Rule 10b-6: Options Trading by Participants in a Distribution

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Put and call options have been the object of considerable interest in the securities industry in recent years. Since 1973, when the Securities and Exchange Commission (SEC) approved the Chicago Board Options Exchange (CBOE), four other exchanges have initiated options trading, thereby making this investment opportunity available to a larger segment of the public. Investor response to these new markets has been overwhelming, and continued growth in both the volume of transactions and the number of investors is anticipated. As the volume of such trading increases, more institutions and individuals will need clarification of the applicability of existing securities laws and regulations to put and call options.

1. This Note deals only with stock options, and thus it is not concerned with commodity options. There are two types of stock options: puts and calls. A put is a right to sell 100 shares of the underlying stock within a specified time. A call is a right to buy 100 shares of the underlying stock within a specified time. See Division of Trading and Exchanges, Securities & Exchange Commission, Report on Put and Call Options 7-9 (1961); J. Miller, Options Trading 99-102 (1975); Anderson, Chicago Options, 27 Bus. Law. 7, 7-9 (1971).


5. In March 1974, the CBOE monthly trading volume was equivalent to 33.6 million underlying shares. J. Miller, supra note 1, at 8-9. Between November 1, 1975 and November 30, 1976, the average monthly volume on the CBOE was equivalent to nearly 170 million underlying shares. The average combined monthly volume for the CBOE, American, Philadelphia, and Pacific Coast exchanges between April 1, 1976 and November 30, 1976 was approximately 253 million underlying shares. 36 U.S. Securities and Exchange Commission, Statistical Bulletin No. 1, at 26 (Jan. 1977).

6. Since the New York Stock Exchange may soon be trading options, see note 4 supra; the dramatic increase in trading volume, see note 5 supra, might well be expected to continue.
transactions. For example, the Securities Exchange Act of 1934 and certain regulations promulgated thereunder control whether participants in a distribution may trade the securities being offered for sale. It is perhaps inevitable that participants in a distribution will discover that they are holding or trading options respecting securities that they are distributing. The question that will arise in this situation is whether—or to what extent—the parties involved should be allowed to trade such options.

After briefly discussing the history of options trading, this Note argues that where participants in a distribution trade options, the potential for abuse is sufficient to warrant regulation of this activity. It then evaluates existing statutes and SEC rules that seek to prevent similar abuses and concludes that language in some of these provisions—particularly rule 10b-6—can be construed to prohibit participants in a distribution from engaging in certain put and call transactions that might manipulate the price of the security being distributed.

I. The Nature of Options Trading

A. Background

Although extensive options trading occurred as early as the

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8. E.g., 17 C.F.R. §§ 240.10b-2, 10b-6, 10b-7, 10b-8 (1977).
9. For the purposes of this Note, the terms "participants" and "interested parties" refer to "issuers," "underwriters," and "prospective underwriters" as used in SEC rule 10b-6, 17 C.F.R. § 240.10b-6 (1977). See note 9 infra. For discussions of the persons to whom rule 10b-6 applies, see 3 L. Loss, Securities Regulation 1596-99 (2d ed. 1961); E. Weiss, Registration and Regulation of Brokers and Dealers 132 (1965); and Comment, The S.E.C.'s Rule 10b-6: Preserving a Competitive Market During Distributions, 1967 Duke L.J. 809, 840-46. See also SEC Exchange Act Release No. 7743 (Nov. 12, 1965), [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,306 (dealer qualified as an underwriter even though the dealer's New York office had refused to underwrite the issue and no underwriting fee had been paid).
10. For a discussion of the term "distribution" as used in this Note, see note 9 infra.
12. The SEC staff is currently studying the rapidly expanding options markets, and Mr. Andrew Klein, head of the Office of Market Structure and Trading Practices, has questioned whether a participant in a distribution can solicit prospective buyers of the stock to write options on the stock. Apparently the SEC's concern is that creating additional interest in the stock will drive up the price. As of yet, however, the SEC has taken no position on this question. See [1976] Sec. Reg. & L. Rep. (BNA) No. 348, at A-9.
13. 17 C.F.R. § 240.10b-6 (1977), quoted in note 97 infra.
14. In general, the questions underlying the analysis of all problems arising under the securities laws are (1) whether these laws were intended to forbid the conduct in question, and (2) whether the broad purposes of these laws would be furthered by applying their sanctions to the situation under review. See SEC v. National Sec., Inc., 393 U.S. 453, 467 (1969).
seventeenth century, options were not widely traded in this country until shortly after the Civil War. Soon thereafter the use of options by unscrupulous financiers engendered adverse public opinion, and some courts, seeking to eliminate such trading altogether, deemed options to be violative of state gambling laws. Other courts, however, upheld options as valid contracts, apparently because they were persuaded that the value of options to business people who desired to mitigate the uncertainty of fluctuating prices for their supplies and products outweighed the risks of manipulation and fraud occasioned by their use. Options trading persisted despite its disapproval in some states; in fact, during the economic boom of the 1920s, options

15. Probably the earliest large-scale use of options occurred during the famous “tulip bulb craze” in seventeenth century Holland. During this period, buyers of tulip bulbs purchased options (calls) in order to assure themselves of sufficient supplies of the commodity; sellers of the bulbs purchased options (puts) in order to assure themselves of a market in which to sell future supplies. Speculators with no interest in acquiring or selling the bulbs underlying these options realized that it was possible to profit on the price fluctuations of the options without ever taking delivery of the underlying bulbs, and they therefore created a market for the options alone. As will be discussed, see text at note 38 infra, this phenomenon of profit-making by trading options serves as the foundation for modern options exchanges such as the CBOE. See generally H. Filer, Understanding Put and Call Options 12 (1959); J. Miller, supra note 1, at 1-10; E. Morgan & W. Thomas, The Stock Exchange: Its History and Functions 21 (1962); Note, Exchange-Traded Stock Options: Investment Techniques and Tax Strategy, 44 U. Cin. L. Rev. 753, 753-54 (1975).

16. See, e.g., J. Miller, supra note 1, at 3; Note, supra note 15, at 753 & n.5.

17. See, e.g., Corcoran v. Lehigh & Franklin Coal Co., 138 Ill. 390, 28 N.E. 759 (1891); Schneider v. Turner, 130 Ill. 28, 22 N.E. 497 (1889); Lock v. Towler, 41 Ill. App. 66 (1891); Osgood v. Bauder, 75 Iowa 550, 39 N.W. 887 (1888); Rudolf v. Winters, 7 Neb. 125 (1878). Remnants of this attitude have survived into the modern era. See [1971] Op. Ga. Atty. Gen. 71-115 (Georgia Attorney General opined that certain put and call options were not gambling devices under the Georgia gambling laws).

Public antipathy toward options is also evident in trust law. In the absence of express statutory authority, the power to grant options has usually not been granted to trustees even though the trustee is empowered to sell trust property. The rationale for this principle has been that at the time of the sale the trustee should be in a position to exercise discretion as to the amount of the purchase price. 3 A. Scott, The Law of Trusts § 190.8, at 1573 (3d ed. 1967); G. Bogert & G. Bogert, Trusts and Trustees § 741, at 567 (2d ed. 1960). In fact, courts have implied a power of a trustee to grant options only when necessary to carry out the purpose of the trust. See Loud v. St. Louis Union Trust Co., 313 Mo. 552, 281 S.W. 744 (1926).

As is the case with investors, adverse attitudes toward trustees dealing in options have eroded. Today state statutes generally give trustees the power to grant options. E.g., Ill. Rev. Stat. ch. 148, § 104.01 (1973); Wash. Rev. Code Ann. § 30.59.070 (2) (1961).

18. These courts generally upheld the options only if the parties had a bona fide intention to deliver or purchase the underlying commodity. Compare Embrey v. Jemison, 131 U.S. 336 (1889) (option invalid under New York and Virginia law because no bona fide intent to deliver), with Story v. Salomon, 71 N.Y. 420 (1877) (option valid upon presumption of bona fide intent). See also 6A A. Corbin, Contracts 673-76 (1962); Annot., 1 A.L.R. 1548 (1919).
became favored devices for fraudulent manipulations. These abuses did not go unnoticed. The Senate Committee on Banking and Currency, in its favorable report on the bill that later became the Securities Exchange Act of 1934, stated that "[m]any of the most flagrant abuses upon stock exchanges would not be possible without the aid of options. They are indispensable concomitants of every pool operation designed to distribute stock at an increased price." The fear of manipulations through options trading was so great that an early draft of the Exchange Act proposed a prohibition of all options trading. Although the final version of the Act did not prohibit options trading, it did contain a general prohibition against the use of manipulative devices. Even more significant was the Act's specific grant of authority to the SEC to promulgate rules regulating the trading of put and call options. Despite the concern over options, no rules were adopted pursuant to this authority, and the options industry continued unchanged for nearly forty years. All trading took place in over-the-counter (OTC) markets and was relatively complicated because the options contained three variables—

21. S. Rep. No. 792, 73d Cong., 2d Sess. 9 (1934). The committee report continues:
  Enormous profits have been made by operators who traded against options without incurring the slightest risk or obligation. The New York Stock Exchange a few months ago, at the suggestion of this committee's counsel, adopted a rule requiring its members to report regularly on options in which they are interested or of which they have knowledge by reason of transactions executed by or through them; but evasion of the rule is easily accomplished by causing the options to be granted to persons who are not members of the exchange or bound by its rules. Here again the necessity for regulation by a commission having authority over nonmembers as well as members of an exchange is evident.
22. See 3 L. Loss, supra note 9, at 1544 & n.45.
25. Indeed, there are currently no rules in effect pursuant to this grant of authority. See text at notes 55-56 infra.
26. The OTC options market, in which all options trading took place during these years, is still in use, but its importance has diminished since the creation of the CBOE and its counterparts. See text at notes 35-39 infra.
27. See 1 L. Loss, supra note 9, at 468. Nearly every transaction in the OTC market involves the Put and Call Brokers and Dealers Association, which serves as a clearinghouse for the options departments of large brokerage firms. See id.; J. Miller, supra note 1, at 14.
the premium,\textsuperscript{28} the striking price,\textsuperscript{29} and the expiration date—all of which were subject to negotiation between the optionor and the optionee.\textsuperscript{30} The ability to choose the terms of the option enabled investors to devise a virtually unlimited variety of option instruments for each issue of stock. The market became cumbersome, but, so long as the optionee held his option with the intention ultimately to exercise it for purposes of increasing or reducing his holdings, the system worked in a reasonably satisfactory manner: each party to the instrument was fully aware of the terms that had been negotiated and each recognized certain rights and obligations pursuant to the option. Thus, when an optionee chose to exercise an option, he was exercising a right the terms of which were tailored to his specific investment needs.

For optionees who desired to recognize immediate profits, however, the OTC market possessed serious drawbacks. In particular, the absence of a readily available "secondary market" in which the options themselves could be resold disadvantaged many investors. If an option holder sought to gain a profit by selling the option itself, he would encounter extreme difficulty in finding a buyer whose needs would be satisfied by the option's unique terms. The unavailability of a meaningful secondary market forced brokers to charge high commissions for matching buyers and sellers.\textsuperscript{31} The alternative means of recognizing a profit was to exercise the option and simultaneously enter the market to cover the exercise by selling or acquiring the underlying stock.\textsuperscript{32} In order to do this, however, the optionee had to pay two commissions—one to exercise the option and another to make the transaction involving the underlying stock.\textsuperscript{33} These disadvantages of the OTC market probably discouraged

\textsuperscript{28} The premium is the "price" charged for the option. See Division of Trading and Exchanges, Securities & Exchange Commn., supra note 1, at 9; J. Miller, supra note 1, at 101; Anderson, supra note 1, at 7.

\textsuperscript{29} The striking price, or contract price, is the price at which the option may be exercised. See Division of Trading and Exchanges, Securities & Exchange Commn., supra note 1, at 9; J. Miller, supra note 1, at 102; Anderson, supra note 1, at 7.

\textsuperscript{30} The optionor is the party who writes or issues the option; the optionee is the party who acquires and has the right to exercise it.

\textsuperscript{31} See Anderson, supra note 1, at 9; Gates, supra note 2, at 432; Note, supra note 15, at 755.

\textsuperscript{32} Whether the optionee would enter the market to sell the underlying stock or to buy it would depend, of course, on whether he held a put or a call. The holder of a call would exercise his option and simultaneously sell the underlying stock when the market price was above his striking price. The holder of a put would exercise his option and simultaneously acquire the underlying stock when the market price was below his striking price. In either case, the optionee would realize a profit equal to the spread between the market price and striking price, less the premium and commissions paid.

\textsuperscript{33} Gates, supra note 2, at 432.
options trading, especially among small investors who were reluctant to contend with the cumbersome and expensive system.34

Because of the disadvantages of the OTC system, in 1973 the SEC approved the Chicago Board Options Exchange (CBOE) as a "national securities exchange."35 Other exchanges have subsequently sought and received approval for options trading.36 These exchanges have benefited options trading in several ways, such as by providing a central marketplace for buyers and sellers and by fixing expiration dates and striking prices.37 Perhaps the most significant benefit of the CBOE and its counterparts on the American, Philadelphia, Midwest, and Pacific Coast exchanges is that these markets, unlike the OTC system, provide a very accessible "secondary market." Whereas the OTC system requires option holders to pay high commissions to sell their options, the exchanges enable holders to sell their options at reasonable transaction costs. In fact, most of the profits and losses on such exchanges are realized on the movement of the prices of options themselves rather than on conversion of the options into their underlying stocks.38 By this streamlining of the secondary market, the new exchanges have made options trading feasible for greater numbers of investors.39

B. Purposes and Uses

Stock option trading serves several legitimate purposes.40 For example, an investor might trade puts and calls in order to compen-

34. The drafters of the early version of the Exchange Act, see text at note 22 supra, and the judges of the late nineteenth century Illinois, Iowa and Nebraska courts, see text at note 17 supra, believed that there was something inherently evil about options trading by parties who have no intention of acquiring or selling the underlying securities. It is arguable under this view that the system for trading options should be made so cumbersome as to deter pure speculators from entering the market. However, the reaction of Congress to the proposed prohibition against option trading, see text at notes 22-23 supra, and the SEC's approval of the Chicago Board Options Exchange, see text at note 35 infra, demonstrates that contemporary attitudes view options trading not as being inherently evil but as offering an investment opportunity that should be available to all investors, including those who have neither the time nor the resources to trade in the over-the-counter market.


36. See note 4 supra.

37. See Anderson, supra note 1, at 9; Gates, supra note 2, at 450-52.

38. See Anderson, supra note 1, at 10. For a discussion of this phenomenon during the seventeenth century tulip bulb craze, see note 15 supra.

39. See Gates, supra note 2, at 452-55; note 5 supra.

40. The SEC has listed four reasons for buying options: (1) to protect a position against fluctuating market prices, (2) to engage in in-and-out trading with a limited potential loss, (3) tax savings, and (4) speculation on a small amount of capital. Division of Trading and Exchanges, Securities & Exchange Commn., supra note 1, at 76-77. Of these four, the last appears to lure the most investors into the options market. "The brokers interviewed were unanimous in the opinion that the rea-
sate for or "hedge" a long\textsuperscript{41} or short\textsuperscript{42} position in a particular security.\textsuperscript{43} Such an investor does not guarantee himself the most profitable transaction possible, but he does ensure his ability to participate in the market in the future at a certain price\textsuperscript{44} and sets an upper limit on his losses.\textsuperscript{45}

Although no reason exists to prevent investors from trading puts and calls as a hedge or for other legitimate ends, different considerations are pertinent when an individual is involved in the distribution of securities that underlie the options he wishes to buy, sell, or exer-

\textsuperscript{41} In the securities industry, an investor is "long" with respect to a particular security when he has an abundant number of shares, or a number of shares in excess of the shares he has become obligated to deliver to another investor in the future. See G. Munn, Encyclopedia of Banking & Finance 546 (7th ed. F. Garcia 1973).

\textsuperscript{42} An investor is "short" with respect to a security when he holds fewer shares of the security than he needs to fulfill his obligations to sell. See, e.g., Boyle v. Henning, 121 F. 376, 380 (W.D. Ky. 1902); Thomas v. McShan, 99 Okla. 88, 225 P. 713, 714 (1924).

\textsuperscript{43} As used in this Note, a "hedge" is a transaction entered into for the purpose of protecting against loss by assuring the existence of a buyer (in the case of a "long" position) or a supplier (in the case of a "short" position). For example, an investor who is "long" in a particular stock can hedge his position by acquiring puts. By doing so, the investor assures himself of a future market in which he will be able to sell his excess supply at a fixed price. While the price may not be as high as he would prefer, he is willing to sacrifice maximum profit for the certainty of the future market. Similarly, an investor who is "short" in a particular security can hedge his position by acquiring calls. The investor thereby assures himself that, despite a sudden rise in the market price of the security, he will be able to fulfill his obligations by acquiring the stock at the call's striking price. Again, the transactions may not be the most profitable, but the investor sacrifices some profit for certainty.

An investor in a long position would not be as likely to write calls as he would be to acquire puts; writing calls would leave him without control over whether he would sell pursuant to the option or on the open market. Moreover, he would be severely disadvantaged if the market price of the stock rose. In that event, his optionees would exercise their calls, and he would be forced to sell at a price below market. Similarly, an investor in a short position is not likely to write puts since the optionees would exercise their puts only if the market price dropped. The optionor would then have to purchase at a price above the market. In either case, the hedging party would prefer to be the optionee.

\textsuperscript{44} See note 43 supra.

\textsuperscript{45} See note 40 supra.
exercise. Because the options exchanges place daily options transactions in public view, parties interested in a distribution are provided with the opportunity to create the appearance of widespread interest in the security being distributed by actively trading options on that security. Thus, the participants in the distribution might trade puts and calls to facilitate sales of the underlying security and thereby manipulate the market for it if, for example, the underwriters have difficulty selling the issue. Moreover, such trading is likely to cause the price of the option to rise, thereby attracting investor interest and indirectly increasing the demand for the underlying security. In effect, an upward "massaging" of the option price tends to have a similar effect upon the price of the underlying security.

More significantly, a participant in a distribution might trade puts and calls in order to affect more directly the market for the underlying security. For example, to facilitate a troublesome distribution, a participant might acquire calls in order to create buying pressure on the security. As a purchaser of calls, the participant can anticipate that the writer of the calls will enter the market and purchase the underlying security in quantities sufficient to ensure that he will be able to meet his obligations when the calls are exercised. If

46. The SEC has expressed concern over this effect in situations where participants have solicited prospective buyers to write options on the stock. See note 12 supra.


48. Upon initial consideration, acquiring calls appears to be the opposite of what an underwriter would do in order to sell the underlying security. By acquiring calls the underwriter, in effect, would be using options in approximately the same manner as if he were attempting to cover a short position. See note 43 supra. However, an underwriter who is having trouble with a "sticky issue" is essentially "long" in the security, and presumably would purchase puts instead of calls in order to create a certain market for the stock. See note 43 supra.

Closer analysis, however, reveals why purchasing calls facilitates distribution of the underlying security. Acquiring a put gives the holder the right to sell a security during an agreed-upon period of time. Holding a right to sell does nothing to increase demand for the security, which is what is needed to facilitate the distribution. Acquiring a call, however, induces the writer of the call to enter the market and purchase the underlying security in quantities sufficient to be able to fulfill his obligation when the call is exercised. Thus, by purchasing large quantities of calls, a participant can generate buying pressure on the underlying security.

With the advent of options exchanges, the writers of the calls are the exchanges themselves. There is no reason, however, why the CBOE and other options exchanges should be less inclined than any other optionor to enter the market and purchase securities in quantities sufficient to fulfill their obligations under outstanding calls. For a discussion of the CBOE as a clearinghouse for all options traded through its mechanisms, see Note, supra note 15.

49. Of course, if the options are "covered" rather than "naked," in the sense that the optionor already owns sufficient shares of the security to satisfy potential obligations created by the calls, the optionor would not enter the market in order to make additional purchases. However, to the extent that the optionor will be with-
the participant in the distribution acquires a large number of calls, the increased buying pressure on the underlying security will cause the price of the security to increase. As the price of the security rises, investors may well be induced to purchase it from the underwriter. Because investors might be deceived into paying inflated prices for securities as a result of options trading by the parties interested in a distribution, it would seem quite appropriate to regulate such trading. The remainder of this Note, therefore, considers whether there are any statutes or SEC rules that can be used to regulate this manipulative activity.

II. REGULATION OF OPTIONS TRADING

The main purpose of the Securities Exchange Act of 1934 was to provide investors with securities markets in which prices would be established by the uninhibited interaction of supply and demand. Manipulative options trading was one of the evils that had been frustrating the free movement of prices. As discussed above, an early draft of the Exchange Act would have prohibited all trading of puts and calls. Although this prohibition was not enacted, in section 9(b) of the Act Congress did grant the SEC the authority to promulgate rules regulating transactions involving such instruments. While the legislative history of the Exchange Act and

holding his shares from the market, the effect is similar to that of making additional purchases because in both situations the supply of the securities is restricted.

50. Lowenfels, supra note 47, at 1407.
53. See text at notes 19-23 supra.
54. See text at notes 20-22 supra.

It shall be unlawful for any person to effect, by use of any facility of a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors—(1) any transaction in connection with any security whereby any party to such transaction acquires any put, call, straddle or other option or privilege of buying the security from or selling the security to another without being bound to do so.

The terms “put,” “call,” “straddle,” “option” and “privilege” are defined in § 9(d) of the Act as not including “any registered warrant, right, or convertible security.”
the language of section 9(b) clearly demonstrate that the drafters contemplated the kinds of options being traded in modern options markets, section 9(b) is not an effective device for controlling potential abuses involving puts and calls: the provision is not self-executing, and currently no rules are in effect pursuant to the section. Notwithstanding the ineffectiveness of section 9(b), there are two other provisions—section 9(a)(2) and section 10(b)—that appear to be sufficiently broad to regulate manipulative activity involving puts and calls.

Section 9(a)(2), which is commonly referred to as the Exchange Act's "general anti-manipulation provision," makes it unlawful to effect, alone or with one or more other persons, a series of transactions in any security registered on a national securities exchange creating actual or apparent active trading in such security or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others. Since section 9(a)(2) contains broad, self-executing language, it could be read as reaching all manipulative transactions, including those in which participants in a distribution employ options to manipulate the price of the security being distributed. However,

15 U.S.C. § 78i(d) (1970). This limiting definition is significant to the interpretation of the term "right" as used in rule 10b-6. See text at notes 99-113 infra.


59. See In re White (White, Weld & Co.), 3 S.E.C. 466, 535-37 (1938) (SEC recognized that, despite the absence of rules under section 9(b), transactions involving options may violate section 9(a)).


61. 15 U.S.C. § 78i(a)(2) (1970). Section 9(a)(6), 15 U.S.C. § 78i(a)(6) (1970), complements section 9(a)(2) by granting the SEC the authority to prescribe rules and regulations as it may deem appropriate to regulate "transactions for the purchase and/or sale of any security registered on a national securities exchange for the purpose of pegging, fixing, or stabilizing the price of such security." As used in this Note, "manipulation" means activity that affects the price of a security to a greater degree than is permissible as a "stabilizing" measure. Stabilization, defined as "the buying of a security for the limited purpose of preventing or retarding a decline in its open market price in order to facilitate its distribution to the public," SEC Exchange Act Release No. 2446, at 3 (March 18, 1940), has long been considered a form of manipulation. See id. at 2. Nevertheless, stabilization was recognized at the time the securities laws were drafted as a legitimate device because it permits underwriters participating in distributions to sell securities quickly.
the conclusion that section 9(a)(2) applies to participants' options transactions during a distribution is not beyond dispute.

Section 9(a)(2) prohibits manipulative "transactions in any security . . . for the purpose of inducing the purchase . . . of such security." An option is commonly considered a security, so this language might be interpreted to mean that, since options trading by participants would be intended to induce purchases or sales of the underlying security rather than of such options, section 9(a)(2) is inapplicable to this kind of options trading. However, such a narrow reading of the statute seems unwarranted. Congress expressly provided that the definitions of the key terms of the Exchange Act, such as "security," are to be applied flexibly to promote the purposes of the Act and should not be employed if "the context otherwise requires." Moreover, it is noteworthy that the SEC has promulgated rule 3a11-1 to clarify the section 3(a)(11) definition of "equity security," a term used in section 16, the provision controlling insider transactions. Rule 3a11-1 states that the term "equity security" includes "any stock or similar security, . . . or any put, call, straddle, or other option or privilege of buying . . . or selling such a security." The statutory definition of "equity security" in section 3(a)(11) is very similar to that of "security" in section 3(a)(10), which is the relevant definition for section 9(a)(2). If the interpretation of "equity security" in rule 3a11-1 may be applied to the term "security," then section 9(a)(2) can be construed as prohibiting put and call transactions that manipulate the


69. 17 C.F.R. § 240.3a11-1 (1977).
prices of their underlying securities, since any transaction involving the options would be deemed to be a transaction involving the underlying security. Indeed, it seems reasonable to conclude that section 9(a)(2), in order to fulfill its general purpose of prohibiting manipulation, requires such an interpretation of the term "security."

Although section 9(a)(2) appears to apply to the trading of options by participants in a distribution, use of this provision to regulate such transactions is not without difficulty. One potential barrier to applying the section is its "intent" requirement—in order for there to be a violation, the transaction must have been undertaken "for the purpose of inducing the purchase or sale" of the security in question. While the SEC rarely initiates cases under section 9 because of the burden of proving the existence of "purpose," the Commission and the courts have been willing to infer the requisite purpose from the circumstances of the transaction. For example, one factor that permits finding such a purpose is whether an individual has a "substantial, direct pecuniary interest in the success of a proposed offering." Certainly a participant in a distribution possesses such an interest and hence has an incentive to manipulate the security's price. Therefore, in most cases, the "purpose" requirement of section 9(a)(2) should pose no barrier to the regulation of options trading by participants in a distribution. Yet, as is suggested by the paucity of SEC litigation, this barrier may not always be surmountable. Thus, the use of other provisions—such as rule 10b-6, which is discussed below—would be preferred if they can control this type of manipulation without requiring a showing of purpose.

Moreover, it is significant that section 9(a)(2) deals only with
securities registered on a national securities exchange. Although this does not render section 9(a)(2) useless in controlling manipulations involving options, it significantly limits the section's scope, since it does not reach manipulations involving OTC options. Finally, section 9(a)(2) requires a "series" of manipulative transactions and thus does not extend to isolated manipulative trades. Clearly it would be advantageous to regulate options trading by participants in a distribution by using a rule that does not require a series of transactions and is not limited to securities traded on national securities exchanges.

Fortunately, section 9(a)(2) is complemented by a broader provision, section 10(b), which makes it unlawful "to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." Unlike section 9(b), the provision of the Act permitting regulation of puts and calls, section 10(b) has been given effect through several specific rules. Rule 10b-5, the broadest of these rules, makes it unlawful "to employ any device, scheme, or artifice to defraud, ... or ... to engage in any practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." It is thus clear that manipulative options trading by parties interested in the distribution of a security falls within the scope of rule 10b-5 to the extent that it operates as a fraud or deceit upon investors. Options trading is undoubtedly an "act, practice or course of business," and if such trading is undertaken to facilitate the distribution of a security, it is clearly "in connection with" the purchase or sale of the security. Moreover, the Supreme Court has stated that an expansive view of section 10(b) should be taken when determining what types of fraud are within its scope. Yet, in other respects, the Court has

79. See text at note 61 supra.
80. See text at note 61 supra.
81. 15 U.S.C. § 78j(b) (1970). In SEC v. Resch-Cassin & Co., 362 F. Supp. 964, 975 (S.D.N.Y. 1973), the court stated that "it is well settled that the manipulative activities expressly prohibited by § 9(a)(2) of the Exchange Act with respect to a listed security are also violations of ... § 10(b) of the Exchange Act when the same activities are conducted with respect to an over-the-counter security."
85. See Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971). Other courts have supported the proposition that manipulative transactions are within the scope of rule 10b-5. See, e.g., United States v. Charney, 537 F.2d 341 (9th Cir. 1976); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 378 (2d Cir. 1974);
restricted the effect of the rule. For example, it has held that a private cause of action for damages will not lie if the plaintiff fails to allege an intent to defraud, or "scienter." Thus, in certain circumstances investors defrauded by manipulative options trading might be forced to make the same showing of intent under rule 10b-5 that they would have to make under section 9(a)(2). Although meeting this burden probably would not be insurmountable in most cases, this consideration—when viewed in light of an apparent trend in Supreme Court cases to limit the effect of rule 10b-5—suggests the desirability of finding some other rule to provide a remedy for investors defrauded by manipulative options trading during a distribution. The remainder of this Note contends that rule 10b-6 is well suited to protect such investors.

Rule 10b-6 specifically addresses the problem of manipulations by persons participating in a distribution. Adopted in response to


88. Both the scienter element of rule 10b-5, see notes 86-87 supra and accompanying text, and the "purpose" element of section 9(a)(2), see text at notes 73-78 supra, require a plaintiff to make a showing of manipulative intent.


90. 17 C.F.R. § 240.10b-6 (1977).

91. Two major issues determine the applicability of rule 10b-6: (1) the identity of persons prohibited from certain activities by the rule, and (2) the nature of a "distribution" of securities. The prohibitions of rule 10b-6 apply to three classes of persons—issuers, underwriters, and prospective underwriters. Section (c) of rule 10b-6 defines "underwriter" and "prospective underwriter":

(1) The term "underwriter" means a person who has agreed with an issuer or other person on whose behalf a distribution is to be made (i) to purchase securities for distribution or (ii) to distribute securities for or on behalf of such issuer or other person or (iii) to manage or supervise a distribution of securities for or on behalf of such issuer or other person.

(2) The term "prospective underwriter" means a person (i) who has agreed to submit or has submitted a bid to become an underwriter of securities as to which the issuer, or other person on whose behalf the distribution is to be made, has issued a public invitation for bids, or (ii) who has reached an understanding, with the issuer or other person on whose behalf a distribution is to be made, that he will become an underwriter, whether or not the terms and conditions of the underwriting have been agreed upon.

Rule 10b-6, it should be noted, defines "underwriter" without the "control" element
the fear that trading by persons involved in a distribution might precipitate artificially high price levels and unjustified impressions of the level of market activity in the offered securities, the rule represents an attempt both to clarify the vagueness of section 9(a)(2) and to implement section 10(b) by providing a precise description of one type of prohibited activity. One court stated the purpose found in the definition of "underwriter" in the Securities Act of 1933, § 2(11), 15 U.S.C. § 77b(11) (1970). For discussions of the persons to whom rule 10b-6 applies, see authorities cited in note 9 supra.

Rule 10b-6 contains no definition of the term "distribution." Commentary on rule 10b-6, however, indicates that the meaning is different from the meaning of the term in § 2(11) of the Securities Act of 1933, 15 U.S.C. § 77b(11) (1970), in that the presence of control is irrelevant under the rule. 3 L. Loss, supra note 9, at 1596-97. For purposes of rule 10b-6, "[i]t is enough if the broker or dealer is engaged in a distribution in the sense of a major selling effort in his own behalf." Id. at 1597 (quoting SEC Securities Act Release No. 4075 (1959)); see Whitney, Rule 10b-6: The Special Study's Rediscovered Rule, 62 Mich. L. Rev. 567, 567 n.3 (1964):

It is not necessary (nor even necessarily easy) to reconcile completely the substantive content of the term ["distribution"], as so used, with that of the same term as used in the context of the Securities Act of 1933. . . . In Rule 10b-6, the term "distribution" is employed to fix the setting in which, for the protection of investors, restrictions must be imposed upon the actors in that setting, in order to prevent distortion of the market price and trading activity of the securities involved. In the 1933 Act . . . , on the other hand, the term is used to facilitate a determination of whether circumstances exist such as to require the registration of securities in order to provide fair and adequate disclosure of factual and financial information on which an intelligent investment decision may be based.

The SEC has made the same point concerning the meaning of the term "distribution" in the context of rule 10b-6. See In re Bruns, Nordeman & Co., 40 S.E.C. 652, 660 (1961). See also E. Weiss, supra note 9, at 125-29; Foshay, supra note 11, at 920-21; Rogoff, Legal Regulation of Over-the-Counter Market Manipulation: Critique and Proposal, 28 Me. L. Rev. 149, 177-82 (1976); Comment, supra note 9, at 819-29.

In the absence of control as a relevant factor, six indicia of a "distribution" for the purposes of rule 10b-6 can be identified: (1) the absolute and relative size of the offering; (2) the number of proposed offerees; (3) required distributive effort; (4) presence of a selling group; (5) payment of a special commission to salesmen; and (6) the degree of a particular broker-dealer's concentration on "pushing" the one security. 3 L. Loss, supra note 9, at 1597; 6 id. at 3766-69 (Supp. 1969).


93. See Jacobs, Regulation of Manipulation by SEC Rule 10b-5, 18 N.Y.L.F. 511, 534 (1973); cf. Senate Comm. on Banking and Currency, Stock Exchange Practices, S. Rep. No. 1455, 73d Cong., 2d Sess. 54 (1934) (Section 10(b) is designed to forbid "every . . . device used to persuade the public that activity in a security is the reflection of a genuine demand instead of a mirage.").

94. See Foshay, supra note 11, at 946; Wolfson, supra note 62, at 810.

At the time it was adopted, rule 10b-6 was not an innovation; it was the result of a series of judicial interpretations of the applicability of §§ 9(a)(2) and 10(b) to trading by participants in securities distributions. See, e.g., In re Adams & Co., 33 S.E.C. 444 (1952); In re Halsey, Stuart & Co., 30 S.E.C. 106 (1949); In re Thornton & Co., 28 S.E.C. 208, aff'd., 171 F.2d 702 (2d Cir. 1948); In re Kidder
of rule 10b-6 quite succinctly when it observed that Manipulation was often accomplished by those about to sell securities or already engaged in selling securities bidding on the market for the same securities, thereby creating an unjustifiable impression of market activity which would facilitate the sale at artificially high prices. This was one of the practices which the Securities Exchange Act was designed to eradicate, and it is this practice which is covered by Rule X-10b-6.95

In essence, rule 10b-6(a)96 forbids any participant in a distribution from directly or indirectly bidding for, purchasing, or attempting to induce any person to purchase the security that is the subject of the distribution or is of the same class or series of the security. The rule also contains eleven exceptions, four of which are relevant to the problem of manipulative options trading.97 Significantly, there is no language in the rule explicitly stating that participants in a distribution are prohibited from trading puts and calls.98

Peabody & Co., 18 S.E.C. 559 (1945); In re Russell Maguire & Co., 10 S.E.C. 332 (1941). See also Comment, supra note 9.


96. The substantive prohibition of rule 10b-6 appears in subsection (a). Other subsections provide definitions and exceptions. Hence, all references to "rule 10b-6" are to rule 10b-6(a) unless otherwise indicated.

97. Rule 10b-6 provides:

(a) It shall constitute a "manipulative or deceptive device or contrivance" as used in section 10(b) of the Act for any person,

(1) Who is an underwriter or prospective underwriter in a particular distribution of securities, or

(2) Who is the issuer or other person on whose behalf such a distribution is made, or

(3) Who is a broker, dealer, or other person who has agreed to participate or is participating in such a distribution, directly or indirectly . . . to bid for or purchase for any account in which he has a beneficial interest, any security which is the subject of such distribution, or any security of the same class and series, or any right to purchase any such security, or to attempt to induce any person to purchase any such security or right, until after he has completed his participation in such distribution: Provided, however, that this section shall not prohibit . . .

(vi) offers to sell or the solicitation of offers to buy the securities being distributed (including securities or rights acquired in stabilizing) or securities or rights offered as principal by the person making such offer to sell or solicitation; or

(vii) the exercise of any right or conversion privilege to acquire any security; or

(viii) stabilizing transactions not in violation of [rule 10b-7, 17 C.F.R.] § 240.10b-7 ([1977]); or

(ix) bids for or purchases of rights not in violation of [rule 10b-8, 17 C.F.R.] § 240.10b-8 ([1977]).

98. In announcing the adoption of rule 10b-6, the SEC declared that "[t]he fact that a particular activity is not specifically dealt with or prohibited in such rules does not necessarily mean that it is not unlawful under the Act or the Commission's other rules." SEC Exchange Act Release No. 5194, July 5, 1955, [1952-1957 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,350. Thus, even if it be concluded that rule 10b-6 is inapplicable to options trading, § 9(a)(2) and rule 10b-5 provide independent bases for regulating manipulative options trading by participants in a distribution. See text at notes 60-90 supra. However, because these provisions are
However, close analysis of the language of the rule reveals that it can be construed to apply to manipulative options transactions.

There exist two alternative routes that lead to the conclusion that rule 10b-6 prohibits manipulative options trading by the participants in a distribution. The first of these approaches focuses on the entirety of the rule’s prohibitory language:

It shall constitute a “manipulative or deceptive device or contrivance” as used in section 10(b) of the Act for any [participant in a distribution] . . . to bid for or purchase . . . any security which is the subject of such distribution, or any security of the same class and series, or any right to purchase any such security.99

At first glance, this rule may not appear to reach manipulative options trading. Yet, although the terms “put,” “call,” or “option” are not used in the rule, the plain meaning of the “right to purchase” suggests that the phrase refers to call options. Under this analysis, acquiring a call on the security being distributed would be a violation of rule 10b-6. A possible weakness of this interpretation is that it appears to leave the rule without provision for regulating the trading of puts, which are “rights to sell”; indeed, if the rule does not cover puts, it may not be intended to cover options at all.

A second interpretative problem with rule 10b-6 is also relevant here: it is by no means certain that the term “right” as used in rule 10b-6 is not a term of art possessing some technical meaning—specifically, it is possible that the drafters of the rule did not intend “right” to denote “option.” For example, section 9(b)100 grants the SEC the authority to promulgate rules and regulations concerning puts, calls, straddles, and other options or privileges. Section 9(d) then states that for purposes of section 9 “the terms ‘put,’ ‘call,’ ‘straddle,’ ‘option,’ or ‘privilege’ . . . shall not include any registered warrant, right, or convertible security.”101 Thus, for purposes of section 9, Congress intended that rights and options be considered as mutually exclusive instruments. It may be, therefore, that the term “right” as used in rule 10b-6 was meant to refer to preferences created by the issuer of the underlying stock and not to “options,” which, of course, may be generated by persons other than the issuer.102 This contention is supported by the fact that rule 10b-6 was proposed and adopted in a “package” that included rules 10b-7103 and 10b-8.104 Rule 10b-8 regulates “distributions through

written in broad terms, it is desirable from a regulatory standpoint to find the specific language of rule 10b-6 applicable to manipulative options trading.

99. 17 C.F.R. § 240.10b-6(a) (1977) (emphasis added).
100. 15 U.S.C. § 78i(b) (1970); see text at notes 55-56 supra.
102. See 1 L. Loss, supra note 9, at 467.
103. 17 C.F.R. § 240.10b-7 (1977). Rule 10b-7 deals with stabilizing activity by participants in a distribution. For a discussion of the Congressional attitude to-
rights,” using the term “rights” in the context of “rights issued on a pro-rata basis to securities holders.” Also, the ninth exception to rule 10b-6(a) refers to “bids for or purchases of rights not in violation of Rule 10b-8.” These usages imply that the term “rights” in rule 10b-6 should be accorded its rule 10b-8 meaning. In short, the context of these rules suggests that, for purposes of the Exchange Act, “rights” are distinguishable from “puts and calls,” and that the omission of any reference to options in rule 10b-6 renders that rule inapplicable to such instruments.

Both the argument that rule 10b-6 applies to calls but not puts and the position that “rights” as used in that rule is a term of art that does not denote “option” lack substantial force in light of a 1971 SEC “no-action” letter. This letter provides a sound basis for arguing that the absence of a specific reference to “puts” in rule 10b-6 is explained by the existence of other language in the rule that prohibits their manipulative use. As mentioned earlier, rule 10b-6 prohibits bids for the security being distributed. In correspondence concerning Progressive Phone Systems, Inc., the SEC staff took the position that the phrase “bid for” includes the issuance of put options. Responding to an inquiry by the issuer and underwriter of a new issue of common stock who wanted to offer put options during the distribution in connection with the shares of stock, the SEC staff concluded that the scheme was “inherently fraudulent” and that “[t]he offering of ‘put options’ by the issuer and the underwriter on the very securities being distributed would constitute a continuing bid by [the issuer] and the underwriter for the common stock and would preclude the granting of any exemption” under rule 10b-6(f), which allows the SEC to waive the rule in its entirety upon a proper showing. The SEC’s broad construction of the term “bid” seems reasonable, since reading the term liberally serves the

ward stabilization at the time the Securities Exchange Act of 1934 was passed, see note 62 supra.

107. See text at note 99 supra.
109. 17 C.F.R. § 240.10b-6(f) (1977): This section shall not prohibit any transaction or transactions if the Commission, upon written request or upon its own motion, exempts such transaction or transactions, either unconditionally or on specified terms and conditions, as not constituting a manipulative or deceptive device or contrivance comprehended within the purpose of this section.
110. The Progressive Phone ruling that the writing of a put option constitutes a bid for the underlying security is reasonable because the writer of a put option in effect promises to buy the underlying security at a specified price from the optionee, regardless of the market price of that security during the life of the option.
purposes of rule 10b-6 and is consistent with the Supreme Court’s position that the judiciary should take a flexible view of section 10(b) when deciding what activities are within its scope.\textsuperscript{111}

If rule 10b-6 prohibits writing puts because this kind of transaction constitutes a “bid for” the underlying security, the argument that the phrase “right to purchase” as used in the rule should be read to include calls is strengthened considerably. As mentioned earlier,\textsuperscript{112} one basis for the position that rule 10b-6 does not apply to options is the assertion that “right to purchase” does not include puts and thus the rule may not apply to options at all. This objection is eliminated by the \textit{Progressive Phone} interpretation of rule 10b-6. It would be incongruous to conclude that rule 10b-6 applies to trading puts but not to trading calls—either kind of transaction can be used to manipulate the price of the underlying security. Writing a put has substantially the same effect as acquiring a call—in either case the party with whom the participant deals can be expected to purchase the underlying security, thereby causing the price of the security to rise.\textsuperscript{113} It is thus appropriate to prohibit participants from engaging in either of these actions, and, to recapitulate, if writing a put is a “bid for” the underlying security and if acquiring a call is acquiring a “right to purchase” that security, then rule 10b-6 is sufficiently broad to proscribe both activities.

Independent of the above analysis of the prohibitory language of the rule is a second route to the conclusion that rule 10b-6 prohibits manipulative options trading by the participants in a distribution. This approach focuses on the term “purchase.” The rule makes it unlawful for a participant “to bid for or purchase” the security being distributed.\textsuperscript{114} Section 3(a)(13)\textsuperscript{115} of the Exchange Act states that the term “purchase” includes “any contract to buy, purchase, or otherwise acquire.” Applying this definition to the rule suggests that certain options transactions may be viewed as “contracts to acquire” and thus are purchases of the underlying securities. Basic contract law defines an option as a unilateral contract between the optionor and the optionee.\textsuperscript{116} If this definition is applied to put and call op-


\textsuperscript{112} See text at note 99 supra.

\textsuperscript{113} If the participant acquires calls, the other party can be expected to enter the market and make purchases of the underlying securities to cover his obligation. See notes 48-50 supra and accompanying text. Similarly, by writing puts with striking prices at or above the market price, the participant can induce the other party to purchase the underlying securities at a price that will make it profitable to exercise the puts.

\textsuperscript{114} See note 97 supra.


\textsuperscript{116} See 1 S. WILLISTON, CONTRACTS § 61A (3d ed. 1957).
tions, it is clear that an individual who acquires puts or calls to a "contract to buy, purchase, or otherwise acquire" the underlying security. According to section 3(a)(13), this amounts to a purchase, and thus rule 10b-6 is applicable to the trans-

While the conclusion that puts and calls are "purchases" under rule 10b-6 may seem clear without further discussion, it is strengthened by an analysis of the policies of rule 10b-6. During early judicial efforts to interpret the Exchange Act, courts agonized over the question whether, for purposes of the "purchase and sale" requirement of section 16(b), a "purchase" of the underlying security occurs in a transaction involving rights, warrants, options, or other conversion privileges when a person acquires such a privilege, or whether the "purchase" occurs when the conversion privilege is exercised and the underlying security is obtained. The courts deciding this question generally have concluded that no purchase occurs until the conversion privileges are exercised, but this view did not develop into a strict rule. The courts ultimately devised a test that explored a particular transaction's potential for abuse; if the transaction served in any way to accomplish results that the statute was designed to prevent, the courts deemed it a "purchase and sale" and held it violative of the Act.


For the purpose of preventing the unfair use of information which may have been obtained by [a] 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 . . . within any period of less than six months . . . shall inure to and be recoverable by the issuer . . .


120. See, e.g., Reliance Elec. Co. v. Emerson Elec. Co., 404 U.S. 418, 424 n.4 (1972); Blau v. Lehman, 286 F.2d 786, 792 (2d Cir. 1960), affd., 368 U.S. 403 (1962); Ferraiolo v. Newman, 259 F.2d 342, 345 (6th Cir. 1958) (citing Comment, The Scope of "Purchase and Sale" Under Section 16(b) of the Exchange Act, 59 YALE L.J. 510, 513 (1950)). Earlier cases might have been applying the same standard, finding no purchase until the rights were exercised, simply because they were attempting to fix the purchase at a point within six months of the sale in order to establish liability under section 16(b). See, e.g., Champion Home Builders Co. v. Jeffress, 490 F.2d 611, 616-17 (6th Cir.), cert. denied, 416 U.S. 986 (1974); Booth v. Varian Assoc., 334 F.2d 1, 3-5 (1st Cir. 1964); Blau v. Mission Corp., 212 F.2d 77 (2d Cir.), cert. denied, 347 U.S. 1016 (1954); Hardee, Stock Options
Although the question whether a purchase or sale occurs when an option is acquired, written, or exercised now appears to be moot for purposes of section 16(b),\textsuperscript{121} it is submitted that the early interpretation of the term “purchase”—that a purchase occurs only when the option is exercised—should not be implanted into rule 10b-6, for to do so would nullify the purpose of the rule. As discussed above,\textsuperscript{122} rule 10b-6 is intended to prevent the manipulation of the price of, and the creation of apparent trading activity in, the security being distributed. It is clear that options transactions can create the adverse effects sought to be prevented by the rule,\textsuperscript{123} and therefore, unless the term “purchase” is interpreted to include writing puts and acquiring calls, the purpose of the rule could be frustrated.\textsuperscript{124}


\textsuperscript{121} Rule 3a11-1, 17 C.F.R. § 240.3a11-1 (1977), as amended by SEC Exchange Act Release No. 9929 (Jan. 29, 1973) [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,196, interprets the § 3(a)(11), 15 U.S.C. § 78c(a)(11) (1970), definition of “equity security” to include “any stock or similar security . . . or any put, call, straddle, or other option or privilege of buying such a security from or selling such a security to another without being bound to do so.” See Freedman v. Barrow, 427 F. Supp. 1129, 1151 n.14 (S.D.N.Y. 1976). Thus, for purposes of § 16(b), which uses the term “equity security,” see note 118 supra, acquiring a conversion privilege clearly constitutes a “purchase” of the underlying security.

In Vogel-Lorber, Inc. v. Options on Shares, Inc., [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,911 (S.D.N.Y. 1974), the court held that rule 3a11-1 should be extended to clarify the § 3(a)(12), 15 U.S.C. § 78c(a)(12) (1970), definition of a “security” as that term is used in § 10(b) and rule 10b-5. In light of this ruling, it should be noted here that it would be inappropriate for a court similarly to hold that rule 3a11-1 also clarifies the definition of “security” for purposes of rule 10b-6. Since rule 10b-6 allows participants to make “offers to sell” the securities being distributed, 17 C.F.R. § 240.10b-6(a)(3)(vi) (1977), considering puts and calls as different forms of their underlying securities would frustrate the policy of the rule. Specifically, rule 10b-6 prohibits “bids for” the security being distributed, and the issuance of put options has been interpreted as a “bid for” the underlying securities. See text at notes 108-09 supra. However, use of the rule 3a11-1 interpretation of “equity security” in the context of rule 10b-6 would allow participants to “offer to sell” put options respecting the security being distributed, by virtue of the sixth exception to rule 10b-6(a), discussed in text at notes 137-40 infra. Therefore, the rule 3a11-1 interpretation of “equity security” should not be extended by analogy to the term “security” as used in rule 10b-6.

The above conclusion does not mean that the court in Vogel-Lorber wrongly relied on the rule 3a11-1 interpretation of “equity security” when dealing with a § 10(b) and rule 10b-5 problem. The preamble to the general definitions of § 3(a) of the Exchange Act, 15 U.S.C. § 78c(a) (1970), states that the definitions in that section shall apply “unless the context otherwise requires.” Thus, the different circumstances covered by rule 10b-5 and rule 10b-6 can justifiably call for different definitions of the term “security.”

\textsuperscript{122} See text at notes 92-95 supra.

\textsuperscript{123} See notes 48-49 & 113 supra; text at notes 46-50 supra.

\textsuperscript{124} It should be remembered that the “purchase” theory is advanced as an alternative to the theories that acquiring calls is proscribed by the prohibition against purchasing “rights to purchase” and writing puts is encompassed within the language prohibiting “bids for” the underlying security. See text at notes 99-113 supra.
10 the interpretation of "purchase" as used in section 16(b). Reference is again made to section 3(a) of the Act,\textsuperscript{125} which provides that the general definitions contained in that section shall apply "unless the context otherwise requires." It is therefore clear that Congress intended the statutory definitions to be applied flexibly, and that, regardless of what "purchase" might mean in section 16 or elsewhere in the Act, the term should be construed in a manner that will promote the purposes of the various sections in which it appears. The Supreme Court accepted this analysis in \textit{SEC v. National Securities, Inc.:}\textsuperscript{126}

Although the interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen, ordinary rules of statutory construction still apply. The meaning of particular phrases must be determined in context . . . . We must therefore address ourselves to the meaning of the words "purchase or sale" in the context of § 10(b). Whatever these or similar words may mean in the numerous other contexts in which they appear in the securities laws, only this one narrow question is presented here.

Therefore, based on the policy of rule 10b-6 and the flexibility inherent in the definition of the term "purchase," it is reasonable to define that term for purposes of rule 10b-6 to include acquiring calls and writing puts.

The two alternative routes to the conclusion that rule 10b-6 prohibits manipulative options trading—the approach focusing on the rule's prohibitory language generally and the approach interpreting the term "purchase"—both lead to the result that the rule proscribes participants in a distribution from writing puts and acquiring calls during the distribution. The rule lists eleven types of activities that are exempt from the rule,\textsuperscript{127} however, and two of these exceptions contain language that, if improperly construed, might vitiate the ability of the rule to control manipulative put writing and call acquisition.

The ninth exception to rule 10b-6 allows "bids for or purchases of rights not in violation of [rule 10b-8]."\textsuperscript{128} Arguably, this language is sufficiently broad to allow the acquisition of calls and perhaps even puts. If the term "rights" is construed to include both kinds

\textsuperscript{126} 393 U.S. 453, 466 (1969). \textit{See} Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971); International Controls Corp. v. Vesco, 490 F.2d 1334, 1343 n.8 (2d Cir.), \textit{cert. denied}, 417 U.S. 932 (1974) ("[W]e should note that having elevated the functional interpretation of the terms 'purchase' and 'sale' to the sine qua non of § 10(b) analysis, . . . . we surely would be remiss were we to discard this functional approach in the milieu of § 10(b). Accordingly, . . . . we do not consider the interpretation of the terms 'purchase' and 'sale' as used in § 16(b) to be dispositive of their meaning in the context of § 10(b)"").
\textsuperscript{127} 17 C.F.R. § 240.10b-6(a)(i)-(xi) (1977).
\textsuperscript{128} 17 C.F.R. § 240.10b-6(a)(ix) (1977) (emphasis added), quoted in note 97 \textit{supra}. 
of options,\textsuperscript{129} it could be argued that the acquisition of such "rights" technically is not a violation of 10b-8\textsuperscript{130} because that rule is concerned only with distributions of securities to existing shareholders on a pro rata basis through issuer-created rights. It would follow that acquiring puts and calls would be "bids for or purchases of rights not in violation of [rule 10b-8]" and thus would be permissible under this exception to rule 10b-6. As discussed earlier,\textsuperscript{131} the term "right to purchase" as used in rule 10b-6 must be construed broadly enough to include call options, but a broad interpretation of the term "rights" as used in the ninth exception to the rule that would allow participants in a distribution to acquire calls ("rights") is unwarranted. It seems clear that the exception was intended to allow only the kind of activity regulated by rule 10b-8. Moreover, such a broad interpretation would contradict the general prohibition against bidding for or purchasing "any right to purchase" in rule 10b-6 by allowing purchases of calls and thus would defeat the rule's antimanipulation purpose. Thus, the ninth exception, if properly interpreted, poses no barrier to applying rule 10b-6 to manipulative options acquisitions.

The eighth exception to rule 10b-6, which allows "stabilizing transactions not in violation of [rule 10b-7],"\textsuperscript{132} could also be misconstrued so as to impair the impact of the rule. Rule 10b-7 allows participants in a distribution to trade the security being distributed in order to stabilize its price. Although a comprehensive discussion of stabilizing is beyond the purview of this Note,\textsuperscript{133} it should be observed that this exception allows any kind of options transaction—not only writing puts and acquiring calls but also acquiring and exercising puts and writing and exercising calls—so long as the activity does not go beyond "stabilizing." In the context of a distribution, it would behoove the participants who desire to "stabilize" to purchase the security itself rather than options on the security, since acquiring the security would more efficiently affect its price. Nevertheless, it is not inconceivable that participants might trade options—in particular, acquire calls\textsuperscript{134}—in order to stabilize the security's price. Arguably, such activity is contemplated by the sixth exception to rule 10b-6,\textsuperscript{135} which in part allows the sale of "rights acquired in

\begin{itemize}
  \item \textsuperscript{129} Note that this exception speaks only of "rights," not "right to purchase," which is used in the prohibitory clause of rule 10b-6(a). It is arguable, therefore, that the former term includes puts as well as calls.
  \item \textsuperscript{130} 17 C.F.R. § 240.10b-8 (1977).
  \item \textsuperscript{131} See text at notes 99-113 supra.
  \item \textsuperscript{132} 17 C.F.R. § 240.10b-6(a)(viii) (1977), quoted in note 97 supra.
  \item \textsuperscript{133} Recognizing stabilization as a legitimate device in 1934, Congress did not prohibit such activity but left it to be regulated by the SEC. See note 62 supra.
  \item \textsuperscript{134} See notes 48-49 & 113 supra; text at notes 48-50 supra.
  \item \textsuperscript{135} 17 C.F.R. § 240.10b-6(a)(vi) (1977), quoted in note 97 supra.
\end{itemize}
stabilizing.” If calls are acquired for purposes of stabilization, other exceptions to rule 10b-6 allow their exercise or sale.136 However, if options are traded for a manipulative purpose (i.e., to do more than stabilize the price of the security), the transaction is not protected by rule 10b-7 and is subject to the antimanipulation provision of rule 10b-6. Thus, the eighth exception to rule 10b-6 does not render the rule ineffective in prohibiting manipulative options trading.

Neither the ninth nor the eighth exception to rule 10b-6 impairs the power of the rule to prohibit participants in a distribution from writing puts or acquiring calls to manipulate the price of the security being distributed. According to the analysis thus far, however, rule 10b-6 does not appear to extend to writing calls, acquiring puts, or exercising either. Two of the eleven enumerated exceptions to rule 10b-6, the sixth and seventh, contain language that permits these types of transactions during the distribution. It is submitted that exempting these transactions from the rule is sensible because these activities, as explained in the following discussion, tend to benefit the distribution without manipulating the security’s price.

First, the sixth exception to rule 10b-6 permits “offers to sell or the solicitation of offers to buy the securities being distributed (including securities or rights acquired in stabilizing) or securities or rights offered as principal by the person making such offer to sell or solicitation.”137 The purpose of this exemption is to assure underwriters, brokers, and dealers that they may make a concerted effort to sell the securities being offered without violating the rule. Certain options transactions that are not inherently manipulative can easily be viewed as “offers to sell” or “solicitation[s] of offers to buy.” The effect of characterizing certain options transactions in such a manner is to insulate them from the prohibitions of the rule.

As discussed above,138 the SEC staff in the Progressive Phone no-action letter took the position that writing puts constituted a “continuing bid” for the underlying securities. It follows from this reasoning that writing calls constitutes a continuing “offer to sell” the underlying security and is therefore permitted by the sixth exception to rule 10b-6. Moreover, it follows that bids for or purchases of puts constitute “solicitations of offers to buy” the securities being distributed: since the writer of a put is in effect making an offer to buy,139 an individual who makes a bid for or purchases a put is in effect “soliciting” an offer to buy. Thus, the sixth exception to rule

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136. The sixth exception, see text at note 137 infra, allows the sale of calls; the seventh exception, see text at notes 142-43 infra, allows their exercise.
138. See text at notes 106-11 supra.
139. See note 110 supra.
10b-6 can be read to allow the writing of calls as "offers to sell," and the acquisition of puts as "solicitations of offers to buy," the security being distributed.

In this context it is appropriate to consider the act of exercising a put. Since courts have determined that exercising a call constitutes a purchase,\textsuperscript{140} it follows that exercising a put amounts to a sale of the underlying security, and such a transaction is outside the scope of rule 10b-6 altogether. This is consistent with the conclusion above concerning the acquisition of puts, which are exempted from the rule by the sixth exception.

In short, the conclusions reached with respect to writing calls, purchasing puts, and exercising puts are consistent with the purpose of rule 10b-6. All of these transactions are ultimately sales of the underlying security; because rule 10b-6 is intended to prohibit only purchases or bids for the security being distributed,\textsuperscript{141} none of these transactions should be prohibited.

Second, the seventh exception to rule 10b-6(a) allows "the exercise of any right or conversion privilege to acquire any security."\textsuperscript{142} Although there are no cases or rulings on point, this exception seems to indicate that participants in a distribution may exercise call options on a security being distributed without such activity constituting a "manipulative or deceptive device." Before this exception was added to the rule, courts had deemed the term "purchase" to include the exercise of call options.\textsuperscript{143} It might appear, therefore, that the seventh exception, in allowing purchases through the exercise of calls, directly contradicts rule 10b-6's general prohibition of all purchases. When this exception is viewed in the context of the entire rule, however, its scope becomes quite limited. Because, as already determined,\textsuperscript{144} the rule prohibits the acquisition of calls during the distribution period except for stabilization purposes, the only calls that may be exercised during this period are those acquired before an individual becomes a participant\textsuperscript{145} and those acquired during the distribution for stabilization purposes. Allowing the exercise of such calls is certainly reasonable. The exception eliminates the hardship imposed upon a participant who acquires calls prior to the distribution or in legitimate stabilizing transactions: but for the exception, the participant would be forced to hold his options and perhaps watch them expire. If calls are exercised in order to manipulate the security's price, such an abuse would be within the scope of section

\textsuperscript{140.} See text at notes 119-20 supra.
\textsuperscript{141.} See text at notes 91-96 supra.
\textsuperscript{142.} 17 C.F.R. § 240.10b-6(a)(vii) (1977), quoted in note 97 supra.
\textsuperscript{143.} See text at notes 118-20 supra.
\textsuperscript{144.} See text at notes 98-126 supra.
\textsuperscript{145.} See notes 9 and 91 supra.
9(a)(2) or rule 10b-5. Thus, the seventh exception permits some calls to be exercised without creating a "loophole" in the rule's antimanipulation scheme.

III. SUMMARY

Although the drafters of rule 10b-6 may not have contemplated the current widespread interest in options trading when they promulgated the rule in 1955, it is clear that options provide the participants in a distribution with the opportunity to manipulate the price of the security being distributed. Fortunately, it is possible to construe the language of the rule as prohibiting manipulative options transactions while permitting other harmless transactions to occur. However, this requires careful interpretation of the subtle language of the rule. Accordingly, the SEC should consider clarifying its position with respect to options trading by persons participating in a distribution.

Rule 10b-6 should be construed to apply to options transactions of the participants in a distribution as follows:

1. Acquiring calls—Because a call is a "right to purchase," the participants in a distribution may not acquire calls on the security being distributed during the period of their participation, except for stabilization purposes.

2. Exercising calls—Exercising a call is a purchase of the underlying security, but such purchases are specifically exempted from the prohibition of rule 10b-6 by the rule's seventh exception. Because participants cannot acquire calls during the distribution except for stabilization purposes, however, the only calls that can be exercised are those acquired by a participant before he attains that status and those that are acquired for stabilization purposes.

3. Writing calls—Because writing a call is an offer to sell the underlying security, rule 10b-6 does not prohibit such transactions.

4. Acquiring puts—Acquiring a put, like writing a call, is essentially a sale of the underlying security. Thus, such transactions are not proscribed by rule 10b-6.

5. Exercising puts—Because exercising a put is clearly a sale, such transactions are not within the scope of rule 10b-6.

6. Writing puts—Writing a put amounts to bidding for the underlying security, and therefore such transactions are prohibited by rule 10b-6.

146. See text at notes 59-90 supra. Rule 10b-6 is not the exclusive provision for the regulation of manipulations. See note 98 supra.