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- Section 16(b) - Corporation Liable as a Director
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Cir. 1969), *petition for cert. filed*, 38 U.S.L.W. 3018
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Recent Decisions

SECURITIES EXCHANGE ACT OF 1934 — SECTION 16(b) — CORPORATION LIABLE AS A DIRECTOR

Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir. 1969),
petition for cert. filed, 38 U.S.L.W. 3018 (U.S. May 16,
1969) (No. 125).

The Securities Exchange Act of 1934¹ was intended to establish and maintain a free and honest market for trading in corporate securities.² In enacting such legislation, Congress was particularly sensitive to the abuses inherent in insider trading. The Act therefore places restrictions upon corporate insiders who, by reason of their relationship to the corporation, can abuse their position and use information not made public to benefit their personal market activities.³ Section 16(b) of the Act⁴ is specifically designed to discourage directors, officers, and large shareholders of the issuer from speculating in short-term trading of the issuer's securities. It operates to achieve this purpose by preventing any director, officer, or 10 percent shareholder from realizing any profit on the purchase and sale, or the sale and purchase of the corporation's equity securities within a period of less than 6 months. To enforce its prohibition, section 16(b) provides that any profits made by such persons shall inure to and be recoverable by the issuer in a suit brought by the issuer or on behalf of the issuer by one of its shareholders.⁵ Within the framework of this statutory mandate, the recent case of

¹ 15 U.S.C. § 78a *et seq.* (1964).

² *See* 15 U.S.C. § 78b (1964).

³ In recognition of the widespread abuse of the corporate privilege, the SEC emphasized in *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), that "[a] significant purpose of the Exchange Act was to eliminate the idea that the use of inside information for personal advantage was a normal emolument of corporate office." *Id.* at 912 n.15. *See also* Comment, *Securities Regulation: Insider Status in Legal Fiction and Financial Fact — A Proposed Revision to Section 16(b)*, 50 CAL. L. REV. 500, 508 (1962).

⁴ 15 U.S.C. § 78p(b) (1964).

⁵ Section 16(b) provides:

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer . . . any profit realized by him from any purchase or sale, or any sale or purchase, of any equity security of such issuer . . . within any period of less than six months . . . shall inure to and be recoverable by the issuer . . . 15 U.S.C. § 78p(b) (1964).

Section 16(b) also provides that a stockholder may institute an action if the corporation "shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter . . ." 15 U.S.C. § 78p(b) (1964). In the latter regard, it should be noted that such a suit differs from a shareholder's derivative action. *See* 2 L. LOSS, *SECURITIES REGULATION* 1045-46 (1961).

*Feder v. Martin Marietta Corp.*⁶ raises the question of whether a corporation is subject to section 16(b) liability *as a director* when its board chairman sits as a director of another corporation whose securities the first corporation then purchases and sells within 6 months.

During the fall and winter of 1962, George M. Bunker, chairman of Martin Marietta's (Martin) board of directors, twice declined invitations extended by Sperry Rand Corporation (Sperry) to sit on Sperry's board of directors. Bunker, however, accepted a third invitation and on April 29, 1963, became a Sperry director. At such time, Martin owned 700,000 shares of Sperry stock;⁷ subsequently, during the period of Bunker's dual role as chairman of Martin's board and as a Sperry director, Martin acquired an additional 101,300 shares of Sperry. On August 1, 1963, Bunker resigned from Sperry and approximately 1 month thereafter, Martin sold all of its Sperry stock. In a stockholder's action instituted on behalf of Sperry, plaintiff sought to recover profits made by Martin on 101,300 shares of Sperry stock acquired during Bunker's 3-month tenure as a Sperry director and sold within 6 months after purchase. Plaintiff alleged that Martin's financial stake in Sperry, Bunker's control over Martin's investments, and Bunker's role as a Sperry director were evidence that Bunker was empowered to act as a deputy for Martin and to represent its interests on Sperry's board. Plaintiff argued that since this enabled Martin to become privy to inside information concerning Sperry and thereby actually function through Bunker as a Sperry director, Martin should be considered a "director" for the purposes of section 16(b) liability. Defendants contended that because Sperry rather than Martin took the initiative to secure Bunker's directorship, and because Bunker had neither reported back to Martin on the affairs of Sperry nor received instructions from Martin regarding his conduct as a Sperry director, the evidence failed to establish that Martin had "deputized" Bunker. However, even assuming that Bunker was Martin's deputy and that Martin thereby became a Sperry "director" under section 16(b), Martin argued that SEC Rule 16a-10⁸ exempted Bunker from director's liability and that Martin should be similarly exempt.

⁶ 406 F.2d 260 (2d Cir. 1969), *petition for cert. filed*, 38 U.S.L.W. 3018 (U.S. May 16, 1969) (No. 125).

⁷ When Sperry initially invited Bunker to join its board, Martin owned no Sperry stock. However, when Sperry extended another offer 2½ months later, Martin held 400,000 shares of Sperry stock. 406 F.2d at 264.

⁸ 17 C.F.R. § 240.16a-10 (1968).

The district court found as a matter of fact that Martin was not subject to section 16(b) liability because it had not deputized Bunker.⁹ The Second Circuit, however, reversed the lower court, finding that Martin had deputized Bunker to represent its interests as a Sperry director and that therefore Martin assumed director's liability under section 16(b) for its short-swing profits.¹⁰ In determining whether Martin was exempt from such liability, the court held that SEC Rule 16a-10 was an invalid exercise of SEC power because it was in derogation of the statutory mandate of section 16(b).¹¹ Thus, since Bunker himself would not have been exempt from liability by virtue of SEC regulations, the court held that Martin likewise was not exempt.

Considering the deputization issue first, the court of appeals demonstrated an initial reluctance to expand the scope of section 16(b) to cover persons other than directors.¹² However, the court pointed to the judicial tendency to liberally construe other terms of the statute as illustrating the necessity for expanding the literal reach of section 16(b). Premised upon the need to apply the statute consistent with the legislative purpose,¹³ and relying upon the

⁹ *Feder v. Martin Marietta Corp.*, 286 F. Supp. 937 (S.D.N.Y. 1968).

¹⁰ In *Blau v. Lehman*, 368 U.S. 403, 408-09 (1962), the Supreme Court suggested that a finding of deputization is solely a question of fact. The court in *Martin Marietta* therefore limited its review of the lower court's findings to the "unless clearly erroneous" standard. FED. R. CIV. P. 52(a). Under this test, the reviewing court may not reverse the lower court if it merely draws inferences contrary to the lower court's; rather, the court must be left with a firm conviction that a mistake was committed below. 406 F.2d at 263. In reversing under this standard, the Second Circuit emphasized facts it considered more germane and which were ignored by the district court. *Id.* at 264. In view of the discretion left to the appellate court by making the deputization question turn solely upon its emphasis of particular facts without a full review of the applicable principle of law, it is not surprising that the deputization concept has been criticized because it lends itself to "disparate interpretations of the same facts by different judges." Comment, *supra* note 3, at 500 n.3.

¹¹ See text accompanying notes 36-37 *infra*.

¹² In evidencing this reluctance, the court stated that "the policy underlying the enactment of § 16(b) does not permit an expansion of the statute's scope." 406 F.2d at 262. But, then, somewhat inconsistently, the court stated that the courts have seen fit to construe section 16(b) consistent with its underlying purpose, "even departing where necessary from the literal statutory language." *Id.* Such legal jargon would only seem to confuse the issue, and the court would have fared better to have forthrightly admitted that it is necessary, at times, to go beyond the literal language of section 16(b) in order to preserve the strength of its edict.

¹³ The courts have scrupulously sought to close loopholes in section 16(b) by rendering a liberal interpretation to its terms. *Colby v. Klune*, 178 F.2d 872, 873 (2d Cir. 1949) (person performing function of an officer, although not officially one, held an "officer"); *Smolowe v. Delendo Corp.*, 136 F.2d 231, 239 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943) (payment of preexisting debt held "sale"); *Blau v. Allen*, 163 F. Supp. 702, 704 (S.D.N.Y. 1958) (purchaser not a director at time of purchase held to the same liability as if at all times he was a "director").

Supreme Court's only decision concerning section 16(b),¹⁴ as well as other case law firmly acknowledging the existence of a deputization theory,¹⁵ the court assumed that the validity of the theory was unquestionable.¹⁶

In finding that Martin had deputized Bunker, the court emphasized the unique position of control that Bunker exercised over Martin's investments, including personal approval of all of Martin's purchases of Sperry stock. In view of Bunker's unique position in Martin, together with his role as a Sperry director, the court reasoned that Bunker had access to inside information concerning Sperry and could use such information for Martin's benefit, irrespective of whether he disclosed the information to other Martin personnel. Although the court recognized that the situation was ripe for the insider abuse that section 16(b) was intended to prevent, it held

¹⁴ *Blau v. Lehman*, 368 U.S. 403 (1962). In dicta the Supreme Court in *Lehman* accepted the validity of the deputization theory reasoning that under certain circumstances a partnership, acting through one of its partners, could become a "director" for the purposes of section 16(b) liability. *Id.* at 409. The Court, however, held, upon the findings below, that the partnership had not deputized its partner to act as a director of another corporation. *Id.* at 410.

¹⁵ The origin of the deputization concept dates back to *Rattner v. Lehman*, 193 F.2d 564 (2d Cir. 1952) (concurring opinion), when Judge Learned Hand stated in an omnibus dictum:

I wish to say nothing as to whether, if a firm deputed a partner to represent its interests as a director on the board, the other partners would not be liable. True, they would not even then be formally "directors"; but I am not prepared to say that they could not be so considered; for some purposes the common law does treat a firm as a jural person. *Id.* at 567.

See *Marquette Cement Mfg. Co. v. Andreas*, 239 F. Supp. 962 (S.D.N.Y. 1965). See also *Molybdenum Corp. of America v. International Mining Corp.*, 32 F.R.D. 415 (S.D. N.Y. 1963). Although prior cases firmly established the validity of the deputization concept, *Martin Marietta* is the first case to impose section 16(b) liability pursuant to a finding of deputization.

¹⁶ The deputization rationale, however, can be assailed because it expands section 16(b) beyond its plain meaning. This expansion is arguably wrong because section 16(b) imposes a harsh automatic liability upon anyone falling within its edict. See note 21 *infra*. Congress therefore intended that section 16(b) liability be measured by a purely objective standard of proof. *Smolowe v. Delendo Corp.*, 136 F.2d 231, 235 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943). Extending the prohibition of section 16(b) beyond circumstances clearly proscribed on its face interjects into the statute a subjective element in derogation of the legislative purpose. *Cf. Heli-Coil Corp. v. Webster*, 352 F.2d 156 (3d Cir. 1965). However, it has been argued that in order to effectuate the congressional intent the courts must avoid building further limitations into an already narrow statute. See *Adler v. Klawans*, 267 F.2d 840, 845 (2d Cir. 1959). By rendering a functional definition to the term "director" the courts can preserve the force of section 16(b)'s command. Yet, a subjective element is not introduced into the objective congressional standard because *liability is still automatic* once one falls within section 16(b)'s provisions. The automatic application of section 16(b) remains unaltered by a threshold inquiry into whether the transaction itself falls subject to the abuses that section 16(b) was intended to prevent. *Cf. Blau v. Lamb*, 363 F.2d 507, 519 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967); *Ferraiolo v. Newman*, 259 F.2d 342 (6th Cir. 1958).

that, without more, Bunker's dual role was not enough to make him Martin's deputy. Instead, the court pointed to additional evidence to support its deputization finding: First, Bunker's letter of resignation to Sperry clearly indicated Sperry's belief that Bunker represented Martin's interests; second, Martin had given formal authorization to Bunker's acceptance of the Sperry directorship; and finally, other Martin directors, serving on the boards of corporations in a manner similar to Bunker, were regularly required to report back to Martin. These facts were taken by the court to be "definite and concrete indicatives that Bunker, in fact, was a Martin deputy."¹⁷ Although the inferences drawn from the court's piecemeal review of these facts support a finding of deputization, unfortunately the approach precludes a delineation of the legal elements underlying the deputization concept.¹⁸ Consequently the decision creates the danger that absent further clarification the court's holding may receive an overly broad application in future cases.

To fully develop a workable application of the deputization principle, it is necessary to examine the statutory definition of director in the perspective of the policy embodied in section 16(b). The mechanical basis for making a corporation a director is found in the Exchange Act itself which provides that "person . . . means corporation"¹⁹ and that director means "any director of a corporation or *any person* performing similar functions."²⁰ Section 16(b) is premised upon the belief that because all directors have access to inside information they are likely to make unfair use of this data. The statutory objective of curbing insider abuse in trading

¹⁷ 406 F.2d at 266.

¹⁸ The court limited its review to whether the lower court's findings were "clearly erroneous." See note 10 *supra*. This method of review resulted in approaching the deputization issue as a *question of fact*. However, it is arguable that the court unnecessarily restricted its review and thereby rendered shallow its development of the legal elements of the deputization concept. Perhaps the court should have approached the issue as a mixed question of law and fact, thus providing a vehicle for further crystallization of the deputization standard.

The Second Circuit, in particular, has not permitted its standard of review to stand in the way of fully delineating the legal principles applicable to the facts. Indeed, that court has recognized that in some instances strict compliance with the standard of review applicable must bend where "there are substantial reasons, particularly relating to consistency of decision, that dictate rather full review." *In re Hygrade Envelope Corp. v. Gibraltar Factors Corp.*, 366 F.2d 584, 588 (2d Cir. 1966). Accordingly, in determining "materiality" for the purposes of liability under Rule 10b-5, the Second Circuit has treated the issue as a mixed question of law and fact and rendered a full review of the findings below. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 850 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). There seems to be no basis for treating the deputization issue differently.

¹⁹ 15 U.S.C. § 78c(a)(9) (1964).

²⁰ 15 U.S.C. § 78c(a)(7) (1964) (emphasis added).

therefore necessitates the creation of a conclusive presumption that a director has used inside information when he engages in short-selling trading of the issuer's securities.²¹ However, the narrowly structured provisions of section 16(b) also indicate that this presumption should not encompass every situation where the potential for insider abuse is present.²² Therefore, in applying the statute, the possibility for insider abuse that may exist in any given relationship should not be singularly important. For example, in the instant case, Bunker's control over Martin's investments and Martin's ownership of a substantial block of Sperry stock created the possibility that Bunker could abuse his director's position to benefit Martin.²³ Yet, before applying the deputization rationale, the court noted the importance of evidence of the view taken by Martin toward Bunker's position with Sperry.²⁴ In the court's opinion, this evidence sufficiently increased the probability of insider abuse to a point where it became reasonable to render operative the restrictive

²¹ A showing of unfair *use* of inside information is not necessary for recovery under section 16(b). Its liability is absolute, and once one falls within its provisions, liability is imposed irrespective of any motive or intent on the part of the insider. *Smolowe v. Delendo Corp.*, 136 F.2d 231, 235 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943). See *Blau v. Lamb*, 363 F.2d 507, 515 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967); 2 L. LOSS, *supra* note 5, at 1041. This conclusive presumption was deemed necessary to curb insider abuse because of the difficulties of proving motive or intent. Hence, Congress devised a "crude rule of thumb" to obviate such evidentiary difficulties. *Hearings on Stock Exchange Practices Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess., pt. 15, at 6557 (1934).

²² The Supreme Court, in *Blau v. Lehman*, 368 U.S. 403 (1962), reasoned that since Congress had considered and rejected an earlier draft of section 16(b) which would have subjected to liability any recipient of inside information, Congress tailored the final draft of section 16(b) to encompass only that specific category of persons mentioned in the statute. *Id.* at 411-12. Such an interpretation of the legislative intent seems correct — particularly in view of other sections in the Act which place restrictions upon disclosure of inside information by insiders. See text accompanying notes 30-32 *infra*.

²³ The UNIFORM PARTNERSHIP ACT § 20 provides: "Partners shall render upon demand true and full information of all things affecting the partnership in any manner." By analogy, the funds which Martin Marietta had invested in Sperry Rand might impose a duty upon Bunker to disclose to Martin upon demand information pertinent to Martin's investments. However, the disclosure duty merely opens the channels of information flow, having little relevance to the probability that Bunker would abuse his position and disclose inside information.

²⁴ The importance of this evidence is that it indicated the extent to which Martin identified its own interests with those of Bunker's Sperry directorship. Martin's formal authorization of Bunker's acceptance of the Sperry directorship, coupled with evidence that other Martin personnel acting as directors on other corporations were required to report back to Martin, created a strong inference that Martin was likely to have access to inside information concerning Sperry. Furthermore, Sperry itself believed that Bunker, in his capacity as a Sperry director, was acting solely in Martin's interest. See text accompanying note 17 *supra*.

provisions of section 16(b).²⁵ However, given slightly different circumstances, the court's decision may have been different. Suppose, for example, that Bunker's position of control over Martin's investments was not as great. Under such facts, the potential for insider abuse is minimized to the extent that any information would pass by necessity through a chain of Martin personnel before it could be used. Thus, in this instance, the court might require a greater showing of other concrete evidence further demonstrating that the probability of insider abuse had substantially increased to where it would be reasonable to conclude that Martin was actually functioning as a "director."²⁶

Although the principles drawn from the above analysis do not evince a precise rule of deputization, they do serve to identify some considerations basic to applying the concept.²⁷ Of primary significance is the fact that any given set of circumstances requires going beyond the existence of the alleged deputer-deputy relationship and considering further evidence bearing upon whether mere

²⁵ The court evidently reasoned that since there was a reasonable probability that Martin possessed inside information and thereby could actually function as a director, it was necessary to render a functional definition to the term director in order to preserve the force of section 16(b)'s mandate.

It is also interesting to note the relevance of the control concept in establishing Martin's liability. A well-established principle of corporate law is that a person exercising controlling influence over a fiduciary assumes for himself the duties owed by the fiduciary to a third party. Cf. *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947). Thus, it can be argued that Martin controlled Bunker and since Bunker owed a duty to Sperry not to take short-swing profits, Martin itself was subject to the same duty. Therefore, within the meaning of section 16(b) it can be argued that Martin assumed the duties of a director by virtue of its control over Bunker. See note 24 *supra*.

²⁶ Where the deputy's control over the deputer-corporation's investments is limited, the court might be more inclined to require affirmative conduct on the part of the deputer-corporation indicating an intent to promote its own interests by utilizing the deputy as a conduit for inside information flowing from the second corporation. For example, in *Blau v. Lehman*, 286 F.2d 786 (2d Cir. 1960), *aff'd*, 368 U.S. 403 (1962), where the issue was whether the partnership had deputized its partner to serve as a director of another corporation, the partner did not exercise the absolute control over the partnership's investments that Bunker exercised over Martin's. The *Blau* court considered it of primary importance that the corporation rather than the partnership took the initiative by inviting the alleged deputy to join its board and that no other affirmative conduct by the partnership caused the alleged deputy's selection as director. *Id.* at 788-89.

²⁷ The uncertainty generated by the failure to establish a clear standard in other areas of section 16(b) has been criticized because of the difficulties it creates for the lawyer in advising his corporate client. See Kramer, *An Examination of Section 16(b)*, 21 BUS. LAWYER 183, 188-89 (1965). Appellee, Martin, employed a similar argument, alleging in its petition for rehearing en banc that the court's ill-defined application of the deputization rationale would cause consternation and chaos within the business community. See Appellee's Brief for Rehearing at 9.

access to inside information is sufficient to support the conclusion that insider abuse is likely to result. Further, as the deputy's position of control within the deputor-corporation decreases, the greater the need for additional evidence such as the conduct of the alleged deputor.²⁸ Finally, where additional evidence establishes a nexus between the interests of both the deputor and the deputy, the justification for applying the deputization rationale increases because the probability of insider abuse that section 16(b) was intended to prevent is more likely. However, where the evidence fails to establish the requisite identity of interests, mere speculation that insider abuse will result from the deputy's position of director should not be sufficient to support a finding of deputization.²⁹ Congress did not intend the conclusive presumption of unfair use of inside information implicit in section 16(b) to act as a panacea for every conceivable abuse inherent in insider trading.³⁰ Congress provided that in some situations an affirmative showing of both the possession and subsequent use of inside information is required to impose liability and for this reason the increasingly flexible provisions of section 10(b)³¹ and Rule 10b-5³² provide a remedy. To the ex-

²⁸ See note 26 *supra*.

²⁹ The Court, in *Blau v. Lehman*, 368 U.S. 403 (1962), emphasized that Congress did not intend that section 16(b) subject a business association "to all the responsibilities and financial burdens of its members in carrying on their other individual business activities." *Id.* at 410. Thus, the courts have imposed a further condition to section 16(b) liability — the existence of a peculiar agency relationship distinguished by the identity of the interests of the deputor and deputy and labeled "deputization."

³⁰ See note 22 *supra*.

³¹ 15 U.S.C. § 78j(b) (1964).

³² 17 C.F.R. § 240.10b-5 (1968). Recent decisions, both by the courts and the SEC, indicate that Rule 10b-5 will be an even more potent threat to insider abuse in the future. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969); *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961). Rule 10b-5 differs from the automatic liability imposed by section 16(b) in that the former requires a showing that inside information was possessed and that it was also used to engage in a purchase or sale. Further, it has been held that the person using inside information still escapes 10b-5 liability if he does not know that the information is unavailable to the investing public. See *Cady, Roberts & Co.*, *supra* at 912. Consequently, since the burden of proof may be greater under 10b-5 than under section 16(b), it is quite possible that some insider abuse will go unchecked. However, to the extent that *Texas Gulf Sulphur* makes more stringent demands upon insiders by imposing a greater burden of care, *i.e.*, negligence may now be enough to give rise to a 10b-5 claim, liability under 10b-5 seems to be moving in the direction of the strict test employed under section 16(b). Thus, since the remedy under 10b-5 is essentially a creature of the courts, in future cases the courts may choose to apply that test to circumstances giving rise to potential liability under the deputization theory. Such an approach has the merit of avoiding the necessity of manipulating the congressionally established standards under section 16(b) in order to curb insider abuse. In addition, unlike section 16(b) which requires that the short-swing profits inure to the issuer —

tent that both section 16(b) and section 10(b) prove inadequate, it is the function of Congress rather than the courts to expand their provisions by enacting new legislation.

Given the court's deputization finding, the second question became whether Martin was exempt from section 16(b) liability by virtue of SEC rules purportedly exempting Bunker. Section 16(a) of the Act requires directors to report changes in their ownership of the issuer's equity securities 10 days after the close of each calendar month.³³ SEC Form 4, however, clarifies this obligation by requiring only persons who were directors during the preceding calendar month to file a monthly report.³⁴ Martin maintained that since Bunker's Sperry directorship ceased during the month of August, pursuant to section 16(a) he was not required to report transactions occurring in September. Thus, because SEC Rule 16a-10 exempts from section 16(b) liability any transaction exempted from filing under section 16(a),³⁵ Martin argued that Bunker was thereby exempt from section 16(b) liability and that it should likewise be exempt. Rejecting this argument, the court stated that the purpose of section 16(b) was to prevent the unfair use of inside information and that where a director resigns his directorship prior to a sale the possibility exists that both the purchase and the sale were actuated by inside information.³⁶ Reasoning that the SEC's exemptive power is limited to transactions "not comprehended within the purpose" of section 16(b),³⁷ the court held that to the extent that SEC Rule 16a-10 exempted the transaction the rule was invalid.

a party which suffered no injury, the remedy under 10b-5 permits the aggrieved purchaser of the securities to recover damages.

³³ 15 U.S.C. § 78p(a) (1964).

³⁴ Form 4 provides that statements must be filed by: "Every person who at any time during any calendar month was . . . a director or officer of the company which is the issuer of such securities, and who during such month had any change in his beneficial ownership of any class of equity securities of such company." SEC Form 4, in R. KNAUSS, SECURITIES REGULATION SOURCEBOOK, SEC Forms § 7 (1965).

³⁵ SEC Rule 16a-10 provides: "Any transaction which has or shall be exempted by the Commission from the requirements of section 16(a) shall in so far as it is otherwise subject to the provisions of section 16(b), be likewise exempted from section 16(b)." 17 C.F.R. § 240.16a-10 (1968).

³⁶ 406 F.2d at 268.

³⁷ Section 16(b) provides: "This subsection 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." 15 U.S.C. § 78p(b) (1964). The court's basis for thus limiting the SEC's exemptive power is unclear because the plain meaning of the statute seems to grant the SEC broad powers to determine the scope of section 16(b) relative to the congressional purpose. The plain meaning approach is particularly desirable in view of the complex and technical problems involved in applying section 16(b). See generally Kramer, *supra* note 27, at 188.

In holding that a former director would be liable under section 16(b) for profits realized on stock purchases while he was a director and sold within 6 months, the Second Circuit became the first court to make such a finding. In an earlier case, however, the court held that a director was subject to section 16(b) liability even though he had not been a director at the time of *purchase*.³⁸ From the standpoint of safeguarding the effectiveness of section 16(b), the obvious corollary to this rule is that an ex-director is similarly subject to liability, notwithstanding his lack of status as a director at the time of *sale*.³⁹ However, in achieving this latter result, the court may have needlessly declared SEC Rule 16a-10 invalid.

Introductory language in section 16(b) suggests that only such persons required to file under section 16(a) were intended to be subject to section 16(b) liability.⁴⁰ However, it can be argued that such language provides that any director required to file a monthly report pursuant to section 16(a) remains subject to section 16(b) liability for the statutory period of 6 months, *regardless of whether he was required to report in the month of sale*. Pursuant to such a construction, Rule 16a-10 would exempt from section 16(b) liability only directors not required to file a monthly report under section 16(a) *within any 6 month period*. SEC Form 4 would clarify a director's *monthly* filing obligations under section 16(a) and would have no bearing upon whether he remained subject to liability for the full statutory period. Thus, since Bunker was re-

³⁸ Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959).

³⁹ Because section 16(b) expressly states that a 10 percent shareholder is liable for his short-swing profits *only* if he was such a shareholder *both* at the time of purchase and sale, the maxim *expressio unius est exclusio alterius* can be used to argue that Congress intended a contrary rule to apply to directors and officers. Adler v. Klawans, 267 F.2d 840, 845 (2d Cir. 1959). However, excluding directors and officers from the purchase-sale requirement applicable to 10 percent shareholders raises an interesting problem. Suppose one purchases shares before becoming a director. He then becomes a director, resigns, and as an ex-director sells the shares 1 month after resigning, but less than 6 months after purchase. Is he liable under section 16(b), even though he was not a director at the time of *purchase or sale*? Using the method of statutory construction suggested by this writer (*see* text accompanying notes 40-41 *infra*), he would not be liable because at no time during his directorship was he required to file a report pursuant to section 16(a), and, therefore, at no time was he subject to liability under section 16(b). To the extent that such a result rests more upon happenstance than logic, SEC clarification of the reporting requirements would seem desirable. For a discussion of the most recent SEC rules promulgated under section 16(a), *see* text accompanying notes 45-51 *infra*.

⁴⁰ Section 16(b) begins: "For the purpose of preventing the unfair use of information which may have been obtained by *such* beneficial owner, director, or officer . . ." 15 U.S.C. § 78p(b) (1964) (emphasis added). Excepting mere redundancy, it follows that the word *such* must refer to "such persons" required to file under section 16(a), and, therefore, it is arguable that section 16(b) has a built-in exemption and SEC Rule 16a-10 merely restates the statutory mandate.

quired under section 16(a) to report purchases made during his Sperry directorship, even following his resignation, he remained subject to section 16(b) liability for his short-swing profits until 6 months after purchase.

In failing to rely upon this alternative construction of SEC Rule 16a-10, the court restricted the SEC's exemptive powers to transactions which the court felt were not in any way susceptible to insider speculation.⁴¹ It, therefore, can be argued that the court considers itself, rather than the SEC, primarily responsible for comprehending what is within the purpose of section 16(b).⁴² Strict adherence to such reasoning in future cases presents the threat that the expertise and experience of the SEC in the highly technical areas of section 16(b) will be ignored.⁴³

On the other hand, suppose the court was aware of the alternative construction; could it have chosen to ignore such an interpretation in order to prompt the SEC into exercising its rulemaking power to further clarify a director's reporting requirements?⁴⁴ If this was in fact the court's purpose, there is little doubt that it was successful. Within a few months after the decision, the SEC proposed an amendment to a director's filing requirements under section 16(a)⁴⁵ and on October 20, 1969, the amendment became effective.⁴⁶ SEC Rule 16a-1 now provides that upon realizing a change in his beneficial ownership of the issuer's stock, a director

⁴¹ See text accompanying note 36 *supra*.

⁴² In adopting this position, the court noted that the promulgation of rules is not a matter within the exclusive dominion of the SEC's expertise. See *Green v. Dietz*, 247 F.2d 689, 692-93 (2d Cir. 1957); *Perlman v. Timberlake*, 172 F. Supp. 246, 254-55 (S.D.N.Y. 1959). However, this attitude toward the Commission results in the court replacing the SEC as the primary interpreter of section 16(b)'s purpose. Such an approach disregards the valuable administrative expertise acquired by the SEC in dealing with this complex area. See Note, *The Role of the Securities Exchange Commission Under Section 16(b)*, 52 VA. L. REV. 668, 686 (1966).

⁴³ See note 42 *supra*. In light of the arbitrary nature of section 16(b) and the complex problems that its application was likely to engender, the draftsmen recognized that "unless considerable latitude is allowed for the exercise of administrative discretion, it is impossible to avoid . . . unworkable 'straightjacket' regulation." S. REP. NO. 792, 73d Cong., 2d Sess. 5 (1934). See *Green v. Dietz*, 247 F.2d 689, 697 (2d Cir. 1957) (dissenting opinion).

⁴⁴ There is ample reason to suspect that the court adopted this approach. In referring to the "arbitrary and unnecessary" loophole created in section 16(b) by the Commission's reporting requirements, the court urged: "[A] less arbitrarily defined reporting requirement for ex-directors is but a logical extension of § 16(b) coverage, would be a coverage in line with the congressional aims, and would afford greater assurance that the lawmakers' intent will be effectuated." 406 F.2d at 269.

⁴⁵ SEC Securities Exchange Act Release No. 8574, 34 Fed. Reg. 7250 (1969).

⁴⁶ SEC Securities Exchange Act Release No. 8697, 34 Fed. Reg. 15246 (1969), amending SEC Rule 16a-1, 17 C.F.R. § 240.16a-1 (1968).

must include in his first Form 4 report all such changes which occurred within the previous 6 months.⁴⁷ The Rule further provides that any person, upon ceasing to be a director, must report a change in his beneficial ownership if it occurs less than 6 months after any such previous change in his ownership.⁴⁸ The new provisions both clarify the situation in *Martin Marietta*, where a director resigns before a sale, and cover the case where a purchase is made prior to directorship.⁴⁹ To the extent that the provisions succeed in covering all transactions in which inside information can be used by a director to make a profit,⁵⁰ they are consistent with the court's interpretation of the statutory mandate.⁵¹

The congressional purpose in enacting section 16(b) was to

⁴⁷ Subsection (d) of SEC Rule 16a-1 provides:

Any director or officer who is required to file a statement on Form 4 with respect to any change in his beneficial ownership of equity securities which occurs within 6 months after he became a director or officer of the issuer of such securities, or within 6 months after equity securities of such issuer first became registered pursuant to section 12 of the Act, shall include in the first such statement the information called for by Form 4 with respect to all changes in his beneficial ownership of equity securities of such issuer which occurred within 6 months prior to the date of the changes which requires the filing of such statement. SEC Rule 16a-1(d), 34 Fed. Reg. 15246 (1969).

⁴⁸ Subsection (e) of the Rule provides:

Any person who has ceased to be a director or officer of an issuer which has equity securities registered pursuant to section 12 of the Act, or who is a director or officer of an issuer at the time it ceased to have any equity securities so registered, shall file a statement on Form 4 with respect to any change in his beneficial ownership of equity securities of such issuer which shall occur on or after the date on which he ceased to be such director or officer, or the date on which the issuer ceased to have any equity securities so registered, as the case may be, if such change shall occur within 6 months after any change in his beneficial ownership of such securities prior to such date. The statement on Form 4 shall be filed within 10 days after the end of the month in which the reported change in beneficial ownership occurs. SEC Rule 16a-1(e), 34 Fed. Reg. 15246 (1969).

⁴⁹ In reference to the latter situation, see text accompanying note 38 *supra*.

⁵⁰ Presumably, the theory of the new provisions is that the policy of section 16(b) dictates that a director be subject to liability when, anytime during a 6-month period between purchase and sale, or sale and purchase, such director has access to inside information by virtue of his status as a director. The amendments, therefore, cover the situation where a purchase is made prior to directorship, director status is then assumed, and less than 6 months after purchase, but 1 month after resigning the directorship, a sale is made. Under even the most liberal construction of the old filing requirements, such a transaction was not covered by section 16(b) because at no time was the director required to file a report pursuant to section 16(a). See note 39 *supra*. However, under new Rule 16a-1, the transaction is subject to section 16(b) liability because a former director must report any change in beneficial ownership occurring less than 6 months after any previous change in ownership. SEC Rule 16a-1(e), 34 Fed. Reg. 15246 (1969). Thus, since a director is required to file pursuant to section 16(a), he remains subject to section 16(b) liability for 6 months after a previous change in ownership.

⁵¹ See text accompanying note 36 *supra*.