Short Swing Speculation by the Sometime 10
Percent Owner: An Analysis of Section 16(b) of
the Securities Exchange Act of 1934

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The Securities Exchange Act of 1934 was enacted as remedial legislation, the result of congressional concern over corporate fiduciaries engaging in "sure-thing" speculation in the stocks of their corporations. Section 2 of the Act reflects this concern and broadly expresses the Act's purpose: to insure the maintenance of fair and honest markets in securities transactions. Further, this general congressional policy against "insider speculation" was intended to be effectuated principally through section 16(b), in which Congress stated its intention to prevent "the unfair use of information" by "insiders" in trading of securities.

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

Id. The term "beneficial owner" is defined in section 16(a), 15 U.S.C. § 78p(a) (1970). See note 5 infra.

5. For the purposes of section 16(b) "insiders" are defined in section 16(a) as follows:

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
To effectively discourage these speculative and manipulative practices, Congress provided in section 16(b) an objective rule-of-thumb prophylaxis. The idea was to take away from the “insider” any profits realized in a short swing speculation, thereby deterring such trading. In order to insure effectuation of the purpose of section 16(b), Congress explicitly made irrelevant the intent of the insider who engaged in short term transactions, and further, did not condition the section’s application on proof of actual use of inside information, or of the existence of a manipulative intent, or of the insider’s intent to trade on a short swing. This objective and inflexible appraisal commanded by section 16(b) is the result of the underlying congressional fears that unfair use of inside information could effectively be deterred only by a flat rule which plainly made it unprofitable to trade securities in the short term.

The purpose of section 16(b), as set forth in the Act itself, is “to prevent the unfair use of inside information,” and that policy is effected by imposition of strict liability on a specified class of transactions. The specific language defining that class is found in the exemptive provision of section 16(b), which exempts those transactions involving beneficial owners of more than 10 percent of a corporation’s securities (statutory insiders) where the beneficial owner did not qualify as such at the time of both the purchase and sale, or the sale and purchase of the security involved. This provision has resulted in much controversy, especially over the intended meaning of the phrase “at the time of,” and has just recently been interpreted by the exempted security which is registered pursuant to section 78l of this title.

6. See note 4 supra.
8. 1934 Hearings, at 6556-58.
10. The exemptive provision of section 16(b) provides in relevant part: “if this subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale or the sale and purchase, of the security involved . . . .”

Id.
11. The two opposing constructions of the phrase “at the time of” are “simultaneously with” and “prior to,” and the choice of either is determinative of the section’s application. For example, suppose X, with no relationship to Corporation A, purchases 15 percent of A’s common stock and within six months sells 10 percent of such stock.
The basic question with which this comment will deal is whether the exemption is intended to cover the initial purchase, by a person who is neither a corporate officer nor director, which creates 10 percent beneficial ownership. This comment will examine the legislative history surrounding section 16(b), will discuss the conclusions reached by the courts on the issue, and will comment on the Supreme Court’s recent interpretation of the section with regard to a short swing transaction consisting of a purchase that resulted in more than 10 percent ownership followed by a sale within six months.

**The Legislative History of Section 16(b)**

**The Necessity for Regulation**

Prior to the enactment of the Securities Exchange Act of 1934, congressional investigations uncovered convincing evidence that disregard by corporate insiders of their fiduciary obligations was widespread and pervasive. Unfair use of inside information or manipulation of corporate activities resulting in fluctuations in market prices of securities were frequent practices of corporate officers, directors, and large stockholders. Among such practices were fictitious or “wash” sales and “matched” orders, or orders for the purchase and sale

By construing the phrase to mean “prior to,” X need not forfeit any profits he realizes because prior to his purchase he did not own more than 10 percent of A’s stock. This however, is not the result under a “simultaneously with” construction of the phrase, because simultaneously with his purchase of 15 percent of A’s stock, X becomes a “more than 10 percent owner” and immediately becomes subject to section 16(b).


13. See 10 SEC ANN. REP. 50 (1944), where the SEC stated:

Prior to the enactment of the Securities Exchange Act of 1934, profits from “sure thing” speculation in the stocks of their corporations were more or less generally accepted by the financial community as part of the emolument for serving as a corporate officer or director notwithstanding the flagrantly inequitable character of such trading.
of the same security which emanated from a common source for the purpose of recording operations on the tape and thereby creating a false appearance of activity.\textsuperscript{14} In one particularly glaring instance, the chairman of the executive committee and another director participated in a pool organized to trade in the stock of their company when the stock was paying no dividends. During the operation of the pool, they caused the company to resume payment of dividends, more than 25 percent of which were received by pool participants. These dividends were paid during the pool’s operation in spite of the fact that the company’s earnings were not sufficient to meet them and part of its surplus had to be diverted for that purpose.\textsuperscript{15} These types of practices were summarized in one of the Banking and Currency Committee reports:

\begin{quote}
Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities. Closely allied to this type of abuse was the unscrupulous employment of inside information by large stockholders who, while not directors and officers, exercised sufficient control over the destinies of their companies to enable them to acquire and profit by information not available to others.\textsuperscript{16}
\end{quote}

It was these and other similar types of predatory operations by speculators having access to information not generally available to the investing public with which Congress was most concerned.\textsuperscript{17}

Recognition of these evils and abuses which flourished on the exchanges finally compelled the conclusion that federal regulation was necessary. An examination of the legislative history reveals this “consciousness” by Congress, and its effort to protect the interests of the public from such evils. In an excerpt from another Banking and Currency Committee report, it was stated that

\textsuperscript{14} See S. Rep. No. 792, 73d Cong., 2d Sess. 7-8 (1934).
\textsuperscript{15} Id. at 9.
\textsuperscript{17} Id. at 68. See also Youd, Trading in Securities by Directors, Officers and Stockholders: Section 16(b) of the Securities Exchange Act of 1934, 38 Mich. L. Rev. 133 (1939); Comment, Section 16(b): Insider Trading, 1974 Wash. U.L.Q. 872.
The purpose of the Act is identical with that of every honest broker, dealer, and corporate executive in the country, viz., to purge the securities exchanges of those practices which have prevented them from fulfilling their primary function of furnishing open markets for securities where supply and demand may freely meet at prices uninfluenced by manipulation or control. The Act strikes deeply not only at the defects in the machinery of the exchanges but at the causes of disastrous speculation in the past. It seeks the eradication of the fundamental and far reaching abuses which contain within themselves the virus for destroying the securities exchanges.\footnote{18}

\textbf{The Development of Section 16(b)}

It is evident that such congressional concern prompted the broad policy to discourage all short swing speculation by insiders which is found in section 16(b) of the Act.\footnote{19} Further, Congress adopted in section 16(b) a strict prophylactic rule, since it believed that the only effective remedy for insider abuses was to take the profits out of the class of short-term insider transactions in which the possibilities of abuse were believed to be intolerably great.\footnote{20}

As noted above, the draconian nature of section 16(b) was intended by Congress, because, as the legislative history reveals, Congress foresaw the difficulty of proving that at the time he purchased, the insider\footnote{21} intended either to speculate, manipulate the price, or engage in a short swing transaction.

Mr. Thomas G. Corcoran, one of the principal draftsmen of the Act, testified before the Senate Subcommittee on Banking and Currency and expressly stated that the short-swing trading insider was to be subject to the sanctions of section 16(b) “irrespective of any intention or expectation to sell the security within six months,” and that as a result the section was a “crude rule-of-thumb.” He further emphasized that “you infer the intent from the fact” of the short-swing transaction.

\begin{footnotes}
\item[19] See note 4 supra.
\item[21] See note 5 supra.
\end{footnotes}
and left no room for doubt of the intended objectivity of the standard.\textsuperscript{22} It is thus apparent that Congress intended to obviate the problems inherent in proving the trader's intentions by imposing a conclusive presumption against that class of transactions. That includes those transactions within less than six months by officers, directors, and more than 10 percent beneficial owners which may have been made on inside information.\textsuperscript{23}

However, since the presumption was conclusive it was only meant to apply to those who "may have access" to inside information.\textsuperscript{24} Because of their positions, officers and directors were clearly insiders with access to inside information. The large stockholder, however, caused much concern. He may or may

\textsuperscript{22} Mr. Corcoran. That is to prevent directors receiving the benefits of short-term speculative swings on the securities of their own companies, because of inside information. The profit on such transactions under the bill would go to the corporation. You hold the director, irrespective of any intention or expectation to sell the security within six months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing.

Senator Gore. You infer the intent from the fact.

Mr. Corcoran. From the fact.

Senator Kean. Suppose he got stuck in something else, and he had to sell?

Senator Barkley. All he would get would be what he put into it. He would get his original investment.

Mr. Corcoran. He would get his money out, but the profit goes to the corporation.

Senator Kean. Suppose he had to sell.

Mr. Corcoran. Let him get out what he put in, but give the corporation the profit.

Mr. Thomas G. Corcoran was one of the principal draftsmen and spokesmen for the Act. 1934 Hearings, supra note 7, at 6557.


not in fact have access to inside information. Congress recognized the inherent difficulties in proving whether the large stockholder actually had access to inside information and therefore presumed him to be an insider, with access similar to that of the corporate officer and director.\textsuperscript{25}

\textsuperscript{25} See 1934 Hearings, supra note 7, at 6556-58. The following brief exchange is illustrative of the concern for an objective rule applicable to those persons who are so situated with their corporation that they may obtain inside information.

Senator Kean. I think it is all right to apply it to a director or officer, but I think to require the ordinary investor—

Mr. Corcoran. A stockholder owning 5 per cent is as much an insider as an officer or director. Whether he is a titular director or not, he normally is, as a practical matter of fact, a director.

\textit{Id.} at 6556. Mr. S. Untermyer, an attorney from New York, on whose expertise the Committee greatly relied, testified to a similar concern:

Mr. Pecora. The theory was that the ownership of 5 per cent of the stock would practically constitute him an insider, and by virtue of that position he could acquire confidential information which he could use for his own enrichment by trading in the open market, against the interests of the general body of the stockholders. That is, the main purpose sought to be served.

Mr. Untermyer. I understand the purpose, and I understand the wisdom of it.

Mr. Pecora. You approve of the principle?

Mr. Untermyer. I approve of the principle, but I do not approve of its application to anybody who owns 5 per cent, who is not an officer or director and has no fiduciary relationship.

Mr. Pecora. If you were to raise that limitation to 20 per cent of a listed or registered security, you probably would have difficulty in having it apply to any individual, because it is a grave question whether, in any listed security, there is any individual who owns 20 per cent or more of the outstanding stock.

Mr. Pecora. We had evidence here last summer from Mr. Van Sweringen. He and his associates felt that if they could acquire a block of stock which amounted to around 10 or 15 per cent of an important railroad line, they would thereby get management control. He admitted that very blandly.

Mr. Untermyer. So, you will not let anybody acquire over 5 per cent.

Mr. Pecora. It is open to anybody to do it, but he can not use the information to trade for his own account against the public interest.

Mr. Untermyer. But he can not get any profit out of it. He is foreclosed from making anything out of it, and the result is that he will not buy it.

Mr. Pecora. He can profit from it provided his transactions are more than six months apart. It is designed avowedly to prevent insiders from utilizing their position to trade for their own account and against the interests of the general body of the stockholders. The only penalty...
Thus Congress has in effect created two presumptions in the section. The first establishes that a beneficial owner of more than 10 percent of the outstanding equity securities of the corporation is an \textit{insider}. That is, it is presumed he has access to inside information the same as the director or officer. The second conclusively presumes that any \textit{transaction} within any period of less than six months which results in profits is made on the basis of inside information. The presumption does not apply where the trader was not the beneficial owner of more than 10 percent "at the time of" both the purchase and the sale. The intentions of the "insider" trader are irrelevant and any profits realized must be forfeited to the corporation.\textsuperscript{28}

Thus it is clear that the congressional intent dominating the section is one of complete prophylaxis.\textsuperscript{27} The intent was to deter speculation by a class—officers, directors, and principal stockholders—because their speculative transactions may have been made on advance inside information.\textsuperscript{28} To emphasize its intent to insure and maintain a fair market in the interests of the public,\textsuperscript{29} Congress expressly declared in the preamble to section 16(b) that the section was specifically "for the purpose of preventing the unfair use of information which may have

against it, as you have observed, is that he has to disgorge his profits for the benefit of all the stockholders.

Mr. Untermyer. But he may just buy for the purpose of protecting the stock, and he may want to sell it as soon as he can. He may not be an insider at all. There are many corporations owned or controlled by big banking houses that have not one per cent of the stock. They know more about it. They have got more information than the fellow who owns thirty per cent of the stock. They know all about it because they are running it. To take one extreme case, like the Wiggin case, and predicate legislation of this kind upon it is very dangerous because, as you know, Mr. Pecora, hard cases make bad laws.

Mr. Pecora. We do not know how many other cases of Wiggins there might be.

Mr. Untermyer. There are plenty.

\textit{Id.} at 7741-43; see note 15 and accompanying text \textit{supra}.


been obtained by [an insider] . . . ."\textsuperscript{30} Further, the section was designedly remedial and it therefore must have been intended to be construed as broadly as possible.\textsuperscript{31} This is apparent by its own terms, which subsume all transactions of all insiders irrespective of the surrounding facts and circumstances.\textsuperscript{32} If any other interpretation is given the section—that is, a restrictive or an inappropriately literal one—then its practical effect would be at odds with its intended purpose.\textsuperscript{33}

### The Exemptive Provision

**An Element of Ambiguity**

The underlying congressional purpose should provide a key for interpreting a statute, in combination with the general background and law which prompted the enactment of the legislation. This must be considered when construing section 16(b), and especially so when construing the exemptive provision at the end of the subsection.\textsuperscript{34} The exemptive clause provides:

This subsection [16(b)] shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale or the sale and purchase, of the security involved . . . .\textsuperscript{35}

\begin{footnotes}
\textsuperscript{30} Id. at § 78p(b).


\end{footnotes}
The term beneficial owner is defined in section 16(a) as "[e]very person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security . . . ." On first impression, the exemptive provision appears to be simple and straightforward; however, it contains an element of ambiguity. It is clear that the term “transaction” means a purchase/sale sequence or a sale/purchase sequence. Logically, then, the next questions are what is a purchase and what is a sale. Congress chose to define those terms in sections 3(13) and 3(14) of the Act respectively, and did so broadly. Although the terms are not entirely precise, the courts have consistently construed them broadly in their application to section 16(b). The ambiguity of the exemption is in the meaning of the phrase “at the time of” the purchase and sale or the sale and purchase.

To illustrate the equivocal nature of the phrase “at the time of,” consider the purchase by which one initially becomes a more than 10 percent beneficial owner. Suppose further that this purchase is followed by a sale within six months. Is this transaction within the meaning of the exemption or is it accountable under section 16(b) for any realized profits? Clearly, the interpretation of the phrase “at the time of” is critical and determinative of the issue.

If one were to interpret the phrase “at the time of” to mean “prior to,” then this transaction would be exempt, because the purchaser would not be a more than 10 percent beneficial owner of securities prior to the purchase of the transaction in question. This construction appears to be the literal translation of the phrase, but as discussed below, not its intended meaning. On the other hand, if one were to construe the phrase to

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36. Id. § 16(a), 15 U.S.C. § 78p(a).
39. Securities Exchange Act of 1934 § 3, 15 U.S.C. § 78c (1970). The terms “buy” and “purchase” each include any contract to buy, purchase, or otherwise acquire, and the terms “sale” and “sell” each include any contract to sell or otherwise dispose of.
mean "simultaneously with," then this transaction would not be exempt from section 16(b) liability. Further, any profits realized on the transaction would have to be forfeited to the issuer as required by the rule.

No doubt the reader has spotted the single flaw in the latter interpretation. By interpreting the phrase "at the time of" to mean "simultaneously with," or "immediately after" in the case of a sale, the section can easily be circumvented by selling enough securities so that after the sale there is less than 10 percent beneficial ownership. Since this would clearly frustrate the deterrent purpose of the section, a "logical" inconsistency must be accepted: the phrase "at the time of" must be interpreted to mean "simultaneously with" in the context of a purchase, and "prior to" in the context of a sale. Further, this construction is most harmonious with the remedial purpose of the section.

The problem of determining the correct interpretation of the section is compounded by the fact that the legislative history surrounding the exemptive provision is scanty at best. However, examination of whatever legislative history there is, in addition to the broad congressional policy underlying the Act and almost 40 years of case authority, compels the "simultaneously with" interpretation requiring accountability under section 16(b). Congress clearly intended a broad tho-


43. See notes 7, 8, 13, 14-18 & 25-26 and accompanying text supra.

44. See, e.g., S. REP. No. 792, 73d Cong., 2d Sess. 1-9 (1934).

roughgoing rule to prevent the unfair use of inside information;" moreover, it is necessary in the determination of a statute’s meaning to recognize that the purpose of Congress is the dominant factor, and where a choice may be made between two possible constructions, that construction should be chosen which would serve to effectuate the congressional purpose rather than defeat it.47

In light of this, it is logically necessary to perceive that a statute’s intended purpose is not to be subverted by a narrow and literal reading of it. To be sure, one may not read into the statute language that is not there; but one must also not blind oneself to the underlying congressional effort. When the underlying policy is so clearly articulated by Congress, the literal words of the section, if in fact they produce an unreasonable result “plainly at variance with the policy of the legislation as a whole,” must yield to the essential policy of the Act48 unless the section itself commands otherwise. Thus, since the intent was to deter the possible use of advance inside information,49 the section must be construed to include the purchase with which insider status is obtained, and the following sale within any period of less than six months.


48. See Federal Deposit Ins. Corp. v. Tremaine, 133 F.2d 827 (2d Cir. 1943), where Judge Learned Hand remarked:

There is no surer guide in the interpretation of a statute than its purpose when that is sufficiently disclosed; nor any surer mark of over solicitude for the latter than to wince at carrying out that purpose because the words used do not formally quite match with it.

Id. at 830. See also Blau v. Oppenheim, 250 F. Supp. 881, 884-85 (S.D.N.Y. 1966), and authority cited therein.

49. See Blau v. Oppenheim, 250 F. Supp. 881, 885 & n.25 (S.D.N.Y. 1966). Such a policy was also stated in SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943), where the Court declared:

However well [rules of statutory interpretation] may serve at times to aid in deciphering legislative intent, they long have been subordinated to the doctrine that courts will construe the details of an act in conformity with its dominating general purpose, will read text in the light of context and will interpret the text so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy.

The Potential for Abuse by the Sometime 10 Percent Owner

As previously noted, the section was designed to prevent the unfair use of information "obtained by such beneficial owner" by reason of his relationship to the issuer. The important factor is the potential for obtaining inside information, not the ripening of equity ownership. It is clear that Congress did not intend to subject the mere stockholder to section 16(b) liability; however, it is also clear that its principal intent was to protect the public's interests by discouraging the misuse of inside information. It was the "vicious" practices uncovered at the Senate Committee hearings—the market manipulations by the "insiders," and the frequent unfair use of advance inside information—which prompted Congress to act and which provided the background to section 16(b). A "prior to" interpretation of the phrase "at the time of" would frustrate the congressional purpose, whereas a "simultaneously with" interpretation would carry it out by focusing not on the "ripening of equity ownership" but on the time period when the potential for obtaining inside information exists. Mr. Pecora, one of the principal draftsmen of the Act, testified to this effect when he expressed concern over the fact that once insider status was acquired, the potential to manipulate corporate affairs and advantageously speculate would exist. The focal point of his testimony was not the acquisition of the securities, but the abusive possibilities thereafter. Mr. Pecora's testimony is supported by the evidence presented at the hearings.

50. See 1934 Hearings, supra note 7, 6556-68, 7741-43.
52. See, e.g., Note, Section 16(b): Ten Percent Beneficial Ownership Must Exist Prior to Both the Purchase and Sale for Liability to Attach, 53 Texas L. Rev. 857 (1975).
53. Mr. Pecora. We had evidence here last summer from Mr. Van Sweringen. He and his associates felt that if they could acquire a block of stock which amounted to around 10 or 15 percent . . . , they would thereby get management control. He admitted that very blandly.

Mr. Pecora. The only point I want to make is that with that evidence in mind, that management control of an active stock could be obtained through control of 10 per cent of the outstanding stock—and there was a large amount of stock outstanding—where an individual owned as much as 5 per cent or more, he would be in a position, through that ownership of a block of stock of that size, to virtually be an insider, and he could very well dictate, with one or two others, elections to the board of directors.

1934 Hearings, supra note 7, at 7742.
clearly suggests that information "obtained by reason of [a] relationship to the issuer" can be information obtained prior to and in connection with becoming a more than 10 percent beneficial owner. In addition, SEC staff opinions have taken the position that a change in beneficial ownership is made when a shareholder makes a firm commitment to take or divest himself of the beneficial ownership of the securities. The SEC position suggests recognition that a trader is a more than 10 percent beneficial owner "simultaneously with" the transaction that makes him one.

Moreover, by literally translating the phrase to mean "prior to," emphasis is placed on the time period which is most inapposite to section 16(b), rather than that period when the potential for misuse of inside information is greatest. A person who purchases 10 percent may or may not have done so on advance inside information; he is not presumed to do so under a "simultaneously with" interpretation. His access to inside information and possible misuse of it is, however, recognized under this interpretation. Once an insider, the possibility that his short term sale was made on inside information is great and it is this potential evil which the section aims to discourage. A "prior to" interpretation will not, simply because it fails to recognize the "initial" short swing transaction, that is, the potential for abuse during the period from acquisition of beneficial ownership through divestiture. The abuses which may

See also the proposed ALI FEDERAL SECURITIES CODE § 1413(d) (Tentative Draft Nos. 1-3, 1974) which attempts to codify a similar analysis. See note 57 infra for text of § 1413(d).


57. See the proposed ALI FEDERAL SECURITIES CODE § 1413 (Tentative Draft Nos. 1-3, 1974), which attempts to clarify and combine the Securities Act of 1933, the Securities Exchange Act of 1934, and various other statutes. It provides for a construction of the present exemptive provision in section 16(b) analogous to the "simultaneous with" construction urged by this Comment; its purpose, as expressed by the Reporter for the ALI Code, is to recognize and preserve the symbolic significance of section 16(b) as distinct from Rule 10b-5 and other similar provisions in the 1933 and 1934 Acts prohibiting abuse of inside information. Reporter's Comments (1) and (2) to the ALI
occur under a "prior to" construction are striking indeed, as illustrated by the following examples—and it should be pointed out that under a "simultaneously with" interpretation, each of these transactions would be subject to the sanction of section 16(b).

First, a person who becomes a 10 percent beneficial owner as a result of a purchase of a large block of stock may have obtained advance inside information prior to the purchase through negotiations for the purchase with the corporation or a substantial stockholder. Such person could purchase the stock on the basis of the advance information so obtained, and then sell the stock for a short swing profit. Second, a person may purchase a large block of stock (more than 10 percent) in a corporation in anticipation of engaging in manipulative practices which would raise the market price of the stock and enable him to sell his stock at a profit. Third, although a person may purchase stock "simultaneously with" or "prior to" becoming an insider without any advance inside information or intent to manipulate the corporation's affairs, he could nevertheless obtain information after having become an insider which could be capitalized upon in effecting a sale of the stock.58

These practices are clearly similar to those "vicious" practices unearthed during the congressional investigations preceding the passage of the Act. To assume that they were not contemplated by Congress seems wholly unrealistic and would make section 16(b) largely ineffectual, since its express purpose was to "prevent the unfair use of information."

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Another factor which suggests that the proper construction of the section should include the initial transaction was briefly noted earlier. It is the premise that the interpretation of a subsection should be consistent with the purpose of the whole section, the purpose of the statute, and the congressional purpose underlying the enactment of the statute. Thus, the provision in section 16(b) cannot be construed in such a manner that either it or other subsections—specifically 16(a), 16(c), 16(d), and 16(e)—become mere surplusage or inconsistent with one another.

To illustrate this, consider that section 16(d), in part, exempts from section 16(b) certain transactions by a securities dealer in the ordinary course of his business and incident to the establishment or maintenance by him of a primary or secondary market. Consider also, that section 16(e) provides an exemption for certain foreign or domestic arbitrage transactions. If one were to construe the provision in section 16(b) to mean "prior to," then sections 16(d) and 16(e) would be largely superfluous because they would for the most part be exempting transactions that the provision in section 16(b) would already have exempted from section 16(b) liability.

Since the typical arbitrage transaction involves only a single purchase and sale, there generally is no pre-existing own-
ership that would subject a trader to the risk of 16(b) liability on sale. It is true, as the Court noted in Foremost-McKesson, Inc. v. Provident Securities Co., that there is nothing on the face of sections 16(d) and 16(e) that would make them applicable to one selling securities the purchase of which made him a "beneficial owner"; thus, liability is possible only if 16(b) itself makes the initial purchase a qualifying event. Under a "simultaneously with" interpretation that is exactly what would happen, and the exemptions would be necessary; otherwise they are largely redundant.

A further factor which suggests that a "simultaneously with" construction was intended by Congress, so that the initial purchase by which one becomes a more than 10 percent owner qualifies under section 16(b), is apparent from the need for Rule 16b-2, which was promulgated by the SEC within

\[\text{BLACK'S LAW DICTIONARY 134 (4th rev. ed. 1968).}\]

64. 423 U.S. 232 (1976).
65. SEC Rule 16b-2, 17 C.F.R. § 240.16b-2 (1975) provides:
   (a) Any transaction of purchase and sale, or sale and purchase, of a security which is effected in connection with the distribution of a substantial block of securities shall be exempt from the provisions of section 16(b) of the Act, to the extent specified in this § 240.16b-2, as not comprehended within the purpose of said section upon the following conditions:
   (1) The person effecting the transaction is engaged in the business of distributing securities and is participating in good faith, in the ordinary course of such business, in the distribution of such block of securities;
   (2) The security involved in the transaction is (A) a part of such block of securities and is acquired by the person effecting the transaction, with a view to the distribution thereof, from the issuer or other person on whose behalf such securities are being distributed or from a person who is participating in good faith in the distribution of such block of securities, or (B) a security purchased in good faith by or for the account of the person effecting the transaction for the purpose of stabilizing the market price of securities of the class being distributed or to cover an over-allotment or other short position created in connection with such distribution; and
   (3) Other persons not within the purview of section 16(b) of the Act are participating in the distribution of such block of securities on terms at least as favorable as those on which such person is participating and to an extent at least equal to the aggregate participation of all persons exempted from the provisions of section 16(b) of the Act by this § 240.16b-2.
66. Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (1970), provides the authority by which the SEC was able to promulgate Rule 16b-2, 17 C.F.R. § 240.16b-2 (1975), which reads in relevant part as follows:
   This subsection shall not be construed to cover any transaction . . .
eight months after the enactment of the Securities Exchange Act of 1934. The purpose of the Rule was declared to be to exempt those transactions in "connection with the distribution of a substantial block of securities." The need for such a rule was perhaps best expressed by Mr. E. Seligman in late 1934, just prior to the promulgation by the SEC of Rule 16b-2. Mr. Seligman inferred that the intended meaning of the words "at the time of" was "simultaneously with" and that

[under this construction if a banker buys from a corporation more than 10% of a class of a registered equity security and offers the same for resale to the public, he must account for any profit to the corporation. [T]his result is obviously a most serious one, especially at the present juncture of economic conditions in this country. . . . [I]t is believed nevertheless that the risk of [this] construction is so great that no conservative banker should take a chance in the matter. Consequently there is a pressing need for regulations by the Commission exempting financing both in the case of 10% owners and directors. The spirit of the Act certainly would not be violated by such an exemption.]

The obvious import of Mr. Seligman's statement was that section 16(b) was discouraging stock financing through registered securities, a necessary tool in corporate finance; unless the underwriter, the essential link in corporate financing, had an exemption, he would, under section 16(b), forfeit any profits he might realize on his efforts. The SEC, recognizing the plight of the underwriter and the necessity of his operations to the financial community, provided the appropriate and needed exemption.

It seems clear that what prompted Congress to add the exemptive provision was its concern regarding the situation where 10 percent beneficial ownership was acquired under circumstances indicating no possibility for speculative abuse. Such situations arise within the context of section 16(b) where "more than 10 percent beneficial ownership" is acquired or lost by way of an estate, gift or otherwise than by purchase or sale.

which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

Consequently, the provision provides an exemption for "any transaction where such beneficial owner was not such both at the time of the purchase and sale..."69

It was Congress' intent to prevent transactions (purchases and sales) which might be made on the basis of inside information. Where there was no possibility of access to information on the purchases or on the sales, then those transactions were not intended to be subject to section 16(b).70 Thus, where a purchase resulted in less than 10 percent beneficial ownership, there could be no section 16(b) presumption that there was access to inside information. It appears from testimony that section 16(b) was not intended to apply to the situations where 10 percent beneficial ownership was acquired or lost because of the purchase by the corporation of some of its outstanding securities, by partial redemption of stock by the corporation, by devise or gift of the corporation's stock, or acquisition of the stock incident to service as an executor or trustee in a similar fiduciary capacity.71 Review of some testimony on the original bill72 before the Senate subcommittee implies just such an in-

70. See note 73 infra.

The proposed ALI FEDERAL SECURITIES CODE § 1413(f) (Tentative Draft Nos. 1-3, 1974) attempts to codify the Securities Act of 1933 and the Securities Exchange Act of 1934. The Code similarly attempts to exempt certain situations from the sanctions imposed on insider short swing speculations. Section 1413 provides in relevant part:

(f) (1) Sections 293(f)(4) and 293(g)(1), (4), and (6) do not apply for purposes of this section.

Section 293 provides in relevant part:

(a) "Sale" or "sell" includes every contract to sell, contract of sale of, or disposition of a security or interest in a security for value.

... (f) Except as provided in section 293(g), the terms in this section include... (4) the payment of a dividend in a security of another company.

(g) Notwithstanding section 293(f), the terms defined in this section do not include a bona fide (1) gift, (2) transfer by death, (3) transfer by termination of a trust, (4) pledge or security loan, (5) split or reverse split, or (6) security dividend... .

See note 57 supra for text of ALI FEDERAL SECURITIES CODE § 1413 (Tentative Draft Nos. 1-3, 1974).
72. S. 2693, 73d Cong., 2d Sess. § 15(b) (1934).
73. Senator Carey. Suppose this stock passed to an estate, and the estate had to raise money?

Mr. Corcoran. I do not think, in that case, sir, the statute would apply.

Senator Kean. Why not?
tent, as illustrated in a brief exchange concerning a situation where stock passed to an estate, which thereby became a "more than 10 percent beneficial owner," and which was within six months forced to sell. Mr. Thomas G. Corcoran unequivocally stated that it was not the intention to include such situations within section 16(b)'s prohibitions.73

Deference to the Courts

Another factor which should be considered in assigning a meaning to the exemptive provision of section 16(b) is its construction by the courts.74 It should be noted that the most frequent forum for securities law cases has been the Second Circuit, which has consistently interpreted section 16(b) in the broadest possible terms in order not to defeat its avowed objective, resolving all doubts and ambiguities against the trader.75 It should also be noted that the Second Circuit has provided much of the construction and application of the Securities Exchange Act—in particular section 16(b)—and its interpretations generally have been deferred to and supported as correct.76 Additionally, the congressional policy has been one of deference to the Second Circuit, especially regarding its interpretation of section 16(b). This is apparent from Congress’ implicit approval of the way the courts have construed and ap-

Senator Carey. The estate is the beneficiary.
Mr. Corcoran. I do not believe it would. Certainly the intention was that it should not apply to that sort of a situation.

1934 Hearings, supra note 7, at 6558.

74. See cases cited in notes 23, 24, 45 supra.


plied the section. Although congressional non-action is far from conclusive, tacit acquiescence must be afforded recognition, especially in view of the consistently broad manner in which the courts have construed the section since its enactment.

THE CASE HISTORY OF SECTION 16(b)

Stella v. Graham-Paige Motors—An Objective Appraisal

The first case in which a court considered the question of whether section 16(b) was applicable to a transaction consisting of a purchase by which 10 percent beneficial ownership was acquired, followed by a sale within less than six months, was Stella v. Graham-Paige Motors Corp. The court was faced with the "novel" problem of interpreting the exemptive provision in section 16(b). Judge Kaufman, speaking for the court, concluded that the phrase "at the time of" contained an element of "ambiguity" and in light of the purpose of the section must be construed to mean "simultaneously with" rather than "prior to." His rationale was that if the phrase was interpreted to mean "prior to," it would be possible for a person to purchase a large block of stock, sell it out until his ownership was reduced to less than 10 percent, and then repeat the process ad infinitum because prior to each re-purchase, the person would not be a "more than 10 percent beneficial owner." He reasoned that the deterrent value of section 16(b) would be undercut because each purchase and sale could easily have been made on the basis of advance inside information. He thus concluded that the underlying congressional purpose of the section could be effectuated if and only if the purchase by which one became a "more than 10 percent beneficial owner" was included as part of the transaction for the calculation of profits which had to be forfeited under the section's mandate. Such a construction, he said, would be consistent with the express remedial purpose of the statute to prevent the possible unfair use of inside information by stockholders owning more than 10

77. 104 F. Supp. 957 (S.D.N.Y. 1952). Plaintiff Stella was a stockholder of Kaiser-Fraizer Corp. and sued Graham-Paige Motors Corp. to recover profits realized on a short swing transaction. Graham-Paige purchased 750,000 shares of Kaiser-Fraizer stock and, by said purchase, Graham-Paige became the beneficial owner of more than 10 percent of Kaiser-Fraizer common stock; within less than six months from the date of purchase, Graham-Paige sold some of the stock it purchased and realized a profit therefrom. Id. at 957-58.
78. Id. at 959.
percent of the equity stock.\textsuperscript{79}

On appeal,\textsuperscript{80} the court adopted Judge Kaufman's interpretation of section 16(b) and without further analysis affirmed over a lone dissent by Judge Hinks, who based his dissent solely on a literal reading of the exemptive provision. The United States Supreme Court subsequently denied certiorari without comment.\textsuperscript{81}

In light of the paucity of cases on this particular issue, and Judge Kaufman's analysis of the congressional purpose and intent of the section, the construction of the provision adopted in \textit{Stella} became authoritative and was adopted by virtually every other court that has considered the question.\textsuperscript{82}

Further, the \textit{Stella} court established the basis for the "objective" approach to section 16(b): it considered the statute's remedial purpose and then construed it to maximize its deterrent effect. This became the recognized policy of the courts, particularly of the Second Circuit, toward section 16(b); its literal meaning became subordinate to the "purpose of preventing the unfair use of inside information."\textsuperscript{83} Indeed, as one court remarked, "The judicial tendency . . . has been to interpret section 16(b) in ways that are most consistent with the legislative purpose, even departing where necessary from the literal statutory language."\textsuperscript{84}

In light of this type of approach, "insiders" came to recognize that the courts would apply the section in the manner most consistent with its broad underlying purpose and that all doubts and ambiguities would be resolved against them.\textsuperscript{85}

Thus, under the "objective" approach, where any profits were

\textsuperscript{79} Id. at 959-60.
\textsuperscript{80} Stella v. Graham-Paige Motors Corp., 232 F.2d 299 (2d Cir. 1956).
\textsuperscript{81} 352 U.S. 831 (1956).
\textsuperscript{85} See note 31 supra.
realized from a short swing transaction, the statute was con-strued liberally, irrespective of the "facts and circumstances" of the transaction, to effect its deterrent purpose. Mr. Justice Stewart, then on the Sixth Circuit Court of Appeals, perhaps best expressed this approach when he stated, "Every transaction which can reasonably be defined as a purchase will be so defined if the transaction is of a kind which can possibly lend itself to the speculation encompassed by section 16(b)." As another court remarked, such an approach requires that the court's initial consideration be the salutary purpose of the section and the practices it was designed to prevent.

In making this determination under the "objective" approach, the courts look to that point at which the insider has the ability to control the transaction and the potential to use inside information to his own advantage and to the detriment of the outside stockholder. Since the potential for unfair use of inside information exists concurrently with insider status, a "simultaneously with" construction is compelled. Such an approach is consistent with the congressional policy to protect the interests of the public, and also implements the section best by preventing those potentially abusive short swing transactions in which "more than 10 percent beneficial ownership" is obtained on purchase.

86. See note 46 supra.


88. Blau v. Max Factor & Co., 342 F.2d 304, 307 (9th Cir.), cert. denied, 382 U.S. 892 (1965) (whether an insider's conversion of one class of common stock into another constituted a section 16(b) purchase).


91. See, e.g., Shaw v. Dreyfus, 172 F.2d 140 (2d Cir. 1949). See generally S. REP. No. 792, 73d Cong., 2d Sess. 7-9 (1934); S. REP. No. 1455, 73d Cong., 2d Sess. 55-68 (1934); note 58 and accompanying text supra.
Reliance Electric v. Emerson Electric—A New Objective Approach

The question of section 16(b)'s applicability to a purchase/sale short swing transaction in which the purchaser became a more than 10 percent beneficial owner on his initial purchase next arose in the Eighth Circuit. In Emerson Electric Co. v. Reliance Electric Co., Emerson initially acquired more than 10 percent of the outstanding stock of Dodge Manufacturing Corporation and shortly thereafter Dodge merged into Reliance. Within six months of its purchase, Emerson sold all of the stock in two steps—the first reduced its holding to just under 10 percent and the second disposed of the remainder. The court adopted the Stella construction of the phrase “at the time of”: “simultaneously with” the purchase and “prior to” the sale. The concern of the Emerson court was that any other view would weaken the application of the statute in contravention of the congressional purpose. The court pointed out that with an initial purchase of a large block of stock, followed by a sale within six months, the stockholder within that period could obtain much inside information and also could influence, manipulate or control corporate transactions. For, as was said by the court in Newmark v. RKO General, Inc., “[t]he presumed access to such information resulting from this purchase provides him with an opportunity, not available to the investing public, to sell his shares at the moment most advantageous

92. 434 F.2d 918 (8th Cir. 1970). Emerson Electric Co. purchased 13.2 percent of the outstanding common stock of Dodge Manufacturing Co. pursuant to a tender offer made in an unsuccessful attempt to take over Dodge. Shortly thereafter, the shareholders of Dodge approved a merger with Reliance Electric Co. Rather than be forced to exchange its Dodge shares for stock in the merged corporation, Emerson decided to sell part of its stock in Dodge, thereby bringing its holdings to just below 10 percent—9.96 percent. See Newmark v. RKO General, Inc., 425 F.2d 348, 354 (2d Cir.), cert. denied, 400 U.S. 854 (1970), where the exchange of shares of one corporation for those of another pursuant to a merger agreement was held to constitute a sale within the meaning of section 16(b). Emerson subsequently disposed of the remainder of its holdings of Dodge stock, 9.96 percent, within six months of its initial purchase. Both sales resulted in profits to Emerson, which profits Reliance claimed belonged to it under section 16(b)'s forfeiture requirement.

93. Id. at 923-24.


to him.\footnote{425 F.2d at 356.} The court in Emerson then noted that the deterrence of such apparent potential mischief must have been within the contemplation of Congress, and concluded that unless the phrase "at the time of" meant "simultaneously with" the purchase, such potentially abusive transactions could not effectively be discouraged.\footnote{434 F.2d at 924. Consider also the abusive practices noted in S. Rep. No. 792, 73d Cong., 2d Sess. 7-9 (1934), and S. Rep. No. 1455, 73d Cong., 2d Sess. 55-68 (1934). See Yourd, Trading in Securities by Directors, Officers, and Stockholders: Section 16(b) of the Securities Exchange Act of 1934, 38 Mich. L. Rev. 133, 139-52 (1959).}

Thus, by way of an "objective" analysis of the purpose of section 16(b), the court held that the purchase by which a security holder acquired more than 10 percent status was intended to be included as part of the "pair" constituting the purchase/sale transaction under section 16(b). The court additionally held that the second part of the two-step sale by Emerson was exempt under the section, reasoning that "at the time of" that sale, Emerson was not a more than 10 percent beneficial owner, and had no section 16(b) access to inside information.\footnote{434 F.2d at 926. See note 92 supra.}

The United States Supreme Court thereafter granted Reliance's petition for certiorari and had before it only the issue of whether the second part of a two-part sale was to be included in calculating the short swing profits under section 16(b) when "at the time of" the second sale, the owner/seller of the securities was not a more than 10 percent owner.\footnote{434 F.2d at 926. See note 92 supra. See generally Stella v. Graham-Paige Motors Corp., 104 F. Supp. 957, 960 (S.D.N.Y. 1952) (dictum), quoting with approval Seligman, Problems Under the Securities Exchange Act, 21 Va. L. Rev. 1, 20 (1934).} Mr. Justice Stewart, speaking for the Court, answered this in the negative, also adopting an "objective" approach to section 16(b). The Court additionally based its holding on an objective reading of the section: it was unable to infer an intent by Congress that the objective standard of the section was to give way upon proof of a pre-existing intent by the seller to avoid section 16(b) liability.\footnote{434 F.2d 918 (8th Cir. 1970), aff'd on other grounds, 404 U.S. 418 (1972). Because Emerson did not file a cross-petition for certiorari, the Court did not have before it the question of whether section 16(b) encompasses the purchase in a purchase/sale sequence by which purchase "more than 10 percent beneficial ownership" was obtained. See note 92 supra.}

\footnote{404 U.S. 418, 424-25 (1972); see T. Corcoran, 1934 Hearings, supra note 7, at 6557.}
The dissent by Mr. Justice Douglas should be noted since he contended that the majority, on the pretext of an "objective" approach, undermined the statute. Dougs reasoned that under an "objective" approach, as taken by previous courts, the primary consideration was the effectuation of the remedial purpose of the statute and that a clearly planned two-step sale to avoid liability could not be permitted in light of its deterrent purpose. The dissent then noted that the general "objective" approach taken by the courts was to construe the section in the broadest terms possible, to impose liability irrespective of the intentions of the insider and to resolve all doubts and ambiguities against him. The majority, Douglas urged, construed the section literally and in a restrictive manner incompatible with the "objective" approach taken by previous courts.

The majority approach seems more persuasive, however, even though Emerson's "avoidance" was calculated. The dissent seemed to explore the transaction from a subjective angle, concluding that it was a planned split-sale which was in substance a single sale, thereby falling within section 16(b). Although the argument in this regard has merit, section 16(b) does not permit such an examination into the intentions of the owner/seller. Further, it should be noted that the construc-

103. The problem with the argument in the dissent is that it is based on a clear, hard case; that is, the intention was admitted, and the two sales were close in time. However, to decide subjectively in this case, as the dissent urges, that the two sales by Emerson were one, would force the Court to inquire into any situation where more than one sale is employed to divest the trader of his holdings of more than 10 percent. Such a task was what Congress sought to obviate. See 1934 Hearings, supra note 7, at 6557-58. But see Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973) (adopting a subjective approach); Lowenfils, Section 16(b): A New Trend in Regulating Insider Trading, 54 CORNELL L. REV. 45 (1969); Painter, The Evolving Role of Section 16(b), 62 MICH. L. REV. 649 (1964).
104. See note 85 supra.
106. See notes 92 & 103 supra.
107. See note 4 supra. See 1934 Hearings, supra note 7, at 6557 (emphasis added), where Mr. T. Corcoran expressly stated that the implementation of the forfeiture of profits requirement of section 16(b) was to be effected "irrespective of any
tion adopted by the majority with regard to the second sale was that adopted and urged by previous courts and commentators applying an "objective" approach.

The question of whether section 16(b) reaches the purchase by which the trader acquires more than 10 percent ownership, not before the Court in *Reliance*, remained unresolved, although there were intimations in the Court's decision that the purchase was encompassed by section 16(b). First, the Court quoted with apparent approval the interpretations of section 16(b) of Mr. E. Seligman and Prof. L. Loss. Since both Seligman and Loss have construed the section as applicable to the initial transaction—that is, the purchase by which one becomes a more than 10 percent beneficial owner followed by a sale within a period of less than six months—and since the quoted portions seized upon by the Court were taken from passages which urged a "simultaneously with" construction, it seemed that had the issue been before the Court, it might have so held.

Another factor that suggested such a construction was the Court's repeated emphasis on the language "at the time of . . . sale" in regard to the split-sale technique employed by Emerson. Again, the opinion seemed implicitly to suggest that section 16(b) would have been applicable had Emerson made a single sale, since "at the time of . . . sale" it would have been a more than 10 percent owner. For Emerson to have been liable on a single sale, the section 16(b) transaction would have had to include the initial purchase as part of the "pair."

Moreover, the construction including the purchase by which one becomes a more than 10 percent owner within the purview of section 16(b) is part and parcel of the "objective" approach, so it seems consistent to infer its tacit acceptance by the majority, particularly since the cases which the Court referred to in support of its position each construed the section in the broadest terms possible."

intentions or expectations" of the insider trader. It is clear, then, that to scrutinize the motives of the trader to determine whether he should fall within section 16(b) is contrary to the section's intended application.

109. *Id.* at 423 & n.3.
111. *See* Bershad v. McDonough, 428 F.2d 693 (7th Cir.), cert. denied, 400 U.S. 992 (1970); Blau v. Lehman, 286 F.2d 786 (2d Cir.), aff'd, 368 U.S. 403 (1962); Adler...
Kern County v. Occidental Petroleum—*The Speculative Abuse Test*

The Court next had an opportunity to resolve the issue of whether the purchase by which the purchaser became a more than 10 percent owner was within the reach of section 16(b) in *Kern County Land Co. v. Occidental Petroleum Corp.*" Occidental, through a series of tender offers to the shareholders of Kern, attempted to acquire control. Its take-over attempt, however, fell short because Kern "defensively" merged with Tenneco Corporation; concommittant with that merger, the outstanding shares of old Kern were to be exchanged for shares of new Kern. Occidental viewed its resulting minority position in new Kern as unacceptable and thus executed an option agreement for the sale of its holdings, which agreement was the basis of Kern's section 16(b) claim. The Court however, in a 6-3 decision, again side-stepped the question," this time by taking a "pragmatic" approach to section 16(b). Mr. Justice White, for the majority of the Court, inquired whether the transaction carried with it a potential for speculative abuse—hence the "speculative abuse test."" The Court then examined Occidental's transaction in light of the surrounding

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112. 411 U.S. 582 (1973), aff'g 450 F.2d 157 (2d Cir. 1971). After unsuccessfully seeking to merge with Kern County Land Co. (Old Kern), Occidental made a tender offer to purchase 500,000 shares of Old Kern common stock. It was a total success, so Occidental extended its offer for an additional 500,000 shares. At the close of the tender offer Occidental owned 887,549 shares of Old Kern or roughly 20 percent. During this period, however, the management of Old Kern undertook measures to frustrate Occidental's take-over attempt, by negotiating a merger with Tenneco to form New Kern. Realizing that if the merger were approved it would have to exchange its shares of Old Kern for New Kern and would be "locked" into a minority position, Occidental entered into an option agreement whereby it granted the rights to purchase the stock it would receive on the merger. The option was not to be exercisable for six months and one day after the close of Occidental's tender offer. It was executed, however, within six months of that date. The merger was effected and Occidental's option (to sell) was exercised more than six months from the date of its execution. Occidental realized substantial profits therefrom, upon which New Kern brought suit under section 16(b)'s forfeiture requirement. The district court granted summary judgment holding that the execution of the option agreement was a sale within section 16(b). Abrams v. Occidental Petroleum Corp., 323 F. Supp. 570 (S.D.N.Y. 1970). The Second Circuit Court of Appeals reversed, holding that neither the option nor the exchange constituted a *sale* within the meaning of section 16(b). Abrams v. Occidental Petroleum Corp., 450 F.2d 157 (2d Cir. 1971).


circumstances and found that as the target of an unsuccessful take-over attempt, Occidental’s transaction was “involuntary” and “unorthodox” and presented no possibility for speculation. In essence, the Court interpreted the sale of securities by Occidental as not constituting a sale within the meaning of section 16(b). The approach taken by the Court only begs the question of whether Congress contemplated such a transaction within section 16(b). In light of the admittedly scant legislative history of the section, it must be assumed that Congress did intend for section 16(b) to reach such a transaction.

Faced with frequent abusive and “vicious” predatory practices, Congress adopted a flat rule to take the profits out of a class of transactions irrespective of the intentions, expectations, or other facts and circumstances, and despite the realization that such a crude rule of thumb would create hardships in certain cases. As Thomas Corcoran stated, “You have to have a general rule. In particular transactions it might work a hardship, but those transactions that are a hardship represent the sacrifice to the necessity to having a general rule.”

The Court’s conclusion in Occidental that the terms “purchase” and “sale,” as used in section 16(b), mean only “vol-

115. Id. The Court’s conclusion seems inconsistent with section 16(b), which was designed to prevent any unfair use of information by taking the profits out of that class of transactions where there was a possibility that inside information was used; the bite of the rule was intended to be sharp, limited only by its arbitrary standards. See Gratz v. Claughton, 187 F.2d 46 (2d Cir.), cert. denied, 341 U.S. 920 (1951). It seems wholly without logic and inconsistent with section 16(b) to state on the one hand that there was no possibility for speculative abuse through unfair use of inside information in Occidental’s transaction, and on the other that “Old Kern voluntarily permitted inspection of Old Kern’s general ledger, consolidated financial statements, consolidated journal entries, details of cash receipts from oil operations, supporting trial balances and other records.” Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 587 & n.12, 600. (1973). The information to which Occidental had access is the kind most useful to the insider speculating on the short swing. See generally S. Rep. No. 792, 73d Cong., 2d Sess. 7-9 (1934); S. Rep. No. 1455, 73d Cong., 2d Sess. 55-68 (1934). It is only too clear that section 16(b) was intended to prevent the realization of profits under such circumstances. See, e.g., Shaw v. Dreyfus, 172 F.2d 140 (2d Cir. 1949). Therefore, the finding of the Court that there was no possibility for speculative abuse and that Occidental’s sale was not a section 16(b) sale is without basis, inconsistent with congressional legislation, and must realistically be viewed as little more than a sympathetic reaction to the loser in a defensive merger. See also Cook & Feldman, Insider Trading Under the Securities Exchange Act, 66 Harv. L. Rev. 612, 626 (1953).

116. See notes 2, 7, 8, 11, 13-18 and accompanying text supra.


118. 1934 Hearings, supra note 7, at 6558.

119. See note 39 supra.
untary” and “orthodox” transactions is arguably a misconstruction of the legislative history behind section 16(b).

The subjective “facts and circumstances” approach which the Court in *Kern County* took is precisely the one that Congress intended to avoid. Its intent was to adopt a rule that would operate mechanically without a subjective exploration into the transaction in each case. Further, testimony from the hearings on the section seemed to imply that Congress intended the rule to apply even where the transaction showed signs of “involuntariness” because of unplanned or adverse events.

Thus, by excluding Occidental’s sale because of its “involuntary” nature, the Court clearly seemed to be fashioning its own test rather than using the one intended by Congress. It is true that the objective approach intended by Congress may indeed work hardships in certain cases, but as noted earlier, they must be accepted as the sacrifice to a successful remedy.

Even discounting legislative history, the Court’s determination that an “involuntary” and “unorthodox” transaction

120. The court in *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir.), cert. denied, 320 U.S. 751 (1943), remarked on the “mechanical” nature of section 16(b) by stating that any other interpretation requiring a subjective standard would render senseless the provisions of the legislation, limiting the liability period to six months, making the intentions immaterial ... and its total effect would be to render the statute little more of an incentive to insiders to refrain from profiteering at the expense of the outside shareholder than are the common law rules of liability. 136 F.2d at 236. See also Note, *Insider Liability for Short Swing Profits: The Substance and Function of the Pragmatic Approach Once Insider Status is Determined*, 72 Mich. L. Rev. 592 (1974).

121. 1934 Hearings, supra note 7, at 6557 (emphasis added):

Senator Gore. You infer the intent from the fact.

Mr. Corcoran. From the fact.

Senator Kean. Suppose he got stuck in something else, and he had to sell?

Senator Barkley. All he would get would be what he put into it. He would get his original investment.

Mr. Corcoran. He would get his money out, but the profit goes to the corporation.

Senator Kean. Suppose he had to sell?

Mr. Corcoran. Let him get out what he put in, but give the corporation the profit.

122. See note 118 and accompanying text supra.

One court perhaps best summed this up when it stated with regard to section 16(b), “[W]e cannot have one rule for insiders with good intentions and another for those who would flagrantly abuse their trust.” *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736, 743 (8th Cir. 1965), cert. denied, 382 U.S. 987 (1966).
does not constitute a "sale" within section 16(b) is tenuous at best. First, by its own terms the section subsumes all purchases and sales.\textsuperscript{123} Second, Congress broadly defined those terms to prevent the very type of interpretation which the Court suggested. For example, section 3(13) declares that a sale is \textit{any contract to sell} or otherwise dispose of securities. Only sympathy for Occidental's plight can explain the Court's choosing to interpret Occidental's option contract with Tenneco Corporation as not within the section 3(13) definition of "sale."

Further, by construing section 16(b) the way it did, the Court chose a route that not only appeared inconsistent with its approach in \textit{Reliance}, but also in direct contravention of the statute's remedial purpose; rather than construing the statute in the broadest terms possible, the Court construed the \textit{exemptive} provision broadly, thereby narrowing the scope of the statute.\textsuperscript{124}

Foremost-McKesson v. Provident Securities—\textit{The "Prior to" Interpretation}

The Supreme Court finally resolved the issue of whether section 16(b) encompasses a transaction which includes the purchase by which the purchaser becomes a more than 10 percent beneficial owner in \textit{Foremost-McKesson, Inc. v. Provident Securities Co.} In its attempt to liquidate and dissolve, Provident sold its assets to Foremost in exchange for convertible debentures which made it a more than 10 percent owner of Foremost equity securities; it then executed a sale within a period of less than six months, upon which Foremost based its section 16(b) claim.\textsuperscript{125} This time there was no evidence of an

\textsuperscript{123} The section refers to \textit{any} purchase and sale within \textit{any} period of less than six months, \textit{irrespective of any} intention or expectation of the owner/trader. 15 U.S.C. § 78p(b) (1970). See note 4 supra.

\textsuperscript{124} The Court's approach to the exemptive provision in section 16(b) seems wholly inconsistent with its previous policy, which was to construe statutory exemptions to remedial legislation strictly. \textit{See, e.g.}, SEC v. Ralston Purina Co., 346 U.S. 119, 125-26 (1953); McDonald v. Thompson, 305 U.S. 263, 266 (1938); Spokane & Inland Empire R.R. Co. v. United States, 241 U.S. 344, 350 (1915); SEC v. Custer Chanel Wing Corp., 376 F.2d 675, 678 (4th Cir.), \textit{cert. denied}, 389 U.S. 850 (1967); SEC v. Sunbeam Gold Mines Co., 95 F.2d 699, 701 (9th Cir. 1938).

\textsuperscript{125} 423 U.S. 232 (1976), \textit{aff'd} 506 F.2d 601 (9th Cir. 1974). Provident Securities was a personal holding company which in 1968 tentatively decided to liquidate and dissolve. Foremost-McKesson emerged as a potential purchaser and eventually purchased Provident's assets. On October 15, 1969, Foremost delivered to Provident $4.25 million in cash and $40 million of debentures subsequently exchanged for two deben-
"involuntary" and "unorthodox" transaction to support an analysis similar to the one the Court used in Kern.\textsuperscript{126} The Court declared that by virtue of the exemptive provision, a beneficial owner is accountable under section 16(b) in a purchase/sale transaction only if he was an owner—a more than 10 percent beneficial owner—"prior to" the purchase.\textsuperscript{127} In reaching its decision, the Court reviewed the legislative history and concluded that Congress intended a literal reading of the exemptive provision's key phrase, "at the time of." Such a construction by the Court, however, defeats the section's remedial purpose and deterrent effect for many of the reasons discussed previously.\textsuperscript{128}

In addition to reversing nearly forty years of precedent, the Court has now "opened the floodgates" to the "sure-thing" speculative transaction.\textsuperscript{129} The Court has, by taking a literal meaning of the operative words "at the time of," focused upon

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\item[127] 423 U.S. 232, 249-50 (1976). It should be noted that the decision of the Court was not limited to the facts of this case, but rather was an interpretation of section 16(b) of the Securities Exchange Act of 1934.
\item[128] See notes 13-23, 27-33 & 58 and accompanying text \textit{supra}.
\item[129] See, e.g., notes 2 & 13 and accompanying text \textit{supra}.
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the "ripening of equity ownership," rather than more appropriately upon the salutary nature of the statute and the evils which Congress sought to curb.130

First, the Court found the approach urged by Foremost, and also by this Comment, unsatisfactory because of its seeming emphasis on those potential abusive situations outside the reach of section 16(b). The Court rather opted for a narrow interpretation of the section itself, and construed the exemptive provision expansively.131

Second, the Court inferred from the evolution of section 16(b), from its initial proposal through its passage,132 that only "more than 10 percent beneficial owners" who held that status "prior to" their purchase/sale transaction were intended to fall within the scope of the section.133

These conclusions are at least unfortunate, and arguably they are wrong. Lacking any express elucidation of Congress' intent, the legislative history is vague as to the exact meaning to be afforded the words "at the time of"; however, the intent that they be construed broadly to limit the applicability of the exemption is implicit in the expressed goal of the section.134 Although the Court quoted extensively from the history of the section, it failed to give way to what should have determined its construction of the section: the congressional policy underlying the section.135 The Court seemed to construe the language of the exemption literally instead of examining the provision's substantive effect on the entire section—a process which would have led to the conclusion that the exemptive provision was added for the purpose of insuring the section's remedial effect,

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130. See notes 48-55 and accompanying text supra.
134. See, e.g., Stella v. Graham-Paige Motors Corp., 104 F. Supp. 957, 959 (S.D.N.Y. 1952), where the court, citing Shaw v. Dreyfus, 172 F.2d 140 (2d Cir. 1949) and Park & Tilford v. Schulte, 160 F.2d 984 (2d Cir. 1947), remarked:

    Although the legislative history of section 16(b) fails to afford a clue as to the precise meaning of the words at the time of, the congressional purpose underlying the enactment of this section is clear. It was "to protect the outside stockholders against at least short swing speculation by insiders with advance information."

(Emphasis added.)
135. See note 47 and accompanying text supra.
and that the changes effected during the evolution of the bills (such as excising the words "owning as of record") were made for the purposes of eliminating the limiting and restrictive language of the early drafts.\textsuperscript{136} The Court, however, expanded the exemption’s applicability in a manner inconsistent with the basic purpose of the section and consequently undermined its deterrent effect. In short, by construing the exemptive provision to mean "prior to," the Court has all but removed the "teeth" of section 16(b).

The Court further justified its interpretation of the exemptive provision by construing the 10 percent ownership requirement which applies only to persons not directors or officers, as evidence of congressional intent not to impose liability on the basis of a purchase when, "prior to" that purchase, the trader was not an insider.\textsuperscript{137} That reasoning is flawed, however, for it focuses narrowly and inappropriately on the purchase itself, rather than on the transaction as a whole. The question which

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136. Compare S. 2693, 73d Cong., 2d Sess. § 15(b) (1934) (emphasis added) with H.R. 8720, 73d Cong., 2d Sess. § 15(b) (1934). S. 2693 would have provided in relevant part:

It shall be unlawful for any director, officer, or owner of securities, owning as of record and/or beneficially more than 5 per centum of any class of stock of any issuer, any security of which is registered on a national securities exchange—

(1) To purchase any such registered security with the intention or expectation of selling the same security within six months; and any profit made by such person on any transaction in such a registered security extending over a period of less than six months shall inure to and be recoverable by the issuer irrespective of any intention or expectation on his part in entering into such transaction of holding the security purchased for a period exceeding six months.

H.R. 8720 would have provided in relevant part:

Any profit realized by such beneficial owner, director, or officer from any purchase and sale or sale and purchase of any such registered equity security within a 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. . . . This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale or the sale and purchase, of the security involved . . . .

See also note 4 supra for the text of Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (1970). It should be noted that other than the change in the minimal ownership requisite for presumed insider status for mere stockholders from 5 percent in H.R. 8720 to 10 percent in section 16(b), H.R. 8720 is substantively similar to section 16(b).

\end{quote}
should be asked is whether the transaction carries with it the dangers and abusive potential which Congress considered intolerable, not whether the purchase (or sale) by itself poses such dangers. Only this approach is adequate to insure that those situations in which there is an opportunity for abuse in the event of a sale after "insider" status is achieved will fall, as they properly should, within the scope of section 16(b).

CONCLUSION

It seems apparent, in light of the Supreme Court's decisions in Kern County and Foremost-McKesson, that if at all possible, section 16(b) will now be construed in favor of the "insider" trader. Once a crude rule of thumb designed to deter any potentially abusive short swing transaction, section 16(b) is now becoming little more than a figurehead in securities regulation. It was indeed intended to be draconian, as indicated by its own terms which subsume all transactions irrespective of whether there was an intent to speculate, or whether there was in fact any actual misuse of inside information. Such an arbitrary rule was adopted because it was believed to be the only effective remedy to prevent the "vicious" practices which were frequent among corporate fiduciaries. The Court however, has now construed section 16(b) in a manner that would allow several of those abusive practices to remain unchecked; as a result, it is unlikely that the fiduciary today would hesitate to trade on advance information. The Court, by removing the "teeth" from section 16(b), has in effect made this possible. Perhaps the growing trend toward using Rule 10b-5 in any securities action explains the Court's con-

138. See, e.g., notes 13-16 and accompanying text supra.
139. See, e.g., note 58 and accompanying text supra.
140. 411 U.S. 582 (1973).
142. See note 58 and accompanying text supra.
144. Rule 10b-5 provides in relevant part:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
struction of section 16(b). But section 16(b) has advantages that rule 10b-5 does not: it was intended to operate mechanically to obviate the burden of proof for the plaintiff. Rule 10b-5, on the other hand, is, in its modern application, virtually limitless in its jurisdictional reach; but it is not self-operative and its applicability depends on proof of intent or injury to the plaintiff—elements which Congress made irrelevant under section 16(b). Moreover, section 16(b)'s scope is not to be affected by alternative sanctions, such as those in rule 10b-5, which might also inhibit abuse of inside information.

As a result, knowing that the Supreme Court is inclined toward a restrictive interpretation of section 16(b), "insiders" will not be wholly discouraged from unfairly speculating on a short swing. The Court has, in effect, chained the watch-dog to the back door.

Michael D. Weiner

(1) to employ any device, scheme, or article to defraud,
(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.


145. Application of section 10(b) and rule 10b-5, is, under its current construction, far from automatic. First, a private damages action under section 10(b) and rule 10b-5 is confined to actual purchasers or sellers of securities. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). Second, in order to recover, the plaintiff must show that defendant's activities involved scienter. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).