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Recent Decisions

SECURITIES EXCHANGE ACT OF 1934 — INSIDER TRADING — CONVERSION OF PREFERRED INTO COMMON STOCK HELD NOT A SALE OF THE STOCK UNDER SECTION 16(b)

Blau v. Lamb, 363 F.2d 507 (2d Cir. 1966).

Prior to the enactment of the Securities Exchange Act of 1934 (Exchange Act),¹ it was not unusual for officers, directors, and influential stockholders to abuse their positions of trust by utilizing confidential information to obtain large profits on stocks of their corporations traded on the national security exchanges.² Speculative profits by insiders were accepted by the financial community as part of the emolument for serving as a corporate officer or director.³ In order to protect the investing public from these practices and to establish a fair and honest market in security transactions, the Exchange Act was enacted.⁴ Section 16(b)⁵ was incorporated into the act to implement its prevailing purpose by making it unprofitable for any insider to engage in short-swing speculation.⁶ Section 16(b) provides that the corporation or an individual stockholder acting in its behalf may bring a suit to recover any short-swing profit realized through a purchase and sale or sale and purchase of any equity security⁷ of the issuer within a period of less than six

¹ 48 Stat. 881, as amended, 15 U.S.C. §§ 78a-hh (1964) [hereinafter cited as Exchange Act].

² Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations by using their positions of trust and the confidential information which came to them to aid them in their market activities. Closely allied to this type of abuse was the unscrupulous employment of inside information by large stockholders who, while not directors and officers, exercised sufficient control over the destinies of their companies to enable them to acquire and profit by information not available to others. S. REP. NO. 1455, 73d Cong., 2d Sess. 55 (1934).

³ For a comprehensive study of the practices leading up to the enactment of § 16(b), see Cook & Feldman, *Insider Trading Under the Securities Exchange Act* (pt. 1), 66 HARV. L. REV. 385 (1953); Yourd, *Trading in Securities by Directors, Officers and Stockholders: Section 16 of the Securities Exchange Act*, 38 MICH. L. REV. 133 (1939). See generally S. REP. NO. 1455, 73d Cong., 2d Sess. 29-68 (1934); S. REP. NO. 792, 73d Cong., 2d Sess. 7-9 (1934); H.R. REP. NO. 1383, 73d Cong., 2d Sess. 13-14 (1934).

⁴ See H.R. REP. NO. 1383, 73d Cong., 2d Sess. 13 (1934).

⁵ Exchange Act § 16(b), 48 Stat. 896 (1934), as amended, 15 U.S.C. § 78p(b) (1964).

⁶ *Smolowe v. Delendo Corp.*, 136 F.2d 231, 235 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

⁷ "Equity security" is defined as "any stock or similar security; or any security con-

months by an officer,⁸ director,⁹ or beneficial owner¹⁰ of more than ten percent of any class of equity security.

Because of the difficulty in establishing a conscious misuse by an insider of confidential information to make a profit, section 16(b) imposes on these individuals a "prophylactic" measure of absolute liability for a purchase followed by a sale within six months.¹¹ Thus, a showing of actual possession or use of inside information is not required, and the fact that the insider did not make use of confidential information or acted in good faith is irrelevant.¹² In *Smolowe v. Delendo Corp.*,¹³ the court recognized the need for having an objective criterion, stating that "it is apparent . . . from the language of section 16(b) itself, as well as from the Congressional hearings, that the only remedy which the framers deemed effective for this reform was the imposition of a liability based upon an objective measure of proof."¹⁴ The court also stated that in order to effectuate the broadly remedial purposes of the

vertible, 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" Exchange Act § 3(a)(11), 48 Stat. 884 (1934), as amended, 15 U.S.C. § 78c(a)(11) (1964).

⁸ "Officers" is defined to mean "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." SEC Exchange Act Rule 3b-2, 17 C.F.R. § 240.3b-2 (rev. ed. 1964).

⁹ "Director" is defined in Exchange Act § 3(a)(7), 48 Stat. 883 (1934), as amended, 15 U.S.C. § 78c(a)(7) (1964) to mean "any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated."

¹⁰ See generally Feldman & Teberg, *Beneficial Ownership Under Section 16 of the Securities Exchange Act of 1934*, 17 W. RES. L. REV. 1054 (1966).

¹¹ See 59 HARV. L. REV. 998, 999 (1946).

¹² See *B. T. Babbitt, Inc. v. Lachner*, 332 F.2d 255, 257 (2d Cir. 1964); *Blau v. Lehman*, 286 F.2d 786, 791 (2d Cir. 1960), *aff'd*, 368 U.S. 403 (1962); *Smolowe v. Delendo Corp.*, 136 F.2d 231, 235-36 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943). The need for having an objective measure of proof was explained by Thomas Corcoran, chief spokesman for the proponents of the act, when he testified before a congressional committee:

That is to prevent directors receiving the benefits of short-term speculative swings on the securities of their own companies, because of inside information. The profit on such transaction under the bill would go to the corporation. You hold the director, irrespective of an intention or expectation to sell the security within six months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing. *Hearings on S. Res. 84 (72d Cong.) and S. Res. 56 & 97 (73d Cong.) Before the Senate Committee on Banking and Currency*, 73d Cong., 1st & 2d Sess., pt. 15, at 6557 (1934).

¹³ 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

¹⁴ *Id.* at 235.

statute it would be necessary to "squeeze" all possible profits which were reaped because of insider information.¹⁵

Section 16(b)'s "crude rule of thumb"¹⁶ regulatory mechanism has been called arbitrary,¹⁷ for although information has been unfairly used the section has no impact on a mere purchase or a sale based on such information. Moreover, the section does not protect the people who bought from or sold to the insider but instead aids the corporation which suffered no injury.¹⁸

The operative words of section 16(b) are "purchase" and "sale." These terms are defined broadly by the statute, for section 3(a)(13) defines "purchase" to include "any contract to buy, purchase, or otherwise acquire"¹⁹ and section 3(a)(14) defines "sale" to include "any contract to sell or otherwise dispose"²⁰ of a security. One writer has stated that section 16(b) is one of the most ambiguous of all the "New Deal" legislation since there are many types of transactions which do not fit within or without the contemplation of the vague statutory language.²¹

Two approaches have been developed by the courts to determine whether a given transaction is a purchase or sale within the prohibition of the statute. The first is the strict or all-inclusive approach.²² This view states that in order to achieve the underlying purpose of the statute, the broadest possible construction must be given to the terms so as to eliminate the possibility of error inherent in discretionary administration.²³ The second view is the liberal or rule of reason approach which urges that the section's purpose can be accomplished without subjecting every transaction that might be

¹⁵ *Id.* at 239.

¹⁶ *Hearings on S. Res. 84 (72d Cong.) and S. Res. 56 & 97 (73d Cong.), supra* note 12, at 6557.

¹⁷ 2 LOSS, SECURITIES REGULATION 1088 (2d ed. 1961).

¹⁸ *Ibid.*

¹⁹ Exchange Act § 3(a)(13), 48 Stat. 884 (1934), as amended, 15 U.S.C. § 78c(a)(13) (1964).

²⁰ Exchange Act § 3(a)(14), 48 Stat. 884 (1934), as amended, 15 U.S.C. § 78c(a)(14) (1964).

²¹ See Comment, 64 MICH. L. REV. 474, 476 (1966).

²² Comment, 11 STAN. L. REV. 358, 359 (1959).

²³ *Ibid.* See, e.g., *Heli-Coil Corp. v. Webster*, 352 F.2d 156 (3d Cir. 1965) (conversion of bond for common stock held a sale); *Blau v. Mission Corp.*, 212 F.2d 77 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954) (exchange by an insider corporation of stock held by it for stock of its less than wholly owned subsidiary held a sale); *Walet v. Jefferson Lake Sulphur Co.*, 202 F.2d 433 (5th Cir.), *cert. denied*, 346 U.S. 820 (1953) (exercise of stock option of treasury stock held a purchase); *Blau v. Hodgkinson*, 100 F. Supp. 361 (S.D.N.Y. 1951) (exchange of stock of subsidiary for stock of parent pursuant to a plan of corporate simplification held a purchase).

a purchase and sale within the definition section of the act to its sanctions,²⁴ the controlling factor being the intent of Congress and not the semantic problem of defining terms.²⁵ Under this view, section 16(b) is not applied if a given transaction poses no possibility of insider abuse.²⁶ However, if a given transaction could produce the result 16(b) was designed to prevent, its sanctions are applied automatically without examining the details of the transaction.²⁷

Park & Tilford, Inc. v. Schulte,²⁸ was the first significant case to consider whether a conversion of preferred into common stock was a purchase. The court held that such a conversion followed by a sale within six months constituted a purchase and sale within the statutory language of 16(b):

Whatever doubt might otherwise exist as to whether a conversion is a "purchase" is dispelled by definition of "purchase" to include "any contract to buy, purchase, or otherwise acquire." . . . Defendants did not own the common stock in question before they exercised their option to convert; they did afterward. Therefore they acquired the stock, within the meaning of the Act.²⁹

This very broad language might suggest that every conversion is a purchase within the meaning of the act, and several courts and writers have so interpreted it.³⁰ However, whether or not the *Park & Tilford* case embraced the strict or all-inclusive view³¹ is unclear because in arriving at its decision, the court considered such factors as the defendant's ownership of a controlling interest in the plaintiff corporation, the convertible preferred not being traded on an exchange, and the preferred not being protected by an anti-dilution provision and thus not the economic equivalent of the common.³²

²⁴ See Comment, *supra* note 22, at 359-61.

²⁵ *Ferraiolo v. Newman*, 259 F.2d 342, 344 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

²⁶ See, e.g., *Roberts v. Eaton*, 212 F.2d 82, 85-86 (2d Cir.), *cert. denied*, 348 U.S. 827 (1954); *Blau v. Mission Corp.*, 212 F.2d 80 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954); *Shaw v. Dreyfus*, 172 F.2d 140, 142 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949).

²⁷ *Blau v. Lamb*, 363 F.2d 507, 519 (2d Cir. 1966).

²⁸ 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947).

²⁹ *Id.* at 987.

³⁰ See *Blau v. Lehman*, 286 F.2d 786, 792 (2d Cir. 1960), *aff'd*, 368 U.S. 403 (1962); *Park & Tilford, Inc. v. Schulte*, 160 F.2d 984, 987 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947); Comment, *supra* note 22, at 359; Note, 107 U. PA. L. REV. 719, 721 (1959); 49 IOWA L. REV. 1346, 1351 (1964).

³¹ See Painter, *The Evolving Role of Section 16(b)*, 62 MICH. L. REV. 649, 660 (1964); 36 U. DET. L. J. 343, 347 (1959).

³² 2 LOSS, *op. cit. supra* note 17, at 1067; *Ferraiolo v. Newman*, 259 F.2d 342, 346 (6th Cir. 1958) (Stewart, J., explaining the *Park & Tilford* case).

One of the more recent decisions adopting the strict view is *Heli-Coil Corp. v. Webster*,³³ which was the first case to consider whether a conversion of a bond into common stock constituted a sale of the bond and purchase of the common within the prohibition of the statute. The defendant in *Heli-Coil* obtained bonds which were convertible into common stock, converted them, and sold the common within six months of the conversion date but more than eight months after purchasing the bonds. The court held that the conversion was a sale of the convertible security and a purchase of the conversion security. However, the court held that the defendant should be held liable only for the purchase aspect of the conversion for no profits were realized on the sale.³⁴ The court reached this result by concluding that these transactions were a purchase and sale within the definition section of the statute and thus 16(b) should apply without further inquiry.³⁵ The court felt that it did not have to consider whether a conversion in any way lent itself to the accomplishment of what the statute was designed to prevent, for if the transaction was a purchase and sale within the definition section of the act 16(b) would apply.³⁶ Although the court conceded that the common stock was the economic equivalent of the debentures and the conversion presented little opportunity for speculation, the court employed a mechanical or automatic rule.³⁷

Other courts have adopted a liberal view and have declined to extend the application of 16(b) to every transaction which conceivably would be a purchase and sale within the definition section of the statute.³⁸ In *Ferraiolo v. Newman*³⁹ it was held that the conversion of preferred into common was not a 16(b) purchase be-

³³ 352 F.2d 156 (3d Cir. 1965).

³⁴ *Id.* at 159.

³⁵ *Id.* at 165.

³⁶ *Id.* at 161.

³⁷ *Id.* at 164-65.

³⁸ See, e.g., *Petteys v. Butler*, 367 F.2d 528 (8th Cir. 1966) (conversion of preferred into common not a purchase); *Blau v. Max Factor & Co.*, 342 F.2d 304 (9th Cir.), *cert. denied*, 382 U.S. 892 (1965) (exchange of common for Class A stock not a purchase); *Blau v. Mission Corp.*, 212 F.2d 77 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954) (sale of stock to wholly owned subsidiary of a corporate insider not a sale); *Roberts v. Eaton*, 212 F.2d 82 (2d Cir.), *cert. denied*, 348 U.S. 827 (1954) (receipt of stock in reclassification not a purchase); *Shaw v. Dreyfus*, 172 F.2d 140 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949) (receipt of stock warrants distributed equally to all stockholders not a purchase); *Hennesey v. Fein*, 184 F. Supp. 86 (S.D.N.Y. 1958) (stock transaction rescinded with judicial approval not a purchase).

³⁹ 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959).

cause the receipt of preferred for common stock placed the insider in no better position to protect the post-conversion profit which he legally could have obtained had he sold the convertible security six months after the date of its original purchase.⁴⁰ The court also based its decision on the fact that the conversion was involuntary, the insiders not being in control of the corporation, that both stocks were listed and actively traded, and that the conversion privilege had an anti-dilution provision.⁴¹ The court's rule of reason approach to the problem was summarized by Judge Stewart (now Mr. Justice Stewart) when he said that "every transaction which can reasonably be defined as a purchase will be so defined, if the transaction is of a kind which can possibly lend itself to the speculation encompassed by Section 16(b)."⁴²

In *Blau v. Lamb*,⁴³ the Second Circuit Court of Appeals rejected the restrictive view and adopted the liberal approach. The plaintiff, a stockholder of Air-Way Industries, Inc., brought suit in the district court pursuant to section 16(b) of the Exchange Act to recover short-swing profits allegedly realized by Edward Lamb and Edward Lamb Enterprises, Inc. as a result of their dealings in the convertible preferred stock of Air-Way. The district court held Lamb and Enterprises liable for short-swing profits of over one million dollars on the ground that the conversion of preferred into common stock was a sale of the preferred because it lent itself to the accomplishment of what section 16(b) was designed to prevent and, when matched with the earlier purchase of preferred by Lamb and Enterprises, rendered them liable for insider profits.⁴⁴ The court of appeals reversed, however, holding that the conversion afforded the insiders no opportunity to realize a gain by speculative trading in the preferred and thus the conversion was not a sale under section 16(b).⁴⁵

The court refused to accept the district court's opinion that the existence of an opportunity for speculative profits could be inferred from the fact of control alone, for the court believed that such a conclusion would be inconsistent with its responsibility to analyze the conversion in order to establish whether the possibility of unfair

⁴⁰ *Id.* at 346.

⁴¹ *Id.* at 345.

⁴² *Ibid.*

⁴³ 363 F.2d 507 (2d Cir. 1966).

⁴⁴ *Blau v. Lamb*, 242 F. Supp. 151 (S.D.N.Y. 1965), *rev'd*, 363 F.2d 507 (2d Cir. 1966).

⁴⁵ 363 F.2d at 522.

speculative profits could exist even with full corporate control.⁴⁶ The court was unwilling to adopt the mechanical or automatic approach as had the Third Circuit in *Heli-Coil Corp. v. Webster*.⁴⁷ Instead, the court in *Lamb* considered whether the conversion of Air-Way preferred into Air-Way common "in any way lent itself to the accomplishments of what Section 16(b) was designed to prevent."⁴⁸ The court held that since the preferred and common stock were economic equivalents, and since Lamb and Enterprises had not changed their investment positions, the conversion gave the insiders no opportunity to realize a gain by speculative trading in Air-Way preferred.⁴⁹ Thus, the court held the conversion was not a section 16(b) sale of the preferred. In essence the court was ascertaining whether the pre-conversion profit was better protected by conversion instead of holding the preferred for sale at a later date. Since the conversion presented the insiders no possibility of making their pre-conversion profit more certain, the court reasoned that the insiders should not be penalized for doing indirectly what they could have done directly.⁵⁰

Although the issue involved in *Lamb* had not been previously considered by the Second Circuit, the Third Circuit in *Heli-Coil* had held that a conversion of a bond into common stock was a sale of the bond and a purchase of the common.⁵¹ Thus, the two circuits reached opposite results on similar facts due to their different interpretations. The Securities and Exchange Commission has resolved the conflict between the two circuits by enacting Amended Rule 16b-9,⁵² which provides for a "blanket" exemption for the conver-

⁴⁶ *Id.* at 521.

⁴⁷ See note 36 *supra* and accompanying text.

⁴⁸ 363 F.2d at 520.

⁴⁹ *Id.* at 522.

⁵⁰ *Id.* at 519. The "rule of thumb" aspect of § 16(b) was not subverted, for the Second Circuit did not examine whether the insiders acted in good faith or used confidential information. The court was simply stating that the insiders had not placed themselves in a position to make unfair use of insider information, since their technical conversion sale gave them no better opportunity to protect and reap their pre-conversion profits than if they had held the convertible security and sold it after six months. The court stated that § 16(b) would be applied automatically once it was determined that an insider had placed himself in a better position to protect and reap his pre-conversion profit.

⁵¹ See note 36 *supra* and accompanying text.

⁵² (a) Any acquisition or disposition of an equity security involved in the conversion of an equity security which, by its terms or pursuant to the terms of the corporate charter or other governing instruments, is convertible immediately or after a stated period of time into another equity security of the same issuer; shall be exempt from the operation of section 16(b) of the Act:

sion of any equity security convertible into any equity security of the same issuer.

Under section 16(b) the Commission has the power to exempt any transaction which falls within the letter of the statute but not its spirit.⁵³ By issuing Amended Rule 16b-9, the Commission has adopted the liberal view of the Second Circuit in *Blau v. Lamb*⁵⁴ and thus has agreed that a conversion does not make possible the unfair insider trading that section 16(b) was designed to prevent. The impact of the new rule will be that a conversion by an insider will not be considered a purchase or a sale within the prohibition of 16(b).⁵⁵

The *Lamb* case was correctly decided, because the conversion of preferred into common stock presented no possibility of unfair use of information by insiders.⁵⁶ The exchange of securities was within the definition section of the statute; however, the privilege of converting normally gives the owner of a preferred security a "continuing inchoate interest in the equity of the common shareholders which causes the value of the preferred to fluctuate with changes in the market price of the common."⁵⁷ This means that the apprecia-

Provided, however, That this section shall not apply to the extent that there shall have been either (1) a purchase of any equity security of the class convertible (including any acquisition of or change in a conversion privilege) and a sale of any equity security of the class issuable upon conversion, or (2) a sale of any equity security of the class convertible and any purchase of any equity security issuable upon conversion (otherwise than in a transaction involved in such conversion or in a transaction exempted by any other rule under section 16(b)), within a period of less than 6 months which includes the date of conversion. 31 Fed. Reg. 3391 (1966), amending 17 C.F.R. § 240.16b-9 (1964). The amendment became effective February 17, 1966.

⁵³ "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 section." Exchange Act § 16(b), 48 Stat. 896 (1934), as amended, 15 U.S.C. § 78p(b) (1964).

⁵⁴ 363 F.2d 507 (2d Cir. 1966). See Brief for the SEC as Amicus Curiae, pp. 17-19, *Blau v. Lamb*, 363 F.2d 507 (2d Cir. 1966).

⁵⁵ Professor Robert Hamilton has concluded that the SEC's decision to exempt substantially all conversions from § 16(b) is sound because Rule 10b-5 can be employed to plug any loopholes. However, he admits that the major difficulty with his approach is the requirement that the material failure to disclose must have been "in connection with the purchase or sale of any security." Hamilton, *Convertible Securities and Section 16(b): The End of an Era*, 44 TEXAS L. REV. 1447, 1494 n.150 (1966). It seems inappropriate to support Amended Rule 16b-9 on the basis that Rule 10b-5 will fill in the gaps when admittedly the 10b-5 alternative may encounter serious difficulties. See text accompanying notes 61-63 *infra*.

⁵⁶ The convertible preferred and common were economic equivalents, and the convertible security contained an anti-dilution provision.

⁵⁷ 59 HARV. L. REV. 998, 999 (1946). See GRAHAM, DODD & COTTLE, SECURITY ANALYSIS 603 (4th ed. 1962).

tion or depreciation in value of the conversion security will be at least equal to that of the convertible security.⁵⁸ Thus, the same pre-conversion profits can be made by converting and selling the conversion security as by selling the convertible security, because conversion simply results in postponing the date when a profit can be made.⁵⁹

The conversion offers an insider no greater opportunity to reap pre-conversion profits than if he held the convertible security, and the risks of holding either are the same, since the prices of the two move together.⁶⁰

In considering the sale and purchase aspects of conversion, it must be recognized that several transactions are factually distinguishable from *Lamb* because conversion in those cases affords the insider greater protection for pre-conversion or post-conversion profit. On the sale side of conversion, if a convertible security does not contain an anti-dilution provision, the price of the convertible security may be less than the conversion security because the market fears a stock split or stock dividend.⁶¹ Although arbitrage will prevent wide fluctuations in price which are unfavorable to a dilutable issue, temporary differentials between the market prices of the securities may still result. Thus, a person who owned the convertible security could obtain a small profit by quickly converting and selling the common stock.⁶² This situation would place an insider who converted in a better position to reap the pre-conversion profit than he would be if he had held the convertible security beyond the six months period. A better rule than the "blanket" exemption given to all equity conversions by Amended Rule 16b-9 would be for the conversion to be called a sale if subsequent events showed that a greater amount of the pre-conversion profit could be realized by holding the conversion security than by holding the convertible security for more than six months from the time of purchase.

There are two situations concerning the purchase aspect where conversion affords the insider additional protection for his post-conversion profit. First, in the absence of an anti-dilution provision, an insider who converted could be placed in a better position to obtain the post-conversion profit than if he had held the convertible

⁵⁸ Comment, 59 YALE L.J. 510, 524 (1950); 72 HARV. L. REV. 1392, 1394 (1959).

⁵⁹ See Comment, *supra* note 58, at 524.

⁶⁰ See *Blau v. Lamb*, 363 F.2d 507, 522 (2d Cir. 1966); Brief for the SEC as Amicus Curiae, p. 18, *Blau v. Lamb*, 363 F.2d 507 (2d Cir. 1966).

⁶¹ See Comment, 64 MICH. L. REV. 474, 483 (1966).

⁶² *Ibid.*

security.⁶³ Thus, a better rule would be that if subsequent events showed that an insider realized a greater amount of post-conversion profit by holding the conversion security during the six months from the time of conversion than by holding the convertible security, the conversion should be called a purchase.

Second, if the corporation redeemed its convertible preferred stock and favorable news followed the redemption, the insider who converted would be able to obtain a profit he could not have obtained had he held the convertible security. Under Amended Rule 16b-9 this transaction would be exempt. However, a better rule would be to consider the transaction a purchase if an insider converted within a six-month period preceding the favorable news. In this situation the insider has clearly improved his position to acquire profits which he would not have been able to realize had he failed to convert.

In conversion cases a particular transaction should be called a sale or purchase only if the defendant's conversion placed him in a position where his opportunity to protect and reap pre-conversion or post-conversion profit is greater than it would have been had he held the convertible security for more than six months. Once it is determined that an insider has placed himself in a preferred position, section 16(b) should be applied automatically. By using a rule of reason to analyze conversion transactions, the purpose of section 16(b) will be fulfilled and transactions will not be penalized which in no way enable an insider to enhance his position to acquire profits to which he would be legally entitled had he not converted.

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⁶³ *Ibid.*