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PUT AND CALL OPTIONS: CRITERIA FOR APPLICABILITY OF SECTION 16(b) OF THE SECURITIES EXCHANGE ACT OF 1934.*

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The recent Second Circuit case of *Miller v. General Outdoor Advertising Co.*[1] is a terse and pointed application of that Court's narrow definition of the scope of summary judgment:

> Because we believe that on the complicated factual pattern presented here it would have been more prudent to permit all the facts to be fully developed at a trial before attempting to determine the applicability of Section 16(b) to Gamble's extremely involved transactions in Alleghany's stock, we are compelled to reverse the orders granting summary judgment.[2]

The "complicated factual pattern" was no juridical hyperbole. Miller, a stockholder of Alleghany Corporation, brought an action pursuant to section 16(b) of the Securities Exchange Act of 1934[3] to recover in Alleghany's behalf any

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1 337 F.2d 944 (2d Cir. 1964), *reversing* 223 F. Supp. 790 (S.D.N.Y. 1963).

2 337 F.2d at 947-48.

3 48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1958):

> 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

profits realized by Gamble-Skogmo, Inc., and its subsidiary General Outdoor Advertising Co. in a series of transactions, including an "Agreement of Put and Call" some incidental contractual features of which were both complicated and novel.[4] The legal relations created were "extremely involved" by virtue not only of the forms employed, but, as the Second Circuit recognized, because of the sweeping potential impact of the legal issues to which they gave rise:

> Since this is the first case to raise the difficult and far-reaching question whether the acquisition of a call may be a "purchase" of an "equity security" under Section 16(b), it falls within that twilight zone where full development of the facts is necessary to decide whether the transactions involved were susceptible to the type of speculation the section seeks to eliminate.[5]

Section 16(b) has given rise to cases applying the definitions[6] of "purchase" and "sale" to many fact situations, and the resulting decisions have often been of limited application.[7] The *Miller* case, on the other hand, raises the broad question of the applicability of section 16(b) to a whole class of securities, that is, to puts and calls. The opinion is of interest as an instance of summary judgment held improvidently granted.[8] Its greater significance, however, may lie in the "difficult and far-reaching question" which, although not decided by the Court, is of continuing importance in light of the extraordinary susceptibility of puts and calls to the speculative activities which are section 16(b)'s *raison d'être*.

A put is an option to sell and a call is an option to buy a security within a period of time at a stated price. They have been somewhat more formally defined by the staff of the Securities and Exchange Commission:

> A "put" is a contract which gives the holder the right for a stated period of time to sell a specified number of shares of a stock to the writer of the contract at a price per share which was fixed at the time when the option was bought. A "call" is a similar

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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.

4 See text at note 35, *infra*.

5 Miller v. General Outdoor Advertising Co., 337 F.2d 944, 948 (2d Cir. 1964).

6 Securities Exchange Act §§ 3(a)(13), (14), 48 Stat. 884 (1934), 15 U.S.C. §§ 78c (a)(13), (14) (1958), quoted in text at note 28, *infra*.

7 See Booth v. Varian Associates, 334 F.2d 1, 3 (1st Cir. 1964), *cert. denied,* 379 U.S. 961 (1965), and cases cited.

8 The following language is of interest on this point:

> We do not, by our disposition of this case, weaken the force of our recent holdings that the summary judgment procedure should be used to pierce the allegations of pleadings and screen out sham issues of fact. See, e.g., Dressler v. Sandpiper, 331 F.2d 130 (2d Cir. 1964). Here we simply recognize that there are instances where summary judgment is too blunt a weapon with which to win the day, particularly where so many complicated issues of fact must be resolved in order to deal adequately with difficult questions of law which remain in the case. Miller v. General Outdoor Advertising Co., 337 F.2d 944, 948 (2d Cir. 1964).

> contract which gives the holder the right to purchase the stock from the writer at a fixed price.[9]

Obviously, the form is adaptable to a wide range of commercial purposes; for example, it can serve as a protective device in the transfer of a block of shares representing control. Puts and calls, however, are most commonly utilized as marketable securities in their own right; they are sold independently of the underlying security. The usual procedure is for a broker to obtain for a customer, or for his inventory for sale to customers, a put or a call written by some person who is willing either to acquire additional shares of the underlying security at a price slightly below the market price, or to sell shares at a price slightly above the market price.[10] The put or call is normally written with an exercise price equal to the existing market, and the writer is paid a "premium," computed with reference to the market price of the underlying security,[11] for writing the option. The option is endorsed, usually for a fee, by a New York Stock Exchange member, performance of the contract thereby being guaranteed. This latter feature accounts for these options being readily susceptible of trading in the securities markets, as the identity of the writer is normally known only to the broker who obtains the options.[12] The economic significance of these instruments is simple: a put is a wager that the market price of a security will go down within a certain period, and a call, conversely, is a wager that it will go up.

At the direction of the Securities and Exchange Commission in 1959, its Division of Trading and Exchanges (now the Division of Trading and Markets) undertook a study of the put and call market designed to consider "how options actually have been used, how profitable they are, and what are the current trading practices."[13] Its report, made public in late 1961, includes a section analyzing the purposes behind the acquisition of puts and calls. While the statistics on which the report was based are now a bit dated, there is nothing in the market history of the intervening four years to suggest that its conclusions are not still valid. After briefly discussing certain such objectives not here relevant,[14] the report states:

> The brokers interviewed were unanimous in the opinion that the reason most persons bought options was the opportunity it afforded them for speculation on a small amount of capital. That is borne out by the fact that when an option holder exercises a call he resells the stock he has acquired immediately.[15]

It is, accordingly, hardly surprising that puts and calls tend in general to be written on highly volatile stocks, with their total volume tending to increase as speculative interest in the market grows.[16] The ratio of potential profit to

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9 SEC, Division of Trading and Exchanges, Report on Put and Call Options 7 (1961) [hereinafter cited as Report on Put and Call Options]. See text at note 13, *infra*.
10 *Id.* at 15.
11 *Id.* at 85-86.
12 *Id.* at 11-12.
13 *Id.* at 3.
14 Protection of a position, *id.* at 76; in-and-out trading in the underlying security, *id.* at 77; and tax savings, *ibid.*
15 Report on Put and Call Options 77.
16 *Id.* at 19, 45.

actual cash investment increases in proportion to the volatility of the underlying security; the greater the fluctuation in market price, the larger the profit. But the dependence of profits on the ability accurately to predict the market fluctuations which produce them increases in similar proportion, and the result is a speculative situation combining maximum opportunity for profit taking with substantial risks for public investors. The following table, reproduced from the *Report on Put and Call Options,*[17] illustrates some of the more spectacular profits realized by the use of six-month calls,[18] exercised at or near the expiration date:

Call Option [on]	*Average Price on day of Exercise*	*Premium Paid*	*Commissions and Taxes*	*Net Profit*	*Profit as % of Premium*
American Motors at 37⅜	88⅜	$ 550	$ 98	$4,452	809%
Ampex Corp. at 67¾	118¾	900	112	4,088	454
Stanley Warner at 26¾	43⅛	375	84	1,179	314
Collins Radio at 33¾	53-58	500	92	1,396	279
Western Union at 36-38	51	425	93	945	222
Cessna Aircraft at 68½	101	1000	110	2,140	214

The *Report* adds that "several shorter-term [*i.e.,* shorter than six months] options also yielded large profits."[19] In vivid contrast to the extravagant returns realized by such investors, however, is the relative infrequency of their occurrence. During the month of June, 1959, when all the calls covered by the above table were purchased, the public invested in call options a total of $1,544,000, sixty-five per cent of which was ultimately lost.[20]

Two separate and distinct issues are involved in determining the applicability of section 16(b) to transactions in which puts and calls are employed. The first to arise in litigation was whether the use of puts and calls in a particular set of transactions amounts to a "purchase and sale" *of the underlying security.* This issue was presented in *Silverman v. Landa.*[21] The second, which was decided by the District Court in *Miller v. General Outdoor Advertising Co.,*[22] is whether puts and calls are themselves equity securities, the purchase and sale of which may give rise to section 16(b) liability independently of whether there is any purchase or sale of the underlying security.

I. Use of puts and calls in "purchase and sale" of the underlying security.

Silverman v. Landa was an action under section 16(b) against a director of Fruehauf Trailer Co. who had simultaneously written puts and calls on Fruehauf stock at the prevailing market price of 24⅜. On the calls, which covered 1,000 shares, Landa received a premium of $4,000; on the puts, which

17 *Id.* at 80.
18 Six months and ten days is the period of time for which puts and calls have frequently been written in recent years, apparently for tax reasons. *Id.* at 26. The data in the table are for 100 share options.
19 *Id.* at 80.
20 *Id.* at 78.
21 306 F.2d 422 (2d Cir. 1962).
22 223 F. Supp. 790 (S.D.N.Y. 1963), *rev'd.* 337 F.2d 944 (2d Cir. 1964).

covered 500 shares, he received $1,000. Relying on cases fixing the date of a purchase or sale at "the time when the . . . insider's rights and obligations become fixed,"[23] plaintiff argued that the simultaneous writing of the puts and calls amounted to a matched purchase and sale of 500 shares, since Landa's obligations to buy from the holder of the put and to sell to the holder of the call were irrevocably fixed, whether or not the holders ever chose to exercise them.

In rejecting this argument, the Court utilized the language in which the issue was framed without really resolving the question on which it depended:

> Plaintiff misconceives the nature of an option. By its nature, the option is one-sided; it fixes the obligations, but not the rights, of the issuer. Landa cannot be said to have "sold" or "purchased" Fruehauf stock; should the options lapse unexercised (and in fact the call options did so lapse), no change in his beneficial ownership of the underlying security would occur. And, most importantly, any change would occur at the pleasure of the optionee. Only if both the options had been exercised within their first six months would there have been a "sale and purchase" of the underlying security within the reach of § 16(b).[24]

What the Court seems to be saying, then, is that a "purchase" (or a "sale") does not occur, within the meaning of section 16(b), until both the rights *and* the obligations of the optionor are fixed. It does not follow, however, that plaintiff "misconceive[d] the nature of an option." Plaintiff appears to have been fully aware that the effect of an option was to fix only the obligations, not the rights, of the optionor; the crux of his argument was that that effect was sufficient to constitute the call option a sale and the put option a purchase.[25] In its emphasis on the circumstance that "any change would occur at the pleasure of the optionee," the Court explicitly rejects the view that the fixing of the optionor's obligations is sufficient, but never goes on to explain the asserted necessity for the concurrent fixing of his rights. Instead it relies on its prior statement in *Blau v. Ogsbury*[26] that the time at which an insider's rights and obligations became fixed is controlling in the application of section 16(b). In the *Blau* case, however, it was unnecessary for the Court to decide whether a "purchase" occurred on the date the right to obtain the stock was acquired, or on the date that the obligation to take the stock also became effective, since both those dates were more than six months from the date of the sale. Furthermore, the Court's reliance in *Blau* on its earlier similar statement in *Falco v. Donner Foundation*[27] appears to be misplaced, since the *Falco* case was decided in the context of an arbitrage transaction involving a contract for purchase (under which the insider's rights were fixed) and a separate contract for sale (under which the insider's obligations were fixed) which were entered into concurrently.

Section 3(a) of the Securities Exchange Act of 1934 defines "purchase" and "sale" as follows:

23 Blau v. Ogsbury, 210 F.2d 426, 427 (2d Cir. 1954), quoted in 306 F.2d at 424.
24 306 F.2d at 424.
25 *Ibid.*
26 210 F.2d 426, 427 (2d Cir. 1954).
27 208 F.2d 600 (2d Cir. 1953).

> When used in this title, unless the context otherwise requires, . . .
> (13) The terms "buy" and "purchase" each include any contract to buy, purchase, or otherwise acquire.
> (14) The terms "sale" and "sell" each include any contract to sell or otherwise dispose of.[28]

An option is, of course, a species of unilateral contract;[29] the fixing of the optionor's obligations should therefore be sufficient to make the writing of the option a "contract to buy" (in the case of a put) or a "contract to sell" (in the case of a call).

The comparatively narrow issue presented on the facts in *Silverman v. Landa* does not, however, exhaust the relevant inquiry into the use of puts and calls to effect transactions in the underlying security. Of greater significance than whether the acquisition of a call is a "purchase" of the underlying security is whether options can be used to manipulate the dates on which the "purchase and sale" of the underlying security are effected. The following example suggests an affirmative answer:

On April 15, *A*, an insider of *X Corporation*, purchases for $5,000 a call on 1,000 shares of *X* common exercisable at 40 for a period of six months and ten days.[30] Assume that by April 23 the market is 60. If on that date *A* acquires inside information tending to show an imminent sharp decline, it will avail him little to exercise the call and resell the common stock so acquired before the anticipated decline; such a sequence would clearly involve a "purchase and sale" of the common acquired by exercise.[31] Consider the consequences, however, if on April 23 he instead *sells* 1,000 shares of *X* common at the prevailing market price of 60. On April 24, the deleterious information is publicly announced and by May 1 the market price of *X* common has reverted to $40 per share. If on October 25 the market price is below 40, so that *A* does not exercise the call,[32] he can repurchase at the market the 1,000 shares sold on April 23, realizing a net cash profit of at least $15,000 (market decline less the premium on the call). If, on the other hand, the market price of *X* common on October 25 is 40 or above, *A* can exercise his call at 40 — a purchase of common which again cannot be matched with the April 23 sale and which again results in a net cash profit of $15,000.

Whether the market rises or falls, *A* has employed inside information in the same way, concluded the series of transactions with the same proportionate equity interest in *X Corporation* with which he began, and realized the same profit, after adjustment for the premium, as he would have realized from a purchase of common on April 15 and a sale on April 23. Since the April 23 sale and the October 25 purchase are made to occur more than six months apart, the profit is not recoverable under section 16(b) — if those two transactions are the only "sale and purchase" by the insider within six months. But

28 48 Stat. 884 (1934), 15 U.S.C. §§ 78c(a)(13), 78c(a)(14) (1959).
29 See 1 Williston, Contracts § 61A (rev. ed. 1957) and authorities cited.
30 See note 18, *supra*.
31 *Cf.* Greene v. Dietz, 247 F.2d 689, 693 (2d Cir. 1957).
32 An unprofitable option may be sold to a broker for a nominal amount, normally $1 per 100 share option, to establish a tax loss. Report on Put and Call Options 72.

if the April 23 sale can be matched with a "purchase" on April 15, section 16(b) applies. A literal application of *Silverman v. Landa* might preclude this result, since only the insider's rights, and not his obligations, were fixed on April 15. But *Silverman v. Landa* could concern itself solely with the intrinsic characteristics of the options because they were not employed to manipulate the date of purchase of the underlying security. Where, as in the example, that additional element is present, the preferable criterion would appear to be one which takes the manipulation into account. Such a criterion was applied in the recent First Circuit case of *Booth v. Varian Associates:*

> The question . . . [is] one of balancing the respective advantages and disadvantages of each contended for "purchase" date and determining which one, if held to be the date of purchase, would be more likely to lend itself to the abuses the statute was designed to protect against. . . . In addition, since we are dealing with a remedial measure, it is important that we consider the probability of bringing the insider to task for his violation of the statute. If one date lends itself to the possibility of abuse as much as the other but, because of the statute of limitations attached to Section 16(b), it would be difficult, if not impossible, to gain recovery against an insider who "purchased" on one of the contended for dates, then practical experience dictates that the purchase date within the recovery period should be selected as the one the statute was designed to include.[33]

The criterion under which the acquisition of the option is treated as a purchase of the underlying security should also be applied to the problem of computing the "profits realized from" the sale matched with that purchase. In an actual out-of-pocket sense, the cost of the insider's April 15 purchase is only $5,000. If the strict rule of *Smolowe v. Delendo Corp.*[34] is applicable, it would appear that the insider's net profit is $55,000 — which seems a somewhat harsh result against the consideration that his liability would be only $20,000 if he purchased common outright on April 15 at 40, and sold it at 60 on April 23. Since the rationale of bringing the acquisition of the call within the scope of section 16(b) is that the statute should be applied evenhandedly to transactions which do not differ in speculative purpose or practical effect, it should follow that the profits recoverable must be computed in such a way as to result in the same liability no matter which form of "purchase" is employed. The simplest rule for reaching such a result would appear to be to treat the *exercise price* of the option, rather than the premium paid for it, as the insider's cost for purposes of section 16(b).

The *Booth* case is factually distinguishable from the illustration in that it involved a bilateral contract to purchase stock, rather than a unilateral contract such as an option. The reasoning, however, seems equally sound in either context, and lends support to the view that the acquisition of an option should be

33 334 F.2d 1, 4 (1st Cir. 1964), *cert. denied,* 379 U.S. 961 (1965).

34 136 F.2d 231 (2d Cir. 1943), *cert. denied,* 320 U.S. 751 (1943). *Smolowe* held that, where there was more than one transaction, at different prices, within the same six-month period, the "profit realized" should be computed according to the formula "lowest price in, highest price out," in order "to squeeze all possible profits out of stock transactions."

treated as a purchase of the underlying security where the transaction is of the character section 16(b) was designed to reach.

II. Applicability of section 16(b) to puts and calls themselves.

Miller arose from the following facts: Gamble-Skogmo, Inc., on the one hand, and John D. Murchison and C. W. Murchison, Jr., on the other, executed an instrument styled "Agreement of Put and Call." By its terms, Gamble-Skogmo acquired a call on — *i.e.*, an option to purchase from the Murchisons — a minimum of 1,500,000 and a maximum of 2,000,000 shares of common stock of Alleghany Corporation at $10 per share. The Murchisons, in turn, acquired a put on the same number of shares on the same terms — in effect, the right to require Gamble-Skogmo to exercise its call. The original expiration date of both options was May 31, 1963. On May 29, 1963, the contracting parties extended the expiration date of Gamble-Skogmo's call to June 30, 1963, and of the Murchisons' put to July 31, 1963. As a result of subsequent extension agreements under date of June 29 and July 29, 1963, the expiration dates of the put and the call ultimately became October 25 and October 15, 1963, respectively. On July 1, 1963, Gamble-Skogmo entered into a contract to sell 1,600,000 shares of Alleghany common to a third party at $10.50 per share. The record before the District Court was silent as to whether any of the options were ever exercised or the contract of sale executed.

Miller, a stockholder of Alleghany, argued that the transactions between the Murchisons and Gamble-Skogmo on June 28 and July 29, 1963, matched with Gamble-Skogmo's unrelated July 1 transaction, amounted to a "purchase and sale" of an "equity security of" Alleghany Corporation within a six-month period, and sought recovery of Gamble-Skogmo's profits therefrom pursuant to section 16(b). The District Court granted Gamble-Skogmo's motion for summary judgment on the ground that the June 28 transaction, if it was a "purchase," could not be deemed a purchase of an "equity security of" Alleghany.[35] In support of this holding, the opinion quoted the following selected language from the 1934 Act's definition of "equity security": "any stock or similar security; or any security convertible . . . into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right."[36] The Court then narrowed its attention to the terms "warrant" and "right to subscribe" and concluded:

> [W]arrants and rights have certain specific characteristics important to the present problem: (1) they are issued by the corporation, (2) they are negotiable, and (3) they are traded as securities.

35 223 F. Supp. at 793-94.

36 Section 3(a)(11), 48 Stat. 882, 15 U.S.C. § 78c(11). The full definition is:

> The term "equity security" means any stock or similar security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security.

> The "agreement of put and call" with which we are concerned has none of these characteristics. It is not issued by Alleghany but by Murchison. . . . It is not negotiable or transferrable; there is a provision against transfer. It cannot be traded as a security on an exchange or any place else; this follows from its non-negotiable character and also from the fact that it is one of a kind.
>
> The "agreement of put and call" thus could never be a "security" as that term is defined in the Uniform Commercial Code § 8-102 (Proposed Final Draft 1950):
>
> "[an] instrument which is issued in bearer or registered form . . . of a type commonly dealt in upon securities exchanges or markets or commonly recognized in any area in which it is issued or dealt in as a medium for investment."[37]

Whatever the merits of the criteria by which the court defines "warrants and rights," it is immediately apparent that those definitions do not exhaust the potential applicability of section 3(a)(11) to puts and calls. That an option to buy — which is what Gamble-Skogmo acquired from the Murchisons — is a class of interest subsumed under the generic term "right . . . to purchase" seems clear both from the plain meaning of the words and from the sense in which they have been used by legal writers.[38] The inclusion of "right to purchase" in the section 3(a)(11) definition of "equity security" would therefore seem literally to require the conclusion that an "option to buy" is comprehended by that section. Moreover, the words omitted in the portion of section 3(a)(11) quoted by the court are "with or without consideration"; that an option to buy common stock is a "security convertible, with . . . consideration, into such a security" seems equally clear. In holding that "equity securities" must be "(1) issued by the corporation, (2) . . . negotiable, and (3) . . . traded as securities," the *Miller* opinion goes considerably beyond the literal language of section 3(a)(11). The criteria it enunciates for defining an "equity security" require further examination in light of the purpose and function of section 16(b).

The tests numbered (2) and (3) are not very different in practical import: if obligations are nonnegotiable, they obviously cannot be "traded as securities" — or as anything else. There is certainly nothing in the language of the statute or the economic context in which it operates to suggest that transferability was intended by Congress to be an element of the definition of "equity security"; a nontransferable option can, of course, also be utilized for speculative purposes.[39] To the extent that it defines "equity security" in terms of a "security" as defined in section 3(a)(10), section 3(a)(11) obviously includes many instruments which can be written in nontransferable form: even common stock, which is certainly an "equity" security by any definition, may be

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37 223 F. Supp. at 795.

38 See, *e.g.*, Cook & Feldman, *Insider Trading Under the Securities Exchange Act*, 66 Harv. L. Rev. 385, 394 (1953); Hardee, *Stock Options and the "Insider Trading" Provisions of the Securities Exchange Act*, 65 Harv. L. Rev. 997, 998 n.7 (1952); Meeker & Cooney, *The Problem of Definition in Determining Insider Liabilities Under Section 16(b)*, 45 Va. L. Rev. 949, 961 (1959); Yourd, *Trading in Securities by Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act*, 38 Mich. L. Rev. 133, 136 (1939); Comment, 59 Yale L.J. 510, 514n (1950); *cf.* 2 Loss, Securities Regulation 1075 (2d ed. 1961) ("stock purchase rights and other options").

39 See S. Rep. No. 1455, 74th Cong., 2d Sess. 56 (1934).

subject to restrictions upon alienation — as, for example, in a small, family-owned corporation.

Because the typical put or call is in fact not only transferable but issued in bearer form,[40] few such instruments are likely to be excluded from the operation of section 16(b) by virtue of this aspect of *Miller*. To the extent, however, that the holding rests on the reasoning that the options in question were not "issued by" Alleghany Corporation, its impact is broad enough to extend considerably beyond the individual characteristics of the particular instruments involved in the *Miller* case and reach the majority of puts and calls commonly traded in the over-the-counter securities market.

The crucial word in the phrase "equity security of such issuer," as that phrase is used in section 16(b), is the preposition "of." The *Miller* Court apparently construed "of" to mean "issued by." Since the word "of" is part of the everyday language of men, resort should have been had in the first instance to its signification in common usage.[41] Defining the word "of" to mean "indicating the possessive relationship, otherwise expressed by the possessive case; belonging or *pertaining to*" not only eliminates the necessity for reading a basic English preposition as a legal term of art, but is altogether a more satisfactory means of effectuating the statutory purpose.[42] The reading "equity security *issued by* such issuer" looks only to the formalities attendant upon creation of the instrument, and in so doing eliminates from the scope of section 16(b) a whole class of instruments whose economic significance in the present-day market is considerable.[43] The reading "equity security *pertaining to* such issuer" or even "equity security *representing an interest in* such issuer," on the other hand, looks to the nature of the legal relations evidenced by the instrument rather than to the technicalities attendant upon its creation, and in so doing comprehends the whole class of instruments subject to speculative abuse without requiring any artificial stretching of ordinary language.

In determining whether particular transactions amounted to "purchases" or "sales" within the meaning of section 16(b), the Courts of Appeals have consistently looked to whether the *transaction* was of a kind in which inside information could possibly be abused in the manner which Congress was seeking to eliminate.[44] The principle was expressly reaffirmed by the Second Circuit in *Miller*. Where the question is whether particular instruments are "equity securities" within the meaning of the same section, the same kind of weight should be given to the demonstrated susceptibility of the *instruments* to manipulation for purposes of short-swing speculation.

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40 REPORT ON PUT AND CALL OPTIONS 11-12.

41 Shaw v. Dreyfus, 172 F.2d 140, 142 (2d Cir. 1949).

42 MERRIAM WEBSTER'S NEW INTERNATIONAL DICTIONARY 1689 (2d ed. 1957). (Emphasis added.) See Comment, 69 YALE L.J. 868, 873-74 (1959).

43 See text at note 20, *supra*.

44 Roberts v. Eaton, 212 F.2d 82, 84 (2d Cir. 1954), *cert. denied*, 348 U.S. 827 (1954); *accord*, Adler v. Klawans, 267 F.2d 840, 848 (2d Cir. 1959); Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959); Shaw v. Dreyfus, 172 F.2d 140, 142 (2d Cir. 1949), *cert. denied*, 337 U.S. 907 (1949); *cf.* Booth v. Varian Associates, 334 F.2d 1 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965); Falco v. Donner Foundation, Inc., 208 F.2d 600, 603 (2d Cir. 1953); see generally 2 LOSS, SECURITIES REGULATION 1069-70 (2d ed. 1961).

The legislative history of section 16(b) leaves little room for doubt that speculative abuses accomplished by means of options — and options, indeed, granted by insiders to third persons in transactions to which the corporation was not a party[45] — were among those the statute was specifically designed to eliminate. The Senate report on the bill which ultimately became the Securities Exchange Act of 1934 describes section 16(b) as designed to protect the public from "the unscrupulous employment of inside information by large stockholders . . . to acquire and profit by information not available to others" and "the flagrant betrayal of their fiduciary duties by directors and officers" who use similar information "to aid them in their market activities,"[46] and discusses in considerable and complex detail some of the more "glaring example[s]" showing "how urgent was the need" for federal regulation[47] directed against such "predatory operations."[48] The significant aspect of those examples, for present purposes, is that the utilization of options in various ways was an integral part of each of them.[49] Congress thus not only recognized the susceptibility of options to speculative abuse, but saw them as the very root of the evils the legislation was intended to remedy:

> the granting of options to pools and syndicates has been found to be at the bottom of most manipulative operations, because the granting of these options permits large-scale manipulations to be conducted with a minimum of financial risk to the manipulators.[50]

The "minimum financial risk" is a particularly striking feature of transactions in which options are sold instead of exercised. During a period studied in the *Report on Put and Call Options,* some 26 per cent of all exercised call options were exercised by brokers to whom the optionees had sold.[51] The *Report* sets out some of the advantages of selling an option prior to its expiration date:

> Put and call brokers and dealers perform certain services as an accommodation for customers in order to make option buying more attractive. One of the most important of these services is the repurchase of options from customers at or near the expiration date in order to exercise them. This service gives the customer two advantages. First, the customer is not required to put up any margin to realize the profit in his option. If he were to exercise the option himself and liquidate his position on the same day, he would have to deposit 25 per cent margin with his broker. Secondly, where the customer has held the option for more than six months, he can establish a long-term capital gain for tax purposes by selling his option.[52]

The speculative leverage inherent in the purchase and sale of puts and calls may be illustrated by the following example. With the market in *X* common rising steadily, *A* purchases a call on 1,000 shares, exercisable at 40 for a period of six months and ten days. The price of the call, including brokers' fees, is $5,000, or one-eighth the amount of the investment which would be

45 See S. Rep. No. 1455, 74th Cong., 2d Sess. 56 (1934).
46 *Id.* at 55.
47 *Id.* at 56.
48 *Id.* at 68.
49 See, *e.g.*, the evidence relating to American Commercial Alcohol Corp. *Id.* at 56-59.
50 H.R. Rep. No. 1383, 74th Cong., 2d Sess. 10-11 (1934).
51 Report on Put and Call Options 72.
52 *Id.* at 71.

required if *A* chose instead to purchase 1,000 shares of *X* common at 40.[53] If the price of *X* common drops suddenly to 20, and remains there during the life of the option, *A* has lost only $5,000 instead of $20,000; if the market rise which initially induced him to take the call continues, however, he can recover his $5,000 investment several times over: the return on his investment will be 200 per cent when *X* reaches 55, 300 per cent when it reaches 60, etc.

Suppose *A* is an insider of *X Corporation* who in anticipation of a market rise purchases the call for $5,000 on April 15, when the market is 40; suppose further that on April 23, when the market is 60, he acquires inside information on the basis of which a sharp decline can be predicted. The easiest means by which *A* can realize maximum gain before the decline is to sell the call, probably for $25,000[54] (400 per cent of his cash investment) before the information is publicly available. Had he purchased common stock on April 15 and sold it on April 23, his profit, in the same dollar amount, would have been recoverable in its entirety in behalf of *X Corporation.* The only distinction between that alternative and the purchase and sale of the call is the amount of the initial cash outlay required. This distinction hardly seems sufficient to hold that a call on common stock is not an "equity security of" *X*.

There are thus two classes of cases in which section 16(b) can appropriately be applied to put and call options: those in which a "purchase and sale" of the underlying security has been effected by means of such instruments, and those in which the options are themselves the subject of a "purchase and sale." The recapture of profits from these two kinds of transactions would not, of course, exhaust the speculative potentialities of puts and calls; section 16(b) cannot, and was obviously never intended to, reach every species of transaction from which an insider might conceivably profit.

Despite the irrelevance of subjective intention to the operation of its objective test,[55] section 16(b) was adopted as a legislative solution to a particular problem, and the effectiveness of its "crude rule of thumb"[56] must ultimately depend upon its application and construction in light of that statutory purpose. But the application of the recovery provisions to transactions without regard to the subjective intention of the parties could result in the recovery of the profits realized, even though the transactions were entered into for legitimate business reasons and with no manipulative purpose. In view of the particular susceptibility of puts and calls to manipulative purposes and the substantial unresolved problems affecting the legal consequences of their use, their utilization should be avoided whenever alternative means are available for accomplishing the business purpose in question.

53 *Id.* at 85.

54 The premium price plus the difference between exercise price and current market. The premium he receives would normally be as high as or higher than the premium he paid, because premiums on puts and calls tend to increase in relation to increases in the market price of the underlying common. *Id.* at 85. If A sold the call to a broker at or near the expiration date, rather than so early as in our hypothesis, he would still obtain, in the typical case, the amount of the difference between exercise price and market price of the common, less brokers' commissions and taxes. *Id.* at 71.

55 Smolowe v. Delendo Corp., 136 F.2d 231, 235-36 (2d Cir. 1943).

56 *Hearings on S. 56 and S. 97 Before the Senate Committee on Banking and Currency*, 73d Cong., 1st & 2d Sess. 6557 (1934), quoted in Smolowe v. Delendo Corp., *supra* note 55, at 235.