

65-00190

IN THE
UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Docket No. 14,809

HELI-COIL CORPORATION,
Plaintiff-Appellee,

v.

REGINALD WEBSTER
Defendant-Appellant.

On Appeal from Judgment of the United
States District Court for the District
of New Jersey

BRIEF FOR THE SECURITIES AND EXCHANGE
COMMISSION, AMICUS CURIAE

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STATEMENT OF QUESTIONS INVOLVED

1. Does a conversion of debentures into common stock, where the debentures have not been called for redemption, constitute a sale of the convertible debentures and a purchase of the common stock within the meaning of Section 16(b) of the Securities Exchange Act, providing that certain corporate insiders will be liable to their corporation for profits "realized . . . from any purchase and sale, or any sale and purchase" of the corporation's equity securities "within any period of less than six months"?

2. If so, where the conversion of debentures occurred within six months of the time they were purchased but no sale of the stock was effected until more than six months after the purchase of the debentures, did an increase in the value of the debentures between the dates of their purchase and conversion constitute a "profit realized" subject to recovery under Section 16(b)?

3. Does common stock acquired by the voluntary exercise of a conversion privilege in debentures come within the exemption from Section 16(b) for any security "acquired in good faith in connection with a debt previously contracted"?

4. Is a conversion of debentures exempt from Section 16(b) as an "arbitrage" transaction where the conversion occurred almost four months after the debentures were purchased and there was no sale of the common stock acquired upon conversion until almost four months thereafter?

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BRIEF FOR THE SECURITIES AND EXCHANGE
COMMISSION, AMICUS CURIAE

The Securities and Exchange Commission ("Commission") submits this brief, amicus curiae, pursuant to the request of the Court for an expression of its views on the issues raised in this appeal. The appeal is taken from the judgment of the court below holding Reginald Webster, a director of Heli-Coil Corporation, liable under Section 16(b) of the Securities Exchange Act of 1934 ("Act"), 15 U.S.C. 78p(b), as amended, for profits allegedly realized by him from short-term dealings in the convertible debentures and common stock of Heli-Coil Corporation.

STATEMENT OF THE CASE

The facts are not disputed. Appellant Webster has been a director of Heli-Coil since its organization on October 16, 1958 (App. 12a).^{1/} On November 20, 1958, Mr. Webster purchased at par plus accrued interest \$60,000 principal amount of Heli-Coil's 5% callable debentures due November 1, 1973 (App. 12a). The debentures were convertible into common stock of Heli-Coil upon the option of the holders at any time prior to redemption or maturity at the conversion price of \$16 2/3 per share. The indenture under which the debentures were issued provided for an adjustment to the conversion price in situations where issuance by Heli-Coil of additional shares of common stock would dilute the interest of the debenture holders (App. 12a).

On March 18, 1959, within six months of the initial purchase, Mr. Webster exercised his conversion privilege and exchanged the debentures held by him for 3,600 shares of Heli-Coil's common stock, none of these debentures having been called for redemption (App. 13a). Between July 16, 1959 and September 1, 1959, Mr. Webster sold 1,300 shares of Heli-Coil common stock for a total consideration of \$90,771.01 (App. 13a).

^{1/} Pages in Defendant-Appellant's Appendix are referred to as "App. ___"; in Defendant-Appellant's Brief as "Def's. Br. ___."

The common stock of Heli-Coil was registered for trading on the American Stock Exchange on December 17, 1958, less than one month after Mr. Webster purchased the debentures and more than three months before Mr. Webster exercised his conversion privilege. The debentures have never been registered for trading on a national securities exchange but are traded from time to time in the over-the-counter market (App. 13a).

The opinion of the court below is reported at 222 F. Supp. 831 (D.N.J., 1963) and reprinted in full in Defendant's Appendix. The district court held that the conversion of the debentures into common stock constituted a sale of the debentures and a purchase of the stock within the meaning of Section 16(b). It further held that neither the exemption contained in Section 16 for securities "acquired in good faith in connection with a debt previously contracted" nor the exemption contained therein for arbitrage transactions was applicable to the transactions involved. The court concluded that Mr. Webster was liable for profits derived from the disposition of the debentures upon conversion within six months of his acquisition thereof and from the sale of common stock within six months after conversion of the debentures into common stock. It awarded judgment for Heli-Coil in the amount of \$116,544.36, without interest, representing the sum of (1) \$71,400, the difference between the initial purchase price of the debentures and their value on the conversion date, and (2) \$45,144.36, the difference between the value of the common stock on the conversion date and the price at which the stock was subsequently sold by Mr. Webster.

The Commission takes the position that the court below correctly held that a voluntary conversion of debentures into common stock constituted a sale of the debentures and a purchase of the common stock within the meaning of Section 16(b), that the stock acquired upon conversion is not exempt from Section 16(b) as a security "acquired in good faith in connection with a debt previously contracted" and that a conversion is not exempt from Section 16(b) as an arbitrage transaction. The Commission believes, however, that under the circumstances of this case no profit was realized by Mr. Webster from the disposition of the debentures upon conversion and that accordingly the judgment against Mr. Webster should have amounted to only \$45,144.36, the profits realized from the sale of the common stock within six months of the conversion.

STATUTES AND RULE INVOLVED

The Securities Exchange Act of 1934 is specifically designed, inter alia, "to insure the maintenance of fair and honest markets" in securities transactions (Section 2 of the Act, 15 U.S.C. 78b). Section 16(b) seeks to implement this general purpose by making it unprofitable for insiders to engage in short-swing speculation. The

preamble to the section expressly states that it was enacted "[f]or the purpose of preventing the unfair use of information which may have been obtained by [a] . . . director, or officer by reason of his relationship to the issuer"

The abuses which led to the enactment of Section 16(b) are discussed in the legislative history of the Act.^{2/} Among these abuses were transactions in which insiders, with advance knowledge of facts which would produce a rise in the market price of the stock of their company, bought stock at then current market prices and sold it when publication of the information had caused the anticipated rise to occur. There were also transactions in which insiders with advance knowledge of facts which would depress the market price sold their stock at then current prices and repurchased when publication had the anticipated effect. On occasion, the ability to obtain such profits led insiders to manipulate the market price of their stock by causing their corporation to follow financial policies calculated to produce sudden changes in market prices.^{3/}

^{2/} See S. Rep. No. 1455, 73d Cong., 2d Sess. 55-68 (1934); S. Rep. No. 792, 73d Cong., 2d Sess. 7-9 (1934); H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13-14 (1934).

^{3/} S. Rep. No. 792, 73d Cong., 2d Sess. 9 (1934).

To prevent such practices in an effective manner, and in view of the difficulty of proving intent on the part of insiders to speculate on inside information, Section 16(a) requires officers and directors of any corporation with securities registered under Section 12 of the Act and beneficial owners of more than 10% of any class of such securities to file reports of their holdings and transactions in any of the corporation's equity securities.^{4/} Section 16(b) provides for the recovery by or on behalf of the corporation of any profits realized by such persons from "any purchase and sale or any sale and purchase" of such securities within a six-month period. Section 3(a)(13), 15 U.S.C. 78c(a)(13), defines a "purchase" to include "any contract to buy, purchase or otherwise acquire," and Section 3(a)(14), 15 U.S.C. 78c(a)(14), defines a "sale" to include "any contract to sell or otherwise dispose of." The term "profits" is not defined in the Act.

Section 16(b) specifically provides that the Commission may exempt by rules and regulations transactions not comprehended within the purpose of the section.

^{4/} Prior to the enactment of the Securities Acts Amendments of 1964, Pub. L. No. 467, 88th Cong., 2d Sess. (August 20, 1964), Section 16 was applicable only to insiders of corporations with securities registered on a national securities exchange. The 1964 amendments, providing for registration under Section 12 of the Act of equity securities issued by certain over-the-counter companies, extended Section 16 to all "securities registered under Section 12".

Section 16(b) also excepts from the provisions of that section any "security acquired in good faith in connection with a debt previously contracted. In addition, Section 16(e) provides:^{5/}

"(e) The provisions of this section shall not apply to foreign or domestic arbitrage transactions unless made in contravention of such rules and regulations as the Commission may adopt in order to carry out the purposes of this section."

Pursuant to this authority the Commission has adopted Rule 16e-1, 17 CFR 240.16e-1, which provides in pertinent part:

"It shall be unlawful for any director, or officer of an issuer of an equity security which is registered on a national securities exchange to effect any foreign or domestic arbitrage transaction in any equity security of such issuer, whether registered or not, unless he shall include such transaction in the statements required by section 16(a) and Rule 16a-1 and shall account to such issuer for the profits arising from such transaction, as provided in Section 16(b). . . . The provisions of Rule 16a-1 and of section 16 shall not apply to any bona fide foreign or domestic arbitrage transaction insofar as it is effected by any person other than such director or officer of the issuer of such security."

^{5/} This section and the rule thereunder were designated Section 16(d) and Rule 16d-1 prior to enactment of the Securities Acts Amendments of 1964, Pub. L. No. 467, 88th Cong., 2d Sess. (August 20, 1964) and are so referred to in the briefs of Mr. Webster and Heli-Coil.

ARGUMENT

1. The Voluntary Conversion of the Debentures Held by Mr. Webster was a "Sale" of the Debentures and a "Purchase" of the Common Stock Within the Meaning of Section 16(b).

By defining in Sections 3(a)(13) and 3(a)(14) of the Act the terms "purchase" and "sale" to include not only contracts to purchase or sell but also contracts to "otherwise acquire" or "dispose of", Congress made clear that the concept of purchase and sale was intended to extend beyond the ordinary meaning of these terms and beyond the conventional limitations applicable under the commercial law of sales. Although these definitions specifically refer only to executory contracts, obviously they were not intended to exclude the more common and important executed transactions.

Consistent with these broad definitions and with the remedial purpose of Section 16(b), the courts have repeatedly found a purchase or sale in a wide variety of transactions, such as the exercise of stock options or warrants granted in connection with an employment contract,^{6/} the exchange of stock in a subsidiary for stock of its parent pursuant to a plan of corporate simplification^{7/} and the exchange by an insider corporation of stock held by it for stock of its less-than-wholly-owned subsidiary.^{8/} The court below, in holding that the conversion

6/ Walet v. Jefferson Lake Sulphur Co., 202 F.2d 433 (C.A. 5), cert. denied, 346 U.S. 820 (1953); Blau v. Hodgkinson, 100 F. Supp. 361 (S.D. N.Y., 1951); Truncale v. Blumberg, 80 F. Supp. 387 (S.D. N.Y., (1948).

7/ Blau v. Hodgkinson, supra, note 6

8/ Blau v. Mission Corp., 212 F.2d 77 (C.A. 2), cert. denied, 347 U.S. 1016 (1954).

involved here constituted a sale of the debentures and a purchase of common stock, followed Park & Tilford, Inc. v. Schulte, 160 F. 2d 984 (C.A. 2), cert. denied, 332 U.S. 761 (1947), where the Court of Appeals for the Second Circuit held that a conversion of preferred into common stock constituted a purchase of common stock.^{9/} Although the court below recognized that Park & Tilford did not deal with the question whether the conversion resulted in a "sale" of the convertible security, it stated that the "ratio decidendi would seem equally applicable to that issue" (App. ^{10/}179a).

Mr. Webster urges, however, that the two securities were economic equivalents, and therefore the facts of the instant case are closely analogous to Ferraiolo v. Newman, 259 F. 2d 342 (C.A. 6, 1958), cert. denied, 359 U.S. 927 (1959), where the Court of Appeals for the Sixth Circuit held that a conversion of preferred stock, which had been called for redemption, into common stock did not constitute a purchase for purposes of Section 16(b). But as the court below noted (App. 181a), "it was the involuntary nature of the conversion in Ferraiolo that was the determinative factor in that case." The court's opinion in Ferraiolo emphasized that the

^{9/} See also, Kogan v. Schulte, 61 F. Supp. 604 (S.D.N.Y., 1945), a companion case to Park & Tilford.

^{10/} See also, Blau v. Lamb, 163 F. Supp. 528 (S.D.N.Y., 1958), where the court denied motions for summary judgment by both parties in a suit seeking recovery of profits alleged to have been realized in connection with a conversion of preferred into common stock, stating that "the defendants have not established as a matter of law that the conversion of their preferred into common was not a sale" (163 F. Supp. at 533-534).

preferred stock, which was convertible into common, had been called for redemption. Since the common stock was selling for nine dollars above the conversion price, and the insiders thus either had to convert or accept a loss upon redemption, the court found that the conversion was, at least in an economic sense, involuntary. Here the conversion was entirely voluntary, since no call for redemption had been issued by Heli-Coil.

Whatever bearing the economic equivalence of Heli-Coil's debentures and common stock urged by Mr. Webster may have on the issue whether a profit has been realized upon conversion, (see p. 14, infra) it is, in our view, irrelevant to the determination whether the conversion constitutes a purchase and sale within the meaning of Section 16(b). In determining to exercise his conversion privilege, Mr. Webster made an investment decision independent of both his initial decision to purchase the debentures and his subsequent decision to sell a portion of his common stock. Although he retained an investment position in Heli-Coil after conversion, the nature of his investment and the risk involved was substantially affected by the decision to convert. The convertible debentures represented fixed debt obligations payable upon maturity or redemption and bearing a fixed interest rate and carried an option to exchange the debt obligation for common stock. The common stock represented an equity interest in Heli-Coil's assets and earnings and carried a voice in its management. Prior to conversion, Mr. Webster

did not own the common stock and had a creditor relationship to Heli-Coil. He acquired the rights of a stockholder only by disposing of the debt security held by him upon conversion.

The situation here is thus entirely different from those involved in Roberts v. Eaton, 212 F.2d 82 (C.A. 2), cert. denied, 348 U.S. 827 (1954), relied upon by Mr. Webster (Def's. Br. 11-12) or in the recent case of Blau v. Max Factor & Co., 342 F.2d 304 (C.A. 9, 1965), where exchanges of securities were not deemed to involve a purchase for purposes of Section 16(b). In the Roberts case the court held that stock was not "purchased" within the meaning of Section 16(b) where it was acquired pursuant to a plan of reclassification in which all shareholders exchanged common stock for a package consisting of common and preferred stock. There the insiders' interests remained proportionately unchanged, a factor, which the court noted, was "of course essential for the defendants' position" (212 F. 2d at 86). In the Max Factor case the defendants converted common stock held by them into the issuers' Class A stock as a preliminary step to a public offering of the Class A. The court there held that the conversion did not involve a purchase of the Class A stock under Section 16(b), noting that the only difference between the two classes of stock was that the board of directors had the power to declare lesser dividends on the common than on the Class A.

In distinguishing the case before it from the conversion involved in Park & Tilford, Inc. v. Schulte, supra, the court noted:

"The preferred and common exchanged in Park & Tilford involved significantly different investment risks. For this and other reasons, the decision to exchange the convertible security required an investment decision within the six months period distinct from the decision to sell the converted security - a new investment risk was undertaken, and a new, if limited, opportunity was presented to realize profit, or avoid loss, through the use of inside information."

Whether a transaction is a purchase or sale for purposes of Section 16(b) cannot depend upon a minute examination of each particular transaction. To require that a plaintiff show a possible benefit to the defendant in a particular case would come close to establishing the subjective burden of proof that Section 16(b) was intended to eliminate.

Under Section 16(b) this Commission was expressly authorized by Congress to exempt by rules any transactions deemed "not comprehended within the purpose of this subsection." Thus, while recognizing that the "crude rule of thumb" of Section 16(b)^{11/} might encompass trans-

^{11/} Stock Exchange Practices, Hearings Before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess., pt. 15 6557 (1934).

actions which are not fairly within its purpose, it indicated that the courts are to apply the rule generally, leaving it for the Commission to make appropriate exemptions. The transactions involved here have not been so exempted.^{12/}

2. For Purposes of Section 16(b) Mr. Webster did not Realize Profits at the Time of the Conversion of the Debentures.

For the reasons stated in Point I, we agree with the court below that the conversion constituted both the sale of the debentures and the purchase of the common stock by Mr. Webster. Section 16(b), however, makes him liable only for "any profit realized." While there would seem to be no question that profits were "realized" upon the sale of the stock, a substantial and novel question arises as to whether or not any profits were "realized" by the conversion of the debentures, as the court below appears to have assumed without discussion. Neither "profit" nor "realized" are defined in the statute and, insofar as we can determine, no court has had occasion to devote much consideration to the question

^{12/} In the administration of Section 16(b) the Commission has adopted eighteen rules exempting various transactions in whole or in part from the provisions of Section 16(b) and in some cases from the reporting requirements of Section 16(a). See Rules 16a-1 to 16a-10 and 16b-1 to 16b-9, 17 CFR 240.16a-1 to 16a-10 and 240.16b-1 to 16b-9. It, of course, may exercise its authority to provide exemptions from Section 16 only if it is persuaded on the basis of its experience in the administration of the federal securities laws that such action would be consistent with the purposes of Section 16(b).

of whether or not a profit has been "realized" since in the ordinary purchase and sale or sale and purchase situation, realization is unquestionable.^{13/}

We believe that neither words used nor the statutory purpose calls for a finding that a profit was "realized" upon the conversion of the debentures under the circumstances of this case. When used with reference to investments, the term "realized" generally refers to the liquidation of an investment position and the collection of whatever profit has accrued. Although in some situations the statutory purpose may require a broader concept, this is not such a case. In no real sense did Mr. Webster liquidate his position or collect a profit when he converted. The debentures were then selling at a price of approximately \$2,100 for each \$1,000 of face value (App. 100a) reflecting the fact that the common stock was selling at approximately \$36 (App. 64a) as compared with the conversion price of \$16 $\frac{2}{3}$. It is thus apparent that for market or speculative purposes the debenture was, at that time, substantially the economic equivalent of the common stock into which it was convertible. After the conversion, as before, Mr. Webster retained his investment position in the securities of Heli-Coil and whatever profits had accrued continued

^{13/} The courts in Park & Tilford v. Schulte, supra, and Ferriolo v. Newman, supra, did not have occasion to consider whether or not any profits were realized upon conversion since, in Park & Tilford the purchase of the convertible security appears to have occurred more than 6 months before the conversion, and in Ferriolo this was clearly true.

to be at the risk of the market and could disappear without "realization" if the market price of the common were to decline substantially. In the parlance of investors, these profits continued to be "paper" profits both before and after the conversion.

The statutory purpose does not require a different result. By converting, Mr. Webster did not place himself in a position where he could make any more advantageous use of inside information for speculative purposes than he could have before, since the market price of the debentures and the common stock could be expected to continue to move together. Indeed, by converting, Mr. Webster reduced his opportunities for pure speculation since he lost the protection of a senior position without gaining any compensating speculative advantage. Ordinarily an investor would convert in this situation, where the convertible security is protected against dilution and has not been called for redemption, only because he hoped to gain a long term advantage from receiving dividend income in excess of the interest payable upon the debentures. Under these circumstances the statutory purpose does not compel a broad application of the term "profits realized" which, as indicated above, contemplates the liquidation of an investment position or some enhancement of the potential for speculative profit.

The foregoing is not to suggest that a profit can never be realized within the meaning of a Section 16(b) in transactions involving the conversion of a convertible security. If the convertible security is purchased, the conversion privilege is exercised, and the security so acquired

is sold all within a 6-month period, we believe that the entire profit resulting from the transaction is recoverable, either on the theory that the profit accrued on the debentures as well as the profit on the common stock has been realized, "within [a] period of less than 6 months" for purposes of the statute, or else upon the theory that, under such circumstances, the purchase of a convertible debenture may be treated as a purchase of stock, since the statute defines purchase as including "any contract to buy, purchase or otherwise acquire" (Section 3(a)(13)), and the purchase of the convertible security includes a contractual right to acquire the conversion security.

Although Mr. Webster did not realize a profit when he converted, he did make an investment decision and acquired a new security, and the profit realized by him upon the sale of that new security within 6 months after its purchase is properly recoverable. The over-all result is that the short term profit realized by Mr. Webster during the 6 months after March 18, 1959 is recoverable, while the over-all profit accruing from his investment in Heli-Coil securities over a period of some 9 months is not recoverable in full. We believe this result to be consistent with the statutory objective of deterring short swing speculation, arbitrarily defined in terms of a 6-month period, while permitting the retention of longer term profits.

3. The Common Stock Acquired by Mr. Webster Upon Conversion was not Exempt from Section 16(b) as a Security Acquired in Good Faith in Connection with a Debt Previously Contracted.

Mr. Webster also argues that, because the conversion of the debentures cancelled Heli-Coil's debt obligation to him, the common stock acquired on conversion was exempt from the provisions of Section 16(b) as a security "acquired in good faith in connection with a debt previously contracted" (Def's. Br. 20). In rejecting a similar claim to this exemption for stock acquired pursuant to a prior contract for the sale of the same stock, the Court of Appeals for the First Circuit in Varian Associates v. Booth, 334 F. 2d 1, 5 (C.A. 1, 1964), affirming, 224 F. Supp. 225 (D. Mass., 1963), quoted approvingly from the opinion of the lower court which stated that to accept the argument urged by the defendants would

"open the door to widespread evasion of the Act, since any acquisition of stock could take the form of a contract in which the seller would owe a debt, that is, would have a firm obligation to deliver stock at some future date, and the buyer would owe a corresponding obligation to pay for the stock at a future date in money or other property."

As the district court also noted (224 F. Supp. at 227):

"Clearly the debt referred to in §16(b) must be an obligation independent of the obligation to deliver the very stock involved in the purchase."

Similarly, in Truncale v. Blumberg, 80 F. Supp. 387, 392 (S.D. N.Y., 1948), the court rejected the claim that warrants acquired pursuant to

an employment incentive contract were exempt from Section 16(b) as securities acquired in connection with a debt previously contracted.

In support of his claim, Mr. Webster relies on Smolowe v. Delendo Corp., 136 F. 2d 231 (C.A. 2, 1943), cert. denied, 320 U.S. 751 (1945) and Rheem Manufacturing Co. v. Rheem, 295 F. 2d 473 (C.A. 9, 1961). In these cases where the exemption was deemed applicable the securities were acquired in settlement of matured debts which existed apart from the obligation to transfer the securities. In Smolowe the debt was due and payable in cash but was satisfied by transfer of securities only with the mutual consent of both parties. Rheem involved the acquisition of securities in satisfaction of the defendant's interest in the company's retirement fund. Although the defendant had the option of obtaining benefits in either cash or securities, the benefits were fully vested and the value of the securities received was equivalent to the amount of benefits to which the defendant was entitled.

The court below held that neither Smolowe nor Rheem was controlling in the instant case "because they involved good faith settlements of independent and matured obligations" whereas "the debentures here were not to mature until November 1973, and were subject to a number of conditions which negative the generally accepted concept of a matured debt" (App. 182a). By converting his debentures Mr. Webster was exercising his contractual right to obtain stock with a value far in excess of the face amount of the debentures. Since the value of the stock Mr. Webster

was entitled to receive on conversion was unrelated to the amount of the debt obligation represented by the debentures, the conversion was in no sense the "one-shot settlement" of a debt which the court in Rheem (295 F. 2d at 476) said was made possible by the exemption for securities "acquired in good faith in connection with a debt previously contracted.

Mr. Webster asserts, however, in conflict with the principle recognized by the court below, that there is nothing "in the statute requiring an independent existence of the debt" (Def's. Br. 25). Apparently, he would urge that the requirement that the stock be "acquired in good faith" means only the absence of an intent to profit on the basis of inside information. Such a limited application of the "good faith" requirement would, of course, lead to the same subjective standard of proof Congress intended to avoid by the prophylactic provisions of Section 16(b).

4. Mr. Webster's Conversion of Debentures into Common Stock was not Exempt from Section 16(b) as an Arbitrage Transaction.

Finally, Mr. Webster contends that the conversion of the debentures into common stock is excluded from the operation of Section 16(b) by Section 16(e), which exempts "arbitrage transactions" from the provisions of Section 16 "unless made in contravention of such rules and regulations as the Commission may adopt in order to carry out the purposes of this section." Mr. Webster recognizes that under Rule 16e-1 the Commission has made it unlawful for an insider subject to Section 16, other than a ten-percent holder, to engage in arbitrage unless he, inter alia, "shall account to [the] issuer, for the profits arising from such transaction as provided in Section 16(b)." He contends, however, that the rule is invalid because it "is a pro tanto repeal of an exemption granted by Congress" and is "discriminatory, unconstitutional, and in direct conflict with the legislative intent" (Def's. Br. 30-31).

The court below found it unnecessary to rule on the validity of Rule 16e-1, since it correctly found that the transactions involved in the conversion were not arbitrage. "Arbitrage" was defined in the legislative history of the statute as "the simultaneous buying of a security in one market at a price for the purpose of selling it in another market at another price for the purpose of profiting from the

difference in prices in such markets."^{15/} Arbitrage may also consist of the purchase of one security and the sale of an equivalent security for the purpose of profiting from the difference in the market prices of the two securities. In either case, its economic function is to eliminate the difference in price where there is no reason for a difference.^{16/} A person engaging in arbitrage makes his profit with respect to convertible securities by buying the convertible security when its price is lower than the market price of the securities into which it may be converted, exercising the conversion privilege and selling the securities acquired upon conversion. Usually the purchase and sale are executed simultaneously or at the next market opportunity so that the transaction is completely riskless, providing a profit equal to the difference between the market price of the securities to be sold less the total of the market price of the securities purchased and the expenses of the transaction.

Since Mr. Webster did not convert his debentures into stock until four months after he purchased them and did not begin to sell the stock acquired on conversion until almost four months thereafter, the conversion clearly was not incident to an arbitrage transaction. Nor can the

^{15/} Remarks of Representative Rayburn, Sponsor of the Act, on H.R. 9323, 78 Cong. Rec. 7700 (1934).

^{16/} Weinstein, Arbitrage in Securities 8 (1931).

conversion by itself be deemed arbitrage, since it merely reflected Mr. Webster's determination to exercise a contractual right adhering to the debentures held by him and did not involve the execution of simultaneous offsetting transactions in the market for the purpose of profiting from the difference in market price between the debentures and the stock into which they were convertible.^{17/} Indeed, Mr. Webster's contention that the conversion constituted arbitrage is wholly inconsistent with his claim (Def's. Br. 29) that he could not profit from the conversion.

The conversion here was entirely different from the transactions of the defendants in Falco v. Donner Foundation, Inc., 208 F. 2d 600 (C.A. 2, 1953), upon which Mr. Webster relies. The court there held that the exemption for arbitrage transactions was available where the defendants sold common stock which carried a right to receive dividends already declared and simultaneously purchased an equal number of shares which did not share that right. Unlike Mr. Webster's transaction here,

^{17/} At all times the debentures could be converted into common stock at the conversion price of \$16-2/2 per share. On November 20, 1958, the date on which Mr. Webster purchased the debentures, he also purchased 500 shares of Heli-Coil common stock at \$14.50 per share (App. 12a). An arbitrageur would have purchased the debentures on that date only if they sold at that time for less than the securities into which they were convertible.

in Falco there were merely riskless market transactions which had the effect of eliminating the difference in price to the extent that it exceeded the amount of the dividends since there was, of course, no economic reason for this difference.

Since the transactions involved here were clearly not arbitrage, this Court, like the court below, need not pass on the question of the validity of the Commission's Rule 16e-1, which in effect removed the exemption for arbitrage transactions of officers and directors subject to Section 16(b). Accordingly, we do not believe it necessary to defend the rule as a reasonable exercise of the Commission's legislative rule-making powers under Section 16(e). It should be noted, however, that by distinguishing between ten percent beneficial owners and officers or directors, the rule reflects the same considerations which presumably prompted enactment of Section 16(e). The exemption was provided in the bill as finally enacted only after it was pointed out during the Senate Hearings that Section 16(b) might unduly interfere with arbitrage transactions because professional arbitrageurs commonly acquire in the course of their activities large holdings in a particular security.^{18/} Since

18/ A representative of the New York Stock Exchange testified:

" . . . [w]e would like to point out that the 5 per cent provision in regard to stockholders, as drafted today, might prevent arbitrage transactions, because it is very common, in arbitrage, for a man to buy one security and at the same time sell against it an equivalent
(continued)

these positions are held only momentarily, the arbitrageur cannot establish a relationship with the issuer by virtue of his holdings which could give him access to confidential information. On the other hand, the officer or director engaging in arbitrage transactions is in a relationship with the corporation which gives him access to inside information. Although it has been said that "arbitrage is . . . clearly divorced from the abuses which Section 16(b) seeks to prevent",^{19/} advance knowledge that information likely to produce a temporary disparity in market prices is about to be released could give one an advantage over others who would also seek to profit from the disparity.

18/ (continued)

security. While that process of the arbitrage is going on he might conceivably accumulate more than 5 percent of this security, and he would be the beneficial owner of that 5 percent. He would, of course, have off-setting contracts or obligations against it, but they are not reflected in the definition, which imposes penalties upon a stockholder owning 5 percent or more of a registered security." (Stock Exchange Practices, Hearings Before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess., pt. 16, 7566-67 (1934).)

H.R. 9323, as initially passed in the House of Representatives, did not contain the provisions of Section 16(b) but extended the reporting requirements now contained in Section 16(a) to 5 percent beneficial owners. The Senate, in adding the profit recovery provisions of Section 16(b) to the House bill, limited the application of Section 16 to officers, directors and 10 percent beneficial owners. These changes were subsequently accepted by the Conference Committee. See, H.R. Rep. 1838, 73d Cong., 2d Sess., 35-36 (1934).

19/ Falco v. Donner Foundation, supra, 208 F. 2d at 604.

CONCLUSION

For the foregoing reasons the order of the court below should be modified to provide only for the recovery of \$45,144.36 as the profits realized by Mr. Webster from the sale of common stock within six months of the conversion of the debentures into stock.

Respectfully submitted,

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