MEMORANDUM TO MR. DONNAHOE

RE: Possible Exemption of Exercise of Long-Term Options from Restrictions of Exchange Act § 16(b)

You have asked us to consider a basis for possible rulemaking by the Securities and Exchange Commission to exempt the exercise of long-term stock options (i.e., options held more than six months) from the profit recapture provisions of §16(b) of the Securities Exchange Act of 1934.

Under the present state of the law, the exercise of a stock option constitutes a purchase of the underlying common stock. If common stock has been sold during the preceding six months or is sold during the ensuing six months, these sales will be matched with the purchase of stock through the option, and any resulting profit is recoverable by the issuer.

The only relief presently afforded for long-term option holders is in the form of an adjustment to the imputed purchase price of the stock being acquired. Under Commission rule 16b-6, the purchase price is treated as being the lowest market price for the stock within six months of the sale of the stock. Under this rule, anyone subject to §16(b) who sells stock within six months of exercising an option will still be required to surrender a portion of the profit unless he sells the stock at the lowest market price occurring within six months of the date of sale.

As an alternative measure of recoverable profits, some courts have looked to the market price of the underlying common stock on the first day the long-term option became exercisable as creating a minimum imputed purchase price. The leading case espousing this method of protecting the long-term portion of the profit inherent in an option is E. T. Babbitt, Inc. v. Lachner, 332 F. 2d, 255 (2d Cir. 1964). Although this alternative method of determining the purchase price has been used on several occasions by the courts where it would produce a lower profit than that computed under rule 16b-6, it has never been formally adopted by the Commission.

As stated in John J. Huber's letter of June 3, 1982 to you, the Commission maintains the position that the exercise of long-term stock options can give rise to speculative abuse of the type which §16(b) was designed to prevent. An insider who became aware of an undisclosed adverse development, for example, could exercise an option and sell the underlying stock prior to any resulting drop in the stock price. Rule 16b-6, under this view, represents a compromise by allowing an insider to retain the difference between the exercise price and the lowest market price within six months of the date of sale but requiring that he surrender any profit above that amount.

It appears that in practice many executives are unwilling to sell stock under rule 16b-6 and to surrender a portion of the profit to the issuer. Instead, the option holder will subject himself to the risks of the market for a minimum of six months in order to retain all of the profit from sale of the stock. The prevalence of this approach appears to be tacitly acknowledged by the Internal Revenue Code provisions which allow recognition of income resulting from the exercise of an option by a person subject to §16(b) to be postponed until the expiration of the six month waiting period.

Because §16(b) is intended to prohibit the use of material non-public information, any proposed exemption should contain safeguards which relate to such use. One possible approach would be a rule exempting long-term options from §16(b) liability provided that the issuer's chief executive officer and chief financial officer, as well as the option holder himself, certified that they were not then aware of any material non-public information concerning the issuer and that the issuer was current in its 1934 Act filings. Such a certificate would be filed with the Commission within a specified time period in order for the exemption to apply.

The option holder would continue, of course, to be subject to the general antifraud rules of both the Securities Act of 1933 and the Securities Exchange Act of 1934. One would anticipate close scrutiny of any sale of stock by an insider which was followed by a drop in the market price of the stock.

Stephen R. Larson

September 21, 1982