CLEARY GOTTLIEB Alert Memorandum

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Second Circuit Decision Clarifies Framework for Treatment of Prepaid Variable Forward Contracts under Section 16

The Second Circuit Court of Appeals' 2014 ruling in *Chechele v. Sperling*[1], which addressed an issue of first impression among the Courts of Appeals regarding the application of Section 16 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), to prepaid variable forward contracts ("PVFCs"), is the most recent attempt by the courts to fill in gaps in the analytical framework governing the application of Section 16 to complex derivatives. The *Sperling* case, which has received scant attention from commentators, is an important decision that should mitigate concern over the risk of a deemed purchase transaction upon settlement and termination of certain complex derivative transactions. While we disagree with some of the reasoning on which the decision is based, the opinion, from an influential Court of Appeals, suggests that the courts are moving in the right direction when it comes to applying Section 16 to PVFCs and other complex derivatives.

Section 16 of the Exchange Act was enacted in order to prevent the unfair use of information by insiders. An insider is defined as a beneficial owner of more than 10 percent of any class of equity security of domestic issuers registered under the Exchange Act, and directors and officers of those issuers.[2] Under Section 16(b), insiders are required to disgorge any profits realized from the non-exempt purchase and sale (or sale and purchase) of any equity security of the company within a six-month period (often referred to as the "Short-Swing Profit Rule").

Section 16(b) was intended to be applied mechanically. It imposes strict liability, even in the absence of wrongdoing and without proof of intent to profit on the basis of inside information. In addition, Section 16(b) was designed to provide bright-line rules. Yet many transactions – particularly complex derivative transactions – do not fit neatly into the plain statutory language of Section 16. In the absence of specific and detailed guidance from the SEC, the courts have been

[1] 758 F.3d 463 (2d Cir. 2014).

[2] 15 USC Section 78p(a)(1).

forced to set forth the basic framework for the treatment of such transactions under Section 16(b), and the law has not evolved in an entirely consistent manner.[3]

In *Sperling* the Court of Appeals held that for the purposes of Section 16(b):

1. PVFCs should be deconstructed into two fixed-price derivatives: the purchase of a put option and the sale of a call option[4]; and
2. the retention of a portion of shares that were pledged by the insider at the commencement of the transaction but not delivered pursuant to the terms of a PVFC does not constitute a "purchase" of company stock within the meaning of Section 16(b) at the time of settlement.

I. FACTUAL BACKGROUND

In *Chechele v. Sperling*, a shareholder of Apollo Group, Inc. ("Apollo") brought suit under Section 16(b) of the Exchange Act for the disgorgement of short-swing profits against John and Peter Sperling (the "Sperlings"). The Sperlings both served on the Apollo Board of Directors – John as the Executive Chairman and Peter as the Vice Chairman – which made the Sperlings "insiders" under Section 16(b).

As insiders of Apollo, the Sperlings held a significant amount of Apollo stock. In an attempt to convert some of their shares into cash, the Sperlings entered into a total of five PVFC transactions. Each PVFC was governed by a series of transaction documents detailing its particular terms, including a master agreement

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3 *See Donoghue v. Murdock*, 2013 U.S. Dist. LEXIS 110605 (S.D.N.Y., 2013) (no sale at settlement of variable prepaid forward contract for which settlement was between the floor and ceiling prices, hereinafter "*Murdock*")); *Donoghue v. Centillium Communications Inc.*, 2006 U.S. Dist. LEXIS 13221 (S.D.N.Y., 2006) (no sale at settlement below the floor price on an unorthodox transaction theory); and *Donoghue v. Patterson*, 990 F. Supp. 2d 421 (S.D.N.Y., 2013) (no purchase at settlement between the floor and ceiling prices). *See*, *also*, *Murdock,* at footnote 6, concerning an informal tentative analysis expressed in 2001 by the staff of the Division of Corporation Finance (the "Staff") of the Securities and Exchange Commission ("SEC") that is inconsistent with the holding in *Sperling.* That informal analysis is discussed in The Section 16 Deskbook, Peter J. Romeo and Alan L. Dye (Spring 2014 edition, at §II.G.3.d(8)(B) ("certain members of the staff expressed the preliminary view that . . . any covered shares not delivered (because the market price of the isuser's stock exceeds the floor price) would be deemed purchased in a non-exempt transaction.").

4 This characterization implies a third transaction for Section 16 purposes: the future sale of the underlying shares at their market price at the time of settlement, adjusted to reflect prepayment. This characterization is, however, inconsistent with the holding in *Murdock*.

that served as the governing document for each PVFC transaction. Each PVFC had a term of longer than six months.

Under the general framework set forth in the master agreements, the banks would prepay the Sperlings an agreed-upon amount of cash on the payment date (the "Payment Date"). In exchange, the Sperlings promised to deliver to the banks a variable number of Apollo shares on a fixed future settlement date (the "Settlement Date"). The Sperlings pledged the maximum number of shares deliverable as collateral, but retained ownership of the pledged shares until the Settlement Date, including retaining the right to vote and receive dividends. Further, the Sperlings could elect to deliver cash – rather than securities – to the banks on the Settlement Date.

On the Settlement Date, the number of shares to be delivered to the banks was determined according to a predetermined, three-prong settlement formula, which included a Ceiling Price and a Floor Price (the "Settlement Formula"). This formula calculated the number of shares to be delivered based on the market price of Apollo stock three trading days prior to the Settlement Date (the "Maturity Date"), in relation to an agreed-upon Ceiling Price and Floor Price in respect of the maximum number of shares to be delivered under the relevant PVFC.

- **Below the Floor Price** – If the market price was below the Floor Price, then the maximum number of shares originally pledged were delivered. The Floor Price protects the Sperlings from (and the banks assumed the risk of) a decline in price of the shares between execution and settlement.

- **Between the Floor Price and the Ceiling Price** – If the market price was between the Floor Price and the Ceiling Price, the number of shares to be delivered *declined* as the share price rose above the Floor Price. Here, the formula was intended to result in the Sperlings receiving the benefit of all of the appreciation between the Floor Price and the Ceiling Price. The Sperlings would retain any undelivered shares and the banks would receive shares with a flat cash equivalent value.

- **Above the Ceiling Price** – If the market price was above the Ceiling Price, the number of shares to be delivered *increased*, as the stock price rose, up to the maximum number of shares to be delivered. Here, the formula was intended to give the banks all of the appreciation above the Ceiling Price. In other words, the banks receive an increasing number of shares of increasing value, but not more than the maximum number of shares originally pledged.

At the Settlement Date, each of the PVFCs at issue settled either above the Ceiling Price or between the Ceiling Price and the Floor Price – none settled below the Floor Price. As a result, the Sperlings did not deliver the maximum number of shares in any of the five PVFC transactions, but rather, retained a portion of the shares that were initially pledged but not delivered in each. The Sperlings did not elect to deliver cash in connection with the settlement of any of the PVFC transactions.

Within six months of the settlement of the PVFC transactions, the Sperlings sold some Apollo shares on the open market. Based on these subsequent sales, the plaintiff alleged that the Sperlings' transactions were subject to the Short-Swing Profit Rule. The plaintiff argued that the Sperlings "sold" the maximum number of shares on the Payment Date and any shares retained upon settlement were "repurchased" by the Sperlings. Thus, under the plaintiff's theory of the case, the "purchase" that occurred from retaining shares is matchable to the subsequent "sale" of Apollo stock on the open market. If the Sperlings' retention of shares was in fact a matchable "purchase", then Section 16(b) would require that any profits from the subsequent sale be disgorged.

The district court held that the transactions at issue did not give rise to liability under Section 16(b) because no purchase (or sale) of securities occurred at the settlement of the PVFC transactions. On appeal, the Court in *Sperling* reviewed only one issue: whether the Sperlings' retention of a portion of shares pledged but not delivered to the banks constituted a "purchase" of company stock under Section 16(b) of the Exchange Act. The Court held that the retention of shares pledged in the PVFC transactions did not constitute "purchases" under Section 16(b).

II. "PURCHASE" AND "SALE" IN CONNECTION WITH DERIVATIVE SECURITIES UNDER SECTION 16(b)

The SEC's approach for determining whether a derivative security transaction involves a purchase or sale begins with the definition of a "derivative security". Rule 16a-1(c) defines a derivative security as:

> any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege at a price

related to an equity security, or similar securities with a value derived from the value of an equity security . . . .

Determining when a purchase or sale of a derivative security occurs requires determining which derivative position the insider holds—a call equivalent position or a put equivalent position. Under Rule 16a-1(b), a "call equivalent position" is a derivative position that increases in value as the value of the underlying equity *increases*. This includes a long call option (including convertible debt) and a short put option. A "put equivalent position", as defined under Rule 16a-1(h), is a derivative position that increases in value as the value of the underlying equity *decreases*. This includes a long put option and a short call option.

Under Rule 16b-6(a), a *purchase* occurs when there is (i) an establishment of or increase in a call equivalent position or (ii) a liquidation of or decrease in a put equivalent position. A *sale* occurs when there is (i) an establishment of or increase in a put equivalent position or (ii) a liquidation of or decrease in a call equivalent position.

This Rule provides an exception for increases or decreases that occur when the exercise price of a floating price security is fixed, but only if the date the price is fixed was not known in advance and was outside the control of the recipient. If so, the increase or decrease will be exempt from Section 16(b) with respect to any offsetting transactions that occurred six months prior to – but not after – the date the price is fixed. In addition, case law has created exceptions for "unorthodox transactions," which are generally transactions that are beyond the control of the insider and therefore not susceptible to speculative abuse.

Further, Rule 16b-6(b) exempts the closing of a derivative security as a result of its exercise or conversion from being a purchase or sale under Section 16. The exercise—as opposed to the expiration—of a derivative security is a "non-event" under Rule 16b-6(b). This is because the insider's opportunity to profit from inside information arises at the commencement of a derivative transaction, not the exercise.[5] Under Rule 16b-6(d), the expiration or cancellation of a derivative security within six months of the writing of the option may be deemed a purchase or sale under Section 16(b).[6]

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5 Not all transactions are eligible for the exemption, including the exercise of "out-of-the-money" options, warrants or rights or the exercise or conversion of a non-derivative security.

6 The Rule provides for an exemption for the expiration or cancellation of a long derivative security position where no value is received from the cancellation or expiration. We note that the Court in *Sperling*, in the

Finally, in determining the timing of when a purchase or sale of a derivative security occurs, Rule 16b-6 distinguishes between fixed-price and floating-price derivatives. Under Rule 16b-6(a), the purchase or sale of a *fixed-price* derivative occurs at the time the contract is written, whereas *floating-price derivative rights* are explicitly excluded from the definition of "derivative security". The purchase or sale of a floating-price derivative does not occur until it is exercised or the exercise price is fixed.

III. Treatment of PVFCs as a Complex Derivative Comprising Two Separate "Fixed-Price" Derivatives And Retention of A Portion of Shares Pledged, But Not Delivered

The Court in *Sperling* recognized that, although a PVFC is a single derivative security, it can be conceptualized as separate components. The Court found that, when so deconstructed, the PVFCs at issue encompassed two analytically distinct derivative positions for the insider: (i) a long fixed-price put option position; and (ii) a short, fixed-price, net-settled, call option position.[7] The Court then concluded that, pursuant to Rule 16b-6(b), the settlement of the PVFC was a "non-event" – neither a purchase nor a sale under Section 16(b).[8] The Court further concluded that, to

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context of a discussion concerning Rule 16b-6(d), states that "for purposes of Section 16 liability, the Sperlings 'sold' call options to the banks on the day they signed the [PVFC], and any matching 'purchases' would occur – *if at all* – on the settlement date if these options went unexercised." (emphasis added). We believe this statement should be read as limited to Rule 16b-6(d) and in that context to mean that the deemed sale arising from the writing of a call option can be matched under Section 16(b) *only* with the expiration within six months of that call option, and that it was not intended more broadly to mean that the non-exempt writing of a call option by an insider cannot be matched with any non-exempt purchase by the insider within six months before or after the writing of the option. As to Rule 16b-6(d), see *Roth v. Goldman Sachs Grp., Inc.*, 740 F.3d 865, 872 (2d Cir. 2014). In any event, this portion of the Court's analysis does not seem to us to materially affect the Court's conclusion in *Sperling*.

7 "The PVFCs at issue here are complex derivatives. On the day the contracts were written, the Sperlings obtained the equivalent of a right to sell a maximum number of shares to the banks, which they would exercise if the share price fell below a floor. . . . In exchange for this put equivalent position, the Sperlings granted the banks a right to receive additional shares as the Apollo stock price rose above the PVFC ceiling price." *Sperling*, at 468.

8 In sum, the Court effectively held that net physical settlement of a short call option position does not result in a deemed purchase for Section 16 purposes, as a straightforward application of Rule 16b-6(b)'s exemption of the closing of a derivative security as a result of its exercise or conversion. This holding is consistent with the statement in SEC Release 34-28869, 56 Fed. Reg. 7242 (1991), in the text preceding footnote 209, that "SARs settled for stock are derivative securities and are accorded the same treatment as options.[209] [fn 209: just as with other derivative securities, any SAR that may be settled for stock . . . would be reported at grant and eligible for the exercise exemption of Rule 16b-6(b).]" We note that the Staff has taken the position, in the discussion following footnote 209 of Release 34-28869 and in subsequent no-action letters (Cravath, Swaine & Moore, Q.6 (May 6, 1991); Simpson Thacher & Bartlett, Q.4 (April 30,

the extent the settlement of the PVFC constituted the expiration of any of the component options, the expiration could be matched only with the writing of that option, and not with any subsequent sales by the Sperlings.[9] Accordingly, in sum, the Court held that the retention of a portion of shares that were pledged by the Sperlings but not delivered upon settlement did not result in Section 16(b) liability, as the retention of those pledged shares at settlement was not a "purchase" against which a "sale" could be matched.

IV. TREATMENT OF PVFCS AS TRADITIONAL DERIVATIVES, NOT HYBRIDS

Somewhat unfortunately, after coming to the conclusions set forth above, the Court undertook an analysis of whether the PVFCs were "hybrid derivatives" and therefore subject to its prior decisions concerning derivative securities that have a combination of fixed and floating exercise prices.[10] As described above, the PVFCs at issue in *Sperling* simply did not have floating exercise prices or a floating number of underlying shares, as none of the Floor Price, the Ceiling Price or the reference number of shares was subject to change during the term of the PVFC. However, the constituent derivatives were effectively net settled, with the consequence that a variable number of shares were to be delivered upon settlement. The Court seems, in our view, to have confused that fact (which is of course a feature of any net physically settled *fixed-price* put or call option) with the circumstance of a derivative that does not have either a fixed exercise price or a fixed number of underlying shares (or both). As discussed below, the Court then went on to distinguish the PVFCs at issue in *Sperling* from other hybrid derivatives in a manner that establishes a principle that we believe is not consistent with prior guidance and not helpful to achieving clarity in respect of the application of Section 16 to complex derivatives.

1991)), that purchase or sale transactions are deemed to occur upon *cash* settlement of a fixed-price derivative ("SARs that can be settled in either cash or stock, but are settled in cash, are treated as an exercise of an option (generally an exempt transaction) and the simultaneous sale of the underlying stock.").

9 This reflects a principle previously established by the Court in *Allaire Corp. v. Okumus*, 433 F.3d 248 (2d Cir., 2006).

10 For example, a right to purchase 100 shares at the lesser of $10 per share and the market price on a specified future date.

More specifically, in its discussion of hybrid derivatives the Court in *Sperling* implicitly accepted that the PVFCs had some floating price or share element[11] but then reasoned that the PVFCs at issue should not be treated as hybrid derivatives – with a potential transaction upon settlement – because the PVFCs settled at a predetermined fixed date, and not upon an election to exercise by the Sperlings.[12] The Court explained that hybrid derivatives present two opportunities to use inside information: once at the writing of the contract and again at their exercise. It emphasized that where one of the parties controls the timing of the exercise, there is an additional danger of manipulation. The Court stressed that the critical factor underlying all of the Second Circuit's hybrid derivative cases is the fact that in those cases one of the parties controlled the timing, and thus the price, at which the derivative security would be exercised. The Court said that the absence of this feature in the PVFCs at issue removed any ability for the Sperlings to time the settlement at an opportunistic date, therefore eliminating a risk of manipulation at settlement and obviating the need to treat the settlement as a deemed purchase or sale.

In our view, this analysis is faulty. To our knowledge, there is no prior guidance that permits a variable price to be considered a fixed price because the price will be determined pursuant to a fixed formula that refers to a market price at a specified date in the future, and there has at least been some guidance to the contrary.[13] The Court's conclusion about the risk of manipulation in *Sperling* was correct, because the PVFCs consisted of two *fixed-price* derivatives and under the plain vanilla approach of the rules to fixed-price derivatives, and not because of control over the timing of settlement. We acknowledge that the reasoning of the

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[11] "It is true that with these PVFCs, as with the securities in our hybrid cases, the number of shares that may be called and the price of those shares is not known at the time the contract is written." *Sperling*, at 470.

[12] "Because the parties are bound to the formula and dates from the time of contracting, the prices of these PVFC options were fixed at the time they entered the contract even if they are not known." *Sperling*, at 470.

[13] See, e.g., SEC Release 34-28869, in the text following footnote 148 ("In the case of an option with a floating price that will become fixed as of an event or a specified date prior to exercise, the right is deemed to become a derivative security upon the fixing of the price") and in footnote 147 ("Some stock purchase plans, such as plans satisfying section 423 of the Internal Revenue Code, offer an ongoing right to purchase stock at the current market price or a discount from market such as 85 percent of market price. The rights or "options" tend to have a duration of six months or a year and operate through payroll deduction mechanisms. Although these plans offer a right to purchase underlying stock, the purchase price of the underlying security often is not fixed and therefore those rights without a fixed exercise price will not be treated as derivative securities until the purchase price is established which occurs usually at exercise of the right.").

Court in *Sperling* may be useful in many contexts for insiders. However, in other contexts, the principle may backfire[14]. Analytically, a purchase or sale should occur when a price is fixed, even if the formula and timing for fixing the price is established in advance.

The Court went on to argue that treating PVFCs as traditional derivatives rather than hybrid derivatives because of the control of the timing issues comports with SEC regulations. The Court pointed to Rule 16b-(6)(a), which exempts certain transactions from Section 16(b), and noted that this Rule was created by the SEC in order to avoid "the unfairness of subjecting insiders to liability under Section 16(b) who engage in a purchase or sale and then have an offsetting sale or purchase thrust upon them thereafter by events 'not known in advance' and 'outside the[ir] control.'" The Court reasoned that treating PVFCs as hybrids would result in the same unfairness.

We find this argument unpersuasive. In citing Rule 16b–6(a), the Court omitted the portion of the rule set forth in italics below:

> [I]f [an insider's] increase or decrease [in a derivative position] occurs as a result of the fixing of the exercise price of a right initially issued without a fixed price, where the date the price is fixed is not known in advance and is outside the control of the recipient, the increase or decrease shall be exempt from section 16(b) *with respect to any offsetting transaction within the six months prior to the date the price is fixed*.

If the SEC intended for the ability to control the timing of price-fixing to dictate when a purchase or sale under Section 16(b) occurs in a transaction, then the exemption for offsetting transactions only within the *prior* six months would be inappropriate. Instead, the Rule should apply to offsetting transactions within the six months prior to *or following* the date the price is fixed.

Finally, the Court reasoned that, if a purchase or sale were to be deemed to occur upon settlement of a typical PVFC, every PVFC would lead to Section 16(b)

[14] For example, assume that an insider purchases 100 shares on the market on February 1 for $10 per share. Assume that on February 2, when the market price has risen to $12 per share, the insider enters into a binding forward contract to sell $1,200 worth of shares on September 1 at 100% of the closing market price on that date. Under the Court's analysis, since the insider has no ability to control the timing of settlement, the transaction may be treated as a sale on February 2.

liability. The Court explained that under a hybrid analysis a "sale" will always occur shortly before settlement of a PVFC, when the value to be delivered is determined. The Court noted that if the expiration of the bank's call option is a deemed "purchase" by the insider, it could be matched with this deemed "sale." The Court stated that this result – effectively eliminating the ability of insider to enter into PVFCs – "does not make sense," without further explanation. Again, we agree with the conclusion that a hybrid analysis should not apply, but the reasoning is not persuasive. We see nothing in the Section 16 framework that guarantees insiders the right to enter into PVFCs or other particular complex derivatives. There are some complex derivative transactions that are very justifiable from a general securities law perspective but that create liability under the bright line rules of Section 16.

V. CONCLUSION

In our view, *Sperling* is further indication that the courts appear to be continuing to fill in the gaps of the analytical framework for applying Section 16(b) to PVFCs in a manner that gets to the right conclusion. However, while the courts have mostly gotten to the right result, they continue to struggle with the analysis.

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