contains a right of contribution. In contrast, 1933 Act § 12 does not. Although contribution is generally recognized, indemnity generally has not been permitted in federal securities claims.

Class Action Settlements

The PSLRA codifies what had become the emerging rule regarding partial settlements of cases involving multiple defendants and or potential defendants. 1934 Act § 21D(f)(7) sets forth the settlement bar rule for pretrial settlements. If a defendant in a Rule 10b–5 action settles prior to trial, the court is directed to enter a bar order which will preclude all future claims for contribution against the settling defendant arising out of the action. The bar order is bilateral in that it prohibits not only contribution claims against the settling defendant, but also any contribution claims the settling defendant might have, except claims against someone whose liability was extinguished by the settlement. PSLRA further provides that any judgment subsequently obtained against non-settling defendants shall be reduced by the greater of (1) an amount corresponding to the settling defendant's percentage responsibility, or (2) the dollar amount paid by the settling defendant to the plaintiff. 1934 Act § 21D(g)(7).

Chapter 13

INSIDER REPORTING AND SHORT–SWING TRADING—1934 ACT § 16

Table of Sections

§ 103. Reporting Requirements for Insiders and Their Transactions in Shares—1934 Act § 16(a)

Overview of 1934 Act § 16 Filing Requirements

By virtue of 1934 Act § 16(a), all officers, directors, and beneficial owners of more than ten percent of any class of equity security registered under 1934 Act § 12 must file appropriate notice with the Commission on Form 3 within ten days of becoming an officer, director, or beneficial owner. The section 16(a) filing must include disclosure of all ownership interest in any of the issuer's equity securities. Further, when there has been a change in an officer's, director's, or beneficial owner's share holdings, notice must also be filed with the Commission, generally on Form 4. The Sarbanes–Oxley Act mandated more rapid reporting of insider transaction than formerly was the case under section 16(a). Section 16(a) requires Form 4 reports of changes in beneficial ownership to be filed with the SEC by the end of the second business day after the day of execution of the transaction. The SEC may set another deadline if it determines the two-day period is not feasible. Form 4 must filed electronically.

Some investment analysts, by watching insider transactions, try to get a sense of how the issuer's securities are likely to fare in the future. Insider sales in the aggregate for any particular company are viewed as one indicator of the issuer's health. Similarly, on a macro level, the market's overall health is judged at least in part by the balance between aggregate insider purchases and aggregate insider sales.

The initial section 16(a) filing must be made on Form 3, while all subsequent filings indicating a change in beneficial ownership must be filed on Form 4. In 1991, the SEC adopted Form 5 to be filed annually to disclose any reportable section 16 transactions that were not reported on Form 3 or 4 because of an exemption or that should have been reported during the year on Form 3 or 4 but were not so reported. If a Form 5 is due, it must be made within forty-five days after the close of the issuer's fiscal year. A delay in making the applicable section 16(a) reports will toll the limitations period for disgorgement of short-swing profits under section 16(b). Under the insider trading reporting regime that was introduced, transactions which are exempt and thus eligible for reporting on Form 5 may voluntarily use Form 4. In addition to filing with the Commission, the appropriate forms must also be sent to the exchange, if any, upon which the security is traded. When a security is traded on more than one national exchange, the issuer may designate one exchange as a recipient of the section 16(a) reports.

Who Must File 1934 Act § 16 Reports

Officers and directors. There has been a good deal of litigation involving the question of who is an "officer" so as to be subject to § 16 of the Act. The revised rules take the position that section 16 should not be applied to individuals who are officers only in name. As such, the rules should put to rest a lot of the uncertainty that has previously existed in trying to determine who qualifies as an officer so as to trigger section 16 responsibilities. 1934 Act Rule 16a–1(f) expands upon the definition of "executive officer." Specifically included in the rule as revised are the president, principal financial officer, principal accounting officer, any vice president in charge of a principal business unit, division, or function as well as any other officer or other person who performs policy-making functions. However, "policy-making function" is not meant to include activities that are not significant. Furthermore, officers of the issuer's parent or subsidiary who perform policy-making functions of the issuer are deemed to be officers of the issuer for section 16 purposes. In the event that the issuer is a limited partnership or a trust, officers or employees of the general partner or trustee who

perform duties similar to those outlined above are officers of the issuer. With regard to advisory, emeritus, or honorary directors, the SEC carried forth its previous policy and thus does not treat them as subject to the section 16. Once it has been determined that someone is an officer or director required to file reports, what about transactions occurring before he or she takes office or after resignation? Someone who becomes an officer is not required to report transactions occurring prior to that date. In contrast, someone who has been an officer or director of a company before it became subject to 1934 Act § 12's registration requirements has filing obligations with respect to transactions prior to the effective date of the reporting obligation. In such a case, the officer or director must make reports with regard to transactions occurring within the six months prior to the company's 1934 Act registration provided those transactions occurred within six months of the transaction that triggered the Form 4 filing obligation. 1934 Act Rule 16a–2(a) The revised provisions continue the former practice of requiring reports of transactions following an officer or director leaving office so long as the transaction occurred within six months of the last transaction while in office. 1934 Act Rule 16a–2(b).

Ten percent beneficial owners. With respect to reporting based on beneficial ownership, the 1991 revisions of the section 16 reporting rules parallel the rules applicable to 1934 Act § 13(d). In making the ten percent holder determination under section 16, nonvoting securities are excluded and derivative securities are included only if they are convertible or exercisable within 60 days. It is not always easy to determine if and when a shareholder reached the ten percent threshold. For example, in the case of issuers who periodically repurchase their shares, the threshold can be a moving target. Further, at least one court has held that if someone does not know (and does not have reason to know) of his or her ten percent ownership status, section 16(b) liability will not be imposed. C.R.A. Realty Corp. v. Enron Corp., 842 F.Supp. 88 (S.D.N.Y.1994). When section 16 insider status is based on the formation of a group, only transactions occurring after formation of the group, as opposed to contemporaneously with the group's formation, will be matched against other transactions for the purpose of determining section 16 (b) liability. *See* Rosenberg v. XM Ventures, 129 F.Supp.2d 681 (D.Del.2001). 1934 Act Rule 16a–1(a)(2) begins by setting forth the basic rule that, for reporting purposes, beneficial ownership hinges upon the direct or indirect pecuniary interest in the shares, and that that interest may be the result of "any contract, arrangement, understanding, relationship, or otherwise." This includes the opportunity to participate, directly or indirectly, in any profit attributable to transactions in the shares in question. The rule then goes on to list examples of an "indirect pecuniary interest" that triggers section 16. Securities held by immediate family members sharing the same household are included. A general partner's proportional interest in securities held by a general or limited partnership are similarly included. In contrast, a shareholder does not have a pecuniary interest in the portfolio securities held by a corporation, limited partnership, or similar entity, so long as he or she is not a controlling shareholder of the entity and does not possess, either alone or with others, investment control over the entity's portfolio securities. The determination of beneficial ownership, as between an insider and spouse frequently presents difficult factual questions. For example, within the context of a section 16(b) action to recover proscribed short-swing profits, it has been held that a wife's sale of securities is attributed to her husband who is a director of the issuer even where the husband and wife maintain separate brokerage accounts but engaged in some joint planning. Whiting v. Dow Chemical Co., 523 F.2d 680 (2d Cir.1975).

Definition of Equity Security

The former rules required inclusion in the ten percent ownership computation of all equity securities which the holder had the right to acquire by exercising presently exercisable rights, warrants, or conversion rights. Former Rule 16a–2(b). However, in light of the revised rules' treatment of derivative instruments generally, the requirement that there be a present right was deleted. 1934 Act § 3(a)(11) and Rule 3a11–1 of the 1934 Act define equity security to include "any security convertible, with or without consideration" into an equity security; this definition also includes warrants and rights to subscribe to or purchase an equity security. The Second Circuit held that convertible debentures do not themselves constitute a separate class of equity security for purposes of section 16. Chemical Fund, Inc. v. Xerox Corp., 377 F.2d 107 (2d Cir.1967). The court explained that the ten percent beneficial ownership threshold for section 16 reporting is computed with regard to the underlying security assuming "full dilution" of the underlying security which would result from exercise of all conversion rights. This would include other warrants and rights as well. The Second Circuit's rule has been codified in 1934 Act Rule 16a–4(a).

Under 1934 Act Rule 16a–4(a), convertible securities are not considered a separate class of equity security, but rather part of the class of the underlying security which would be acquired upon the exercise of the conversion rights. This computation of ten percent beneficial ownership applies to convertible securities conversion rights, and derivative securities that are currently exercisable without contingencies. However, when the conversion rights have material contingencies and therefore are not presently exercisable, the shares underlying convertible securities will not be aggregated with other direct holdings in the underlying securities.

The Commodity Futures Modernization Act of 2000 permits trading in security future products. Since a security futures product is not convertible into the underlying security until the settlement date for the contract, the underlying securities are not counted in an owner's long position until settlement.

Exemptions from 1934 Act § 16 Filing Requirements

The revised rules contain various exemptions from the reporting and/or short-swing profit provisions of section 16. Although revised as compared to their predecessors, the revised rules continue the exemption for qualifying employee benefit plans from the short-swing profit provisions. 1934 Act Rule 16b–3. Rule 16a–9 exempts from section 16 stock splits or stock dividends applying equally to all members of a class of equity securities. Also exempted are pro rata grants of rights to all holders of a class of equity securities; this would cover the grant of many poison pills. Although the acquisition of the rights is exempt, the exercise or sale of the rights is a reportable event.

§ 104. Disgorgement of Insider Short–Swing Profits—1934 Act § 16(b)

Overview of 1934 Act § 16(b)

1934 Act § 16(b) imposes liability for short-swing profits in the issuer's stock upon all persons required to file reports under 1934 Act § 16(a). Thus, officers, directors, and beneficial owners of ten percent of a class of equity securities subject to the Exchange Act's reporting requirements are subject to the short-swing profit prohibitions. These listed statutory insiders must disgorge to the issuer any "profit" realized as a result of a purchase and sale or sale and purchase of covered equity securities occurring within a six month period. Section 16(b) is not designed as a compensatory remedy. The preamble to section 16(b) indicates that this civil liability is imposed "for the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer." The legislative history reveals congressional recognition of such a great potential for abuse of inside information so as to warrant the imposition of strict liability. The statute was viewed as a "crude rule of thumb" or objective method of preventing "the unscrupulous employment of [corporate] inside information." Hearings on S.Res. 84, S.Res. 97 Before The Senate Comm. on Banking and Currency, 73d Cong., 1st Sess. pt. 15 at 6557 (1934). Accordingly, in light of its broad remedial purpose, section 16(b) will require disgorgement of insider short-swing profits even in the absence of any wrongdoing. The liability so imposed is often referred to as prophylactic in nature. Section 16(b) thus does not make moral distinctions as it penalizes insiders who commit a technical violation but are still "pure of heart" while at the same time a more culpable insider may be able to avoid liability by going beyond the letter of the statute.

The Sarbanes–Oxley Act contains provisions designed to strengthen the prohibitions on insider trading. The Act prohibits directors and executive officers are prohibited from purchasing or selling company equity securities during black-out periods under 401(k) and other similar retirement funds. 15 U.S.C.A. § 7244(a)(1). The company may recover (including through a shareholder derivative-type action) any profits realized from such prohibited purchases or sales. Unlike section 16 of the 1934 Act, this disgorgement action does not require a matching transaction within the black-out period.

Issuers and Securities Covered

As noted above, the applicability of section 16(b)'s disgorgement provisions is determined by reference to section 16(a)'s reporting requirements. Accordingly, section 16(b) liability attaches to officers, directors, and ten percent beneficial owners of a class of equity securities registered under 1934 Act § 12. Section 16(a)'s reporting provisions determine the parameters of section 16(b)'s coverage. By virtue of 1934 Act Rule 16a–10 the exemptions from section 16(a) carry over to section 16(b). Similarly, the definition of equity security is equally broad under section 16(b) as under section 16(a) and extends to conversion rights, warrants, and even stock appreciation rights. Also, the same rules apply to the determination of beneficial ownership under sections 16(a) and 16(b).

Procedural Aspects; Standing; Demand Requirement; Right to Jury Trial; Statute of Limitations

The private remedy embodied in section 16(b) is self contained, sui generis, and is a hybrid variety of derivative suit. For example, the statute on its face requires that the shareholder make a demand upon directors prior to being sued.

Standing to bring a suit under section 16(b) has three basic requirements. First, the plaintiff must be an owner of an equity security covered by section 16. Second, the security so owned must be the same class of security traded by the section 16(b) defendant. Third, the plaintiff must own the security at the time that the section 16(b) action is instituted. There is no requirement comparable to derivative actions generally imposing a contemporaneous

ownership rule requiring that the plaintiff owned the security at the time of the violation. Instead, section 16(b) requires "only that he has 'some continuing financial stake in the litigation' so as to satisfy minimum standing requirements imposed by the jurisdictional limitations of Article III." DiLorenzo v. Edgar, 2004 WL 609374 *2 (D. Del. 2004), quoting from Gollust v. Mendell, 501 U.S. 115 (1991). In 1991, the Supreme Court in *Gollust* addressed the question of whether a shareholder of a corporation that was subsequently merged into another can bring suit under section 16(b) against officers, directors, or ten percent beneficial holders of the merged disappearing corporation. The plaintiff was a shareholder of a merged corporation, and under the terms of the merger agreement he received a combination of stock and cash. Plaintiff instituted his section 16(b) claim prior to the merger and the court held that he had standing under the statute since he owned a security of the issuer at the time he instituted the suit. In reaching this result, the Court emphasized that while section 16(b) sets forth a narrow class of potential defendants, it sets forth a broad class of plaintiffs—much broader than would apply under the contemporaneous ownership rule applicable to derivative suits generally. The Court in *Gollust* set forth two requirements for standing under section 16(b): first, the suit must have been initiated at a time that plaintiff was a shareholder; and second, the plaintiff must have a continuing interest in the corporation (or its assets) so as to allow him or her to benefit from any recovery.

Notwithstanding the possible champerty implications, the courts have held that it is no defense to an action under section 16(b) that the suit was motivated primarily by an attorney's desire to obtain the attorneys' fees that may be awarded to the successful plaintiff. *See* Magida v. Continental Can Co., 231 F.2d 843 (2d Cir.1956), cert. denied 351 U.S. 972 (1956). Attorneys' fees are awarded out of the fund created by the section 16(b) recovery and are not added to the defendant's liability.

It is generally a requirement of derivative suits that the plaintiff must first make a demand on directors to bring suit on behalf of the corporation. As noted above, section 16(b) contains its own demand requirement. The corporation, through its directors, then has sixty days to decide whether or not to bring suit. However, no demand is required when it would be a futile gesture due to the self-interest of the directors.

The section 16(b) action may be brought either in law or in equity. It has been held that the plaintiff's failure to demand a jury trial renders the action one in equity, thus denying the defendant the right of election.

Section 16(b) contains a two-year limitation period which begins to run from the date of the second transaction, that is, the one that creates the section 16(b) profits. However, the statute of limitations period may be extended until the time of reasonable discovery where there has been a failure to file timely section 16(a) reports. The statute of limitations will not be tolled beyond the filing of the Form 4 or 5.

Timing (the "Short Swing")

Section 16(b) was intended to be straightforward in application, thus providing the predictability necessary for sound planning. However, the terms of the statute have given rise to much litigation. It is not always clear whether a particular person comes within the section's reach. Similarly it is frequently difficult to determine whether and when a purchase or sale occurs. The computation of the six-month period has not escaped judicial scrutiny. It is clear that the prohibitions of section 16(b) extend to six months both prior and subsequent to the date of any particular transaction, assuming, of course, that insider status attaches. Furthermore, the statute speaks in terms of a "period of less than six months" in which the transactions are prohibited and thus two transactions occurring within exactly six months of each other are not subject to section 16(b)'s disgorgement provisions. *See* Morales v. Reading & Bates Offshore Drilling Co., 392 F.Supp. 41 (N.D.Okl. 1975).

Determination of "Profit"

There has also been significant question as to the method of computing a "profit" within the meaning of section 16(b). Someone who sells stock and subsequently repurchases the amount sold for a lower price within a six-month period realizes a section 16(b) profit. Many courts have taken a broad view of what constitutes a section 16(b) "profit" when there have been a series of transactions within a six-month period. The apparent majority view is to match the lowest purchase price against the highest sales price within that period. Arrow Distributing Corp. v. Baumgartner, 783 F.2d 1274, 1277–78 (5th Cir.1986); Whittaker v. Whittaker Corp., 639 F.2d 516, 530–32 (9th Cir.1981), cert. denied 454 U.S. 1031 (1981); Gratz v. Claughton, 187 F.2d 46 (2d Cir.1951); Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir.1943), cert. denied 320 U.S. 751 (1943). This method is the harsher of the alternative interpretations since it captures a "profit" even in situations where an out-of-pocket loss for all transactions entered into during the six-month period may exist. There is a strong argument that this measure of damages is unnecessarily punitive and cannot be justified by section 16(b)'s remedial purpose. As is pointed out elsewhere, punitive damages

are generally not available in actions arising under the federal securities laws. Imposing liability for excess "profits" which in fact exceed actual profits can be viewed as unjustifiably punitive and thus contrary to the spirit of 1934 Act § 28(a) which limits damages to actual damages.

There is some authority to the effect that dividends declared on shares that are sold at a profit will be considered part of the section 16(b) profit, provided that the dividend recipient had insider status at the time of declaration of the dividend. However, there is considerable authority to the contrary, holding that dividends are excluded from the section 16(b) computation absent evidence that the defendant manipulated the dividend.

Actual Use of Inside Information Not Necessary

In light of section 16(b)'s remedial and prophylactic purposes, it is not necessary that the defendant have utilized inside information in planning the transactions. Nor is it necessary that the transactions have resulted in injury to the issuer. The rule of the statute is absolute, imposing strict liability for short-swing profits by statutory insiders of 1934 Act registered reporting companies. Notwithstanding the clear congressional intent to provide a catch-all, prophylactic remedy, not requiring proof of actual misconduct, the statute is not always strictly applied. When dealing with traditional cash-for-stock purchases and sales, the courts uniformly employ an objective approach, not looking beyond the terms of the statute. However, when faced with "unorthodox" transactions, the courts will look behind the transaction under a pragmatic mode of analysis. Under the pragmatic approach courts will include or exclude unorthodox transactions from section 16(b)'s reach depending upon the presence or absence of the potential for speculative abuse. In any event, the section presents severe limitations on insider trading in stock subject to the Exchange Act's reporting requirements. To a large extent section 16(b) remains a trap for the unwary.

Equitable Defenses Rejected

The generally accepted rule is that equitable defenses will not defeat an action brought under section 16(b). For example, equitable estoppel will not be a defense to a section 16(b) action. *In pari delicto* is not a defense to section 16(b) liability. Thus, the fact that the issuer has participated in the transaction does not preclude recovery, even where the issuer may have been the impetus for the transaction. As is the case with securities law claims generally, waiver will not constitute a defense to section 16(b) liability. The anti-waiver provision does not apply to settlement of existing or threatened litigation.

Exemptions from 1934 Act § 16(b)'s Disgorgement Provisions

Section 16 does not apply to many foreign issuers. Section 16(b) does not apply to transactions in registered investment company shares that are exempt from the Investment Company Act's short-swing prohibitions.

Acquisitions of securities resulting from reinvestment of dividends or interest may be exempt from section 16(b). The exemption is conditioned upon the existence of a plan providing for regular reinvestment, and further upon availability of that plan to all holders of the class of securities in question. 1934 Act Rule 16b–2.

Qualifying employee benefit plans, including those involving stock appreciation rights or phantom stock, may qualify for an exemption from section 16(b). 1934 Act Rule 16b–3 divides employee benefit plan transactions into two principal categories: grant/award transactions and participant-directed transactions. The grant and award of securities under qualifying plans are exempt so long as the securities are held for at least six months. Shareholder approval continues to be a requirement for most exempt plans. Rule 16b–3(d)(1) further provides that that stock transactions from an issuer to insiders "involving a grant, award or other acquisition" of issuer equity securities shall be exempt from section 16(b) liability if the transaction is "approved by the board of directors of the issuer." It is not necessary that each transaction be individually approved so long as the plan authorizing the transaction is approved by the board. The rule also contains two conditions that apply to all plan transactions involving employer securities: (1) the transaction must be pursuant to a written plan and (2) with limited exceptions, the plan must require any derivative securities to be nontransferable. Another condition for the exemption is that any grants of options or other rights to insiders have to be made either (1) by a disinterested committee of directors that makes all substantive decisions with regard to timing, eligibility, pricing, and the amount of the awards or (2) pursuant to an automatic formula which specifies those terms. Rule 16b–3(c). The reason for this condition is to preclude insiders from influencing key terms, thereby taking advantage of inside information.

Other exemptions from section 16(b) include securities acquired through certain issuer redemptions. There is an exemption for redemption of other securities where the securities so acquired replace securities of an issuer whose assets consist of cash, government securities, and equity securities of the issuer whose securities were acquired. 1934 Act Rule 16b–4. The SEC rules continue the exemption for bona fide gifts and inheritance. 1934 Act Rule 16b–5. Securities acquired in certain mergers also are exempt. 1934 Act Rule 16b–7. Rule 16b–8 exempts acquisitions and dispositions of securities resulting from the deposit to or withdrawal of securities from a voting trust. However, the exemption does not apply if there has been a non-exempt purchase or sale of an equity security of the class deposited within six months. 1934 Act Rule 16a–9 provides an exemption from section 16 for acquisitions of rights pursuant to a pro rata grant to all holders of a class of securities.

Two additional exemptions are set forth in the statute. 1934 Act § 16(d) provides that bona fide market making transactions are not subject to section 16(b), nor are they subject to section 16(a)'s reporting requirements nor section 16(c)'s prohibition regarding short sales and sales against the box. 1934 Act § 16(e) exempts from section 16 true arbitrage transactions. Rule 16e–1 exempts arbitrage transactions by ten percent beneficial owners who are not also officers and directors of the issuer, while officers' and directors' arbitrage transactions are subject to section 16(a) reporting and section 16(b) disgorgement, but not to section 16(c)'s prohibitions against short sales and sales against the box.

In addition to the foregoing exemptions from the disgorgement provisions, section 16(b) excludes from its coverage securities "acquired in good faith in connection with a debt previously contracted." This exemption from section 16(b)'s coverage should be narrowly construed to avoid extending it to transactions where the potential for speculative abuse exists. The exemption accordingly does not apply to shares that were not necessary for retirement of the debt and thus were not directly attributable to the previously acquired debt.

§ 105. Who Is Subject to 1934 Act §§ 16(a) and (b)? When Does Insider Status Attach?

Section 16(b)'s damage provisions, like section 16(a)'s filing requirements, apply to officers, directors, and ten percent beneficial owners of any class of equity security subject to 1934 Act § 12's registration requirements. Section 16 identifies three classes of persons whose relationship to the issuer is sufficiently close to conclusively presume access to inside information. The Act does not precisely define officer, director, or ten percent beneficial owner; and, as a result numerous questions have arisen as to the scope of section 16's coverage.

Officers and Directors

For example, when dealing with a business trust or other unincorporated form of business association, does a trustee or partner qualify as a director under section 16? Presumably the issue would be approached by asking whether the person performs functions similar to those of a director. While there is no explicit definition of director in the Act, 1934 Act Rule 3b–2 provides that an " 'officer' means a president, vice president, treasurer, secretary, comptroller, and any other person who performs for an issuer, whether incorporated or unincorporated, functions corresponding to those performed by the foregoing officers." Reasoning by analogy, "director" should include the functional equivalent regardless of title; this view is confirmed by other SEC rules.

When a person, although not holding a formal office, performs the functions of an officer and therefore has access to inside information, section 16(b) will require disgorgement of all short-swing profits. Although expressly refusing to pass on the validity of 1934 Act Rule 3b–2, the Second Circuit adopted a functional equivalency test under the terms of the statute. C.R.A. Realty Corp. v. Crotty, 878 F.2d 562, 567 (2d Cir.1989). The SEC's rule was upheld in two subsequent decisions, both of which held that, on the facts of each case, statutory insider status did not attach to an assistant secretary or assistant comptroller.

In the early cases defining "officer," the courts were faced with the issue of whether to subject a person not holding an officer's title to section 16(b) liability. In two subsequent cases the issue was whether a person, although denominated an officer by title, is properly treated as "officer" for purposes of section 16(b). The Ninth Circuit held that where a company had three hundred and fifty "executive vice presidents" the title merely created an inference of "opportunities for confidential information." Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Livingston, 566 F.2d 1119, 1122 (9th Cir.1978). The court went on to say that the defendant vice president was not subject to section 16(b) liability since he met the burden of proof "that the title was merely honorary and did not carry with it any of the executive responsibilities that might otherwise be assumed."

In addition to the definition of officer contained in Rule 3b–2, 1934 Act Rule 3b–7 defines "executive officer" to include the president, any vice president in charge of a principal unit or division as well as "any other officer who performs a policy making function," or any other person performing "similar policy making functions." In 1991, the SEC revamped its section 16 reporting rules and in doing so adopted a definition of officer that is modeled on but expands upon Rule 3b–7's definition of executive officer. 1934 Act Rule 16a–1(f) begins with the basic definition of executive officer and then adds principal financial and accounting officers as well as officers of a parent organization having policy-making functions with respect to the issuer. Consistent with the cases discussed above, the SEC has stated that a person's title alone should not determine whether he or she is subject to section 16. The focus should be on whether, in discharging his or her duties, the individual is likely to obtain information that would be helpful in his or her personal market transactions.

Deputization as the Basis of Insider Status

Another problem in determining who is subject to section 16(b) arises in the context of deputization. The Supreme Court has explained that where a partnership has profited from short-swing transactions in a corporation's stock and has designated or "deputized" one of its partners to sit on that corporation's board of directors, the partnership will be deemed to be a "director" under the doctrine of deputization. Blau v. Lehman, 368 U.S. 403 (1962). The Court held that the mere possibility of inside information flowing to the partnership was not sufficient and gave the plaintiff the burden of proving an actual deputizing or agency relationship. The Second Circuit retreated from the Supreme Court's heavy burden of proof on the deputization issue. Where a corporation's president and chief executive officer sat on the issuer's board and where that person had a say in the corporation's investment interest, and further where the president resigned as a director of the issuer after the decision to sell within six months of a purchase, deputization was established and the corporation had to disgorge its short-swing profit. Feder v. Martin Marietta Corp., 406 F.2d 260 (2d Cir.1969), cert. denied 396 U.S. 1036 (1970). The Second Circuit pointed out that although there was no actual proof of a formal or a de facto deputization, the corporation had a recurring pattern of placing a representative on the board of any company in which it owned a substantial number of shares. The defendant's representative on the issuer's board was not only its president and chief executive officer but also had participated in discussions with other corporate personnel about its investment holdings. Deputization was found notwithstanding the lack of evidence of any actual communication of inside information since the potential for abuse was more than a mere possibility. The Second Circuit's approach was quite realistic, given the circumstances surrounding the case.

Family Relationships

Somewhat akin to the question of deputization is the question whether a spouse's holdings are to be attributed to the other spouse who is a section 16(b) insider. One case held that a wife's sales were to be matched against her husband's exercise of stock options where the husband was a director. Whiting v. Dow Chemical Co., 523 F.2d 680 (2d Cir.1975). The husband/director did not control the wife's investments; the couple maintained separate brokerage accounts but engaged in joint estate planning. The court reasoned that the wife, by virtue of her relationship and investment related conversations with her husband, had access to inside information.

Federal rather than state law determines the question of beneficial ownership with regard to securities held by husband and wife. With regard to stock held by a spouse or child of an insider or trusts for either, the Seventh Circuit has required a "direct pecuniary benefit" to the insider in order to find section 16(b) liability. "[T]ies of consanguinity," "an enhanced sense of well-being" or the insider's being "led to reduce his gift giving" to the stock owner or its beneficiary will not alone lead to attribution under section 16(b). CBI Industries, Inc. v. Horton, 682 F.2d 643, 646–47 (7th Cir.1982). Reading these two cases together, the courts quite properly will attribute beneficial ownership when it appears that the potential for speculative abuse exists.

Ten Percent Beneficial Ownership

In order to be found to be a beneficial owner of the stock, the purported owner was required by the cases to have a direct pecuniary interest in those shares. The SEC rules define who is considered a beneficial owner, for the purpose of matching purchases and sales, and include in the definition of beneficial owner anyone who has a direct or indirect pecuniary interest. Courts and the SEC have extended to concept of beneficial ownership to a group owning more than ten percent in the aggregate and that has agreed to act together in exercising control.

What happens if the owner is not made aware that his or her holdings have crossed the ten percent threshold? Especially in the case of issuers who periodically repurchase their shares, the threshold can be a moving target. If an owner is not at least put on inquiry notice that his or her holdings have reached the threshold, then there should be no section 16(b) liability until those facts come to light. *See* C.R.A. Realty Corp. v. Enron Corp., 842 F.Supp. 88 (S.D.N.Y.1994). In contrast to the cases dealing with officers and directors, section 16(b) on its face provides that where insider status attaches by virtue of ten percent beneficial equity ownership, the section applies only where such person was a beneficial owner "both at the time of the purchase and sale, or the sale and purchase." Notwithstanding some lower court decisions to the contrary, the Supreme Court held that the threshold purchase that pushes the defendant over ten percent beneficial ownership does not qualify as a "purchase" subject to section 16(b) and that only purchases made after that date will give rise to liability when matched with subsequent sales occurring within six months and resulting in a profit. Foremost–McKesson, Inc. v. Provident Securities Co., 423 U.S. 232 (1976). In another case, the Court held that where a ten percent beneficial owner first sells just enough shares to put him below the ten percent threshold, and on the next day liquidates the remainder of his holdings, the second sale cannot be

subject to section 16(b) because of the statute's express "at the time of" requirement. Reliance Electric Co. v. Emerson Electric Co., 404 U.S. 418 (1972). This ruling was based on an objective reading of the statute rather than a subjective evaluation of the statutory insider's motives in so structuring the two-step sale.

§ 106. The Definition of "Purchase" and "Sale" and the Pragmatic Approach Under 1934 Act § 16(b)

1934 Act § 3(a)(13) defines "purchase" to "include any contract to buy, purchase, or otherwise acquire." The definition is not limited to normal day-to-day cash for stock transactions. Accordingly courts have had to decide whether other transactions such as exercise of stock options or conversion rights and exchanges of securities pursuant to a merger—so called "unorthodox transactions"—fall within section 16(b)'s reach.

A number of early section 16(b) cases raised the question of whether a voluntary conversion of stock constituted a purchase of the new security or, alternatively, a sale of the convertible security, so as to have section 16(b) consequences. The cases were in conflict, although they tended not to find a purchase or sale unless the surrounding circumstances created a potential for the type of speculative abuse that section 16(b) was designed to prevent. It was out of the conversion cases that the pragmatic or subjective trend arose, with the courts looking at the facts to determine if section 16 evils were present.

The opportunity to realize a profit begins the moment an insider purchases or is granted a derivative security. It follows that the acquisition of a derivative security not only is a reportable event under section 16(a) (*see* Rule 16a–4(a)) it can be matched against dispositions of either the derivative or underlying security occurring within the preceding or following six months. *See* 1934 Act Rule 16a–6(a). Thus for example, an acquisition of a call option may be matched with any disposition of either the underlying security or other equivalent call option. *See* Sec.Exch.Act Rel. No. 34–28869 (Feb. 8, 1991). Conversely, an acquisition of a put option may be matched with an acquisition of the underlying security or disposition of an equivalent put position. Just as acquisitions of derivative securities are reportable and matchable events, dispositions of derivative securities have similar section 16 implications.

In the leading case of Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973), the Supreme Court addressed the applicability of section 16(b) to sales of the target company's shares by a defeated tender offeror. The management of Kern, the target company, had opposed the takeover by defendant

Occidental, and within two weeks responded with a defensive stock for stock merger with Tenneco. Rather than sell its holdings immediately, two weeks after approval of the merger, Occidental entered into an agreement with Tenneco to issue to Tenneco an option to purchase the Tenneco preferred shares received pursuant to the merger in six months at one hundred and five dollars per share. In return, Tenneco agreed to pay Occidental a premium of ten dollars per option which would be applied to the exercise price. More than six months after both Occidental's purchase of the Old Kern stock and its acquisition via the exchange of the Tenneco stock, Tenneco exercised the option. The district court held that Occidental's acquisition of Tenneco stock pursuant to the Old Kern–Tenneco merger was a section 16(b) "sale" within six months of its Kern purchases pursuant to the original tender offer, and further that the subsequent option agreement was a "sale" of the revised securities and thus also within the reach of section 16(b). The Supreme Court affirmed the Second Circuit's ruling of no liability and its adherence to a pragmatic analysis of the transaction: "In deciding whether borderline [unorthodox] transactions are within the reach of the statute, the courts have come to inquire whether the transaction may serve as a vehicle for the evil which Congress sought to prevent—the realization of short-swing profits based upon access to inside information—thereby endeavoring to implement congressional objectives without extending the reach of that statute beyond its intended limits." *Id.* The Court's opinion recognized that Occidental was in a very difficult position at the time that the Old Kern–Tenneco merger had been announced since the only realistic alternative to participating in the exchange and subsequent sale to Tenneco would have been to dispose of the Old Kern stock on the open market via a garden variety cash-for-stock sale which clearly would have resulted in certain section 16(b) liability.

Proceeding on the theory that there had not been a statutory sale by virtue of the share exchange, the next question for decision was whether Occidental "sold" its new Tenneco shares on the date of the option agreement or at the later date it was exercised. The Court reasoned that Occidental's obligation to dispose of the stock did not become fixed until Tenneco's exercise of the option on December 11. The Court also pointed out that as of June 2, Occidental had not locked in a profit since, had the stock price declined sufficiently in value by the exercise date, the defendant would have been left with Tenneco holdings worth less than the "purchase" price, notwithstanding the option premium. Although this pragmatic analysis creates some uncertainty in the section 16(b) analysis, it gives the courts the ability to achieve the statute's purpose.

The apex of the pragmatic approach was reached in Gold v. Sloan, 486 F.2d 340 (4th Cir.1973), cert. denied 419 U.S. 873 (1974), where the court held one selling director liable under section 16(b) while exonerating three others. The issue was whether an exchange of stock pursuant to a merger between the Atlantic Research and Susquehanna corporations constituted a "purchase" under section 16(b). Within less than six months after the merger had been consummated, the defendant insiders sold their newly acquired Susquehanna holdings at a profit. The Fourth Circuit pointed to the Supreme Court's decision in *Kern County* as having "resolved [the] conflict and adopted what had earlier been described as a 'pragmatic rather than technical' test" for unorthodox transactions. It was thus necessary "to examine the particular situation of each defendant as it relates to the merger." Three of the defendants had no contact whatsoever with the merger negotiations and thus were held to have had no access to Susquehanna's inside information. In contrast, the fourth defendant, Atlantic's chief executive officer, had been "in complete charge of the negotiations" and "had access to the books and records * * *." Accordingly, this access created a potential for abuse and thus warranted finding the merger exchange to have been a section 16(b) purchase by the inside director. Although certainly consistent with the Supreme Court's rationale in *Kern*, the *Gold* decision has been criticized as running contrary to the straightforward, crude rule of thumb that section 16(b) was designed to provide. Critics of the *Gold* decision were particularly upset with the ruling that the same transaction produces differing treatment for individuals falling within the statute's objective reach.

§ 107. Prohibitions Against Short Sales by Insiders—1934 Act § 16(c)

1934 Act § 16(c) prohibits certain speculative activity by insiders who must file reports under the reporting provisions of § 16(a) (*i.e.,* officers, directors, and ten percent beneficial owners of any class of equity securities subject to the Exchange Act's reporting requirements). The section is aimed at two types of speculative transactions: (1) short sales, or selling the security without owning the underlying security, and (2) sales against the box, where the seller delays in delivering the securities. In both instances, the investor's hope is that the price will decline from the time of sale, thus enabling the seller to cover at a lower price. Both short sales and sales against the box are permissible trades, provided there is compliance with the applicable SEC rules and margin requirements. Both short sales and sales against the box present the potential for speculative abuse where the seller has access to inside information and thus both are prohibited by section 16(c).

Although they are certainly legitimate speculating devices in certain instances, the practices of selling short and selling against the box are high risk transactions which, as in the case with the short-swing profit, are subject to speculative abuse and are therefore declared improper for insiders. It has been held that section 16(c) was not intended to create a private remedy parallel to the one provided by section 16(b). Executive Telecard, Ltd. v. Mayer, 941 F.Supp. 435 (S.D.N.Y.1996).

Section 16(c)'s prohibition against short sales and sales against the box is strictly construed because of the speculative abuse that can arise out of such transactions. On the other hand, it has been held that a statutory insider's issuance of a naked "call" option, which if exercised would have triggered an obligation to sell and deliver the securities within twenty days after the sale, was not in itself a sale and therefore did not violate section 16(c). Silverman v. Landa, 306 F.2d 422 (2d Cir.1962), affirming 200 F.Supp. 193 (S.D.N.Y.1961).

The SEC clarified the treatment of derivative securities for the purposes of section 16(c)'s short sale prohibitions. 1934 Act Rule 16c–4 provides that establishing or increasing a put equivalent position is exempt from section 16(c) so long as it is a covered position (the put position does not exceed the amount of underlying securities owned). This exemption makes clear that an uncovered put equivalent should be treated as a short sale, as, at least in the context of section 16(c)'s prohibitions, an uncovered put option is functionally equivalent from an investment standpoint.

Chapter 14

MARKET REGULATION; BROKER–DEALERS

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