note 141, at 8; J. KEYNES, *supra* note 60, at 159 ("It is usually agreed that casinos should, in the public interest, be inaccessible and expensive. And perhaps the same is true of Stock Exchanges."); Tracy & MacChesney, *The Securities Exchange Act of 1934,* 32 MICH. L. REV. 1025, 1030 (1934); *see also House Hearings, supra* note 85, at 35 ("widespread speculation or gambling on the part of the masses of the people").

183. *See supra* note 36.

184. *Stock Exchange Practices, supra* note 31, at 6557, *quoted in* Cook & Feldman, *supra* note 12, at 407-08; *see also House Hearings, supra* note 85, at 133; *Stock Exchange Practices, supra* note 31, at 7742.

185. The drafters of § 16 recognized the tippee problem. The Fletcher-Rayburn bill would

The management control version of section 16 also explains section 16's failure to deal with trading by tippees. While tipping presents a serious problem for those who would guarantee traders equal information, it is not particularly important for those concerned only with aligning management and stockholder interests and preventing manipulation. If managers are allowed to trade on good inside information, there is no reason to worry about their tipping such information. Tipping bad information is not likely to be a problem either if the reason for regulating trades made in contemplation of depressed prices is to discourage managers from depressing corporate earnings. Tipping information may be relatively costless for the tippee, but depressing corporate earnings is personally costly for officers and directors, whose careers will suffer, and for principal stockholders, whose holdings will suffer.[186] Insiders who might be willing to tip information for friendship or in hopes of future reciprocity will presumably be much less willing to suffer personal loss to create opportunities for others' profits.[187]

(3) Disgorgement and Corporate Recovery

Another intriguing aspect of section 16(b) is its enforcement mechanism.[188] In striking contrast with other substantive provisions of the Exchange Act, section 16(b) does not require or forbid anything.[189] It simply declares that the profits of certain types of matched

have made it illegal for the enumerated insiders "[t]o disclose . . . any confidential information regarding or affecting any such registered security not necessary or proper to be disclosed as a part of his corporate duties." Fletcher-Rayburn bill, *supra* note 73, § 15(b)(3). The bill also provided for forfeiture of the tippee's profits with respect to transactions in the securities of the issuer within six months after an unlawful disclosure. *Id.* It is conventional to explain the deletion of this provision on the ground that "the burden of proof made enforcement unfeasible." Smolowe v. Delendo Corp., 136 F.2d 231, 236 (2d Cir.), *cert. denied,* 320 U.S. 751 (1943); 2 L. Loss, *supra* note 2, at 611. *See infra* notes 287-291 and accompanying text.

186. *See supra* notes 105-107 and accompanying text.

187. H. MANNE, *supra* note 18, at 30. Managers who share in the profits of their outside tippees are likely to be held answerable under § 16(b) if they are discovered. *See* Exchange Act § 16(b), 15 U.S.C. § 78p(b) ("profit realized"); *see also* CBI Indus., Inc. v. Horton, 682 F.2d 643 (7th Cir. 1982) (director who was trustee of trading trust); *Stock Exchange Practices, supra* note 31, at 6556; H. MANNE, *supra* note 18, at 25; Feldman & Teberg, *Beneficial Ownership Under Section 16 of the Securities Exchange Act of 1934,* 17 W. RES. L. REV. 1054 (1966); Jacobs, *supra* note 12, at 540-44; Seligman, *supra* note 12, at 10 (distinction between "beneficial owner" in § 16(a) and "any profit realized" in § 16(b)); *cf.* 2 L. Loss, *supra* note 2, at 572 n.86 (discussing Exchange Act § 20(a)).

188. *See also infra* note 257 and accompanying text (drafters' interest in sanctions and enforcement).

189. *See* Exchange Act §§ 5 (unlawful to effect transactions on unregistered exchanges), 7 (unlawful extension or maintenance of credit), 8 (unlawful borrowing and lending by brokers,

trades shall inure to issuers and provides a mechanism to ensure that issuers realize those profits. Not only is there no such thing as a violation of section 16(b), the SEC cannot take action to compel the forfeiture for which it does provide.

Section 16(b) is well designed to discourage the manipulation of corporate conduct and to compensate the victims of such manipulation insofar as compensation is practicable when deterrence fails.[190] Putting aside for the moment the question of compensation, consider how well section 16(b) works as a deterrent. Insiders within its scope are sure to be forced to disgorge their profits under section 16(b) once their short-swing trading is discovered, and the reporting requirements of section 16(a) usually lead to discovery.[191] Accordingly, section 16(b) generally keeps insiders from engaging in profitable short-swing trading.[192] When control persons do effect short-swing trades, the amount they are required to disgorge under section 16(b) may be less than the damage they do by trading.[193] So far as modifying behavior goes, however, it is enough to require insiders to disgorge their profits. If insiders are consistently forced to disgorge the profits of short-swing trading, then section 16 will effectively discourage such trading, and it does not matter why short-term trading is objectionable.[194] Of course,

dealers, and exchange members), 9 (unlawful manipulation), 10 (unlawful manipulation in contravention of certain rules), 11 (unlawful to violate rules on functions of brokers, dealers, and exchange members), 12 (unlawful for exchange members or brokers to trade unregistered securities), 13 (issuers shall report), 14 (unlawful to solicit proxies in contravention of rules), 15 (unlawful to make over-the-counter market transactions in contravention of rules), 16(a) (control persons shall report), 16(c) (short-sales by insiders unlawful), 17 (exchanges, members, brokers, and dealers shall keep records and make reports); *see also id.* § 32 (criminal penalties).

190. *See generally* D. Dobbs, Handbook on the Law of Remedies 1-8 (1973).

191. *See also* Regulation S-K, item 404(c), instruction 4, 17 C.F.R. § 229.404(c) (1988); Schedule 14A, item 7(b), 17 C.F.R. § 240.14a-101 (1988) (proxy statements must disclose certain management obligations arising under § 16(b)); Jacobs, *supra* note 12, at 216-18 (other sources of information about trading); Smith, *supra* note 122, at 5, col. 1 (discussing civil enforcement of § 16(b) by shareholders). The two-year limitations period provided in § 16(b) is tolled while § 16(a) reports are delinquent. Whittaker v. Whittaker Corp., 639 F.2d 516 (9th Cir.), *cert. denied,* 454 U.S. 1031 (1981); Jacobs, *supra* note 12, at 627-29; Kramer, *An Examination of Section 16(b),* 21 Bus. Law. 183, 185-91 (1965). The reporting requirements of § 16(a) might be more effective if insiders who failed to report faced a more onerous sanction. *See* Exchange Act Release No. 26,333, *supra* note 6, ¶ 89,600-01 (reporting delinquencies and SEC proposals for reforms); Jacobs, *supra* note 12, at 218-24; Samuelson, *supra* note 15, at 520-22; *Task Force Report, supra* note 7, at 1102-03.

192. 2 L. Loss, *supra* note 2, at 550; *Task Force Report, supra* note 7, at 1133-34; *see also* H. Manne, *supra* note 18, at 28 (§ 16 has influenced moral attitudes of the business community).

193. The measure of the damage insiders do by short-swing trading is a function of what it is about such trading that is objectionable.

194. This is not to say the definition of profits usually employed in § 16(b) cases—matching the highest sale price with the lowest purchase price, *see supra* note 36 and accompanying text—accomplishes disgorgement. *Cf. Task Force Report, supra* note 7, at 1135.

insiders who sell on bad news and do not repurchase, or who buy on good news and do not subsequently sell, are not required to disgorge anything; thus, section 16(b) will have relatively little effect on those insiders who trade on inside information without both buying and selling. If this is a defect, however, it is a result of section 16(b)'s focus on short-swing trading, not the measure of forfeiture it incorporates. So far as its goal simply is to discourage short-swing trading, section 16(b) is a good statute.

While the certainty of being forced to disgorge all profits might be enough to discourage anyone from effecting matched transactions within the scope of section 16, sanctions serve purposes other than changing behavior. Given the emotional overtones of most criticism of insider trading,[195] one might expect a statute directed at "the unfair use of information" to condemn the malfeasors and brand them as criminals.[196] The failure to include a criminal sanction for short-swing trading may reflect oversight or a political compromise. This is unlikely, though, inasmuch as the other substantive provisions of the Exchange Act are enforceable by criminal penalties.[197] A more plausible explanation is that the drafters of section 16 were more concerned with altering the way corporations do business than with moral failings of managers.[198] In other words, Congress was concerned with creating

195. *See* Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School,"* 1986 DUKE L.J. 628, 628; Lawson, *supra* note 66, at 727-28 (no other forms of business conduct "seem to raise moral hackles in quite the same way as insider stock trading"); Langevoort, *Investment Analysts and the Law of Insider Trading,* 76 VA. L. REV. 1023, 1046-50 (1990) (emphasizing the strong political sentiment against insider trading).

196. The government has played a leading role in prosecuting insider trading under rule 10b-5. *See, e.g.,* United States v. Carpenter, 484 U.S. 19 (1987); Dirks v. SEC, 463 U.S. 646 (1983); Chiarella v. United States, 445 U.S. 222 (1980); SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969); *cf.* 2 L. Loss, *supra* note 2, at 545 n.11 (increased prison time for those convicted of insider trading before eligibility for parole).

If § 16 were to make short-swing trading illegal, it would presumably be necessary to allow insiders to sell soon after they bought in order to meet unexpected emergencies. This could be done by requiring the government to prove wrongful intent in any criminal action. The first version of § 16 would have required the government to prove intent in criminal actions, Fletcher-Rayburn bill, *supra* note 73, § 15(b)(1), although it is important to note that it was intent to trade for the short-swing, not possession of inside information. *See supra* note 73.

197. *See supra* note 189.

198. The management control hypothesis offered here also helps to explain why the SEC has such a limited role in § 16(b). The SEC cannot enforce § 16(b) forfeiture and in fact has no role in § 16(b)'s administration beyond providing exemptions. This sharply contrasts with the rest of the Act, in which the SEC has a dominant enforcement role.

Here again, one can argue that the statutory enforcement scheme suggests that the drafters thought they were creating a new incentive system that would change the way managers ran publicly held companies. The SEC was supposed to protect investors and the public interest in the stock market, but it was not expected to develop expertise in business practices. Moreover, the most effective opposition to the movement that culminated in the Exchange a new system of incentives that would better serve the needs of society rather than with condemning conduct that is unfair or unethical, apart from being harmful.

Most of the conduct with which a management control statute would be concerned is not wrongful, and in the rare cases where it is, section 16 does provide a criminal penalty.[199] If a manager cannot cause the price of the company's stock to rise steadily that is too bad, but it is unlikely that Congress would declare incompetent managers criminals.[200] These days it seems wrong for managers to manipulate corporate affairs to produce short-swing trading opportunities, but it may not have been so clear in 1934.[201] Moreover, short-swing trading opportunities are most likely to present a problem in times of crisis, when it is not clear what course management should pursue.[202] In contrast to situations that may simply involve errors in business judgment, it is inexcusable for a manager to undermine corporate profits in order to produce opportunities to sell short; section 16(c) makes it a crime to sell short.

Remedies should compensate victims as well as deter or punish objectionable conduct, and if the point of section 16 is to ensure that all traders have equal access to corporate information it is hard to see why issuers get the money disgorged under section 16(b).[203] Even if

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Act was based on the charge that it would have instituted bureaucratic control of industry, and the drafters may have been reluctant to involve bureaucrats in the administration of any provision that they thought of as being directed at the way businesses were run. *See* C. MEYER, THE SECURITIES EXCHANGE ACT OF 1934 ANALYZED AND EXPLAINED 21 (1934) ("The Securities and Exchange Commission is not empowered to interfere in the internal management of any corporation."); *see also infra* notes 340-341 and accompanying text.

199. *See supra* notes 122-125 and accompanying text (management short-selling).

200. *See* Bratton, *Corporate Debt Relationships: Legal Theory in a Time of Restructuring,* 1989 DUKE L.J. 92, 150 ("[T]he law, while it requires management to pursue profit and gain . . . stops well short of mandating optimal performance even to benefit stockholders . . . .").

201. Manipulation will usually take the form of delayed disclosure, and in 1934 there was a substantial body of opinion that felt corporate information belonged to the corporation and its disclosure was solely a matter of management grace. *See Task Force Report, supra* note 7, at 1091 ("[P]rior to the enactment of the Securities Act of 1933 . . . and the 1934 Act, there was virtually no public access to information regarding the financial condition of corporations. Before 1934, in most states, a corporation's balance sheet was protected from public disclosure as a trade secret."). *See generally* Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors,* 70 VA. L. REV. 669 (1984); Seligman, *supra* note 115.

202. *See supra* notes 153-161 and accompanying text.

203. *See* R. CLARK, *supra* note 4, at 269 (The view that insider trading is unfair or that it undermines the proper functioning of the market "has profoundly different remedial implications than the [view that insider trading injures the issuer]. It seems to call for a remedy on behalf of a subclass of stockholders, while the corporate harm theory calls for a recovery on behalf of the corporation, as in a derivative suit."). Clark thinks that insider trading seldom harms issuers, and he particularly doubts that the opportunity to trade on inside information will change the way insiders run their companies. *Id.* at 267.

the disgorgement provision effectively discourages short-swing trading, it seems that once profits are disgorged they should go to whomever is injured by short-swing trading. If the reason section 16(b) requires affiliates to disgorge their profits is that it is unfair to trade on inside information, then the disgorged profits should go to the victims of the unfairness.

Those who think that all traders should have equal access to corporate information are not always clear about why they think this is so or who ought to be concerned about it,[204] but it is clear enough that they usually feel that insiders who trade on nonpublic information victimize the people with whom they trade.[205] If section 16 reflects a judgment that all traders should have equal access to corporate information, then one would expect that it would give the investors the insider's disgorged profits. Congress took this approach in 1988, when it amended the Exchange Act to make any person who trades on the basis of material, nonpublic information in violation of the Exchange Act, or rules promulgated thereunder, liable to contemporaneous traders for up to the amount of profit gained or loss avoided in the illegal transaction.[206] Yet under section 16 disgorged profits go to the issuer, leaving one to "wonder how lawmakers could ever have been so stupid as to provide for corporate recovery of insider trader profits."[207]

204. *See id.* at 271 ("But others (including myself) find unfairness to be an opaque notion . . . ."); Easterbrook, *supra* note 63, at 83. *But see* 2 L. Loss, *supra* note 2, at 607-08 ("And the grievous defect of the strictly economic arguments against insider trading regulation is their apparent scorn for the moral or public opinion factor, which is relegated to the 'it's just not right' propositions.").

205. *See* R. Clark, *supra* note 4, at 268-73 (the investors injured by insider trading are either those with whom insiders trade or perhaps all investors who traded while the insiders kept information secret); *id.* at 289-90 (investors' claim to compensation is weak, but the fundamental objection to insider trading is that insiders take gains at the expense of investors); *cf.* Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. Cal. L. Rev. 1217 (1981) (investors precluded from trading are injured). *See generally* ABA Comm. on Fed. Reg. of Secs., *Report of the Task Force on Regulation of Insider Trading—Part I: Regulation Under the Antifraud Provisions of the Securities Exchange Act of 1934*, 41 Bus. Law. 223, 227 (1985).

206. Exchange Act § 20A(a), (b), 15 U.S.C. § 78t-1(a), (b) (1988) (added by The Insider Trading and Securities Fraud Enforcement Act, Pub. L. No. 100-704, § 5, 102 Stat. 4680 (1988)). Anyone designing a private action for insider trading must decide who should recover and define the damages measure. Exchange Act § 20A gives the action to contemporaneous traders and limits damages to the wrongdoers profits. Both of these techniques were known in 1934 and embodied in the Exchange Act. Section 9(e) of the Exchange Act, 15 U.S.C. § 78i(e) (1988), gave contemporaneous traders injured by ceratin manipulative practices a private right of action. The limitation of recovery to the defendant's profit operates along the lines of the limitation on underwriter's liability for false registration statements that the Exchange Act added to § 11 of the Securities Act. Exchange Act, ch. 404, sec. 203 (d), 48 Stat. 881, 907-08 (1934) (amending Securities Act § 11(e)) (codified at 15 U.S.C. § 77k(e) (1988)).

207. R. Clark, *supra* note 4, at 288.

Like the rest of section 16, issuer recovery is entirely appropriate if the purpose of section 16 is to prevent manipulation and to align management and stockholder interests to the end of encouraging the efficient operation of corporations. In many cases in which managers trade, they will not have manipulated corporate affairs and there will be no injury at all. When managers do manipulate corporate affairs to create trading opportunities, their manipulation will damage the corporation and it is appropriate that the corporation recover. Disgorged profits may not fully compensate the corporation, and in fact bear no relationship to any injury the corporation may have suffered at the hand of the trader, but the purpose of disgorgement is to deter mismanagement. The corporation gets the profits not as compensation but because it is the best party to receive any ill-gotten gains.

III. The Purpose of Section 16

The preceding material shows that section 16 can be understood as a management-control statute. No matter what Congress intended to accomplish, it is important to understand how section 16 influences the way publicly held companies are run. Having said that, the obvious question is whether section 16 was intended to regulate the way corporations do business.[208] This is an important question, for those who wrote and enacted section 16 have greatly influenced the conduct of many people. For the most part there is no question about what it requires and forbids, and thus there is relatively little need for explicit statutory interpretation and few opportunities for administrators or courts to interfere with the section's operation. Because section 16 is clear and likely to be enforced, its immediate goals have been ac-

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> [T]he corporate recovery approach seems to make little sense, whether viewed as an instrument of compensation or deterrence. It pays the wrong persons [the issuer, and indirectly, non-selling stockholders and post-disclosure buyers], does not help the injured persons [those who sell before disclosure is made, including those who sell to insiders], and gives [the insider] a conciliatory handshake rather than a slap on the wrist.

Id.; 2 L. Loss, *supra* note 2, at 543 ("It is interesting that [Congress did not provide] for civil liability to the other party to an insider's transaction" along the lines that ultimately developed under rule 10b-5); Munter, *supra* note 12, at 87 (recovery under § 16(b) does not even inure to the injured party); Smith, *supra* note 122, at 6, col. 5 ("That the enactors were concerned about the effect on the corporation itself is evidenced to some extent by Section 16(b)'s remedy. It is the corporation that recovers . . . not the counter-party to the trade.").

208. The intention or understanding of those intimately involved with § 16, which will be explored here, may be different from the idealized congressional purpose to which courts often refer when they are called upon to apply statutes in difficult cases. Because of the language of § 16, it may be singularly inappropriate to consider what motivated the drafters when applying the statute. *See infra* notes 389-404 and accompanying text.

complished: directors, officers, and principal stockholders of publicly held corporations eventually report their ownership of equity securities, and by and large, they do not sell short or trade with a view to short-swing profits. These reporting requirements and trading restrictions influence the way corporations work; the drafters were, then, successful if they wanted to regulate corporate management.

The "conventional wisdom is that Congress . . . expressed its concern with insiders' informational advantage by enacting section 16."[209] Conventional wisdom notwithstanding, the historical roots of section 16 are somewhat obscure, and the political choices that underlie it seldom have been explored. Nonetheless, the record does show that some of those involved in enacting the Exchange Act hoped that section 16 would prevent insiders from trading on the basis of inside information.[210]

Before the Exchange Act was enacted, academic commentators had generally condemned insiders who traded on the basis of nonpublic corporate information, even though such trading was thought to be widespread and the common law generally permitted it.[211] Drafters and members of Congress alike said that section 16 dealt with the unfair use of inside information,[212] and various proposed versions of section 16, especially the first one introduced, were clearly directed at achieving some sort of informational equality among traders.[213] Moreover, Congress itself explained at least the forfeiture provision of section 16 in terms of equality of information, stating in the statute that "[f]or the purpose of preventing the unfair use of information which may have been obtained by [a principal stockholder], director,

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209. Dooley, *supra* note 5, at 56-57.

210. Given the conventional wisdom, surprisingly little was said in Congress about the propriety of trading stock on the basis of nonpublic information while the Exchange Act was being considered. The subject of insiders taking advantage of corporate information was not diligently pursued in either the congressional hearings on the Exchange Act or the broader Senate investigation of stock exchange practices. The drafters and congressional critics did occasionally discuss § 16 in terms that seemed to criticize managers for trading while in possession of corporate information. This broad and undeveloped criticism, however, is open to more than one interpretation. *See* H. MANNE, *supra* note 18, at 9 ("one looks in vain for an analysis as to why this trading was deemed evil . . . ."); Dooley, *supra* note 5, at 56 n.235 ("unfortunately loose language"). A few commentators have questioned whether § 16 was meant to secure informational equality or prevent insiders from trading on the basis of inside information. *See* H. MANNE, *supra* note 18, at 9-10, 34; Dooley, *supra* note 5, at 55-59 (suggesting that the purpose of § 16 was to prevent insider manipulation).

211. *See supra* note 77. *See generally* H. MANNE, *supra* note 18, at 4-8.

212. *See, e.g., House Hearings, supra* note 85, at 133; *Stock Exchange Practices, supra* note 31, at 7742; H.R. REP. No. 1383, *supra* note 31, at 13; S. REP. No. 792, *supra* note 117, at 20-21.

213. *See infra* notes 283-304 and accompanying text.

or officer by reason of his relationship to'' a publicly held company, the short-swing trading profits of control persons shall inure to such companies.[214]

There is also some support for the conventional wisdom in the way section 16 operates. Section 16(b) in particular may prevent trading on inside information by a group of people who were thought to be particularly pernicious in 1934: the speculative pools.[215] The pools manipulated the market, but they also took advantage of inside information. While insiders can keep their profits from inside information if they are willing to hold new positions for six months, section 16(b) would probably deter an insider from joining or assisting a pool. The pools typically undertook substantial trading operations, and, accordingly, generally lacked the patience and wherewithal to hold their positions for very long. It would be difficult for anyone subject to the six-month holding period imposed by section 16(b) to profit from participating in a pool.

Of course, section 16 may have been intended to accomplish more than one end. Indeed, with certain qualifications to make it reflect the way section 16 works, the conventional wisdom is entirely consistent with the proposition that section 16 was designed to move managers to pursue stockholder interests.[216] Unfortunately, the broadly stated proposition that section 16 was designed to prevent insiders from trading on the basis of corporate information has dominated discussion of section 16, and it has apparently distracted some commentators who have suggested that the drafters might have been concerned with the way corporations go about producing goods and services but then failed to pursue the possibility.[217]

Whatever the drafters and sponsors of section 16 thought about parity of information among traders, it is clear that they hoped section 16 would bridge the gap between ownership and control in the publicly held corporations, and thereby improve the way those corporations

214. Exchange Act § 16(b), 15 U.S.C. §78p(b) (1988).

215. *See supra* notes 162-170 and accompanying text.

216. Section 16 bridges the gap between managers and stockholders by reinforcing management incentives to act like stockholders and by destroying incentives for managers to manipulate corporate affairs in order to create trading opportunities for themselves. In the latter respect, informational equality and corporate governance are closely related. Corrupt managers often depend on informational inequality when they manipulate corporate affairs to produce profitable trading opportunities; they can trade profitably because they know what they are doing and the market does not. *See also* Dooley, *supra* note 5, at 56 ("The few questions pertaining to inside information [asked during the hearings that preceded the Exchange Act] were only incidental to inquiries regarding the manipulations in which the information had been used, which were Congress's primary concern.").

217. *See, e.g.*, O'Connor, *supra* note 6, at 342 (stating the proposition that § 16(b) may reduce the incentive to manipulate corporate events).

are managed. The historical situation in which the Exchange Act was considered and adopted was such that any proposal to regulate the stock market was bound to address the separation of ownership and control. Section 16 seems to address the separation problem, but it does not do much to ensure informational equality, conventional wisdom and the purpose clause of section 16(b) notwithstanding. Indeed, judging by the operative provisions of section 16—that is, the requirements that directors, officers, and principal stockholders of publicly held companies report their holdings and trading, forfeit short-swing profits, and refrain from short sales—one would conclude that the drafters were concerned solely with the way publicly held corporations are run.

It is almost inconceivable that section 16 helped to align the interests of management and stockholders by accident. The Exchange Act was "worked out . . . under the pressure of [a] most vicious and persistent lobby."[218] The legislation was not enacted until after it had been repeatedly revised, often with the help of its critics.[219] Whether or not this revision process made for a better statute, it did weed out unjustified and poorly articulated provisions.[220] The proponents of the Act would not have wasted their efforts on section 16 if they had simply wanted to prevent insiders from taking advantage of inside information.

Vengeful and stubborn legislators may sometimes be willing to pay the price for imprecise statutes, but the Exchange Act was more than the product of populist outrage with the stock market. The Ex-

218. Statement of Rep. Rayburn (Apr. 30, 1934), *reprinted in* 78 CONG. REC. 7693 (1934) ("Few bills have ever had such thorough consideration as this stock-exchange bill. . . . We have worked out the terms of this bill under the pressure of the most vicious and persistent lobby that any of us have ever known in Washington."); *see also* Letter from President Roosevelt to Senator Fletcher (Mar. 26, 1934), 3 PUB. PAPERS 169-70 (1938), *reprinted in* S. REP. No. 792, *supra* note 117, at 2, *and in Stock Exchange Practices*, *supra* note 31, at 7577-78 ("It has come to my attention that a more definite and more highly organized drive is being made against effective legislation to this end than against any similar recommendation made by me during the past year."); H.R. REP. No. 1383, *supra* note 31, at 31-32 ("It is safe to say that no bill has produced more correspondence for Members of Congress than this bill."); J. SELIGMAN, *supra* note 21, at 73 ("one of the most bruising lobbying struggles ever waged in Washington").

219. *See House Hearings*, *supra* note 85, at 625 (statement of Rep. Rayburn), 674 (Corcoran testimony); 78 CONG. REC. 7866 (statement of Rep. Maloney), 7921 (statement of Rep. Mapes), 7935 (statement of Rep. Bulwinkle), 7938 (statement of Rep. Milligan) (1934); M. PARRISH, *supra* note 21, at 132; J. SELIGMAN, *supra* note 21, at 93-95; T. MCCRAW, PROPHETS OF REGULATION 178 (1984); D. Levin, *supra* note 21, at 375-84.

220. The original proposals were typically criticized as overly rigid. The drafters responded by replacing statutorily mandated changes in the way the market was to work with broad grants of administrative power, often subject to statutorily enunciated directives of the goals administrators were to pursue. *See* Thel, *supra* note 21, at 458-60. During the course of congressional consideration, flexibility was introduced into § 16 as well.

change Act's sponsor in the House of Representatives, Sam Rayburn, is famous for his unequalled ability to accomplish his goals without antagonizing anyone unnecessarily.[221] The people who actually wrote the Exchange Act—primarily Benjamin Cohen, Thomas Corcoran, and James Landis—were extraordinarily able and careful.[222] They would not have put forward an equality-of-information provision as imprecise as section 16, and they must have known that their product regulated corporate management.

In the preceding exposition of the way section 16 influences corporate operations, commentary dating to the enactment of the Exchange Act was cited to show that trading restrictions that may now seem an excessive response to the problems created by the separation of management and control might appear reasonable in different circumstances. While this commentary filled out the management-regulation explanation of section 16, it also showed that in 1934 many people, including the drafters of the Exchange Act and some of the legislators responsible for getting the Act passed, worried that the separation of ownership and control left managers free to pursue selfish ends to the detriment of stockholders and the public.

Although section 16 was not as widely discussed as other provisions of the statute, it was repeatedly revised while the Exchange Act was being considered. The substance of these revisions and the trail of documents left as the section was perfected show that the drafters and sponsors of the Exchange Act were interested in the way corporations worked and wanted to use section 16 to close the gap between ownership and management. The Exchange Act was in large measure the product of a movement for the reform of large corporations, and the unique circumstances of the Great Depression focused attention on the way large corporations were run. The peculiar approach to improving corporate management embodied in section 16 was determined by prevailing political and constitutional norms, to-

221. "The avoidance of open controversy [was] his genius." N. MacNeil, Forge of Democracy 108 (1963) (quoting Rep. Lee Metcalf). *See generally* A. Champagne, Congressman Sam Rayburn 161 (1984); C. Dorough, Mr. Sam (1962); D. Hardeman & D. Bacon, Rayburn: A Biography (1987); A. Steinberg, Sam Rayburn (1975).

222. T. McCraw, *supra* note 219, at 171 ("The group combined a sophisticated appreciation of the intricate nature of the [securities] industry (the special competence of Corcoran and even more of Cohen) with an extraordinary understanding of the virtues and defects of particular tools of administration (the distinctive strength of Landis)."); J. Lash, Dealers and Dreamers vii (1988) (Cohen and Corcoran had a sixth-sense feeling for the programs that were politically feasible not simply ideally desirable.); *see also id.* at 166-67 (describing various challenges and objections Cohen and Corcoran withstood); Thel, *supra* note 21, at 443 n.255. *See generally* J. Lash, *supra* (biography of Cohen and Corcoran); D. Ritchie, James M. Landis (1980) (biography of James M. Landis).

gether perhaps with the fundamentally conservative bias of those most intimately involved in writing the Exchange Act.

A. Stock Exchange Reform and Corporate Law Reform

Most commentators trace the history of the Exchange Act to the so-called Money Trust Investigation conducted by the House Banking and Currency Committee in the aftermath of the Panic of 1907.[223] The committee's mandate was to investigate the concentration of economic power. In its report, the committee noted what it saw as shortcomings in corporate law and discussed the potential for federal reform.

The committee was troubled by what it took to be the permissive nature of state corporate law, but it apparently recognized, as Theodore Roosevelt had immediately after the Panic,[224] that under prevailing theories of constitutional law the federal government had little power to regulate corporations directly.[225] The committee, however, suggested that Congress might wisely use its power over the stock market to improve corporate business practices as to which, according to the committee, the states had largely abdicated their responsibilities.

> Great and much-needed reforms in the organization and methods of our corporations may be legitimately worked out through the power wielded by the stock exchange over the listing of securities. Much of the confusion and many of the defects in corporate regulation due to the diversity of State laws and to the bidding of the States against one another in laxity of administration in order to attract corporations within their borders may be corrected and uniformity of methods introduced through the listing department of the exchange.
>
> . . . In short, [the exchange's] opportunities as an agency of corporate reform are almost endless, provided its own practices can be

223. *Money Trust Investigation: Investigation of the Financial and Monetary Conditions in the United States Under House Resolution Nos. 429 and 504 Before A Subcomm. of the Comm. on Banking and Currency*, 62d Cong., 3d Sess. (1913) [hereinafter *Money Trust Hearings*]; H.R. REP. No. 1593, *supra* note 31. *See House Hearings, supra* note 85, at 15-16 (testimony of James Landis); F. ALLEN, THE LORDS OF CREATION ch. 6 (1935); 2 L. LOSS, *supra* note 2, at 1165-66; Carosso, *The Wall Street Money Trust from Pujo through Medina*, 47 BUS. HIST. REV. 421, 425-26 (1973); Klebaner, *The Money Trust Investigation in Retrospect*, 3 NAT'L BANKING REV. 393, 394-96 (1966); Thel, *supra* note 21, at 402-07; Tracy & MacChesney, *supra* note 182, at 1033; Sheldon, *supra* note 31, at 2251-2381; D. Levin, *supra* note 21, at 18-20; *cf.* 1 M. MYERS, THE NEW YORK MONEY MARKET 307-14 (1931) (earlier reform movements).

224. 42 CONG. REC. 1347, 1349 (1908); *see also* J. SELIGMAN, *supra* note 21, at 42 ("the long-held populist and progressive goal of superseding lax state corporation laws with more stringent federal standards").

225. *Cf.* H.R. REP. No. 1593, *supra* note 31, at 115 ("It is doubtful . . . whether the Federal Government has power generally to regulate Stock Exchanges."). *See generally id.* at 199-28 (power of Congress).

reformed so as to entitle it to exercise these broad powers.[226]

The reforms the committee recommended contained the seeds of Exchange Act provisions that regulate management of publicly held corporations. The committee proposed to subject stock exchanges to regulation by the Postmaster General, and exchanges would in turn have regulated issuers of exchange-traded securities.[227] The committee's bill would have required exchanges to insist that issuers of listed securities make periodic reports,[228] and no security could have been listed unless the issuer ordered its officers and directors not to sell short and required them to notify the directors in writing before trading at all.[229]

The parallels between these recommendations and the issuer reporting and insider trading provisions of the Exchange Act are not coincidental. The committee's findings and recommendations greatly influenced the drafters of the Exchange Act and the attitude of the general public toward Wall Street.[230] The committee's counsel, Samuel Untermyer, became a widely respected commentator,[231] and he was a key participant in the stock-market reform movement played out early in the New Deal.[232] The constitutional impediments to federal corporate law had not disappeared by 1934 either, and for constitutional and other reasons any federal regulation of corporations would have to come through the back door of exchange regulation.

Popular interest in stock-exchange reform waned after the Money Trust Investigation. The impetus for the Exchange Act was the stock market crash that began in October 1929. In the depression that followed the crash, the operating and financial policies that managers adopted for their corporations were seen as implicating the interests of the public at large, not merely the interests of investors.[233] At the

226. *Id.* at 114-15.

227. The committee's bill is appended to the committee's report. *Id.* at 170-73 [hereinafter Money Trust bill].

228. Money Trust bill, *supra* note 227, § 1(a)-(b).

229. *Id.* § 1(i).

230. Louis Brandeis popularized the findings of the Money Trust Investigation in a series of magazine articles eventually collected and published in his book *Other People's Money*. L. BRANDEIS, OTHER PEOPLE'S MONEY (1914). Whereas the committee had investigated a wide variety of abuses, Brandeis focused almost exclusively on business practices. Brandeis was particularly troubled by the ability of bankers to control so much with relatively little of their own money. He recommended requiring investment bankers to disclose their profits when they sold securities, in hopes of depriving them of the wealth they used to control business. *Id.* at 101. Brandeis and *Other People's Money* probably influenced the Exchange Act even more than the published findings of the Money Trust Investigation. *See* Thel, *supra* note 21, at 405-06.

231. *See* J. SELIGMAN, *supra* note 21, at 51.

232. *See infra* notes 242-248 and accompanying text.

233. *See* J.W. HURST, THE LEGITIMACY, *supra* note 53, at 103-04 ("[F]rom the 1930s on

same time, Berle and Means created substantial doubt about the efficacy of existing checks on the power of corporate managers.[234] Reform was almost inevitable in these circumstances, "[f]or a democracy will not long tolerate in its midst centers of power that are not perceived as responsive to the needs of the people and at least in some measure accountable to the popular will."[235]

Manipulative management practices were a recurring theme in the debate over federal control of the stock market and federal regulation of issuers of publicly traded securities.[236] Even in the 1920s, some of the critics who complained about the unfairness of insiders trading on the basis of nonpublic information also expressed concern about their manipulation of corporate affairs to create trading opportunities.[237] Harmful management practices were of even greater concern in 1934, when economic activity was depressed. There was little good news for insiders to take advantage of by then, but there was a real need for everyone to get back to business.

The Senate Banking and Currency Committee began extensive hearings on stock exchange practices in 1932, and the Exchange Act was tailored to respond to the abuses identified in those hearings. The hearings were far reaching, but it is fair to say that the "relationship between insider trading and the danger of manipulation of corporate affairs . . . was frequently alluded to in the congressional hearings."[238] Practices designed to create trading opportunities for corporate managers took on a graver aspect in the context of the Senate hearings.

. . . a social interest arose in the investor quite different from the original concern with him as a part of the internal governance of the firms whose shares he held. This new social interest was an interest in the corporate security structure as a whole, as a now essential part of the machinery for distributing income and wealth, maintaining broad, reliable, consumer purchasing power, and bulwarking the life expectations of millions of individuals with such assurance as contributed not only to economic but also to political stability."); *id.* at 110 ("[B]y the 1920s . . . [t]he new size and reach of corporate enterprises meant that their behaviour affected a broader range of interests than before."); *see also supra* notes 46-50 and accompanying text (importance of large companies according to Berle & Means).

234. *See supra* notes 51-54 and accompanying text; *see also* J.W. HURST, THE LEGITIMACY, *supra* note 53, at 95-111.

235. Stevenson, *The Corporation as a Political Institution,* 8 HOFSTRA L. REV. 39, 39 (1979).

236. *See supra* note 141 and accompanying text.

237. W. RIPLEY, *supra* note 31, at 204-06; Berle, *Publicity of Accounts and Directors' Purchases of Stock,* 25 MICH. L. REV. 827, 830-31 (1927) ("[A] corporate management which, as individuals, chooses to enter the open market and which at the same time exercises control over the release of information concerning corporate affairs, can deal with the current value of its securities . . . with tremendous effect; and the liquid value of the corporate securities held by the stockholder becomes a matter which the corporate management itself can determine."); *see also* H. MANNE, *supra* note 18, at 231 n.21 (criticizing Ripley).

238. H. MANNE, *supra* note 18, at 8; *see also supra* note 140 and accompanying text.

In addition to undermining business, such practices exacerbated speculative tendencies in the market. Speculation had long been seen as a problem, but by 1934 excessive speculation was widely held to account for the collapse of the economy.

The committee's counsel submitted a preliminary report in February 1933.[239] This report was one of the only carefully prepared and disinterested commentaries on contemporary stock exchange practices that was available while the Exchange Act was being drafted.[240] Its list of "practices which . . . might properly be made the subject of criticism and legislative action" included:

> the buying and selling of stocks by officers of corporations who had inside information of the affairs of the corporations and whose transactions on the exchange were conducted in such a manner as to prevent the public from knowing of their dealings; . . . short selling and selling against the box; . . . and the manipulation of the affairs of trading corporations and investment trusts for the benefit of those who had the matter of their affairs within their control and to the detriment of the investing public.[241]

During the 1932 presidential campaign, Franklin Roosevelt denounced speculation and called for stock market reform.[242] Shortly after the election, Roosevelt's staff asked Samuel Untermyer, who had directed the Money Trust Investigation, to draft a bill to reform the stock exchanges.[243] Untermyer revised the Money Trust bill, but his new proposal was rejected because of objections to subjecting the stock market to regulation by the Post Office.[244] As a result of this false

239. *Letter from the Counsel, supra* note 85, at 1.

240. *See* Thel, *supra* note 21, at 411 n.112.

241. *Letter from the Counsel, supra* note 85, at 3-4; *see also id.* at 32 ("Among the various subjects touched upon . . . are . . . the manipulations of the affairs of corporations by those in control; . . . [and] the selling of stocks by officers and directors against the box for the purpose of concealing the fact that they were disposing of the same."). Among other examples, the report offered the trading pool in the stock of General Asphalt. A pool of investors including officers of that company bought stock knowing that the company intended to start paying dividends and subsequently captured a substantial part of those dividends.

> All this [the manager of the pool] characterized as a pure coincidence; but one can not help drawing the conclusion that the existence of the pool and the personal advantage to those who were managing it and at the same time handling the affairs of the General Asphalt Co. had a great deal to do with the diversion of part of the surplus, if not part of the capital, of the General Asphalt Co. into the dividend channel.

Id. at 12; *see also id.* at 18-19 (capture of dividends by Warner Bros. Pictures pool). (The Senate committee report was probably referring to the General Asphalt and Warner pools when it explained § 16(b). S. REP. No. 792, *supra* note 117, at 9-10; *see supra* notes 144, 163.).

242. R. DEBEDTS, *supra* note 21, at 25-27; M. PARRISH, *supra* note 21, at 43-44; J. SELIGMAN, *supra* note 21, at 19-20; Thel, *supra* note 21, at 414.

243. Thel, *supra* note 21, at 414 n.127.

244. J. SELIGMAN, *supra* note 21, at 52; Thel, *supra* note 21, at 414 n.128.

start, the Roosevelt Administration's focus turned to a narrower project that culminated in the Securities Act.[245] Although Untermyer's proposal was never offered to Congress, it does reveal what motivated the reformers who pressed for the Exchange Act.[246]

Untermyer would have regulated publicly held companies as well as exchange members and trading practices. He would have controlled security issuers by conditioning their participation in the exchange market on compliance with statutory and administrative requirements. While Untermyer would have required issuers of publicly held securities to disclose information from time to time,[247] he did not propose to perfect an equality-of-information regime, and he would not have forbidden insiders to trade on the basis of corporate information. He did, however, propose substantive regulation of security issuers, and he proposed to require issuers to include certain governing provisions in their articles and bylaws, including restrictions on insider trading similar to those that were enacted in section 16. In particular, he would have required officers and directors to report their security sales immediately and forbidden them to sell securities short.[248]

Within a month after being inaugurated, Roosevelt had a narrower bill prepared and submitted to Congress.[249] The bill essentially

245. Thel, *supra* note 21, at 415-16.

246. Untermyer's bill is the first item in the "Preliminary Drafts" volume of James Landis's collection of materials relating to the drafting of the Exchange Act. 2 DOCUMENTARY HISTORY COLLECTION, *supra* note 78 [hereinafter Untermyer bill].

247. For instance, exchanges would have had to require issuers to file financial reports, Untermyer bill, *supra* note 246, § 1(b), and to require that the issuer's governing documents permit stockholder access to corporate books and records, *id.* § 1(b-1). Exchanges would also have been required to take steps to ensure that trading-pool agreements were in writing and available for public inspection. *Id.* § 1(d).

248. Untermyer's bill would have made it illegal to use the mails in connection with the business of stock exchange unless the exchange's governing instruments provided, among other things:

> that no securities of any corporation shall herafter [sic] be listed, quoted or dealt in on said exchange unless the charter, by-laws or other regulations thereof contain certain express prohibition [sic] against the sale by any officer or director of any such corporation of any stock or security of such corporation of which he is not the owner at the time of such sale or the sale directly or indirectly by him of any shares of stock or other security of any such corporation or any interest therein, either alone or jointly with others, unless within one day thereafter written notice of such sale shall have been given to the corporation, nor unless all such transactions shall be immediately reported in writing to the secretary.

Untermyer bill, *supra* note 246, § 1(l).

249. Message from the President Transmitting a Recommendation to Congress for Federal Supervision of Traffic in Investment Securities in Interstate Commerce, H.R. REP. DOC. No. 12, 73d Cong., 1st Sess. (March 29, 1933) [hereinafter Message from the President], *reprinted in* 2 LEGISLATIVE HISTORY, *supra* note 31, item 15 *and reprinted in* 77 CONG. REC. 937 (1933); *see* H.R. 4314, 73d Cong., 1st Sess. (1933), *reprinted in* 3 LEGISLATIVE HISTORY, *supra* note

provided for full publicity in the sale of securities. The President emphasized that it was only a first step that "should be followed by legislation relating to the better supervision of the purchase and sale of all property dealt in on exchanges, and by legislation to correct unethical and unsafe practices on the part of officers and directors of banks and other corporations."[250]

Although the bill had a limited scope, it quickly became controversial. This controversy had important implications for the President's promised legislation on unethical and unsafe practices on the part of officers and directors (i.e., the Exchange Act) and indeed for any federal statute regulating corporate management. Section 16's automatic approach and the unique exclusion of the SEC from its operation can be traced to the failure of the administration's first securities bill. By the time the Securities Act was enacted, it was clear that any legislation that limited the discretion of corporate managers would be controversial and that Congress would not put government bureaucrats in control of the way corporations do business.

The administration's bill provided that, with certain exceptions, no security could be offered or sold until after a registration statement was filed with the Federal Trade Commission (FTC).[251] The bill required that the registration statement disclose certain information, but it went far beyond requiring mere candor. It authorized the FTC to revoke a registration upon finding that an issuer's affairs were "in unsound condition or insolvent,"[252] or that the enterprise or business of an issuer was "not based upon sound principles, and that the revocation is in the interest of the public welfare."[253]

The bill soon came under intense criticism for permitting the FTC to revoke a security's registration because of the unsoundness of the issuer's affairs.[254] Even Sam Rayburn, the bill's sponsor in the House,

31, item 22; S. 875, 73d Cong., 1st Sess. (1933), *reprinted in* 3 LEGISLATIVE HISTORY, *supra* note 31, item 28. [H.R. 4314 and S. 875 are substantially identical and are hereinafter referred to as the Thompson bill]. *See generally* J. SELIGMAN, *supra* note 21, at 52-57 (detailed history of the bill during the beginning of Roosevelt's administration).

250. Message from the President, *supra* note 249, at 1-2; *see also* R. DEBEDTS, *supra* note 21, at 56 (discussing the President's intention to initiate simultaneously legislation regarding securities issuance and stock market regulation); Thel, *supra* note 21, at 416 (the administration and others did not think the Securities Act would solve the stock market problem).

251. Thompson bill, *supra* note 249, §§ 3-4. Whereas the Securities Act as finally enacted contemplated the FTC invalidating a registration statement if it was dishonest, the bill contemplated that securities could be sold upon filing of the registration statement, with the FTC revoking the registration if it discovered a problem. *Id.* § 6(a)-(c).

252. Thompson bill, *supra* note 249, § 6(e).

253. *Id.* § 6(f).

254. J. SELIGMAN, *supra* note 21, at 56; Landis, *The Legislative History of the Securities*

observed that Congress had not "given anybody that much power" in any of the bills passed in the early days of Roosevelt's presidency, and he was not sure that Congress should give "an administrative officer of the Government . . . that much power, as a general principle—to pass upon whether or not a man's business is based on sound principles."[255]

With the bill in trouble, the administration brought in Felix Frankfurter for help, and Frankfurter brought in three people who would shape both the Securities Act and the Exchange Act: Benjamin Cohen, Thomas Corcoran, and James Landis.[256] Cohen and Corcoran were lawyers with backgrounds in corporate law, and Landis was a professor of legislation who had been exploring "the nature and variety of the sanctions available to government to bring about conformance with its statutory mandates and in dealing with the nature of standards capable of reasonable enforcement."[257] They revised the bill for Rayburn, starting from the premise "that its requirements should be limited to full and fair disclosure of the nature of the security being offered and that there should be no authority to pass upon the investment quality of the security."[258] Their revision served as the basis for the Securities Act,[259] and during the next year they would draft the Exchange Act.

Act of 1933, 28 GEO. WASH. L. REV. 29, 31-33 (1959); Ritchie, *The Legislative Impact of the Pecora Investigation*, 5 CAPITOL STUD. 87, 93 (1977). The civil liability provisions of the bill were also criticized, as was another provision that allowed the federal government to enforce state blue sky laws. *See* H.R. REP. No. 85, 73d Cong., 1st Sess. 27-30 (1934) (minority views), *reprinted in* 2 LEGISLATIVE HISTORY, *supra* note 31, item 18; J. SELIGMAN, *supra* note 21, at 55-71; Landis, *supra*, at 30-49.

255. *Federal Securities Act: Hearing Before the Comm. on Interstate and Foreign Commerce*, 73d Cong., 1st Sess. 135 (1933), *reprinted in* 2 LEGISLATIVE HISTORY, *supra* note 31, item 18; *see also id.* at 135-46 (debate regarding the FTC's power to determine whether a security issuer is financially sound and to regulate registration of securities).

256. J. SELIGMAN, *supra* note 21, at 61; Landis, *supra* note 254, at 32-33.

257. Landis, *supra* note 254, at 33.

258. *Id.* at 34. The retreat was signalled clearly in § 24 of the Securities Act, 15 U.S.C. § 77w (1988), which declares that the fact that a registration statement has been filed or has become effective shall not be held to mean that the FTC has in any way passed upon the merits of such security, and makes any representation to the contrary unlawful. *See also* Frankfurter, *The Federal Securities Act: II*, FORTUNE, Aug. 1933, at 55 ("Acting upon the President's suggestion, the Securities Act carefully withholds authority from the Federal Trade Commission 'to take any action which might be construed as approving or guaranteeing that newly issued securities are sound . . . .'") (quoting Message from the President, *supra* note 249).

259. J. SELIGMAN, *supra* note 21, at 63-71; Landis, *supra* note 254, at 34-49. The concern of some legislators with the regulation of securities on the basis of their merit as investments was reflected in the Securities Act's exemption for common carrier securities subject to the Interstate Commerce Act, Securities Act § 3(a)(6) (since repealed), and Title II of the Securities Act, 15 U.S.C. §§ 77bb to 77mm (1988), which provided for the establishment of a Corporation

After the Securities Act was enacted, Assistant Secretary of Commerce John Dickinson organized a committee to study stock exchange legislation.[260] The task the committee set for itself and the way it went about that task reveal a lot about section 16. The committee was made up of Dickinson, Adolf Berle, who had the President's ear and had just popularized the problem of the separation of ownership and control, James Landis, who stayed in Washington as a member of the FTC responsible for administering the Securities Act, and two lawyers who, along with Dickinson, were sympathetic to the interests of the business and financial community.[261]

This diverse group apparently had little trouble agreeing that excessive speculation and manipulation had to be eliminated.[262] The com-

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of Foreign Security Holders. *See* J. SELIGMAN, *supra* note 21, at 68-70; Landis, *supra* note 254, at 42-43, 48-49. Rayburn had long favored some federal control of the allocation of capital through Interstate Commerce Commission (ICC) regulation of railroad securities. J. SELIGMAN, *supra* note 21, at 55; *see also* 2 A. SCHLESINGER, JR., THE AGE OF ROOSEVELT: THE COMING OF THE NEW DEAL 400 (1958). He insisted that common carrier securities be exempt from the Securities Act even though the ICC did not regulate sales activities. Landis, *supra* note 254, at 39.

260. Thel, *supra* note 21, at 416-24. Another administration committee revised Untermyer's stock-exchange bill early in 1933. *See id.* at 417 n.142. The revision was no more an equality-of-information bill than Untermyer's had been. A memorandum summarizing and commenting upon the revised bill indicates the considerations that motivated at least some members of the Roosevelt administration who favored stock market reform. In a section labeled "Restrictions upon sale of Corporate Securities by Officers and Directors," the memorandum explained that prohibiting short sales by officers and directors was appropriate because it would prevent them from taking unfair advantage of nonpublic information. The Stock Exchange Bill (A Synopsis and Commentary by the Inter-Departmental Committee) (prepared by Grosvenor M. Jones, Chief of Finance and Investment Division, Department of Commerce (May 1933)) 8 (copies in National Archives, Record Group 40, file 80553/21, box 492, and in Franklin D. Roosevelt Library, Adolf Berle Papers, box 22, Stock Market Investigation—John Dickinson file). Of course, forbidding short selling will hardly prevent insiders from taking advantage of insider information. The memorandum's more extensive discussion of manipulative pools suggests that what really concerned the author was the possibility of insiders manipulating corporate affairs to create trading opportunities, and that at least when he expressed concern about insiders taking "unfair advantage of their privileged position," he was not so much troubled by inequality as by duplicity. *See* Dooley, *supra* note 5, at 56-59. The memorandum quoted at length from a speech in which the president of the New York Stock Exchange (NYSE) admitted that insiders occasionally caused their corporations to "issue[] false statements in the hope of making personal profit. The Exchange deeply deplores the fact that any corporate official has been false to his trust and has put his personal advantage above his duty to stockholders." The Stock Exchange Bill, *supra*, at 11; *see also id.* at 12 ("unduly optimistic or other unwarranted statements about the company's prospects," "no justification for the publication of false statements"). In other words, insider trading is objectionable not when insiders take advantage of information but when, in connection with their trading, they act in a way that is inconsistent with their fiduciary obligations to pursue their stockholders' interests.

261. Thel, *supra* note 21, at 418.

262. Report to the Secretary of Commerce by the Committee on Stock Exchange Regulation at 3 [hereinafter Report to Secretary of Commerce], *reprinted in* Senate Comm. on Banking

mittee also recognized that any program of stock market reform would have important implications for the internal affairs of publicly held corporations.

> Your committee realizes that, perhaps, the most effective way to deal with certain evils connected with manipulation of stock by directors and officers[,] . . . incomplete publicity of corporate accounts and similar problems is by the requirement of Federal incorporation . . . . These particular problems can, however, to some extent, be dealt with through the regulation of stock exchanges and stock-exchange operations. . . . [T]his report will concern itself as to ways and means of controlling these and other evils by the method of regulating the exchanges.[263]

The committee's concern with the internal affairs of large corporations was not surprising, given Berle's membership. Moreover, the idea that the federal government should play some role in the operation of business was hardly exceptional at the time anyway, for although few were willing to concede control of business to the government, there was a broad consensus that the country's best hope was in public-private cooperation under the National Industrial Recovery Act.[264]

The difficult question was how to deal with practices that almost everyone acknowledged could be destructive. The bulk of the committee's report dealt with "the major problem involved in any consideration of proposed stock-exchange regulation[:] . . . the methods and mechanism through which the proposed regulation is to be ap-

and Currency, 73d Cong., 2d Sess.; Letter From the President of the United States to the Chairman of the Committee on Banking and Currency with an Accompanying Report Relative to Stock Exchange Regulation (Comm. Print 1934), *reprinted in* 5 LEGISLATIVE HISTORY, *supra* note 31, item 16.

263. Report to Secretary of Commerce, *supra* note 262, at 4; *see also id.* at 17-19. The committee seems to have agreed very quickly that any stock exchange bill would somehow regulate trading by officers, directors, and principal stockholders. *See* Irreducible Minima (undated memorandum) (reports of stock transactions) (copy in 8 DOCUMENTARY HISTORY COLLECTION, *supra* note 78, item 4); Henry Richardson's Draft of Stock Exchange Legislation, Schedule B (November 16, 1933) (copy in 2 DOCUMENTARY HISTORY COLLECTION, *supra* note 78, item 2).

While it criticized insider manipulation of stock prices, the committee's report did not develop the idea that it is unfair for insiders to take advantage of inside information. Berle had criticized the exploitation of inside information during at least one committee meeting, however, *see* Grosvenor Jones, Report on Meeting of Stock Exchange Committee 2 (Nov. 7, 1933) (copy in National Archives, Record Group 40, file 80553/21, box 493, folder 4), and the Committee did recommend forbidding directors and officers to reveal nonpublic information to trading pools and requiring directors and officers to report their trading. Report to the Secretary of Commerce, *supra* note 262, at 18.

264. National Industrial Recovery Act, ch. 90, 48 Stat. 195 (1933) (declared unconstitutional in Schechter Poultry v. United States, 295 U.S. 495 (1935)). *See* S. BRUCHEY, *supra* note 47, at 459 ("Industry leaders greeted the [NIRA] with unrestrained enthusiasm."); Thel, *supra* note 21, at 421-22.

plied."[265] This was to be the central problem in the intense debate on the Exchange Act that was soon to begin. The committee recommended "a method of stock-exchange regulation by broad discretionary authority vested in an administrative agency rather than through detailed and specific statutory prohibition and requirement of particular practices."[266] The committee's position prevailed in the end, section 16's automatic inflexibility notwithstanding. The solution to most of the problems identified in the Exchange Act was essentially left to regulatory agencies.

B. Section 16 and the Regulation of Corporate Management

While the Dickinson committee was studying stock exchange reform, Landis, Corcoran, Cohen, and others were independently working on legislation.[267] They intended to use stock exchange legislation as a vehicle for corporate law reform, but they also recognized a variety of political and practical constraints on federal power to control publicly held corporations.

Late in 1933 Landis, by then a member of the FTC, directed I.N.P. Stokes, a member of his staff, to explore alternative methods of regulation and to begin drafting a bill.[268] Stokes prepared an outline for a bill that included two sets of substantive suggestions, one for regulation of exchange transactions and one for "regulation of corporate management."[269] This preliminary bill included many corporate-law reforms eventually incorporated in the Exchange Act, including mandatory financial reports and provisions for the regulation of proxy solicitations and security trading by officers, directors, and affiliates.[270] Stokes went much further, however, suggesting that the federal government might regulate corporate mergers and reorganizations and the selection of corporate directors. In particular, he offered the pos-

265. Report to the Secretary of Commerce, *supra* note 262, at 5.

266. *Id.* at 13.

267. On the drafting of the Exchange Act, see R. DeBedts, *supra* note 21, at 56-85; E. Hawley, The New Deal and the Problem of Monopoly 309 (1966); R. Moley, After Seven Years 284-86 (1939); M. Parrish, *supra* note 21, at 108-44; D. Ritchie, *supra* note 222, at 95-100; 2 A. Schlesinger, Jr., *supra* note 259, at 456-67; J. Seligman, *supra* note 21, at 73-100; James M. Landis Interviews, Columbia Oral History Collection 197-206; D. Levin, *supra* note 21, at 347-56.

268. *See* M. Parrish, *supra* note 21, at 115-16; J. Seligman, *supra* note 21, at 83-85; D. Levin, *supra* note 21, at 347-51. Stokes would hold the yellow pad for the Exchange Act, keeping track of criticism, suggestions, and proposed revisions as the Act moved through Congress.

269. Outline by I.N.P. Stokes, 2nd (Nov. or Dec. 1933) (copy in 2 Documentary History Collection, *supra* note 78, item 3).

270. *Id.*

sibility of requiring cumulative voting, board representation of non-equity security holders, government appointment of directors, and regulation of voting trusts.[271]

Stokes does not appear to have been so naive as to have expected Congress to enact these reforms, and perhaps his outline was something of a wish list. Although the Exchange Act did not incorporate Stokes' more radical suggestions, it did employ the mechanism he recommended for regulating corporations. As had previous reformers,[272] Stokes proposed to force corporations to agree to specific reforms as a condition to listing their securities on a stock exchange.[273] The provisions of the Exchange Act that regulated corporations all used this mechanism. When a company registers its stock with an exchange, it subjects itself to the reporting, proxy solicitation, and insider trading provisions of the Act, and when the Exchange Act was enacted these provisions did not apply at all unless a corporation registered its securities on an exchange.[274]

The selection of this mechanism for reforming corporate law had important implications for the structure and substance of the Exchange Act. If stock listing triggered corporate regulation, corporations could avoid regulation by foregoing the privilege of listing their securities on a stock exchange. Once the drafters chose this approach, they had to accommodate the interests of those who controlled cor-

271. *Id.* Stokes's proposal is described in D. Levin, *supra* note 21, at 347-48; *see also* James M. Landis, Comments on Fundamental Problem ¶ 2 (Nov. 8, 1933) ("Reports of stock transactions of directors, officers, issuers etc." to be filed with exchanges and government agency); Max Lowenthal, Memorandum entitled "Stock Exchanges" 14-22 (undated) (proposing extensive investigation of "Listing of securities by the [New York Stock] Exchange in violation of decent or sound standards of dealing with security investors") (copy in 8 DOCUMENTARY HISTORY COLLECTION, *supra* note 78, item 25) (Lowenthal was an influential member of Pecora's staff particularly interested in legislative reform. *See* M. PARRISH, *supra* note 21, at 113, 115; J. SELIGMAN, *supra* note 21, at 144; Ritchie, *supra* note 254, at 96.); D. Levin, *supra* note 21, at 349; Stokes, Memorandum re Regulation of Stock Exchanges 6 (Nov. 24, 1933) ("Consideration might also be given to the desirability of requiring that a certain number of directors be elected on a ballot in which each share holder has one vote regardless of the number of shares he controls.") (copy in 8 DOCUMENTARY HISTORY COLLECTION, *supra* note 78, item 9).

272. *See supra* notes 225-230, 263-266 and accompanying text (Money Trust Investigation and Dickinson committee).

273. Stokes, Memorandum re Regulation of Stock Exchanges, *supra* note 271, at 2-3 ("The most effective solution would presumably be compulsory Federal incorporation for all corporations whose securities are listed on the exchanges . . . . Assuming that such a step is out of the question as too radical, the solution must lie in forcing corporations to adopt provisions in their charters and by-laws which are adequate to protect the security holders. This may be achieved by making such provisions a prerequisite . . . to listing.").

274. The Exchange Act was amended in 1964 to require most publicly held corporations to register securities with the SEC and thus subject themselves to the corporate-law provisions of the Exchange Act. *See supra* note 28 and accompanying text.

porations. If the burdens imposed on them exceeded the value created by an exchange market, corporations would simply forego listing their securities. Even if they could have had it enacted, the drafters would not have wanted a statute with corporate law rules so onerous that companies would have refused to list their securities on exchanges. The drafters recognized that by using listing as a trigger they gave the management of each publicly held corporation effective power to opt out of the statute, and thus they had to consider and justify the price that every reform exacted from those who controlled publicly held corporations.[275] This recognition no doubt contributed to the drafters' willingness to limit the scope of section 16 as the bill was considered in Congress. It also would have kept them from supporting a provision as overinclusive and underinclusive as conventional explanations make section 16 out to be.

Over the next several weeks, Stokes's outline was refined into the bill that formed the basis for the Exchange Act. Originally, Stokes proposed to authorize the FTC to determine the conditions under which a security would be admitted to trading on an exchange, and his early drafts of the bill did not articulate what would be required of publicly held corporations.[276] Subsequently, Telford Taylor, another young lawyer, was brought into the drafting process,[277] and he prepared de-

275. *See* Draft for Memorandum re Amendments to Order of April 3, 1934 ("in connection with the threat of de-listing and the answering argument that stockholders will not permit de-listing the fact should not be overlooked that the influential stockholders may be in favor of de-listing as a result of this section [i.e., the predecessor of § 16]") (copy in 2 DOCUMENTARY HISTORY COLLECTION, *supra* note 78, item 22); Outline by I.N.P. Stokes, 2nd, *supra* note 269, at V (handwritten interlineation: "How likely are corporations to forego listing?"); I.N.P. Stokes, 2nd, Draft No. 1 for Memorandum § 15 (March 28, 1934) (The predecessor of § 16 "seems to me the most dangerous, in regard to the possibility of a substantial withdrawal from listing by important corporations. It might be well to confine it merely to reports of transactions by directors and officers.") (copy in 2 DOCUMENTARY HISTORY COLLECTION, *supra* note 78, item 20); *see also* H.R. 9323, 73d Cong., 2d Sess. § 15(c) (1934), *reprinted in* 10 LEGISLATIVE HISTORY, *supra* note 31, item 31 (bill enacted by House and sent to conference) (predecessor of § 16 would not apply if securities were registered on an exchange without consent of corporation). The veto power managers had over any corporate law rules triggered by exchange regulation was complicated by a dilemma inherent in trading rules. It is not practicable to require managers to take and hold large equity positions, and any burden on selling has the perverse effect of discouraging managers from buying in the first place. *See, e.g., supra* notes 76-77 (§ 16(b) may discourage managers from buying at all). In the end, the judgment on any trading rule must balance the benefits of discouraging inappropriate trading against the cost of discouraging ownership generally.

276. *See* Draft of bill by I.N.P. Stokes, 2nd (Jan. 10, 1934) (copy in 2 DOCUMENTARY HISTORY COLLECTION, *supra* note 78, item 5); Draft of bill by I.N.P. Stokes, 2nd, with changes (Jan. 12, 1934) (copy in 2 DOCUMENTARY HISTORY COLLECTION, *supra* note 78, item 6).

277. *See* D. Levin, *supra* note 21, at 349 (Corcoran directed Taylor to write a bill); *see also* M. PARRISH, *supra* note 21, at 115, 116 n.7; J. SELIGMAN, *supra* note 21, at 83 ("Another young attorney, Telford Taylor, then joined Stokes in drawing up drafts of a Stock exchange bill; these were reviewed by both Landis and Cohen.").

tailed provisions that would have empowered the FTC to promulgate minimum listing requirements

> designed to insure that adequate information shall be given and made public with respect to the financial condition of the issuers of securities . . . to protect the interests of creditors of such issuers . . . and to insure that publicity be given to transactions in the stock of corporations by officers or directors.[278]

Stokes and Taylor then collaborated on a bill that would have forbidden directors and officers to sell exchange-listed stock short or buy it on margin, without any need for implementing regulations.[279]

The bill that Stokes and Taylor prepared was submitted to the Senate committee and its counsel, Ferdinand Pecora.[280] Pecora insisted on a more rigid bill that specifically outlawed a variety of suspect practices. Although Landis would have preferred to retain the flexibility inherent in the administrative discretion of the earlier drafts, the bill was rewritten to the satisfaction of Pecora.[281] Senator Duncan Fletcher introduced the bill, on February 9, 1933, and Sam Rayburn introduced it in the House of Representatives the next day.[282] After the Fletcher-Rayburn bill was carefully considered and repeatedly and substantially amended, it was enacted as the Exchange Act.

Section 15(a) of the Fletcher-Rayburn bill would have required officers and directors of companies with exchange-registered securities and anyone owning more than five percent of any security of such a company to report the amounts of all securities she owned beneficially or of record, and to report any changes in ownership thereafter.[283] Section 15(b) would have made it illegal for an officer or

278. Telford Taylor, Draft of Bill § 19 (undated) (copy in 2 DOCUMENTARY HISTORY COLLECTION, *supra* note 78, item 7); *see also* Draft by I.N.P. Stokes, 2nd., § 6 (undated, but subsequent to Telford Taylor draft) (FTC to promulgate rules to "prevent unfair practices in transactions in securities by" officers and directors) (copy in 2 DOCUMENTARY HISTORY COLLECTION, *supra* note 78, item 10). Taylor's draft is described in D. Levin, *supra* note 21, at 349 n.3.

279. Stokes & Taylor, Draft for Stock Exchange Bill § 18 (Jan. 23, 1934) (copy in 2 DOCUMENTARY HISTORY COLLECTION, *supra* note 78, item 11).

280. The table of contents of Landis's collection of drafts indicates that the draft of Jan. 23, 1934, *supra* note 279, was submitted to the Senate, but the collection also includes another draft prepared by Stokes and Taylor, dated Feb. 1, 1934 (copy in 2 DOCUMENTARY HISTORY COLLECTION, *supra* note 78, item 13), which the table of contents indicates was submitted to Duncan Fletcher, who was the chairman of the Senate committee. The February 1 draft would have incorporated the provision of the January 23 draft that forbade officers and directors to sell short or buy on margin, although it moved the provision forward to put it after the provision prohibiting manipulation of security prices.

281. *See* J. SELIGMAN, *supra* note 21, at 83-85; Ritchie, *supra* note 254, at 96-97; *see also* D. Levin, *supra* note 21, at 350-51; Benjamin V. Cohen, Draft Bill (Feb. 5, 1934) (copy in 2 DOCUMENTARY HISTORY COLLECTION, *supra* note 78, item 16).

282. Fletcher-Rayburn bill, *supra* note 73.

283. *Id.* § 15(a). (The structure of the Fletcher-Rayburn bill was retained in the enacted

director[284] of a company with a security registered on a national securities exchange or anyone owning more than five percent of any class of stock of such a company to buy

> such registered security with the intention or expectation of selling the same security within six months; and any profit made by such person on any transaction in such a registered security extending over a period of less than six months shall inure to and be recoverable by the issuer, irrespective of any intention or expectation on his part in entering into such transaction of holding the security purchased for a period exceeding six months.[285]

Covered persons would also have been forbidden to sell registered securities short or against the box.[286] Finally, the Fletcher-Rayburn bill would have made it illegal for the listed insiders to disclose confidential information regarding or affecting any such registered security unless such disclosure was necessary or proper as a part of the insider's corporate duties. Any person to whom an unlawful disclosure was made would have had to forfeit to the issuer any profit from matched trades during the ensuing six months unless the tippee had no grounds to believe the disclosure was improper.[287]

Section 15 of the Fletcher-Rayburn bill was transformed into section 16 of the Exchange Act over the following months. The numerous revisions made over the course of several introduced bills essentially accomplished two changes. First, the statute became more easily enforceable and more certain to achieve the reforms it contemplated.

Exchange Act, but the section numbers changed with the insertion of § 4, 15 U.S.C. § 78d (1988), which established the SEC.)

284. *Id.* § 15(b)(1). The first few lines of § 15(b)(1) were poorly drawn, but Thomas Corcoran explained that it was intended to reach officers and directors regardless of their holdings. *House Hearings, supra* note 85, at 133; *Stock Exchange Practices, supra* note 31, at 6555.

285. Fletcher-Rayburn bill, *supra* note 73, § 15(b)(1). The limitation to purchases followed by sales (as opposed to sales followed by purchases) may have been inadvertent. *See Stock Exchange Practices, supra* note 31, at 6557-58.

286. Fletcher-Rayburn bill, *supra* note 73, § 15(b)(2). The analogous provision of the Exchange Act, § 16(c), covers sales of any equity security of an issuer with registered equity securities.

287. Fletcher-Rayburn bill, *supra* note 73, § 15(b)(3). Although the provision called for tippees to forfeit profits from any transaction within six months of the disclosure, it apparently contemplated forfeiture only for matched trades, because it went on to provide for profit to be calculated by matching the highest sale price during the period with the lowest purchase price. (Substantially the same language was included in the provision governing short-swing trading by officers, directors, and principal stockholders. *Id.* § 15(b)(1).) This provision was not included in Cohen's draft bill of February 5, which included a version of § 15 that was otherwise virtually identical to that in the Fletcher-Rayburn bill. *See* Benjamin V. Cohen, Draft Bill, *supra* note 281, § 15; *see also* Mimeograph Preliminary Print of House Bill § 15 (also omitting § 15(b)(3)) (copy in 3 DOCUMENTARY HISTORY COLLECTION, *supra* note 78, item 2).

Second, it became less a tool for ensuring equal access to inside information and more a tool for aligning management and stockholder interests. While each of these goals are apparent in both the Fletcher-Rayburn bill and the Exchange Act, in successive amendments the drafters removed provisions that would have contributed to informational equality at the same time that they refined the whole section to direct it to situations in which there was reason to worry that publicly held companies might be mismanaged.

Consider first the anti-tipping provision of the Fletcher-Rayburn bill. The bill would have prohibited insiders from improperly disclosing corporate information and would have required knowing recipients of improper tips to forfeit any near-term trading profits. This provision demonstrates the sponsors' interest in informational equality, but its presence also makes it hard to explain the rest of section 15 of the Fletcher-Rayburn bill (or section 16 of the Exchange Act) in those terms.

While section 15 of the Fletcher-Rayburn bill made it illegal for control persons to disclose inside information improperly, it did not forbid them to trade on the basis of inside information and it did not require them to forfeit their profits if they did. The failure to forbid insiders to trade on inside information in section 16 of the enacted statute is consistent with the conscious exclusion of any sanction that required proof of anything beyond the fact of trading.[288] That explanation, however, cannot account for the omission from the Fletcher-Rayburn bill. Section 15(b) of the bill would have forbidden tippees to trade after knowingly receiving material inside information improperly, but it would not have forbidden insiders to trade on the basis of such information. The bill did contemplate inquiry into the mental state of a trading insider, but the inquiry was not to be into whether the insider possessed inside information. Instead, the government would have had to prove that the insider bought with "the intention or expectation of selling the same security within six months."[289] Thus, the bill would have let insiders trade on inside information but proposed to punish them when they undertook to speculate on the possibility of immediate and transitory price changes.

The failure of the Fletcher-Rayburn bill's tipping provision to make it into the Exchange Act is also instructive. The decision to drop the tipping provision does not prove that the drafters and their spon-

288. *See supra* note 7 and accompanying text.

289. Fletcher-Rayburn bill, *supra* note 73, § 15(b)(1). *See also Stock Exchange Practices, supra* note 31, at 6557 (Senate regarding short selling by a corporate director); *supra* note 73 and accompanying text.

sors were unconcerned with equality of information. The tipping provision and the prohibition of intentional short-swing trading probably were omitted because they could not be enforced. The sponsors did not want to recommend or fight for statutory provisions that could not be enforced,[290] and the drafters did not favor corporate-law provisions that would create burdens without accomplishing worthwhile changes.[291] Both omissions underscore the preoccupation of those responsible for section 16 with writing an effective statute. Moreover, the omission of the tipping provision shifted the focus of the section away from informational equality, although this shift may have been offset in part by the omission of the criminal sanction for premeditated short-swing trading, inasmuch as criminal sanctions would presumably influence the way managers do business even more than section 16(b).

Other modifications definitely made the insider trading section less effective at discouraging insiders from taking advantage of corporate information while making it a better tool for aligning stockholder and manager interests. These changes might well be labeled technical even in the context of securities law, and they were not made in response to public criticism. On the contrary, their subtlety suggests that very few people noticed them, let alone understood their implications. Nonetheless, those implications were important, and the changes were made for a reason.

An issuer triggers section 16 of the Exchange Act by registering an equity security, and once an issuer registers an equity security, section 16 regulates affiliates trading in any of its equity securities, registered or not. As was developed above, this system makes section 16 particularly well suited to aligning management and stockholder interests in publicly held companies. Section 16 covers only companies in which ownership and management are split, and it reaches virtually all transactions necessary to discourage those in control from running

290. *See House Hearings, supra* note 85, at 135-38; *Stock Exchange Practices, supra* note 31, at 6560-61, 6967-68, 7267; *cf. id.* at 6955; Dooley, *supra* note 5, at 58.

291. *See supra* note 275 and accompanying text (corporations could opt out of corporate-law provisions); *cf.* I.N.P. Stokes, 2nd, Draft No. 1 for Memorandum, *supra* note 275, § 15(b)(1) ("With its prohibition against purchases with the intention of speculating, [the Fletcher-Rayburn bill, § 15(b)(1)] seems to me entirely too drastic on its face and too difficult to enforce as a matter of fact. As long as provision is made for recovery of profits, I do not see the need for a criminal penalty as well."); *id.* § 15(b)(3) (Fletcher-Rayburn bill § 15(b)(3) "would seem rather difficult of enforcement."). Aside from problems of enforcement and burden, the drafters do not seem to have thought that the tipping provision was very important. *See supra* note 287 (no tipping provision in Cohen's Feb. 5 draft); *see also supra* notes 241, 247 and accompanying text (no recommendations on tipping in Untermyer bills or Letter of the Counsel). *But see supra* note 259 (Dickinson committee recommended prohibiting giving tips to pools).

such companies for their own trading interests.[292] The Fletcher-Rayburn bill took the opposite approach; it was triggered by registration of any security, equity or not, but it governed trading only in registered securities.[293] That approach would have better assured everyone trading in the stock market equal access to corporate information. It would have covered more companies, and its limitation to trading in registered securities would not have undermined its power to protect the integrity of the public trading market. Amendments that limited the operation of the provision (ultimately section 16) to a smaller universe of companies and regulated a different set of transactions in the securities of those companies were inconsistent with the goal of informational equality, but they resulted in a provision that is much better suited to regulating the way publicly owned companies are run.[294]

292. The Fletcher-Rayburn provision would have regulated trading in registered debt securities, but § 16 does not regulate any trading in debt securities.

293. The change was not an inadvertent one resulting from redrafting. Committee prints that showed changes from earlier drafts clearly revealed that the trading prohibition was being extended to all equity securities. *See, e.g.,* Confidential Sen. Comm. Print. No. 2 (showing changes of substance to the text of H.R. 8720 agreed to by the Senate committee and proposed changes recommended by the subcommittee to § 15(b)) (Apr. 14, 1934) (copy in 5 DOCUMENTARY HISTORY COLLECTION, *supra* note 78, item 6).

294. The definition of control implicitly incorporated in § 16 also changed as the proposal was revised. The Fletcher-Rayburn bill reached some people who are not reached by § 16: principal owners of unregistered debt or equity securities issued by companies with registered securities; substantial record holders who were not beneficial owners; and beneficial owners of between five and ten percent of a class. While the changes in the companies and transactions subject to the provision worked to align the interests of managers and investors better, even as they undermined the equalizing effect of the Fletcher-Rayburn bill, it is hard to characterize the changes in the people covered by the provision.

The original inclusion of debtholders may have been inadvertent. The title of the provision in the Fletcher-Rayburn bill referred to "principal stockholders," and while the Fletcher-Rayburn bill required large debtholders to report their ownership, it did not restrict their trading or tipping. Almost no one commented on the fact that the Fletcher-Rayburn bill reached substantial debt holders. *See Stock Exchange Practices, supra* note 31, at 7274. Bondholders may have been removed because their original inclusion was inadvertent or because there was no reason to include them, on the not entirely satisfactory reasoning that debtholders typically do not have either control or access to information. *See House Hearings, supra* note 85, at 307; *Stock Exchange Practices, supra* note 31, at 6566, 7226, 7274, 7741-43 (testimony of Untermyer); *see also* I.N.P. Stokes, 2nd, Draft No. 1 for Memorandum, *supra* note 275, at § 15 (Handwritten notes: "Title shd include 'bondholders'"; "5% bondholders—shd be exempt.").

The change that excluded substantial owners of unregistered equity securities of companies with registered equity securities is difficult to explain under either approach to § 16. These owners may influence corporate policy and they may have access to corporate information. In explaining the original bill, Corcoran emphasized that it covered substantial owners of any class of stock of a company with registered securities, *House Hearings, supra* note 85, at 132; *Stock Exchange Practices, supra* note 31, at 6555, and no one seems to have urged the bill be rewritten to exclude them. In the end the drafters may not have realized they were excluding such owners, and the other exclusions may have resulted simply from an over-economy of

Thomas Corcoran explained the Fletcher-Rayburn bill in the House and Senate committees that considered it. He suggested that section 15, which he called the "anti-Wiggin provision,"[295] was supposed to prevent insiders from speculating on inside information.[296] He did not explain how it would do this, but he did say that the forfeiture provision would prevent insiders from speculating on short-term swings in stock prices.[297]

Critics of the bill saw that the anti-Wiggin section would control the way that publicly held corporations were run.[298] Richard Whitney, the president of the New York Stock Exchange, led a coalition of interest groups in a bitter attack on the Exchange Act.[299] Whitney attacked the provisions that dealt with stock exchange practices directly, arguing that an inflexible statute would cripple the market.[300] He took a different approach to the parts of the bill that regulated issuers. Whitney freely admitted that state law had failed to prevent abusive and dishonest corporate management practices. Although he criticized the Fletcher-Rayburn bill for transferring "many of the functions of management . . . to an administrative department of the Government,"[301] Whitney emphasized that the New York Stock Exchange agreed that federal reform "is not only desirable but is really necessary."[302] His problem with the anti-Wiggin provisions was that they

language in § 16(a). *Cf.* FEDERAL SECURITIES CODE § 605(a) (1980) (reporting requirement extended to owners of more than 10% of a class of equity security of a registered company).

The drafters did eliminate record owners and move the threshold on beneficial ownership from five to ten percent on purpose. The change was designed to minimize the burden of the section and reflected a compromise on the measure of substantial ownership. *See infra* note 355 and accompanying text.

295. *House Hearings, supra* note 85, at 134; *Stock Exchange Practices, supra* note 31, at 6555.

296. *House Hearings, supra* note 85, at 132-33; *Stock Exchange Practices, supra* note 31, at 6557; *see also id.* at 7742 (Pecora).

297. *House Hearings, supra* note 85, at 133 (§ 15(b) "says he cannot trade in the stock on short-time speculative swings—that is a 6-month swing"); *Stock Exchange Practices, supra* note 31, at 6560 (forfeiture of tippee's profit from "the 6 months' swing in the stock").

298. *See, e.g., Stock Exchange Practices, supra* note 31, at 7020 (letter from New York Airbrake Co.) (The Fletcher-Rayburn bill "only purports to regulate exchanges, but through various provisions directly affects the business and management of all corporations whose securities may be dealt in or listed on an exchange. . . . [T]he attempt to regulate the internal management of State corporations seems to be in derogation of the rights of the several States to deal with such matters.").

299. J. BROOKS, *supra* note 21, at 200-04; C. COWING, POPULISTS, PLUNGERS, AND PROGRESSIVES: A SOCIAL HISTORY OF STOCK AND COMMODITY SPECULATION 1890-1936, at 240-42 (1965); M. PARRISH, *supra* note 21, at 123; J. SELIGMAN, *supra* note 21, at 89; James M. Landis Interviews, *supra* note 267, at 199-200.

300. Thel, *supra* note 21, at 434-35.

301. *House Hearings, supra* note 85, at 152; *Stock Exchange Practices, supra* note 31, at 6624.

302. *House Hearings, supra* note 85, at 225; *Stock Exchange Practices, supra* note 31, at 6637.

did not belong in a stock exchange bill: "They belong in the laws governing the incorporation and management of companies."[303] Whitney accordingly urged Congress to adopt a federal corporation law.[304]

The broader implications of section 16 were not lost on the congressional committees responsible for the Exchange Act either. When Corcoran quoted Whitney's support for federal corporation law as evidence of the need for federal stockholder-protection legislation, Senator Barkley said he was "not concerned as much about the stock-exchange reaction to this section as I am about the effect on the average man."[305] At that point, Senator Gore interjected: "This [i.e., the anti-Wiggin provision] is aimed at the general evil of officers and directors rigging their stock up and down, and squeezing out their own stockholders. . . . I think the objective is desirable."[306]

The drafters and others working behind the scenes also saw section 16 as a device to regulate corporate management. Cohen, Corcoran, and Landis produced and received a great quantity of correspondence, memoranda, and proposals while they were drafting the Exchange Act. Landis saved most of the working drafts of the Exchange Act (and of the Securities Act) and a great deal of related material as well. The hundreds of documents he collected invaluably record what the drafters had in mind as they wrote and refined the Exchange Act. The first volume of his collection on the legislative history of the Exchange Act is a set of "previous bills introduced in Congress relating to stock exchanges."[307] While not

303. *House Hearings, supra* note 85, at 225; *see also id.* at 307; *Stock Exchange Practices, supra* note 31, at 6637, 6914, 6954; Raoul E. Desvernine, Memorandum of Important Differences Between H.R. 7852 and Revision of H.R. 7852 Appended Hereto 7 (undated) ("Section 15 of HR 7852, relating to transactions by directors, officers and principal stockholders, has been omitted from the revised Bill as not being pertinent to exchange regulations.") (copy in 2 DOCUMENTARY HISTORY COLLECTION, *supra* note 78, item 23).

304. *House Hearings, supra* note 85, at 225; *Stock Exchange Practices, supra* note 31, at 6636-37; *see also House Hearings, supra* note 85, at 307 (Frank Hope, president of the Association of Stock Exchange Firms); *Stock Exchange Practices, supra* note 31, at 6715-16 (Corcoran quoting Whitney's statement), 6914 (Hope), 6954 (Alfred Bernheim, Director of the Securities Markets Survey of the Twentieth Century Fund). *But see House Hearings, supra* note 85, at 729 (Whitney); *Stock Exchange Practices, supra* note 31, at 7484 (Whitney) (Roland Redmond, counsel to NYSE); Letter from Whitney to Presidents of All Listed Corporations, Feb. 26, 1934, *reprinted in Stock Exchange Practices, supra* note 31, at 7283-86. *See generally* J. SELIGMAN, *supra* note 21, at 87 (recommendation for federal corporation act).

305. *Stock Exchange Practices, supra* note 31, at 6559.

306. *Id.*; *see also id.* at 6558 (Senator Gore on tipping: "Would this [the forfeiture provision] prevent him from confederating with someone else, if he were willing to forfeit the profit? His friends on the outside would take the profit resulting from the influence he exercised on the market, and then split the pot with him."). Senators Barkley and Gore, senior Democratic members of the Subcommittee on Stock Exchange Practices, were influential supporters of the Exchange Act. *Cf.* J. SELIGMAN, *supra* note 21, at 98 (Chairman Fletcher described Barkley as "sympathetic to the legislation.").

307. 1 DOCUMENTARY HISTORY COLLECTION, *supra* note 78.

exhaustive,[308] this compilation does include fifty-one bills introduced between 1924 and 1933, the first of which is a bill entitled the Corporation Act[309] that was introduced in the Senate in 1924. The Corporations Act was largely a polemic against Wall Street,[310] and it does not seem to have gone anywhere after it was introduced. It did envision particular substantive reforms, however, and one of its provisions, discussed below, was apparently the model for section 16.

The Corporation Act would have provided for federal chartering of corporations and more or less complete regulation of the stock exchanges, and while the bill was not very clearly written, it seems to have contemplated forbidding both margin buying and short selling. Redundantly, the bill made it a crime for anyone to sell short

> any security of a corporation . . . in which he is an officer or employee . . . [who] relies on . . . buying said security . . . at a future time, which will show a profit in the transaction, and who through the sale of this security, and his future acts or influence as officer, or employe [sic], of said corporation . . ., hopes to depress the market value of the securities of said corporation . . . so that he may buy said securities back at a profit.[311]

This provision proposed to regulate insider short sales (addressed in section 16(c) of the Exchange Act) when combined with offsetting purchases of the sort addressed by section 16(b). As the cited passage suggests, however, it would have operated only on insiders who intended to mismanage their companies. Even if the Corporation Act was not the model for section 16, it brought home to the drafters both that those in control of corporations might manipulate corporate affairs in order to create trading opportunities and that trading rules could regulate the way corporations are run.

The most extensive discussion of the anti-Wiggin provision in the drafters' private papers is contained in a long memorandum on "certain provisions of the [Fletcher-Rayburn bill] bearing upon the rela-

308. *Cf.* Hanna, *The Federal Regulation of Stock Exchanges*, 5 S. CAL. L. REV. 9, 10, 11, 18 n.9 (1932) (noting some earlier bills).

309. S. 1826, 68th Cong., 1st Sess. (1924). *See generally* Thel, *supra* note 21, at 407 n.95.

310. *See, e.g.*, S. 1826, *supra* note 309, § 1 ("The term 'gambler in stocks' means one who stakes his money on a contingency—he is not an investor or a speculator, never buys a share outright—he it is who plays against the bank, or the other gamblers who accept his bet. It is this element who are destroying the confidence of the investing public and security values, and who this Act is meant to eliminate . . . .").

311. *Id.* § 4; *see also* S. 4647, 72d Cong., 1st Sess. § (1)(i) (1932) (no security to be dealt with on a stock exchange unless the issuer forbade officers and directors to effect short sales and required them to give the board advance notice of any purchase or sale of any security of the issuer and post-trade notice to the exchange) (copy in 1 DOCUMENTARY HISTORY COLLECTION, *supra* note 78, item 35); S. 782, 73d Cong., 1st Sess. § (1)(i) (1933) (same) (copy in 1 DOCUMENTARY HISTORY COLLECTION, *supra* note 78, item 36).

tions between investors in, and managements of, American corporate enterprise."[312] Alexander Sachs, an economist who had just left the National Industrial Recovery Administration, prepared this fine piece of work for Landis, Corcoran, and Cohen in response to their request for his comments on the bill.[313] The gist of his argument was that "while motivated by the high minded purpose of eliminating the manipulation of prices by interested parties exploiting confidential information regarding corporate action,[314] the [Fletcher-Rayburn] Bill, particularly Section 15, is vitiated by an underlying self-contradiction."[315] Sachs suggested that, by limiting management to "lock-in" investments with the short-swing trading provision and by placing an almost intolerable burden on any management communication with the provisions on tipping and false statements in filed documents, the bill "effected a

312. Memorandum on Obstacles in the Securities Exchange Act to Efficient Investment and Enterprising Management, Abbreviated Statement 1 (Feb. 1934) [hereinafter Sachs Memorandum] (copy in 8 DOCUMENTARY HISTORY COLLECTION, *supra* note 78, item 35); *see also* Letter from Alexander Sachs to Landis, Corcoran, and Cohen [hereinafter Letter from Alexander Sachs] (addressed "Dear Jim, Tom and Ben") 1 (Mar. 9, 1934) (cover letter for Sachs Memorandum) ("I have confined myself largely to the effects of the Bill on the processes of investment and business in their bearing on recovery.") (copy in 8 DOCUMENTARY HISTORY COLLECTION, *supra* note 78, item 35).

313. Along with the criticism discussed in the text, Sachs articulated objections to the Act that have since come to be regarded as the Act's most important flaws. He saw that the Exchange Act reflected a "touching faith in . . . mere information," Sachs Memorandum, *supra* note 312, Abbreviated Statement 3, when what investors really wanted was access to management interpretation of facts and predictions of the future, *id.* at 3-4; *cf.* H. KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE (1979). He also saw that any prohibition on insider trading and tipping would interfere with investment analysis. Sachs Memorandum, *supra* note 312, Part I (entitled "Obstacles in the Act to Efficient Investment Research and to Management Enterprise"); *cf.* Dirks v. SEC, 463 U.S. 646, 678 (1983) (Blackmun, J., dissenting) (discussing vagueness of the disclosure requirement). He suggested that such a prohibition would lead to "a bootleg market in confidential information," Sachs Memorandum, *supra* note 312, Part I, at 13, in which government officials were likely to participate, *id.* Part II, at 3; *cf.* H. MANNE, *supra* note 18, at 171 (outlining government access to information affecting stock market prices).

314. Sachs saw that the authors hoped to reform corporate management, but he focused on what he saw as the Fletcher-Rayburn bill's unintended effects on business operations. Sachs predicted that the immediate consequence of the bill would be "economic deflation and disorganization of the system." Letter from Alexander Sachs, *supra* note 312, at 3. By discouraging management investment and restricting the flow of inside information, the anti-Wiggin provision would separate ownership from management and would leave investors with little choice but to invest in widely followed market-leaders. The Brandeisian drafters must have been troubled by his prediction of the stifling of smaller units of business and the acceleration and magnification of "monopolistic tendencies." *Id.* at 1-2.

315. Sachs Memorandum, *supra* note 312, Abbreviated Statement, at 3. Sachs's problem with managers using inside information for their own ends was not that everyone should have equal access to inside information, but instead that managers who can take advantage of inside information may manipulate the flow of that information. Insider trading was wrong chiefly because it might lead to manipulation, not because it was inherently unfair.

complete divorce of ownership from management!"[316] There is no record of how the drafters responded to Sachs's memorandum, but the enacted statute accords with his recommendations to the extent that it eliminates the restrictions on tipping and provides for administrative flexibility.[317]

C. The Purpose Stated in Section 16(b)

The Senate and House committees considering the Fletcher-Rayburn bill took the public and private criticism seriously, and Rayburn introduced a revised bill on March 19, 1934.[318] Most of the substantive provisions of the bill were changed, including the anti-Wiggin provision.[319] The new provision was triggered by the registration of an equity security (the original anti-Wiggin provision applied whenever any security was registered),[320] and it applied to officers, directors, and beneficial holders (the Fletcher-Rayburn bill applied to principal record holders as well).[321] It was no longer a crime to buy with a view to selling within six months, but affiliates had to forfeit their profits if they sold a registered equity security (as opposed to any registered security in the Fletcher-Rayburn bill and any equity security in the Exchange Act) within six months after buying or, for the first time, if they bought within six months after selling.[322] The prohibition of short selling also was limited to registered equity securities as was the prohibition of sales against the box, which was further modified to allow affiliates twenty days to deliver (as opposed to five under the Fletcher-Rayburn bill).[323]

316. *Id.*

317. *See id.* at 8 ("Concretely the plan is as follows: (1) that the Act be amended along flexible, realistic lines and that its administration be invested in a regulatory body independent of the existing" FTC.).

318. H.R. 8720, *supra* note 175.

319. *Id.* § 15. *See generally* Thel, *supra* note 21, at 442-47.

320. *See supra* note 283 and accompanying text.

321. *Id.* Record owners were deleted "to protect banks when acting as agents or trustees where the securities held by the banks for its principals are registered in the name of nominees; and also brokers 'in whose name there was registered more than 5 per cent of a corporation's stock who might not own or have a beneficial interest in a single share.'" Herlands, *Criminal Aspects of the Securities Exchange Act of 1934*, 21 VA. L. REV. 139, 167 (1934) (references to congressional hearings omitted); *see House Hearings, supra* note 85, at 307; *Stock Exchange Practices, supra* note 31, at 6914, 7226.

322. Senator Bulkley had suggested this extension to Corcoran during the latter's committee testimony on the Fletcher-Rayburn bill. *Stock Exchange Practices, supra* note 31, at 6557-58.

323. Witnesses had recommended this change. *House Hearings, supra* note 85, at 262; *Stock Exchange Practices, supra* note 31, at 6836, 6839 (statement of Frank Shaunessy, President of the San Francisco Stock Exchange), 6992-93 (statement of Eugene Thompson, President of the Associated Stock Exchange), 7228 (statement of William Potter, Chairman of the Board, Guaranty Trust Co.).

Rayburn also provided for the exemption of securities and transactions from his revised anti-Wiggin provision. The provision would not have applied to any "exempted security."[324] This was a new term in the bill, and broadly speaking, it encompassed securities of the United States and any other securities that the Act's administrators determined should be exempt from particular provisions of the Act.[325] Rayburn also provided two exemptions from the forfeiture provision in a single sentence at the end of the provision:

> This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale or sale and purchase of the security involved, nor any transaction which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection [i.e., the forfeiture provision] of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer.[326]

The exemption for beneficial owners who were not such both at the time of the purchase and the sale has had a history befitting its turbidity. The only explanation suggested by the hearings is the possibility that an estate that received a substantial amount of stock and then had to liquidate to raise funds would have to forfeit profits.[327] If so, the phrase "was not such" was supposed to mean that the forfeiture provision applied only when the same entity bought and sold

324. Only the reporting part of the anti-Wiggin provision of Rayburn's bill explicitly excluded exempted securities, H.R. 8720, *supra* note 175, § 15(a), but the short-swing trading and sale provisions referred to "such registered equity security," *id.* § 15(b), (c), apparently incorporating the exemption. The Exchange Act explicitly excludes exempted securities from each operative part of § 16.

325. H.R. 8720, *supra* note 175, § 3(a)(13).

326. *Id.* § 15(b). The bill also added an exception for securities "acquired in good faith in connection with a debt previously contracted." *Id.* This exception is incorporated in § 16(b) of the Act in the same words.

For what it is worth, the exclusion of securities acquired in connection with previous debts seems to have been agreed upon first, then the exclusion of exempted securities, and finally the exemption that began with "[T]his subsection shall not be construed to cover any transaction." *Id. Compare* Second Revision of Bill after introduction *with* Second Revision of Bill with changes *and* Third Revision of Bill (copies in 2 DOCUMENTARY HISTORY COLLECTION, *supra* note 78, items 6, 7, 8 respectively).

327. *See Stock Exchange Practices, supra* note 31, at 6558, 7266. The explanation is weak, but it is the best one based on the historical record. *See also* H.R. 8720, 73d Cong., 2d Sess. (Committee Print with handwritten comments) (handwritten comment facing first line of § 15(b): "estate sells under 6 mos after acquiring . . . shd exempt bks, trustees & exrs but may exempt") (copy in 4 DOCUMENTARY HISTORY COLLECTION, *supra* note 78, item 9). The SEC offered this explanation to the Supreme Court, but the Court rejected the Commission's argument that the exemption should be limited to persons who became principal stockholders involuntarily. Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418, 425-27 (1972); *see also* Brief for the SEC as Amicus Curiae at 29-34, *Reliance Electric,* 404 U.S. 418 (No. 70-79).

(or sold and bought).[328] The Supreme Court has construed the clause to limit forfeiture to people who beneficially owned the requisite amount of stock (as enacted, more than ten percent) at the time of each of the matched trades, substantially limiting the burden that section 16(b) places on principal stockholders.[329] If the drafters only meant to clarify that trades effected by different beneficial owners were not to be matched, the subsequent history of the clause teaches a great lesson in the dangers of using the word "such" as a substitute for careful drafting.

Section 16 also retains administrative power to grant relief from the forfeiture provision (substituting the SEC for the FTC), but Rayburn's language was broken into two parts. Rayburn would have permitted transactions to be exempted from the forfeiture provision if they were not comprehended within the stated statutory purpose. Section 16 incorporates this exemption, but the stated statutory purpose is at the beginning of section 16(b) and the administrative authority at the end.[330] As enacted, then, the forfeiture provision begins with the defined statutory purpose, expressed in the same words Rayburn used, and ends with the exemptive authority, again stated in Rayburn's words. Section 16(b) begins: "[f]or the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director or officer by reason of his relationship to the issuer," certain short-swing trading profits shall inure to and be recoverable by issuers.

Commentators and courts often cite the introductory language of section 16(b) to support the proposition that section 16 was supposed to achieve parity of information.[331] The purpose clause does seem to

328. In other words, the word "such" was intended to refer to ownership (i.e., "where such beneficial owner was not *the owner* both at the time of the purchase and sale") rather than the status of being a principal stockholder (i.e., "where such beneficial owner was not *the owner of more than 5% of a class* both at the time of the purchase and sale").

329. Foremost-McKesson, Inc. v. Provident Sec. Co., 423 U.S. 232 (1976) (§ 16(b) does not apply if the owner of the securities was not a beneficial owner at the time of both sale and purchase); *see also Reliance Elec. Co.*, 404 U.S. at 423. The proposed Federal Securities Code would change the language of the statute to overrule these cases. FEDERAL SECURITIES CODE § 1714(d)(1), (2) (1980); *see also id.* comments 5, 6.

330. The Senate Banking Committee divided the clause this way when it reworked Rayburn's revision, and it may have put the purpose clause at the beginning of § 16(b) as a matter of style. *Compare* S. 3420, 73d Cong., 2d Sess. § 7(a) (1934), *reprinted in* 11 LEGISLATIVE HISTORY, *supra* note 31, item 37 (purpose clause at end of first sentence) *with* Exchange Act § 7(a), 15 U.S.C. § 78g(a) (1988) (purpose clause at beginning of sentence).

331. *See, e.g.*, Kern County Land Co. v. Occidental Corp., 411 U.S. 582, 591 (1973) ("As specified in its introductory clause, § 16(b) 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.'"); Exchange Act Release No. 26,333, *supra* note 6, ¶ 89,599 ("'For the purpose of preventing the unfair use of information which may have been

justify the conventional understanding that the drafters created section 16 (or at least section 16(b))[332] to ensure equal access to corporate information; it is certainly a nagging problem for anyone who would explain the section in the terms proposed in this Article.

In thinking about the purpose clause, it is important to bear in mind how it got into the statute and the function it was intended to perform. The clause may deserve respect,[333] but when it was inserted, no one suggested that it would control the operative reach of the statute, and by and large it has not.[334] Congress did not enact the purpose clause because the drafters or anyone else wanted Congress to justify the section. Even if Congress wanted to justify section 16, the circumstances in which the Exchange Act was drafted and revised were not calculated to produce statutory language that correctly or clearly expressed the purpose of section 16.

The legislative history bears out Professor Loss when he explains that the purpose clause, which he calls a preamble, "was intended merely as an aid to constitutionality, as well as a guide to the Commission in the exercise of its rulemaking authority."[335] The purpose clause was only a tag on the grant of administrative power to exempt transactions from the forfeiture provision, which authority Rayburn presumably incorporated in response to consistent complaints of statutory inflexibility. The purpose clause, in turn, was presumably included in order to avoid giving the administrators unfettered discretion.[336]

Given the drafters' reasons for adding the purpose clause and the constraints on their work, there is reason to be cautious in taking it at face value in trying to discover what they wanted the operative pro-

obtained by [an insider] by reason of his relationship to the issuer,' Congress enacted Section 16(b).") (footnote citing § 16(b) omitted; alteration in Release); R. CLARK, *supra* note 4, at 295 ("The purpose of section 16(b), as stated in the statute itself . . . ."); W. PAINTER, *supra* note 115, at 12; Dietz, *A Practical Look at Section 16(b) of the Securities Exchange Act*, 43 FORDHAM L. REV. 1, 1 (1974); Meeker & Cooney, *supra* note 12, at 950; Seligman, *supra* note 12, at 3.

332. Section 16(e) refers to the plural but unstated "purposes" of the section, whereas § 16(b) refers to a singular, stated "purpose" of the subsection.

333. If congressional intent is to determine the way § 16 operates in marginal cases, perhaps the purpose stated in the statute should control the actual purpose of the drafters and their sponsors. *See infra* notes 392-393 and accompanying text.

334. It is very well settled that "a showing of an actual unfair use of inside information is not required for recovery" under § 16(b). 2 L. Loss, *supra* note 2, at 547; *see also id.* at 556. The purpose clause, however, has sometimes informed the construction of the statute. The Supreme Court has construed the language of the statute to avoid forfeiture in so-called unorthodox transactions in which it is unrealistic to assume or infer that the defendant had access to inside information when it traded. *Kern*, 411 U.S. at 596-97. *See also infra* notes 394-404 and accompanying text.

335. 2 L. Loss, *supra* note 2, at 547-48.

336. *Cf.* 78 CONG. REC. 7864, 8091 (1934).

visions of section 16 to accomplish.[337] If they were simply trying to ensure that the grant of rule-making authority was not unconstitutionally broad, it was not important to state the purpose accurately; any stated goal would do, so long as it was a goal Congress had the right to pursue. The whole bill was being revised at the time, and other changes that had clear and important substantive implications no doubt appeared more important. In any case, it seems clear that the drafters put little time into the change that included the purpose clause.[338]

337. It is clear that those most intimately involved with the anti-Wiggin provision continued to see it as a device for aligning the interests of ownership and management, notwithstanding the language of the purpose clause. This is apparent from a five-page congratulatory telegram Alexander Sachs sent the drafters a few days after Rayburn introduced his revision. Telegram from "Alexander" to Winfield Riefler (Mar. 22, 1934) (original in Library of Congress, Thomas G. Corcoran papers, box 266, Exchange Act correspondence folder 1) [hereinafter Telegram] (Riefler was a friend of Benjamin Cohen who was on the staff of the Federal Reserve Board and who helped draft the Exchange Act. M. PARRISH, *supra* note 21, at 115. "Alexander" was almost certainly Alexander Sachs; the telegram was sent from New York and it referred to Sachs's memorandum to Cohen, Landis, and Corcoran, Sachs Memorandum, *supra* note 312, as "my report." Telegram, *supra,* at 2. The telegram closed by asking Riefler to "please show this to my friends the authors," and the original ended up in Corcoran's papers.).

Sachs recommended that the anti-Wiggin provision be changed further. He suggested that the six-month lock-in of the revised anti-Wiggin provision would discourage management stock ownership and the "unrealistic application" of that restriction to five percent stockholders would injure small business by causing substantial investors to flee to big-capitalization companies. *Id.* at 1-2. He argued that these provisions could be liberalized without undermining the "object" of the provision, which in the turgid language of a telegram Sachs said was "to eliminate temptation exploitation or influencing corporate policy on dividends and like for market manipulation." *Id.* at 2.

The telegram also reinforces the conclusion that the forfeiture provision was intended to focus on the initial leg of a pair of matched trades. *See infra* note 338 and accompanying text. Sachs asserted that the sort of manipulation that the provision was designed to eliminate surely "never extends to six months." Telegram, *supra,* at 2. Yet the six-month holding period effectively required by the provision would discourage managers from owning stock, which was too high a price "for catching dimly premeditated plan which all sorts economic market forces bound change in six months." *Id.* Accordingly, Sachs recommended changing the period to 30 days, a recommendation the ABA Task Force recently repeated. *See supra* note 74.

338. The purpose clause does not seem to have been written very carefully. It does not, for example, proscribe all use of inside information, but only the unfair use of such information. Moreover, whereas the forfeiture provision of the Rayburn revision (and the bill) refers to the purpose of the subsection, the arbitrage provision of the revision (and the bill) refers to the *purposes* of the section. The loose language of the beneficial-owner clause, added at the same time as part of the same sentence, is also instructive. *See supra* notes 327-329 and accompanying text.

The drafters might have stated their corporate governance goals more clearly had they thought that their language would have influenced future regulators, but they were acutely aware that the course of administrative regulation was going to be determined not by what the statute said but by who administered it. The question of who would administer the statute was central in the debate over the Exchange Act. *House Hearings, supra* note 85, at 148-49; *see also* Thel, *supra* note 21.

In the end, though, the drafters did put the purpose of section 16(b) in terms of information availability rather than manipulation or management regulation. It is odd that they did so, since the practical implications of section 16's operation and the whole history of its enactment suggest that the drafters were intent on improving the way large corporations worked. Even if they were not paying much attention, the drafters were clever, and it is unlikely that their choice of words was entirely unconsidered.

The drafters and their sponsors may have been trying to hide their agenda.[339] In the face of tremendous opposition to other parts of the proposed Act on the grounds that they would result in government control of business,[340] the drafters might have been reluctant to explain how section 16 would affect the way corporations operate, especially since they were introducing administrative discretion into the section at that time. Cohen, Corcoran, and Landis must have been acutely aware of the potential political problems. After all, they had been asked to work on the securities statutes only because of the outrage that greeted Roosevelt's original proposal to authorize federal bureaucrats to forbid the sale of securities if they found the issuer's affairs were unsound.[341]

The drafters' reluctance to admit that they were regulating the way corporations did business would have been reinforced by their anxiety over the extent of the federal government's constitutional power to regulate business, an understandable concern at a time when the federal government was thought to have less of a role in regulating commerce than is now recognized. Critics of the proposed Act consistently argued that Congress was exceeding its power, and supporters recognized that the issue was difficult.[342] The key to the Act's con-

339. If this was what happened, it was an interesting turn in which legislative staff tried to hide a substantive reform that was adopted by Congress instead of claiming a reform that was rejected. *Cf.* Lukhard v. Reed, 481 U.S. 368 (1987); Johnson v. Transp. Agency, 480 U.S. 616 (1987) (Scalia, J., dissenting); Posner, *Legislation and Interpretation: A Primer,* 68 NEB. L. REV. 431, 440 (1989).

340. *See* H.R. REP. No. 1383, *supra* note 31, at 30 (minority views); S. REP. No. 792, *supra* note 117, at 10; D. RITCHIE, *supra* note 222, at 55-56; J. SELIGMAN, *supra* note 21, at 89-90, 96-97; *see also supra* note 301 and accompanying text (Whitney charged that bill transferred functions of management to the government); *cf.* J. SELIGMAN, *supra* note 21, at 76-81 (pressure to amend Securities Act); Tracy & MacChesney, *supra* note 182, at 1056-57 (controversy over § 16).

341. *See supra* notes 251-258 and accompanying text.

342. Landis was the first witness to testify before Congress on the Fletcher-Rayburn bill. He started by saying that he thought there was no need to speak upon the need for regulation of the stock exchanges and turned immediately to the question of constitutionality, which he conceded was "not free from doubt." *House Hearings, supra* note 85, at 16-20; *see also id.*

stitutionality was the relationship between stock market transactions and interstate commerce.[343] It was safer to say that the purpose of section 16 was to prevent insiders from trading on inside information than to say that the purpose was to improve the way corporations went about producing goods and services. Under the first characterization, Congress was trying to prevent fiduciaries from effecting inherently fraudulent securities transactions in an interstate market.[344] Under the second, Congress would have been trying to use its power over interstate trading in securities to influence manufacturing and other activities, which at the time were thought to be quite remote from interstate commerce.[345]

Finally, the language of the purpose clauses may have been a result of the drafters being lawyers as much as of any strategy for accomplishing a controversial program.[346] Henry Manne has attributed what he takes to be a misguided consensus that it is unfair for insiders to trade on the basis of nonpublic information to the fact that lawyers have dominated public discussion of the subject to the exclusion of more objective and morally detached economists.[347] Lawyers do not all think the consensus is misguided of course,[348] but critics of insider trading would have to agree that much discussion of insider trading has heavy "overtones of fairness and morality."[349]

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at 917 (Memorandum Submitted by Noel T. Dowling Concerning the Power of Congress, Under the Commerce Clause, To Regulate Security Exchanges), 925 (Brief Submitted by Thomas G. Corcoran and Benjamin V. Cohen in Support of Constitutionality of Stock Exchange Bill).

343. *See, e.g., id.* at 16 (Landis testimony).

344. This was the argument proponents offered in favor of the provision. *Id.* at 937-38.

345. *See, e.g., id.* at 29-32 (discussion between Landis and Rep. Huddleston), 41-42 (letter from Landis to Rep. Rayburn), 233-46 (Thomas B. Gay), 246-51 (Landis' written opinion questioning constitutionality of earlier bill), 562-71 (brief of Hunton, Williams et al.); Hanna, *supra* note 308, at 18-23; Tracy & MacChesney, *supra* note 182, at 1037 n.*; *cf.* Hammer v. Dagenhart, 247 U.S. 251 (1918) (Congress could not prohibit interstate commerce in goods produced with child labor).

346. *See supra* notes 256-257 and accompanying text; *see also supra* note 222.

347. H. MANNE, *supra* note 18, at 2-4.

348. *See* Macey, *supra* note 5, at 21 n.53 (referring to "a veritable cottage industry" attempting to respond to Manne).

349. *See supra* note 2 (fairness arguments against insider trading). According to Manne:

> [W]hen lawyers, judges, and law professors are faced with issues of broad social or economic consequences, their tendency is to approach the subject with relationships between specific individuals in mind. Their acceptance or rejection of a practice will reflect their notion of the fairness of the transaction simply from the point of view of the two individuals involved. It is not difficult to see why lawyers have generally concluded that there is something unfair (primarily in the sense of "unequal") about insiders with undisclosed good news buying shares from existing shareholders.
>
> . . . .
>
> . . . The absence of any accepted economic tools for analyzing this subject made

The fairness argument against insider trading is a winning one,[350] and accordingly advocates of section 16 had much to gain by using it.[351] Moreover, the fairness argument is available whenever a corporate manager manipulates corporate affairs to create trading opportunities. To profit from price changes created by the manipulation, the manipulator has to trade before the market understands the manipulation.[352] Thus, while not everyone who trades on inside information manipulates corporate affairs, everyone who manipulates corporate affairs to create trading opportunities intends to trade on the basis of inside information.

> the insider-trading area a fertile one for the lawyers' equity approach with its overtones of fairness and morality.

H. MANNE, *supra* note 18, at 3.

350. *See supra* note 18 (commentators have ignored anti-manipulative character of § 16). Section 16 states the equality-of-access argument in its strongest form; it does not condemn all use of nonpublic information, but instead condemns "unfair use of information which may have been obtained by [an affiliate] by reason of his relationship to the issuer."

351. It is also simpler to assert that it is wrong for insiders to take advantage of information they obtain by reason of their relationship with their corporation than it is to explain how management incentives can be refined by regulating insider trading.

352. Commentators often assert the unfairness of trading on nonpublic information at the same time they condemn managers for manipulating corporate affairs to create trading opportunities. *See, e.g.*, 78 CONG. REC. 8038 (1934) (Rep. Rayburn); Samuelson, *supra* note 15, at 513 ("Congress' primary concern in passing Section 16 was to protect the interests of public market participants against company insiders who were able to take advantage of privileged information to manipulate stock prices."); *see also supra* notes 155, 260, 313-317 and accompanying text. This can complicate and obscure the argument. Consider for example one of the most cited articles on § 16, Meeker & Cooney, *supra* note 12. That article noted that when Congress adopted the Exchange Act, it was aware that, "On occasion, the ability to obtain [trading] profits led corporate insiders to manipulate the market for their stock by causing their corporation to follow financial policies calculated to produce sudden changes in market prices." *Id.* at 952. The authors nonetheless thought that in enacting § 16, Congress was concerned with the misuse of confidential corporate information and that "[s]ection 16(b) is tailored to eliminate profiteering on short swings in market value on the basis of advance information." *Id.* "The strictures of section 16(b) . . . were designed to prevent short swing market speculation on the basis of inside information and its concomitant evil, the manipulation of corporation affairs in a manner designed to cause market fluctuations." *Id.* at 979. The article went on to examine several interpretative questions in terms of confidential information.

While Meeker & Cooney recognized a relationship between § 16 and the way managers conduct corporate business, their treatment of the relationship differs from that suggested here. They seem to have thought that Congress objected to managers trading corporate securities after causing the corporations to act in a way that temporarily changes the price of those securities only because Congress felt that insiders should not use confidential corporate information for their own advantage. This Article takes the position that the manipulation of corporate affairs is itself objectionable, apart from any objection to the related trading, and for reasons that may be more compelling than those that make trading on nonpublic information objectionable. Those in charge of public corporations should not run them for their own benefit; and when they do, they undermine the legitimate expectations of investors and the interests of the public. Apart from discouraging the use of confidential information by corporate insiders, § 16 protects the expectations of non-trading investors and the interest of the public by encouraging the proper management of public corporations.

D. The Enactment of Section 16

Although Rayburn's revision was not introduced in the Senate, the Senate Banking Committee considered it.[353] The Senate committee modified the bill further, and wrote an anti-Wiggin provision very similar to the one eventually enacted as section 16.[354] The Senate committee's version applied only to officers, directors, and beneficial owners of more than ten percent of a class of exchange-registered equity securities,[355] and it exempted arbitrage transactions except those made in contravention of administrative regulations.[356] The Senate committee also broke up the provision that authorized administrators to exempt transactions from the forfeiture provision, putting the purpose clause at the beginning of the subsection where it is now.[357]

The House Commerce Committee also modified Rayburn's revision. Its anti-Wiggin provision followed Rayburn's revision in covering beneficial owners of more than five percent of a class of registered equity securities (as opposed to the Senate committee's ten percent threshold), as well as officers and directors. It also augmented the reporting requirements by requiring issuers to include information on

353. *See Stock Exchange Practices, supra* note 31, at 7414, 7538.

354. S. 3420, *supra* note 330, § 16.

355. *Id.* In testimony before the Senate committee, Samuel Untermyer argued that the five percent threshold was too low. *Stock Exchange Practices, supra* note 31, at 7741-43; *see also* 78 CONG. REC. 7961 (1934); I.N.P. Stokes's master draft of comments on Fletcher-Rayburn bill, *supra* note 78, item 2 (handwritten comment facing § 15(a): "Untermyer contra 5% SH rule").

356. S. 3420, *supra* note 330, § 16(d). *See* Memorandum Submitted on Behalf of Members of the New York Stock Exchange who are Engaged in Domestic Arbitrage 18-19 (copy in 9 DOCUMENTARY HISTORY COLLECTION, *supra* note 78, item 8). Richard Whitney proposed the statutory language that was used eventually to exempt arbitrage transactions. He explained that the New York Stock Exchange continued its general opposition to the bill, *Stock Exchange Practices, supra* note 31, at 7479-80, but he proposed a set of amendments, including one that the committee added as § 16(d) of its bill, which were explained by Roland Redmond, a lawyer for the Exchange. *Id.* at 7539-86; *cf.* H.R. 8720, 73d Cong., 2d Sess. 57 (Confidential Committee Print with handwritten changes) (handwritten note at end of § 15: "(d) Redmond's addition—exc arbitrage.") (copy in 4 DOCUMENTARY HISTORY COLLECTION, *supra* note 78, item 11).

357. The bill that the House of Representatives sent to conference did not contain a forfeiture provision, *see infra* notes 358-365 and accompanying text, so the report of the Senate Committee on Banking and Currency was the only committee report that discussed what became § 16(b) of the Exchange Act. The section-by-section analysis in that report stated: "The expressed purpose of [the forfeiture provision] is to prevent the unfair use of inside information. The Commission may exempt transactions not falling within this purpose." S. REP. No. 792, *supra* note 117, at 21. The narrative portion of the report explained that § 16 would "render difficult or impossible the kind of transactions which were frequently described to the committee, where directors and large stockholders participated in pools trading in the stock of their own companies, with the benefit of advance information regarding" dividend changes. *Id.* at 9.

changes in the holdings of officers and directors in their periodic reports to stockholders. On the whole, however, the House committee's bill was much less intrusive than the Senate committee's. In the House committee's bill short sales and sales against the box were still forbidden, but the House Committee's bill no longer provided for the forfeiture of profits from short-swing trading.[358]

When the House of Representatives took up the House committee bill, the discussion was rather broad, with much talk about the evils of Wall Street and Socialism. Nonetheless, in the face of sustained criticism that the bill would result in government control and regimentation of industry,[359] the sponsors of the bill admitted up front that it was addressed to the way publicly held corporations did business.[360]

358. H.R. 9323, *supra* note 77, § 15(a). The differences between the treatment of the anti-Wiggin provision in the Senate and House committee reports may shed light on what the forfeiture provision was meant to accomplish. The Senate committee discussed § 16 of its bill, which included a forfeiture provision, along with the provisions that became §§ 9 and 10 of the Exchange Act, under the heading "Manipulative Practices." S. REP. No. 792, *supra* note 117, at 7-9. (It also referred to all three provisions as containing "sanctions[] aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function." *Id.* at 6.) The House committee discussed the anti-Wiggin provision of its bill, which did not contain a forfeiture provision, together with the provision governing proxy solicitation under the caption "Control of Unfair Practices by Corporate Insiders." H.R. REP. No. 1383, *supra* note 31, at 13. (The House report discussed the predecessors of §§ 9 and 10 of the Exchange Act alone under the caption "Control of Manipulative Practices." *Id.* at 10-11.) *See also supra* note 280 (Stokes and Taylor saw insider short selling as form of manipulation).

359. *See, e.g.*, 78 CONG. REC. 7690 (1934) (Rep. Cooper), 7691 (Rep. Cox), 7691 (Rep. Parks), 7710 (Rep. Merritt), 7710 (Rep. Britten), 7937-38 (Rep. Bakewell), 7944 (Rep. Britten), 7961 (Rep. Dirksen), 8009 (Rep. Treadway), 8012 (Rep. McGugin), 8090 (Rep. Snell); *cf.* 78 CONG. REC. 7696-97 (Rep. Rayburn discussing criticism).

360. According to Representative Clarence Lea, a senior Democrat member of the Commerce Committee who had helped revise the bill:

> It is well to realize that today the vast wealth invested in stocks, bonds, corporate securities, and bank deposits represents nearly one half the wealth of the United States and involves the separation of ownership and control. . . . It means that those in control of our great corporations . . . are not the people who primarily suffer from fraud or imprudent investments these stocks may represent. There is the greatest temptation that managements have ever had to be unfaithful to their trusts.
>
> In the main, the men controlling these great corporations are not large owners of the stocks of the corporations they control. Too often they have yielded to the temptation to control these great business institutions to their own interests, and with a zeal out of proportion to the loyalty they have shown their stockholders. . . .
>
> . . . At the present time, however, under remote stock transactions, the victims of mismanagement of a corporation are remote from those who inflict the injury, the associates of the perpetrator do not ostracize or upbraid him. The victims are unseen by those who inflict their injuries. This bill proposes to hold these wrongdoers to a higher degree of responsibility.
>
> This measure, as I suggested, goes a good deal further than the regulation of

It might seem that the relatively innocuous anti-Wiggin provision of the House committee bill, which only required ownership reporting and forbade short sales and sales against the box, would not have attracted much attention, but it did. In defending the bill, Sam Rayburn made it clear that his goal was to regulate those in control of publicly held corporations.

Several representatives suggested that the disclosure of sales by substantial stockholders might lead to unwarranted panic, leading to the destruction of values.[361] The committee had considered excluding principal stockholders from the anti-Wiggin bill, and one of its members proposed that the House amend the bill to the same effect.[362] After some debate, Rayburn successfully defended the anti-Wiggin provision of the committee bill, which he called "a very important antimanipulative section," and the amendment was defeated.[363] Rayburn argued that if principal stockholders were excluded, they would simply dominate corporations by choosing and controlling officers and directors. He made clear that his concern was with managers running companies for their own ends to the detriment of public stockholders:

> Here is a man however, who says: "I do not want to be an officer or a director for the reason that if I accept such office I am held under this provision. . . . I will not, therefore, allow myself to be elected an officer; I will not allow myself to be elected a director; but I will stay on the outside, I will control the company, I will manipulate its stock up and down. When it is the proper time to run the market up I will run it up; when it is to my interest to run the market down I will have the power to run it down.[364]

> stock exchanges. . . . The question of the integrity of the management of the corporation is involved; the question of the prudence of the investment represented by the stock is involved.

78 CONG. REC. 7861-62 (1934); *see also id.* at 7864 (Rep. Wolverton), 7866-69 (Rep. Maloney), 7938 (Rep. Milligan); M. PARRISH, *supra* note 21, at 131-32 (Lea's influence).

361. *See, e.g.*, 78 CONG. REC. 7937 (1934) (Rep. Bakewell), 8036 (Rep. Pettengill).

362. 78 CONG. REC. 8036-37 (1934) (Rep. Pettengill); *see also* Amendment intended to be proposed to S. 3420 by Mr. Hebert, 73d Cong., 2d Sess. (May 10, 1934) (limiting anti-Wiggin provision to reporting by officers and directors and forbidding short sales and sales against the box), *reprinted in* 11 LEGISLATIVE HISTORY, *supra* note 31, item 38; Suggested Amendments to H.R. 8720, Submitted by John Dickinson, Assistant Secretary of Commerce 10-11 (Mar. 30, 1934) (copy in Harvard Law School Library, James McCauley Landis Papers, box 1, file 7) ("It is highly questionable in my opinion whether it is necessary or desirable to prevent trading in the stock of a corporation by anyone who owns more than five per cent thereof."); Thel, *supra* note 21, at 453-54 (discussing this memorandum).

363. 78 CONG. REC. 8038 (1934).

364. *Id.* The House then approved an amendment providing that the anti-Wiggin provision would not apply if the predicate registration of an equity security was secured without the consent of the issuer. H.R. 9323, 73d Cong., 2d Sess. § 15(c), *reprinted in* 10 LEGISLATIVE HISTORY, *supra* note 31, item 31; *see also* H.R. REP. No. 1838, *supra* note 143, at 36.

The House passed its bill on May 4, 1934.[365] The Senate then amended the Senate committee's bill in a few respects and passed it in place of the House bill.[366] The Senate floor debate was more substantive than that in the House, but the anti-Wiggin provision was not an important issue. Instead, the Senate focused on the creation of a new regulatory commission and a set of amendments to the Securities Act.[367]

There were substantial differences between the House and Senate conference bills, and the conferees spent most of their time on the margin provisions and on the creation of a new regulatory agency.[368] Section 16 of the conference bill was substantially the same as the Senate bill,[369] and it was enacted.[370]

IV. Implications of the Regulatory Explanation of Section 16

Clearly section 16 was designed to prevent manipulation by corporate insiders and at least some of those who secured the enactment of section 16 thought about it in terms of the separation of ownership and control. It is less clear what to make of all this. The explanation of section 16 offered here may have important implications for the meaning of section 16 and the rest of the Exchange Act, but the meaning of a statute turns as much on institutional values as on the words it employs or the events that led it to be enacted in a particular form. The greatest value of the preceding examination of the operation of section 16 and the way it came to be enacted may lie in the insight it provides into the way legislation should be understood and the importance of individual effort in law reform.

A. Writing and Understanding Statutes

Statutes should be read in historical context. As Felix Frankfurter wrote in describing the Securities Act shortly before the Exchange Act

365. 78 Cong. Rec. 8116 (1934) (bill passed); *see* H.R. 9323, 73d Cong., 2d Sess. (1934), *reprinted in* 10 Legislative History, supra note 31, item 31.

366. 78 Cong. Rec. 8712-14 (1934) (bill passed); *see* H.R. 9323, 73d Cong., 2d Sess. (1934), *reprinted in* 10 Legislative History, *supra* note 31, item 32.

367. The Senate debate is reprinted in 4 Legislative History, *supra* note 31, item 10.

368. *See* H.R. 1383, *supra* note 31 (conference report); 78 Cong. Rec. 10,111 (explanation of Sen. Fletcher), 10,260-66 (statement of House managers and explanation of Rep. Rayburn); M. Parrish, *supra* note 21, at 139-42; J. Seligman, *supra* note 21, at 98-100; D. Levin, *supra* note 21, at 400-02.

369. The conferees added the requirement that any suit to recover short-swing profit be brought within two years of the date such profit was realized. *See* H.R. Rep. No. 1838, *supra* note 143, at 36.

370. 78 Cong. Rec. 10,185 (1934) (Senate); *id.* at 10,269 (House).

was introduced, "Legislation is not anticipation. It is a response, too often a laggard response, to serious need."[371] The Exchange Act was a product of the pervasive unemployment that preoccupied the country in 1934. It was adopted because many people thought that the stock market collapse that began in 1929 had somehow caused the Great Depression. This is not to say that parochial interests did not shape the Exchange Act. The various securities exchanges, commercial bankers, securities dealers, industrialists, and other powerful institutions and individuals tried to shape the Act to protect their interests, and their efforts are clearly reflected in the compromise legislation that was finally enacted. Nonetheless, these interests shaped only the edges of the Exchange Act; the Exchange Act really was supposed to protect the productive economy from the stock market.

Probably just about everyone who knows that the Exchange Act exists would agree that it was passed in response to the Depression, yet the Depression hardly figures in recent academic or judicial discussion of the Act. To say "Of course the Exchange Act was a response to the Depression" and then move on to some particular problem is to miss the point: the Depression was not a matter of course. If Congress had been responding to injured investors, it might have done what conventional wisdom claims was done: made the stock market a level playing field. On the other hand, when finally moved by a profound crisis to take control of what was arguably the country's most powerful and important private institution, Congress would hardly have rested with a statute that did no more than "substitute a philosophy of full disclosure for the philosophy of *caveat emptor*."[372]

This Article argues that the Exchange Act was supposed to protect the productive economy by reducing speculation and manipulation and by aligning the interests of managers with stockholders. Others might argue that the Act was supposed to protect the economy by making the stock market work more efficiently, whether by eliminating wasteful practices or by improving the market's product—security prices. Maybe the Act was supposed to do all of this. No matter what the Act was supposed to do, though, it is necessary to bear in mind the circumstances in which the Act became law to make sense of it.

The history of section 16 also shows that even when reformers convince the legislature that reform is necessary, someone must craft a statute carefully if reform is to occur. The enactment of section 16

371. Frankfurter, *supra* note 258, at 53.

372. Santa Fe Indus. v. Green, 430 U.S. 462, 477 (1977) (quoting Affiliated Ute Citizens v. United States, 406 U.S. 138, 151 (1972) (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963))).

was an interesting example of law reform.[373] Adolf Berle eventually claimed the Exchange Act was at least partly his on the basis of *The Modern Corporation*,[374] yet the book did not propose anything like the Exchange Act, and Berle did not help to write the Act. Berle did make an important contribution to the Act and to section 16. With Means, he showed that something had to be done about the separation of ownership and control in the publicly held corporation. What Berle and Means did not do was identify the solution. *The Modern Corporation* did not set out an agenda,[375] and little of the particular technique eventually incorporated in section 16 can be traced to the book or to any of Berle's other works.[376] More than any other provision of the Exchange Act, section 16 emphatically rejects the collectivist ideology usually attributed to Berle.[377]

After the problem of management manipulation was identified, it remained to be solved. More than anything else, the drafters of the Exchange Act knew how to solve problems. Sam Rayburn, Benjamin Cohen, and Thomas Corcoran have been widely recognized for their ability to get legislation enacted.[378] James Landis supplemented their talents by focusing on crafting sanctions and enforcement devices to implement policy choices. Landis is best known today for his contributions to the theory and practice of administrative law.[379] He started his career, however, as a professor of legislation, and he became in-

373. Commentators often explain the early New Deal as a conflict between two schools: one, characterized by Adolf Berle, favoring national planning and the other, characterized by Frankfurter, favoring a more conservative individualism. *See* J. SELIGMAN, *supra* note 21, at 39-42 (Berle), 58-59 (Frankfurter). This explanation may be simplistic, but section 16 was influenced strongly by both schools.

374. A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY at vii, 253 n.* (rev. ed. 1968); Berle, *Modern Functions of the Corporate System*, 62 COLUM. L. REV. 433, 437 (1962); *see also* J. SCHWARZ, *supra* note 46, at 61 (crediting THE MODERN CORPORATION with laying the foundation for reform).

375. *See* McCraw, *supra* note 45, at 8 (discussing lack of concrete suggestions for reform).

376. Berle and Means did criticize trading by officers and directors whose possession of nonpublic information gave them "a tremendous advantage in speculating in the securities" of the corporation over the public. They thought the solution lay in requiring public corporations to disclose information and concluded that "[a]s the standards of disclosure of corporate affairs become more exacting, the problem of the directors and managers in the market will become increasingly less important." A. BERLE & G. MEANS, *supra* note 31, at 330.

377. *See* J. SCHWARZ, *supra* note 46 (characterizing Berle's solution to the problem of bigness: "Big corporations should be regulated by a supreme national power in Washington that liberated Americans from economic oligarchy and broadened wealth without altering the essentials of American individualism.").

378. *See supra* notes 221-222 and accompanying text.

379. *See* J. LANDIS, THE ADMINISTRATIVE PROCESS (1938); *see also* G. CALABRESI, A COMMON LAW FOR THE AGE OF STATUTES 85-86 (1982) (Landis's powerful contribution to the understanding of statutes).

volved in drafting the federal securities statutes because of his expertise with statutes.[380]

What distinguished Landis as both statute writer and administrator was his recognition of "the importance of matching the sanctions to the problems."[381] One of his biographers credits him with originating "the fundamental SEC strategy of manipulating private incentives to serve public ends."[382] A refined set of incentives along the lines of section 16 is exactly the sort of device Landis would have used to regulate corporate management. Section 16 nonetheless stands apart from the rest of the Exchange Act. Everywhere else in the Act, administrators are trusted to accomplish reforms. In stark contrast, section 16 takes an approach one might find in the common law, creating a set of rules like those that govern fiduciaries.

In devising this solution, the drafters had to deal with what to them probably seemed a profoundly unsettling new problem. They were sensitive enough to its implications that they did not try to force their preferred solution of delegation on it. Nor did they propose to punish errant affiliates or subject their affairs to review by courts or bureaucrats. Instead, recognizing that prevention is cheaper than cure, they tried to eliminate the incentive for mismanagement that they thought attended the separation of ownership and control.[383] In short, their contribution was to put care and energy into solving a problem that others had identified.

380. *See* Landis, *Statutes and the Sources of Law,* in HARVARD LEGAL ESSAYS 213 (R. Pound ed. 1934). Landis first became involved with federal securities regulation when Felix Frankfurter asked him to help draft what became the Securities Act because of his study of legislation. N. DAWSON, LOUIS D. BRANDEIS, FELIX FRANKFURTER, AND THE NEW DEAL 79 (1980); Landis, *supra* note 254; *see also supra* note 256 and accompanying text.

381. T. MCCRAW, *supra* note 219, at 175; *see also supra* note 257 and accompanying text (Landis's study of the use of sanctions to bring about conformance with statutory mandates).

382. T. MCCRAW *supra* note 219, at 195.

383. *See* Douglas, *supra* note 42, at 1322-23:

> [I]t is timely to consider the corrective measures necessary if the board is to be employed as a medium for the protection and enhancement of the interests of the corporation and the stockholders, rather than as a convenient device for the exercise of economic and political power for the selfish interests of those who happen to be in a position of dominance. . . . The problem then becomes one of making as explicit as possible the various types of situations to be controlled. The record of the last decade has revealed most of them. Specific statement in a statute, within minimal and practicable limits, has several advantages. . . . This leaves the difficult, and in spots the insoluble, problem of designing methods of control which will be both just and fair from the viewpoint of directors and efficient from the viewpoint of investors. In that connection our remedies should not be as hysterical as the practices which made the demand and need for regulation insistent. Prevention will prove more wholesome than punishment. It is a rebuke to our skill and judgment if we cannot effect competent police measures without driving from the field of enterprise the men of greatest competence and substance.

The current movement to reform the governance of publicly held corporations suggests the measure of their task. Some reformers have gotten bogged down in trying to draft precise standards by which to judge corporate officers and directors.[384] Other reformers have desired to shift control of publicly held corporations from management to some other group, whether stockholders, employees, or the state, but have failed to accomplish their agenda. This failure is hardly surprising, for conferring great power on anyone is suspect in a democracy,[385] and most reformers would not be interested in publicly held corporations were they not confident that such corporations are powerful.[386]

Section 16 approached the problem of publicly held corporations more pragmatically. It undertook to reduce the opportunity for those in control of publicly traded corporations to abuse their power, and it accomplished this change at minimal political cost. It did not shift power over publicly held corporations to some other group of persons, and it did not subject managers to review by others.[387] The reform simply undertook to prevent managers from abusing their power over publicly held corporations. Since everyone agreed that those corporations did not belong to their managers, it was hard for anyone to quarrel with section 16. Despite its broad implications, section 16 was enacted in substantially the same form in which it was first proposed.[388] The drafters took a situation that everyone saw as a problem, and without calling any more attention to it than necessary, they forged a solution. It may be that the separation of ownership from control in fact did not harm anyone, but when the Exchange Act was passed most people thought it did. One lesson of section 16 is that identifying a problem is not enough; it is equally important to construct effective and politically palatable solutions. This work need not arouse con-

384. *See* Dent, *supra* note 45, at 882.

385. *See* J.W. Hurst, Law and Social Order, *supra* note 50, at 242 ("The constitutional ideal, a stubbornly enduring part of the country's political tradition, insisted that all forms of private and public power should be accountable to others than the powerholders."); Chayes, *The Modern Corporation and the Rule of Law,* in The Corporation in Modern Society 25, 31 (E. Mason ed. 1959). *See generally* J.W. Hurst, Legitimacy, *supra* note 53. State antitakeover laws may owe their political success to the fact that they typically leave control where it is, in management. *See* Johnson & Millon, *Missing the Point About State Takeover Statutes,* 87 Mich. L. Rev. 846 (1989).

386. *See* Manning, *Thinking Straight About Corporate Law Reform,* 41 Law & Contemp. Prob. 3, 9-27 (1977) (nine species of corporate law reform).

387. The reporting requirements of § 16(a) may be an exception. Like the proxy provisions of the Exchange Act, they were presumably intended to shift control or provide for its monitoring. *See supra* note 57 and accompanying text.

388. In this, § 16 was almost alone among the provisions of the Exchange Act. *See* J. Seligman, *supra* note 21, at 100.

troversy. On the contrary, the key to success may often lie in conciliation.

B. The Operation of Section 16

Although it is usually clear how section 16 is supposed to work, occasionally courts have to decide what specific terms mean in order to apply it in specific cases.[389] Courts often turn to what they call legislative intent or purpose for guidance in construing statutes,[390] and they have done so in construing the federal securities laws.[391] The task of construing a statute to achieve the goals of Congress is a difficult one in any case, but it is complicated especially in a section 16(b) case because Congress expressly stated a purpose in the statute. Powerful arguments can be made for respecting such a stated purpose.[392] If courts and administrators take Congress at its word, it may be easier for Congress to express itself and for members to understand what they are deciding, and sponsors of legislation may find it more difficult to hide what they are doing from the public. On the other hand, there is reason to interpret statutes on the assumption that legislation is enacted by reasonable people. Since section 16 works to improve the way corporations do business and the history of its enactment suggests that Congress wanted to improve business, one can argue that section 16 should be construed to effectuate this implicit—albeit hidden—purpose.

389. *See* 2 L. Loss, *supra* note 2, at 550 ("There is no rule so 'objective' ('automatic' would be a better word) that it does not require some mental effort in applying it on the part of the person or persons entrusted by law with its application.") (*quoting* Blau v. Lamb, 363 F.2d 507, 520 (2d Cir.), *cert. denied,* 385 U.S. 1002 (1966)); *see also* R. CLARK, *supra* note 4, § 8.6 (discussing case law by focusing on the statutory terms "beneficial owner," "equity security," and "any profit").

390. G. CALABRESI, *supra* note 379, at 6 n.27 ("interpretation is defined conventionally as a search for original legislative intent").

391. *See, e.g.,* Schreiber v. Burlington N., Inc., 472 U.S. 1, 8-12 (1985); Marine Bank v. Weaver, 455 U.S. 551, 555-59 (1982); Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477-78 (1977); United Hous. Found., Inc., v. Forman, 421 U.S. 837, 849-51 (1975); Tcherepnin v. Knight, 389 U.S. 332, 345-46 (1967); SEC v. Ralston Purina Co., 346 U.S. 119, 124-25 (1953); SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946). *See generally* Chang, *Meaning, Reference, and Reification in the Definition of a Security,* 19 U.C. DAVIS L. REV. 403, 404 (1986) (cases interpreting statutory definitions of society have relied on legislative history and the purposes of the securities acts for guidance); Karjala, *Federalism, Full Disclosure, and the National Markets in the Interpretation of Federal Securities Law,* 80 Nw. U.L. REV. 1473, 1474-75 (1986) (discussing how judicial interpretation of the Exchange Act frustrates legislative purpose).

392. *See* Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model,* 86 COLUM. L. REV. 223 (1986) (traditional approach to statutory interpretation best furthers public goals).

A discussion limited to section 16 probably cannot show whether courts dealing with statutes should try to accomplish the goals of Congress or how courts should determine such goals if they choose to. An exploration of statutory interpretation is beyond the scope of this Article.[393] Nonetheless, section 16 offers a rich opportunity for study, since the SEC and the courts can choose between at least two purposes when looking for guidance or support in interpreting section 16. To the extent that the scope of section 16 is to be determined by its purpose, that choice may be critical. Accordingly, it may be appropriate to illustrate the interaction of the competing purposes of section 16 that have been identified here.

Courts have often cited the expressed purpose of preventing traders from using inside information to support their constructions of section 16(b). They have sometimes applied section 16 expansively so as to prevent insiders from profiting from inside information, and they have sometimes construed it as not applying to principal stockholders who they have concluded could not have had access to inside information.[394] The scope of section 16 might be different had courts recognized it as a tool to prevent the manipulation of corporate affairs by those seeking to create trading opportunities.

Consider, for example, the apparently simple interpretation of the meaning of "officer." Section 16 requires officers of issuers with registered equity securities to file ownership and trading reports, forbids them to sell short or against the box, and provides that any profits they realize from short-swing trading will inure to their companies. The word "officer" is not defined in the statute, however, and in some cases it is difficult to determine whether a person is an officer.[395] If

393. For recent examples of treatment of the issue of legislative intent, see Posner, *supra* note 339; Sunstein, *Interpreting Statutes in the Regulatory State,* 103 HARV. L. REV. 405 (1989); *Symposium: The First Annual Federalist Society Lawyers Convention,* 11 HARV. J.L. & PUB. POL'Y 1 (1988).

394. *See, e.g.,* Foremost-McKesson, Inc. v. Provident Sec. Co., 423 U.S. 232, 249-52 (1976) (construing "at the time"); Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 593-98 (1973) (construing "sale"); Blau v. Lehman, 368 U.S. 403 (1962) (construing "director"); Chemical Fund, Inc. v. Xerox Corp., 377 F.2d 107, 110-12 (2d Cir. 1967) (construing "class of equity security"); Colby v. Klune, 178 F.2d 872, 873 (2d Cir. 1949) (construing "officer"); Smolowe v. Delendo Corp. 136 F.2d 231, 235-36 (2d Cir.) (construing "any profit"), *cert. denied,* 320 U.S. 751 (1943). *But see* Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418, 423-27 (1972) (construing "at the time"). *Chemical Fund* is an especially interesting example. *See* R. CLARK, *supra* note 4, at 298-99; 2 L. Loss, *supra* note 2, at 576-78.

395. *See generally* 2 L. Loss, *supra* note 2, at 564-65 (discussing the definition of officer for § 16); Comment, *Section 16(b) of the Securities and Exchange Act of 1934: Is a Vice President an Officer?,* 58 NEB. L. REV. 733 (1979) (authored by David E. Gardels) (discussing eight cases construing "officer"); Comment, *Who Is an "Officer" Under Section 16(b)—Who*

Congress created section 16 to prevent trading on the basis of inside information, Congress' purpose will be served best by construing the term "officer" to mean employees with access to confidential information.[396] On the other hand, if Congress created section 16 to align stockholder and management interests, the term should encompass only the smaller group of those with influence over corporate operating policies.[397]

This is only one example of the way competing visions of the statute may come into conflict in defining the scope of section 16.[398]

Knows?, 12 SAN DIEGO L. REV. 378, 379 (1975) (authored by A. John Murphy) (discussing various tests that are applied to construe "officer").

396. Colby v. Klune, 178 F.2d 872, 873 (2d Cir. 1949).

397. The SEC has proposed to define the term officer in this manner for purposes of § 16. Proposed rule 16a-1(f), 4 FED. SEC. L. REP. (CCH) ¶ 26,013, at 19,031 (certain executive officers and "any other officer who performs a policy-making function"); *see also* Exchange Act Release No. 27,148 (Aug. 17, 1989), *supra* note 6, at 80,383-84; *cf.* rule 3b-2; 17 C.F.R. § 240.3b-2 (1988) (definition of officer).

398. Another example is suggested by Blau v. Lehman, 368 U.S. 403 (1962). The question in that case was whether an investment banking firm had to forfeit profits from short-swing trading in the stock of a corporation when one of its partners was a director of the corporation. *Id.* at 404-05. The Supreme Court said that a partnership can be a director for purposes of § 16(b) if it has deputized one of its members to serve as director. *Id.* at 409-10. There was no deputization in the case before the Court, however, because the partner-director did not participate in the partnership's trading profits and adequate steps had been taken to ensure that he did not pass corporate information to the partnership. *Id.* at 406-08. If the Court had seen the purpose of § 16 as focusing the attention of management on long-term corporate profitability, it might have approached the case differently. Even if the partner-director did not influence the partnership's trading decisions, he might have tried to manipulate the corporation's operations for the purpose of benefiting his partners had he known of their position or their trading plans.

Yet another example is § 16(b)'s exclusion of transactions "where such beneficial owner [of more than 10% of a registered class of equity securities] was not such both at the time of the purchase and sale . . . of the security." In *Foremost-McKesson*, 423 U.S. 232 (1976), the Court held that where a defendant holds less than 10% immediately before a purchase it does not have to forfeit profits sales within six months. This holding might have been based on the language of the statute, but the Court focused instead on the purpose of the statute. According to the Court, § 16(b) does not apply to a stockholder until after it exceeds 10% beneficial ownership, because only at that point did Congress presume it would have access to inside information. *Id.* at 253-54. The Court might have reached a different conclusion had it seen § 16 as a corporate governance provision. Even if a substantial buyer does not have access to information, it may by virtue of its purchase alone influence the operations of the issuer. For example in *Reliance Electric*, 404 U.S. at 420, the beneficial owner's initial purchase led to the issuer's merger into another company, presumably with substantial consequences for its operations. Thus the statute might be construed to match the trade by which a person becomes a 10% holder with subsequent dispositions if the point of forfeiture is to assure that managers devote themselves to profitable operations. This example underscores the fact that agreement on a statute's purpose does not determine interpretive questions. Even if a court accepted that § 16 is a corporate governance measure, it would have to decide whether to extend forfeiture to cases that raise the possibility of manipulation by non-trading officers and directors in hostile response to trading principal stockholders. This possibility may not have

Even when the courts apply section 16(b) "automatically" and no questions of statutory construction or interpretation seem to be involved, the nominal purpose of section 16 (preventing the unfair use of inside information) and the actual purpose of the drafters (preventing manipulation by managers) conflict.[399] Courts have consistently refused to condition forfeiture under section 16(b) on proof that the defendant-insider had inside information when she traded.[400] When courts order forfeiture without considering whether an affiliate in fact took advantage of inside information, they effectuate the congressional intention that is reflected in the operative terms of the statute, which does not call for such consideration. Yet reflexively ordering an affiliate who did not know any secrets to forfeit her profits sometimes imposes a significant burden without furthering the stated purpose of preventing the unfair use of information. This incongruity has led to repeated calls to amend section 16(b) to better serve its stated goals.[401] As noted above, it has also led the Supreme Court to construe section 16 narrowly to avoid forfeiture in so-called unorthodox transactions in which there is supposedly no possibility of abuse of inside information.[402]

Legislators sometimes buy easy statutory administration at the price of occasional unfairness,[403] and Congress certainly might have decided to accept the occasional unfairness of the strict rule articulated in section 16(b) because a strict rule would best achieve its goal, whatever that goal was. Just as certainly, at some point judges should refuse to apply Congress' flatly stated rule when the prophylactic effect

occurred to anyone in 1934, and even if it did, clearly the drafters were concerned primarily with the possibility that officers, directors, and principal stockholders might manipulate corporate affairs to further their own trading schemes. *See* R. CLARK, *supra* note 4, § 8.7 ("[t]akeovers, as a species of recurring corporate behavior, only became common and salient after [§ 16] was passed."); Block & Barton, *supra* note 6, at 204 (§ 16(b) is ineffective in handling problems associated with corporate takeovers); *cf.* Ribstein, *supra* note 12, at 504-05 (§ 16(b) should not apply to tender offerors who are outsiders). This application is remarkably similar to the controversial new Pennsylvania anti-takeover statute, which speaking broadly, requires control persons to disgorge short-term profits. 15 PA. CONS. STAT. §§ 2573, 2574 (1990); *cf.* 76 A.B.A. J. 24 (1990) (quoting one of the drafters to the effect that the disgorgement provision, the most controversial in the new statute, is "new and novel and untested").

399. *Cf.* D'Amato, *Aspects of Deconstruction: The "Easy Case" of the Under-Aged President,* 84 Nw. U.L. REV. 250 (1989) (there are no real easy cases).

400. This was settled by Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir.), *cert. denied,* 320 U.S. 751 (1943).

401. *See, e.g.,* Munter, *supra* note 12, at 96; *cf.* Weinstock, *Section 16(b) and the Doctrine of Speculative Abuse: How to Succeed in Being Subjective Without Really Trying,* 29 BUS. LAW. 1153 (1974) (definition of purchase and sale).

402. *See supra* note 394; *see also* 2 T. HAZEN, *supra* note 12, at 19-20 n.1, 37 n.1 (bibliography of law review commentary).

403. R. CLARK, *supra* note 4, at 296.

of application does not justify imposing an outrageous burden on a real person. To know whether they are facing an outrageous case, judges have to know what it was that Congress wanted to achieve; sometimes tolerating a particular unfair result may help align management and stockholder interests in the long run but not prevent the unfair use of information (and vice versa).

Judging only the operative terms of the statute, one would never conclude that Congress adopted an arbitrary rule because it thought that was the best way to prevent the unfair use of information. On the contrary, judging only on the operative terms, Congress intended to align management and stockholder interests. The reflexive application of section 16(b) will further the congressional purpose reflected in the operative terms of the statute in the long run. The "plain meaning" of section 16(b) seems to dictate a refusal to inquire into what the defendant knew or might have known; however, over the long run that refusal furthers a legislative purpose (preventing manipulation) different from the one stated in the statute (preventing the unfair use of inside information).[404] The refusal to make insiders who trade on the basis of inside information over six months and a day forfeit their profits also furthers the purpose of Congress that is implicit in the way the statute operates, rather than the purpose that is stated in the statute.

C. The Compass of Federal Securities Regulation

The conventional wisdom that Congress created section 16 to ensure equal access to corporate information is mirrored in the conventional statement that "the fundamental purpose of the [Exchange] Act [is] to 'substitute a philosophy of full disclosure for the philosophy of *caveat emptor*.'"[405] If the Exchange Act is essentially a mandate for full disclosure, then it has little role to play in the way corporations are run; on the contrary, Congress "did not seek to regulate transactions which constitute no more than internal corporate mismanagement."[406]

404. *Cf.* Meeker & Cooney, *supra* note 12, at 958 ("[T]he desirability of preventing conflict between the insider's interests and his duties, as well as the express purpose of preventing the unfair use of inside information, might suggest an application of the statute to all cases which may come literally within its scope.").

405. Santa Fe Indus. v. Green, 430 U.S. 462, 477 (1977) (quoting Affiliated Ute Citizens v. United States, 406 U.S. 138, 151 (1972) (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963))).

406. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971) (discussing § 10(b)); *see also* Schreiber v. Burlington N., Inc., 472 U.S. 1, 12 (1985) (Congress did not

Settled doctrine notwithstanding, section 16 does regulate internal corporate affairs, and at least some members of Congress did seek to regulate corporate management in the Exchange Act. Section 16 is not the only provision of the Exchange Act that was designed to protect the productive economy from selfish managers and the effects of disruptive stock market practices. Some provisions, most obviously those that provided for the regulation of proxy solicitations, contemplated the regulation of information flow toward the end of controlling business operations and changing the way publicly held corporations are run.[407] Others, such as the provisions providing for the regulation of credit used in stock market operations,[408] contemplated direct substantive regulation of practices that were thought to have undermined economic growth and efficiency.[409] Whatever accounts for the change in prevailing views,[410] securities regulation under the Exchange Act has evolved in ways that probably could not have been foreseen when the Act was enacted.

The changing conceptions of the purpose of the Exchange Act have not always worked to limit the scope of federal involvement in the securities markets and corporate affairs. Consider the way that the SEC and the courts have regulated insider trading under rule 10b-5. The issue is largely academic now,[411] but there are problems with the

intend, through § 14(e), to have courts judge fairness of tender offers); CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 78-87 (1987); *Santa Fe,* 430 U.S. at 479 ("Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law *expressly* requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.") (quoting Cort v. Ash, 422 U.S. 66, 84 (1975)). For a particularly broad statement in a related context, see Schotland, *supra* note 67, at 1452 ("The corporation's welfare probably is not a consideration cognizable under the federal securities laws, which focus upon disclosure and not upon the internal running of the corporation."). *Compare* Anderson, *The Meaning of Federalism: Interpreting the Securities Exchange Act of 1934,* 70 VA. L. REV. 813 (1984) *with* Kitch, *A Federal Vision of the Securities Laws,* 70 VA. L. REV. 857 (1984) (responding to Anderson).

407. *See* J.W. HURST, LEGITIMACY, *supra* note 53, at 94-95; Dent, *supra* note 45; Thel, *supra* note 21, at 396-415. Even the issuer reporting requirements that epitomize the disclosure-orientation of the Exchange Act, 15 U.S.C. § 78m (1983), represented an intrusion into internal corporate affairs that had not theretofore been the subject of state law. There is some debate over whether publicly held corporations were prepared to disclose information themselves, but clearly corporations were free to keep secrets before Congress acted. *See supra* notes 77-93 and accompanying text.

408. Exchange Act §§ 7, 8, 15 U.S.C. §§ 78g, 78h (1988).

409. *See generally* 2 L. Loss, *supra* note 2, at 652-53 (discussing Exchange Act's credit provisions). In addition, the Act provides for pervasive substantive regulation of the securities industry. *See, e.g.,* Exchange Act §§ 15, 17, 15 U.S.C. §§ 78*o*, 78q (1988).

410. For one tentative explanation, see Thel, *supra* note 21, at 461-64.

411. Congress has effectively ratified regulation of insider trading under rule 10b-5. *See supra* note 4 (recent insider trading legislation).

SEC's regulation of conduct that Congress was entirely capable of regulating in an area in which Congress enacted a pervasive regulatory scheme.[412]

Congress intended to confer broad authority on the SEC when it enacted section 10(b) of the Exchange Act,[413] but no matter how broad the SEC's regulatory authority may have been, it is a stretch to say it extended to forbidding conduct Congress specifically declined to forbid. During the debate over the Exchange Act, proposals to make it illegal for insiders or tippees to trade while in possession of material, nonpublic corporate information were considered and rejected.[414] The enacted statute regulated trading by insiders, and it did not forbid them to trade on the basis of inside information. Moreover, the drafters and their sponsors knew that insiders could continue to trade legally on the basis of inside information so long as they complied with section 16. The House Commerce Committee report recognized that the reporting provisions of its anti-Wiggin provision "are not air-tight and that the unscrupulous insider may still, within the law, use inside information for his own advantage."[415]

On the other hand, Congress created the SEC and gave it extensive rulemaking power because it wanted the statute to be flexible enough to deal with a complicated and evolving business environment. Perhaps the SEC should regulate insider trading if it has determined that it is wrong for insiders to trade on the basis of inside information. Congress intended the SEC to decide what practices needed regulating,

412. *See* H. MANNE, *supra* note 18, at vi, 13, 30; Dooley, *supra* note 5, at 55-56 ("By proceeding without due regard for the legislative process the courts and the SEC have produced a system that is unjust and inefficient. These undesirable consequences result from the dissonance between the courts' purposes in regulating insider trading under section 10(b) and the purposes for which that statute was enacted."); Easterbrook, *supra* note 66, at 317-20 (the courts have read SEC rules more expansively than warranted); Manne, *Insider Trading and the Administrative Process,* 35 GEO. WASH. L. REV. 473, 491-92 (1967); Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?,* 57 NW. U.L. REV. 627, 652-54 (1962); *cf.* Kitch, *supra* note 406, at 861 (Congress could have promulgated rule 10b-5 itself).

413. *See* Thel, *supra* note 21.

414. *See, e.g.,* Suggested Amendments to H.R. 8720, Submitted by John Dickinson, *supra* note 362, at 11 ("I suggest that Section 15b . . . be amended by . . . substituting the following: 'Any profit realized by such beneficial owner, director or officer from any purchase and sale, or sale and purchase, of any such equity security as a result of information available to him only in his character of such beneficial owner, director, or officer, shall inure to and be recoverable by the issuer.'"); *see also supra* notes 283-291 and accompanying text.

415. H.R. REP. No. 1383, *supra* note 31, at 13; *see also House Hearings, supra* note 85, at 134 (testimony of Thomas Corcoran) ("'You cannot sell your own stock short. If you know from your information that the company is in a bad way, be honest and sell your stock and get out and do it publicly.'"); *Stock Exchange Practices, supra* note 31, at 7742 (comment of Pecora) (an insider can profit from inside information provided his transactions are more than six months apart).

and maybe in the last fifty years issues of fairness in the securities markets have become more important than issues of economic efficiency. Moreover, if Congress was primarily interested in regulating the way corporations do business when it enacted section 16, it is somewhat artificial to say that Congress made a conscious decision not to adopt an equality-of-information rule. Critics of rule 10b-5 have argued that forbidding insider trading undercuts the efficient operation of corporations. If they are right, maybe it is incumbent on the SEC to use its discretionary power to modify the regulatory scheme, in which case the challenge to rule 10b-5 comes down to a simple criticism of the policy the SEC has chosen to pursue. If the issue is one of administrative power, however, critics should address it with sensitivity to what Congress actually did.

Appendix: The text of section 16

DIRECTORS, OFFICERS, AND PRINCIPAL STOCKHOLDERS

Sec. 16. (a) Every person who is directly or indirectly the beneficial owner of more than 10 percentum of any class of any equity security (other than an exempted security) which is registered pursuant to section 12 of this title, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security on a national securities exchange or by the effective date of a registration statement filed pursuant to section 12(g) of this title, or within ten days after he becomes such beneficial owner, director, or officer, a statement with the Commission (and, if such security is registered on a national securities exchange, also with the exchange) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been a change in such ownership during such month, shall file with the Commission (and if such security is registered on a national securities exchange, shall also file with the exchange), a statement indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

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

(c) It shall be unlawful for any such beneficial owner, director, or officer, directly or indirectly, to sell any equity security of such issuer (other than an exempted security), if the person selling the security or his principal (1) does not own the security sold, or (2) if owning the security, does not deliver it against such sale within twenty days thereafter, or does not within five days after such sale deposit it in the mails or other usual channels of transportation; but no person shall be deemed to have violated this subsection if he proves that notwithstanding the exercise of good faith he was unable to make such delivery or deposit within such time, or that to do so would cause undue inconvenience or expense.

(d) The provisions of subsection (b) of this section shall not apply to any purchase and sale, or sale and purchase, and the provisions of subsection (c) of this section shall not apply to any sale, of an equity security not then or theretofore held by him in an investment account, by a dealer in the ordinary course of his business and incident to the establishment or maintenance by him of a primary or secondary market (otherwise than on a national securities exchange or an exchange exempted from registration under section 5 of this title) for such security. The Commission may, by such rules and regulations as it deems necessary or appropriate in the public interest, define and prescribe terms and conditions with respect to securities held in an investment account and transactions made in the ordinary course of business and incident to the establishment or maintenance of a primary or secondary market.

(e) The provisions of this section shall not apply to foreign or domestic arbitrage transactions unless made in contravention of such rules and regulations as the Commission may adopt in order to carry out the purposes of this section.