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## CURRENT PROBLEMS UNDER SECTION 16 OF THE SECURITIES EXCHANGE ACT OF 1934<sup>1</sup>

In the twenty-five odd years since its passage, Section 16 of the Securities Exchange Act of 1934,<sup>2</sup> and more particularly Section 16(b) has survived a variety of attacks on its constitutionality, wisdom and efficacy. It still exists however, substantially unchanged, for the purpose of preventing "insiders" from profiting from their special knowledge by trading in the equity securities of an issuer on a short swing basis. To restate briefly the substance of Section 16; subsection (a) requires periodic filing of reports of ownership of securities listed on a national exchange by owners of more than ten per cent of any class of any equity security and by owners who are also officers and directors of the issuer. Section 16(b)<sup>3</sup> makes the above named persons accountable to the corporation (issuer) at the suit of the corporation or any shareholder to the extent of any profits realized from a purchase and sale or sale and purchase<sup>4</sup> of any equity security of such issuer, within any period of less than six months.<sup>5</sup> Section 16(c) prohibits the above named persons from selling short, and Section 16(d) exempts arbitrage transactions from the operation of Section 16, subject to rules and regulations promulgated by the Commission. The Act also gives the Com-

<sup>1</sup> 48 STAT. 881 (1934); 15 U.S.C.A. §78 a-hh (1951).

<sup>2</sup> 15 U.S.C.A. §78 p (1951).

<sup>3</sup> 15 U.S.C.A. §78 p (b) is as follows:

"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 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 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.

<sup>4</sup> The requirements of a sale and a purchase are satisfied by a firm commitment or an irrevocable liability to do either. *Stella v. Graham-Paige Motors Corp.* 232 F. 2d 299 (2d Cir. 1956); SEC Securities Exchange Act Release No. 116, March 9, 1935, 11 Fed. Reg. §10968 (1946).

<sup>5</sup> The last day of "less than six months," the short swing period within which Section 16 (b) allows the recovery of profits from a transaction in securities by an insider, is the second day prior to the date in the sixth month which corresponds numerically with the first day of the month in which the first transaction occurred. *Stella v. Graham-Paige Motors Corp.*, 132 F. Supp. 100 (S.D.N.Y. 1955), *aff'd*. 232 F. 2d 299 (2d Cir. 1956).

mission power to exempt certain securities from the operation of Section 16, and to make rules and regulations in order to carry out the purpose of the Act.<sup>6</sup>

Notwithstanding its comparatively long existence, Section 16 is still the subject of considerable uncertainty in some areas, and recent court decisions have not been models of consistency. It is not the purpose of this comment to review Section 16 completely, but rather to examine certain points of present conflict. Briefly stated, the problems to be discussed are: (1) The definition of the term "officers" within the meaning of Section 16; (2) The time at which one becomes an insider and thus subject to liability under Section 16(b); and (3) The exemption from Section 16(b) of stock acquired under a restricted stock option plan as provided by the rules of the Commission.

#### I. WHO ARE "OFFICERS"?

The Act itself gives a clear definition of the term "director",<sup>7</sup> but Congress has not provided a definition of the term "officer". Therefore the Commission, under its rule making power, has defined the term in Rule X-3B-2 as follows:

The term 'officer' means a president, vice president, treasurer, secretary, comptroller and any other person who performs for an issuer, whether incorporated or unincorporated, functions corresponding to those performed by the foregoing officers.<sup>8</sup>

The difficulty arises when one considers the large number of officers and executive positions which are found in most large corporations. For example, the rule set forth by the Commission does not clearly define the status of assistant secretaries, assistant treasurers, division officers, etc. Persons with these titles who consider themselves officers and are so denominated by the by-laws, were uncertain as to their obligation to file the reports of stock ownership under Section 16(a), and, what is more important, they were uncertain as to their potential liability for profits under Section 16(b). In an effort to clarify its position, the Commission interpreted Rule X-3B-2 on a strictly objective basis, determining that the status of "officer" depends upon the actual performance of the duties of that office.<sup>9</sup> Thus, if an

<sup>6</sup> Section 3 (b); 15 U.S.C.A. §78 c (b) (1951) gives the Commission the power to define terms used in the Act. Section 16 (b) authorizes the Commission to exempt securities from the operation of Section 16 (b). Section 23 (a); 15 U.S.C.A. §78 w (a) (1951) is the general grant of authority to the Commission to make rules and regulations necessary for the execution of the Act. §3(a)(12); 15 U.S.C.A. §78c(a)(12) (1951), gives the general power to exempt.

<sup>7</sup> Section 3 (a) (7) defines a director as: "Any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated." 15 U.S.C.A. §78c(a)(7) (1951).

<sup>8</sup> 17 C.F.R. §240.3b-2 (1949).

<sup>9</sup> SEC Securities Exchange Act Release No. 2687, November 16, 1940, provides in part:

"It is the opinion of the General Counsel of the Commission that an assistant would be an 'officer' if his chief is so inactive that the

assistant treasurer performs all or a substantial amount of the duties of the treasurer, the assistant is an officer within the purview of Section 16. On the other hand, the Commission would not consider one an officer who performed none of the functions of the treasurer, or who performed some of such functions under the supervision of the treasurer.

In *Colby v. Klune*<sup>10</sup> the Court of Appeals for the Second Circuit questioned the authority of the Commission to issue such a confining rule, and laid down a broader test which it considered to be more sympathetic with the purposes of the Act. The court below had granted defendant's motion for summary judgment upon affidavits setting forth the corporation's by-laws.<sup>11</sup> The Court of Appeals, in reversing, stated that a triable issue of fact was present, even if the authority for the issuance of Rule X-3B-2 by the Commission did exist. The court pointed out, by way of dictum, that the term "officer"

. . . includes *inter alia* a corporate employee performing important executive duties of such character that he would be likely, in discharging these duties, to obtain confidential information about the company's affairs that would aid him if he engaged in personal market transactions. It is immaterial how his functions are labeled or how defined in the by-laws or that he does or does not act under the supervision of some other corporate representative.<sup>12</sup>

The Commission's interpretation<sup>13</sup> was expressly rejected.<sup>14</sup>

The issue has been raised in two subsequent cases, both of which followed Rule X-3B-2 and disregarded as dictum the test proposed in the *Colby* decision. In *Lockheed Aircraft Corp. v. Rathman*,<sup>15</sup> an attempt was made to impose liability under Section 16(b) on an assistant treasurer of a corporation which had a full time treasurer, none of whose functions were performed by the defendant. The court noted that the language of Rule X-3B-2 which refers to ". . . other persons

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assistant is really performing his chief's functions. However, an assistant, although performing some functions which might be those of his chief, would not be an 'officer' so long as these duties were under the supervision of his chief. Temporary absence or brief vacation of an officer during which an assistant performs the officer's duties would not constitute the assistant an 'officer.' Subject to the foregoing, assistant treasurers, assistant secretaries, and assistant comptrollers, for example, are not to be considered 'officers' for the purpose of this definition."

<sup>10</sup> 178 F. 2d 872 (2d Cir. 1949).

<sup>11</sup> *Colby v. Klune*, 83 F. Supp. 159 (S.D.N.Y. 1949).

<sup>12</sup> *Colby v. Klune*, *supra* note 10 at 873.

<sup>13</sup> *Supra* note 9.

<sup>14</sup> *Colby v. Klune*, *supra* note 10 at 875, footnote 15, "[T]hat 'release' . . . sets forth 'the opinion of the General Counsel of the Commission' as to the meaning of 'officer' under Rule X-3B-2. As this 'opinion' of the General Counsel is not part of the 'Commission's formal action,' it does not bind the Commission and certainly not the courts. Since we disagree with it, we disregard it."

<sup>15</sup> 106 F. Supp. 810 (S.D. Cal. 1952).

. . . who perform for the issuer, whether incorporated or unincorporated, functions corresponding to the above officers"<sup>16</sup> is identical to the language used in Section 3(a)(7) which defines "directors",<sup>17</sup> and interpreted it to refer to corporations or associations where the issuer had no such officer or director in name, but had personnel who performed those functions under another name. It followed that since the corporation (Lockheed) had a treasurer, it was not possible that defendant could be an officer within the meaning of the Act. The decision was strengthened by the fact that though the by-laws listed the assistant treasurer as an officer, defendant's duties were of an administrative nature, and he did not perform the duties of the treasurer even in his absence.

The *Colby* test was again rejected in *Lockheed Aircraft Corp. v. Campbell*,<sup>18</sup> but the court departed somewhat from the strict objectivity of the test of the Commission and the *Rathman* case, and heard evidence concerning the nature of defendant's duties because it felt that in a large corporation two persons might perform the same functions in different spheres of the corporation's activities.

Attention should be given to Section 23(a)<sup>19</sup> which provides that no liability shall be imposed upon one who complies in good faith with any rule or regulation of the Commission. In ordinary circumstances this would serve to insulate the assistant officer from liability, but the question may well be raised whether one "relies in good faith" after the *Colby* decision. The *Rathman* and *Campbell* cases suggest that the *Colby* dictum does not prevent reliance on Rule X-3B-2 from being in good faith. In the *Rathman* case, the defendant had taken the additional step of seeking an opinion from the Commission before acquiring the stock. The opinion simply drew defendant's attention to the Rule without mention of the doubt cast upon its validity by the *Colby* decision. Obtaining an opinion does little more than demonstrate that the reliance was authentic, since it does not constitute formal action by the Commission and is not binding on the courts.<sup>20</sup>

The position of the Commission is still in accordance with Rule X-3B-2. A proposed amendment of the Rule in 1952<sup>21</sup> which would have adopted the *Colby* rule was rejected on the grounds that it would

<sup>16</sup> *Supra* note 8.

<sup>17</sup> *Supra* note 7.

<sup>18</sup> 110 F. Supp. 282 (S.D. Cal. 1953).

<sup>19</sup> 15 U.S.C.A. §78 w (a) (1951).

<sup>20</sup> *Supra* note 14. Enforcement of Section 16 (b) liability is accomplished through the courts by the issuer corporation or shareholder and not by the Commission. It is apparent that excusal from filing reports by the Commission does not prevent a court from finding liability for insider profits under Section 16 (b). See *Lockheed Aircraft Corporation v. Rathman*, *supra* note 15 at 814.

<sup>21</sup> SEC Securities Exchange Act Release No. 4754, September 24, 1952; 17 Fed. Reg. 8900 (1952).

tend to create uncertainty. However, the Commission noted that the determination rested ultimately with the courts, and that the *Colby* decision "indicates the possibility that the provisions of the Act applicable to officers may be held to reach a broader class of persons than might otherwise appear from the definition contained in Rule X-3B-2."<sup>22</sup>

Since the *Campbell* case, the issue has not been discussed by the courts. *Colby v. Klune* did not expressly hold the Rule to be invalid so it must be considered in effect in all jurisdictions, though its status is uncertain in the Second Circuit. From the shareholder's viewpoint, the *Colby* rule has much to recommend it, since such a definition of "officers" would certainly enlarge the area of potential liability. Furthermore, the broader test is probably more consistent with the spirit of Section 16, since the possibility of obtaining and unfairly using inside information is not limited to the select few who fall within the Commission's definition. The Commission's position, on the other hand, has the advantage of easy and certain application.<sup>23</sup> The objective test, in most instances, makes identification a relatively simple matter, and furnishes a ready guide for corporation counsel. A general adoption of the more subjective test of the *Colby* case would necessitate much additional proof in each case, and would make the individual position of the quasi-officer very uncertain. This is doubly true with respect to the reporting requirements of Section 16(a). If the reports are not submitted, the statute of limitations does not run against the Section 16(b) suit,<sup>24</sup> while filing, on the other hand, might be construed as an admission of sorts and would be an invitation to suit if the quasi-officer engaged in short swing trading. As pointed out above, an opinion of the Commission gives little assurance and no protection. Furthermore, the Commission's caveat<sup>25</sup> with respect to the rule's validity may weaken a defense of good faith reliance under Section 23(a). For all practical purposes, the dictum in *Colby v. Klune* may have invalidated the Rule as effectively as an express holding would have done.

## II. WHEN DOES ONE BECOME AN "INSIDER" FOR PURPOSES OF SECTION 16?

The relevant provisions of Section 16(b) are as follows:

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner [of

<sup>22</sup> SEC Securities Exchange Act Release No. 4718, June 18, 1952; 17 Fed. Reg. 5674 (1952).

<sup>23</sup> LOSS, *Securities Regulation*, (Supp. 1955, at 266-267).

<sup>24</sup> The pertinent provision of Section 16 (b) provides, ". . . but no such suit shall be brought more than two years after the date such profit was realized." If the insider does not file the reports required under Section 16 (a) the limitation does not run until the plaintiff has knowledge that the profit was realized. *Grossman v. Young*, 72 F. Supp. 375 (S.D.N.Y. 1947); *Blau v. Albert*, 157 F. Supp. 816 (S.D.N.Y. 1957) (Action brought two years after delinquent filing); *c.f. Carr-Consolidated Biscuit Co. v. Moore*, 125 F. Supp. 423 (M.D. Pa. 1954) (Requiring an allegation of fraud and concealment).

<sup>25</sup> *Supra* note 22.

more than ten per centum of any class of any listed equity security], director or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale or sale and purchase . . . shall . . . be recoverable by the issuer. . . . 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. . . .<sup>26</sup>

Respecting the beneficial owners of more than ten per cent of any class of equity security, the language of the act would seem to exclude the purchase by which an amount in excess of ten per cent was acquired. However, in *Stella v. Graham-Paige Motors Corp.*<sup>27</sup> the court held that the acquiring transaction constitutes a "purchase" within the meaning of Section 16(b) against which a sale within less than six months may be matched and liability for the profits imposed. The reasoning of a lower court was adopted.<sup>28</sup> It construed the words "at the time of the purchase and sale" to mean "simultaneously with", and stated: "This construction of the statute would be consistent with the declared purpose of the statute to prevent the unfair use of inside information by officers, directors, or stockholders owning more than ten per cent of the equity stock."<sup>29</sup> A persuasive dissent states that the clear language of Section 16(b) admits of no construction, and points out that the majority's interpretation does not serve the purpose of the Act since the inference that one has inside information is not raised until after the individual acquires the ten per cent interest.<sup>30</sup> The dissent said that the Congressional intent to exclude the acquiring transaction was made doubly clear by the last sentence of Section 16(b), and that the court's interpretation was contrary to this intent.

The same issue was raised in a recent case, *Adler v. Klawans*,<sup>31</sup> in which a director had purchased stock shortly before his election as director, and sold part of it within six months of the date of purchase. The court held that the last sentence of Section 16(b) applied only to beneficial owners of ten per cent of the equity stock and that purchases made before becoming an officer or director could be matched against sales made after election or appointment to such a position. After stating the purpose of the act, the court said,

<sup>26</sup> *Supra* note 3.

<sup>27</sup> 232 F. 2d 299 (2d Cir. 1956).

<sup>28</sup> *Stella v. Graham-Paige Motors Corp.*, 104 F. Supp. 957 (S.D.N.Y. 1952).

<sup>29</sup> *Id.* at 960.

<sup>30</sup> *Stella v. Graham-Paige Motors Corp.* *supra* note 27 at page 302-305. The reasoning of the dissent was used in the *Arkansas-Louisiana Gas Co. v. W. R. Stephens Investment Co.*, 141 F. Supp. 841 (W.D. Ark. 1956) in which a broker-dealer firm was held liable for profits made in the regular course of its investment business. The court refused to treat the original transaction, by which an excess of ten per cent was acquired, as a purchase within the meaning of Section 16 (b).

<sup>31</sup> 267 F. 2d 840 (2d Cir. 1959).

This makes plain the intent of Congress to reach a "purchase and sale" or "sale and purchase" within a six month period by someone within one of the proscribed categories, i.e., one who was a director, officer, or beneficial owner *at some time*.<sup>32</sup> (emphasis by the court)

The *Adler* decision rests upon much firmer ground than the decision in the *Stella* case, since the last sentence of Section 16(b) apparently applies only to ten per cent stockholders. However, the issue still seems to be an arguable one; since the defendant was not an insider at the time of the purchase, no special, inside information should be attributable to him. The Act seems to be aimed at "purchases and sales" and "sales and purchases" made *while* one is an insider, i.e., when both transactions are completed by one who is in a position to have inside information. The *Adler* and *Stella* cases demonstrate the conviction of the Second Circuit "to squeeze all possible profits out of insiders' stock transactions."<sup>33</sup> This Court is certainly giving the Act its broadest possible coverage, but perhaps at the expense of indulging in courtroom legislation.<sup>34</sup>

### III. THE EXEMPTION OF STOCK ACQUIRED UNDER A RESTRICTED STOCK OPTION PLAN

Rule X-16B-3,<sup>35</sup> enunciated by the Commission pursuant to the authority granted in Section 16(b)<sup>36</sup> has been the subject of a running controversy between the Federal Courts of the Second Circuit and the SEC. The Rule exempts from the operation of Section 16(b) "Any acquisition [but not the sale] of non-transferable options or of shares of stock including stock acquired pursuant to such options by a director or officer of the issuer," provided that the option or stock is acquired pursuant to a bonus, profit-sharing, retirement, stock option, thrift, savings or similar plan.<sup>37</sup> To qualify for the exemption, the

<sup>32</sup> *Id.* at 844. See also *Blau v. Allen*, 163 F. Supp. 702 (S.D.N.Y. 1958).

<sup>33</sup> *Smolowe v. Delendo Corp.* 136 F. 2d 231, 239 (2d Cir. 1943). The authoritative interpretation given Section 16 (b) in this case has been approved and followed in almost all of the subsequent decisions dealing with this section of the Act. For a more liberal interpretation see, *Ashland Oil & Refining Co. v. Newman*, 163 F. Supp. 506 (N.D. Ohio 1957).

<sup>34</sup> *Stella v. Graham-Paige Motors Corp.*, *supra* note 27, dissenting opinion of Judge Hincks. See also *Cole, Insider's Liabilities Under the Securities Exchange Act of 1934*, 12 Sw. L. J. 147, 156 (1958).

<sup>35</sup> 17 C.F.R. §240.16b-3 (Supp. 1959).

<sup>36</sup> *Supra* note 3. The pertinent provisions of Section 16 (b) read as follows: ". . . This subsection shall not be construed to cover . . . any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."

<sup>37</sup> These acquisitions are not exempt from the reporting requirements of Section 16 (a). The exemption of the purchase only from Section 16 (b) means that a sale of stock within less than six months cannot be matched against the acquisition under the option. However, the sale of the securities so acquired may be matched against any other purchase within the stated period. With respect to the determination of profits generally see, *Smolowe Corp. v. Delendo Corp.* *supra* note 33, and *Gratz v. Claughton*, 187 F. 2d 46 (2d Cir.



plan must have been approved by a majority of the corporation's shareholders and must limit the aggregate amount of funds or securities which may be allocated thereunder.<sup>38</sup> Though the rule was originally adopted, in different form, in 1935<sup>39</sup> stock options attained their greatest significance with the passage of Section 130(A) of the Internal Revenue Act of 1950<sup>40</sup> which gave stock option plans favored tax treatment. Rule X-3B-2 was amended in 1952 in order that these tax advantages might be utilized,<sup>41</sup> and was amended into its present form in 1956<sup>42</sup> so as to conform with the requirements of the Internal Revenue Code and to remove certain ambiguities.<sup>43</sup>

In 1957 the Court of Appeals for the Second Circuit, in the case of *Greene v. Dietz*, "expressed doubt" as to the power of the Commission to promulgate a rule, "the broad language [of which] may permit acts by insiders sought to be prevented by the Securities Exchange Act."<sup>44</sup> The grounds of the attack, as expressed in the *Greene* case and in *Perlman v. Timberlake*,<sup>45</sup> a 1959 decision by the District Court for the Southern District of New York which held the Rule to be beyond the power of the Commission and void, are: (1) that Section 16 (b) imposes an absolute liability upon officers and directors to account for any profits made from short swing trading in the securities of the issuer; (2) that the exercise of the Commission's rule-making power exceeded its authority in this instance since the use of options was one of the devices that Congress had expressly intended to curb by enacting the Securities and Exchange Act of 1934.<sup>46</sup> The

1951). As to the measure of profits from trading in non-exempt options, or securities acquired thereunder, see Cole, *op. cit. supra* note 34 at 166-171, and Hardee, *Stock Options and the "Insider Trading" Provisions of the Securities Exchange Act*, 65 HARV. L. REV. 997 (1952). Rule X-16B-6, 17 C.F.R. §240.16b-6 (Supp. 1959) has been adopted by the Commission in order to compensate for the natural increase in value of securities acquired through the exercise of non-exempt options by considering the purchase price to be either the price paid or the lowest market price within six months before or after the date of the sale, whichever is the greater. In order to qualify under Rule X-16B-6, the option must have been acquired either more than six months before exercise or pursuant to an employment contract entered into more than six months prior to exercise.

<sup>38</sup> This can be accomplished either by fixing the maximum amount which may be allocated to each participant or by fixing the maximum amount which may be allocated to all participants.

<sup>39</sup> SEC Securities Exchange Act Release No. 392, October 9, 1935; 17 C.F.R. §240.16b-3 (1949).

<sup>40</sup> 26 U.S.C.A. §130 A, which is now §421 of the Internal Revenue Act of 1954, 26 U.S.C.A. §421 (1954).

<sup>41</sup> SEC Securities Exchange Act Release No. 4754, Sept. 24, 1952; 17 Fed. Reg. 8901 (1952).

<sup>42</sup> 17 C.F.R. §240.16b-3 (Supp. 1959).

<sup>43</sup> SEC Securities Exchange Act Release No. 5312, May 21, 1956; 21 Fed. Reg. 3647 (1956). The history of the Rule is discussed in *Greene v. Dietz*, 247 F. 2d 689 (2d Cir. 1957) and *Perlman v. Timberlake*, 172 F. Supp. 246 (S.D.N.Y. 1959).

<sup>44</sup> 247 F. 2d 689, 692 (2d Cir. 1957).

<sup>45</sup> 172 F. Supp. 246 (S.D.N.Y. 1959).

<sup>46</sup> "These are far from isolated transactions and herein lies the real evil. The

court in the *Perlman* case examined the provisions of the Act which grant the Commission the power to make implementing rules<sup>47</sup> and determined that the Commission's power had been narrowly circumscribed by Congress, leaving matters to the discretion of the Commission only in cases where relief from hardship is called for.<sup>48</sup>

In a strong dissent in the *Greene* case, Judge Lombard asserted that the Commission had acted within its power, that the matter was within the expertise of the Commission, and that the court should not substitute its own opinions on highly technical subjects for those of the experts.

On motion for rehearing,<sup>49</sup> the court, in denying the motion, compounded the confusion by suggesting that the defense of good faith reliance under Section 23 (a)<sup>50</sup> might not be available to officers and directors who acquired stock pursuant to restricted stock options and made sales of such stock within six months of the acquisition. The court said:

We learn . . . [from the Commission's brief] that the Commission is re-evaluating its Rule X-16B-3. In the meantime pending any modification of the Rule after such re-evaluation, it would seem that any reliance upon it by persons entitled to exercise stock purchase options under employee stock option plans substantially similar to that here in issue would be ill-advised.<sup>51</sup>

Dissenting again,<sup>52</sup> Judge Lombard criticized what he considered a misuse of the power of dictum, and stated that the majority decisions amounted to a finding of invalidity of the Rule without actually so holding. Aside from the uncertainty which the decisions created, more significant perhaps is the restriction which a finding of

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widespread use of these options to the favored classes in possession of information not available to other shareholders and as a matter of fact initiated by these very individuals (last amendment to Rule eliminating eligibility provisions) constitutes a gratuitous preference to that very class which Congress thought were most in need of regulation, in an area which was one of the moving forces for the enactment of Section 16(b) . . ." *id* at 256.

<sup>47</sup> *Supra* note 6.

<sup>48</sup> "With . . . [the court's] interpretation of the Commission's authority, it cannot logically be found as defendants argue that the Commission has quasi-legislative discretion to lift out of the stricture of the statute a transaction which factually falls within it; rather it follows that the Commission may only, because it is presumed in a better position to do so, make a factual determination that a particular transaction does or does not correspond with the facts enumerated in the statute and make a declaration of exemption on that ground. In other words, if we are to be faithful to the Congressional purpose as clearly expressed, the only meaning which we may give the words "as not comprehended within the purpose" is "if not comprehended," the "if" to be determined by the Commission." *Supra* note 45 at 255.

<sup>49</sup> *Supra* note 44 at 697. The rehearing was sought by the Commission *amicus curiae*.

<sup>50</sup> *Supra* note 19.

<sup>51</sup> *Supra* note 44 at 697.

<sup>52</sup> *Supra* note 44 at 697.

invalidity would put upon the Commission's power to make exemptions, since, as was pointed out by Judge Lombard, any exemption will of necessity allow some insider profits, and possibilities of abuse will almost invariably be present.

Since the *Greene* decision, several attempts have been made to match stock option purchases against sales made within less than six months.<sup>53</sup> In *Perlman v. Timberlake*,<sup>54</sup> the court held the Rule void, but did not allow plaintiffs to recover because of defendant's conformity with and good faith reliance upon the Rule. The defendant had relied upon the advice of counsel and did not have actual knowledge of the *Greene* decision. The District Court for the Northern District of Ohio, in *Gruber v. Chesapeake & Ohio Ry.*,<sup>55</sup> decided before the *Perlman* case, simply held that the stock option plan in issue came within the ambit of Rule X-16B-3 and was therefore exempt. The court noted, without comment, the doubt expressed by the *Greene* dictum, but grounded its decision on an assumption of the Rule's validity. Similarly in *Emerson Electric Mfg. Co. v. O'Niell* (E.D. Mo. 1958)<sup>56</sup> where the defendant had no actual knowledge of the *Greene* decision and had acted on the advice of counsel, the court felt that a determination of the validity of the rule was unnecessary, since the exculpatory provision in Section 23 (a) protected defendant from liability. Plaintiff's assertion that defendant was presumed to know the law and therefore could not be in good faith was rejected by the court. The court stated: "The presumption of knowledge of the law is not applicable to a determination of good or bad faith."<sup>57</sup> In *Van Aalten v. Hurley*,<sup>58</sup> the court, in a well-reasoned opinion, refused to impute constructive knowledge of the *Greene* decision, and philosophically summarized the present state of the law, saying ". . . [T]he most that can be presumed, if we are to indulge in presumptions at all, is that the defendants knew the law was unsettled."<sup>59</sup> Although the *Van Aalten* case was decided in the District Court for the Southern District of New York, the court, unlike the court in the *Perlman* case, did not feel constrained to follow the *Greene* dictum and said with respect to that dictum and its effect on the exculpatory provision of Section 23 (a) :

The observation that reliance upon the Rule would be "ill-advised" apparently has been misconstrued by plaintiff as converting a dictum into a holding and as constituting a caveat

<sup>53</sup> Rule X-16B-6, *supra* note 37, limits the amount of recoverable profits in the event that the acquisition be considered non-exempt.

<sup>54</sup> *Supra* note 45.

<sup>55</sup> 158 F. Supp. 593 (N.D. Ohio 1958).

<sup>56</sup> 168 F. Supp. 804 (E.D. Mo. 1958).

<sup>57</sup> *Id.* at 806.

<sup>58</sup> 176 F. Supp. 851 (S.D.N.Y. 1959).

<sup>59</sup> *Id.* at 857.

to investors situated as are these defendants. In that context, it is utterly inadmissible to argue that the words "ill-advised" are to be construed as tantamount to a shaking of the judicial index finger in the faces of the large body of holders of stock purchase options under restricted stock option plans. . . .

. . . The majority opinions cannot be distorted into a judicial determination of invalidity, nor successfully relied on to preclude the defendants from the protection afforded by Section 23 (a).<sup>60</sup>

The court's lengthy discussion of the reliance clause in Section 23 (a) suggests that even actual knowledge of the *Greene* decision would not affect the good faith aspect of one's reliance. Of course, there was no such actual knowledge in this case and the court expressly refused to decide the effect of actual knowledge.<sup>61</sup> It was noted, however, that the test of good faith reliance is merely an honest intention to conform, and that the reasonable man test should have no application here.<sup>62</sup> That the defendants had acted in honest reliance was shown by evidence that: (1) they had meticulously complied with the reporting requirements under Section 16 (a); (2) they had attended meetings at which they were advised that the Rule provided an exemption for purchases under the plan; (3) they had received similar advice from counsel; and (4) they acted only after receiving such advice, without knowledge of the expressions of doubt as to the validity of the Rule.

One of the most recent cases was decided in the District Court for the Southern District of Texas, and is the only case which has expressly rejected the *Greene* and *Perlman* decisions, and upheld the validity of the Rule. The court, in *Continental Oil Company v. Perlitz*,<sup>63</sup> reviewed decisions of the United States Supreme Court upholding Congressional delegation of rule-making powers to administrative agencies, and decided that the matter was within the discretion and the expertise of the Commission and further held, in accordance with the dissent of Judge Lombard in the *Greene* case,<sup>64</sup> that such administrative rulings were not to be overturned on the basis of mere possibility of abuses and judicial conjecture.<sup>65</sup> The court's interpretation of

<sup>60</sup> *Id* at 856.

<sup>61</sup> *Id* at 858 n. 15.

<sup>62</sup> ". . . A reasonably prudent man, it might be contended, faced with the choice between (i) relying on a duly promulgated rule which, though not judicially determined invalid was clouded by expression of serious doubts in a dictum by a Court whose decisions are entitled to the highest respect, or (ii) continuing his holdings though contra-indicated by his personal financial condition and the uncertainties of the market place, would choose the latter. Parenthetically, the reasonably prudent man might well plead that a proper regard for him should not place him in that dilemma." *Id* at 856.

<sup>63</sup> 176 F. Supp. 219 (S.D. Tex. 1959).

<sup>64</sup> *Greene v. Dietz*, *supra* note 44 at 696, 697.

<sup>65</sup> "An examination of *Greene v. Dietz* and *Perlman v. Timberlake* clearly shows that these decisions would strike down Rule X-16B-3 on the possi-

the Congressional intent was the opposite of that reached in the *Perlman* case, i.e., that Congress never intended to "lay down any inflexible rules as to the liability of officers and directors of a company."<sup>66</sup>

The decisions of the Second Circuit have created a real dilemma for the officer and director optionees under restricted stock option plans.<sup>67</sup> The first problem is whether the finding of invalidity (or the expressions of doubt) is justifiable. The answer would seem to be no.<sup>68</sup> The situation falls within the congressional intent to allow the Commission, in light of its continuous experience and expert knowledge of a highly complex subject, to make determinations and provide exemptions in situations where the possibility of abuse is slight in comparison with the legitimate objectives to be attained. The options which Congress sought to regulate at the time of the passage of the Act, as pointed out in the *Perlitz* case,<sup>69</sup> differ considerably from the restricted stock options which the Rule exempts. The limitations upon the amount of stock which may be used for such purposes and the requirement that the approval of a majority of the shareholders be first obtained, reduce the likelihood that the exemption privilege will be abused. Furthermore, the requirements of the Internal Revenue Code<sup>70</sup> (the tax advantages being one of the prominent reasons for the widespread use of restricted stock options) discourage the use of the device for the benefit of only a few persons.<sup>71</sup> There are several legitimate reasons for their use. Stock option plans have long been employed as an incentive device, for compensation purposes, and to increase the efficiency of employees by giving them a proprietary interest in the business. Since the options are often granted on a yearly basis, the recovery of profits from sales of stock within less than six months before or after purchase would largely frustrate the legitimate use of the plans.<sup>72</sup> This is especially true since the exercise of the option is often financed by

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bility that it would permit abuses and that there has not been a clear showing that the Commission did not act reasonably in promulgating the Rule and within the purpose of the subsection." *Continental Oil Company v. Perlitz*, *supra* note 63 at 227.

<sup>66</sup> *Id.* at 225.

<sup>67</sup> The greater part of Section 16 (b) litigation is commenced in the Second Circuit. Section 27 of the Act provides that the district courts of the United States have exclusive jurisdiction over such suits, and it has been held that a Section 16 (b) suit may be maintained in any district in which any act or transaction in violation of the section occurred. *Gratz v. Claughton*, 187 F. 2d 46 (2d Cir. 1951).

<sup>68</sup> The Memorandum of the SEC, *amicus curiae*, submitted on the motion for rehearing in *Greene v. Dietz*, provides a comprehensive summary of the arguments in support of Rule X-16B-3. (CCH Fed. Sec. L. Rep. ¶90,821 (1957)).

<sup>69</sup> *Supra* note 63 at 224.

<sup>70</sup> *Supra* note 40.

<sup>71</sup> Corporation law imposes further limitations on their use. See *Kerbs v. California Eastern Airways*, 33 D. Ch. 69, 90 A. 2d 652 (1952).

<sup>72</sup> *Cook and Feldman, Insider Trading Under the Securities Exchange Act*, 66 HARV. L. REV. 612, 635 (1953).

the sale of other stock.<sup>73</sup> Finally, the non-exemption of such stock acquisitions would tend to negate the beneficial tax treatment which such plans receive.<sup>74</sup>

The *Greene* and *Perlman* decisions are unfortunate for another reason. To say that an exemption may be invalidated on the mere possibility that abuses may exist leaves the Commission with very little discretionary power, and undermines the position of the Commission in the area of securities regulation. As the court said in the *Perlitz* case: "It does not follow that because some stock options are pregnant with fraudulent possibilities that every type of option is necessarily so."<sup>75</sup> The *Greene* and *Perlman* decisions are difficult to rationalize when the following language of the United States Supreme Court is considered:

Its judgment is entitled to the greatest weight, while recognizing that the Commission's discretion must square with its responsibility, only if the remedy chosen is unwarranted in law or is without justification in fact should a court attempt to intervene in the matter.<sup>76</sup>

The second problem raised by the Second Circuit decisions presents greater practical difficulty, and its solution depends more upon clairvoyance than upon a reading of case law. The "doubt" expressed in the *Greene* case as to the validity of Rule X-16B-3 has, by now, received considerable publicity, and reliance upon advice of counsel as an indicia of good faith may begin to weaken as a defense. That the half-way finding of invalidity in the *Greene* case created the quandary, and is for this reason reprehensible, does not provide an answer for the officer or director-optionee who is faced with a Section 16 (b) suit for recovery of profits. The position taken by the court in *Van Aalten v. Hurley*<sup>77</sup> that such dictum does not constitute a determination of invalidity and does not, therefore, preclude good faith reliance, seems to be the preferable solution.<sup>77</sup>

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<sup>73</sup>In a statement accompanying a proposed amendment to Rule X-16B-3 the Commission noted the existence of this problem, but has not as yet formally proposed a solution. SEC Securities Exchange Act Release No. 6111, November 5, 1959; 24 Fed. Reg. 9272 (1959).

<sup>74</sup>"Section 421 of the Internal Revenue Code renders improbable the sale of stock so acquired before six months have elapsed but it does not preclude a quick profit from the sale of other prior acquired stock. . . . Moreover as the Court of Appeals pointed out in *Greene v. Dietz*, . . . the possible inhibiting effect of tax provisions upon the security transactions of insiders is a matter completely apart from that of defining the power of the SEC and the validity of a rule which contains no such inhibitions. . . . And the fact that Congress has encouraged these plans by conferring tax benefits on them . . . does not mean that it intended to immunize them from their less favorable aspects." *Perlman v. Timberlake*, *supra* note 45 at 257.

<sup>75</sup>176 F. Supp. 219, 226 (S.D. Tex. 1959). The court quoted from the Memorandum of the Commission referred to *supra* note 68 at page 92,577.

<sup>76</sup>*American Power and Light Co. v. SEC*, 329 U.S. 90, 112 (1946).

<sup>77</sup>*Supra* note 58.

The Commission has taken action to amend Rule X-16B-3 in light of the conflicting views expressed in the cases. A proposed amendment was published in November of 1959<sup>78</sup> and republished, with certain modifications, in April of 1960.<sup>79</sup> The amendment, if adopted, would delete the exemption afforded to the acquisition of securities upon the exercise of the option, but would retain the exemption with respect to the acquisition of the options pursuant to a qualified plan. The exemption would also continue to apply to shares acquired pursuant to an option under a bonus, thrift, retirement, profit sharing, or savings plan. The amendment would also impose certain restrictions with respect to the selection of participants in the plan, requiring either a disinterested majority on the selecting committee or board, or the approval of a participation formula by a majority of the stockholders. The Commission concluded "that Rule X-16B-6<sup>80</sup> provides a means for separating profits which may be attributed to long term increments in value arising from the very nature of the restricted stock option device, and which the statute is not designed to discourage, from the profits fairly attributable to the short term aspects of the transaction which the Act intended to denude of profit."<sup>81</sup> Pending adoption of an amended Rule, the validity of which should cause little if any judicial unrest, the Rule, in its present form and with its attendant problems, is still in effect.

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<sup>78</sup> SEC Securities Exchange Act Release No. 6111, November 5, 1959; 24 Fed. Reg. 9272 (1959).

<sup>79</sup> SEC Securities Exchange Act Release No. 6227, April 6, 1960; 25 Fed. Reg. 3218 (1960).

<sup>80</sup> *Supra* note 37.

<sup>81</sup> *Supra* note 78.