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a reinvestment of the sale proceeds in like kind property within a stated time."[67] An alternative remedy may be applied in the courts. The courts have determined that the substance of the transactions will determine the incidence of taxation.[68] If they would now establish that the substance of a transaction is the net result coupled with the intention of the parties, they could still uphold purchase-option contracts while terminating the type of inequity which occurred in *Carlton*. Either remedy would insure that a different tax treatment would not follow when two businessmen in the same business wish to expand or relocate their businesses, but businessman *A* is able to effectuate a direct exchange while businessman *B* can not, or inadvertently does not, acquire the property he needs in a direct exchange. Until one of the above proposed remedies is effectuated, persons attempting to create like kind exchanges should be extremely careful. If the result in *Carlton* is followed, the formal exchanges of deeds or titles must occur, irrespective of the total effect of the transaction.

Robert A. Kantor

The Ten Per Cent Owner of Convertible Debentures and Section 16(b): A Redefinition

Chemical Fund, Inc., an open-end investment company, desired to decrease its common stock holding in Xerox Corporation and increase its convertible debenture holding in that corporation. Accordingly, it began selling the common stock and buying the debentures convertible into common shares. By December 12, 1962, Chemical Fund owned ten per cent of the outstanding debentures. The program was continued over the next eleven months. At no time during this period could the debentures have been converted into more than one-half of one per cent of the oustanding common stock. Xerox claimed the right to the paper profits[1] realized by Chemical Fund during this period from the sales and purchases. Xerox asserted (1) that section 16(b) of the Securities Exchange Act of 1934[2] provides for recovery of short-swing profits taken by an owner of more than ten per cent of "any class of any equity security" of the corporation through transactions in the corporation's equity securities, and (2) that Chemical Fund was liable under the statute because it owned more than ten per cent of the class of convertible debentures. Chemical Fund brought

[67] Spears & Freedman, *supra* note 35, at 193.

[68] Carlton v. United States, 385 F.2d 238 (5th Cir. 1967); Alderson v. Commissioner, 319 F.2d 790 (9th Cir. 1963); W. D. Haden Co. v. Commissioner, 165 F.2d 588 (5th Cir. 1948).

[1] Xerox claimed that matching the highest sales of common stock with the lowest purchases of debentures resulted in a profit of $153,972.43. This form of profit computation was used in Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943). The decision in the principal case did not require the court to decide the correct profit computation.

[2] 48 Stat. 896, *as amended*, 15 U.S.C. § 78(p) (1964). The statute applies to officers and directors without regard to their percentage of ownership as well as to the ten per cent shareholder. For a part reading of the statute, see note 6 *infra*.

suit for a declaratory judgment that it was not subject to section 16(b) since convertible debentures were not a "class of any equity security" within the meaning of the Act. Chemical Fund appealed the dismissal of its suit and the judgment in favor of Xerox on its counterclaim for the profits.[3] *Held, reversed*: Section 16(b) of the Securities Exchange Act of 1934 is not applicable to a ten per cent owner of convertible debentures unless he would own ten per cent of the common stock following a hypothetical conversion of the debentures he holds. *Chemical Fund, Inc. v. Xerox Corp.*, 377 F.2d 107 (2d Cir. 1967).

I. Legislative and Judicial History of Section 16(b)

The Securities Exchange Act of 1934,[4] enacted during the Depression, had as one of its objectives the establishment, through full disclosure, of a free and open market which would reflect prices of securities at a fair evaluation of their worth.[5] Section 16(b)[6] was enacted to deter the use of trading advantage gained by a person having special access to corporate information or having the power of manipulation of corporate policies.[7] Generally, the section provides for the recovery of short-swing profits realized by insiders[8] through speculation in the corporation's equity securities.

Congress intended that the section be applied objectively without requiring a showing of actual fraudulent intent to use inside information.[9]

[3] Xerox cross-appealed from the denial by the trial court of interest on the judgment.

[4] Securities Exchange Act of 1934, 48 Stat. 881, 15 U.S.C. § 78 (1964).

[5] Smolowe v. Delendo Corp., 136 F.2d 231, 235 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943); Yourd, *Trading in Securities by Directors, Officers and Shareholders; Section 16 of the Securities Exchange Act*, 38 MICH. L. REV. 133 (1939).

[6] Securities Exchange Act of 1934, 48 Stat. 896, *as amended*, 15 U.S.C. § 78(p) (1964), which reads in part:

> (b) 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 . . . shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer. . . . Suit to recover such profit may be instituted . . . 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 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.

[7] The evils which the section sought to prevent were brought out by Senate investigations prior to enactment. *See* S. REP. Nos. 792, 1455, 73d Cong., 2d Sess. (1934). *See also* 2 L. LOSS, SECURITIES REGULATION 1037-38 (2d ed. 1961); Cook & Feldman, *Insider Trading Under the Securities Exchange Act (pt. 1)*, 66 HARV. L. REV. 385 (1953); Rubin & Feldman, *Statutory Inhibition upon Unfair Use of Corporate Information by Insiders*, 95 U. PA. L. REV. 468 (1947); Yourd, *supra* note 5.

[8] Insiders are defined in § 16(a) of the Securities Exchange Act of 1934, 48 Stat. 896, *as amended*, 15 U.S.C. § 78(p) (1964), as officers, directors, and beneficial owners of more than ten per cent of any class of any equity security.

[9] It was immediately seen by the draftsmen that such intent would be impossible to prove and that a "rule of thumb" approach would be necessary. *Hearings on S. 84, S. 56 & S. 97, Before the Senate Comm. on Banking and Currency*, 73d Cong., 2d Sess., pt. 15, at 6657 (1934). For cases emphasizing the irrelevance of proof of actual intent and usage of inside information, see Blau v. Lamb, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967); Booth v. Varian Associates, 334 F.2d 1, 3 (1st Cir. 1964); B.T. Babbitt, Inc. v. Lachner, 332 F.2d 255, 257, 259 (2d Cir. 1964); Ferrailo v. Newman, 259 F.2d 342, 344 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959); Magida v. Continental Can Co., 231 F.2d 843, 846 (2d Cir.), *cert. denied*, 351 U.S. 972 (1956); Smolowe v. Delendo, 136 F.2d 231, 235, 236, 239 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

Therefore the statute decreed that any profitable short-swing transaction of an insider should be treated as if it were the result of unfair use of inside information.[10] The application of the statute in such an objective manner was the result of congressional compromise between those who sought absolute prohibition of insider trading and those who advocated no regulation at all.[11]

Section 16(b) has given rise to voluminous litigation since its enactment.[12] Generally the reason seems to be the litigation-stirring ambiguities present in the statute itself and their propensity toward creating borderline situations. Contributing to this built-in problem is the courts' apparent dislike of such an arbitrary, automatic application of the statute.[13] Definitional problems have plagued the courts, particularly the meaning of such terms as "officer,"[14] "equity security,"[15] "purchase and sale,"[16] and "beneficial ownership."[17]

"Class" of an Equity Security. One term which has been only superficially defined is "class."[18] As a source of definition to section 16(b), section 16(a) defines an insider as an officer, director, or "the beneficial owner of more than ten percentum of any *class* of any equity security . . . ."[19] The term "equity security" is defined as "any stock or similar security; or any *security convertible*, with or without consideration, into such a security . . . ."[20] The term "security" is defined as any note, stock, treasury stock, bond, *debenture*, or in general, any instrument commonly known as a security.[21]

The only reported case in which a court has had occasion to apply the above sections to the phrase "class of any equity security" was *Ellerin v. Massachusetts Mutual Life Insurance Co.*,[22] decided by the Second Circuit.

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[10] Meeker & Cooney, *The Problem of Definition in Determining Insider Liabilities Under Section 16(b)*, 45 VA. L. REV. 949 (1959).

[11] Note, *Purchase and Sale Under Section 16(b) of the Securities Exchange Act*, 10 SYRACUSE L. REV. 296 (1959).

[12] Hamilton, *Convertible Securities and Section 16(b): The End of an Era*, 44 TEXAS L. REV. 1447, 1449 (1966).

[13] One area that particularly evidences the trend of the courts toward a subjective treatment of the statute is the "purchase and sale" question. *See* Hamilton, note 12 *supra*.

[14] Colby v. Kline, 178 F.2d 872 (2d Cir.), *rev'g and remanding* 83 F. Supp. 159 (S.D.N.Y. 1949); Lockheed Aircraft Corp. v. Rathman, 106 F. Supp. 810 (S.D. Cal. 1953).

[15] Voting trust certificates are equity securities by statute. Securities Exchange Act of 1934, § 3(a)(10), 48 Stat. 884, 15 U.S.C. § 78(c)(a)(10) (1964); Walet v. Jefferson Lake Sulphur Co., 202 F.2d 443 (5th Cir.), *cert. denied*, 346 U.S. 820 (1953) (treasury stock is an equity security).

[16] *See* Hamilton, note 12 *supra*.

[17] The questions of family relationships, partnerships, holding companies, and trusts are dealt with in 2 CCH FED. SEC. L. REP. ¶¶ 26,031-26,050 (1966); 2 L. Loss, *supra* note 7, at 1100-08; Shreve, *Beneficial Ownership of Securities Held by Family Members*, 22 BUS. LAWYER 431 (1967).

[18] The word "class" does not appear in § 16(b), but the section depends upon the definitions found in § 16(a). "Class" is used in § 16(a) in defining the ten per cent ownership insider. *See* note 8 *supra*.

[19] Securities Exchange Act of 1934, § 16(a), 48 Stat. 896, *as amended*, 15 U.S.C. § 78(p)(a) (1964).

[20] Securities Exchange Act of 1934, § 3(a)(11), 48 Stat. 884, 15 U.S.C. § 78(c)(a)(11) (1964) (emphasis added).

[21] Securities Exchange Act of 1934, § 3(a)(10), 48 Stat. 884, 15 U.S.C. § 78(c)(a)(10) (1964) (emphasis added).

[22] 270 F.2d 259 (2d Cir. 1959). The only other case relating to the ten per cent insider, Stella v. Graham-Paige Motors Corp., 104 F. Supp. 957 (S.D.N.Y. 1952), held that a stockholder is an

In that case defendant Massachusetts Mutual bought and sold common stock of General Tire and Rubber Company within a six-month period at a profit. General Tire had two issues of cumulative preferred stock outstanding at the time of defendant's transaction. Defendant owned more than ten per cent of one of these issues but did not own ten per cent of the two issues combined. The two issues of preferred differed as to dividend rates, redemption prices and dates, and sinking fund provisions but were identical in par value, preference rights, voting rights, and pre-emptive rights. Contending that each issue of preferred constituted a "class" in itself and that Massachusetts Mutual owned more than ten per cent of one of the classes, Ellerin, a stockholder of General Tire, brought an action for recovery of the profits. The court held that these issues were merely "series" within the "class" which included all of the cumulative preferred stock. Therefore, defendant was not a ten per cent holder and not liable under section 16(b).[23] Plaintiff's assertion that the phrase "any class of any equity security" required the court to treat a series as a class because the words "any class of" would otherwise be superfluous was rejected.[24] The court noted that plaintiff acted under a misconception when he considered "equity security" to mean a general category such as cumulative preferred stock and that a subdivision (class) of such a category would be a series. Rather, the court stated, "It is much more natural, we think, to read the phrase 'any equity security' as referring to the kind or nature of the security."[25] Although the court went no further in its definition, the implication of this statement was that the court was reading the phrase "any equity security" in light of the common classification of securities as either "equity" or "debt."[26] Proceeding from this definition, it was not difficult for the court to find that "class" meant any general breakdown of equity participating securities, such as common stock and preferred stock. Commenting on the legislative intent in using the phrase "class of any equity security," the court stated, "Congress thought the meaning of the phrase . . . was reasonably clear and it was using familiar terms in their ordinary and generally accepted sense . . . ."[27] The court's language was later to be regretted.

The Convertible Debenture. It is not surprising that the next case[28] to require a further interpretation of the meaning of "class" involved convertible debentures, particularly since this security enjoys, or perhaps suffers from, a hybrid status. Primarily a debt security offering the safety of a debtor-creditor relationship with a stated annual interest rate, a convertible debenture has the added attraction of conversion into an equity

insider if his only transactions are the purchase of over ten per cent of a class of corporate security and the subsequent sale of this stock.

[23] 270 F.2d 259, 265 (2d Cir. 1959).

[24] *Id.* at 263.

[25] *Id.*

[26] The convertible debenture normally would fall within the debt type of security, but it is deemed an equity security for the purposes of the statute.

[27] Ellerin v. Massachusetts Mut. Life Ins. Co., 270 F.2d 259, 262 (2d Cir. 1959).

[28] Chemical Fund, Inc. v. Xerox Corp., 377 F.2d 107 (2d Cir. 1967).

security, usually common stock, which allows the investor to take advantage of sympathetic price rises in the underlying stock. Because of the conversion feature, the convertible debenture tends to behave on the market in direct relation to the security into which it is convertible. Advances or declines of the common stock generate the same proportional advances or declines in the debenture.[29] While a bond without the conversion option is outside the operation of section 16(b),[30] a bond which carries conversion rights, and which therefore is susceptible to use like common stock in taking advantage of short-swings and inside information, is explicitly included in the definition of "equity security"[31] and is subject to section 16(b).

II. Elimination of Convertible Debentures as a Class

The *Chemical Fund* case provided the first opportunity for a court to consider the applicability of section 16(b) to the profits taken by a ten per cent holder of an issue of convertible debentures. The reasoning of the court was simple and straightforward: since the convertible debenture is an equity security only because it can be converted into an equity security, it shall be part of the class of "equity security" into which it can be converted.[32] In this case the convertible debentures were convertible into common stock, so the court looked to that class to determine whether Chemical Fund was a ten per cent holder.[33] In rejecting Xerox' contention that the convertible debenture issue was a class within itself, the court reasoned that a ten per cent holder of convertible debentures had no standing or position with the officers, directors, or large shareholders of a company that would provide access to inside information.[34] The court noted that if Xerox' theory were followed, a nine per cent owner of common stock would not be liable under section 16(b) while a holder of ten per cent of debentures convertible into less than one-half of one per cent of the common stock would be liable.[35]

The court in *Chemical Fund* was faced with a dilemma of the highest order. On one hand the clear language of the statute and the general definition of "class" would include an issue of convertible debentures as a separate "class." On the other hand, believed the court, such a definition would be a misdirection of the statutory purpose of section 16(b). The court chose to eliminate convertible debentures as a separate "class." Ra-

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[29] *See* B. Graham, D. Dodd & S. Cottle, Securities Analysis 103 (4th ed. 1962). The foregoing discussion assumes that the market price of the common stock is above the conversion price of the debentures. When the market price of the common stock is below the conversion price of the debentures, the debt aspects of the debentures tend to steady the debenture at that price. At this point the debenture does not act wholly like the underlying security.

[30] *See Hearings on Stock Exchange Practices Before the Senate Comm. on Banking and Currency*, 73d Cong., 2d Sess. 6423, 6430 (1934), where the section was revised so as to exclude bond holders.

[31] *See* note 20 *supra*, and accompanying text.

[32] Chemical Fund, Inc. v. Xerox Corp., 377 F.2d 107 (2d Cir. 1967).

[33] Chemcial Fund would have owned only 2.7 per cent of the common stock after conversion, so it did not qualify as a ten per cent holder.

[34] Chemical Fund, Inc. v. Xerox Corp., 377 F.2d 107, 111 (2d Cir. 1967).

[35] *Id.*

ther, "the class consist[s] of the common stock augmented, as to any beneficial holder in question, by the number of shares into which the debentures it owns are convertible."[36] This mingling of the two issues to determine liability under section 16(b) seems to recognize the virtual identity between common stock and debentures convertible into common stock.[37] Commentators have stated that the buyer or holder of a bond is for all purposes making a commitment in the common stock, for the debenture and the stock would not only advance together but also decline together over an exceedingly wide price range.[38]

Recent proposals in accounting procedures further recognize that a commitment is made in the common stock when convertible debentures are purchased. These proposals call for a recognition of the dilution effect that convertible securities have on net earnings per share of common stock.[39] A true picture of the health of the common stock, according to these proposals, cannot be drawn without including the effects of the convertible debentures outstanding. In addition, the Internal Revenue Service does not recognize gains or losses through conversion of debentures as a taxable event, on the theory that the new property is substantially a continuation of the old investment. The exception to recognizable gains will exist when "differences exist between the property parted with and the property acquired, but such differences are more formal than substantial."[40]

Recent decisions in another problem area of section 16(b) have done much toward recognizing the similarities between convertible debentures and the underlying security. These decisions have dealt with the problem of whether a conversion can be a "sale" or "purchase" within the meaning of section 16(b). Quite early it was decided that conversion was a purchase and sale,[41] but later decisions were more reluctant to impose liability in a case which left the trader after the conversion in an economically equivalent position to that before the conversion.[42] Conceding the merits of these decisions, the Securities Exchange Commission changed its opposing position by adopting an amendment to rule 16(b) which exempted nearly all conversions from section 16(b).[43]

The *Chemical Fund* decision continued this trend toward treatment of convertible debentures and common stock as equivalents. In declaring that an issue of convertible debentures was not itself a "class" for the purposes of section 16(b), the court had to contradict its earlier decision in *Ellerin*

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[36] *Id.* at 110.

[37] *See* note 29 *supra*, and accompanying text.

[38] B. GRAHAM, D. DODD & S. COTTLE, SECURITIES ANALYSIS 103 (4th ed. 1962).

[39] *See APB Opinion No. 9, ¶ 43 (Dec. 1966)*, 123 J. ACCOUNTANCY 55, 61 (Feb. 1967), "supplementary proforma computations of earnings per share should be furnished, showing what the earnings would be if the conversions . . . took place." *Cf.* S.A. Release No. 4910, CCH FED. SEC. L. REP. ¶ 77,567 (1968).

[40] Treas. Reg. § 1.1002-1(c) (1957). For specific exclusion of debenture conversion into common stock, see 4 P-H FED. TAX ¶ 31,071 (1968).

[41] Park & Tilford, Inc. v. Schulte, 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947).

[42] *E.g.*, Blau v. Lamb, 363 F.2d 507 (2d Cir. 1966); Ferrailo v. Newman, 259 F.2d 342 (6th Cir.), *cert. denied*, 359 U.S. 927 (1959). For an excellent article discussing the whole problem of "purchase and sale," see Hamilton, note 12 *supra*.

[43] 31 Fed. Reg. 3391 (1966), *amending* 17 C.F.R. § 240.16b-9 (1964), was formally adopted on Feb. 17, 1966.

as well as to disregard obvious differences between convertible debentures and common stock. In *Ellerin* the court stated that Congress intended the word "class" to have its familiar, ordinary, and generally accepted meaning.[44] Yet, the court in *Chemical Fund* enunciated a highly technical and most unfamiliar definition of "class."[45] Furthermore, in *Ellerin* it was suggested that, had the two series of preferred stock been less similar in their rights and powers, each series might have been a class within itself.[46] In *Chemical Fund* there were pronounced differences between the two security issues which the court did not consider indicative of different classes.

The primary difference is the debt aspect of the debentures as compared to the equity aspect of common stock. Notwithstanding the definition of "equity security" and the inclusion of convertible debentures in that definition for purposes of the statute, without conversion the owner of convertible debentures has rights and powers common to a creditor-debtor relationship. He receives interest payments and gets priority treatment as a creditor upon liquidation. He is subject to economic factors that cause fluctuation in debt securities but not equity securities, and he is party to an indenture which confers rights and powers different from those of a common stock owner. Concurrently, a common stock owner receives dividends and is subordinated to senior securities on distribution at liquidation. But most importantly, he is empowered, at least in theory, to elect the directors who shape corporation policy and vote for changes in corporation structure through by-law and charter amendment.

The court was not concerned with similarities and differences, however, as much as with the inequity of applying the statute in a case to which it thought the statute's purpose was not directed.[47] The apparent absence of a relationship between a debenture holder and the corporation which is conducive to receipt of inside information or control of corporate policy was the touchstone of the court's reasoning that the convertible debentures did not constitute a class. Equating access to inside information and control of corporate policy with the voting power of the ten per cent holder of common stock, the court reasoned that convertible debenture holders, devoid as they are of the power to elect friendly directors and influence corporate decisions, cannot possibly take advantage of situations that the statute was enacted to prevent. Apparently assuming that the legislators could not have intended usage of section 16(b) beyond its stated purpose,[48] the court's logical conclusion was that an issue of convertible debentures was not a "class" within the meaning of section 16(b). Ironically, the same reasoning—that Congress did not intend the statute to operate beyond its

[44] Ellerin v. Massachusetts Mut. Life Ins. Co., 270 F.2d 259, 262 (2d Cir. 1959). *See* discussion at note 24 *supra*.

[45] The court realized the contradiction with *Ellerin*. It said, "But this court referred to the common meaning of class in that case because there was no prior case law, statutory history, or legislative definition to guide it. Chemical Fund, Inc. v. Xerox Corp., 377 F.2d 107, 111 (2d Cir. 1967).

[46] Ellerin v. Massachusetts Mut. Life Ins. Co., 270 F.2d 259, 262-63 (2d Cir. 1959). *See* discussion at note 24 *supra*.

[47] This is precisely the reason for the liberal interpretation of the statute in the area of "purchase and sale."

[48] "For the purpose of preventing the unfair use of information which may have been obtained . . . ." Securities Exchange Act of 1934, 48 Stat. 896, *as amended*, 15 U.S.C. § 78(p)(b) (1964).

purpose—can be used to arrive at the opposite conclusion: convertible debentures would not have been included in the meaning of "equity security" unless Congress believed that inclusion would more nearly effectuate the purpose of the statute.[49]

There may well be reason for inclusion of convertible debentures as a separate class. Debenture holders certainly have a relationship with the corporation determined by the indenture. The needs of the corporation for additional capital without dilution of the equity position may require solicitation of investments from institutional investors, which in turn gives the institutions a bargaining power. In addition to the standard requirements of periodic submission of financial information, some indentures confer consent and veto powers, *e.g.*, on additional financing by the corporation, which in turn imply disclosure of corporate plans.[50] While it may be argued that these powers are derived from the debt aspect of the convertible debentures and that ordinary debts (bonds without conversion rights) are excluded from section 16(b), the reply is that such knowledge cannot, in the case of straight debt, enable the holder to take advantage of inside information through market speculation of the issue it holds, whereas the opposite is true with the holder of convertible debentures. Furthermore, the desire of corporations to have ownership of their convertible debentures concentrated and the converse ability of large holders to depress prices by threatened or actual sales of large blocks create additional bargaining power. The large debenture holder by its very nature as a sophisticated investor protects itself through some relationship to the corporation productive of inside information.[51]

III. The Formula

The most far reaching effect of *Chemical Fund* will be the formula employed by the court in determining whether the holder owned ten per cent of any class of any equity security. The court said the test shall be "the total percentage of common stock which a holder would own following a hypothetical conversion of the debentures it holds . . . ."[52] The principal case illustrates how completely the court limited the possibility of classifying convertible debentures as a class, for a holder of 100 per cent of the issue could only have commanded 2.7 per cent of the common stock. It is doubtful that many corporations have a convertible issue so large that it would comprise more than ten per cent of the common stock if exercised and even more doubtful that one investor owns the entire convertible issue. In most cases, then, a holder of convertible debentures will be liable under section 16(b) only if he has a large holding of common stock independent of the conversion shares. It has never been held by the courts

[49] The author is not overlooking the fact that the decision does not completely forbid application of § 16(b) to convertible debentures.

[50] The court did not discuss the indenture in the instant case, so it is not known what weight, if any, it carried in their decision. It can be expected that later cases will involve indentures different from the one involved here. Whether the court will look at these indentures to determine a relationship to the corporation is an open question.

[51] In the principal case one of Chemical Fund's directors was also a director of Xerox.

[52] Chemical Fund, Inc. v. Xerox Corp., 377 F.2d 107, 110 (2d Cir. 1967).

that ownership of the various classes can be added together to reach a ten per cent status. While the decision that convertible debentures are part of the class of common stock has superficially evaded this question, a new problem is created: when determining whether a common stock owner is a ten per cent holder, should the court also take into account the holder's convertible debentures?[53] To be consistent the answer must be an emphatic "yes!"

The formula appears to look to potential access to inside information and potential policy control since it makes a hypothetical conversion. Yet, by the court's own earlier reasoning, until there is actual conversion the convertible debenture holder can neither exercise control nor utilize avenues of inside information.[54] Thus, the court would apply section 16(b) to a transaction that occurred at a time when access to information was not available; this conflicts with the court's singular reason for holding the convertible debentures not a "class" within itself in the first place.

But the problem of the potential aspect of the formula goes even further. If the court is looking only to potential insider control and information, why did it not make a hypothetical conversion of the entire issue of convertible debentures?[55] This would seem to provide a more accurate estimate of potential. But even under the formula as stated, if convertible debentures are to be considered part of the class of common stock because of the potential control and access to inside information, must not the same potential be taken into account when determining ten per cent ownership in common stock; in other words, should not the class of common stock consist of all outstanding common stock plus the amount of common stock into which the entire issue of convertible debentures can be converted? From this discussion it can be seen that the formula, if employed by the courts consistent with the reasoning of the decision, is susceptible to substantial extension.

IV. Conclusion

The Securities Exchange Act of 1934 was conceived and drafted by a group of experts in the field of securities and securities law.[56] It is doubtful that the word "class," in its "ordinary and generally accepted sense," would have been used unless the drafters intended it to have exactly that meaning. The Second Circuit in *Chemical Fund*, desiring to achieve an equitable result, chose to redefine "class" and, in effect, amended the statute.[57] The court-enacted amendment with its ill-conceived formula may

[53] An example of such a situation would be where the holder owned eight per cent of the common stock and enough convertible debentures to constitute more than two per cent of the common stock if converted.

[54] Chemical Fund, Inc. v. Xerox Corp., 377 F.2d 107, 111 (2d Cir. 1967).

[55] The SEC in fact follows this latter approach in determining ten per cent ownership of voting trust certificates. 17 C.F.R. § 240.16a-2 (1968). It might be noted that it is solely the right to convert a voting trust certificate into "stock or similar security" that brings these securities under § 16(b). In all fairness it should be pointed out that the court was not required to go this far since Chemical Fund would not have been liable in either case.

[56] *See* R. deBEDTS, THE NEW DEAL'S SEC: THE FORMATIVE YEARS 56-85 (1964).

[57] While this Note labored through the printing process, the "amendment" was seconded by the SEC when it adopted a proposal that 17 C.F.R. § 240.16a-2 (1968), which sets forth the methods

have the effect of bringing into the courts litigants who previously cowered in the face of the statute's clear language. The extent of litigation will depend upon the willingness of the courts to allow logical extensions of the real meaning of the formula. If the courts refuse to extend the meaning of the formula, then they must expose the absence of logical grounds for its use, and therefore, the logic of the whole decision.

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of determining ten per cent beneficial ownership, be amended by the addition of the following section:

> (b) In determining for the purpose of Section 16(a) of the Act whether a person is the beneficial owner, directly or indirectly, of more than ten percent of any class of equity securities, such person shall be deemed to be the beneficial owner of securities of such class which such person has the right to acquire through the exercise of presently exercisable options, warrants or rights or through the conversion of presently convertible securities. The securities subject to such options, warrants, rights or conversion privileges shall be deemed to be outstanding for the purpose of computing, in accordance with paragraph (a), the percentage of outstanding securities of the class owned by such person.

Exchange Act Release No. 8325 (June 6, 1968), CCH FED. SEC. L. REP. ¶ 77,560 (1968).