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THE SCOPE OF "PURCHASE AND SALE" UNDER SECTION 16(b) OF THE EXCHANGE ACT

Prior to 1934, quick market killings were an accepted and major source of income for corporate directors and officers. These profits from short term speculation in the securities of corporations they managed were primarily attributable to inside information about the corporation’s affairs. In addition, profit-taking potentialities were enhanced by the power of these insiders to pervert corporate policy to their private speculative ends. Thus, disclosure of important information could be delayed until management had had its chance to profit therefrom. Dividend payments could be increased, resumed, or passed, depending on which way management wanted the market to go.

Abuses flowing from this unbridled insider trading were obvious. Existing common law remedies offered amateur investors little or no protection. Particularly flagrant was the fact that the profits were made at the expense of the stockholders, the true owners of the corporation. As a result, investors began to lose confidence in stock exchanges as free and uncontrolled market places for security transactions. Business enterprises found it increasingly difficult to raise additional funds. Moreover, to the extent that insider

3. Hearings before Committee on Banking and Currency on S. Res. 84, S. Res. 56 and S. Res. 97, 72d Cong., 2d Sess., and 73d Cong., 1st and 2d Sess. pts. 5-6 (1933-4).
5. SEN. REP. No. 792, 73d Cong., 2d Sess. 9 (1934).
6. For a description of some of these abuses as revealed in congressional hearings, see SEN. REP. No. 1455, 73d Cong., 2d Sess. 55-68 (1934).
7. The common law was largely concerned with the question whether insiders had any duty of disclosure when making sales or purchases to or from a stockholder. The so-called majority rule was and is that there is no fiduciary relation in this sort of transaction, and hence no duty of disclosure. Yourd, supra note 2, at 139 n. 27. But the minority rule, imposing a fiduciary obligation and a duty of disclosure, has found almost unanimous support from the text and article writers. Id. at 140 n. 31. And the majority rule is apparently bent in many jurisdictions by imposing the duty in “special circumstances.” E.g., Strong v. Repide, 213 U.S. 419 (1909). This gives practically the same result as an outright adoption of the minority rule.

Nevertheless, transactions over an exchange tend to insulate traders from common law liability. Yourd, supra note 2, at 146 n. 48. And the stockholder has the heavy burden of proving knowledge possessed by the insider, which, had it been disclosed, would have affected the price at which the transaction took place. These factors made it impossible for the common law doctrines to check the prevalent speculation on the basis of inside information. Id. at 139-52; Berle, Publicity of Accounts and Directors’ Purchases of Stock, 25 MICH. L. REV. 827 (1927).
trading forced stock quotations on the nation's securities markets away from a true evaluation of the corporation's worth, security exchanges were prevented from performing their function of directing the flow of private investment into appropriate channels.

It was not surprising, therefore, that proposals to curb insider speculation were included on the agenda when Congress undertook, in 1934, to enact a comprehensive scheme for regulating national securities exchanges. Devising a practicable statutory control of "sure-thing" trading, however, posed a dilemma. Any all-embracing prohibition of stock trading by corporate managers of necessity would extend the penalty to legitimate dealings. On the other hand, actual proof of the fiduciary's misuse of confidential information would be difficult to assemble.9

This dilemma was resolved by way of compromise. Congress recognized that the longer stock is held, the greater the likelihood that the market will react to factors unforeseen by the insider. Hence the certainty of profit varies inversely with the length of the period elapsing between initial purchase and subsequent sale of a security. And in fact congressional hearings revealed that abuses of inside information took place almost entirely in short-term speculation, especially in pool operation.10 Consequently, Congress concluded that a thorough-going penalization limited to this short-term trading would prevent most of the abuse while at the same time allowing legitimate long-term investment by insiders.

As finally enacted, therefore, Section 16(b) of the Securities Exchange Act of 1934 fixes the dividing line between "short-term" or "illegitimate," and "long-term" or "legitimate" trading at six months. It provides that any profits realized by corporate insiders from "any purchase and sale, or any sale and purchase of any equity security [of their own corporation]

8. Yourd, supra note 2, at 133.
9. See, e.g., the testimony of Mr. Thomas Corcoran, chief spokesman for the draftsmen and proponents of the Securities Exchange Act: "[I]t will be absolutely impossible to prove the existence of such intention or expectation. . . . [Y]ou cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing." Hearings, supra note 3, at 6557. See also Smolowe v. Delendo Corp., 136 F.2d 231, 235-6 (2d Cir. 1943), cert. denied, 320 U.S. 751 (1943); Yourd, supra note 2, at 134 n.2. But see testimony of Albert H. Wiggin, Hearings, supra note 3, at 3027-8. Section 16(b) has familiarly been termed the "anti-Wiggin" provision. PECK, WALL STREET UNDER OATH 269 (1939).
10. SEN. REP. NO. 792, 73d Cong., 2d Sess. 9 (1934).

The overall purpose of the Securities Exchange Act of 1934 was to protect the public by freeing the securities markets from all artificial influences. Sections 6 and 19 regulate exchange practices; §§9, 10 and 15 outlaw manipulative and deceptive devices; §§7 and 8 supervise the extension of credit by anyone to purchasers, brokers and dealers; and §§12, 13 and 14 establish minimum reporting and disclosure requirements for issuing corporations and proxy-solicitors. However, the burden of keeping the corporate insider within the bounds of his fiduciary position falls particularly upon §16(b).

On the Securities Exchange Act of 1934 in general, see MEYER, THE SECURITIES EX-
within any period of less than six months, shall inure to and be recoverable by" the corporation. If the corporation, upon request, fails to initiate the action itself, suit may be brought by any stockholder in the name of and in behalf of the corporation. Effective operation of Section 16(b) is made possible by Section 16(a)'s requirement of full and prompt publicity of all insider holdings and dealings.


"(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name of and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover . . . any transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection." 48 STAT. 896 (1934), 15 U.S.C. §78p(b) (1946).

13. Ibid. Congress recognized that the corporation itself might be loath to bring an action under §16(b), particularly where the insiders in question were still in controlling positions, consequently, it was necessary to give stockholders the right to sue in the name of the corporation for recovery of illegal profits in order to secure effective enforcement.

14. "SEC. 16. (a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered on a national securities exchange, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security or within ten days after he becomes such beneficial owner, director, or officer, a statement with the exchange (and a duplicate original thereof with the Commission) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been any change in such ownership during such month, shall file with the exchange a statement (and a duplicate original thereof with the Commission) indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month." 48 STAT. 896 (1934), 15 U.S.C. §78p(a) (1946).

The reports filed under 16(a) "are available for public inspection from the time they are filed. . . . The Commission . . . publishes a monthly official summary of security transactions and holdings which is widely distributed among individual investors, brokers and dealers, newspaper correspondents, press services and other interested persons. Files of this summary are maintained at each of the Commission's regional offices and at the offices of the various exchanges." 13 SEC ANN. REP. 40 (1947).
Whenever "purchase," "sale" and "profit" all occur within six months, liability under Section 16(b) is automatic. And since most transactions are clearly identifiable as either "purchase" or "sale" within the meaning of Section 16(b), knowledge that profits may be taken away has had a marked deterrent effect on abusive insider trading.

Some transactions, however, are neither clearly included in, nor excluded from, the statutory definition of "purchase" and "sale." As used in Section 16(b), "purchase" may or may not include the receipt, by virtue of stock ownership, of stock rights and stock dividends. "Sale" may or may not include gifts, whether for charitable or non-charitable purposes. The exercise of a conversion feature may or may not be either or both. If insider trading is to be effectively deterred, "purchase" and "sale" must consequently be interpreted in the light of Section 16(b)'s purpose. The question whether to include particular transactions within their scope therefore must be tested by the following standard—is inclusion necessary to recover profits made from short term insider speculation?

RIGHTS, STOCK DIVIDENDS AND STOCK SPLITS

Most of the "purchase," "sale" and "profit" problems of Section 16(b) are raised by one basic fact situation. A, an insider, purchases stock in his own corporation. He receives preemptive rights issued on that stock. He either sells these rights or exercises them, acquiring stock therefor. He sells stock. All of these transactions may occur within six months. If so, there has clearly been a "purchase and sale" within the meaning of Section 16(b), and all profits accruing to the insider may be recaptured by the corporation. Frequently, however, only two or three of these transactions take place within a six month period. For example, only the purchase of stock, issuance of rights and sale of rights may take place within six months.

15. In the first judicial test of 16(b) the second circuit held that the Section required no proof of an intent to misuse inside information. The measure of profit was fixed as "lowest price in, highest price out—within six months." Thus profits can be found even though the transactions as a whole result in a loss. The accounting measures of "first in, first out," and "identity" were rejected as inadequate. Constitutionality as thus interpreted was upheld. Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir. 1943), cert. denied, 320 U.S. 751 (1943), 12 Ford. L. Rev. 282.

16. Accordingly, litigation has been slight. In addition to Smolowe v. Delendo, supra, and the five cases discussed below, there have been only two other reported cases: Arbetman v. Playford, 83 F. Supp. 335 (S.D.N.Y. 1949) (plaintiff has right to sue either at law or in equity); Colby v. Klune, 83 F. Supp. 159 (S.D.N.Y. 1949) (production manager held not an "insider" as defined by § 16(b)).

17. See 14 SEC Ann. Rep. 37 (1948). Repeal of Section 16(b) has been strongly advocated on the ground that the arbitrary rule does more harm than good. The SEC, on the other hand, has urged its retention. Hearings before Committee on Interstate and Foreign Commerce on a Comparative Print Showing Proposed Changes in the Securities Act of 1933 and the Securities Exchange Act of 1934, and H.R. 4344, H.R. 5085, and H.R. 5832, 77th Cong., 1st Sess. 1246–62 (1942); Rubin & Feldman, supra note 1, at 509–594.
Similarly, only the issuance and exercise of the rights and sale of the stock, or only the exercise of the rights and sale of the stock may occur within a six month period. Should issuance of rights be called a "purchase" or the exercise of rights a "sale"; and if so, when?

Issuance of Rights

Although some technical distinctions can be made, "right," generically speaking, is used to include "options" and "warrants." All of these clearly come within the Act's definition of "equity security," which includes "any warrant or right to subscribe to or purchase any stock or similar security." Consequently, when they are bought and sold by an insider within a six months period, the profit is recoverable.

A more difficult question arises when the rights are not bought on the open market but are received as part of a preemptive right distribution. In either case a corporate insider may derive the same profits from the sale of a right which has appreciated in value within six months of its acquisition. But unless a preemptive right distribution creates possibilities for misuse of inside information, incorporating the issuance of rights within the meaning of "purchase" as used by Section 16(b) may be neither necessary nor desirable.

18. All three terms refer to a certificate issue by a corporation evidencing a right to acquire stock from the issuing corporation. An "option" can also be given by a private individual. Such a private contract, however, does not come within the terminology "equity security of such issuer," note 12 supra, and will not be included in this analysis. Dewing uses "right" in connection with privileged subscriptions offered to old shareholders. 1 DEWING, FINANCIAL POLICY OF CORPORATIONS 252 n.t (4th ed. 1941). He observes that "in Boston, New York, and the country generally, a 'right' is the fractional privilege that belongs with each old share; in Philadelphia it is the privilege of buying a new share." 2 id. at 1192 n.c. On the other hand, he uses "warrants" and "options" as more inclusive terms denoting certificates representing a contract right which enables the owner to buy—subject to predetermined conditions—some form of a corporate security. Where the contract right is given by a clause in a bond or stock agreement, or in a separate piece of paper issued as an attachment to another security, it is a "warrant." When it is in a separate piece of paper issued independently, it is an "option." 1 id. at 245.

For other distinctions, see GRAHAM & DODD, SECURITY ANALYSIS 542 et seq. (1934).

19. "The term 'equity security' means any stock or similar security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; 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." 48 STAT. 884 (1934), 15 U.S.C. § 78c(a)(11) (1946).

20. For discussion of preemptive rights in general, see BALLANTINE, CORPORATIONS § 209 (1946); DEWING, CORPORATION SECURITIES 111 (1934); 2 DEWING, FINANCIAL POLICY OF CORPORATIONS 1191–1215 (4th ed. 1941); PATON, ACCOUNTANT'S HANDBOOK 1004 (1945); Frey, Shareholders' Pre-emptive Rights, 38 YALE L.J. 563 (1929).
This issue was first presented to the courts in *Shaw v. Dreyfus*. Celanese Corporation of America had issued warrants to its common stockholders. These warrants evidenced rights to subscribe, at $50 per share, for additional shares of common stock on the basis of one share for each 10 shares held. Defendant Dreyfus, a common stockholder and director, sold a number of his warrants within six months of their issuance, but more than six months after acquisition of his stock holdings. Dinah Shaw, a stockholder of Celanese Corporation, brought suit under Section 16(b) to recover for the Corporation the entire proceeds of the sale of the rights as "profit" from a "purchase and sale of an equity security within a six months period."

The second circuit affirmed the lower court's summary judgment dismissing the complaint. The court recognized that insiders, controlling corporate policy, have the power to influence or compel the issuance of rights. However, since these rights were distributed to all common stockholders in proportion to their holdings, the court decided that there could have been no improper incentive to exercise this control. The absence of any possibility of making profits made it unnecessary to extend the meaning of "purchase" beyond the popular definition of the word.

Where more than six months elapses between the initial acquisition of the stock on which the rights are issued and the subsequent sale of the rights after they have appreciated in value, the court's conclusion that no profit can be obtained by compelling the issuance of stock rights is correct. Immediately before the declaration of stock rights, the market value of the

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22. The facts were undisputed. The resolution was adopted October 8, 1945; rights to subscribe to additional shares of common stock were mailed to common stockholders of record on October 9, 1945, authorizing subscription on the basis of one share at $50 for each 10 shares held. Dreyfus accordingly received 106,343 rights, each entitling the holder to subscribe to 1/10 of a share of the new issue, to be exercised on or before November 24, 1945. Dreyfus sold 76,340 rights on the open market before the closing day, the proceeds being $5,915. Shaw v. Dreyfus, 79 F. Supp. 533, 534 (S.D.N.Y. 1948).

23. Since the corporation did not choose to bring the action, any stockholder was entitled to bring it on behalf of the corporation under § 16(b). See note 13 supra. The proceeding is analogous to a stockholder's derivative action. Pottish v. Dihak, 71 F. Supp. 737 (S.D.N.Y. 1947).

24. 172 F.2d 140 (2d Cir. 1949). In the lower court, both parties had moved for summary judgment under Federal Rule 56 upon an agreed statement of facts. The district court granted the defendant's motion and dismissed the action on the ground that the rights connoted nothing more than the option which Dreyfus as a stockholder already possessed. Since he acquired nothing new by the receipt of the rights, that receipt could not be considered a "purchase." 79 F. Supp. 533 (S.D.N.Y. 1948).

25. 172 F.2d 140, 142 (2d Cir. 1949).

26. Provided that the issuance of rights is not discriminatory. See p. 519 infra.
insider's stock holdings would equal the combined market values of the stock rights and shares ex-rights after the issuance of the rights.\textsuperscript{27} Thereafter, the stock and the rights fluctuate together. The value of the right plus the subscription price will always be equal to the value of the stock.\textsuperscript{28} Consequently, the same profit than an insider might derive from the subsequent sale of these appreciated rights, he might equally obtain, without any issuance of rights, from a similar sale of part of his original stock. This profit from the sale of these original shares held for more than six months would be clearly immune under Section 16(b). And in fact, an insider may actually be worse off by compelling the issuance of rights and subsequently selling them at a profit. Whether he compels the issuance of rights or sells off a part of his original stock, he surrenders a portion of his equity in the corporation. But the dilution of his equity caused by the exercise of the rights after their sale by the insider would normally exceed his loss of equity from the sale of his original stock.\textsuperscript{29}

\textsuperscript{27} BACKMAN, EFFECT OF PRIVILEGED SUBSCRIPTIONS ON THE VALUE OF STOCK (unpublished paper in Harvard Graduate School of Business Administration Library, 1926); DEWING, CORPORATION FINANCE 315 (1931); WERLY, PRIVILEGED SUBSCRIPTIONS 55-9 (unpublished paper in Harvard Graduate School of Business Administration Library, 1929).

While in fact this theoretical equality may be disturbed by market reactions to an announcement of the declarations, DEWING, CORPORATION FINANCE 315 (1931), such market fluctuations can be ignored because all stockholders will benefit or lose ratably from that type of market adjustment. The survey made by WERLY, supra, concludes at p. 56 that the deviation normally is only that the actual market value is about 1/16 or 1/8 below the theoretical value, due to the simplicity and convenience of buying directly.

On October 9, 1945, the day the Celanese Corporation rights were issued, there were no quotations on the New York Stock Exchange for the rights or warrants. The common stock of the Corporation was listed on that day as follows:

<table>
<thead>
<tr>
<th>Low</th>
<th>High</th>
</tr>
</thead>
<tbody>
<tr>
<td>54</td>
<td>54 3/4</td>
</tr>
</tbody>
</table>

On October 10, 1945, the rights appeared for the first time on the Exchange and were quoted with the common stock as follows:

<table>
<thead>
<tr>
<th>Low</th>
<th>High</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Stock</td>
<td>52</td>
</tr>
<tr>
<td>Common Rights</td>
<td>3/8</td>
</tr>
</tbody>
</table>

\textsuperscript{162} COMMERCIAL AND FINANCIAL CHRONICLE 1775 (Oct.—Dec. 1945).

28. Inequality is prevented by arbitrage. If the value of the right plus the subscription price falls much below the value of the stock, speculators will buy up and exercise the rights until equality is again attained.

29. Assume a 1000-share corporation with a market value originally of $10,000, or $10 a share. The insider in question owns 900 shares. Assume also that the insider knows of a new invention or a valuable contract which will boost the market worth of the corporation by $100,000.

First, Issuing Rights:

The insider might plan a new stock issue of 1,000 shares, preemptive rights to be offered to subscribe at $9 a share, on the basis of one share for each share held. The market value of the right can be obtained by using the formula $R = \frac{M - S}{N+1}$, where
THE SCOPE OF "PURCHASE AND SALE"

These arguments lose force when an insider purchases stock, receives preemptive rights thereon and sells the rights on the open market less than six months from the original purchase of stock. Since the transactions occur within the statutory time limit, a profit made by sale of part of the original stock holding would be subject to Section 16(b) liability. If the insider is willing to sacrifice a part of his equity in the corporation, he can realize this same profit by selling off his rights. Consequently, application of the Dreyfus rule—that issuance of rights is not a "purchase"—to this situation might enable the insider to do by one method what the statute penalizes him for doing by another.

This danger could be avoided in two ways. Profits made by a sale of rights could be recovered by modifying the Dreyfus rule and calling any issuance of rights, followed by a sale of these rights within six months of stock acquisition, a "purchase" within the meaning of Section 16(b).23

R = the value of the right, M = the market price of the stock just before it appears ex-rights, S = subscription price for the new issue, and N = number of shares entitling holder to one share of the new issue. Dewing, Corporation Finance 315 (1931); Graham & Dodd, Security Analysis 673 n.44 (1934).

Substituting, $R = \frac{M - S}{N + 1} = 1.1 = \$0.50$. Correspondingly, the market value of each old share after the issuance should be $\$9.50$.

The $100,000 increase would be split equally between the stock and the rights, each share of stock and each right afterwards being worth $50 more. Each share of stock would now have a market value of $\$59.50$, and each right a market value of $\$0.50$. If the insider sold all his rights, he would obtain $900 \times \$50.50$, or $\$45,450$.

The market value per share after all the rights have been exercised: ($\$110,000 market value of corporation aside from subscription payment + $9000 paid in under subscription arrangement) / 2000 shares = $\$119,000/2,000 = $\$59.50$. Thus the insider retains 900 shares at $\$59.50$, total value of $\$53,550$. His percentage of control is 900 shares / 2,000 shares, or 45%.

Second, Selling Stock:

Without any issuance of rights, the director has after the increase 900 shares worth $110 each, or $99,000. To get the $45,450 realized under the other method by the sale of the rights, he would have to sell 45,450/110, or 413.18 shares. He would retain 486.82 shares. The market value of the retained equity, as in the other method, would again be $53,550 (486.82 \times \$110)$. But the control represented would be 486.82/1000, or 48.68%, as compared with the 45% control retained under the previous method.

30. Only part of the proceeds from a sale of rights represents speculative profits. An insider who sells rights is selling part of his original equity interest as well as realizing a speculative profit. Consequently, only the surplus over what he paid for this particular part of his interest should be treated as recoverable profit.

The usual formula for determining the cost basis of a right, $R = \frac{M - S}{N + 1}$, note 29 supra, is therefore unsatisfactory. Where most of the appreciation in value occurs after the issuance of the rights, the recovery will be larger than necessary. On the other hand, where the appreciation occurs before the issuance of rights, the sale proceeds would be either equal to or less than the basis obtained, and hence there would be no recovery at all. The correct basis, $B$, can be calculated only by taking a fractional part of the basis described in note 29 supra. Specifically, the ordinary basis should be multiplied by the
Distinguishing the *Dreyfus* case away, however, would be unnecessary if the original purchase of stock could be matched against a subsequent sale of rights. The right and the stock obtainable therefor would seem to be the same kind and class of equity security.\(^{31}\) Even if they are not, Section 16(b) nowhere requires that only profit from transactions in the same class and kind of equity security can be recovered.\(^{32}\) Specifically, the Act refers to "any profit . . . from any purchase and sale . . . of any equity security."\(^{33}\) Since both stock and rights are equity securities, and one has clearly been purchased and the other sold, matching the two transactions for purposes of determining liability under Section 16(b) does no violence to the statutory language, permits recovery of speculative profits\(^{34}\) and requires no limitation of the *Dreyfus* "no purchase" rule.

In at least three other exceptional situations, however, some modification of the *Dreyfus* rule may be appropriate: where the insider expects a market decline, where rights are issued under an employment contract, or where rights are issued on a discriminatory basis. Each of these creates possible avenues for speculative profits based on inside information.

**Market Downswings.** Where the insider can "guess" market fluctuations, he can use the issuance of rights to his advantage by controlling the length of the subscription period. Thus an insider desiring to retain control over a corporation may anticipate an abrupt downswing in the market value of the corporation's stock. Prior to the downswing, he can compel the distribution to all stockholders of preemptive rights exercisable until a date after the expected decline, when market price will have fallen below subscription price. Since potential subscribers ordinarily exercise stock rights late in the subscription period,\(^{35}\) most rights would not be exercised at all.

\[ B = \frac{C}{M} \times \frac{M-S}{N+1} \]

\(^{31}\) Support for the view that rights and stock on which they are issued are of the same class can be found in the Internal Revenue Code, which regards the sale of rights as a disposal of part of the capital interest represented by the old shares. See *Int. Rev. Code* § 113.

\(^{32}\) But see *Smolowe v. Delendo Corp.*, 136 F.2d 231, 237 n. 13 (2d Cir. 1943) (matched transactions must be in securities of the same class). If so, then purchase and sale of securities that fluctuate together should be considered as being in effect a purchase and sale of the same class of security. See Rubin & Feldman, *supra* note 1, at 486.


\(^{34}\) In matching the purchase of stock with the sale of rights, that part of the stock purchase price attributable to the rights may be obtained by the formula \[ B = \frac{C}{M} \times \frac{M-S}{N+1} \]

\(^{35}\) For example, Southern New England Telephone Company in 1946, in an 18 day subscription period, had had only 32% of the issue subscribed by the close of the 13th day. Of the remaining 68%, 67% was subscribed in the last 5 days, 40% on the last day. In 1947, again in an 18 day subscription period, only 25% of the issue had been sub-
The insider could thus hedge the decrease in value of his original shares, without much loss in voting control, by selling his rights before the decline while they still had value. He could, of course, make the same profit by selling old shares before the decline and buying back after the drop. But this profit would be recoverable, since Section 16(b) includes "any sale and purchase," as well as "any purchase and sale." 32

Admittedly, situations where this abuse will be possible are likely to be rare. When these peculiar facts are shown, however, courts must be willing to create an exception to the Dreyfus rule and regard the issuance of rights as a "purchase." Otherwise, the liability created by Section 16(b) may too easily be circumvented.

**Discriminatory Issue of Rights.** When rights to purchase one class of stock are issued to holders of another class, capitalization on inside information again becomes possible. For example, insiders holding only preferred stock may know of an imminent rise in the value of the corporation's common stock. In order to profit from this information, these insiders could purchase existing common for resale subsequent to its appreciation in value. If both transactions occurred within six months, however, all profits would be recoverable by the corporation. Alternatively, these insiders could compel the issuance to all preferred stockholders of rights to buy common. These rights would appreciate in value as the common appreciated. Hence, the same amount of profit would result, with no liability under Section 16(b) unless the issuance of rights in this case is regarded as a "purchase." Failing to do so would again enable insiders to achieve by one device what Section 16(b) prevents them from doing by another. 33

Similar possibilities for misuse of inside information exist where insiders can limit the issuance of rights to holders of one of a corporation's two classes of securities that fluctuate together. Thus insiders may hold only common stock in a corporation with only two classes of stock outstanding—common, and preferred convertible into common. They might then compel the corporation to issue to themselves, as common stockholders, rights to purchase either the preferred or the common, without issuing similar rights to holders of the convertible preferred. The rights, the preferred and the common would thereafter fluctuate together. Any appreciation in the value of one would be reflected in an equal appreciation of the others. As a result of the discriminatory issuance of rights, the corporation will have more equity

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33. 36. Insiders in this situation would not be deterred by fear of diluting their equity interest by the issuance of these rights. The stock issued upon exercise of these rights will dilute the equity of the other class, not of their own class.
37. For example, preferred may be temporarily in control under a charter provision providing for such a shift upon the failure to pay a preferred dividend. BALLANTINE, CORPORATIONS 419 (1946).
38. Insiders in this situation would not be deterred by fear of diluting their equity interest by the issuance of these rights. The stock issued upon exercise of these rights will dilute the equity of the other class, not of their own class.
securities outstanding. Any appreciation in value foreseen by the insider will, therefore, have to be divided among more securities. Because of the issuance of rights, the insiders will have a greater percentage of the securities over which this appreciation will have to be distributed. Consequently, by selling off all of their stock and their rights, they can secure a greater proportion of the corporation’s appreciation in value than they could have secured by selling off their original stock after the appreciation without the issuance of rights. In order to get this extra profit, therefore, the discriminatory issuance of rights must be regarded as a “purchase” under Section 16(b).

Even if the issuance of rights is not regarded as a “purchase” under Section 16(b) the shareholder is not entirely helpless. At common law, such discriminatory rights are regarded as a breach of the director’s fiduciary duty, and may be enjoined or remedied in damages. But the existence of these remedies need not preclude shareholders from seeking recovery of insider profits under Section 16(b). Permitting suits under Section 16(b) makes available a federal forum, with venue provisions and rules of procedure more liberal than many state courts provide. Moreover, suits under Section 16(b) permit nation-wide service of process. Finally, the possibility of double damages, once at common law, and once under Section 16(b), may twice as effectively deter insiders from such chicanery.

Employment Contracts. Rights issued pursuant to employment contracts that provide for the payment of stock or stock options as compensation or incentive also require a modification of the Dreyfus rule. Unlike the preemptive right situation, the issuance is not based on existing stockholdings. In essence, rights received under these contracts are, therefore, more closely akin to rights actually purchased on the open market. It is apparent, for example, that where the securities are given in lieu of compensation, the insider is in effect exchanging cash for securities. Consequently, the agreement is clearly a “purchase” within the meaning of Section 16(b).

40. Stone v. United States Envelope Company, 119 Me. 394, 111 Atl. 536 (1920); see note 52 infra.
42. Ibid.
43. “Sec. 28. (a) The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this title shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of...” 48 STAT. 903 (1934), 15 U.S.C. § 78bb (1946). For the opinion that this subsection permits the corporation to bring a § 16(b) action when shareholders have already recovered the director’s unlawful profits at common law, see Yourd, supra note 2, at 149 n. 56.
44. For a general discussion of these contracts see WASHINGTON, CORPORATE EXECUTIVE COMPENSATION (1942); Comment, Abuses of Employee Stock Purchase Plans, 21 CALIF. L. REV. 358 (1933).
Even incentive options which give the insider a right to buy stock at a price higher than market price prevailing when the contract is entered into fall into this category of "purchases" under Section 16(b). Failing to treat the issuance of these rights as a "purchase" opens up the possibility of speculative profits based on inside information, no matter what their exercise price. Whether labelled "compensation" or "incentive" options, the rights issued under these contracts are indistinguishable. The initiative in extending "incentive" options probably lies with the insider, not the corporation. Moreover, hinging possible liability under Section 16(b) on whether the exercise price was above or below market price would make avoidance too easy. Finally, Section 16(b) itself does not envisage such a distinction keyed to exercise price, for the statutory definition of "purchase" includes "any contract to buy, purchase, or otherwise acquire.

In some cases, the date of "purchase" can be equated with the date the contract is signed, though actual delivery of the securities involved may not take place until a later date. This later delivery under the contract need not be characterized as a second "purchase," even though sale may take place within six months of that receipt and more than six months from the contract date. All the terms will be fixed and binding as of the original contract date, with no opportunity to exercise speculative judgment at the later date. However, if the original contract permits an exercise of choice when the rights are actually to be delivered, this later delivery should be a "purchase" if he accepts stock, or a "sale" if he takes cash. For example, if each year the employee has the option to take cash instead of securities, inside information might again be used in deciding whether to take the securities. Any "profit" from a subsequent sale where securities were originally taken, or purchase where cash had been accepted, within six months of the election, should be recoverable under Section 16(b).

45. If the insider, by definition, is in control of the corporation, he is in effect issuing the options to himself.
46. For example, the current market for a company's common stock may be 50. Because of a gold mine discovery, an insider expects a rise to 100 in the next few months. Before announcing the discovery of the gold mine, he could have issued to him as "incentive" an option to purchase 500 shares at $60, or $10 above the current market. Then, after the rise, he could sell his option for 500 X $40, or $20,000. The higher exercise price merely means that his profits will be a little lower.
48. But see Truncale v. Blumberg, 80 F. Supp. 387, 392 (S.D.N.Y. 1948). Representative Wolverton recently proposed the following legislative clarification: "For the purposes of this subsection [§16(b)], (i) an equity security issued or sold pursuant to an agreement (whether such agreement be heretofore or hereafter entered into and whether it provides for such issuance or sale unconditionally or only upon the happening of certain contingencies specified therein) shall be deemed to be purchased by the person to whom such security is so issued or sold at the time such agreement was or is entered into . . .

Stock Dividends and Stock Splits

Neither stock dividends nor stock splits ordinarily permit an insider to profit from inside information. In this respect, they closely resemble the issuance of preemptive rights. Like rights, the new stock issued as a result of a dividend or split is distributed on the basis of prior stockholdings. Presumably, the old and the new stock are fungible. The new stock will, therefore, reduce the market value of all the stock, and, as in the case of rights, any subsequent appreciation in value will be shared equally by the old and new stock. Consequently, a director who wanted to capitalize on a foreseen market advance would not be tempted to compel a stock dividend or stock split. Just as in the case of rights, he could make the same profit by selling off a portion of his original holding. If this sale took place more than six months after his initial acquisition of stock, the profit would be immune from Section 16(b) liability. Hence it is unnecessary to characterize the issuance of dividends or split as a "purchase," even where the subsequent sale takes place less than six months after the original purchase of the stock on which the stock dividend or split is declared. In the latter case, the insider has clearly "purchased" and "sold" an equity security of the same kind and all profit would be recoverable without regarding the dividend or split as a "purchase" at all.

Possibilities of abuse arise, however, where the director may select the form in which to receive his dividend. For example, the dividend may be payable in cash or stock at the shareholder's option. Inside information

49. Unlike the case of rights, where the issuance and sale of rights will result in a greater dilution of equity than the sale of original stock holdings, see note 29 supra, both the sale of dividend stock and the sale of original stock will lessen the insider's equity to the same extent. For example, the insider may receive one share of dividend stock for each share of original stock he holds. If he sells all his dividend stock, he will have diluted his equity in the corporation just as much as if he had sold half of his original shares, without any dividend having been issued. The dividend alters neither the rights of the recipient in the corporation nor total capital of the corporation itself. The only effect on the corporation is the necessary bookkeeping entry, a capitalization of surplus. The amount and character of the enterprise obligation remain constant. Sterling v. Watson, 241 Pa. 105, 88 Atl. 297 (1913); Ballantine, Corporations 481-3 (1946); Bogen, Financial Handbook 791-5 (1948); Dewing, Corporation Finance 163-71 (1931); Kester, Advanced Accounting 460-1 (3d ed. 1933); Leland, Contemporary Accounting c. 9, pp. 7-9 (1945); Paton, Advanced Accounting 577-80, 586-90 (1947). But see Comment, 39 Yale L. J. 1163, 1169-70 (1930) (question of revocability).

50. See Shaw v. Dreyfus, 172 F.2d 140, 142 (2d Cir. 1949): "'Purchase' is not an apt word to describe the receipt by a stockholder of shares representing a stock dividend..."

The SEC has indicated that a stock dividend is not to be considered a "purchase." Item 9 of SEC instructions with respect to Form 4, required by Section 16(a) of the Act, 2 CCH Fed. Sec. Law Serv. ¶ 33,702 (2d ed. 1944), note 73 infra. Also, a stock dividend in general is not a "sale" for purposes of registration under the Securities Act of 1933. Securities Act Release No. 929 (1936). Cf. Commissioner v. Koshland, 81 F.2d 641 (9th Cir. 1936) (tax rule).
will undoubtedly influence the insider’s choice of which to receive. If he expects the stock to appreciate he will elect to receive stock for subsequent sale. On the other hand, if he expects a decline, he will choose cash which he may later use to purchase stock after the decline. In essence, he is exchanging one for the other, stock for cash or cash for stock. Consequently, the election to receive payment in stock must be regarded as a “purchase,” and the election to receive cash must be regarded as a “sale” of the shares he could have received as a dividend.

Similarly, where a corporation has outstanding only two classes of stock that fluctuate together, the issuance of discriminatory stock dividends creates the same possibilities of abuse as the discriminatory issuance of rights. Insiders who hold only common may compel the corporation to issue to common stockholders, exclusively, additional common or additional preferred convertible into common. If similar stock had been issued to all stockholders on a pro rata basis, there would never be a need to characterize the issuance of the dividend as a “purchase.” A sale of stock within six months of purchase would result in profits recoverable under Section 16(b) while a sale more than six months after purchase would not. After a discriminatory issuance of stock dividends, however, a sale more than six months after the original purchase, but less than six months after the issuance of the dividends, may result in greater profits to the insider than a sale of his original stock without the issuance of the dividend. The dividend will give the corporation more outstanding securities over which any subsequent appreciation will have to be divided, and, at the same time, will give the insider a greater proportion of the stock which shares in this appreciation. By selling off all of his new and old shares, therefore, an insider can obtain a greater percentage of this appreciation and consequently make greater profits than he could have obtained by not compelling the issuance of rights and selling off his original holding after it had appreciated in value. Unless the issuance of dividends is regarded as a “purchase,” this extra profit will not be recoverable under Section 16(b). These profits may be recoverable, as in the case of rights, under common law or state statute. But again, as in the case of rights, giving stockholders a remedy under Section 16(b) is desirable, if directors are to be deterred more effectively from engaging in such practices.

51. The equivalence of this election to an actual purchase and sale is even clearer where the dividend is first declared payable in cash and an option of satisfaction by stock is given later. Only this transaction is a “sale” under the Securities Act of 1933. Securities Act Release No. 929 (1936).

52. See notes 39 and 40 supra; Rowell, Rights of Preferred Shareholders in Excess of Preference, 19 Minn. L. Rev. 406, 418 (1935); Morawetz, The Preemptive Right of Shareholders, 42 Harv. L. Rev. 186, 188 (1928); Note, Right of Preferred Stock to Share in Stock Dividends, 16 B. U. L. Rev. 189 (1936). For a list of states that have adopted statutes restricting such dividends, see Hills, Model Corporation Act, 48 Harv. L. Rev. 1334, 1369 n.39 (1935).

Conversion

Exercise of Conversion Privilege

After issuance, a right is essentially a convertible security. Like other convertible securities which have long been a common type of security traded on national stock exchanges, they can be changed from one form into another form at the option of the holder. Many types of convertible securities, however, provide that the conversion may be effected by a mere surrender of the convertible security, without any additional payment. The holder of a right, on the other hand, may convert it into another type of security only by surrendering it plus a subscription price to the issuing corporation. For Section 16(b) purposes, the presence or absence of a requirement of an additional cash payment to effect conversion is immaterial. The same rules which apply in general to other convertible securities apply also to rights.

Normally, wherever there is a conversion from one type of equity security to another, there is no possibility for abuse, and hence no need to apply Section 16(b) labels. The convertible security plus the cash payment necessary, if any, in general never falls below the worth of the conversion security, i.e., the security for which it can be exchanged. Otherwise conversion would take place. Consequently, where there is an appreciation in value of the conversion security there will normally be an equal or greater appreciation of the convertible security. The same profits which can therefore be made by converting and selling the conversion security can be made by simply selling the convertible security. In the latter case, there would be no Section 16(b) liability, provided the original purchase of the convertible security took place more than six months before its sale. In general, therefore, conversion merely means postponing the date when profit is realized, rather than a liquidation of the original investment. Since conversion offers the insider no greater opportunity to profit than a mere retention of his original shares, the act of converting need not be regarded as a “sale” of the convertible security, or as a “purchase” of the conversion security.

A similar argument applies where the ultimate sale of the conversion

54. Section 3(a)(11) of the Securities Exchange Act defines “equity security” to include “any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security...” 48 Stat. 884 (1934), 15 U.S.C. § 78c(a) (11) (1946), note 19 supra.
56. Id. at 243 n.e., 247 n.m., 250 n.p., 257 n.x.
57. To emphasize the fact that a conversion security is in reality purchased only when the convertible security is acquired, Representative Wolverton recently sought to amend 16(b) by adding the following provision: “For the purposes of [§16(b)]... (ii) an equity security issued upon conversion of, or in exchange for, another security pursuant to a conversion or exchange privilege appertaining thereto or upon exercise of a warrant, option, or other purchase right shall be deemed to have been purchased by the person exercising such conversion or exchange privilege or purchase right at the time...
security occurs less than six months after the purchase of the convertible security. Under these facts the insider might equally have secured the same profit by choosing not to convert and selling off his original convertible security. Since less than six months had elapsed between the purchase and sale, these profits would be vulnerable to attack under Section 16(b). Presumably, conversion and sale of the conversion security should also yield recapturable profits. Otherwise, possible liability under Section 16(b) could easily be avoided. One way of recovering these profits, of course, would be to regard every conversion as a “purchase” and “sale” where sale of the conversion security takes place within six months of the purchase of the convertible security. This theory, however, emphasizes the fact of conversion, rather than the fact that both end transactions occurred within six months. Presumably Section 16(b) penalizes not conversion but illegal gains obtained by an insider within a statutory time limit. Alternatively, these profits might be recaptured by matching the original purchase of the convertible security with the subsequent sale of the conversion security. As in the case of stock rights sold within six months of an original purchase of stock, matching the purchase of a convertible security with a sale of a conversion security is consistent with the statutory language of Section 16(b). Furthermore, it permits the recovery of all the profit realized by the insider.

Termination of Conversion Feature

Frequently, a corporation will announce termination of the conversion option within six months of an insider’s acquisition of his holding. Expiration of the conversion feature will compel the insider to decide whether to convert his security, sell it outright, or, in some cases, retain it as an independent security. Since the two securities will thereafter fluctuate independently, the security he chooses to hold will depend on his knowledge of what is likely to happen. Consequently, when he converts, he expects the conversion security to appreciate in value. If he wanted to secure this profit without converting, he would have to go out and buy the conversion security for subsequent resale. Where the resale occurred within six months, these profits would be recoverable. He can, however, secure the same amount of profit by converting and subsequently selling the conversion security. Therefore, in order to prevent insiders from achieving what Section 16(b) of the purchase by such person of the security so converted or exchanged or of the warrant, option, or right so exercised. . . .” H.R. 4634, 80th Cong., 1st Sess. (1947).

58. Because of the dependent fluctuation, an insider could also speculate by selling the convertible security and later purchasing the conversion security. These transactions should also be matched, as should all others where there is dependent fluctuation between the two classes of securities.

59. See pp. 517-18 supra.

60. Securities will often remain outstanding in the case of convertible bonds or convertible preferred, but never in the case of securities which represent merely the conversion option, such as preemptive rights.
prevents them from doing by outright purchase and sale, conversion must be regarded as a "purchase" where less than six months elapses between conversion and sale of the conversion security. Since most rights have a life of only two to seven weeks, the acquisition of stock by preemptive rights will generally be a "purchase" of that stock.

In dealing with this problem courts have gone farther than necessary. The leading case still remains Park & Tilford, Inc. v. Schulte, where the impact on Section 16(b) liability of conversion just prior to expiration of a conversion privilege was first tested. Conversion, termination, and sale of the conversion security all occurred within six months, though more than six months after the convertible securities were acquired. Since the conversion took place under a threat of redemption of the convertible security, the court properly held that profits resulting from the conversion and sale of the conversion security were recoverable under Section 16(b). To arrive at this correct result, the court based its argument on the broad ground that all conversions are "purchases." This doctrine, however, may impose Section 16(b) liability on some innocent transactions where expiration of a conversion feature did not impend and capitalization on inside information was consequently impossible. Section 16(b) need not go so far.

GIFTS

The Securities Exchange Act does not specifically include "gifts" within its definition of "sale." Under the Act, "sale" includes only "any contract to sell or otherwise dispose of" securities. At first glance, therefore, a "sale" under Section 16(b) could include "gifts" only by a strained interpretation of the language. On closer inspection, however, it becomes apparent that only a construction that "gifts" are "sales" gives effect to all of the language employed to define a "sale." Obviously, securities can be disposed of only by sale or by gift. A "contract to give" securities would be a

61. Where the security itself remains outstanding, conversion before termination should be a "sale" of the convertible security in addition to being a "purchase" of the conversion security.


63. Id. at 986-7.

64. Ibid.

65. "The Act certainly applies as well to executed acquisitions as to executory contracts to acquire. Not otherwise could the Act accomplish the Congressional purpose to protect the outside stockholder against at least short swing speculation by insiders with advance information. . . . We think a conversion of preferred into common stock followed by a sale within six months is a 'purchase and sale' within the statutory language of §16(b). . . ." 160 F.2d 984, 987 (2d Cir. 1947). Accord, Kogan v. Schulte, 61 F. Supp. 604 (S.D.N.Y. 1945); cf. Shaw v. Dreyfus, 172 F.2d 140 (2d Cir. 1949), affirming 79 F. Supp. 533 (S.D.N.Y. 1948), cert. denied, 337 U.S. 907 (1949), where the second circuit assumed that the exercise of rights was a "purchase" of the stock thus acquired.


67. Neither bailment nor pledge is usually considered a "disposal," since ordinarily the bailor or pledger will get his property back.
nullity for want of consideration, while the presence of consideration, on the other hand, would convert the "contract to give" into a "contract to sell." Contract, as used in the definition, must therefore refer only to contracts to sell. And if the phrase "otherwise dispose" is to have any meaning, that meaning must be "gift." Such broad constructions are the rule rather than the exception when the underlying remedial purposes of statutes like the Securities Exchange Act are involved.

Nevertheless, insiders who dispose of securities by gift rather than by sale, and within six months of their acquisition, have thus far avoided any liability under Section 16(b). Courts have uniformly held that such gifts, whether for charitable or non-charitable purposes, are not "sales" within the meaning of the Securities Exchange Act. In each case, these courts have operated on the theory that there is no profit possible in such transactions, and hence no danger of short-term speculation. The profits they talk about however are actual money gains. They overlook the possibility that these gifts may actually result in tax benefits and other economic advantages sufficient to warrant inclusion of gifts within the definition of "sale" under Section 16(b).

Charitable Gifts

The leading case for the proposition that charitable gifts are not Section 16(b) "sales" is Truncale v. Blumberg. The defendant received stock options under an employment contract. Within six months he gave these options to various charities. A stockholder brought a Section 16(b) action to recover an alleged profit. Although assuming that the receipt was a "purchase," the court denied liability on the ground that the gift was not a corresponding "sale." Judge Medina conceded that the term "sale" should...
be interpreted broadly in order to remove all incentive to insiders to profit from confidential information on short-swing transactions. But he saw no possibility of profiting by means of gifts and hence no danger. The tax laws, in his opinion, had nothing to do with the question. "To describe these gifts to charity as a 'tax dodge,' seems nothing short of a gratuitous slur. . . ."  

The SEC, in an amicus brief, agreed that there was no possibility of insider abuse through charitable gifts, and urged the interpretation either that there was no "sale" or that there was no "profit."  

Realistically speaking, publicly proclaimed charitable gifts may yield substantial benefit to the donee in the form of prestige and community standing. Charitable donations are frequently coldly calculated "advertising" expenditures. By making large gifts, the donor may increase the sales of his company, or establish a reputation for financial responsibility and business success. Moreover, the tax laws permit an individual to secure whatever benefits flow from large charitable gifts at low cost. The Internal Revenue Code does not levy any capital gain or income tax on more

The securities had been "purchased" when he concluded the contract, more than six months previously. See pp. 520-21 supra.


Prior interpretation by the SEC also had taken the attitude that a bona fide gift is neither a "sale" nor a "purchase." Item 9 of the SEC's instructions with respect to "Form 4," for the report of changes in ownership, provides that "if the transaction is other than a purchase or sale, it should be so indicated; e.g., gift, 5% stock dividend, etc., as the case may be." 2 CCH Fed. Sec. Law Serv. ¶ 33,702 (2d ed. 1944).

74. Consider, for example, the case of Frank Algernon Cowperwood, a character created by Theodore Dreiser in The Titan (1914). Cowperwood, interested in street railways in Chicago shortly after the turn of the century, wanted to furnish funds for the building of elevated roads. For interesting personal reasons, he had incurred the enmity of the Chicago banking interests, and could not obtain credit there. And when he approached New York and foreign bankers, he found that reports of this hostility had preceded him. Consequently these out-of-town bankers were suspicious of investing in his scheme.

At this juncture, one Dr. Hooper, president of the University, approached him for a $10,000 subscription toward the cost of the lens for a new telescope the University wanted. Seeing his opportunity, Cowperwood pledged $300,000 for the entire telescope and the building to house it, the unit to be named in his honor. The international prominence which this gift received created the desired impression on the outside capital. Here they had convincing proof that they were dealing with a man whose finances were secure enough and strong enough to withstand temporary difficulties.

He now was able to conclude the desired financing arrangement with an English-American banking house, and he was given ample means wherewith to proceed. "Instantly the stocks of his surface lines bounded in price, and those who had been scheming to bring about Cowperwood's downfall gnashed impotent teeth." Dreiser, The Titan 363-72 (Liveright ed. 1925).

75. Lasser, How Tax Laws Make Giving to Charity Easy 22 (1948); Wormser, The Theory and Practice of Estate Planning 75 (1946); 62 Harv. L. Rev. 706 (1949).
unrealized appreciation, and allows a charitable deduction on the total appreciated value at the date of gift, provided charitable gifts do not exceed 15 per cent of the taxpayer's income. An insider may, for example, make a charitable gift on securities worth $1000. As a result the income on which he has to pay a tax is reduced by $1000. If his income after deductions and exemptions were over $200,000, his total income tax would have been reduced correspondingly by $821. Assuming that he had paid the full $1000 for the securities that year, the charitable gift would only have cost him $179, since he could not have kept the other $821 anyway. Of course, the cost will approach actual outlay as net income falls. But whenever income is large, the cost of the donation will be substantially less than its market value at the time of the gift.

In addition, despite Judge Medina's dictum to the contrary, charitable gifts offer a profitable way of disposing of securities that have appreciated in value. An insider who purchases the securities of his corporation while low and then gives them away at their appreciated value may obtain the 15 per cent deduction without really giving away 15 per cent of his income. In some rare cases, he may even realize a net gain from the gift. Thus, an insider may buy securities for $500, knowing that they are bound to appreciate in value. Five months later, when they rise to $1000, he may give them to his favorite charity. The increase does not add to his taxable income. He is nevertheless entitled to deduct the full $1000 from his taxable income. If the insider is in the $200,000 or over bracket, the $1000 deduction from income results in a corresponding $821 deduction in the tax he has to pay. In other words, had he chosen not to buy the securities in the first place, he would have had to pay $821 more in taxes than he actually pays as a result of his gift. Since he had to pay only $500 for the securities with which he got this $821 saving, his charitable gift of appreciated securities enables him to retain $321 more of his income than he would otherwise have been able to.

These tax consequences only bolster the argument that charitable gifts must be considered "sales" in order to prevent speculative abuses. People of wealth, position and influence are expected to make charitable contribu-


77. Int. Rev. Code § 23(o).

78. The aggregate of the tentative normal tax rate and the tentative surtax rate on that part of an adjusted gross income over $200,000 is 91½%, or $910 out of $1000 of income. Int. Rev. Code §§ 11, 12. The Internal Revenue Code, in § 12(a), however, provides for a 9.75% reduction of the amount by which the aggregate of the tentative normal tax and the tentative surtaxes exceeds $100,000. The $910 figure would therefore have to be reduced by 9.75%, or $88.73, leaving a total of $821.27 which would have to be paid to the government out of every $1000 by which an adjusted gross income exceeds $200,000.

79. See Rubin & Feldman, supra note 1, at 485. And see note 75 supra.
tions. These charitable gifts need not, however, take the form of securities. Corporate insiders, for example, are equally at liberty to sell their stock at its appreciated value and make a gift of the cash proceeds. The benefits to be derived from a charitable gift are the same in either case. Where proceeds from a sale are donated, the insider incurs liability under Section 16(b) in order to obtain these benefits. Failure to include gifts of securities within the category of "sales" under Section 16(b) permits him to secure, with impunity, the same benefits, and in fact obtain greater tax savings than if his gifts take the form of cash. 80

Non-charitable Gifts

Even where the gift is for a non-charitable purpose, the second circuit has also concluded that such gifts offer no opportunity for profit, and hence that the gift need not be regarded as a "sale." 81 As in the case of charitable gifts, this position is unrealistic. It overlooks the fact that a gift of equity securities is in reality the same thing as a gift of cash. Non-charitable gifts to relatives, friends, employees or business associates, like cash, can be used as compensation for services rendered, or to induce future loyalty and services. Likewise, a gift to one's family, relatives or friends can be made to

80. The donor of cash would still get his charitable deduction, but at the same time his income would be increased by the amount of the realized appreciation. Suppose an insider with a $210,000 income purchases securities at $500, sells them within six months at $1000, and gives the proceeds to some charity. The sale, a realization of $500 appreciation, boosts his income to $210,500—deducting his $1000 contribution, he pays a tax on $209,500. Had he made the gift directly in the appreciated securities, he would not have had to recognize the appreciation, but could still deduct $1000, thus paying a tax on only $209,000.

The $500 appreciation realized on the sale in the above example would be taxed as an addition to net income, and not under the long term capital gain rates. Inr. Rev. Code § 117(b). It is only a queer coincidence that the six-months period arbitrarily fixed as the dividing line between abusive and non-abusive insider trading corresponds with a similar six-months period distinguishing short term from long term capital gains under Inr. Rev. Code § 117. In some cases, however, the date of "purchase" in the two situations may not be identical, see Inr. Rev. Code § 117(h) (5). 81


Dreyfus had received 106,343 preemptive rights, and sold 76,340 of them. 30,003 rights remaining from the original allotment were exercised, while the other three were allowed to expire. Of the 3000 shares issued for these 30,003 rights on October 23, 1945, 1460 were given away on or before January 6, 1946. 79 F. Supp. 533, 536.

"Certainly bona fide gifts, as these were conceded to be, are not within the accepted meaning of 'sales'; nor do they involve 'any contract to sell or otherwise dispose of' the property given. ... Nor are they within the evil at which the statute was aimed. ... . . . Certainly so long as neither he [Dreyfus] nor his donee made any profit within the six months period no unfair use of inside information, within the intendment of the statute, has occurred. It is plain that Dreyfus realized no profit by making the gifts. We see no justification for construing 'profit realized from any purchase and sale' to mean merely emotional gratification resulting from making the gift." 172 F.2d 140, 142-3.
stimulate return favors or to satisfy obligations. Thus, the insider can secure substantial economic benefits in much the same way as if he made an outright sale of stock for cash and then used this cash to procure his results.82

The SEC’s attitude toward these non-charitable gifts differs from that of the second circuit. While unwilling to admit the possibility of misuse of inside information where charitable gifts are concerned, the SEC does see some danger of abuse in the case of non-charitable gifts.83 In the SEC’s view these dangers exist only when profits measurable in money are actually realized. Where the donor sells the security and donates the proceeds, recoverable profits within the meaning of Section 16(b) are clearly realized. After a gift, the SEC contends, no such profit is realized, unless the donee resells the security. Only this resale, the SEC argues, makes the two different transactions equivalent and creates a liability under Section 16(b). Accordingly, the SEC’s proposed solution is to treat the non-charitable donee as “standing in the shoes of” the donor. And where the donee resells within six months of the donor’s purchase, the SEC would regard the gift as a sale by the donor.84

This Commission recommendation is inadequate. It ignores the possibility that some “economic benefit” may accrue to the donor, whether or not the donee resells.85 Moreover, as the SEC is aware, the proposal imposes an impossible burden on stockholders seeking to enforce Section 16(b). These stockholders would have no practicable way of ascertaining the requisite information about the donees’ stock dealings, even if the insider were compelled to name his donees in the monthly report of his stock dealings required under Section 16(a).86 A similar duty of reporting might be placed on all donees. But imposition of such an obligation seems outside the Commission’s present statutory authority.87

82. “If one has at hand so ready a means of recompensing faithful personal service at home or in the office, or of making the ties of personal loyalty of company executive officers yet stronger than before . . ., I should think the necessity of doing so only through the use of the stock itself, instead of the money which might be realized therefrom, was one which could be accepted with considerable tranquility.” Clark, J., dissenting, Shaw v. Dreyfus, 172 F.2d 140, 143 (2d Cir. 1949).


85. See note 82 supra.

86. Note 14 supra.

In the alternative, the SEC proposes to classify all non-charitable gifts as sales under Section 16(b). The Commission retains its belief that an insider may capitalize on inside information and actually realize speculative profits only where the non-charitable donee resells within six months of the donor's purchase. It fears, however, that courts will be reluctant to accept its proposal that gifts are "sales" only when the donee, "standing in the shoes of the donor," resells the donated security. Confronted with an all-or-none choice, the SEC would prefer to regard all non-charitable gifts as "sales."

Unfortunately, the SEC has coupled this alternative proposal with an inadequate measure of profits. The Commission would permit recovery only of the difference between the cost of the securities to the donor, and the market price of the securities at the time of the gift. This suggested measure of profits fails to provide an effective deterrent to abuse of inside information. Since the amount of recoverable profit would be limited to the appreciation in value of the donated securities occurring before the gift, an insider knowing of an imminent rise in the value of the corporation's stock, could therefore get his benefit and avoid liability by purchasing stock and making the gift immediately. A more realistic measure of profits would be the difference between the purchase price of the securities and the maximum market price they attain within six months of the date the securities were acquired by the insider.

Why the Commission hesitates to go further and also recommend the inclusion of charitable gifts within the definition of "sale" under Section 16(b) is not apparent. It may be that the Commission is deferring to a public policy premise that charitable gifts are to be encouraged. But charitable gifts may often confer as great an economic benefit as non-charitable gifts where the donee fails to resell. Since Section 16(b) itself makes no distinction between the two, all gifts, whether for charitable purposes or not, would best be treated as "sales" giving rise to "profit" recoverable under Section 16(b).


Consider also the complications that might arise should the first donee, still within the six-months period, give to a second donee, and so on ad infinitum.


89. Actually, in the Dreyfus case, none of the donees transferred any of the stock given them within six months from the date of the gift. 172 F.2d 140, 141 (2d Cir. 1949). The court specifically reserved the question of the effect of resale: "Whether recovery could be had from either Dreyfus or his donee had the stock been sold within six months we need not say. . . ." Id. at 143.

On the other hand, Judge Medina, in Truncale v. Blumberg, 80 F. Supp. 387 (S.D. N.Y. 1948, specifically rejected any distinction as to resale by the donee. Id. at 392.

Conclusion

Because of the six-months rule, Section 16(b) penalizes many innocent transactions and fails to strike at others where inside information may be used to yield speculative profits. Nevertheless, Congress obviously thought such a harsh and arbitrary statute was necessary in order to deter insiders from trading in securities of the companies they managed and controlled. This legislative purpose could easily be defeated if, despite the six-months rule, insiders could escape liability under Section 16(b) by merely exercising their ingenuity. The possible loopholes are infinite. Instead of buying and selling to make a profit, insiders may issue rights, declare dividends and splits, convert from one security to another, or make a gift.

In order to plug these loopholes, courts should be guided by two criteria. Where the outright purchase and sale of equity securities would yield exactly the same profits, immune from Section 16(b), doubtful transactions need not be regarded as a “purchase” or “sale” in order to deter insider speculation. On the other hand, where any alternative way of securing profits from short term trading by obvious purchase and sale would result in Section 16(b) liability, all transactions that result in the same or greater profits must result in Section 16(b) liability. And where necessary, these profits should be recoverable either by characterizing the transaction itself as a “purchase” or “sale,” or by matching transactions whether or not these transactions are in equity securities of the same class and kind.

Once a court has disentangled the various fact situations in which Section 16(b) problems may arise, these tests are simple and easy to apply. They would penalize only those transactions where Congress, by legislating the six-months rule, has conclusively presumed misuse of inside information is possible. Moreover, they would make it impossible for insiders to escape the six-months rule itself, except by bona fide investment.