Straddle Not a Purchase and Sale under SEC Section 16(b)

CASE COMMENTS

STRADDLE NOT A PURCHASE AND SALE UNDER SEC SECTION 16(b)

The Securities Exchange Act of 1934[1] regulates the secondary distribution of securities listed on the national exchanges, its main purpose being to protect the investing public from the abusive use of the facilities provided on the national exchanges.[2] To accomplish this purpose, the act imposes a measure of regulatory control on the brokers and dealers and and the methods and practices they use.

One area of particular concern to Congress in its consideration of market abuses was trading by insiders.[3] The investigation preceding the passage of the act revealed that insiders frequently utilized knowledge obtained from their elevated positions within their companies to reap large profits from the market to the detriment of the outsider shareholders.[4] Congress sought to remedy such invidious practices by including section 16 in the act.[5] The subsection of particular relevance to the following discussion is subsection (b). The underlying rationale of section 16(b) is that removal of the possibility of insider profit will

---

[1]Securities Exchange Act of 1934, 15 U.S.C. § 78(a)-78(h)-1 (1958).

[2]Section 2 of the act sets forth in detail the necessity for security regulation. See H.R. Rep. Nos. 1383, 1838, 73d Cong., 2d Sess. (1934); S. Rep. No. 1455, 73d Cong. 2d Sess. (1934); Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir. 1943); Sook and Feldman, Insider Trading Under the Securities Exchange Act, 66 Harv. L. Rev. 385, 612 (1953).

[3]Section 16(a) of the Securities Exchange Act of 1934 defines as an insider: "Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered on a national securities exchange, or who is a director or an officer of the issuer [corporation]of such security...."

[4]S. Rep. No. 1455, 73 Cong., 2d Sess. 32, 33, 47 (1934).

[5]Subsection (a) is based on the theory that if such abusive transactions are publicized they will be discontinued. Publication under subsection (a) is achieved by the mandatory filing with the Commission of a report setting forth the current holding of the insider. The theory underlying subsection (b) is that if the possibility of profit is removed, short-swing trading by insiders will be discontinued. This is accomplished by providing that all insider profits occurring from the purchase and sale of the corporate stock within a six month period may be recovered by the corporation. Subsection (c) absolutely prohibits short sales or "sales against the box" and prevents deceptive stock manipulation. Cook and Feldman, Insider Trading Under the Securities Exchange Act, 66 Harv. L. Rev. 385, 386-87 (1953).

bring about a discontinuance of "short-swing"[6] trading by insiders. Section 16(b) provides that profits in "equity securities"[7] realized by the insider from transactions completed within six months may be recovered either directly by the corporation with whom the insider is associated or through a derivative action[8] initiated by any security holder.

Before a cause of action can be established, the plaintiff[9] must show that the profit realized was obtained "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

---

[6]The term "short-swing" profit relates to the profit received by a person within a period of six months. For the computation of the actual profit realized from short-swing trading, see, Cook and Feldman, Insider Trading Under the Securities Exchange Act, 66 Harv. L. Rev 612 (1953). The general formula used to determine profits was set forth in Smolowe v. Delendo Corp., 136 F.2d 231, 239 (2d Cir. 1943) as follows: "The only rule whereby all possible profits can be surely recovered is that of lowest price in, highest price out—within six months...." Therefore, profits may be found even though the transactions as a whole result in a loss.

[7]The Securities Exchange Act of 1934 § 3(a)(11) defines the term "equity security" as "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 for the protection of investors, to treat as an equity security." See Loss, Securities Regulation 1095 (2d ed. 1961). It is generally stated by legal commentators that "options, calls, spreads and straddles should also be considered equity securities if they confer upon their holders a right to acquire an equity security." Cook and Feldman, Insider Trading Under the Securities Exchange Act, 66 Harv. L. Rev. 385, 394 (1953). There do not appear to be any cases on this point other than the principal case of Silverman v. Landa, 306 F.2d 422 (2d Cir. 1962).

[8]The stockholder's derivative suit is a class action that developed from equity. The suit allows the shareholder to enforce a corporate right against insiders or outsiders where those in control of the corporation refuse to have the corporation sue directly. Section 16(b) specifically provides for derivative shareholder actions to recover insider short-swing profits if the corporation fails within sixty days after the shareholder's request to institute a direct action to recover insider profits. Arbetman v. Playford, 83 F. Supp. 335 (S.D.N.Y. 1949); Dottenheim v. Emerson Elec. Mfg. Co., 7 F.R.D. 195 (E.D.N.Y. 1947).

[9]In a derivative action instituted under § 16(b) the plaintiff does not have to be a stockholder as in the usual derivative action against a corporate official. Blau v. Lamb, 31 U.S.L. Week 1146 (2d Cir. March 8, 1963). The plaintiff may be a debenture holder or a bondholder. Also, a plaintiff in a derivative action under § 16(b) need not have been a security holder at the time the cause of action arose. Bemisch v. Cameron, 81 F. Supp. 882 (S.D.N.Y. 1948). Further, the motive of the plaintiff in purchasing the security is immaterial. Magida v. Continental Can Co., 12 F.R.D. 74 (S.D.N.Y. 1951).

months. . . ."[10] Although seemingly simple to define, the term "purchase and sale" is extremely troublesome and elusive.[11]

The difficulty of defining "purchase and sale" within section 16(b) presented a novel question in the recent case of *Silverman v. Landa*.[12] Plaintiff Silverman, a shareholder of Fruehauf Trailer Company, brought an action both derivatively and in his own behalf as an individual stockholder to recapture a short-swing profit allegedly realized by defendant Landa, a director of Fruehauf. The issues raised were submitted to the court on cross motions for summary judgment. The court granted defendant's motion and denied plaintiff's cross motion for summary judgment. The Court of Appeals affirmed.[13]

The facts were undisputed. On October 27, 1959, Landa was a director and beneficial owner of 2,000 shares of Fruehauf common stock, which was registered on a national exchange. On that date, Landa issued three options to a "put and call dealer"[14] in respect

[10]Securities Exchange Act of 1934 § 16(b), 15 U.S.C. 78 p (b) (1958). [Emphasis added.] Section 3(a)(13), (14) of the act is the definitive section wherein the terms "purchase" and "sale" are defined. This pertinent section is set forth in the text, infra at note 22.

[11]Considerable difficulty arises when § 16(b) is used to recover short-swing profits for the transfer of stock "rights" as distinguished from the outright purchase and sale of the underlying security on the market. Generically, "rights" include option contracts (e.g., puts and calls) and stock warrants, but for the purpose of § 9 of the act, it should be noted, "The terms 'put,' 'call,' 'straddle,' 'option,' or 'privilege' as used in this section shall not include any registered warrant, right or convertible security." A finding that a purchase and sale is effected in respect to such rights depends upon the change or effect on the beneficial ownership of the security itself. Stella v. Graham-Paige Motors Corp., 232 F.2d 299 (2d Cir. 1956); Falco v. Donner Foundation, Inc., 208 F.2d 600 (2d Cir. 1953); Shaw v. Drefus, 172 F.2d 140 (2d Cir. 1949); Park & Tilford v. Schulte, 160 F.2d 984 (2d Cir. 1947); Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir. 1943); Truncale v. Blumberg, 80 F. Supp. 387 (S.D.N.Y. 1948); Loss, Securities Regulation 467, 1097 (2d ed. 1961); 59 Yale L.J. 510 (1950).

[12]200 F. Supp. 193 (S.D.N.Y. 1961).

[13]306 F.2d 422 (2d Cir. 1962).

[14]The Put and Call Brokers and Dealers Association, Inc., is a voluntary association which adopts rules for the conduct of the business and the affairs of its members. The dealers generally arrange for the purchase and sale of new options on order, acting as principals rather than agents. The options are written in bearer form by the members of the Association, endorsed by the stock exchange houses and then bought and sold in the market. Section 9(b) of the act grants to the Commission the power to prescribe any rules or regulations necessary or appropriate to protect investors from any abusive practices regarding the purchase or sale of such options. However, the Commission has not adopted any rules in this respect, presumably because the other anti-manipulative weapons have worked so well that it is felt that such rules would only hamper the legitimate use of options. Loss, Securities Regulation 468, 1544 (2d ed. 1961); Filer, Understanding Put and Call Options 10 (1959).

to Fruehauf common stock: two "call"[15] options for 500 shares each and one "put"[16] option for 500 shares. As a result, defendant issued a "straddle"[17] and a separate call for a total "premium"[18] of $5,000 received from a put and call dealer. This matched put and call (i.e., a straddle) plus the extra call constituted a "strap."[19] The fairness of the premium was not in question. On October 20, 1960, immediately prior to the expiration date of the options, defendant's broker, who had guaranteed the performance of the options,[20] assumed Landa's obligations under the straddle in consideration of the payment by Landa of $3,300.

The two call options expired unexercised on October 26, 1960; however, the put option was exercised sometime after April 26, 1960 (six months after the date of issuance).

In the District Court and the Court of Appeals, the main issue[21] was whether a simultaneous issuance of a put and call in and of itself constitutes a purchase and sale of the underlying security under section 16(b). Unless answered in the affirmative, the premiums received by Landa for the three options were not within the purview of the act and not subject to recapture.

The theory advanced to support a purchase and sale was as follows: Upon the issuance of the call, there is a change in the beneficial ownership of the stock since the issuer has irrevocably bound himself to

---

[15] "A 'Call' is an option given for an agreed premium entitling the holder thereof at his option, to buy from the issuer of the option on or before a fixed date, a specified number of shares at a predetermined price." 200 F. Supp. at 195.

[16] "A 'Put' is an option given for an agreed premium entitling the holder thereof at his option, to sell to the issuer of the option on or before a fixed date, a specified number of shares at a predetermined price." Ibid.

[17] "A 'Straddle' consists of two separate options, one a 'Call' and one a 'Put.' Both the 'Put' and 'Call' are identical as to stock, contract price and time expiration." Ibid.

[18] "The 'Premium' is the amount of money paid by the buyer for an option." Ibid.

[19] A "strap" is a straddle with an extra call. A "strip" is a straddle with an extra put. Loss, Securities Regulation 468 (2d ed. 1961). Filer, Understanding Put and Call Options 106, 107 (1959).

[20] All puts and calls are bearer options and must be endorsed by a member of the national exchange, who thus guarantees performance by the issuer. 200 F. Supp. at 195; Filer, supra note 19.

[21] Two other issues were presented to the court: (1) Whether the issuance of a call constitutes a sale under § 16(c)(2) of the act so as to constitute a violation thereof if there is no delivery of the underlying security within 20 days of issuance, irrespective of whether the option is exercised; and (2) whether § 16(c)(2) extends a private right of action to an injured party where a violation occurs, and if so, whether the injured party can assert the same on behalf of Fruhauf. The District and Circuit Courts found for the defendant on the main issue and the first issue. Therefore, neither court passed upon the second issue.

sell the underlying security to the optionee upon demand. Similarly, by issuing the complementary put, the issuer has irrevocably bound himself to *purchase* the same underlying security. He has created rights on the part of the optionee and has undertaken correlative legal obligations neither of which existed prior to the issuance of the straddle. The short-swing profit allegedly gained is the amount of the profit realized from the premiums paid in consideration for the three options.

Once the contracts for purchase and sale are established, the contention is that this is sufficient to fulfill the "any contract" provision as defined in section 3(a) of the act. Section 3(a) (13) and (14) defines the term "purchase" and "sale" and the pertinent parts provide:

> "Section 3(a) 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."[22]

This theory was rejected by both the District Court and the Court of Appeals. Both courts recognized the existence of unilateral contracts[23] to purchase and sell; however, they reasoned that such contracts were not contracts to purchase and sell within the scope of section 16(b).[24] The fatal element seized upon by both courts was

---

[22]Securities Exchange Act of 1934 § 3(a), 15 U.S.C. § 78(c) (1958). [Emphasis added.]

[23]A contract for an irrevocable offer is an option. Such contracts are unilateral in nature since optionor is legally bound to keep his offer open for the specified period; whereas the optionee has no legal obligation until the option is exercised. 1 Williston, Contracts § 61A (3d ed. 1957).

[24] As reflected in both the District and Circuit Court opinions, a material factor used in determining whether a purchase or sale exists is the change in beneficial ownership. The District Court acknowledged that some change in the beneficial ownership occurred; however, the court said the asserted change was not susceptible of exact determination at the time the option was issued. Therefore, the court refused to find a purchase and sale based upon the change in beneficial ownership.

In 1935, the General Counsel of the Commission issued an opinion wherein he stated that a "director or stockholder is to be deemed to have acquired beneficial ownership of a security at the time when he takes a firm commitment for the purchase thereof, and to divest himself of such beneficial ownership at the time when he takes a firm commitment for the sale thereof." He further stated that if it was uncertain whether the conditions would occur prior to the exercise of the option, then it could not be said that the beneficial change occurred. Opinion of General Counsel of Commission, Release No. 116, March 9, 1935, 11 Fed. Reg. 10968.

In 1961, § 240.16a-6 relating to certain transactions subject to § 16(a) was the unilateral nature of the option contract. Since the option contract "fixes the obligation but not the rights of the issuer," the court said such a contract was not within section 16(b). The District Court said:

> "Not until the stock was 'Put' to him [Landa] or until he was 'Called' to sell would his option contract or continuing offer blossom into a purchase or sale contract within the purview of §16 (b)."[25]

Therefore, the court held that unless *both* the put (purchase) and the call (sale) were exercised no purchase and sale would occur.

In affirming, the Court of Appeals added that merely because the straddle was entered into for a speculative purpose, it did not follow that it constituted a purchase and sale of the type proscribed by section 16(b). The court said that section 16(b) was not intended to penalize *every* speculative transaction by an insider; otherwise, the act would not have categorically limited its impact to purchases and sales occurring within six months.[26]

This statement by the Court of Appeals that section 16(b) does not penalize every speculative transaction by an insider clearly illustrates the problem confronting the courts in interpreting the language of sections 3(a) and 16(b). Certainly the technical argument may be advanced that the court erred in its exclusion of the straddle from the sanction of 16(b); however, the ultimate decision lies with the courts as to whether they will interpret purchase and sale within section 16(b) in its broad or narrow sense.[27] The introductory clause of section 3(a) provides for such discretion.[28]

In *Ferraiolo v. Newman*,[29] the court concluded that "every transaction which can reasonably be defined as a purchase [or sale] will be so defined, if the transaction is of a kind which can possibly lend itself to the speculation encompassed by 16(b)." It would appear that *Ferraiolo* is in conflict with *Silverman;* however, the court in *Ferraiolo*

amended as follows: "The acquisition or disposition of any transferable option, put, call, spread or straddle shall be deemed such a change in the beneficial ownership of the security to which such privilege relates as to require the filing of a statement reflecting the acquisition or disposition of such privilege." 17 C.F.R. § 240.16a-6 (Supp. 1963). By recognizing the necessity of reporting such changes in beneficial ownership, it would seem that the Commission has changed its position concerning options; therefore, options should be considered as effecting the necessary change in ownership to bring them within the purview of § 16(b) of the act.

[25] 200 F. Supp. at 196.

[26] 306 F.2d at 425.

[27] Blau v. Lehman, 368 U.S. 403, 411 (1962) (dictum).

[28] Securities Exchange Act of 1934 § 3(a), 15 U.S.C. 78c(a)(1958).

[29] 259 F.2d 342, 345 (6th Cir. 1958).

acknowledged that an analysis of the series of decisions[30] relating to purchase and sale showed that the approach to the problem of defining purchase and sale is pragmatic rather than technical. "Each case has been decided on its own facts, and the enunciation of a 'black letter rubric' has been expressly avoided."

The pragmatic approach taken by the District and Circuit Courts in *Silverman* appears to be quite reasonable when considered upon its facts, i.e., when considered in the light of the one year option contracts. Little danger arises from insider profits when the option extends for a period of greater than six months, because the possibility of abuse of insider information and manipulation varies inversely with time. Congress has recognized that the longer stock is held, the greater the likelihood that the market will react to factors unforeseen by the insider.[31] This is evident from the arbitrary six months limitation placed on insider profits which is designed to overcome the difficult burden of proving the link between the profit realized and the use of the inside information.[32]

The efficacy of the straddle becomes apparent when it is accompanied by an extra put or call.[33] By issuing a "strap" (a matched put and call plus an extra call), the issuer shows confidence that the price of the stock will drop; if this speculation is successful, he will not lose on the premiums received for the two calls, since these options will go unexercised. He will lose to some extent, however, on the put. His profit will depend upon the difference between the premiums received for the three options minus the loss suffered from the exercise of the put, plus commission costs by the broker. Should the market take an unexpected upswing, however, the issuer could offset his loss on the calls by the amount of the premium received for the put. Thus, the issuer can provide an element of security against losses by using

---

[30]Id. at 344. The cases analyzed appear on this page.

[31]S. Rept. No. 792, 73d Congress. 2d Session. 9 (1934).

[32]The necessity for the six months limitation was succinctly stated before the Senate Committee in the testimony of Thomas G. Corcoran, chief spokesman for the draftsmen of the act. 15 Hearings before Senate Committee on Banking and Currency on S. Rep. 84, 56, and 97, 73rd Cong. 2d Sess. 6557 (1934). The constitutionality of the six months limitation was upheld in Smolowe v. Delendo Corp., 136 F.2d 231, 239 (2d Cir. 1943), cert. denied, 320 U.S. 751 (1943).

[33]The straddle alone may be used as a speculative device to gain a short-term profit in the form of premiums. Using his inside knowledge, the insider may predict with considerable accuracy that the price will not move appreciably within the limited period of the option. The insider's market position would not be jeopardized if the stock moved only a few points either way, unless the movement was sufficient to offset the total amount of the broker's commission fee for the exercise of the option. Filer, Understanding Put and Call Options (1959).

the "strip" or "strap" market position.[34] Therefore, it is apparent that the issuer can utilize his inside information to obtain a profit in the form of premiums without fear of recapture under section 16(b), for under the rationale of *Silverman* a purchase of the underlying security would occur only if the put alone were exercised. Since a purchase *and* sale are necessary to invoke section 16(b), no recapture of the profits realized in the form of the premiums can result. The only way to have the necessary purchase and sale is if both the put and the call were exercised (in which case little or no profit would remain), or unless the option, whether exercised or not, is included within the "any contract" provision of section 3(a). Therefore, if the doctrine of *Silverman*—that insider straddles unexercised or partially exercised within a six months period do not fall within the scope of section 16(b)—is applied only to straddles issued for periods of *more than* six months, it does not appear that the court has departed from the legislative purpose of the act, for the profit will accrue after the six months period. But, if partially unexercised short term straddles, strips or straps (those issued for less than six months) are excluded from the act altogether, then it is dubious whether the legislative purpose is being accomplished, for clearly the insider is profiting from the premiums received from his issuance of short term option contracts.

The technical reasoning relied upon to exclude straddles from the "any contract" provision in section 3(a), however, does not seem to indicate that the *Silverman* doctrine will be applied only to straddles exceeding six months periods. The disturbing fact remains that the technical rationale actually used in *Silverman* excludes all straddles, unless both the put and the call are exercised irrespective of their duration, from the term purchase and sale. If this is true, then options may be issued for periods of less than six months and the insider's information may greatly enhance the possibility of turning over a conservative short-swing profit in the form of a premium without any fear of corporate recovery. A rule allowing insiders to realize profits from such practices would not be in accord with the legislative purpose of the act.

The danger of permitting insider speculation of short term straddles can be eliminated either by judicial decision or through admin-

[34]The economic purpose of the option, singly or in combination, "is to serve as insurance against future market movements. For example, a person who is long may purchase a put as insurance that he will be able to sell if the market falls to a certain level, and a person who is short may purchase a call to ensure that he will be able to cover (buy) if the market rises to a certain figure." Loss, Securities Regulation 468 (2d ed. 1961).