Prevention of Improper Securities Transactions by Employees: The Responsibility for and Feasibility of Adopting Preventative Programs

Bruce Alan Mann

Recommended Citation
Available at: https://repository.uchastings.edu/hastings_law_journal/vol25/iss2/5
Prevention of Improper Securities Transactions by Employees: The Responsibility for and Feasibility of Adopting Preventative Programs

By Bruce Alan Mann*

Since the decision in the Texas Gulf Sulphur Co. case, numerous articles have been written emphasizing the potential liability of corporate directors for acts of employees who violate the federal securities laws and the degree of protection afforded directors against personal liability for such violations by liability insurance. Although the desirability of preventative programs aimed at avoiding either intentional or inadvertent securities law violations by employees has been frequently discussed, few authors have attempted to delineate the va-
riety of preventative programs or to comment on the practicality of their implementation. Such will be the function of this article.

This discussion first will analyze the reasons why preventative programs are considered, then will consider the risk of liability to directors for improper securities transactions by corporate employees, the criteria for evaluating preventative programs, and finally the advantages and disadvantages of the most frequently considered programs. Basically, then, this article focuses on the practical ramifications of various preventative programs specifically designed to curtail improper or illegal securities transactions by corporate employees. Although compliance programs which may be instituted to prevent other improper or illegal conduct, such as antitrust law violations, are not within the purview of this article, many considerations and problems are relevant to all preventative programs without regard to their specific purpose. Thus, in considering whether to implement programs to prevent improper securities transactions, any experience of the corporation in implementing other preventative programs should be analyzed.

It is well established that an employee who trades on inside information violates both Rule 10b-5 under the Securities Exchange


7 This rule provides: "Employment of manipulative and deceptive devices. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate [sic] commerce, or of the mails of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240, 10b-5 (1973).
Act of 1934\(^8\) [Exchange Act] and state law and that such improper trading may result in liability to the person with whom the employee deals or to the corporation.\(^9\) A discussion of the parameters of Rule 10b-5 liability is beyond the scope of this article,\(^10\) since preventative programs are designed to proscribe activities which may be, or may appear to be, improper and not to determine whether particular conduct is illegal or what sanctions should be imposed once conduct is established to be illegal.

**Why Should Preventative Programs Be Considered?**

At the outset, it is necessary to analyze the reasons which may motivate a board of directors to implement programs designed to prevent securities law violations by corporate employees.

Foremost among these reasons is the concern that the duty of the board to supervise management and corporate affairs also encompasses a duty to prevent improper conduct. Under section 20(a)\(^11\) of the Exchange Act directors may be held personally liable for violations of Rule 10b-5 by the corporation and its employees, if the directors in some way control the violators\(^2\) and have not acted in good faith. It has frequently been assumed that acting in good faith

---


\(^9\) With respect to liability under the Exchange Act, see note 30 and accompanying text *infra*. With respect to employee liability under state law, see Diamond v. Oreamuno, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969). The principle that under state law a “tippee” may be held liable to the corporation for profits resulting from the use of inside information despite the lack of a direct fiduciary relationship was adopted in Schem v. Chasan, 478 F.2d 817 (2d Cir. 1973), *petition for cert. filed sub. nom.*, Lehman Bros. v. Schem, 42 U.S.L.W. 3137 (U.S. Sept 18, 1973) (No. 73-439).

\(^10\) Not only are the parameters of Rule 10b-5 constantly changing, but numerous other articles have been written dealing with the types of securities transactions proscribed by the rule. The factors which appear to influence courts in determining whether particular conduct violates Rule 10b-5 are discussed in Mann, *Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter*, 45 N.Y.U.L. Rev. 1206 (1970). The difficulty inherent in attempts to define the scope of the Rule is discussed in Painter, *Rule 10b-5: The Recodification Thicket*, 45 St. John’s L. Rev. 699 (1971).

\(^11\) This section provides: “Liabilities of controlling persons. (a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.” 15 U.S.C. § 78t(a) (1970).

\(^12\) See notes 59-69 and accompanying text *infra*. The problem of determining the meaning of control is discussed in Sommer, *Who’s “In Control”?—S.E.C.*, 21 Bus. Law. 559 (1966).
does not require the implementation of preventative programs. However, recent decisions have indicated that the good faith defense requires more than an ostrich-head-in-the-sand approach and that "the [controlling person must] show that some precautionary measures were taken to prevent the injury suffered." Taking little comfort from the fact that outside directors seem to be held to a lower standard in establishing the good faith defense, business publications have emphasized the potential liability of the outside director who is apparently innocent of any intentional wrongdoing.

A second reason for considering preventative programs is the directors' legitimate desire to prevent occurrences which, even if legal, would adversely reflect on the corporation, its directors or management. Even the rumor that the Securities and Exchange Commission [SEC] is investigating transactions in a company's securities can have a dramatic, adverse impact on the market price. In addition, transactions by officers and directors in the corporation's securities must be made public which can result in embarrassing questions from the


15. Referring to "a rising tide of lawsuits by disgruntled stockholders" one commentator noted that "a corporation need hardly breathe bad news before its directors find themselves hit." Vanderwicken, Change Invades the Boardroom, FORTUNE, May, 1972, at 156.

16. It has been argued that "in the competition for investment capital, funds tend to flow in the same direction as analyst interest and public confidence, and both of these depend in large measure upon the corporation's commitment to full disclosure." Feuerstein, SEC Restrictions on the Use of Inside Information, 37 Financial Executive, Dec., 1969, at 16, 19. The validity of this argument was illustrated when the common stock of Vetco Offshore Industries was suspended from trading on the American Stock Exchange for five weeks while the SEC investigated transactions in the stock. Although the company was an innocent victim and ultimately recovered a "short swing profit" realized by the subject of the SEC investigation, the episode resulted in the market price for its common stock dropping 50 percent. BARRON'S, Aug. 27, 1973, at 19, col. 2.

17 Section 16(a) of the Exchange Act, 15 U.S.C. § 78p(a), requires that any change in the beneficial ownership of a security listed on a national securities exchange or registered pursuant to Section 12(g), 15 U.S.C. § 78l(g) (1970), of such Act of an officer, director or beneficial holder of more than 10% of the class be reported within 10 days after the close of the month in which it occurs. Reports of changes of beneficial ownership are regularly published in the Wall Street Journal and, if notable, are discussed under the caption "What 'Insiders' are Doing" in FINANCIAL WORLD MAGAZINE,
press and shareholders.

Directors have also considered adopting preventative programs to avoid inadvertent violations of federal securities laws by employees. Although directors and principal executive officers are generally aware of their responsibility not to trade on inside information, to pass such information on to their friends and associates, or to engage in other transactions violative of the federal securities laws, lower-level employees such as secretaries and bookkeepers may not be cognizant of their similar responsibility.

Preventative programs may also be adopted in the belief that the act of implementing such programs manifests an intention to comply with the federal securities laws. Consequently, if violations of securities laws should subsequently occur, implementation of a preventative program hopefully will be viewed favorably by the staff of the commission in determining what sanctions should be sought or what penalties should be imposed. Frequently preventative programs are not implemented until after a violation has occurred, at which time such programs may become part of the terms of settlement. However, the implementation of preventative programs prior to any violations may have a material effect on the outcome of any effort by the SEC to obtain a permanent injunction against the violator.

18. Two officials of Occidental Petroleum Corp. were questioned and named by the Wall Street Journal in a lead article on trading on inside information. The Wall Street Journal, Oct. 31, 1972, at 2, col. 6. Both officers had purchased shortly before the announcement of a materially favorable corporate development, but claimed to have legitimate reasons for their purchases and no knowledge of the impending development. Id. at 28, col. 3. Similar criticism arose as a result of sales by Equity Funding executives shortly before announcement of unfavorable news regarding that company. Id. April 20, 1973, at 1, col. 1.

19. See, e.g., In re Merrill, Lynch, Pierce, Fenner & Smith, Inc., SEC Securities Exchange Act Release No. 8459 (Nov. 25, 1968), [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,629, at 83,347, where Merrill, Lynch's underwriting division was charged by the SEC with disclosing to personnel involved in institutional sales for the firm information obtained in the course of preparing a registration statement which was disclosed to selected customers prior to public dissemination. The Commission accepted an offer of settlement which included an undertaking to implement extensive provisions designed to prevent future disclosure by the underwriting division of such information to other employees of the firm. The Commission stated that "In determining to accept the offer of settlement submitted by respondents we have taken into consideration registrant's undertaking to adopt, implement, and ensure compliance with [the proposed preventative program]." Id. at 83,350. In SEC v. Lums, Inc., [Current Binder] CCH FED. SEC. L. REP. ¶ 94,134, at 94,555 (S.D.N.Y. 1973), the court refused to hold a broker-dealer liable for the violation of Rule 10b-5 by its employee salesman because the broker-dealer had demonstrated that it not only did not induce the salesman's breach but that it had demonstrated its good faith by having a comprehensive compliance program designed to prevent improper employee conduct.
A further reason for implementing preventative programs, particularly in large multidivisional corporations, is a desire to establish standards for executive conduct which will be applied uniformly within the corporate structure, rather than permitting standards to vary from division to division. Uniform standards would appear especially desirable where the executives of the corporation and its subsidiaries do not present all questions involving securities transactions to the same legal counsel.

Finally, the view favoring the adoption of preventative programs and establishment of standards of conduct for corporate employees who deal in their employer’s securities is a reflection of changing attitudes toward insider trading. This change results from an increased awareness that those who trade on inside information may expose themselves and the corporation to civil liability, and that the time and expense devoted to nonproductive litigation can be reduced by the establishment of programs designed to prevent potentially unlawful acts.

20. In SEC v. Bangor Punta Corp., 331 F. Supp. 1154 (S.D.N.Y. 1971), rev’d on other grounds, 480 F.2d 341 (2d Cir. 1973), cert. denied, 42 U.S.L.W 3215 (Oct. 15, 1973), the court refused to issue a permanent injunction because it found that the SEC had “failed to carry its burden to establish, with persuasive evidence, that Bangor Punta, its officers, directors and employees have a propensity or natural inclination to violate the securities law.” 331 F. Supp. at 1163. The Second Circuit upheld the denial of the injunction, but in dissent Judge Timbers insisted that the district court applied the wrong standard in deciding whether an injunction should issue. “It has uniformly been held that the correct standard is ‘whether there is a reasonable likelihood that the wrong will be repeated.’” 480 F.2d at 385. Judge Timbers argued that the requirement of showing “a propensity or natural inclination to violate the securities law” placed a greater burden on the SEC, specifically by requiring proof of an intent to violate those laws. Id. at 385-86. Judge Mansfield, concurring with Judge Gurlein, rejected the proposition that the slight difference between the standards demanded reversal, characterizing the dissent’s contention as “petty semanticism.” Id. at 405. To the extent that there is a real difference between the standards, it could be argued that the implementation of a program to prevent a particular wrong from recurring would satisfy the standard insisted upon by Judge Timbers, but not the standard applied by the district court. In SEC v. Lum’s Inc., [Current Binder] CCH FED. SEC. L. REP ¶ 19,134, at 94,555 (S.D.N.Y 1973) the district court permanently enjoined the issuer from violations of Rule 10b-5, despite the fact that the corporation had subsequently implemented a policing program. The court found the precautions “inadequate” in view of prior leaks of corporate information, and directed the corporation to “establish written guidelines for the dissemination of corporate information to the investment community.” Id. at 94,569.

On the other hand, implementation of an appropriate preventative program prior to any wrong-doing may tend to negate the existence of a propensity or natural inclination to violate the securities laws.

21. Prior to the Texas Gulf Sulphur decision approximately 1,700 subscribers to the Harvard Business Review were asked what they would do if they learned that their company was about to merge with a smaller company whose stock was certain to rise when the news of the merger became public. 42% indicated that they would buy
On What Theories May Directors Be Held Liable for the Failure to Implement Preventative Programs?

A major consideration of directors in deciding whether any program should be implemented is the risk that they may be held personally liable for any improper trading in the corporation’s securities. A variety of legal theories have been advanced for holding directors responsible for failing to take preventative steps against such acts.22

Failure to Supervise

While it is the officers of the corporation and not the directors who are traditionally charged with responsibility for day-to-day operations,23 directors are under a duty to supervise the activities of officers and other employees and to establish the overall policies of the corporation.24 Where corporate losses25 are attributable to the directors’ negligent failure to supervise the conduct of persons in charge of corporate

for themselves, 14% would tell a friend and 2% would tell a broker. Bumhart, How Ethical are Businessmen?, 39 HARV. BUS. REV. July-Aug., 1961, at 6, 16. Although no comparable survey has been published recently, the author believes a significant change in attitudes has occurred. The effect of the SEC attack on traditional attitudes of insiders has been described as “stirring up trouble and confusion among corporate executives and people in the securities business.” New Rules on “Insiders”—The Word from Those Affected, U.S. NEWS & WORLD REPORT, Sept. 16, 1968, at 94.


24. 3 W FLETCHER, PRIVATE CORPORATIONS §§ 1070-71, at 671-82 (rev. ed. 1965) [hereinafter cited as FLETCHER]; KNEPPER, supra note 23. But see Dyson, The Director’s Liability for Negligence, 40 IND. L.J. 341, 345 (1965) [hereinafter cited as Dyson].


26. In general, the conduct of a corporate director is measured by the “due care” or negligence standard. See, e.g., H. BALLANTINE, BALLANTINE ON CORPORATIONS §§ 62-67 (Rev. ed. 1946); KNEPPER, supra note 23, at 1-3; Dyson, supra note 24, at 371-76; Morrison, supra note 2, at 202. In some jurisdictions the standard is expressed in terms of the care taken by the prudent man in the management of his own affairs, and in others as the care taken by the ordinary prudent director. See, e.g., Adkins & Jans, Some Observations on Liabilities of Corporate Directors, 20 BUS. LAW. 817, 817-21 (1965). At least one commentator has expressed the opinion that the same results are reached regardless of the terms in which these standards are expressed. Dyson, supra note 24, at 344, 371. In some jurisdictions, the standard of care has been codi-
affairs, directors have been held liable to the corporation, its shareholders and, in some cases, its creditors.\(^7\)

What constitutes negligent supervision of corporate affairs is ordinarily a question of fact.\(^8\) No court has held board members personally liable for failure to take steps to prevent insider trading of the corporation's securities. Possibly this omission is attributable to an application of the principle that the degree of care required of directors must be commensurate with the evil to be avoided.\(^9\) Specifically, the "evil" must be measured by its potential impact on the corporation and its shareholders rather than on the general public. In the context of insider trading,\(^10\) the "loss" to the corporation is the improper use of a corporate asset, namely inside information, of utterly no value to the corporation except as a vehicle for illegally trading in its own stock.\(^11\) A further result is the loss of goodwill and prestige associated with public revelation that the corporation's insiders were bilking the public.\(^12\) The somewhat intangible\(^13\) nature of these losses would

\(^{27}\) See, e.g., Israels, A New Look at Corporate Directorship, in 1 THE CORPORATE GENERAL COUNSEL WORKSHOP 153, 155-56 (Practicing Law Institute 1969).

\(^{28}\) See generally Morrison, supra note 2, at 204-06.

\(^{29}\) Of course, a director would ordinarily have no defense if the rest of the board was held to have been negligent where that director willfully failed to exercise any judgment, for example, by habitually absenting himself from directors meetings or delegating his decision-making function to others. See, e.g., Platt Corp. v. Platt, 42 Misc. 2d 640, 249 N.Y.S.2d 1 (Sup. Ct. 1964); Davis v. Walker, 170 Neb. 891, 104 N.W.2d 479 (1960); Knepper, supra note 23, at 84; Morrison, supra note 2, at 202.


\(^{30}\) Of course, a director would ordinarily have no defense if the rest of the board was held to have been negligent where that director willfully failed to exercise any judgment, for example, by habitually absenting himself from directors meetings or delegating his decision-making function to others. See, e.g., Platt Corp. v. Platt, 42 Misc. 2d 640, 249 N.Y.S.2d 1 (Sup. Ct. 1964); Davis v. Walker, 170 Neb. 891, 104 N.W.2d 479 (1960); Knepper, supra note 23, at 84; Morrison, supra note 2, at 202.

\(^{31}\) Section 10(b) of the Exchange Act and Rule 10b-5 have been interpreted by the courts to impose a fiduciary obligation on an "insider" to disclose to the purchaser or seller of the security purchased or sold by him material facts affecting the value of a security and known to him by virtue of his inside position. See, e.g., Speed v. Transamericana Corp., 99 F Supp. 808 (D. Del. 1951). The concept of an "insider," originally thought limited to the officers, directors and majority shareholders, has grown to include any person having "such a relationship to the corporation that he had access to information which should be used 'only for a corporate purpose and not for the personal benefit of anyone.'" Ross v. Licht, 263 F Supp. 395, 409 (S.D.N.Y 1967), quoting In re Cady, Roberts & Co., 40 S.E.C. 907 (1961) See also SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968). See generally Rapp & Loeb, Tippee Liability and Rule 10b-5, 13 CORP. PRAC. COMMENT, Feb., 1972, at 374, 379-80. Recent actions by the SEC have attempted to establish liability where no such relationship exists between the "insider" and the issuer. See notes 107-09 and accompanying text infra.

\(^{32}\) If the information is material and not available to the public generally, trades by the corporation in its own stock would constitute a violation of Rule 10b-5. See, e.g., Rogen v. Ilikon Corp., 361 F.2d 260 (1st Cir. 1966); Kennedy, Transactions by a Corporation in Its Own Shares, 19 Bus. LAW 319 (1964).

\(^{33}\) An interesting illustration of one of the few situations where disclosure of
January 1974] SECURITIES TRANSACTIONS BY EMPLOYEES 363

justify a lesser duty of directors than the duty to prevent, for example, embezzlement of the corporation's funds.

On the other hand, notice of facts reasonably indicating that the agents of a corporation are mismanaging its affairs seems to increase a director's supervisory obligation significantly. In Briggs v. Spaulding, 34 the United States Supreme Court held that bank directors could not be held liable for losses incurred as a result of officer mismanagement, stating that ""[i]f nothing has come to [the directors'] knowledge, to awaken suspicion of the fidelity of the president and cashier, ordinary attention to the affairs of the institution is sufficient."" 35 The Court added, however, that ""[i]f [the directors] become acquainted with any fact calculated to put prudent men on their guard, a degree of care commensurate with the evil to be avoided is required, and a want of that care certainly makes them responsible."" 36

Upon this doctrinal basis, a number of courts have held that directors must proceed with additional diligence in supervising corporate officers and employees upon some warning of trouble. 37 The courts have held directors responsible for failure to take affirmative corrective action after notice that the president of a bank was investing in speculative enterprises, 38 that an employee had been engaged in embezzlement, 39 that the bank was in critical financial condition, 40 that expenditures were being made without proper approval, 41 that an appraiser improper trading might have significant impact upon corporate affairs is provided by the case of Brennan v. Midwestern United Life Ins. Co., 286 F. Supp. 702 (N.D. Ind. 1968), aff'd, 417 F.2d 147 (7th Cir. 1969), cert denied, 397 U.S. 989 (1970).

34. 141 U.S. 132 (1891).
35. Id. at 148, quoting Percy v. Millaudon, 10 La. (Martin) 32, 35 (1829).
36. Id., 10 La. (Martin) at 35-36.
37. See, e.g., DePinto v. Provident Sec. Life Ins. Co., 374 F.2d 37 (9th Cir. 1967); Michelsen v. Penney, 135 F.2d 409 (2d Cir. 1943); Federal Deposit Ins. Corp. v. Mason, 115 F.2d 548 (3rd Cir. 1940); Atherton v. Anderson, 99 F.2d 883 (6th Cir. 1938); Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 188 A.2d 125 (Sup. Ct. 1963); Chicago Title & Trust Co. v. Munday, 297 Ill. 555, 131 N.E. 103 (1921). See also Fletcher, supra note 24, § 1078, at 687-88; Dyson, supra note 24, at 345. 38. Rankin v. Cooper, 149 F 1010 (W.D. Ark. 1907).
39. Federal Deposit Ins. Corp. v. Mason 115 F.2d 548 (3rd Cir. 1940). The board failed to determine the full extent of the loss at the time of discovery, and failed to avoid a repetition of the loss by taking measures to insure that other employees could not use the same device in the future.
of collateral for loans made by the company had been implicated in losses suffered in previous loans,\textsuperscript{42} that an employee was living beyond his apparent means and had been accused of counterfeiting,\textsuperscript{43} and that the management of a company from which the corporation was considering the purchase of stock has been the object of complaints.\textsuperscript{44}

Generally, absent any indications of unusual conduct, the implementation of reasonable corporate activity review procedures will tend to insulate directors from responsibility for losses resulting from employee misconduct.\textsuperscript{45} In addition, their absence has been held to indicate a lack of due care, particularly where the implementation of such procedures is customary.\textsuperscript{46} However, the few courts which have sought to delineate the extent of the programs required have emphasized that directors are entitled to rely upon the honesty of persons in daily control of corporate activities, absent special circumstances.\textsuperscript{47} Elaborating on this point, the court in \textit{Graham v Allis-Chalmers Manufacturing Co.} held:

\begin{itemize}
\item \textsuperscript{42} Loan Soc'y v. Eavenson, 248 Pa. 407, 94 A. 121 (1915).
\item \textsuperscript{43} Anderson v. Bundy, 161 Va. 1, 171 S.E. 501 (1933).
\item \textsuperscript{44} DePinto v. Provident Security Life Ins. Co., 374 F.2d 37 (9th Cir. 1967).
\item \textsuperscript{45} Cory Mann George Corp. v. Old, 23 F.2d 803 (4th Cir. 1928); Dresser v. Bates, 250 F. 525 (1st Cir. 1918), \textit{modified on other grounds}, 251 U.S. 524 (1920); Bynum v. Scott, 217 F. 122 (E.D.N.C. 1914); Sternberg v. Blaine, 179 Ark. 448, 17 S.W.2d 286 (1924); Ohlendorf v. Rathje, 230 Ill. App. 427 (1923).
\item \textsuperscript{46} A number of courts have indicated that the directors' failure to personally examine the books of the corporation or adopt procedures to reveal misconduct, such as the enlistment of independent auditors, is a strong indication of negligence. See, e.g., Federal Deposit Ins. Corp. v. Mason, 115 F.2d 548 (3rd Cir. 1940); Atherton v. Anderson, 99 F.2d 883 (6th Cir. 1938); Rankin v. Cooper, 149 F. 1010 (W.D. Ark. 1907); Ford v. Taylor, 176 Ark. 843, 4 S.W.2d 938 (1928) (court found that failure to adopt proper auditing procedures, in addition to constituting negligence, served to encourage unlawful activity); Lippitt v. Ashley, 89 Conn. 451, 94 A. 995 (1915); Ventress v. Wallace, 111 Miss. 357, 71 So. 636 (1916); Campbell v. Watson, 62 N.J. Eq. 396, 50 A. 120 (1901); Broderick v. Marcus, 152 Misc. 413, 272 N.Y.S. 455 (Sup. Ct. 1934); Neese v. Brown, 218 Tenn. 686, 405 S.W.2d 577 (1964). The foregoing cases consider the standard of care required of bank directors. Several courts have held that, because of the nature of the institution, bank directors are held to a higher standard of care in the management of corporate assets than directors of other corporations operated for profit. See, e.g., Atherton v. Anderson, 99 F.2d 883 (6th Cir. 1938); Allied Freightways v. Cholfin, 325 Mass. 630, 91 N.E.2d 765 (1950); Greenfield Sav. Bank v. Abercrombie, 211 Mass. 252, 97 N.E. 897 (1912); Campbell v. Watson, 62 N.J. Eq. 396, 50 A. 120 (1901); Broderick v. Marcus, 152 Misc. 413, 272 N.Y.S. 455 (Sup. Ct. 1934). See generally Annot, 25 A.L.R.3d 941 (1969).
\end{itemize}
Liability of Directors Under Rule 10b-5 for Failure to Supervise Transactions by Employees in the Company's Securities

Plaintiffs have argued unsuccessfully that Rule 10b-5 requires directors to exercise due care to ensure that prospective purchasers of the company's securities are fully informed of all material facts and to investigate the conduct of persons actually engaged in the corporation's securities transactions. In Cohen v. Franchard Corp. and Lanza v. Drexel & Co., for example, the purchasers sought without success to hold directors of the issuer liable for the negligent failure to ascertain and disclose material misstatements in sales materials and financial information furnished by corporate agents. These cases, while arguably distinguishable from those involving insider trading, shed some light on the investigatory duties imposed on directors by Rule 10b-5.

In Cohen the court rejected the notion that a director's negligent failure to discover misconduct of his codirectors or corporate officers makes the director liable to purchasers:

Appellants urge that we adopt a standard that failure to discover material facts when such facts could have been ascertained

---

48. 41 Del. ch. 78, 85, 188 A.2d 125, 130 (Sup. Ct. 1963). The court was obviously concerned with the impracticability of broad supervision of the acts of minor officials in large companies, stating: "The duties of the Allis-Chalmers Directors were fixed by the nature of the enterprise which employed in excess of 30,000 persons, and extended over a large geographical area. By force of necessity, the company's Directors could not know personally all the company's employees. The very magnitude of the enterprise required them to confine their control to the broad policy decisions." Id. See also Atherton v. Anderson, 99 F.2d 883 (6th Cir. 1938).

Since the definition of "insider" for purposes of Rule 10b-5 has been broadened to include any employee who is in possession of material undisclosed information obtained in the course of his employment, see note 30, supra, the rationale of the above-quoted language in the Allis-Chalmers case would appear more persuasive where the trading is conducted by "minor officials" than where it is conducted by co-directors or executive officers. See note 67 and accompanying text infra.

49. 478 F.2d 115 (2d Cir. 1973).
50. 479 F.2d 1277 (2d Cir. 1973).
51. In both cases material misrepresentations were alleged to have been made by agents of the company on its behalf, rather than by insiders trading for their own accounts. Secondly, the alleged liability was based upon the failure of the directors to disclose material inside information to the purchasers, and only secondarily on the failure of the directors to supervise the conduct of employees.
without inordinate effort is enough to establish a private action under Rule 10b-5, "particularly where fiduciary relationships require attention." We decline the invitation.\textsuperscript{52}

In \textit{Lanza} the court, sitting en banc, elaborated further on the same theme:

We conclude that a director in his capacity as a director (a non-participant in the transaction) owes no duty to insure that all material, adverse information is conveyed to prospective purchasers of the stock of the corporation on whose board he sits. A director's liability to prospective purchasers under Rule 10b-5 can thus only be secondary, such as that of an aider and abettor, a conspirator, or a substantial participant in fraud perpetrated by others.\textsuperscript{53}

Significantly, the Eight, Ninth and Tenth circuits have approved, at least in dicta, a finding in other contexts of Rule 10b-5 liability for negligent conduct.\textsuperscript{54} However, as Professor Ruder has pointed out, whatever the rationale behind the elimination of the \textit{scienter} requirement for holding persons primarily liable under Rule 10b-5, the negligence standard seems clearly inappropriate for holding unknowing nonparticipants liable for their negligent failure to uncover and disclose the truth.\textsuperscript{55}

\textbf{Liability of Directors as "Controlling Persons" Under the 1933 and 1934 Acts}

Both section 15 of the Securities Act of 1933\textsuperscript{56} [Securities Act] and section 20(a) of the Exchange Act\textsuperscript{57} provide that under certain circumstances controlling persons may be held liable for the unlawful

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{52} 478 F.2d 115, 123 (2d Cir. 1973).
\item \textsuperscript{53} 479 F.2d 1277, 1289 (2d Cir. 1973).
\item \textsuperscript{54} See \textit{City Nat'l Bank v. Vanderboom}, 422 F.2d 221, 229-30 (8th Cir.), cert. dened, 399 U.S. 905 (1970); Stevens v. Vowell, 343 F.2d 374, 379-80 (10th Cir. 1965); Ellis v. Carter, 291 F.2d 270, 274 (9th Cir. 1961).
\item \textsuperscript{55} Ruder, \textit{supra} note 2, at 630-38. \textit{But see SEC v. Spectrum, Ltd.}, 231 BNA SR & LR E-1 (Dec. 12, 1973), in which the court held that in an action for injunctive relief an individual can be enjoined as an aider or abettor without proof of \textit{scienter} if he has been negligent.
\item \textsuperscript{56} Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1970) [hereinafter cited as Securities Act]. Section 15, 15 U.S.C. § 77o, provides: Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k [Securities Act § 11] or 77l [Securities Act § 12], shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."
\end{itemize}
\end{footnotesize}

At least one court seems to have assumed that a director is by definition a person in control of corporate employees within the meaning of section 20(a). In \textit{Moerman v. Zipco, Inc.},\footnote{Securities Act § 12(1)-(2), 15 U.S.C. §§ 77l(1)-(2) (1970).} the plaintiff brought an action against the issuers and its directors for rescission under section 12(1) and 12(2) of the Securities Act\footnote{Exchange Act § 20(a), 15 U.S.C. § 78t(a) (1970).} and for damages under Rule 10b-5 and section 20(a) of the Exchange Act.\footnote{302 F Supp. at 447.} The plaintiff alleged that the president of the corporation had induced him to purchase shares through misrepresentation of material facts. While the court found that the plaintiff had no significant contact with any of the directors, it observed that the directors had participated in corporate affairs by raising a substantial portion of the initial capital, by representing a large portion of the total shares on the board, by signing board meeting minutes, by participating in meetings, and by signing a Form S-1 registration statement filed with the SEC.\footnote{Id., quoting Myzel v. Fields, 386 F.2d 718, 738 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968).} Based on these observations, the court stated:

The conclusion is inescapable that persons who act as directors are in control of the corporation. This is especially true in light of the liberal construction of this section [Section 20(a) of the Exchange Act] as including "indirect means of discipline or influence short of actual direction."\footnote{Lanza v. Drexel & Co., [1970-1971 Transfer Binder] CCH FED. SEC. L. REP., 92,826, at 90,829, 90,104 n.17 (S.D.N.Y. 1970).} The strict \textit{Zipco} approach was regarded as "persuasive"\footnote{Id. at 90,829.} by the district court in \textit{Lanza v. Drexel & Co.},\footnote{Escott v. Barchrs Constr. Corp., 283 F Supp. 643 (S.D.N.Y. 1968).} a case growing out of the now famous \textit{BarChris}\footnote{Lanza v. Drexel & Co., [1970-1971 Transfer Binder] CCH FED. SEC. L. REP., ¶ 92,826, at 90,829, 90,104 n.17 (S.D.N.Y. 1970).} litigation. However, the court refrained from taking a position since the director in question was found to have shown "good faith."\footnote{Id. at 90,829.} On the other hand, the court in \textit{Mader v. Armel},\footnote{Lanza v. Drexel & Co., [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,826, at 90,829, 90,104 n.17 (S.D.N.Y. 1970).} held that whether or not a director is a "control person" within the meaning of section 20(a) of the Exchange Act is essentially a
question of fact. The court suggested that directors may be controlling persons with respect to the acts of codirectors and executive officers without being in control of the extra-corporate conduct of other employees.69

In addition, the Mader court regarded the Zipco holding, coupled with the tendency of some courts to ground 10b-5 liability upon a showing of negligence, as "frightening." It was not prepared to hold an outside director, not exercising practical control or influence over the other corporate directors or officers, liable "simply by virtue of the fact that he was a director."70

Thus, the question of whether a director is or is not a controlling person, absent some showing of actual participation in the unlawful transaction or practical control over corporate affairs, remains unresolved.

Both section 15 of the Securities Act and section 20(a) of the Exchange Act provide a defense for controlling persons who are found to have acted in good faith. Most reported cases involving a consideration of the good faith defense under these sections have dealt with the responsibility of brokerage houses for acts of their registered representatives.72 The district court in Hecht v Harris, Upham & Co.,73 for example, observed that with respect to section 20(a) of the Exchange Act:

It has been held that absent a showing by the controlling person that it acted in good faith, the controlling person is liable and, further, that to satisfy the requirement of good faith it is necessary to show that precautionary measures were taken to prevent the violation and, further, that failure of the controlling person to maintain and diligently enforce a proper system of internal supervision and control constitutes participation in the misconduct and the violation will be deemed to have been committed, not only by the controlled person, but also by the controlling person who did not perform the duty to prevent it.74


69. Id. at 90,797-98.

70. Id. at 90,798.

71. Id.


73. 283 F. Supp. 417 (N.D. Cal. 1968), modified on other grounds, 430 F.2d 1202 (9th Cir. 1970).

74. Id. at 438. It is interesting to note that the court also observed that "[t]he
It has also been held that directors cannot be expected to exercise the kind of supervision over corporate employees that brokers must exercise over salesmen. While no reported case has held that directors may establish good faith and avoid liability merely by delegating the duty of supervision or relying on independent consultants, reliance by a director upon independent consultants in evaluating his officers' conduct would tend to establish the director's "good faith" for purposes of the defense under section 20(a). In interpreting this "good faith" defense, the court in Mader v. Arnel held that, while the burden of showing good faith is placed on the controlling person, "The opposite of good faith is 'bad faith.' Bad faith certainly implies something more than negligence."

Similarly, the Second Circuit in Lanza v. Drexel & Co. has held recently that the intent of the defense found in section 15 of the Securities Act is to insulate control persons from liability except in instances where "control is effectively exercised to bring about the action upon which liability is based." In addition, the court stated that liability under section 20 of the Exchange Act must be predicated upon a showing that the director was "in the fraud perpetrated by controlled persons." Negligent conduct is not, according to the court, actionable "culpability" under section 20 of the Exchange Act.

**Director Responsibility for Aiding and Abetting Violations of the Securities Laws**

Increasingly, plaintiffs have sought to overcome the defenses available under the controlling persons liability provisions of the Securities

---


77. Id. at 90,798-99.

78. Id. at 90,798. See also Lanza v. Drexel & Co., [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,826, at 90,829 (S.D.N.Y. 1970), where the district court held that the fact that a director was deceived by culpable members of the board, and had therefore no knowledge of the fraud, tended to establish "good faith."

79. 479 F.2d 1277 (2d Cir. 1973).

80. Id. at 1298.

81. Id. at 1299.

82. Id.
and the Exchange Acts by advancing the common law tort theory of aiding and abetting. The most notable success to date occurred in the case of Brennan v Midwestern United Life Insurance Co.

The district court held that the defendant corporation, by its affirmative conduct, had aided and abetted the fraudulent activities of a securities broker dealing in the corporation's stock. Specifically, the court found that failure by Midwestern to take remedial action before the Indiana Securities Commission, in spite of an earlier request by the Commission to report further irregularities and in spite of an earlier warning to the offending broker that Midwestern intended to go to the Commission, enabled the broker to continue in his fraudulent scheme. The corporation thereby implicitly encouraged the scheme by indicating that Midwestern would not report the broker's activities.

The court further found that Midwestern allowed the fraudulent conduct to continue in order to avoid public disclosure that there had been irregular trading activities in its stock since negotiations were under way to merge the corporation with, at various times, two other corporations. The court relied on the formulation of aiding and abetting set forth in the Restatement of Torts:

For harm resulting to a third person from the tortious conduct of another, [a] person is liable if he

(b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself.

The ramifications of Brennan and earlier aiding and abetting cases with respect to director liability for insider trading are far from clear. In Brennan the court found that the corporation tacitly encouraged the illicit scheme in order to avoid any decline in the price of its shares and possibly to effect an increase in price. In most situa-

---

83. See generally Ruder, supra note 2, at 605-08.
84. See id. at 609-10, 620-38. The related doctrine of conspiracy has not yet been meaningfully differentiated from aiding and abetting by courts seeking to impose civil liability upon corporations or their directors arising out of trading violations by others. Id. at 639-41.
86. 286 F Supp. at 704.
87 id. at 726-27
88. id. at 719.
89. id. at 708, quoting RESTATEMENT (SECOND) OF TORTS § 876 (1965).
90. See, e.g., Pettit v. American Stock Exch., 217 F Supp. 21 (S.D.N.Y 1963). The SEC has long enlisted the aider and abettor concept in enforcement proceedings. See cases collected in Ruder, supra note 2, at 625 n. 124.
91. The broker, Dobich, was involved in the purchase of large blocks of Midwestern shares for resale to his customers and had represented to Midwestern that
tions involving insider trading the corporation would seem to have little business interest in assisting insiders in securities law violations.\textsuperscript{92} Moreover, the court emphasized that the corporation had, by its \textit{affirmative encouragement} of the broker, entered the realm of unlawful aiding and abetting.\textsuperscript{93} At least two courts have stated, however, that an aider and abettor cause of action may be predicated upon encouragement through silence or inaction.\textsuperscript{94}

Thus, \textit{Brennan} may be said to stand for the proposition that where a person knows of and is able to take corrective action with respect to unlawful activity and the offender knows that no corrective action will be taken, the offender is being tacitly encouraged to continue and is therefore being aided and abetted. With respect to insider trading, if the directors are aware of such improper conduct and fail to take corrective measures, they presumably would be exposed to claims on the basis of common law neglect of duty\textsuperscript{95} and would be unable to carry their burden of showing good faith in defense of a claim of liability as controlling persons. On the other hand, if the insider is successful in keeping his conduct secret, it is difficult to imagine even the \textit{Brennan} court finding that he was aided and abetted by the directors.

\textit{Brennan} holds one lesson which has specific relevance to the formulation and implementation of preventative programs: any pro-

they would appreciate in value as a result of his activities. 286 F Supp. at 708. Midwestern, in the meantime, was negotiating a merger with another insurance company, the terms of which were a function or relative market prices of the securities of the two companies. It was to Midwestern's advantage, therefore, to augment the market value of Midwestern shares. \textit{Id.} at 724.\textsuperscript{92}

92. The court in Diamond v. Oreamuno, 24 N.Y.2d 494, 499, 248 N.E.2d 910, 912-13, 301 N.Y.S.2d 78, 82 (1969), observed that "insider" trading when revealed, derogates from the prestige and good will of the corporation. \textit{But cf.} Richardson v. MacArthur, 451 F.2d 35 (10th Cir. 1971).\textsuperscript{93}

93. 286 F Supp. at 728.

94. Anderson v. Francis I. duPont & Co., 291 F Supp. 705 (D. Minn. 1968). In Anderson, however, it was alleged that the defendant aided and abetted the person conducting the unlawful activity by providing office space, endorsing his skill and standing as a commodities trader and holding him out as a valued customer. \textit{Id.} at 709. It also appears that duPont may have benefited, at least marginally, from its business relationship with the commodities trader. \textit{See id.} at 707 In spite of the court's language to the contrary, it is doubtful that that case could forcefully be cited for the proposition that mere failure to disclose an unlawful scheme constitutes aiding and abetting. In Strong v. France the court stated that silence or inaction will give rise to liability "only when a duty to disclose has arisen." 474 F.2d 747, 752 (9th Cir. 1973) (dictum).\textsuperscript{94}


gram which is adopted should be effectively enforced. Midwestern had informed the broker that his activities would be reported to the Indiana Securities Commission in the event Midwestern received further complaints from his customers, but later implicitly retracted its threat to report this conduct. The court found that this served to encourage the continued illegal activity. By similar analysis, a court might reason that a weak and ineffective supervisory program or a strict program which is not enforced could have the effect of encouraging improper trading by demonstrating that management was not seriously concerned about such conduct.

Criteria for Evaluating Preventative Programs

In order to evaluate alternative preventative measures, criteria should be established for judging each particular program. Although the relative importance of criteria for evaluation will vary from company to company, the following questions would appear to be relevant in most situations:

1. What conduct is the program designed to prevent? In order to answer this question a decision is necessary as to the purpose of the program. If the program is to prevent unintentional violations arising out of an insufficient knowledge of the securities laws, its educational aspects will be most relevant. On the other hand, if the program is to prevent intentional misconduct, its ability to expose violations of the securities laws and to deter attempted concealments of such violations will be more relevant.

2. Will the program be an effective means of preventing the proscribed conduct? When dealing with programs which are primarily educational, the answer to this question will depend on how clearly the information is communicated to employees. The possibility that employees will misinterpret what they are told must be considered, as must be the possibility of extension of the program’s education aspects to

96. 286 F. Supp. at 711.
97. The court said: "The significance of MULIC's practice was not that it prevented Dobich customers from complaining to the Indiana Securities Commission. The significance of MULIC's practice was that it indicated to Dobich that MULIC would not, as it had previously threatened, itself report Dobich's activities." Id. at 723.
98. Of course, it also must be shown that the persons assisting the unlawful conduct have at least some general awareness that they are somehow assisting improper conduct. See text accompanying notes 34-48 supra; SEC v. National Bankers Life Ins. Co., 324 F. Supp. 189, 195 (N.D. Tex.), aff'd mem., 448 F.2d 652 (5th Cir. 1971); Ruder, supra note 2, at 630-38. Cf. SEC v. Spectrum, Ltd., note 55 supra, in which the court considered negligent failure to obtain the information which would have resulted in such awareness to be sufficient where only injunctive relief was sought.
lower level employees who may have difficulty understanding what they are being told. If the function of the program is to prevent intentional misconduct, the ease with which the program may be circumvented must be considered. For example, policy statements against disclosure of confidential information, perhaps effective in preventing unintentional misconduct, will be ineffective in preventing the intentional disclosure of inside information to outsiders.

3. What alternative measures are capable of preventing the same conduct? This question is predicated on the assumption that if several preventative programs will accomplish the same results, the most desirable program is that which accomplishes its goals with the least restriction of an employee's freedom.

4. What effect will the program have on employee morale? In most companies employee morale is important and would be adversely affected by programs which give the employee the impression that he is not trusted or that his intelligence or integrity is not respected by his employer. For this reason, even the most innocuous preventative program must be communicated to employees tactfully with an assurance that it is not a reflection on any particular employee or group of employees. Consideration of employee morale also requires an analysis of the interrelationship between the preventative program and the company's stock option, stock purchase and other benefit plans.

5. What will the program cost to implement? Cost may be measured in a variety of ways. Actual out-of-pocket costs in terms of communications to employees and additional paperwork and personnel are relatively easy to compute. The cost in terms of the demands of the program on the time and energies of key executives is more difficult to ascertain. Thus, a preventative program which requires frequent exercise of judgment at a relatively senior level is generally less desirable than a program providing for clear restrictions and relatively few possible exceptions.

The nature of the judgment which must be exercised should also be considered. It is frequently easier to ascertain whether a particular fact is "generally known in the investment community" than it is to determine whether a fact is "material." The former question can be resolved at a lower level within the corporate structure than the latter question, the resolution of which requires a greater overall understanding of the corporation's activities.

6. What administrative problems are involved in implementing and enforcing the program? This question requires an analysis of the program to determine its feasibility. The ease with which a program
may be implemented and enforced without the necessity of numerous exceptions for types of conduct or classes of employees is an essential administrative consideration. Similarly, the ease with which the program may be kept operational despite turnover either among those persons administering the program or among the employees subject to it must be considered.

7 Can the program be enforced in an effective manner? No program should be implemented without a realization that violations may occur and that the violator may be a key executive whose continued loyalty is important to the corporation. Previolation enforcement techniques which may be applied across the board without regard to the status of the employee, such as stop-transfer orders, restrictive legends and similar preventative techniques, are relatively simple to implement.

The enforcement of the program becomes more difficult, however, when the question of imposing appropriate sanctions does not arise until after the improper conduct has occurred. An effective program should provide appropriate sanctions for violations without undue publicity and without increasing the risk of subsequent shareholder attack. The possibility should be considered of providing for sanctions of various degrees of severity and of forewarning employees that such sanctions may be imposed. The risk that a key employee will intentionally violate a prohibition against insider trading is greater if he believes the corporation's only choices are to ignore the transaction or discharge him than when public admonishment for the conduct and disgorgement of his profits are available alternatives.

8. Will the program be understood and followed? No program will be effective unless it is understood by the persons subject to it. Legalisms and ambiguous terms should be avoided. It is frequently desirable to elicit comments on the program from several of the employees subject to it and to modify it on the basis of these comments prior to broad dissemination. Programs which are likely to be misinterpreted or which would lend themselves to inadvertent or economically pressured violations are generally unsatisfactory. For example, in corporations where a substantial portion of the net worth of many employees is invested in the employer's securities, it is generally not realistic to prohibit the employees from borrowing money secured by those securities.

9 To what extent can employees subject to the program be expected to commit the violations proscribed by it? Once the decision
is made to implement a particular preventative program, the question of who should be subject to it must be considered. Certain programs are only relevant to highly paid employees. Consequently, the administrative difficulty of implementing them with respect to lesser paid employees must be weighed against the likelihood that such employees would engage in the prohibited conduct. For example, a clerical employee is not only unlikely to engage in puts, calls or straddles, but the problem of explaining their prohibition to him may be insurmountable.

Analysis of Particular Preventative Programs

Although the number and variety of possible programs designed to prevent improper transactions in the employer's securities are unlimited, the following types of programs are most frequently considered. These programs are not mutually exclusive and in some cases they overlap. Thus, the decision to implement a particular preventative program must take into account the impact of other preventative programs which the corporation also intends to implement.

Programs Designed to Discourage Recommendations or Expressions of Opinion as to the Desirability of Purchasing or Selling Company Securities

Recommendations and opinions concerning an employer's securities are frequently solicited informally by friends and acquaintances of corporate employees. In many cases the employee is not in a position to express an informed opinion. The board of directors should consider establishing a policy against the expression of such opinions, whether or not the employee possesses material inside information or is capable of expressing an informed opinion as to the desirability of investing in the company's securities. This policy, together with an explanation of why it is in the best interest of the employee and the corporation, should be widely publicized.

Such a policy may be justified on two grounds: (1) the employee, by not having all the facts, may mislead the person seeking information, and (2) if the employee has inside information, he will be personally liable for transactions by his tippee.99 Although there is no completely effective way to enforce such a program, a high de-

99. Persons receiving inside information from insiders knowing such information to be material and undisclosed may be held jointly and severally liable with the insider for profits realized as a result of trades made prior to public disclosure. See, e.g., Schein v. Chasen, 478 F.2d 817 (2d Cir. 1973). See generally Rapp & Loeb, Tippee Liability and Rule 10b-5, 7 CORP. PRACT. COMMENT. 374 (1972).
gree of voluntary compliance by employees will result if reasons for the program are communicated to them adequately. Furthermore, the existence of such a program will provide employees with a basis for declining to express an opinion in circumstances under which they would otherwise find it difficult to do so.¹⁰⁰

Information on which recommendations and opinions may be based is also solicited by analysts, stockbrokers and other members of the investment community. In general, these inquiries are directed to the corporation's financial or public relations executives. A formalized procedure for dealing with these inquiries, with all responses cleared through a single officer, will reduce the likelihood that the members of the investment community will receive conflicting or inaccurate information from corporate spokesmen. Moreover, the task of policing disclosures to make sure that previously undisclosed material information is disseminated widely rather than selectively is facilitated by having a single officer of the corporation responsible for approving all press releases, interviews and other responses to inquiries from the investment community.

**Prohibition Against Trading Activity**

Although many corporations encourage employee share ownership, transactions of a trading, rather than an investment, nature cannot be justified as a part of employee participation in ownership. Even if such transactions are not an attempt to capitalize upon inside information, they may adversely reflect on the corporation and its management by giving the appearance of improper motivation.¹⁰¹ Moreover, if the employee realizes a substantial profit in connection with a trading transaction, it will be difficult if not impossible to convince outsiders that he was not capitalizing on inside information.

Officers, directors and 10 percent beneficial owners are precluded from selling short or selling “against the box” by section 16(c) of the Exchange Act.¹⁰² Their ability to utilize puts, calls or straddles

---

¹⁰⁰. An appropriate answer, such as, “I believe that the long term prospects of the Company are good, but I'm no expert in the stock market and can't predict how it will act,” may seem obvious. However, many employees would not think of it if confronted with a question about investing in their employer's securities.

¹⁰¹. Because a call “is not the vehicle an executive would normally use to invest in his company merely because he thought it had a good long-term future” the risk that he will have to defend a lawsuit where he purchases a call rather than the security itself is substantially greater. Interview with Prof. Robert Mundheim, in *Those Lawsuits Against Executives*, 92 DUNN'S REV., Oct., 1968, at 51, 52. See also SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 851 (2nd Cir. 1968).

¹⁰². “It shall be unlawful for any such beneficial owner, director, or officer, di-
(which are typically purchased for periods of less than six months) to capitalize on material inside information is negated in large measure by section 16(b), which requires them to turn over to the corporation any profit realized from the purchase and sale, or sale and purchase, of a registered class of equity securities within a six-month period. However, the prohibitions of section 16(b) do not apply to non-officers or to securities other than registered equity securities. Thus, section 16(b) does not ordinarily proscribe transactions in securities by officers or directors of an affiliated corporation or a subsidiary.

103. "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 comprehend within the purpose of this subsection." Exchange Act § 16(c), 15 U.S.C. § 78p(c) (1970).

104. See Lee Nat'l Corp. v. Segur, 281 F Supp. 851 (E.D. Pa. 1968). The term "officer" is defined in Rule 3b-2 under the Exchange Act, 17 C.F.R. § 240.3b-2 (1973); to mean "a president, vice-president, treasurer, secretary, comptroller, and any other person who performs for an issuer functions corresponding to those performed by the foregoing offices." Thus, the title of the position is not determinative and persons who are not technically officers of the corporation may be subject to the proscriptions of section 16.

A program designed to prevent trading activities would generally extend prohibitions similar to those contained in section 16(b) to other trading activities, such as the purchase of a put or a call, and to other employees whose level of compensation and access to information may tempt them to engage in such activities. However, exceptions should be considered for transactions which are not prohibited by section 16(b) and which are motivated by tax considerations, such as short sales against the box, and for transactions economically dictated by stock option and other employee benefit plans, such as the sale of securities to raise funds to exercise a stock option.

If a program designed to prevent trading activities is to be effective, it must include follow-up procedures and appropriate sanctions. Although there is no completely effective way to determine whether an employee has purchased or sold a put or call on the employer's securities or if he has purchased or sold shares held in "street name," the transfer agent can be required to advise the employer of all transactions in the employer's securities by employees subject to the prohibition.

Utilization of Blackout Periods

In order to preserve secrecy, material inside information frequently is not known to a number of officers and directors until the company is in a position to issue a press release. Despite their lack of knowledge, such key employees should not engage in securities transactions prior to the press release, since their transactions would be viewed with suspicion by the investment community. Moreover, where an action is brought to recover their profit, such employees may have difficulty establishing their lack of inside information.

The risk of such unfortunate coincidences may be reduced by the utilization of a blackout period procedure. Under this program a designated official is advised whenever there is material undisclosed information concerning the company which makes sales or purchases undesirable. He then communicates the existence of a blackout period to all officers and key employees, indicating that until further notice transactions in the company's securities should not be undertaken. In order

106. But see Lee Nat'l Corp. v. Segur, 281 F Supp. 851, 852 (E.D. Pa. 1968) (court suggested that an officer of a subsidiary of the issuer might be regarded as an "officer" of the issuer if he performs the functions of an officer of the issuer.)

to reduce the likelihood that transactions will be motivated by the announcement regarding the blackout period, the announcement should indicate that neither purchases nor sales should be made. This will help conceal the favorableness or unfavorableness of the inside information.

The primary advantage of the blackout period procedure is its ability to prevent transactions which appear to be, but are not, improper. However, at times when no blackout period is in effect, such a procedure may be viewed as implying that there is no material undisclosed information. Thus, blackout period procedures have been criticized on the basis that they require the corporation to determine continuously whether undisclosed information is, in fact, material.

Arbitrary Limitation of Securities Transactions to Specified Periods

A number of programs are designed to prevent all securities transactions during periods when material undisclosed information is likely to exist. These programs offer the advantage of providing arbitrary restrictions which are not geared to the existence of material undisclosed information, and which do not permit the drawing of conclusions as to whether such information exists.

A company which decides to implement this program must analyze its business to determine those times at which material undisclosed information is most likely to exist. Suggestions by the New York Stock Exchange108 provide a basic framework for this type of restrictive program. The Exchange suggests that it is appropriate to buy or sell securities for a 30-day period commencing one week after the annual report has been mailed to stockholders, provided that the annual report adequately covers important corporate developments. The Exchange also suggests that transactions may be appropriate following the release of quarterly results if no important undisclosed developments are pending, or following the wide dissemination of information on the current status of the company, such as the distribution of a proxy statement or a prospectus. Likewise, trading could be permitted when there is relative stability in the company’s operations and the market for its securities, such as periods of historic inactivity in seasonal businesses.

Permitting insiders to engage in transactions during periods following dissemination of an annual report or earnings statement increases the burden on the corporation to include all material information in the publication relied on to inform the public of the corpora-

tion's affairs. Annual reports to shareholders have historically attempted to portray the corporation in the most favorable light, emphasizing those factors which are positive and minimizing those considerations which are negative. Substantial sales by insiders following the publication of such an annual report may well result in purchasers of securities basing a Rule 10b-5 action against the corporation on the report's content.

Similarly, it is risky to assume that adequate information is available to the public because a quarterly report has been disseminated, since a quarterly report generally does not discuss the business of the company. The allegation could be made that publication of the quarterly results, lacking comment on pertinent investment factors, produces a misleading report violative of Rule 10b-5. Finally, because of the time spent preparing and disseminating the typical annual report, it may not contain the most currently available information. Unlike a proxy statement or prospectus, the annual report frequently restricts its comments to results of the prior year, which may have ended three or four months before its dissemination.

**Arbitrary Limitation of Securities Transactions to a Predetermined Pattern**

Arbitrary restrictions requiring an employee to determine in advance what transactions he will pursue may justify purchases or sales during the existence of material undisclosed information. Such would be the case if the employee can prove that he was irrevocably committed to purchase or sell before the facts giving rise to such material undisclosed information arose. For example, purchases may be permitted pursuant to a periodic investment program and purchases or sales may be permitted under an established program administered by a broker where the timing of the transactions is outside the control of the individual. However, such programs are inherently inflexible and fail to take into account the individual financial needs of the em-

---

108a. The SEC recently proposed rule changes which would require the annual report to stockholders to contain much of the information presently required by Form 10-K. SEC Securities Exchange Act Release No. 10591 (Jan. 10, 1974). If these changes are adopted, it is likely that the annual report will be regarded more as a disclosure document requiring a balanced presentation than as a shareholders' public relations vehicle.

109. Moreover, if adjustments are made in the results for the entire year which might have appropriately been reflected in the interim report, liability may arise under Rule 10b-5 unless the issuer can sustain the burden of going forward with evidence demonstrating that the accounting treatment in the interim report was correct. Republic Technology Fund, Inc. v. The Lionel Corp., [Current Binder] CCH Fed. Sec. L. REP ¶ 94,069, at 94,303 (2d Cir. 1973).
ployee who, because of unforeseen personal circumstances, may find it necessary to engage in transactions which cannot be preprogrammed. Furthermore, such programs are suitable only for the implementation of long-term decisions to purchase or sell. Thus, the employee is denied the right to dispose of his entire position in the company even though he has no inside information.

Prohibition Against Transactions in Securities of Affiliates, Customers, Suppliers and Other Parties with whom the Employer is Negotiating or Dealing

Recent proceedings have indicated that the class of persons who are precluded from acting on undisclosed material information may be substantially expanded. Although early "tippee" cases indicated that the material information must be obtained pursuant to a confidential relationship creating a direct fiduciary obligation,110 recent administrative decisions by the Securities and Exchange Commission have expanded the "tippee" concept to include persons who bear no such fiduciary relationship to the issuer.111 Further expansion of this concept to preclude transactions by persons who not only lack a fiduciary relationship to the issuer but who obtain such information from sources which have no fiduciary relationship to the issuer is a distinct possibility in light of recent actions involving pre-press release trading in shares of Equity Funding.112 Accordingly, adoption of a policy precluding insiders from purchasing or selling securities of suppliers, customers and other parties with whom the employer is negotiating should be considered.

110. See note 30 supra.
112. In a disciplinary proceeding growing out of the collapse of Equity Funding, the New York Stock Exchange charged Raymond L. Dirks with violating Section 10 of the Exchange Act by "tipping" clients between March 6 and March 26, 1973. The "material inside information" which Mr. Dirks was charged with improperly disclosing was not alleged to have been obtained from or as a result of any relationship with the Company or its officials, but resulted from Mr. Dirks' own investigation of a charge made by a former employee of Equity Funding. BNA Sec. Reg. & L. Rep., No. 198, at A-2 (April 18, 1973). Purchasers from Mr. Dirks' "tippees" have also sought to recover on the theory that the information relied on by the sellers was material inside information which could not be acted upon, notwithstanding the absence of any confidential relationship between Equity Funding and Mr. Dirks. Salomon Bros. v. John W Brstol & Co., Inc. (S.D.N.Y. filed April 11, 1973), in BNA Sec. Reg. & L. Rep., No. 199, at A-2 (April 25, 1973). Referring to the Equity Funding case as "a law professor's dream," the Wall Street Journal was impelled to ask "Is Everybody an Insider?" Goldstein, Equity Funding Case Raises Many Legal Questions About Inside Information but Yields Few Answers, Wall Street Journal, May 14, 1973, at 30, col. 1.
If such a program is implemented, care must be taken in determining what companies are initially placed on the restricted list and how changes are made. For example, the mere addition to the restricted list of a company with which confidential negotiations are in progress may itself be a material disclosure to persons bent on profiting from such transactions. Although an insider may be unaware of a material pending transaction with another corporation at the time of his purchase or sale, he will have difficulty so convincing the marketplace. The arbitrary prohibition of transactions in securities of companies with which the employer is dealing eliminates both the existence and the apparent existence of wrongdoing.

Prohibition Against Ownership of Securities of Nonpublic Affiliates, Suppliers, Customers and Competitors

Although this prohibition is frequently discussed in connection with the consideration of programs to prevent insider trading, its purpose is entirely different. Prohibiting employees from investing in nonpublic affiliates is predicated upon the absence of an established market price for the affiliates' securities and the desire to preclude any relationship which creates or appears to create a conflict in interest which might affect the employee's performance of his duties.

Although not articulated in the requirements for listing on the New York Stock Exchange, there has long been a policy of discouraging officers of listed companies from engaging in transactions with or having a minority interest in, affiliates and subsidiaries. The Exchange has also taken into account the interests of directors, officers and principal shareholders in subsidiaries, competitors, suppliers and customers in determining whether a listing application should be favorably considered.113 The prohibition against investments in nonpublicly held customers or suppliers is also predicated upon the existence of a fiduciary obligation to the employer corporation.

Pretransaction Notification or Clearance Programs

The pretransaction notification or clearance procedure is designed to prevent transactions when material undisclosed information exists, whether or not such information is known to the officer, director or key employee who proposes to enter into the transaction. It is predicated on the assumption that employees subject to obtaining pretransaction clearance may not be able to establish that they were unaware of such information.

113. NYSE Manual, supra note 5, § B-1 at B-5.
Pretransaction clearance programs assume that material inside information can exist at any time and that, therefore, arbitrary blackout periods are not feasible. All subject employees are required to notify a designated officer of the corporation prior to engaging in any purchase or sale of the employer's securities. Under the notification procedure if the employee is not advised to forego the transaction within a specified period, he is free to enter into it. Under a clearance procedure he must await advice from the designated officer prior to engaging in the transaction.

One basic objection to the pretransaction notification or clearance procedure is that at times a corporate officer has difficulty keeping abreast of all material undisclosed information. To place such a burden on any officer involves the corporation to a degree which may subject it to liability as an aider or abettor of any improper transaction. Another objection to the pretransaction procedure is that, in spite of its effectiveness, the establishment of communication channels for the effective and expeditious operation of the program may involve the expenditure of substantial administrative time and expense. The act of advising an employee not to engage in a transaction is likely to create rumors which may actually motivate employees to enter into such transactions. However, if the same advice is given every time material insider information exists, whether favorable or unfavorable, the action of the clearance officer would not be considered an indication that prices for the security would be expected to increase rather than decrease. Therefore, it is unlikely that the advice itself would provide a basis for action.

Posttransaction Notification as a Preventative Device

An alternate to pretransaction notification is posttransaction notification, that is, a requirement that all persons report all transactions in the issuer's securities after they have been made. If an employee knows that his transaction must be brought to the attention of corporate officials in a position to investigate it, he may be less likely to enter into a transaction when he possesses material inside information.

The primary advantages of this procedure over pretransaction notification are greater simplicity, avoidance of delay by the employee in effecting transactions, allowance of innocent transactions which might be barred under a pretransaction procedure and elimination of a clearance officer whose actions would indicate the existence or non-existence of material undisclosed information. A primary disadvantage to this procedure is its inability to prevent inadvertent improper trans-
actions. The employer is put on notice of such a transaction at a
time when the only sanctions available are those more severe than merely
advising the employee not to enter into the transaction. Furthermore,
posttransaction notification would not prevent the company from being
charged with failure to take adequate steps to prevent improper trans-
actions before they occurred.

**Restrictions on Extensions of Credit in
Connection with Purchase of Securities**

Notwithstanding policies favoring a meaningful investment by
management in the equity securities of the employer, the company
may consider restricting the use of credit in connection with the acquisi-
tion of the employer's securities and discouraging a dispropor-
ionate commitment of the employee's personal wealth to those securities.
Such policies are predicated on the assumption that an employee who
has incurred substantial indebtedness in connection with the purchase
of his employer's securities is more likely to act on the basis of inside
information, particularly where such information is likely to result in
the market price dropping below the level at which his loan would
be called or additional collateral would be required.

Although a corporation may decide to limit a stock option grant
to that which the employee can afford without incurring substantial
personal debt, no effective procedure exists for imposing sanctions
on those employees who incur excessive personal debt. Moreover, many
corporations prefer to have key employees with an inordinate commit-
ment to the employer's securities, on the theory that such employees
are less likely to seek other employment or work against the employer's
interests. Finally, this policy is the most subject to the criticism that it
interferes with the employee's personal affairs. The effective imple-
mentation of such a credit restriction program necessarily would require
a knowledge of the employee's overall financial condition.

114. *E.g. id. § A2, at A-24.*

115. This policy must be differentiated from that reflected by statutes which re-
strict the ability of the corporation to make loans or guarantee obligations of officers
or directors or of any person on the security of shares of the corporation, such as
CAL. CORP. CODE § 823 (West Supp. 1973), which are intended to prevent insiders
from taking advantage of their position. *See Wulfjen v. Dolton, 24 Cal. 2d 878,
151 P.2d 841 (1944) (involving prior version of CAL. CORP CODE § 823 (West Supp.
1973).”

116. An alternative to incurring debt in order to exercise options is selling securi-
ties purchased through prior stock option exercises in order to finance the purchase
of subsequent installments. In addition to the risk that officers will inadvertently en-
gage in a transaction proscribed by Section 16(b) of the Exchange Act, this practice
dilutes the officer's interest in the company's securities and the incentive value of the
option.
Restrictions on Stock Option Grant Procedures

Even where no preventative program is implemented for purposes of regulating the timing of purchases and sales by employees, a corporation should consider the desirability of taking steps to assure that no stock option will be granted at a time when material inside information exists. If the information is adverse and the market price of the security drops after the option is granted, the value of the option and the incentive produced by it will be substantially reduced. If the information is favorable, the grant of the option may be criticized on the same philosophy that relates to purchases and sales by insiders.\textsuperscript{117} Moreover, if the employee is aware of the material inside information at the time he accepts the option, he may have to disclose such information to the option committee or risk the rescission of the option under Rule 10b-5.\textsuperscript{118}

Restrictions of Purchases and Sales to Normal Broker's Transactions

Transactions in an employer's securities which do not occur in normal broker's transactions may create the appearance of improper conduct, even if completely proper. Included in such transactions are private purchases or sales at other than the existing market price, purchases in connection with the public offering of a new issue and purchases at the time of the employer's initial public offering.

If transactions between insiders and customers or suppliers of the corporation occur at prices other than those prevailing in the regular market, they may constitute a form of benefit or compensation designed to encourage favorable treatment.

The purchase of securities in connection with a public offering by company personnel involved in the registration process, particularly those who participate in the pricing of new securities issues, may also be restricted. The basic concern motivating these restrictions is not that the employee will have the advantage of undisclosed material information, since the prospectus should contain all such information, but that such employees will be improperly influenced in their decision


\textsuperscript{118} In the \textit{Texas Gulf Sulphur} case, it was held that a member of top management was required before accepting a stock option to disclose material inside information. 410 F.2d 833, at 856 n.24. The district court had held that optionees who were not members of top management could reasonably assume that their superiors would disclose any material inside information to the Stock Option Committee, if required. 258 F Supp. at 291. Since the SEC did not appeal this holding, the appellate court was not confronted with the issue of whether acceptance of option grants by them violated Rule 10b-5. 401 F.2d at 856.
on pricing the issue by the benefit which they may gain through their personal investment.

Often companies which have not previously had a public market request that the managing underwriter reserve shares for or direct shares to key employees, customers and suppliers.\(^{119}\) Frequently a chief executive's allocation of shares in an offering which he believes will be a "hot issue," adversely affects company morale. If the offering is, in fact, a hot issue, those employees not allocated shares or those financially unable to purchase them will be dissatisfied. On the other hand, if the market price of the securities falls below the initial public offering price,\(^{120}\) those employees who did purchase them will be dissatisfied. Because it is frequently assumed that hot issues will not remain hot, insiders purchasing these securities tend to dispose of them rapidly in the after market. This has an adverse affect on the stability of the market for the corporation's securities. If the purpose of directing shares is to encourage greater employee participation, a better means of accomplishing this is through employee stock purchase programs designed for long-term commitments to the issuer's securities rather than for trading profits.

**Adoption and Promulgation of Policy Statements Reflecting the Board's Concepts of Ethical Conduct**

It is generally assumed that key employees are honest and ethical and would not intentionally engage in transactions which they believe to be improper. Thus, the mere promulgation of policy statements indicating the impropriety of trading on material inside information may be sufficient to discourage this practice. Particularly in companies where key employees may be unaware of their potential liability for trading on inside information, education of key employees as to their responsibilities under the securities laws is desirable.

**Alternative Means of Implementing Preventative Programs**

Once a corporation has decided which preventative programs to

---

119. The reservation of shares must be disclosed on the cover of the prospectus, on the theory that the failure to do so will give a false impression of the number of shares actually available for the public. See also, NASD Interpretation of Board of Governors, adopted November 1, 1970, CCH NASD Manual ¶ 2151, at 2039-42 (Nov. 1970), 2043-45 (May 1972).

implement, it must determine who will implement them. Three basic alternatives exist. First, implementation may be assigned to an existing department. If the corporation is relatively small or if the preventative programs adopted are relatively simple, this may be done without a substantial increase in corporate personnel and without the administrative difficulty inherent in establishing new channels of communication.

Second, where the preventative programs introduced are complicated in nature or would require the addition of substantial personnel, use of compliance officers or of a compliance department not involved in other corporate activities may be desirable. Even where compliance activities may be absorbed into an existing department, it is sometimes desirable to assign them to a separate department which does not have other corporate responsibilities. This will minimize the impact of compliance decisions on other relationships within the corporation.

A third alternative, the utilization of a nonmanagement staff directly responsible to the board of directors, separates the operation of the corporation from enforcement of insider trading policies to an even greater degree. In advocating the creation of a directors' staff, Arthur J. Goldberg121 has argued forcefully that a large company's board of directors does not have the ability to gather and analyze that information necessary to control and manage the company. Noting the responsibility of the board of directors under Rule 10b-5 and under state law, Mr. Goldberg has urged the formation of a "Committee of Overseers," separate from the executive committee, empowered to hire a small staff of experts responsible only to the board.122

The independent staff concept may be criticized because of its potential as a divisive force in the corporation, undercutting management's authority and ability to act effectively. It may also be criticized as creating an unwieldy separation of powers tending to dilute the direct responsibility of senior management to manage the affairs of the corporation. Where a legitimate question exists as to whether undisclosed information is material, management may be better able to answer it than an independent staff. In the event of a disagreement between the management and the independent staff as to whether information is material, resolution of the conflict would be exceedingly difficult and might have a demoralizing effect on management.

121. Goldberg, Debate on Outside Directors, N.Y. Times, Oct. 29, 1972, § 3, at 1, col. 3.
122. Id.
Conclusion

While few courts have either rejected the necessity or denounced the desirability of implementing programs designed to curtail improper securities transactions by corporate employees, neither the courts nor the SEC presently requires the adoption of such procedures. To conclude that a duty exists to adopt such programs where evidence of improper employee transactions is nonexistent would not only be contrary to the presumption of employee honesty on which the board is entitled to rely, but would extend concepts of indirect liability for a failure to act beyond all prior limits.

However, reasons unrelated to potential liability of the directors may justify the adoption of preventative programs. In the event corporate insiders engage in improper trading, directors may be forced to defend against claims of negligent failure to prevent the misuse of corporate assets, of complicity as controlling persons in violations of securities laws, and of inaction tantamount to aiding and abetting the violation of securities laws. It is reasonable to predict that the implementation and enforcement of programs would be extremely effective if not dispositive in meeting allegations of lack of due care, lack of good faith or lack of affirmative action.

123. Although it has been suggested that the SEC should establish standards for director conduct which would include a duty to take appropriate action to prevent violations from occurring, address by SEC Chairman Cook, Southern Methodist Univ. School of Business Administration, April 6, 1973, the current chairman of the SEC has expressed doubts that the Commission could or should establish standards for director conduct. Wall Street Journal, Sept. 17, 1973, at 24, col. 1.