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Oversimplification and the SEC's Treatment of Derivative Securities Trading By Corporate Insiders

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ARTICLE: OVERSIMPLIFICATION AND THE SEC'S TREATMENT OF DERIVATIVE SECURITIES TRADING BY CORPORATE INSIDERS.

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SUMMARY:

... In attempting to equate trading in straight stock with the economically comparable position in a derivative security, the SEC has oversimplified. ... First, a trade in a derivative security can be coupled with a reverse trade in the same derivative security. ... Second, a trade in the underlying security or a derivative security can be coupled with a contra-position in a derivative security. ... Generally, these rules state that the acquisition and the disposition of a derivative security are treated as identical to the economically comparable investment in the underlying stock. ... A "call equivalent position" is a position in a derivative security whose value increases as the price of the underlying security rises. ... Likewise, the acquisition of a put equivalent security is both the acquisition of the derivative security and the sale of the common stock. ... The new SEC rules, however, explicitly address the issue by removing any requirement that a derivative security be issued by the subject corporation. ... The expansion to include trading in a derivative security itself is slight in comparison with the SEC's approach to the second basic fact pattern. ...

HIGHLIGHT: In 1991, the Securities and Exchange Commission completed a comprehensive revision of its rules under the short-swing profit disgorgement provisions of section 16 of the Securities Exchange Act of 1934. An important goal of these revisions was to remedy the often confusing and illogical application of the short-swing profit disgorgement rules to trading in derivative securities. By equating transactions in derivative securities with the analogous purchase or sale of the underlying stock, the SEC adopted a unifying and systematic regulatory regime for the treatment of derivative securities trading by corporate insiders.

The clarity and simplicity of the new regulations come, however, at some expense. First, the new rules overturn significant court precedent interpreting section 16(b) and its application to derivative securities trading. This raises the critical issue of the SEC's authority under the statute to adopt the new rules. Unlike the broad grant of authority under section 10(b) of the 1934 Act, section 16(b) offers little support for the SEC's wholesale rewriting of the statute's content, especially when the result is to expand the provision's scope. Furthermore, a close examination of the new rules' effect reveals a more fundamental challenge to both their wisdom and the SEC's authority to adopt them. While treating simple put and call transactions as equivalent to the purchase or sale of the underlying stock is compelling, more complex derivative strategies do not offer the same potential for the abuse of nonpublic information. In fact, some are inherently unable to benefit from any informational advantage. Therefore, in adopting the new rules, the SEC has oversimplified.

TEXT:

[*1287] In February 1991, the Securities and Exchange Commission completed a comprehensive revision of its rules n1 under section 16 of the Securities Exchange Act of 1934. n2 After more than two years of study, n3 the Commission adopted the revisions "to achieve greater clarity . . . and [*1288] enhance consistency with the statutory purposes of section 16." n4 Section 16(b) sets forth the infamous short-swing profit disgorgement provision of the federal securities laws. The provision's purpose is generally assumed to be the prevention of insider trading. A major impetus for the revisions to the rules under section 16 was the boom in the trading of puts, calls and other derivative securities. n5 The new rules attempt to set forth a cohesive framework for the application of section 16(b) to the trading of these securities. This Article argues, however, that the new rules remain seriously flawed.

Derivative securities include standardized put and call options, employee stock options, warrants and other rights to acquire or to sell equity securities. n6 Since trading in derivative securities offers opportunities for abuse of inside information as does trading in the underlying stock, it was natural to extend the short-swing trading prohibition of section 16(b) to derivative securities. But this simple analogy becomes elusive when the complexity of the derivatives market is compared with the relatively simple story of buying and selling stock within a six-month period. The application of section 16(b) to derivative securities trading by corporate insiders poses some of the most intractable interpretation problems for practitioners, the SEC and the courts in section 16(b) doctrine. n7

Nor has this application received uniform treatment in the courts. n8 The SEC has from time to time attempted to create some uniformity through its rulemaking authority under section 16(b). These earlier attempts did not meet with success. An early rule, although limited to the treatment of employee stock options issued under a qualified plan, was [*1289] criticized by the Second Circuit n9 and even struck down by one court n10 as inconsistent with the legislative purpose of the statute.

The SEC's latest revision of the section 16 rules n11 endeavors again to make sense of the application of section 16(b) to derivative securities trading, offering an even more comprehensive approach and attempting to reverse substantial judicial precedent. Since these rules throw a net over an insider's use of derivative securities, including employee stock options, that is wider than the majority judicial interpretation, they are likely to be challenged. In evaluating the SEC's use of administrative power, the courts will be again required to examine the rules in light of the legislative purpose of the statute.

There is a tension between the stated purpose of section 16(b) and its content. The statute begins with the express purpose of "preventing the unfair use of information which may have been obtained by [an insider] by reason of his relationship to the issuer." n12 That "[s]ection 16 is but one weapon against insider trading" n13 is virtually unquestioned. n14 However, the actual restrictions of the statute are only invoked when an insider buys and sells, or sells and buys, equity securities of his or her corporation within six months. It is difficult to accommodate the broad goal of deterring insider trading within this narrow prohibition of short-swing trading. There is no necessary correlation between the simple fact of a purchase and sale or a sale and purchase within six months and the abuse of inside information. Inside information can be abused with but one trade, and matched trades are not ineluctably motivated by inside information. Therefore, courts have been forced to struggle with the innocent insider whose activity fits within the literal prohibition, n15 as [*1290] well as with the clearly culpable insider whose antics do not. n16 Cohesive rules of application have evaded the courts as they seek to apply the basic statute to a purpose it was not well suited to achieve. The discord is only more extreme in the case of derivative securities.

In attempting to equate trading in straight stock with the economically comparable position in a derivative security, the SEC has oversimplified. It may be initially appealing to assert that like investment positions should receive uniform treatment, because derivative investment strategies are inherently short-term bets. But section 16(b)'s expanded net is likely to capture an even greater proportion of innocent transactions than a scheme simply dealing with straight stock trading. These harsh results will again force courts to examine the validity of the SEC's rules.

This Article begins with an examination of the new rules governing derivative securities trading under section 16(b). Part I discusses the assumption of equivalency between straight stock trading and comparable derivative positions which underlies the rules. Part II of the Article then examines how these new rules differ from the courts' prior interpretations of the statute. We shall see that, for the most part, the new rules have resolved uncertainties in the interpretation of the statute in favor of a more expansive role for the short-swing prohibition.

Courts have criticized section 16 rules, on the one hand, because they allow potential abuses to slip through the net and, on the other, because they penalize innocent transactions. In both instances, courts have pointed to the statutory

purpose of deterring insider trading as the guiding principle. While one set of commentators has focused on illustrations which expose the new rules to the first criticism, n17 this Article focuses in Part III on how a simplistic application of the short-swing trade paradigm to derivative securities trading captures transactions which, by their nature, cannot benefit from inside information. Nevertheless, these transactions are captured by the profit disgorgement provisions of section 16(b) as applied under the new rules. Part IV of this Article discusses the implications of this oversimplification for the question of the SEC's authority to adopt the new rules. This Article also examines and rejects other challenges based on the criticism that the new rules unduly widen the statute's net. Several commentators have focused on challenging the new rule's exemption of options exercises from the statute. This Article concludes that this particular aspect of the new [*1291] regulation is valid and justifiable. Other aspects of the new rules, however, are not. While the new rules do offer a comprehensive, uniform regulatory scheme, these salutary qualities alone do not establish a valid exercise of delegated authority under the statute.

Even if the courts are generally willing to accept the SEC's authority to adopt the new rules, there is no basis for upholding application of the rules in the specific instances in which abuse of inside information is simply not possible. The SEC should amend the new regulations to eliminate these inappropriate results. In the end, however, Part V concludes that it may be wiser to simply accept section 16(b)'s obsolescence in the face of complex developments in securities markets, such as straddles, spreads and convertible, resettable preferred stock. An examination of the "no action" letters which have accumulated since adoption of the new rules indicates that the problem of oversimplification can only grow worse. Section 16 was one of the few Exchange Act provisions in which the SEC was not given substantial flexibility to accommodate change. n18 That ultimately may be the statute's undoing.

I. THE SIMPLE STORY OF EQUIVALENCY

Section 16(b) provides a right of action against an officer, director or ten percent stockholder of a corporation for the profit earned in short-swing trading. Short-swing trading is defined as any purchase followed within six months by a sale or any sale followed within six months by a purchase. n19 The avowed purpose of this disgorgement provision is deterring the unfair use of inside information. Furthermore, the statute states that it is to be applied objectively. Therefore, it is unnecessary to establish any actual use of inside information to impose liability as long as the literal requirements of the statute are satisfied. n20 One must simply identify a trade which is reversed within six months. Abuse of inside information is irrebuttably presumed, and liability is imposed. Courts have often found that where abuse is clear, the literal application of the statute is not. Using an expansive, purpose-based approach, they have stretched the narrow ambit of the short-swing prohibition to include less [*1292] obvious transactions as matched sales or purchases. n21 More recently, the courts have been more concerned with limiting, rather than expanding, application of the statute and have used this same "pragmatic" approach to reject literal application of the statute to transactions posing no risk of insider trading. n22 Both strains of section 16(b) precedent pose difficulties for the approach taken in the new rules to insiders' trading of derivative securities.

Section 16(b) issues related to derivative securities involve three basic fact patterns. Each presents a different possible coupling to establish a short-swing trade. First, a trade in a derivative security can be coupled with a reverse trade in the same derivative security. So we might match the purchase of a call option — an option to purchase stock at a fixed price within a specified period of time — with its disposition. Second, a trade in the underlying security or a derivative security can be coupled with a contra-position in a derivative security. So we might match the purchase of stock or of a call option with the purchase of a put option — an option to sell at a fixed price within a specified period of time. Finally, the exercise or conversion of a derivative security can be treated as a trade in the underlying security and coupled with a contra-trade in either the underlying security or a derivative security. So if an insider exercised a call option, thus receiving the underlying stock, we could match that event with a subsequent or preceding sale of the stock. Each of these pairs could be deemed a short-swing trade. If completed within six months, any profit would be recoverable from the insider. But to conclude that any one of these matched transactions is a short-swing, we must show how these pairs implicate the story of insider trading and the reading of section 16(b) as a response. To use the courts' "pragmatic" approach, we need to show how such a characterization serves the statute's purpose of preventing the unfair use of inside information.

The basic story of insider trading is that an insider can profit by taking a positive investment position based on non-public good news and a negative investment position based on bad news. Because the value of [*1293] derivative securities is directly related to the changes in value of the underlying security, the insider trading opportunity is similar. Therefore, the SEC argues that if section 16(b) is meant to deter such practices involving stock, it must also apply to trading involving these derivative instruments. n23 On the surface, this application of the statute seems logical. Indeed,

the opportunity for abuse of the kind addressed by a short-swing prohibition appears especially acute in the case of derivative securities. Their very nature presumes a highly time-oriented investment strategy based on contra positions. In a sense, they are almost inherently a bet on short-swing price movements in the underlying stock. A call option bets that a stock price will rise within a short-term period; a put bets the opposite. Furthermore, these bets can be placed with substantially less capital than a straight stock trading scheme, making it even easier for the insider to exploit an unfair informational advantage. n24 The equivalency between the straight stock position and the comparable, simple derivative position is made most explicit by examining their respective pay-off profiles.

The profile for a long stock position, in which the investor simply owns shares outright, is portrayed in Figure 1. Figure 1 provides a simple example of a share of stock purchased for \$100. The horizontal axis measures the change in the market price for the share; the vertical axis reflects the consequent effect on the investor's return. Therefore, as seen on the graph, if the stock price falls to zero, the investor will suffer a complete loss of the \$100 investment. If the stock price climbs to \$200, the investor will have a profit of \$100, or the market price of \$200 less the cost of \$100.

[*1294] [SEE Figure 1 IN ORIGINAL]

[SEE Figure 2 IN ORIGINAL]

[*1295] Figure 2 represents the pay-off profile for a comparable long call position. Instead of purchasing a share of stock for \$100, the investor has purchased a call option to purchase the stock for \$100 anytime within a specified time period. n25 The example assumes that the purchase price, or premium, paid for the call option was \$5.

The obvious difference between the straight stock and the call option strategies is the effect of a falling stock price. Unlike the long stock investor, the purchaser of a call option has eliminated the down-side risk. If the stock price falls below \$100, the option holder will not exercise the option, since open market purchases will be less costly. Therefore, the only loss on the option is the amount of the premium, or \$5. However, once the stock price climbs beyond \$105 (at which point the call option holder has recouped the cost of the option), the investor's gains are comparable to those of the straight stock holder. One important difference is the effect of leverage on the percentage gains of the different investment strategies. Although at a market price of \$200 the stock investor has earned a \$100 profit and the option holder has earned only \$95, remember that the former required an initial investment of \$100 yielding a percentage return of 100%. The option holder invested only \$5, yielding a percentage return of 1900%. Put differently, with the same \$100 investment, the option investor will have \$1,800 more profit than the stock investor.

We can see from these examples that if an insider knows of nonpublic information regarding, for example, a significant mineral discovery by her mining company, she can earn a riskless profit by either buying call options or buying the stock. In fact, because of the leverage available in using options, the use of derivative securities is even more attractive. Once the company's stock price reacts to public disclosure of the discovery, both strategies will profit from the rising stock price. This view of the equivalency of the two investment strategies underlies the SEC's approach in its new rules addressing derivative securities. n26

Generally, these rules state that the acquisition and the disposition of a derivative security are treated as identical to the economically comparable investment in the underlying stock. n27 However, the exercise or conversion of the derivative security into the underlying instrument is exempt from the short-swing prohibition because such transactions are [*1296] seen as merely changing one form of beneficial ownership into another. n28

To see how these rules work in our basic fact patterns and how they differ from the judicial precedent, consider a simple case. If an insider purchases a one-year call option on January 1, exercises the option on July 1 and sells the underlying stock on December 31, does the insider come within the scope of section 16(b)? Most courts have said yes; the new rules say no. n29 The courts have held that the exercise of an option constitutes a purchase of stock under section 16(b) since at that point ownership becomes definite. n30 If followed by a sale within six months, there would be a short-swing trade even though the insider had held the option, and thus effectively beneficial ownership in the underlying security, for more than six months. n31 The new rule rejects the formalism of the courts' approach and starts the clock at the point when an economic interest is first established, when the call option is first acquired. This rule does allow some short-swing trades to escape the statute. Insiders may exercise an option, then learn of negative news, sell stock within six months and escape section 16(b) liability. n32 This loophole brings the rule in conflict with an earlier Second Circuit opinion n33 which was highly critical of the SEC's earlier rulemaking efforts in this area.

However, on balance, the new rules do more to expand than to contract the scope of the short-swing disgorgement

provision. n34 Consider another case. Suppose instead of the facts described above the insider allows the call option to expire unexercised, but on May 1 sells stock that she had owned for years. Most courts have said there is no section 16(b) exposure; n35 under the new rules, the insider would have liability. Since the courts did not consider the acquisition of an option to [*1297] be definite enough to constitute a "purchase," n36 there was nothing to couple with the subsequent sale of stock. Under the new rules the acquisition of the option on January 1 constitutes a "purchase," which is coupled with the sale five months later. n37 By equating the purchase of an option with the "equivalent" stock transaction, the rules have added an additional securities market, the market for standardized options trading, n38 to the transactions which can be matched with stock transactions to generate section 16(b) liability. In fact, since standardized options generally have an expiration of no more than nine months, n39 these rules largely exclude insiders from that market.

The new rules are structured around two concepts: "call equivalent positions" n40 and "put equivalent positions." n41 A "call equivalent position" is a position in a derivative security whose value increases as the price of the underlying security rises. Because this is an economic equivalent to a long position in the stock itself, the opening or increase of a call equivalent position is equated with a purchase of stock for section 16(b) purposes. n42 A "put equivalent position" is simply the inverse investment strategy and is therefore equated with a sale of stock. n43 Call equivalent positions are created by acquiring the right to buy stock at a fixed price within a specified period of time, such as by buying a standard call option. n44 Put equivalent positions are created by acquiring the right to sell stock at a fixed price within a specified period, such as by buying a standard put option. n45

[*1298] The rules also include within each concept the short position in the opposite investment vehicle which is created by "writing" the option. When one writes an option, one sells to another party the right to buy or to sell stock from or to the option writer at a fixed price for a specified period. n46 So a call equivalent position is created when one *writes* a put option; a put equivalent is created when one *writes* a call option. Thus a person who writes a call option has agreed to sell stock at a specified price upon the option holder's election during the life of the option. Similarly, a person who writes a put option obligates herself to purchase stock for a specified price if the option holder exercises the option prior to its expiration. In exchange for writing an option, the writer receives a monetary payment, or "premium."

The approach taken by the SEC in drafting the new rules is artful. The rules seek to capture trading in derivative securities by redefining "purchase" and "sale." Rather than simply bringing derivative securities within the ambit of section 16(b) by including them within the term "any equity security," n47 the rules capture trades in derivative securities by defining such trading to be either purchases or sales of the underlying equity security. n48 This approach eliminates the artificial separation of trading in derivative securities from trading in the underlying stock. Under the new rules, the acquisition of a call equivalent security, such as a convertible debenture, is treated as both the acquisition of the derivative security itself, the debenture, and a purchase of the underlying common stock. n49 Likewise, the acquisition of a put equivalent security is both the acquisition of the derivative security and the sale of the common stock. n50

Thus, the rules operate by dividing all possible transactions into the two portfolio positions — call equivalent and put equivalent. One makes a purchase or sale of the underlying stock based on which position one is seen as adding to or subtracting from. Call equivalent positions are seen as bets on an increasing stock price. The same bet is made when one purchases stock outright. Therefore any increase in the call equivalent position *or any decrease* in the put equivalent position is deemed the equivalent of a purchase of the underlying stock. n51 Similarly, since a [*1299] put equivalent position is a bet on a decreasing stock price, any increase in the put equivalent position *or any decrease* in the call equivalent position is deemed the equivalent of a sale. n52

Rather than attempt to enumerate all possible short-swing match-ups in trading which involve derivative securities or a mixture of derivative securities and the underlying stock, the SEC used the concept of equivalency to adopt generic rules to capture comprehensively all permutations. Returning to the three basic fact patterns mentioned above, the new rules bring all variations of the first two cases within the ambit of section 16's disgorgement provision — the trade in a derivative security followed by a reverse trade as well as the trade in the stock or a derivative security followed by a contra-position in the stock or a derivative security. The new rules, however, exclude from section 16(b) examples of the third case, such as conversions or exercises of derivative securities. n53 No longer are we to match the exercise of an option with the subsequent sale of the security acquired upon exercise. This was one of the most frequently triggered snares in section 16(b) doctrine prior to the new rules' adoption. n54 Its loss may lead some to complain that the new SEC rules have gone too far in enlarging section 16(b)'s net. n55

Finally, the new rules address one wrinkle in the case of insiders who write options. Because inside information is presumed to allow the insider to make a riskless bet on the direction of her corporation's stock price, the new rules see

an opportunity for speculative abuse in simply writing options. If an insider knows the stock price will rise, the insider can write put options without any risk that they will be exercised (since sales in the market will be more attractive to the option holder). Therefore, the premium earned for writing the put is a riskless profit. Similar abuse is possible in writing calls if the insider knows of negative inside information. The new rules consequently provide that if an option expires within six months, any profit derived from writing the option will be recoverable under section 16(b). n56

[*1300] In combination, these new rules define transactions involving derivative securities as either "purchases" or "sales" that may not be juxtaposed within a six-month period by insiders. These categories can be summarized rather easily. Each of the following constitutes a "purchase" of an equity security under section 16(b):

- 1) Purchase of Stock
- 2) Purchase of a Call Equivalent n57
- 3) Writing of a Put Equivalent n58
- 4) Sale of a Put Equivalent n59

Each of the following constitutes a "sale":

- 1) Sale of Stock
- 2) Purchase of a Put Equivalent n60
- 3) Writing of a Call Equivalent n61
- 4) Sale of a Call Equivalent n62

Of course, to accomplish either the first or fourth of these sales, the insider must have previously acquired an inventory of stock or call options. But even if she has not, she can achieve the same economic result by effecting one of the other choices. If any of the "purchase" transactions precedes any of the "sale" transactions by more than six months, the insider's profit n63 is subject to forfeiture. Also, if any "purchase" follows a "sale" within six months, the same result ensues.

Two special transactions can follow the writing of an option to create a short-swing match. As we have seen, if an insider writes a put [*1301] equivalent, she is deemed to have effected a purchase. A sale will follow if the option expires within six months n64 or if the insider disposes of the short position by transferring the obligation under the option contract to another party. n65 Likewise, if an insider writes a call option, which we have seen constitutes a sale, she will be liable for any profit if either the option expires within six months n66 or if she disposes of that short position. n67

The new rules offer a comprehensive and uniform regulatory scheme for applying section 16(b) to derivative securities trading. By adopting the notion of equivalency and reducing each investment strategy to a bet on either increasing or decreasing stock prices, the SEC has found both an artful framework for crafting its regulations and implicit justification for them. The regulations are a response to the same evil seen in short-swing trading of straight stock. However, despite the appeal of the new rules' internal coherence, they face at least two related obstacles. First, a substantial body of judicial interpretation predates these rules and often contradicts them. The question will be whether the SEC now has the authority to change the landscape. n68 Second, even if the SEC is generally authorized to make such sweeping changes, what becomes of SEC's authority if the concept of equivalency behind the new rules is illusory and the connection between the rules' prohibitions and the evil of insider trading evaporates?

II. CHANGES TO PRIOR LAW

The uniformity and coherence offered by the new SEC rules contrasts sharply with the prior law. With few exceptions, issues in applying section 16(b) to trading involving derivative securities were either unsettled or subject to conflicting judicial pronouncements. n69 The new rules remove the confusion. However, in doing so, they overturn several of the few settled rules. Acquisition of an option used to be excepted from the reach of the statute; n70 similarly, exercise of the option [*1302] was uniformly considered to be a purchase. n71 Under the new rules, these conclusions are reversed. n72 Furthermore, the writing of options was not considered a transaction susceptible to the abuse addressed by the statute. n73 The new rules not only specifically bring these transactions within the statute's ambit, n74 but also expand the concept of a short-swing to include the profit earned from writing options which expire within six months. n75 Both the

reversal of the few settled principles and the resolution of the unsettled issues and conflicting precedents, while justified as part of establishing a comprehensive regulatory scheme, open the new rules to challenge. n76 Although the statute clearly contemplates SEC authority to exempt transactions "not comprehended within the purpose of the subsection," n77 some courts have taken a very limited view of the agency's power. n78 Even more difficult, however, is the SEC's ability to expand, rather than restrict, application of the statute. Unlike section 10(b), section 16(b) does not invite the SEC to evolve its regulatory scheme within a broad delegation of authority. n79 If we contrast the judicial struggles with applying section 16(b) to derivative securities trading with the SEC's approach in its new rules, we see that nevertheless the SEC has done just that.

To return to the three basic fact patterns, the question is whether there has been "any purchase and sale, or any sale and purchase, of any equity security of such issuer . . . within any period of less than six months." n80 Successive plaintiffs have argued that the purchase and sale of a derivative security, or the purchase of a derivative security followed by the sale of stock, or the exercise of an option followed by the sale of stock, constitutes a short-swing trade. Together, the precedent cases present a fabric with frayed and tangled edges which the SEC has attempted to weave into a new, larger tapestry.

Begin with the most basic issue — whether a derivative security is an "equity security of such issuer" subject to section 16(b)'s scope. There [*1303] is little doubt that the term "equity security" includes the various forms of derivative securities. n81 The ambiguity arises from the remainder of the phrase. n82 If the phrase "of such issuer" means that the derivative security must actually be issued by the subject corporation, the vast majority of derivative instruments, including all exchange-traded options, n83 might be excluded from section 16's coverage. If, however, the phrase merely requires that the security be related to the issuer or the issuer's stock in some manner, trading in the derivative security itself, such as the purchase and sale of exchange-traded call options, could trigger liability. n84

The courts have left this issue unsettled. The district court in *Miller v. General Outdoor Advertising Co.* n85 granted summary judgment in favor of the insider defendant by concluding that a privately negotiated call option was not an "equity security" for purposes of section 16. n86 The court concluded that the statutory definition required that such instruments be (1) issued by the corporation, (2) negotiable and (3) traded as securities. n87 However, the court expressly reserved judgment on whether a "transferrable option not issued by the corporation" would come within the definition. n88 This alone left open a substantial question as to whether exchange-traded options were subject to section 16's coverage. The Second Circuit reversed the district court's holding that privately negotiated, non-traded options written by parties other than the subject corporation were not comprehended within section 16's short-swing prohibition. n89 The appeals court concluded that "[s]ince this is the first case to raise the difficult and far-reaching question of whether the acquisition of a call may be a 'purchase' of an 'equity security' under section 16(b), it falls within that twilight zone where full development of the facts is necessary to decide whether the transactions involved were susceptible to the type of speculation the section seeks to eliminate." n90 No case since has led us out of this twilight zone.

The new SEC rules, however, explicitly address the issue by removing any requirement that a derivative security be issued by the [*1304] subject corporation. n91 Rule 16a-1(d) specifically defines "equity security of such issuer" to include derivative securities "whether or not issued by that issuer." n92 Therefore, under the new rules, no doubt remains that the first basic fact pattern, the purchase and sale within six months of a derivative security, will trigger section 16(b) liability. While the result appears to be a logical extension of the statute, n93 the SEC's authority to make the determination and to make it by clearly expanding, rather than restricting, the ambit of the statute remains to be established. n94

The expansion to include trading in a derivative security itself is slight in comparison with the SEC's approach to the second basic fact pattern. Central to the equivalency framework underlying the new rules is a means to match contrapositions regardless of the vehicle used to achieve them. The key to capturing the purchase of a call option followed by the purchase of a put, or the sale of a convertible debenture followed by the purchase of stock, is the ability to couple transactions in different securities. Dictum in the very first federal appellate case to interpret section 16(b) strongly suggests such matches are not contemplated by the statute. In *Smolowe v. Delendo Corp.*, n95 the court volunteered the following in a footnote: "The statute might be read literally to permit a recovery where stock of one class is purchased and stock of another class sold. But the possibility that Congress intended such a result is beyond the realm of judicial fantasy." n96

Subsequent commentators have argued we should ignore this utterance. n97 Forty years after the decision in *Smolowe*, one court did. In *Gund v. First Florida Banks, Inc.*, n98 the court matched the sale of convertible debentures with the

purchase of stock within six months. Asserting that application of the statute was clear, the court refused to consider a "pragmatic" argument that the insider's trades lacked any [*1305] possibility of speculative abuse. n99 The defendant argued that since the conversion feature of the debentures was "out of the money" and therefore they were not trading in relation to the common stock, the logic of equivalency could not be applied. n100 Without significant discussion, the court simply ignored the issue of whether unlike securities could be matched and rejected the defendant's more specific argument concerning equivalency. A decision applying the new SEC rules would reach the same result. n101

Rather than simply overrule any uncertainty concerning the matching of unlike securities, the new rules achieve the same result by redefining the concepts of "purchase" and "sale." n102 The solution is quite ingenious. To address the situation found in *Gund*, it would have been simple merely to proclaim that economically equivalent securities, such as stock and convertible debentures, can be matched. However, this simpler notion of equivalency would not have captured other, economically equivalent variations such as the purchase of a call followed by the purchase of a put. In the latter case, we literally find two purchases of unlike securities even though the profile of this investment parallels a purchase and a sale of the underlying stock. By characterizing derivative positions in terms of their economic equivalence to a purchase or sale of the underlying stock, the new rules eliminate both the uncertainty over matching unlike securities and any ambiguity arising from the difference between the literal description of the investment, such as the *purchase* of a put, and its underlying significance. While accomplished through a literal purchase, the establishment of a put position is actually equivalent to the *sale* of the underlying stock, and the new rules treat it as such.

This artful solution poses some troubling questions about the SEC's authority to adopt the new rules. The expansion of the statutory concepts of "purchase" and "sale" to include fluctuations in call equivalent and put equivalent positions directly contradicts settled judicial interpretation of the statute. The SEC's action serves not to exempt, but to capture, transactions heretofore unmolested by the short-swing disgorgement provision.

[*1306] First, consider the case in which an insider buys stock one day and on the next writes a call option. The new rules would impose short-swing liability. Under Rule 16a-1(h), n103 a "put equivalent position" is created when an insider writes a call. Under Rule 16b-6(a), n104 this is deemed a "sale" which can be matched with the prior day's purchase. However, the Supreme Court, in *Kern County Land Co. v. Occidental Petroleum Corp.*, n105 and the Second Circuit, in *Silverman v. Landa*, n106 held the writing of a call option not to be a "sale" under section 16(b).

In *Kern County*, n107 Occidental had acquired more than ten percent of Kern's stock in a hostile takeover attempt. Occidental's plans were thwarted when Kern entered into a defensive merger agreement with Tenneco. The merger involved a conversion of outstanding Kern stock into Tenneco stock. Occidental was not interested in holding a minority investment in Tenneco. It negotiated with Tenneco for an opportunity to convert the Tenneco stock it would receive into the cash value ascribed to it in the merger. Aware of the potential section 16(b) liability, Occidental agreed to sell Tenneco a call option on its stock for an almost ten percent premium. Specifically designed to circumvent section 16(b), the option could not be exercised until six months and one day after Occidental's last purchase of Kern stock. The option was in fact exercised almost immediately after it first became exercisable. Suit was brought under section 16(b), arguing, among other things, that the purchase of Kern stock should be matched with the sale of the call option. The Court refused to equate the sale of a call option with a "sale." n108

In *Silverman*, the insider engaged in a "straddle" transaction, writing both calls and puts on stock. n109 Just as the SEC rules now provide, the plaintiff argued that writing a call is equivalent to a sale and writing a put is equivalent to a purchase. Thus the straddle involved a purchase and sale which should be matched to create section 16(b) liability. The court, however, refused to match the two transactions. n110

Both opinions make much of the fact that the writer of an option has not definitively passed beneficial ownership of the stock since control over whether the option will be exercised is vested in the buyer of the option. n111 The importance of this point is made clear in the *Kern* [*1307] *County* opinion by the manner in which the opinion distinguishes a single contrary precedent. In *Bershad v. McDonough*, n112 the court examined a similar call option arrangement but concluded that the grant of the option did constitute a "sale" under section 16(b). The critical difference from the facts in *Kern County*, according to the Supreme Court, was that the arrangement in *Bershad* came with "a wink of the eye." n113 The Court concluded that although the option grantor in *Bershad* had no contractual control over the exercise of the option, for all practical purposes, the exercise was a certainty. The Court concluded that the option writer in *Kern County*, in contrast, had no assurance that the option would be exercised until the holder actually chose to do so. n114

The courts in *Kern County* and *Silverman* ultimately determined that the potential for the speculative abuse of inside

information was not sufficient to include the option writing within the scope of section 16(b). n115 Nevertheless, as we have seen, the new rules specifically include the writing of options within the concepts of "purchase" and "sale" under section 16(b). It is therefore noteworthy that the SEC release accompanying the announcement of the new rules n116 fails to mention the holding in *Kern County*. It does, however, cite *Bershad* approvingly twice. n117 But after the decision in *Kern County*, it is difficult to read *Bershad* as anything more than a holding limited to its specific facts. n118

[*1308] In addition to expanding the classes of equity securities subject to the statute to include derivative securities, such as exchange-traded options, issued by third parties and expanding the concepts of "purchase" and "sale" to include the writing of options, the new rules impose order on what is probably the most vexing conundrum in the application of the statute to derivative securities trading. Two lines of cases created the illogic which the new rules and their concept of equivalency are principally designed to rectify.

Consider the case in which an insider buys a call option one day and sells stock on the next. The new rules find a short-swing trade. Rule 16a-1(b) n119 states that a "call equivalent position" is created when an insider buys a call option. Under Rule 16b-6(a) n120 this is a "purchase" which can be matched with the next day's sale of stock. However, courts faced with this issue have concluded that the acquisition of a call option is not a "purchase" under section 16(b). n121

Consider the second case in which an insider sells stock on one day and exercises an option the next. Both the stock sold and the option exercised were held for more than six months. Under the new rules, there is no short-swing since the exercise of the option is no longer considered a purchase under the new SEC Rule 16b-6(b). n122 However, under settled judicial interpretation, the exercise of an option constitutes the purchase of the underlying stock. n123

These two rules — the acquisition of an option is a non-event but the exercise is — have led to several nonsensical results. Commentators n124 and at least one judicial opinion n125 have been sharply critical, calling for the more logical view of equivalency. The new rules answer this cry for reform and reverse the two old rules. Although this change to the existing law is the most stark, it is nevertheless the least objectionable. As already stated, there is substantial doubt concerning the SEC's [*1309] authority to expand application of the statute. But in reversing the cases which led to the two old rules, the SEC is not expanding the statute, but rather is exercising its exemptive powers under the statute. It is, however, expanding application of the statute when it extends the concepts of "purchase" and "sale" beyond the simplest analogy between straight stock trading and derivative investment strategies. In attempting to update the "crude rule of thumb" n126 of section 16(b), the SEC has gone too far with its artful solution to the longstanding problem of excluding option grants, but capturing option exercises.

III. OVERSIMPLIFICATION AND THE INNOCENT SHORT-SWING TRADER

Consider more closely the facts of *Silverman v. Landa*. n127 In that case, the insider implemented a variation of a "short straddle" option strategy. A short straddle is created by writing both a put and a call with the same expiration date and the same exercise price. n128 The insider in *Silverman* wrote calls on 1,000 shares and puts on 500, each at market for a one-year term. He received total premiums of \$5,000. Under the new SEC rules, the writing of the put would be a "purchase" n129 and the writing of the call would be a "sale." n130 The court in *Silverman*, however, refused to find a short-swing trade because it concluded that "the likelihood of profits from inside information is too remote to warrant continued restriction in the free play of market transactions." n131 The opinion notes that a short straddle is a bet that stock prices will remain stable. n132 This description is illustrated by the pay-off profile for a short straddle.

[*1310] [SEE Figure 3 IN ORIGINAL]

As Figure 3 illustrates, the investor's gains are capped at the amount of premiums received from writing the offsetting call and put options. As the stock price rises, the investor will not be required to cover the put since the put holder will do better by selling in the market. However, the call holder will exercise and deprive the investor of the difference between the call price and the current market value of the stock. This loss grows as the market price rises, ultimately depleting the premiums received and perhaps exposing the investor to a net loss. Similarly, as the stock price falls, the investor's profits are eliminated and a net loss can begin to accrue.

In *Silverman*, the plaintiff argued that the insider could have placed a bet on stable prices on the basis of inside information. The court rejected this simplistic use of the insider trading story, stating that it is a "wholly untenable assumption" that inside information can provide an insider a riskless bet that his company's stock price will remain stable for a year. n133 The case makes two very important points. First, an option [*1311] strategy, like a short straddle,

which involves a purchase and sale under the new SEC rules, is a bet on a stable stock price. Second, inside information does not allow a riskless bet on future stock price stability.

Consider again the classic story of insider trading. Possessing non-public information which predicts a significant stock price movement, an insider makes a risk-free trade. Assumed in this picture is a unidirectional relationship between the non-public information and the stock price movement. The information not only indicates that the stock price will move, but also that it will move in a given direction. So insiders buy before "good" news and sell before "bad" news. But can inside information be valuable when the only indication is that there will be no movement? Or where movement is indicated, but without a specified direction? Put another way, is there value to having non-public information which indicates the future volatility of a stock price? The answer is clearly yes, but the next question is more difficult. Is there inside information which allows a trader to make risk-free bets on the stock price's volatility?

Consider the two sides of the question — we can bet on either movement or stability if we have information indicating one or the other. We can readily imagine inside information which will indicate future volatility. n134 For example, knowledge that one's company is about to pursue a high-risk project, creating both a risk of significant losses and the possibility of extraordinary earnings, may safely indicate that the future stock price will be significantly different from what it is today. Another example would be knowledge of precarious merger negotiations involving a company whose stock price has already risen to reflect takeover rumors. The insider may know that a successful deal will cause an even larger stock price increase, and failed talks will cause a collapse. Under either scenario, inside information which indicates a change in stock price without a specific direction can nevertheless be used in riskless trading strategy. For example, the payoff profile for a long straddle, n135 the inverse strategy from that used in *Silverman*, shows [*1312] gains increasing as the stock price either rises or falls significantly; losses are the greatest when the stock price does not move.

But what information would assist an insider in making a bet like the short straddle in *Silverman*? What information would allow the insider to make an advantaged bet that a stock's price will not vary significantly over the life of the options, providing a risk-free profit equal to the premiums received for writing the options? As the *Silverman* court noted, volatility arises from factors beyond simply company-specific data. n136 A change in general market conditions, such as interest rates, can have a dramatic effect on a stock's price. But inside information, at least as it is generally viewed, n137 does not advantage an insider in predicting such market phenomena. Therefore, knowledge that "nothing new" is on the horizon for the company far from guarantees that the firm's stock price will remain stable. It does not provide a risk-free trading opportunity. Under the payoff profile of a short straddle, gains only exist to the extent the stock price does not move significantly. If you lose that bet, losses are potentially limitless.

The point of this example must be apparent. Under a straight long or short investment, the payoff profile is a straight line. As a stock price rises, the long position gains, and vice versa. These strategies are clearly susceptible to misusing inside information. A straight investment in derivative securities has a similar investment profile, and thus also fits within the story of insider trading. If we decide that short-swings involving straight stock are indicative of speculative abuse, it is easy to say the same about short-swings in derivative securities. But common investment strategies using derivative securities involve contra-positions. Some, like long straddles, profit from large stock price movements in either direction. The insider trading story easily accommodates that variation by positing types of inside information which allow a risk-free bet on a stock price's volatility. Others, however, do not fit so comfortably within the story. It is difficult to see how an insider taking a short straddle position, which fits literally within the short-swing paradigm, can benefit from inside information.

The concept of equivalency between straight stock investment strategies and derivative securities investments is an oversimplification. Often a derivative position is neither a bet on stock prices going up nor a bet on their coming down. In fact, the power of options is the flexibility they give investors to achieve nonlinear payoff structures. n138 [*1313] There is a distinction which deserves some attention between bets on up, down or both, and bets on stability or specified outcomes. The new rules, however, simply lump all derivative strategies together.

Thus arises the central problem. Under the new SEC rules, several transactions which pose no danger of the abuse of inside information nevertheless are deemed to constitute short-swing trades and expose an insider who effects them to section 16(b) liability. In capturing a transaction which has little possibility of being motivated by a misuse of inside information, is the rule valid? Casting the net further, has the SEC only exacerbated the central problem of section 16(b) doctrine?

Given an ever greater number of fact patterns which fit "literally" within the paradigm of a short-swing trade but which pose little likelihood of abuse of inside information, the reader of the statute repeatedly faces a tough choice. She can sacrifice "innocent" transactions in the name of objectivity and the greater good of a prophylactic rule against the pernicious evil of insider trading. n139 Or, recognizing that at some point this approach must undermine the integrity of the rule, she can seek a more ameliorative approach, interpreting the statute to capture only those transactions that are likely to involve the perceived abuse. n140 But in so doing the insider sacrifices the original genius of a mechanistic rule. n141 While the courts may debate the wisdom of either approach in choosing how to interpret the statute, the issue posed by the new rules is whether the SEC has the authority to make the decision.

IV. THE QUESTION OF AUTHORITY

In evaluating the validity of the new SEC rules, we must be discriminating. Different criticisms may be levelled at different parts, and not all of the regulation is invalid. Thus, while the general attempt to include derivative securities within a regulation of insider trading is not objectionable, there is no authority for the SEC to do so by administrative fiat. On the other hand, although the greatest number of questions have been raised about them, those parts of the new rules adopting the equivalency framework and overruling the interpretation of section 16(b) [*1314] which holds the exercise, and not the acquisition, of a call option to be a "purchase," are valid. The same is true of the parts which deem the acquisition of a put option to be a "sale" under the statute. However, when the concept of equivalency is extended to more complex derivative investment strategies, both the wisdom and the validity of the new rules become uncertain. We will examine each of these conclusions in turn.

A. *The Validity of Defining "Equity Security of Such Issuer"*

Rule 16a-1(d) provides that "[t]he term *equity security of such issuer* shall mean any equity security or derivative security relating to an issuer, whether or not issued by that issuer." n142 While the SEC admits that the courts have not determined whether section 16(b) applies to derivative securities issued by third parties, such as exchange-traded options, n143 it adopted the new definition to make clear that the section does so apply. The words "of such issuer" are to be read to mean that the derivative security must only relate to, and derive its value from, the equity securities actually issued by the issuer. n144 According to the SEC, "[t]o do otherwise would be to countenance the evasion of section 16(b) liabilities through the trading of standardized or third party options or other rights issued by a third party relating to equity securities of the issuer." n145

The SEC's policy conclusion is beyond debate. Congress itself has made clear that the misuse of inside information in trading options is no less reprehensible than in the trading of ordinary stock. n146 Support for the result, however, does not establish the agency's authority to make the conclusion. At best, Rule 16a-1(d) is a statement of the SEC's position in hope of its adoption by the courts in interpreting the statute.

In fact, one paragraph in the SEC Release addresses objections to the new rule and reads much like a brief. By resorting to a favorite ploy in Exchange Act interpretation, n147 the SEC notes that the word "of" can [*1315] mean both "issued by" and "relating to." Once offered these two plain English choices, the SEC contends, we must choose based on which one best serves the statutory purpose. n148 While this is a compelling argument for a court to consider, none has yet accepted it. n149

Section 3(a)(11) of the Exchange Act does provide that "equity security" means "any stock or similar security . . . or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security." n150 While this affords the SEC broad discretion in expanding the concept of "equity security," it does not address the issue of what limitations are imposed by the phrase "of such issuer." That phrase, which is found in section 16(b), is to be construed within the substantially narrower grant of authority given to the SEC under section 16(b). That narrower authority permits the SEC to adopt rules only to *exempt* transactions outside the statutory purpose. n151

In the end, however, the validity of Rule 16a-1(d) is not critical. The expansion of the concepts of "purchase" and "sale" under Rule 16b-6(a) n152 also serves to capture third party derivative securities within section 16(b). n153 Rule 16a-1(d) seems to be only an additional bootstrap. Invalidation of Rule 16b-6(a), however, would tear the very heart from the new rules.

[*1316] B. *The Validity of the Simple Story of Equivalency*

Although no reported case has explicitly articulated the argument, the one challenge to the new rules anticipated by

commentators n154 and the SEC n155 is based on the decision in *Greene v. Dietz*. n156 In *Greene*, the Second Circuit took great pains to criticize a prior SEC rule which exempted exercises of employee stock options issued pursuant to plans which met certain qualifications. n157 The case involved corporate insiders who had sold stock either less than six months before or less than six months after they exercised stock options. Although the court held that good faith reliance on the SEC rule exonerated the insiders from section 16(b) liability, it stated that insiders should not rely on the rule in the future. n158 The court's opinion indicated that the rule was invalid because its "broad language may permit acts by insiders sought to be prevented" by section 16(b). n159 Subsequently, the district court in *Perlman v. Timberlake* n160 adhered to the dictum in *Greene* in holding that the rule "is in conflict with the expressed purpose of the statute and therefore invalid." n161 In both cases, the rule failed because its exemption *might* allow a transaction in which an insider could profit from inside information.

A recent article makes the same objection to Rule 16b-6(b), which exempts the exercise of options from section 16(b). n162 The article's principal critique is that the new rules reverse the longstanding judicial construction of the statute which held that the exercise of an employee [*1317] option constituted a "purchase" to be matched with a preceding or subsequent sale of stock under section 16(b). Under the new rules, as long as the insider holds the stock option for at least six months, the insider is then free to exercise the option and immediately sell the underlying stock. Like the earlier courts, the authors of the article are concerned that this would allow insiders to take advantage of inside information which is expected to affect negatively the stock's price. n163 Knowing of an imminent price decline, the insider can exercise options, sell the underlying stock and avoid the loss.

For practitioners, the continuing validity of this critique is one of the most important issues under the new rules. The most common scenario in which an insider quickly acquires and disposes of stock involves the exercise of options. n164 Freed from the restrictions imposed by the earlier interpretations of section 16(b), insiders need no longer wait six months before selling stock acquired upon exercise of options. In fact, they may now take advantage of the "cashless exercise" programs offered by brokerage firms, n165 achieving in effect a simultaneous exercise of the option and sale of the underlying stock. n166 This new flexibility depends on the validity of Rule 16b-6(b). n167 And until its validity is definitively [*1318] established, there is even some concern that insiders will rely on it to their peril. n168

Section 23(a) of the Exchange Act exonerates from liability under the Act any person who acts in reliance upon an SEC rule "notwithstanding that such rule . . . may thereafter be . . . determined . . . to be invalid for any reason." n169 However, the court's opinion in *Greene* clearly warns that insiders should not rely on the prior rule exempting option exercises. n170 Once a court overrules the SEC's action, reliance on the rule is no longer an effective defense. n171 The issue is whether the *Greene* decision taints the new Rule 16b-6(b). If the dictum in *Greene* is rejected and the Rule is upheld, insiders who have effected "cashless exercises" will escape liability. If not, the issue will be whether the *Greene* decision was sufficient notice that Rule 16b-6(b) is invalid to forestall reliance on the Rule under section 23(a). The second is a difficult question, but we need not face it if we conclude the Rule is valid.

Rules 16b-6(a) and (b), to the extent they capture the acquisition of call options as "purchases" and of put options as "sales" and exempt their exercises, are valid. Rule 16b-6(b) is valid because it exempts transactions not comprehended within the purpose of the statute. The expansion of "purchase" and "sale" is valid since it merely repeats the statutory definitions of those terms. A question arises because early decisions interpreting section 16(b) struggled with the mechanical rule in attempting to impose liability where the courts saw abuse. In doing so, case by case, the courts evolved a rule which they would not have written if they had been able to address the issues in other than piecemeal [*1319] fashion. It just so happened that the first case involving derivative securities trading under section 16(b) involved the conversion of a derivative security.

While we must concede the point made in the earlier opinions and a recent article that the exercise of an option can be part of a scheme to misuse inside information, on closer examination the criticism is not apposite. Remember that if instead of acquiring an option, the insider had acquired stock more than six months ago, there would be no argument for liability under section 16(b). The critical question becomes, therefore, why is an insider who acquires stock and then sells it more than six months later, perhaps reacting to inside information, not covered by section 16(b), while the option holder who now exercises and sells is? As a matter of economic incentive, there is no difference between the stock owner and the option holder. It is fortuitous that the option holder has engaged in some transaction susceptible to characterization as a "purchase," thus rolling forward the six-month clock. It seems odd that a statute would rely on such insignificant and arbitrary differences in imposing section 16(b) liability. While those who are opposed to insider trading and therefore disappointed in any limitation on the scope of section 16(b) might bemoan the loss of any snare, that zeal is not sufficient

grounds to withstand a reasoned critique of the new rules. Nor can it be the basis for asserting that exempting transactions which can only lead to fortuitous short-swing matches violates the purpose of the statute. To do so is to read the statute as utterly arbitrary. However, if we examine the origins of the old rules, we discover both the same zeal and the same reliance on fortuitous events in the cases which led to the rule that exercises count and acquisitions do not.

The first case to apply section 16(b) to derivative securities trading was *Park & Tilford, Inc. v. Schulte*.ⁿ¹⁷² In *Schulte*, the central issue was whether the conversion of a convertible preferred stock constituted a "purchase" under that statute so that a "sale" within six months of the common stock received upon conversion would give rise to section 16(b) disgorgement. The court's conclusion that it did was based on the simplistic picture that the stockholder "did not own the common stock in question before [he] exercised [his] option to convert . . . [although he] did afterward."ⁿ¹⁷³ According to the logic underpinning the new rules, the argument against such a reading is that the holder of the preferred stock has a beneficial interest in, does in fact "own," the common stock [*1320] underlying the conversion feature from the date the holder acquired the preferred stock. Therefore, the six months should be counted from the date of the original acquisition of the preferred stock, not from the date of conversion. But the court found the conversion to be a "purchase." Its reasoning, beyond the simplistic picture of ownership, was that "[n]ot otherwise could the Act accomplish the Congressional purpose" ⁿ¹⁷⁴ Perhaps this is true, but the key to that conclusion is a very loose reading of section 16(b). It requires one to ignore the fact that the provision requires trades in both directions before liability attaches. For the court in *Schulte*, this structure was merely an arbitrary limitation on the scope of insider trading cases to which the section could be applied. And, it is a limitation to be pushed to its outer boundary. Therefore, if a "purchase" transaction can be identified within six months of a sale, short-swing liability can be imposed.

The zeal shown by the court in *Schulte* is perhaps understandable, especially if one takes a broader look at the background of the case, which was one of at least three legal proceedings stemming from a single series of transactions.ⁿ¹⁷⁵ The Schulte family owned a controlling interest in Park & Tilford, Inc. The sales of stock which triggered liability in *Schulte* appeared to be part of a larger scheme to distribute a substantial portion of the family's holdings to the public. The scheme included controlling volume to maintain market prices, as well as announcing of a distribution to shareholders to be paid in whiskey.ⁿ¹⁷⁶ This liquor dividend "was expected to create greatly increased market activity and a sharp rise in price" ⁿ¹⁷⁷ As the court of appeals in *Schulte* noted:

Between the date of conversion and the date when defendants completed their sales . . . the quoted price increased by over 50 percent, or almost \$30 per share. In the next month it fell by a much greater amount or more than \$68 per share. Yet the record is bare of any indication that plaintiff's assets and liability position underwent any similar change during this period. As a matter of fact, the evidence recited by the [*1321] Commission in *Matter of Ira Haupt & Co.* . . . lends credence to Kogan's contention of market manipulations by the Schulte interests to set the market price. ⁿ¹⁷⁸

There seems to be little doubt about what the Schultes were doing. But why was it a violation of section 16(b)? Can it be simply because of the fortuitous event that some preferred stock was converted within six months prior to the sales?

The answer is that the perceived purpose of the statute and the court's zeal to capture any abuse by insiders in the trading of their corporation's stock dominated the court's reading of the statute. The court found insiders misusing inside information, manipulating market prices, and profiting at the expense of their shareholders in breach of their fiduciary duties. That is exactly what the preamble to the statute told them section 16(b) was all about. So the case was made to fit. In doing so, however, the court began a long story of confusion.

In *Blau v. Ogsbury*,ⁿ¹⁷⁹ a corporate officer was granted options on stock. Under the option agreement, even though the officer exercised the option, he was permitted to postpone actual payment for and receipt of the stock until after termination of employment or death. However, once he exercised the option he was unconditionally required to make the payment. The officer exercised the option in 1945 but, under the postponed delivery provision, did not make payment or receive the stock until almost three years later. Within six months before receipt of this stock, the insider had sold stock. The plaintiff sought to match the prior sales with the receipt of stock under the option. The court concluded that the payment under the option was not a "purchase," and that the "purchase" had occurred when the option was exercised three years earlier.ⁿ¹⁸⁰

On the surface, this holding would appear consistent with the ruling in *Schulte*. The court again held that the "purchase" arose at the time of exercise under the option. However, under closer examination, the decision offers greater

support for the approach taken by the new SEC rules.

In struggling with the issue of where to find the "purchase," the court was offered two choices. The plaintiff argued for the time of payment which, in a typical option arrangement, is the time of exercise. The court rejected the formalism of fixing the date at the point where legal title passes, although this was precisely the analysis offered in [*1322] *Schulte*. Instead the court stated: "It matters not to the speculator who has title or possession or who can vote the stock or receive dividends. What he needs is firm assurance that a fixed quantity can be acquired or disposed of at a fixed price." n181 This reasoning is based on precisely the notion of equivalency which informs the new rules. However, in applying this analysis, the court looked back only so far as the point "when the alleged insider's rights *and obligations* became fixed." n182 This, the court concluded, occurred when the insider became committed to pay for the stock and not when he first acquired the option.

The question is why, having rejected the formalistic answer that "purchase" occurs upon legal transfer of title, the logic of equivalency did not push the court back to the point when the option was first acquired? Why must the insider's *obligations* be fixed when speculative abuse requires only fixed *rights* to assure a fixed quantity at a fixed price? The answer is that it was unnecessary to go that far in the analysis to decide the case at hand. n183

The court was clearly aware of the proposition that the "purchase" should be established at the time of the first acquisition of the option. The opinion mentions two law review pieces, n184 both of which argued that the holding in *Schulte* was wrong, at least as to stock options, and that the time of acquisition of the option should be the "purchase" under section 16(b). n185 While the holding in *Ogsbury* did not go so far, its reasoning was clearly based on the analysis offered by these commentaries. However, faced with its earlier opinions, the court was treading warily.

Judge Charles Clark wrote the opinion in *Blau v. Ogsbury*. In his pre-conference memorandum, n186 in which he proposed a sketch of the opinion he ultimately wrote for the court, he stated:

We are finding that the definitions of purchase and sale in the provisions of S.E.C. Act § 16(b) recovering short-swing profits by an insider for the benefit of a corporation are not as easy of definition as they might appear on the surface

There may be some danger in these successive refinements on the statutory words, but I do not see how that is to be [*1323] avoided. Certainly the executory contract to purchase the stock comes within the statutory terms by express definition, and that is a perfectly rational conclusion to meet the evil the Congress had in mind if there is insider's manipulation of the stock sales, which of course occurs when the insider binds himself finally to either purchase or sale. I think therefore that [the lower court's] ruling that the time of entering into the contract, not the time of payment under it, is the governing period and hence these transactions were without the statutory period. This, I take it, is the holding of writers such as the Note in 59 *Yale L.J.* 510, 520, and by Hardee, 65 *Harv. L. Rev.* 997.

Although he did not actually adopt "the holding of writers such as" the two commentators cited, Judge Clark was pursuing the concept of equivalency. But he hesitated, fearful of the "danger in these successive refinements." n187 Later opinions, however, do not pursue the logic of Judge Clark's opinion. Rather they take its holdings at face value.

In *Stella v. Graham-Paige Motors Corp.*, n188 the same court was able to establish a short-swing trade by setting the "purchase" at the later closing of a sale transaction rather than the earlier execution of the sale agreement. The court reasoned that, although the buyer held a contractual right to acquire the stock (akin to holding an option), its obligation to complete the purchase was conditioned upon receipt of certain financing. Only when this condition was satisfied would the [*1324] buyer's "rights and obligations [become] fixed," n189 giving rise to a "purchase." *Ogsbury* and *Schulte* were read for the proposition that only upon exercise does a "purchase" occur with respect to an option. n190 Forgotten was the notion of equivalency discussed in *Ogsbury*. n191 The court could have read *Ogsbury* as authority to go the other way. Since the buyer in *Stella* had the fixed right to acquire the stock, and since it could waive the financing condition (at least hypothetically), it had an assurance of a fixed quantity of stock at a fixed price. But such a holding would have allowed the defendant to escape section 16(b) liability.

By the time the Second Circuit decided *Greene v. Dietz*, n192 there was no discussion of the rule. The exercise of stock options was a "purchase" under section 16(b). And since one could not "justify finding two 'purchases' where in fact but one exists," n193 if the exercise of an option is a "purchase," the acquisition of the option could not be. n194

Despite the seemingly unequivocal adoption of the rule of "exercise equals purchase," the notion of equivalency and

its inherent critique of the rule were not vanquished. Another line of cases developed in which courts distinguished the conversion of convertible securities from the exercise of options.

In *Ferraiolo v. Newman*,ⁿ¹⁹⁵ the Sixth Circuit faced precisely the same issue posed to the Second Circuit in *Park & Tilford, Inc. v. Schulte*. In *Ferraiolo*, the insider had held convertible preferred stock for several years before he converted it. Within six months of the conversion, he sold some of the common stock received in the conversion. A shareholder sought disgorgement under section 16(b). The court concluded, however, that the conversion was not a "purchase."ⁿ¹⁹⁶

In reaching its holding, the Sixth Circuit attempted to synthesize the Second Circuit cases and discerned "an approach to the problem which is pragmatic rather than technical."ⁿ¹⁹⁷ Faced with the clear precedent of *Schulte*, the court nevertheless concluded that even the Second Circuit might not be constrained to follow the rule of that earlier case since "[e]ach case has been decided on its own facts, and the enunciation of a [*1325] 'black letter rubric' has been expressly avoided."ⁿ¹⁹⁸ Thus, the court concluded, it was free to re-examine whether, in the case at hand, a conversion should constitute a "purchase" to vindicate the purposes of the statute.

The opinion distinguished *Schulte* on several points, including the voluntariness of the conversion.ⁿ¹⁹⁹ However, the opinion emphasized that the "conversion of [the] preferred to [the] common had none of the economic indicia of a purchase; it created no opportunity for profit which had not existed since [the time the preferred was first acquired]."ⁿ²⁰⁰ This holding was based on precisely the notion of economic equivalency which underlies the new rules.ⁿ²⁰¹ The court denigrated the importance of the exercise of a derivative instrument and held that the initial acquisition of the right to acquire an equity security at a fixed price is the time at which the opportunity for speculative abuse first arises.

Both the logic of equivalency and the restrictive reading of *Schulte* found in *Ferraiolo* were adopted in later decisionsⁿ²⁰² and ultimately by the SEC. In the prior Rule 16b-9, the SEC exempted conversions of convertible securities from the statute's reach.ⁿ²⁰³ Although one judge questioned the SEC's authority to promulgate a rule exempting conversions,ⁿ²⁰⁴ the rule has been upheld as primarily a codification of prior judicial interpretation of the statute.ⁿ²⁰⁵

[*1326] The new Rule 16b-6(1) subsumes the old Rule 16b-9 by exempting both conversions and exercises from the statute. Although this expansion of the logic of equivalency from conversions to exercises of options does directly contradict *Greene v. Dietz*,ⁿ²⁰⁶ viewing that case in the larger context of judicial interpretation of the statute greatly reduces its value in determining the validity of the new rule. *Greene* relied on a reading of the statute that has been limited to the facts of unique cases. In each instance in which courts have been asked to extend the rationale of *Greene* beyond the simple case of exercising an option, the courts have instead adopted the equivalency analysis. Thus, although the seed which grew into the rule that exercises count was *Park & Tilford, Inc. v. Schulte*, a conversion case, the courts now hold that one counts the acquisition of the convertible security and not its conversion.ⁿ²⁰⁷ There is no rational basis for treating exercises any differently.ⁿ²⁰⁸ We only do so because of how the case law happened to evolve.

One compelling objection to the exemption might be that it would serve to exonerate not just the liquidation of a long-term position through the exercise of an option and sale of the stock, but also short-swing trades. In other words, if we now exempt exercises, an insider could receive an option, exercise and sell the stock in rapid sequence because there is no "purchase" to match with the sale. Under prior law this might have been true, since courts refused to find a "purchase" in the acquisition of an option;ⁿ²⁰⁹ even if they did, they refused to match the purchase of one security, the option, with the sale of the other, the stock.ⁿ²¹⁰ However, as the SEC noted in the Release accompanying the new rules,ⁿ²¹¹ the new rules sacrifice exercises while explicitly capturing [*1327] the acquisition of the option or other derivative security itself and matching that transaction with any contra-position.

Doubt over the validity of Rule 16b-6(a)'s conclusion that acquisition of an option is equivalent to a purchase or sale stems from uncertainty resulting from the decisions in *Miller v. General Outdoor Advertising*ⁿ²¹² and *Silverman v. Landa*.ⁿ²¹³ But the simplest reading of the statute dispels any concern. The Exchange Act defines the term "purchase" to "include any contract to buy, purchase, or otherwise acquire."ⁿ²¹⁴ Similarly, the term "sale" is defined to "include any contract to sell or otherwise dispose of."ⁿ²¹⁵ Options are clearly contracts to buy or sell.ⁿ²¹⁶ To the extent Rule 16b-6(a) equates calls and puts with purchases and sales, it is merely amplifying the statutory definitions. The courts could not adopt this apparent reading of the statute because their early decisions holding an exercise or conversion to be a "purchase" precluded such an uncomplicated analysis.

In sum, any challenge to Rule 16b-6(b) based on *Greene v. Dietz* is unconvincing. The rationale of that case forces an arbitrary reading of the statute and rejects the more lucid and apparent conclusion that options, as contracts to buy or sell, are equivalent to "purchases" and "sales" under section 16(b). The courts themselves have struggled to repudiate the

analysis in *Greene* outside of the literal exercise cases and to adopt the equivalency concept. It would be unsupportable to allow such discredited reasoning to overturn the SEC's current effort to extend the logic of equivalency from conversions to the indistinguishable exercise transactions.

C. The Invalidity of Oversimplification

While Rule 16b-6(a) does give effect to the statutory definitions of "purchase" and "sale" in extending section 16(b) to the *acquisition* of calls and puts, the remainder of the new Rule attempts to extend the statute to the disposition n217 and the writing n218 of the option contracts as well. Although a court may be persuaded to adopt this full extension [*1328] of the logic of equivalency, n219 the SEC has no authority to do so. When Rule 16b-6(a) moves beyond the simple story of acquiring contracts to purchase (call options) or contracts to sell (put options), the SEC is expanding the statutory scheme. Unlike the majority of provisions in the Exchange Act, section 16(b) does not delegate to the SEC broad rulemaking authority.

The last sentence of section 16(b) provides that "[t]his subsection shall not be construed to cover . . . any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection." n220 By contrast, section 10 of the Exchange Act provides that "[i]t shall be unlawful for any person . . . [t]o use or employ . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." n221 The different structure of the two provisions was intentional. Section 10 and other similar provisions in the Exchange Act were intended as broad delegations of administrative authority. n222 Section 16(b), in contrast, is a self-implementing, substantive rule contemplating minimal agency involvement. n223

Under section 10, the SEC is charged with the task of developing a regulatory scheme to implement the broad purpose of the statute. n224 Congress specifically refused to set forth immutable rules of conduct, leaving to an expert administrative agency the responsibility of developing the regulatory scheme in response to experience and changing [*1329] circumstances. If the statutory grant of authority under section 16(b) had mimicked that under section 10, there would be no argument as to the *prima facie* authority of the SEC to adopt all of its new rules under section 16(b). n225 However, Congress did not repeat the language of section 10, and the SEC may only rely on the much more limited language of section 16(b).

In the Release accompanying announcement of the new rules, n226 the SEC cited to the Supreme Court's decision in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, n227 as support for its authority to adopt the new rules. *Chevron* does stand for the proposition that an agency's interpretation of a statute it is charged to administer is entitled to deference. n228 However, an agency must clear a first hurdle before a court must defer: "First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." n229 Furthermore, "[t]he judiciary is the final authority on issues of statutory construction If a court . . . ascertains that Congress had an intention on the precise question at issue, that intention is the law and must be given effect." n230

Under these *Chevron* principles, the three aspects of Rule 16b-6(a) fare differently. To the extent Rule 16b-6(a) equates the acquisition of an option with either a "purchase" or "sale," the SEC is merely interpreting the statutory definitions. n231 This administrative interpretation should be accorded deference. Nor is there any basis for asserting that the interpretation is unreasonable or contradictory to the purpose of the statute. n232 Therefore, under *Chevron*, this aspect of the Rule should be upheld. The analysis under the other two aspects is less sanguine.

To the extent Rule 16b-6(a) expands the concepts of "purchase" and "sale" to include the writing of options, the SEC has contradicted both [*1330] judicial interpretation of the statute and the express legislative limitation on the agency's role under the statute. The deference principle does not apply, and the legislative and judicial utterances control. Both the Supreme Court in *Kern County Land Co. v. Occidental Petroleum Corp.* n233 and the Second Circuit in *Silverman v. Landa* n234 have stated that the writing of options does not come within the ambit of the statute. n235 The new rules attempt to change this result and expand the statute's scope. This contradicts both the judicial reading of the statute and the legislative command that the SEC limit itself to *exempting* transactions not within the statutory purpose. n236 Furthermore, as illustrated in Part III, this expansion of the statute captures transactions not contemplated by the statutory purpose. Under *Chevron*, this aspect of the new Rule is not a valid exercise of administrative authority.

The final component of Rule 16b-6(a) may fall somewhere in between the two clear cases. On the one hand, the expansion of the statute to include the *disposition*, as opposed to the *acquisition*, of derivative securities is not supported

by the statutory definitions of "purchase" and "sale." n237 Therefore, the new Rule expands the statute in direct contravention of the legislative intent to restrict the SEC's role in administering section 16(b). On the other hand, as we have already seen, this aspect of Rule 16b-6(a) is also achieved by adopting Rule 16a-1(d) and expanding the definition of "equity security of such issuer." n238 Therefore, the agency may be merely addressing a statutory ambiguity — the meaning of the phrase "of such issuer." n239 Under [*1331] *Chevron*, this interpretation must be accorded considerable weight unless unreasonable. n240

Although not free from doubt, the better analysis focuses on the clear congressional choice to limit the SEC's authority under section 16(b). That choice undermines the very rationale for deference to administrative interpretation. To allow a perceived ambiguity in the term "of such issuer" to open the door to the SEC's fundamental expansion of section 16(b) to trading in derivative securities themselves does violence to section 16's unique character.

There is little argument against an extension of any regulation of insider trading to derivative securities trading. Nor are there substantial social costs in imposing a short-swing prohibition on derivative securities trading by corporate insiders. Even if inherently innocent transactions will be captured, we might be little concerned that officers and directors of corporations with publicly-traded securities are now restricted from straddles, covered calls and other derivative investment strategies. n241 As a policy matter, we may have little objection to updating section 16(b) to cover the modern boom in the derivative securities market. But that conclusion is inapposite.

While Congress specifically designed most provisions of the Exchange Act as delegations to a flexible, expert regulator, it expressly denied section 16(b) the ability to evolve. In fact, many of the most ardent reformers supporting the adoption of the Exchange Act viewed delegation provisions like section 10 as undue compromise with industry interests who were likely to co-opt the bureaucrats of the SEC. n242 These advocates won for themselves the few provisions in the Act which contained self-implementing regulation and private rights of action, thus eliminating any reliance on the administrative agency for implementation. n243 Section 16(b) expressly limits the SEC's authority to tinker. n244 It would be incongruous now to accord that same agency deference when it does so.

History may have proven the reformers' fears to be wrong. In fact, because insider trading doctrine under section 10 eclipses the stilted regime under section 16(b), their choice may have been unwise. [*1332] Nevertheless, the statute is clear. If, as a matter of policy, the short-swing prohibition should be extended to the derivative securities market, only Congress may now do so.

V. CONCLUSION

This Article has examined the SEC's recent attempt to provide a cohesive and uniform regulatory scheme for the application of section 16(b) to derivative securities trading by corporate insiders. This has been one of the most difficult areas of section 16(b) interpretation for the courts. Because insider transactions often involve stock options, this is an area of particular interest to both the plaintiffs' bar and corporate counsel. To eliminate the confusion in this area, the SEC has offered a single, unifying concept of equivalency. Based on the notion that derivative investments have comparable economic profiles to investments in ordinary stock, the new SEC rules expand the definitions of "equity security of such issuer," "purchase" and "sale" to capture transactions involving derivative securities.

In doing so, the new rules untwist a long-standing distortion in section 16(b) doctrine. Whereas courts have long recognized the concept of equivalency in applying section 16(b) to convertible securities, they have struggled with an early line of cases which held the exercise or conversion of a derivative security to be the significant event for the statute's purposes. This line of cases evolved into the rule that option exercises count, but option acquisitions do not. The new rules reverse this anomalous rule.

In doing so, the new rules have been criticized. One set of commentators has suggested that the new rules are invalid to the extent they exempt option exercises. n245 This Article concludes that this criticism is misplaced. It relies on the rationale underlying the anomalous line of cases establishing the old rule. As the courts and the SEC have recognized, the concept of equivalency provides a superior reading of the statute.

Once the concept of equivalency is extended beyond the simple case of acquiring a put or call option, the justification and the authority for the new regulations evaporate. As this Article discusses, several derivative investment strategies are considered short-swing trades under the new rules. However, several of these offer no opportunity for abuse of inside information. By extending the concept of equivalency to all analogous contexts, the SEC has oversimplified. Furthermore, in expanding the [*1333] ambit of the statute beyond option transactions which constitute contracts to buy

or sell, the SEC has exceeded its authority under the statute.

The first conclusion is, therefore, that the SEC must amend its new rules to prevent application of the statute to transactions which inherently pose no danger of speculative abuse. Specifically, the SEC oversimplified when it included the short position, or the writing of options, within its concept of equivalency. But the problems of oversimplification are vaster.

By expanding the reach of section 16(b) to include transactions in any instrument which derives its value from a corporation's equity securities, the SEC has exposed the statute to a constant barrage of new and unanticipated interpretational challenges. It has done so in three ways.

First, the new rules have the effect of inserting section 16(b) into the terms of every employer stock option plan or comparable compensation scheme. Under the old rules, the adoption of a stock option plan which did not comply with the SEC's exemptive provisions was more a nuisance than a disaster. Because it was only the exercise of an option which triggered a section 16(b) "purchase," an insider could control application of the statute by timing exercises to avoid a short-swing match. Under the new rules, unless the plan qualifies for the exemption provided, the mere grant of an option will establish a six-month trading bar, both prospectively and retroactively. n246 If an insider receives annual grants, this will foreclose any sale transactions unless they are effected on the two days which are precisely six months after a grant or six months before the next. n247 This consequence confers a new and substantial importance on compliance with the new rules when adopting insider compensation schemes. Therefore, it is not surprising that as of January 1, 1993, fifty-five of the sixty-six letters on the SEC's list of significant No-Action Letters involving derivative securities concerned compensation plans. n248

Second, and perhaps more ominously, the new rules sweep a vast portion of the creative product of corporate finance into section 16(b). The SEC has already been forced to consider how the statute applies to [*1334] derivative securities such as dual class common stock, n249 contingent value rights n250 and convertible resettable preferred stock. n251 As more and more novel investment vehicles fall within the sweeping definition of "derivative security," more instances of oversimplification are sure to arise.

Third, while expanding coverage of section 16(b) to include the derivatives market, the SEC has left completely unaddressed the difficult issues of applying the disgorgement rule in the corporate takeover context. n252 The new rules seem to give rise to only another difficult set of issues. For example, options are commonly used to solidify friendly mergers between public companies. n253 If the mere grant of the option is a purchase, a bidder who later capitulates to another suitor may face disgorgement of the profit on the option when it sells its position to the victor. n254 Furthermore, the profit is recovered by the victor, who now owns the issuer. Whether or not lock-up options should be discouraged, this was not an anticipated result of section 16(b).

Faced with a continuing set of challenges, we must conclude that, as artful as they may be, the new SEC rules do not save section 16(b) from its greatest flaw. We can applaud the ambition of a "flat rule" n255 capable of mechanical application. But ultimately we must admit that Congress in 1934 could not have written a narrow statute like section 16(b) and expected it to serve a broad purpose like preventing the misuse of inside information. It is no surprise that as the statute struggles to survive obsolescence, it does so by being distorted beyond recognition. It is perhaps unfortunate that the same Congress which accepted the [*1335] necessity of regulatory flexibility to address an evolving industry in section 10(b) failed to do so in section 16(b).

Legal Topics:

For related research and practice materials, see the following legal topics:

Securities LawLiabilitySecurities Exchange Act of 1934 ActionsInsider TradingPenaltiesSecurities LawAdditional Offerings & the Securities Exchange Act of 1934Directors, Officers & Principal StockholdersShort Swing TradingSecurities LawLiabilitySecurities Exchange Act of 1934 ActionsInsider TradingDisgorgement

FOOTNOTES:

n1 Ownership Reports and Trading by Officers, Directors and Principal Security Holders; Final Rule, Exchange Act Release No. 28,869, 56 *Fed. Reg.* 7242 (1991) [hereinafter Final Release].

n2 15 U.S.C. § 78p (1988).

n3 The initial revisions were proposed in December of 1988. Ownership Reports and Trading by Officers, Directors and Principal Stockholders, Exchange Act Release No. 26,333, 53 Fed. Reg. 49,997 (1988) [hereinafter Proposing Release].

n4 Final Release, *supra* note 1, at 7243.

n5 *Id.* at 7248.

n6 Rule 16a-1(c) provides a definition of "derivative securities." It states in part: "The term *derivative securities* shall mean any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege at a price related to an equity security, or similar securities with a value derived from the value of an equity security" 17 C.F.R. § 240.16a-1(c) (1993).

n7 See Final Release, *supra* note 1, at 7249-50 (discussing the lack of uniformity in judicial applications of § 16(b) to transactions involving derivative securities); Mark R. Beatty, *Exchange-Traded Options and Section 16(b): Panacea or Plague for Insider's Short-Swing Profits?*, 38 BUS. LAW. 515 (1983); Covington Hardee, *Stock Options and the "Insider Trading" Provisions of the Securities Exchange Act*, 65 HARV. L. REV. 997 (1952) (discussing complexity of issues posed by derivative securities trading under § 16); George P. Michael, Jr. & Barbara A. Lee, *Put and Call Options: Criteria for Applicability of Section 16(b) of the Securities Exchange Act of 1934*, 40 NOTRE DAME L. REV. 239 (1965) (same).

n8 Proposing Release, *supra* note 3, at 50,007; Final Release, *supra* note 1, at 7250.

n9 See *Greene v. Dietz*, 247 F.2d 689, 692 (2d Cir. 1957).

n10 See *Perlman v. Timberlake*, 172 F. Supp. 246, 258 (S.D.N.Y. 1959) ("We hold that Rule X-16b-3 is in conflict with the expressed purpose of the statute and therefore invalid."). But see *Continental Oil Co. v. Perlitz*, 176 F. Supp. 219, 227-28 (S.D. Tex. 1959) (rejecting *Greene* and *Perlman* and upholding Rule 16b-3).

n11 Final Release, *supra* note 1. The new rules are found principally at 17 C.F.R. §§ 240.16a-1 to 16c-4 (1993).

n12 15 U.S.C. § 78p(b) (1988).

n13 Final Release, *supra* note 1, at 7243.

n14 E.g., Marc I. Steinberg & Daryl L. Landsdale, Jr., *The Judicial and Regulatory Constriction of Section 16(b) of the Securities Exchange Act of 1934*, 68 NOTRE DAME L. REV. 33, 34 (1992) ("section 16 . . . deals explicitly with insider trading"). But see Karl S. Okamoto, *Rereading Section 16(b) of the Securities Exchange Act*, 27 GA. L. REV. 183 (1992) (arguing that purpose of § 16 is to prevent insiders from manipulating stock prices through trading rather than to deter the unfair use of inside information).

n15 E.g., *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973) (construing statute to avoid liability for failed bidder in hostile takeover contest since no possibility of abuse of inside information was present).

n16 E.g., *Park & Tilford, Inc. v. Schulte*, 160 F.2d 984 (2d Cir.) (finding the conversion of a convertible preferred stock to constitute a "purchase" under § 16(b) in order to impose liability on insider clearly misusing nonpublic knowledge of an apparent scheme to manipulate the corporation's stock price), *cert. denied*, 332 U.S. 761 (1947).

n17 See Steinberg & Landsdale, *supra* note 14. See also discussion *infra* part IV.B.

n18 See discussion *infra* part IV.C.

n19 15 U.S.C. § 78p(b) (1988).

n20 In *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir.), cert. denied, 320 U.S. 751 (1943), the court read the last clause of § 16(b) to preclude any requirement that actual misuse of inside information be established before liability would be imposed. This interpretation has not changed. Final Release, *supra* note 1, at 7243 ("Unlike other provisions applicable to insider trading . . . , section 16 is a strict liability provision under which an insider's short-swing profits can be recovered regardless of whether the insider actually was in possession of material, non-public information.").

n21 Perhaps the most aggressive use of the so-called "pragmatic" interpretation of § 16(b) to expand its coverage is found in the plaintiff's argument in *Blau v. Lehman*, 368 U.S. 403 (1962). Supported by the SEC, the plaintiff attempted to obtain disgorgement of the short-swing profits earned by an investment banking firm. A partner of the firm was a director of the corporation whose stock was traded. See also *Rattner v. Lehman*, 193 F.2d 564 (2d Cir. 1952) (earlier case involving similar facts). The Supreme Court refused, however, to expand the ambit of § 16(b) beyond the persons specifically defined as liable under the statute. *Blau*, 368 U.S. at 411.

n22 E.g., *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973) (refusing to apply § 16(b) to a short-swing trade when a 10% holder had no possible access to inside information).

n23 See Proposing Release, *supra* note 3, at 50,007-08; Final Release, *supra* note 1, at 7248-50.

n24 See Proposing Release, *supra* note 3, at 50,007 ("Indeed, the opportunity for profit is usually magnified through the use of derivative securities because the leverage involved allows a substantially greater profit opportunity.").

n25 This discussion ignores the effect of time in calculating the returns on the investment strategies.

n26 See Final Release, *supra* note 1, at 7248 (the two forms of investment are "functionally equivalent").

n27 *Id.*

n28 *Id.*

n29 See 17 C.F.R. § 240.16b-6(b) (1993).

n30 See 5 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 2315, 2359 & n.72 (3d ed. 1990).

n31 This was the basis for a critique of the old rule in *Seinfeld v. Hospital Corp. of Am.*, 685 F. Supp. 1057, 1066 (N.D. Ill. 1988). The SEC quoted this case extensively in its discussion of the new rules. See Final Release, *supra* note 1, at 7250 n.118.

n32 This was precisely the hypothetical used by the court in *Greene v. Dietz*, 247 F.2d 689, 693 (2d Cir. 1957), to show that an earlier Rule 16b-3 exceeded the SEC's statutory authority by allowing a transaction which posed a possibility of abuse. It is also the basis for the critique of the new rules in Steinberg & Landsdale, *supra* note 14, at 65.

n33 *Greene*, 247 F.2d 689.

n34 Cf. Steinberg & Landsdale, *supra* note 14, at 65.

n35 5 LOSS & SELIGMAN, *supra* note 30, at 2362-63.

n36 E.g., *Colan v. Monumental Corp.*, 713 F.2d 330 (7th Cir. 1983); *Morales v. Mapco, Inc.*, 541 F.2d 233 (10th

Cir. 1976), cert. denied, 429 U.S. 1053 (1977).

n37 Under Rule 16b-6(a), 17 C.F.R. § 240.16b-6(a) (1993), the purchase of the call option itself shall be deemed a "purchase" under § 16(b). That purchase can be matched with the sale of stock five months later even though the option itself was never exercised.

n38 The Chicago Board of Options Exchange, the principal trading floor for standardized options, opened in 1973. RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 483 (Kenneth A. MacLeod & Ira C. Roberts eds., 4th ed. 1991); RAJNA GIBSON, *OPTION VALUATION: ANALYZING AND PRICING STANDARDIZED OPTION CONTRACTS* 1 (Kenneth A. MacLeod ed., 1991). The significance of this market can be seen most simply from the fact that its share equivalent volume exceeds the number of shares traded on the New York Stock Exchange. *Id.* at 2.

n39 GIBSON, *supra* note 38, at 6.

n40 17 C.F.R. § 240.16a-1(b) (1993).

n41 *Id.* § 16a-1(h).

n42 *Id.* § 16b-6(a).

n43 *Id.*

n44 RICHARD M. BOOKSTABER, *OPTION PRICING AND INVESTMENT STRATEGIES* 1-2 (3d ed. 1991); GIBSON, *supra* note 38, at 4.

n45 BOOKSTABER, *supra* note 44, at 4-6; GIBSON, *supra* note 38, at 4.

n46 BOOKSTABER, *supra* note 44, at 2-4, 6.

n47 This is the approach suggested in 5 *LOSS & SELIGMAN*, *supra* note 30, at 2354 n.69.

n48 17 C.F.R. § 240.16b-6(a) (1993).

n49 *Id.*

n50 *Id.*

n51 Rule 16b-6(a) provides in part: "The establishment of or increase in a call equivalent position or liquidation of or decrease in a put equivalent position shall be deemed a purchase of the underlying security for purposes of section 16(b) of the Act . . ." *Id.*

n52 *Id.*

n53 *Id.* § 240.16b-6(b).

n54 Robert A. Barron, *Control and Restricted Securities: Some Comments on Current Questions Under Section 16(b) of the Securities Exchange Act of 1934*, 18 SEC. REG. L.J. 194, 195 (1990) (describing this scenario as "the most usual situation leading to section 16(b) liability").

n55 A recent article discussing the new rules under section 16(b) criticized the treatment of derivative securities because it was too permissive. *See* Steinberg & Landsdale, *supra* note 14, at 64-65. As I have already stated, I believe the flaw is not that the new rules are too permissive but rather that they capture too many transactions which cannot possibly be motivated by inside information. *See* discussion *infra* parts III & IV.

n56 17 C.F.R. § 240.16b-6(d) (1993).

n57 The establishment of a call equivalent position is a purchase under Rule 16b-6(a). *Id.* § 16b-6(a).

n58 Rule 16a-1(b) defines "call equivalent position" to include a short put option position. *Id.* § 240.16a-1(b). Therefore, writing a put equivalent establishes a call equivalent position which, under Rule 16b-6(a), is a purchase. *Id.* § 240.16b-6(a).

n59 The liquidation of a put equivalent position is a purchase under Rule 16b-6(a). *Id.* § 240.16b-6(a).

n60 The establishment of a put equivalent position is a sale under Rule 16b-6(a). *Id.* § 240.16b-6(a).

n61 Rule 16a-1(h) defines "put equivalent position" to include a short call position. *Id.* § 240.16a-1(h). Thus, the writing of a call equivalent constitutes the establishment of a put position which, under Rule 16b-6(a), is a sale. *Id.* § 240.16b-6(a).

n62 The liquidation of a call equivalent position is a sale under Rule 16b-6(a). *Id.* § 240.16b-6(a).

n63 The new rules suggest how to calculate the profit subject to forfeiture by addressing the issue of how to calculate the gains from trading in non-identical securities. *Id.* § 240.16b-6(c).

n64 *Id.* § 240.16b-6(d).

n65 This presumably would constitute a decrease in a call equivalent position which, under Rule 16b-6(a), is a sale. *Id.* § 240.16b-6(a).

n66 *Id.* § 240.16b-6(d).

n67 This would constitute a decrease in a put equivalent position which, under Rule 16b-6(a), is a purchase. *Id.* § 240.16b-6(a).

n68 *See Frankel v. Slotkin*, 948 F.2d 1328 (2d. Cir. 1993) (refusing to apply retroactively rationale of new rules which overturn court precedent).

n69 Final Release, *supra* note 1, at 7248-50; 5 *LOSS & SELIGMAN*, *supra* note 30, at 2353-64.

n70 5 *LOSS & SELIGMAN*, *supra* note 30, at 2359, 2362-64.

n71 *Id.* at 2359.

n72 Final Release, *supra* note 1, at 7248-49.

n73 5 *LOSS & SELIGMAN*, *supra* note 30, at 2363.

n74 Short option positions are specifically included in the definitions of "call equivalent position" and "put equivalent position." 17 C.F.R. § 240.16a-1(b) & (h) (1993).

n75 *Id.* § 240.16b-6(d); Final Release, *supra* note 1, at 7253.

n76 The SEC appears to be aware of this risk and has offered a peremptory response in the Release accompanying adoption of the new rules. Final Release, *supra* note 1, at 7251.

n77 15 U.S.C. § 78p(b) (1988).

n78 *See* 5 *LOSS & SELIGMAN*, *supra* note 30, at 2443-46 n.237.

n79 *See infra* part IV.C.

n80 15 *U.S.C.* § 78p(b) (1988).

n81 *See* 5 *LOSS & SELIGMAN*, *supra* note 30, at 2354, 2412-14. *See also* Beatty, *supra* note 7, at 522.

n82 Beatty, *supra* note 7, at 522-25.

n83 Exchange-traded options are issued by the Options Clearing Corporation. GIBSON, *supra* note 38, at 22.

n84 Beatty, *supra* note 7, at 523.

n85 223 *F. Supp.* 790 (S.D.N.Y. 1963), *rev'd*, 337 *F.2d* 944 (2d Cir. 1964).

n86 *Id.* at 794-95.

n87 *Id.* at 795.

n88 *Id.*

n89 *Miller*, 337 *F.2d* at 947-48.

n90 *Id.* at 948.

n91 Final Release, *supra* note 1, at 7251-52.

n92 17 *C.F.R.* § 240.16a-1(d) (1993).

n93 Commentators have repeatedly argued in favor of this result. *E.g.*, Beatty, *supra* note 7, at 522-25; Donald L. Laufer, *Effect of Section 16(b) of the Securities Exchange Act on Use of Options by Insiders*, 8 *N.Y.L.F.* 232, 236-39 (1962); Michaely & Lee, *supra* note 7, at 246-49. *But see* Nicholas N. Sears, Note, *Puts and Calls Under Section 16: Is a New Approach Needed?*, 7 *GA. L. REV.* 153, 158-65 (1972).

n94 *See* discussion *infra* part IV.

n95 136 *F.2d* 231 (2d Cir.), *cert. denied*, 320 *U.S.* 751 (1943).

n96 136 *F.2d* at 237 n.13. One of my students has suggested that "judicial fantasy" might be read to suggest some regret on the part of Judge Clark, who wrote the opinion, that Congress did not go so far as to capture trading in unlike securities.

n97 *See* Beatty, *supra* note 7, at 527; Laufer, *supra* note 93, at 239-40 ("[T]his dictum was written relatively early . . . , and it is contrary to the pragmatic view adopted by most of the recent decisions . . .").

n98 726 *F.2d* 682 (11th Cir. 1984).

n99 *Id.* at 686-87.

n100 *Id.* at 685.

n101 A convertible debenture, regardless of whether the conversion feature is in or out of the money, is considered a "call equivalent position" under Rule 16a-1(b). 17 *C.F.R.* § 240.16a-1(b) (1993). Any decrease in

a call equivalent position, such as a sale of the debentures, is deemed to be a "sale" under Rule 16b-6(a). *Id.* § 240.16b-6(a). This sale would then be matched under section 16(b) with the subsequent purchase of stock.

n102 *See supra* notes 47-67 and accompanying text.

n103 17 C.F.R. § 240.16a-1(h) (1993).

n104 *Id.* § 240.16b-6(a).

n105 411 U.S. 582 (1973).

n106 306 F.2d 422 (2d Cir. 1962).

n107 The facts of the case are recited at 411 U.S. at 584-91.

n108 *Id.* at 601-04.

n109 306 F.2d at 423-24.

n110 *Id.* at 423-25.

n111 411 U.S. at 602; 306 F.2d at 424.

n112 428 F.2d 693 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971).

n113 411 U.S. at 604 n.30 (quoting *Abrams v. Occidental Petroleum Corp.*, 450 F.2d 157, 165 (2d Cir. 1971) (lower court's opinion in same case)).

n114 *Id.* at 604.

n115 *Id.* at 601; 306 F.2d at 425. *See also Miller*, 337 F.2d at 948 (In determining whether the acquisition of a call should be deemed a "purchase" under § 16(b), the court must "decide whether the transactions involved were susceptible to the type of speculation the section seeks to eliminate.").

n116 Final Release, *supra* note 1.

n117 *Id.* at 7249 n.106, 7250 n.117.

n118 In fact, had the Supreme Court itself not gone to such efforts to distinguish *Bershad*, there would be little reason to believe *Bershad* survived the holding in *Kern County*. In *Kern County*, the price paid for the option was a little less than 10% of the total exercise price and the option was in fact exercised immediately after the lapse of six months. 411 U.S. at 589. In *Bershad*, the option price was approximately 14% of the total exercise price and the option was also exercised immediately after the necessary six months had lapsed. 428 F.2d at 695. The only difference was that in *Bershad* the option grantors also transferred their voting control when granting the option. *Id.* But in *Kern County*, where the option writer was destined to be a minority shareholder in a corporation already controlled by the option holder, the issue of voting control was superfluous. The distinction is vacuous. What probably really mattered was that *Bershad* involved the activities of a corporate director, while *Kern County* involved a hostile 10% shareholder.

n119 17 C.F.R. § 240.16a-1(b) (1993).

n120 *Id.* § 240.16b-6(a).

n121 5 LOSS & SELIGMAN, *supra* note 30, at 2362-64. Similarly, in *Frankel v. Slotkin*, 705 F. Supp. 105

(*E.D.N.Y.* 1989), *aff'd*, 984 *F.2d* 1328 (2d. Cir. 1993), the court concluded that the acquisition of a put does not constitute a "sale" of the underlying stock. 705 *F. Supp.* at 109.

n122 17 *C.F.R.* § 240.16b-6(b) (1993).

n123 5 *LOSS & SELIGMAN*, *supra* note 30, at 2359.

n124 *E.g.*, 5 *LOSS & SELIGMAN*, *supra* note 30, at 2363-64; Hardee, *supra* note 7, at 1002-07; Timothy Tomlinson, *Section 16(b): A Single Analysis of Purchases and Sales — Merging the Objective and Pragmatic Analyses*, 1981 *DUKE L.J.* 941, 959-62; Comment, *The Scope of "Purchase and Sale" Under Section 16(b) of the Exchange Act*, 59 *YALE L.J.* 510, 520-21 (1950).

n125 *See Seinfeld v. Hospital Corp. of Am.*, 685 *F. Supp.* 1057, 1065-68 (*N.D. Ill.* 1988).

n126 This famous epithet for the statute is taken from the congressional testimony of Thomas Corcoran, one of the Exchange Act's principal drafters. Stock Exchange Practices: Hearings Before the Senate Committee on Banking and Currency, United States Senate on S. Res. 84 (72d Congress) and S. Res. 56 and S. Res. 97 (73d Congress), 73d Cong., 1st Sess. 6557 (1934).

n127 306 *F.2d* 422 (2d Cir. 1962).

n128 *BOOKSTABER*, *supra* note 44, at 100-05.

n129 *Id.* § 240.16b-6(a) (1993). The writing of a put is a "call equivalent position" under *id.* § 240.16a-1(b).

n130 *Id.* § 240.16b-6(a). The writing of a call is a "put equivalent position" under *id.* § 240.16a-1(h).

n131 306 *F.2d* at 425.

n132 *Id.* The court does not discuss the fact that the insider had a long position in the stock that covered the call portion of the short straddle. This changes the payoff profile of the insider's portfolio from a simple short straddle. The insider will make the greatest gains if there is a substantial increase in the stock price since the profit on his residual long position will begin to overshadow the cost of the straddle. The central point remains, however, that the creation of the short straddle was a movement from a purely "bullish" position to a more neutral position.

n133 *Id.*

n134 One purpose often offered for § 16(b) is deterring manipulation by insiders aimed at creating volatility to support their trading schemes. *E.g.*, *Report of the Task Force on Regulation of Insider Trading, Part II: Reform of Section 16*, 42 *BUS. LAW.* 1087, 1092 (1987).

n135 A long straddle is created by buying equivalent puts and calls. If the stock price remains constant, both options will expire valueless and the investor will lose their original cost. If the stock price increases, so will the value of the call, and vice versa. But a profit will only result if the increase in either the put or call value stemming from the stock movement exceeds the original cost of the straddle. *BOOKSTABER*, *supra* note 44, at 100-06; *GIBSON*, *supra* note 38, at 21.

n136 306 *F.2d* at 425.

n137 One study has suggested that insider trading is predictive of general market movements. H. Nejat Seyhun, *The Information Content of Aggregate Insider Trading*, 61 *J. BUS.* 1 (1988).

n138 *BOOKSTABER*, *supra* note 44, at 7-10; *GIBSON*, *supra* note 38, at 16-21.

n139 Justice Douglas advocated this approach in his dissents in *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 605 (1973) (Douglas, J., dissenting), and in *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 428 (1972) (Douglas, J., dissenting).

n140 This was the approach taken by the majorities in *Kern* and *Reliance Electric*.

n141 This was Douglas' lament. 411 U.S. at 609-11 (Douglas, J., dissenting). A good discussion of the dangers of a pragmatic approach and the benefits of a mechanistic rule is provided in *Seinfeld v. Hospital Corp. of Am.*, 685 F. Supp. 1057, 1062-63 (N.D. Ill. 1988).

n142 17 C.F.R. § 240.16a-1(d) (1993).

n143 Final Release, *supra* note 1, at 7250.

n144 *Id.* at 7252. Several commentators have urged this interpretation. *E.g.*, Beatty, *supra* note 7, at 522-25; Michaely & Lee, *supra* note 7, at 246-50; Comment, *Put and Call Options Under Section 16 of the Securities Exchange Act*, 69 YALE L.J. 868, 873-74 (1960).

n145 Final Release, *supra* note 1, at 7252.

n146 Section 20(d) of the Exchange Act explicitly extends liability for trading based on material, nonpublic information to the trading of options. 15 U.S.C. § 78t(d) (1988). *See also* William K.S. Wang, *A Cause of Action for Option Traders Against Insider Option Traders*, 101 HARV. L. REV. 1056 (1988).

n147 The ploy is to cite to the dictionary. *See* Final Release, *supra* note 1, at 7252 n.130. A more famous example is found in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 nn.20-21 (1976) (using Webster's International Dictionary as authority for determination that scienter is required for liability under § 10(b)).

n148 Final Release, *supra* note 1, at 7250.

n149 *See supra* notes 81-90 and accompanying text.

n150 15 U.S.C. § 78c(a)(11) (1988).

n151 *Id.* § 78p(b). *See infra* part IV.C.

n152 17 C.F.R. § 240.16b-6(a) (1993).

n153 As discussed later, the terms "purchase" and "sale" include contracts to purchase or to sell. Therefore, call or put options, which are simply contracts to purchase or to sell, even if not "equity securities of such issuer" are captured by section 16(b). *See infra* notes 214-18 and accompanying text.

n154 Robert A. Barron, *Control and Restricted Securities*, 19 SEC. REG. L.J. 419, 420-22 (1992); Steinberg & Landsdale, *supra* note 14, at 65-69.

n155 Final Release, *supra* note 1, at 7251.

n156 247 F.2d 689 (2d Cir. 1957).

n157 The Rule exempted any acquisition of stock, including by exercise of options, pursuant to certain employer stock plans. The Rule is quoted in full in *Greene*, 247 F.2d at 691 n.3. Apparently in response to the criticism by the Second Circuit, the SEC amended the rule to revoke the exemption for option exercises. *Keller Indus., Inc. v. Walden*, 462 F.2d 388, 390 (5th Cir. 1977); Barron, *supra* note 154, at 420. The SEC had also adopted a rule limiting the profit recoverable from a short-swing trade based on an option exercise if the option was held for

more than six months. Final Release, *supra* note 1, at 7250 n.115. The SEC's authority to adopt this rule was also challenged. *Kornfeld v. Eaton*, 327 F.2d 263 (2d Cir. 1964). In what can only be seen as a reversal of attitude, the Second Circuit showed little sympathy to this later attack on the agency's rulemaking authority.

n158 *Greene*, 247 F.2d at 697.

n159 *Id.* at 692.

n160 172 F. Supp. 246 (S.D.N.Y. 1959). But see *Continental Oil Co. v. Perlitz*, 176 F. Supp. 219 (S.D. Tex. 1959) (upholding SEC rule).

n161 172 F. Supp. at 258.

n162 See *Steinberg & Landsdale*, *supra* note 14, at 65.

n163 Of course, the insider might still face liability for trading on material, nonpublic information in an action under Rule 10b-5. The objection is therefore limited to the loss of the mechanical liability which would be imposed under § 16(b).

n164 *Barron*, *supra* note 54, at 195.

n165 See *id.* at 424 ("[T]here have been a significant, if not dramatic, number of Section 16 insiders who, starting on May 1, 1991, have utilized the 'same day exercise and sale' procedure at securities brokerage firms.").

n166 In a "cashless exercise," the insider delivers to a brokerage firm the documents necessary to exercise the option. The brokerage firm advances the exercise price and sells the stock received under the option in the market. It then delivers to the insider the cash received less the exercise price and the costs of the transaction. *Id.* at 422-24.

n167 It is interesting to note here that a series of cases dealt with fact patterns substantially identical to a "cashless exercise" by an insider. Each case involved the surrender or cancellation of a stock option or warrant in exchange for cash or stock. *E.g.*, *Portnoy v. Texas Int'l Airlines, Inc.*, 678 F.2d 695 (7th Cir. 1982) (sale of warrants for cash equal to the spread is not subject to § 16(b)); *Portnoy v. Memorex Corp.*, 667 F.2d 1281 (9th Cir. 1982) (same); *Portnoy v. Seligman & Latz, Inc.*, 516 F. Supp. 1188 (S.D.N.Y. 1981) (same); *Matas v. Siess*, 467 F. Supp. 217 (S.D.N.Y. 1979) (exercise of stock appreciation right allowing surrender of options in exchange for cash equal to the spread is subject to § 16(b)); *Freedman v. Barrow*, 427 F. Supp. 1129 (S.D.N.Y. 1976) (exercise of stock appreciation right allowing surrender of options in exchange for stock having a value equal to the spread not subject to § 16(b)); *Rosen v. Drisler*, 421 F. Supp. 1282 (S.D.N.Y. 1976) (cancellation of stock options for cash amount equal to spread between market price and exercise price not subject to § 16(b)). In each, the plaintiff argued that the transaction, while in form the simple surrender or cancellation of an option or warrant, was in fact two separate transactions effected simultaneously. The first transaction was the exercise of the option or warrant; the second was the sale of the stock. By exchanging the rights for cash or stock equal to the spread between the market price for the stock and the exercise price, the option or warrant holder was achieving precisely the same economic result she would have obtained by completing the two transactions separately. And since the exercise of an option or warrant constitutes a "purchase" under § 16(b), it should be matched with the simultaneous "sale" to impose liability. The plaintiffs' logic is flawless. If, as *Greene v. Dietz* states, the statute seeks to prevent an insider from misusing inside information of a declining stock price by selling stock held under option before the price declines, the surrender of options directly for their economic value must also be prevented. This was the basis for the one ruling which imposed liability. See *Matas*, 467 F. Supp. at 223. However, with the exception of the holding in *Matas*, the decisions ignore the thrust of *Green v. Dietz* and hold that the surrender or cancellation of an option or a warrant does not offer the opportunity for speculative abuse sought to be prevented by the statute. This is one example of the courts' restricting the "exercise equals purchase" rule to the basic case and refusing to extend its rationale.

n168 Cf. *Barron*, *supra* note 154, at 420-21.

n169 15 U.S.C. § 78w(a)(1) (1988).

n170 247 F.2d at 697.

n171 *Colema Realty Corp. v. Bibow*, 555 F. Supp. 1030, 1040 (D. Conn. 1983).

n172 160 F.2d 984 (2d Cir.), cert. denied, 332 U.S. 761 (1947).

n173 *Id.* at 987. For a general discussion of convertible securities, see William K.S. Wang, *Some Arguments That the Stock Market is Not Efficient*, 19 U.C. DAVIS L. REV. 341, 377-78, 383 (1986).

n174 160 F.2d at 987. But see *Recent Cases*, 59 HARV. L. REV. 983, 999 (1946) ("Although an exchange of securities pursuant to an option to convert may technically be a 'purchase' within the literal meaning of the Act, the present case seems to illustrate a situation hardly within its purpose.").

n175 See, e.g., *Kogan v. Schulte*, 61 F. Supp. 604 (S.D.N.Y. 1945); *In re Ira Haupt & Co.*, 23 S.E.C. 589 (1946).

n176 An excellent statement of the facts is found in *Ira Haupt*, 23 S.E.C. at 590-594.

n177 *Id.* at 598.

n178 160 F.2d at 990-91.

n179 210 F.2d 426 (2d Cir. 1954).

n180 *Id.* at 427.

n181 *Id.*

n182 *Id.* (emphasis added).

n183 The court states: "Other possible abuses of stock options do not now concern us." *Id.*

n184 *Id.* The pieces cited are Hardee, *supra* note 7; Comment, *supra* note 124.

n185 Hardee, *supra* note 7, at 1002-07; Comment, *supra* note 124, at 520-21.

n186 Charles E. Clark, Pre-Conference Memorandum for *Blau v. Ogsbury* (Jan. 5, 1954) (on file with author). Used by permission of the Yale University Library.

n187 In an opinion later that same year, Judge Clark's fear turned to exasperation. In *Roberts v. Eaton*, 212 F.2d 82 (2d Cir.), cert. denied, 348 U.S. 827 (1954), Clark wrote: "Thus haltingly we have endeavored to effectuate the statutory mandate to curb insider short-swing speculation. The lines to be drawn become increasingly fine" 212 F.2d at 84. Judge Clark expressed himself in far more "literary" terms in his preconference memorandum for the case:

The lines to be drawn under § 16(b), 15 U.S.C. § 78p(b), become finer and finer. That is the nature of the judicial process. But the pitfalls lurking in the simple word "purchase" I'll bet will hardly seem possible to the great drafting pair, Corcoran and Cohen. [Two of the principal drafters of the Exchange Act.] Like other judges (I assume) I have been sensitive to two pitfalls: (1) the construction of the language so stiffly and so unrealistically in the context of actual investment experience as to deny it real operative effect and thus publish its innocuous character to the world and for the future, or (2) a construction so potentially broad as to encourage the vultures to seek carrion, so to speak, in each and every dunghill (to preserve my metaphors). But to quote the sainted Mortimer Snerd when Edgar

Bergen asks him how he can be so stupid, "'T aint easy."

Charles E. Clark, Pre-Conference Memorandum for *Roberts v. Eaton* (Mar. 15, 1954) (on file with author). Used by permission of the Yale University Library.

n188 232 F.2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956).

n189 *Id.* at 301 (quoting *Blau v. Ogsbury*, 210 F.2d 426, 427 (2d Cir. 1954)).

n190 *Id.* ("one who holds an unexercised option is not usually in a position to obtain [inside] information"). This reading of these cases persists. *Champion Home Builders Co. v. Jeffress*, 490 F.2d 611, 616 (6th Cir.), *cert. denied* 416 U.S. 986 (1974); *Pay Less Drug Stores v. Jewel Cos.*, 579 F. Supp. 1396, 1399-1400 (N.D. Cal. 1984).

n191 *See supra* note 182 and accompanying text.

n192 247 F.2d 689 (2d Cir. 1957).

n193 *Blau v. Ogsbury*, 210 F.2d 426, 427 (2d Cir. 1954).

n194 *Colan v. Monumental Corp.*, 713 F.2d 330, 334 (7th Cir. 1983).

n195 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

n196 *Id.* at 346.

n197 *Id.* at 344.

n198 *Id.* The phrase "black letter rubric" refers to Judge Clark's opinion in *Roberts v. Eaton*, 212 F.2d 82, 85 (2d Cir.), *cert. denied*, 348 U.S. 827 (1954).

n199 259 F.2d at 346.

n200 *Id.*

n201 Earlier in the opinion, the court stated that "once the market price of the common stock rose above the redemption price of the preferred, the preferred, with its undilutable conversion privilege, became, in the objective judgment of the market place, the *economic equivalent* of the common." *Id.* at 345 (emphasis added).

n202 *See Petteys v. Butler*, 367 F.2d 528 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967); *Blau v. Lamb*, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967); *Blau v. Max Factor & Co.*, 342 F.2d 304 (9th Cir.), *cert. denied*, 382 U.S. 892 (1965); 5 *LOSS & SELIGMAN*, *supra* note 30, at 2345-53. *But see Heli-Coil Corp. v. Webster*, 352 F.2d 156 (3d Cir. 1965). An interesting discussion of the case law development is provided in Robert Hamilton, *Convertible Securities and Section 16(b): The End of an Era*, 44 *TEX. L. REV.* 1447 (1966).

n203 The old rule is discussed in 5 *LOSS & SELIGMAN*, *supra* note 30, at 2346-53, and in Hamilton, *supra* note 202, at 1476-78.

n204 *See Petteys v. Butler*, 367 F.2d at 539 (Blackmun, J., dissenting) ("I am not entirely sure that Congress, by the subsection's final sentence, meant to give the Commission the power so to legislate at will by abruptly changing the reach of the statute which it had regarded otherwise for over a generation, or that, if it did, such delegated authority is not vulnerable to attack, or that the announced new rule is consistent with the statute anyway."). *But see* Hamilton, *supra* note 202, at 1478-79.

n205 *E.g., T-Bar, Inc. v. Chatterjee*, 693 F. Supp. 1, 7 (S.D.N.Y. 1988).

n206 *See supra* notes 156–61 and accompanying text.

n207 *See supra* notes 195–205 and accompanying text. Other examples in which courts refused to extend the logic of the old rule are the "cashless exercise" cases. *See* discussion *supra* note 167. *See also Seinfeld v. Hospital Corp. of Am.*, 685 F. Supp. 1057, 1064–68 (N.D. Ill. 1988) (discussing inconsistency between results of cashless exercise cases and rule that exercise of an option constitutes a purchase).

n208 Nevertheless, even under the new Rule, there continues to be an inexplicable inequality of treatment between options and convertible securities. *See* Sullivan & Cromwell, SEC No-Action Letter, [1990-91 Transfer Binder] *Fed. Sec. L. Rep. (CCH)*, para. 79,687, at 78,107 (Apr. 30, 1991) (under Rule 16b-6(b), out-of-the-money exercises are not exempt but out-of-the-money conversions are).

n209 *See supra* note 36 and accompanying text.

n210 *See supra* note 96 and accompanying text.

n211 Final Release, *supra* note 1, at 7251 ("[I]n contrast to the rules adopted today, the exemption for the exercise considered in *Greene* was not a corollary of a regulatory scheme that defined derivative securities as holdings of the underlying securities and specifically subjected transactions in derivative securities to § 16(b), as transactions matchable against transactions in the underlying equity.").

n212 *See* discussion *supra* notes 85–90 and accompanying text.

n213 *See* discussion *supra* notes 109–10 and accompanying text. Most discussions of this case ignore the important fact that *Silverman* involved the writing, and not the acquisition, of options.

n214 15 U.S.C. § 78c(a)(13) (1988).

n215 *Id.* § 78c(a)(14).

n216 Michael & Lee, *supra* note 7, at 244.

n217 *See supra* notes 40–52 and accompanying text.

n218 *See supra* notes 73–75 and accompanying text.

n219 A discussion of the legitimacy of a judicial expansion of the statute through interpretation is outside the scope of this Article. However, the examples of oversimplification provided in Part III would also form the basis for a critique of any such judicial effort.

n220 15 U.S.C. § 78p(b) (1988).

n221 *Id.* § 78j.

n222 For an in-depth discussion of the historical background to the adoption of § 10, see Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385 (1990).

n223 For a fuller discussion of the historical background to the adoption of § 16(b), see Okamoto, *supra* note 14, at 222–45. *See also* Steve Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 HASTINGS L.J. 391, 400 (1991) ("Section 16's technique of manipulating private incentives with simple, statutorily enunciated rules is uncharacteristic of the Exchange Act. . . . Almost every substantive provision of the Act provides for regulation . . . by an administrative agency . . . which is supposed to perfect the regulatory scheme in light of experience and changing circumstances. Administrators, however, play a minimal role in section 16."). Not only does § 16(b) grant only exemptive powers to the SEC, but it also restricts standing under the statute

to corporate shareholders.

n224 *Thel*, *supra* note 222, at 458–60.

n225 Courts do maintain the power to review SEC rules even if promulgated under a plenary grant similar to that in § 10. *E.g.*, *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990) (invalidating SEC's one share/one vote rule as exceeding delegated authority).

n226 Final Release, *supra* note 1, at 7251 n.125.

n227 467 U.S. 837 (1984).

n228 *Id.* at 844–45.

n229 *Id.* at 842–43 (footnote omitted). *See also Board of Governors of the Fed. Reserve Sys. v. Dimension Fin. Corp.*, 474 U.S. 361, 368 (1986) ("The traditional deference courts pay to agency interpretation is not to be applied to alter the clearly expressed intent of Congress.").

n230 467 U.S. at 843 n.9.

n231 *See supra* notes 217–19 and accompanying text.

n232 *See* discussion *supra* part IV.B.

n233 411 U.S. 582 (1973).

n234 306 F.2d 422 (2d Cir. 1962).

n235 *Accord* HAROLD S. BLOOMENTHAL ET AL., EMERGING TRENDS IN SECURITIES LAW § 2.09[2] (1991).

n236 Even if the SEC were granted plenary rulemaking authority, as it is in § 10, it would still not have authority to adopt rules which contradict the intention of the statute. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212–14 (1976) (since scienter is required under § 10(b), no lesser requirement can be found within the rules promulgated thereunder). For a more general discussion of nonacquiescence, see Peter J. Rooney, Comment, *Nonacquiescence By the Securities and Exchange Commission: Its Relevance to the Nonacquiescence Debate*, 140 U. PA. L. REV. 1111 (1992) (reviewing several instances of SEC nonacquiescence). *See also* Douglas M. Branson, *SEC Nonacquiescence in Judicial Decisionmaking: Target Company Disclosure of Acquisition Negotiations*, 46 MD. L. REV. 1001 (1987).

n237 While the acquisition of an option is easily equated with a contract to buy or sell, the statute makes no mention of disposing of the contract itself.

n238 *See* discussion *supra* part IV.A.

n239 The courts have yet to resolve this question. *See supra* notes 81–90 and accompanying text.

n240 467 U.S. 837, 844 (1984).

n241 The social cost analysis may be more complicated when we examine trading by 10% beneficial holders, such as parties to a corporate takeover using a lock-up option or a large, passive investor using a portfolio hedging strategy.

n242 Okamoto, *supra* note 14, at 231.

n243 *Id.* at 227-34.

n244 For this reason, the exemptive power was read as sharply restricted by the prophylactic purpose of the statute. *Greene v. Dietz*, 247 F.2d 689, 692-93 (2d Cir. 1957).

n245 Steinberg & Landsdale, *supra* note 14.

n246 Rule 16b-3 exempts all transactions pursuant to an employee benefit plan which meets various conditions set out in Rule 17. See 17 C.F.R. § 240.16b-3 (1993). Therefore, if the particular plan qualifies, neither the grant nor the exercise of a stock option will constitute a "purchase" under the statute. Rule 16b-3(c) conditions exemption of the grant on the insider's holding either the option or the underlying security for a total of at least six months. Failure to satisfy Rule 16b-3 will bring the grant within § 16(b) because, under Rule 16b-6(a), the grant will be deemed a "purchase" because it is an increase in a call equivalent position. *Id.* § 240.16b-6(a).

n247 5 LOSS & SELIGMAN, *supra* note 30, at 2380-81 (discussing measurement of six-month period).

n248 The list is provided in 25 Sec. Reg. & L. Rep. (BNA) No. 2, at 66-71 (Jan. 15, 1993).

n249 See Lilly Industrial Coatings, Inc., SEC No-Action Letter, [1990-91 Transfer Binder] *Fed. Sec. L. Rep. (CCH)* para. 79,699E (May 9, 1991); Hechinger Co., SEC No-Action Letter, [1991 Transfer Binder] *Fed. Sec. L. Rep. (CCH)* para. 79,772 (Sept. 17, 1991).

n250 See Marion Merrell Dow Inc., SEC No-Action Letter, [1991-92 Transfer Binder] *Fed. Sec. L. Rep. (CCH)* para. 76,082 (Jan. 24, 1992).

n251 See Realty South Investors, Inc., SEC No-Action Letter, [1992 Transfer Binder] *Fed. Sec. L. Rep. (CCH)* para. 76,219 (June 17, 1992).

n252 All but the first Supreme Court decision on § 16(b) involved a corporate takeover. See *Gollust v. Mendell*, 111 S. Ct. 2173 (1991); *Foremost-McKesson, Inc., v. Provident Sec. Co.*, 423 U.S. 232 (1976); *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973); *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418 (1972). The first decision was *Blau v. Lehman*, 368 U.S. 403 (1962).

n253 RONALD J. GILSON, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 827-30 (1986).

n254 Cf. *Seinfeld v. Hospital Corp. of Am.*, 685 F. Supp. 1057 (N.D. Ill. 1988) (identifying the moment of purchase in a cash for stock exchange as the moment a purchaser becomes irrevocably entitled to obtain equity security).

n255 *Reliance*, 404 U.S. at 422.