UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

Barbara Schaffer, Derivatively On behalf of LaserSight Incorporated,	:	
Plaintiff,	:	
v.	:	No. 99 Civ. 2821 (VM)
CC Investments, LDC, et al.,	:	
Defendants.	:	

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE

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By order dated February 15, 2000, the Court invited the Commission to file an amicus curiae brief in this case, in which the defendants have moved to dismiss plaintiff's action brought under Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78p(b) ("the Exchange Act" or "the Act").

The Court's order notes that defendants CC Investments, LDC ("CCI") and Castle Creek Partners, LLC ("Castle Creek") have argued that the Commission "exceeded the authority conferred on it by Congress when the Commission adopted its Rule 16a-1(a)(1) as such rule pertains to liability under Section 16(b) of the Securities Exchange Act" (February 15, 2000 Order, p. 1). This argument has been adopted by the other defendants. The Court's order continues:

> In view of the significance of this issue to the disposition of the motions and of the vital interest the Commission has in any determination affecting the validity of its rules, the Court invites, sua sponte, the Commission to submit an amicus curiae brief limited to the application of SEC Rule 16a-1(a)(1) and the concept of "group" liability under Section 13(d)(3) of the Act to Section 16(b) of the Act * * *.

(Order, p. 1).

As the Court noted, the Commission has a strong interest in this issue. Although Section 16(b) of the Exchange Act is enforced in private actions, and not in Commission enforcement actions, the Commission, nevertheless, has an interest in assuring that proper private actions can be brought. As the Supreme Court has repeatedly recognized, such actions "provide 'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to Commission action.'" Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 310 (1985) (quoting J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964)).

Section 16(b) of the Exchange Act is intended to curb the abuse of inside information by officers, directors and beneficial owners of more than ten percent of an issuer's registered equity securities. The rule at issue, by defining who is a beneficial owner of securities for purposes of Section 16(b), seeks to assure that the section is enforceable in private actions against the full range of shareholders to whom it should apply. Moreover, the rule also applies in determining beneficial ownership of securities

for purposes of the reporting requirement in Section 16(a) of the Exchange Act, 15 U.S.C. 78p(a), a provision which the Commission does enforce.

The Commission construes the Court's order as requesting its views only on the issue of the Commission's authority to promulgate Rule 16a-1(a)(1). Accordingly, this brief is limited to that issue.

BACKGROUND

A. The Regulatory Scheme of Section 16 and Rule 16a-1(a)(1)

Section 16 of the Act, 15 U.S.C. 78p, contains two provisions directed at curbing the misuse of inside information by corporate insiders. Under Section 16(a) of the Act, 15 U.S.C. 78p(a), those insiders - - who are identified as officers and directors of an issuer of securities and also the "beneficial owner" of more than ten percent of any class of registered equity securities of the issuer - - must report, at the time of registration of the securities under Section 12 of the Exchange Act or at the time the insider becomes an officer, director, or greater than ten percent beneficial owner, the amount of all securities such insider beneficially owns.

Section 16(b) of the Act provides that the issuer or a shareholder of the issuer may bring an action to recover short-swing profits (i.e., profits from the purchase and sale of the issuer's equity securities within a period of less than six months) realized by an officer, director or "such beneficial owner" as identified in Section 16(a)).

In enacting Section 16(b) "Congress recognized that insiders may have access to information about their corporations not available to the rest of the investing public." Foremost-McKesson, Inc. v. Provident Securities Co., 423 U.S. 232, 243 (1976). The provision was designed to "curb the evils of insider trading [by] * * * taking the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great." Reliance Electric Co. v. Emerson Electric Co., 404 U.S. 418, 422 (1972). Congress concluded that corporate officers, directors, and the beneficial owners of more than ten percent of a class of an issuer's registered equity securities may be presumed to have access to inside information. Reliance Electric Co. v. Emerson Electric Co., 404 U.S. at 424. See also Gollust v. Mendell, 501 U.S. 115, 121 (1991).

Section 16 of the Act, however, contains no definition of beneficial owner. In order to bring clarity to the term "beneficial owner," in 1991 the Commission amended its definitional rule under the section, Rule 16a-1, to add a new Rule 16a-1(a)(1). For purposes of determining who is a beneficial owner of securities under Section 16, that rule adopts the definition of "beneficial owner" found in Section 13(d) of the Exchange Act, 15 U.S.C. 78m(d), and the rules promulgated under that section.

Rule 16a-1(a)(1), provides, in pertinent part, that

> Solely for purposes of determining whether a person is a beneficial owner of more than ten percent of any class of equity securities registered pursuant to Section 12 of the Act, the term "beneficial owner" shall mean any person who is

> deemed a beneficial owner pursuant to Section 13(d) of the Act and the rules thereunder * * * ."

A beneficial owner under Section 13(d) includes "any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares" "voting power" or "investment power." See Rule 13d-3(a), 17 C.F.R. 240.13d-3(a). Rule 13d-5(b)(1), 17 C.F.R. 240.13d-5(b)(1), provides that when such shareholders

> agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer, the group formed thereby shall be deemed to have acquired beneficial ownership, * * * as of the date of such agreement, of all equity securities of that issuer beneficially owned by any such persons.[1]

Thus, if a defendant "even 'indirectly' 'shared' voting or investment power, including the power to direct the disposition of [an issuer's] shares, [he] must be found to be a beneficial owner" of all of the shares of the group. Schaffer v. Soros, No. 92 Civ. 1233 (LMM), 1994 WL 381442 at *5 (S.D.N.Y. July 20, 1994), vacated in part on other grounds, 1994 WL 592891 (S.D.N.Y. Oct. 31, 1994).

As applied under Section 13(d), this means that where a group holds more than 5% of an issuer's registered equity securities, the group must file a statement on Schedule

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[1] Rule 13d-5(b)(1) was promulgated, in part, under Section 13(d)(3) of the Act, 15 U.S.C. 78m(d)(3), which provides that "[w]hen two or more persons act as a * * * group for the purpose of acquiring, holding, or disposing of securities of an issuer, such * * * group shall be deemed a 'person' for the purposes of this subsection."

13D. As imported to Section 16, this means that where a Section 13(d) group holds more than ten percent of an issuer's equity securities, the members of the group are subject to the reporting requirements of Section 16(a) and are liable under Section 16(b) for recovery of short-swing profits realized from transactions involving their shares.

This does not mean, however, that each member of the group necessarily is liable for short-swing profits realized from transactions involving the shares held by all members of the group. While Rule 16a-1(a)(1) uses the Section 13(d) standard for purposes of determining whether a person has crossed the ten percent beneficial ownership threshold, Rule 16a-1(a)(2), 17 C.F.R. 240.16a-1(a)(2), applies a "pecuniary interest" test for all other purposes of Section 16, including the determination of the shares from which the defendant may be held liable for short-swing profits. A person thus is liable only for profits realized on those shares in which he has a pecuniary interest. [2]

B. Facts

The plaintiff, Barbara Schaffer, a shareholder in LaserSight Incorporated ("LaserSight"), brought this action on behalf of LaserSight under Section 16(b) to recover short-swing profits against CCI, Castle Creek, Societe Generale, Shepherd Investments

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[2] Rule 16a-1(a)(2) provides, in pertinent part, that "[o]ther than for purposes of determining whether a person is a beneficial owner of more than ten percent of any class of equity securities * * *, the term 'beneficial owner' shall mean any person who, directly or indirectly, * * * has or shares a direct or indirect pecuniary interest in the equity securities * * *."

International, Ltd. ("Shepherd Investments"), Stark International, and two investment managers, Michael Roth and Brian Stark, who are alleged to have controlled the investment decisions of Shepherd Investments and Stark International (Complaint at 1-3). The defendants purchased preferred stock that was convertible to common stock and warrants to purchase common stock in LaserSight under a private placement agreement. Thereafter, they are alleged to have bought and sold LaserSight securities within a period of less than six months.

Schaffer alleges that, of the defendants, only CCI was individually a beneficial owner of more than ten percent of LaserSight common stock (Complaint at 5). Schaffer alleges, however, that Castle Creek, Societe Generale, Shepherd Investments and Stark International are also liable for short-swing profits under Rule 16a-1(a)(1) because they were members of a Section 13(d) group with CCI (Complaint at 4-5).

Accordingly, although only CCI is alleged individually to have beneficially owned more than ten percent of LaserSight common stock, Schaffer employs the group concept of beneficial ownership of Section 13(d)(3) of the Exchange Act and Rule 13d-5(b)(1) to aggregate the shares of common stock beneficially owned by Castle Creek, Societe Generale, Shepherd Investments, Stark International, Stark, and Roth with those of CCI in order to reach the ten percent threshold for application of Section 16(b).

Schaffer also alleges that Shepherd Investments and Stark International together beneficially owned more than ten percent of LaserSight common stock and that they

formed a second Section 13(d) group, apart from the larger group that also includes CCI, Castle Creek, and Societe Generale (Complaint at 5). In a brief filed in support of their motion to dismiss, Shepherd Investments and Stark International, whose investment decisions were controlled by Roth and Stark, concede that they "constitute a group under Section 16." They do contest, however, that they are members of the larger group (Stark Defendants R.Br. at 11 n.3).[3]

Schaffer seeks to recover a total of $7,091,975 in short-swing profits: $1,935,540 from CCI; $721,600 from Societe Generale; and $4,434,835 from Shepherd Investments and Stark International (Complaint at 13).[4] Under Rule 16a-1(a)(2) the defendants are liable for only their individual profits and not those of the other members of the group.

Defendants moved to dismiss Schaffer's complaint for failure to state a claim pursuant to Fed. R. Civ. P. 12(b)(6). Among the arguments made by CCI and Castle Creek, and adopted by the other defendants, is their assertion that the Commission exceeded the authority delegated to it by Congress when it promulgated Rule 16a-1(a)(1).

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[3] "__ Br. at __" refers to a brief of one of the parties in support or opposition to summary judgment and the page number of the brief. "__ R.Br. __" refers to a reply brief filed by one of the defendants in response to plaintiff's brief in opposition to summary judgment.

[4] Schaffer also seeks additional undetermined profits, if any, and prejudgment interest.

ARGUMENT

I. THE COMMISSION ACTED WITHIN ITS AUTHORITY IN ADOPTING RULE 16a-1(a)(1).

The Commission had the authority, under its rulemaking grant in Section 23(a) of the Exchange Act, 15 U.S.C. 78w(a) and under its definitional authority in Section 3(b), of the Act , 15 U.S.C. 78c(b), to define the term "beneficial owner." The definition it chose is necessary or appropriate to carrying out the purposes of Section 16(b), as required by Section 23(a), and is consistent with the provisions and purposes of Section 16(b), as required by Section 3(b).

A. The Commission Had the Power to Define "Beneficial Owner" Under Its Rulemaking and Definitional Authority in Sections 3(b) and 23(a) of the Exchange Act.

The principal statutory authorities for applying the Section 13(d) definition of beneficial owner to Section 16 are the Commission's authority to define terms under Section 3(b) of the Exchange Act and its general rulemaking authority under Section 23(a) of the Act. The Commission relied on both of these provisions in adopting Rule 16a-1. See Ownership Reports and Trading by Officers, Directors and Principal Securities Holders, Exchange Act Release No. 28869, 48 SEC Docket 234, 257 (Feb. 21, 1991). As a general matter, courts have broadly construed the Commission's rulemaking authority under both of these provisions. See, e.g., Falcon Trading v. SEC, 102 F.3d 579, 582 (D.C. Cir. 1996) (finding the Commission's quorum rule valid under

Section 23(a)); Touche Ross & Co., Inc. v. SEC, 609 F.2d 570, 581-82 (2d Cir. 1979) (finding former Rule 2(e) valid under Section 23(a)); Continental Oil Co. v. Perlitz, 176 F. Supp. 219, 221, 227 (S.D. Tex. 1959) (finding a Section 16(b) rule promulgated pursuant to Section 23(a) valid); Lockheed Aircraft Corp. v. Rathman, 106 F. Supp. 810, 813-14 (S.D. Cal. 1952) (finding a Section 16(b) rule promulgated pursuant to Section 3(b) valid).

1. The Commission Had Authority to Promulgate Rule 16a-1(a)(1) Under Section 23(a).

The defendants argue that the Commission's general rulemaking authority under Section 23(a) does not empower it to adopt a rule under Section 16(b). They claim that the section only empowers the Commission to

> make such rules and regulations as may be necessary or appropriate to implement the provisions of [the Exchange Act] *for which they are responsible or for the execution of the functions vested in them by the [Exchange Act].* * * *

(omissions and italics in original) (CCI Br. at 24, quoting Section 23(a)). The defendants assert that because the Commission is not empowered to enforce Section 16(b) it therefore has no "responsibility" or "function vested in them" with respect to the section (other than the expressly conferred power to grant exemptions).

This argument rests on a very selective and misleading editing of Section 23(a). The pertinent portion of Section 23(a) reads in full as follows:

> The Commission, the Board of Governors of the Federal Reserve System, and the other agencies enumerated in Section 3(a)(34) of this title shall each have power to make such rules and regulations as may be necessary or appropriate to implement the provisions of this title for which they are responsible or for the execution of the functions vested in them by this title, and may for such purposes classify persons, securities, transactions, statements, applications, reports, and other matters within their respective jurisdictions, and prescribe greater, lesser, or different requirements for different classes thereof. * * *

Read in context, it is clear that the terms "responsibility" and "functions" are used in Section 23(a) only to differentiate the scope of the Commission's power from that of the Federal Reserve Board and other agencies that share responsibility for administration of the Act. Under Section 23(a), the only substantive limitation placed on the Commission's general rulemaking power by Section 23(a) is that the Commission must not make a rule in an area delegated to another agency, and those rules must be "necessary or appropriate" to implement the Exchange Act. [5]

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[5] Another part of Section 16 supports this interpretation. Section 16(e), 15 U.S.C. 78p(e), provides that Section 16, including Section 16(b), does not apply to "foreign or domestic arbitrage transactions unless made in contravention of such rules and regulations as the Commission may adopt in order to carry out the purposes of this section." By exempting arbitrage transactions "unless made in contravention of such rules and regulations as the Commission may adopt in order to carry out the purposes" of Section 16, Congress necessarily recognized that the Commission has the authority (continued...)

2. The Commission Had Authority to Promulgate Rule 16a-1(a)(1) Under Section 3(b).

The defendants similarly argue that the Commission's authority under Section 3(b) to define terms contained within the Exchange Act is inapplicable to Section 16(b). They quote Section 3(b) as limiting the Commission "as to matters within their * * * jurisdiction, the power by rules and regulations to define technical, trade, accounting, and other terms used in [the Exchange Act] * * * " (omissions in original) (CCI Br. at 24, quoting Section 3(b)). The defendants then assert that "the application of [the beneficial ownership] definition to Section 16(b) is not 'a matter within their jurisdiction' * * * * " (CCI Br. 24).

Once again, the defendants selectively quote the section. The full text of Section 3(b) provides:

> The Commission and the Board of Governors of the Federal Reserve System, as to matters within their respective jurisdictions, shall have power by rules and regulations to define technical, trade, accounting, and other terms used in this title, consistently with the provisions and purposes of this title.[6]

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[5](...continued)
to make rules that would have the effect of making Section 16(b) applicable to arbitrage transactions. In other words, Congress contemplated that the Commission has the power to make affirmative rules defining the reach of Section 16(b), not merely exemptive rules.

[6] Section 3(b) was amended in 1975 to add the words "and other terms" in order "to broaden the authority of the Commission and the Board of (continued...)

As with Section 23(a), the purported limitation is merely a means of distinguishing those areas under the Exchange Act in which the Commission may regulate from those in which other agencies have authority.

3. The Commission Did Not Need A Special Grant of Rulemaking Authority in Section 16(b) Itself.

The defendants place significant weight on the fact that the text of Section 16(b) expressly provides the Commission only the authority to make rules exempting transactions from its operation, and does not expressly provide other rulemaking authority.[7] "[A]n express grant of authority is not necessary to sustain the validity of the challenged rule or regulation." Touche Ross & Co. v. SEC, 609 F.2d 570, 580-81 (2d Cir. 1979) (finding former Rule 2(e), allowing the Commission to sanction attorneys and accountants who practice before it, valid under Section 23(a)). There was no reason to provide the Commission with special rulemaking authority in Section 16(b) itself, when it already had general rulemaking authority under Section 23(a) and definitional authority under Section 3(b).

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[6](...continued)
Governors of the Federal Reserve System to make clear that they may define any term used in the Exchange Act, whether or not it is already defined in the title." S. Rep. No. 94-75, at 94 (1975).

[7] Section 12(h) of the Act, 15 U.S.C. 78l(h), also authorizes the Commission, by rule or order, to exempt certain securities and any officer, director, or beneficial owner from Section 16, if the Commission finds such an exemption is "not inconsistent with the public interest and/or protection of investors."

There are many provisions in the Exchange Act that the Commission enforces and under which it may adopt rules, even under defendants' pinched reading, but which provide no special grant of rulemaking authority. To take just the most pertinent example, the reporting provisions in Section 16(a) are enforced by the Commission, yet contain no express rulemaking authority. The defendants do not dispute that the Commission had the power to adopt Rule 16a-1(a)(1) for the purpose of defining the term "beneficial owner" in that section.

Indeed, the fact that the Commission has the power to define the term "beneficial owner" for purposes of Section 16(a) necessarily means it has the power to do the same for Section 16(b). Section 16(b) specifies to whom it applies by referring back to Section 16(a). [8] Congress intended the term "beneficial owner" to have the same meaning in both subsections. It is inconceivable that the Commission could define the term for purposes

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[8] Section 16(a) provides that "[e]very person who is directly or indirectly the *beneficial owner* of more than 10 per centum of any class of any equity security * * * or who is a director or an officer of the issuer" shall report the amount of securities he owns to the Commission (emphasis added).

Section 16(b) then refers back to Section 16(a) stating that "[f]or the purpose of preventing the unfair use of information which may have been obtained by *such beneficial owner*, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase or sale, * * * of any equity security of such issuer * * * within any period of less than six months * * * shall * * * be recoverable by the issuer * * *."

of Section 16(a), but that the term, when incorporated by reference into Section 16(b), would somehow acquire a different meaning. [9]

B. Rule 16a-1(a)(1) Is Necessary or Appropriate to Carrying Out, and Is Consistent with the Provisions and Purposes of, Section 16(b).

Once it is established that the Commission possesses the requisite authority to make rules under Section 16(b), the next question is whether Rule 16a-1(a)(1) is "consistent[] with the provisions and purposes" of the section, as required by Section 3(b) or "necessary or appropriate" to carrying out the purposes of Section 16(b), as required by Section 23(a).[10]

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[9] Defendants also argue that the Commission "has recognized that its role with respect to Section 16(b) is extremely limited" (CCI Br. at 23). As support for this assertion defendants cite a no-action letter in which the staff wrote that "[b]ecause the Commission does not have enforcement power under Section 16(b) of the Securities Exchange of 1934, the Division [of Corporation Finance] can express no view outside the context of the exemptive rules promulgated by the Commission." Service Merchandise Company, No-Action Letter, 1988 WL 233569 (January 11, 1988).

This misapprehends the context in which the statement was made. A no-action request is a request that the staff state it will not, on the facts as represented by the requestor, recommend enforcement action. Since the Commission does not enforce Section 16(b), the staff obviously could not give a position regarding prospective enforcement action. However, the staff does issue interpretive letters addressing its rules under Section 16(b). None of this has anything to do with the Commission's rulemaking authority.

[10] When it construed Section 23(a) in a different context in Touche Ross & Co. v. SEC, 609 F.2d 570, 579 (2d Cir. 1979), the Second Circuit quoted (continued...)

The first step in those inquiries is whether the language of Section 16 is clear on its face, since "[i]f the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837, 842-43 (1984).

But Congress' intent in using the term "beneficial owner" is not clear. Section 16 does not purport to define the term "beneficial owner" and it is a term that plainly can have more than one meaning. Under these circumstances, where Congress "is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute." Chevron, 467 U.S. at 843. [11] See also Nationsbank of North Carolina v. Variable Annuity Life Ins. Co.,

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[10](...continued)
the Supreme Court's guidance that "[w]here the empowering provision of a statute states simply that the agency may 'make * * * such rules and regulations as may be necessary to carry out the provisions of the Act,' * * * the validity of the regulation promulgated thereunder will be sustained so long as it is 'reasonably related to the purposes of the enabling legislation.'" Mourning v. Family Publications, Inc., 411 U.S. 356, 369 (1973) (omissions in original) (quoting Thorpe v. Housing Authority of the City of Durham, 393 U.S. 268, 280-81 (1969)). Thus, Rule 16a-1(a)(1) is valid so long as it is "necessary or appropriate" to carry out the purposes of Section 16(b) or "reasonably related" to the purposes of Section 16(b). See, e.g., Continental Oil Co. v. Perlitz, 176 F. Supp. 219, 223-27 (S.D. Tex. 1959).

[11] "Deference under Chevron to an agency's construction of a statute that it administers is premised on the theory that a statute's ambiguity constitutes an implicit delegation from Congress to the agency to fill in the statutory
(continued...)

513 U.S. 251, 257 (1995). An agency's interpretation of a statute it administers is to be accorded substantial deference "whenever its interpretation provides a reasonable construction of the statutory language and is consistent with legislative intent." Securities Industry Assoc. v. Board of Governors of the Federal Reserve System, 468 U.S. 207, 217 (1984). See also Nationsbank v. Variable Annuity Life Ins. Co., 513 U.S. at 256-57.

Two things are readily apparent about Congress' intent when it enacted Section 16. The first is that Section 16 was intended to deter the misuse of inside information. The second is that Congress presumed that a person with an investment in more than ten percent of the equity securities of an issuer is likely to have access to inside information about the issuer and was determined to suppress the abuse of inside information by such large stockholders.

The Commission had this Congressional intent in mind in 1991 when it adopted the definition of beneficial owner in Section 13(d) for purposes of determining ten percent beneficial owner status under Section 16(b). The Commission stated:

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[11](...continued)
gaps." FDA v. Brown & Williamson Tobacco Corporation, __ U.S. __, 120 S.Ct. 1291, 1314 (2000). Where Congress is silent, the Supreme Court recently noted, only in "extraordinary cases" should a court hesitate before concluding that Congress intended such a delegation. Id. The Court found that Brown and Williamson, supra, was such an extraordinary case, in part, because the regulation of tobacco was an especially politically sensitive area and because Congress had enacted several pieces of legislation regulating tobacco on its own, thereby, in the Court's view, indicating its intent not to delegate regulation of tobacco to an administrative agency. Id. at 1315.

> Section 16, as applied to ten percent holders, is intended to reach those persons who can be presumed to have access to inside information because they can influence or control the issuer as a result of their equity ownership. Section 13(d) of the Exchange Act specifically addresses such relationships. As proposed, the rules adopted today define ten percent holders under Section 16 as persons deemed ten percent holders under Section 13(d) of the Exchange Act and the rules thereunder. The Section 13(d) analysis * * * [is] imported into the ten percent holder determination for Section 16 purposes.

Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Exchange Act Release No. 28869, 48 SEC Docket 234, 236 (Feb. 21, 1991).

The objective of Section 13(d) is to provide notice of the rapid accumulation of securities in an issuer. Although filings are required regardless of whether the investors have a control purpose, Section 13(d) was adopted as part of the Williams Act and is intended to provide an early warning of accretions of stock ownership that could potentially affect or influence control. See, e.g., GAF Corp. v. Milstein, 453 F.2d 709, 717 (2d Cir. 1971). If a group of persons that beneficially owns more than five percent of an issuer under Section 13(d) standards can be presumed to have the potential to influence corporate control, then it reasonably may also be concluded that a group that beneficially owns more than ten percent of an issuer may have access to inside information. Furthermore, if an individual who owns more than ten percent of an issuer can be presumed to have access to inside information, that presumption can also hold true for a

group that owns more than ten percent of an issuer and is acting in concert for the purpose of acquiring, holding, voting, or disposing of securities of the issuer.[12]

The defendants suggest that a shareholder should be found to be a member of a Section 13(d) group only when the shareholder has a pecuniary interest in the shares of the group. That would be too narrow an approach. Where shareholders act in concert for the purpose of acquiring, holding, voting, or disposing of securities, they can reasonably be expected to have collective voting strength which will give them presumptive access to inside information. This is so regardless of whether each member of the group has a economic interest in the securities of the other members.

Nevertheless, the defendants express concern that a group member might be found liable for profits derived from the securities transactions of another member of the group, even though the group member had realized no gain on the transaction. This was a primary concern expressed in several pre-Rule 16a-1(a)(1) cases that rejected applying

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[12] While such a presumption is appropriate, there are some, relatively rare, circumstances where it may be concluded that a Section 13(d) group does not in fact have access to inside information and its members should not be subject to Section 16(b). In these rare instances, which have involved group membership that was an involuntary condition to employment, where group members were numerous and individually rarely owned more than one percent of outstanding securities, the Commission staff has provided interpretive relief stating its view that Section 16 does not apply. See, e.g., Morgan Stanley Group Inc., SEC No-Action Letter, 1991 WL 178730 (April 30, 1991).

Section 13(d) beneficial ownership concepts to Section 16.[13] These cases were primarily concerned that, since Section 16(b) provides for the recovery of short-swing profits, wholesale application of the Section 13(d) beneficial ownership concept to Section 16(b) would mean that a member of a group is liable for profits from transactions in securities in which he or she had no pecuniary interest.

This concern has been addressed in the rule. Rule 16a-1(a)(2) provides that a person is *not* the beneficial owner of securities for purposes *other than* determining his status as a ten percent owner, *unless* he has a "pecuniary interest" in those securities. Rule 16a-1(a)(2) defines pecuniary interest as "the opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject securities." Accordingly, while a shareholder may be subject to suit under Section 16(b) because of his membership in a Section 13(d) group, his liability in that suit is limited to the profits he directly or indirectly realized.

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[13] See Meyer v. Chesapeake Ins. Co., Ltd., 877 F.2d 1154, 1162 (2d Cir. 1989), cert. denied, 493 U.S. 1021 (1990); CBI Inc. v. Horton, 682 F.2d 643, 646 (7th Cir. 1982); C.R.A. Realty Corp. v. Goodyear Tire & Rubber Co., 705 F.Supp. 972, 976-77 (S.D.N.Y.), aff'd without opinion, 888 F.2d 125 (2d Cir. 1989); Rothenberg v. Jacobs, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,199 (S.D.N.Y. Jan. 11, 1989), aff'd. without opinion, 888 F.2d 126 (2d Cir. 1989). See also Mendell v. Gollust, 793 F. Supp. 474, 480-81 (S.D.N.Y.) (decision rendered after the adoption of the rule concerning a transaction that took place prior to adoption), aff'd without opinion, 983 F.2d 1048 (1992).

Thus, in a recent decision, Strauss v. Kopp Investment Advisors Inc., [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶90,666, 1999 WL 787818 at *3 (S.D.N.Y. Sept. 30, 1999), the court held that Rule 16a-1 met the concerns voiced by the defendants and in earlier pre-Rule decisions. The court noted that it was

> mindful that the ultimate purpose of determining beneficial ownership within Section 13(d), which provides notice to the marketplace of potential takeover control, differs from Section 16(b), which is intended to prevent and discourage insider trading. Meyer v. Chesapeake Ins. Co., 877 F.2d 1154, 1162 (2d Cir. 1989). Likewise, the Court is cognizant that because Section 16(b) imposes strict, economic liability - - as opposed to the obligation to disclose information to the public imposed by Section 13 - - it should be construed narrowly. See Foremost-McKesson v. Provident Securities, 423 U.S. 232, 251 (1975) ("In short, this statute imposes liability without fault within narrowly drawn limits.").

Nevertheless, the court found "without merit" the argument that these differences made it inappropriate to apply the Section 13(d) group concept of beneficial ownership to Section 16(b) because:

> the SEC clearly contemplated the impact of Section 13(d) groups within the Section 16(b) [ten percent threshold] determination of beneficial ownership when it drafted the 1991 Rule, since in those Rules each member of a "group" is required to also have a "pecuniary interest" in the equity at issue before imposing short-swing liability.[14]

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[14] Other cases from the Second Circuit and the Southern District of New York have applied Rule 16a-1(a)(1) within the group context while neither addressing nor taking issue with the validity of the rule. See, e.g., Morales v. Freund, 163 F.3d 763, 766-67 (2d Cir. 1999); Lerner v. Millenco, 23 F. (continued...)

The defendants also argue that Rule 16a-1(a)(1) is inconsistent with Section 16(b) because it imports the "fuzzy," "subjective" concept of group beneficial ownership from Section 13(d) into a strict liability provision (CCI Br. at 21). This argument assumes that the term "beneficial owner" had some obvious meaning that allowed for a clear determination when Section 16(b) applies. In fact, Rule 16a-1 provides greater clarity by defining the term and specifying criteria to be applied.

Rule 16a-1 was adopted as part of a comprehensive effort by the Commission to overhaul the Section 16 rules to better adapt them to the complexities in the modern securities industry and to alleviate uncertainties that had generated litigation. See generally Ownership Reports and Trading By Officers, Directors and Principal Security Holders, Exchange Act Release No. 28869, 48 SEC Docket at 234, 235. The Commission adopted the Section 13(d) definition of "beneficial owner" for Section 16 purposes because there was an established body of Section 13(d) case law to guide investors with some measure of certainty. Defendants CCI and Castle Creek, after attacking the validity of the group concept as "fuzzy," concede this in their reply brief when they argue that the Section 13(d) case law must guide the district court's decision because

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[14](...continued)
Supp. 337, 344 (S.D.N.Y. 1998); Strauss v. American Holdings, Inc., 902 F. Supp. 475, 479-80 (S.D.N.Y. 1995); Schaffer v. Soros, No. 92 Civ. 1233 (LMM), 1994 WL 381442 (S.D.N.Y. July 20, 1994), vacated in part on other grounds, 1994 WL 592891, (S.D.N.Y. Oct. 31, 1994).

> When the SEC promulgated Rule 16a-1 in 1991, the concept of a "group" under Rule 13d-5(b), and the prerequisites for finding such a "group," had a settled meaning, widely accepted in the federal courts. In adopting Rule 16a-1, the SEC expressly incorporated that accepted meaning into §16(b). It decided to do so *only after extensive, deliberate consideration in a two-year public rule making proceeding.*

(emphasis added) (CCI R.Br. at 3). In a footnote to this statement, CCI and Castle Creek quote a leading commentator on Section 16 who observed that

> It appears that a primary consideration from the Commission's perspective in adopting the Section 13(d) standards was the convenience of using them under Section 16. A mature body of law on the calculation of beneficial ownership already exists under Section 13(d), and it is transportable to Section 16 *without the lingering interpretive uncertainties* attendant to most newly adopted standards.

(emphasis added) (CCI R.Br. at 3 n. 1, quoting P. Romeo and A. Dye, Section 16 Treatise and Reporting Guide, §4.02 at 4-13 (1994). Thus, the Commission acted, as the defendants concede, to adopt as certain a standard as possible for purposes of the reporting provision of Section 16(a) and the strict liability provision of Section 16(b).

II. THE APPLICATION OF A GROUP CONCEPT OF BENEFICIAL OWNERSHIP UNDER SECTION 16 IS CONSISTENT WITH THE LEGISLATIVE HISTORY OF THAT PROVISION.

The legislative history of Section 16(b) supports the application of the concept of group beneficial ownership to that provision. The Senate Report on the bill that eventually was largely enacted as the Exchange Act, S. 3420, elaborates on the need for the legislation, stating that the provision

> aims to protect the interest of the public by preventing directors, officers, and principal stockholders of a corporation * * * from speculating in the stock on the basis of information that is not available to others.

S. Rep. No. 73-792, 73d Cong., 2d Sess. 9 (1934). Following a brief description of the reporting and short-swing profits recovery provisions of Section 16, the report continues that

> Such a provision will render difficult or impossible the kind of transactions which were frequently described to the [Banking] Committee, where directors and large stockholders participated in pools trading in the stock of their own companies, with the benefit of advance information regarding an increase or resumption of dividends in some cases, and the passing of dividends in others.

After discussing one example involving a pool organized by the chairman of a company and another director, the Senate report goes on to describe that

> In another case, the president of a corporation testified *that he and his brothers controlled the company with little over 10 percent of the shares*; that shortly before the company passed a dividend, they disposed of their holdings for upward of $16,000,000 and later repurchased them for about $7,000,000, showing a profit of approximately $9,000,000 on the transaction.

(emphasis added) S. Rep. No. 73-792, at 9.

From the reports' descriptions of the problem Section 16 seeks to resolve, Congress plainly understood that the evils at which the section was directed could be effected by a group controlling a "little over 10 percent." Although the example is not

precisely the same as the typical situation contemplated under Section 16a-1(a)(1), since one member of the group was the president of the company who was already subject to Section 16(b) regardless of his holdings, it does suggest that access to inside information can exist among members of a group. Moreover, the example is similar to the facts alleged here, where one member of the group was a greater than ten percent owner, and thus independently an insider for Section 16 purposes.

Each of the examples described in the report's discussion of Section 16 involved pools of shareholders where each shareholder appears to own his shares independently of the other members of the pool. Moreover, in its section entitled "Market Activities of Directors, Officers, and Principal Stockholders of Corporations," the Stock Exchange Practices Report [15] describes several abuses of inside information that all occurred at the hands of pools of corporate officials or officials and principal shareholders who appear to have owned their securities independently of one another. Even if these examples are not precisely the same as the situation where no group member is individually a greater than ten percent owner, it is a reasonable extension to apply Section 16 to such groups.

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[15] S. Rep. No. 93-14551 at 55-68. This is a report on hearings held before the Senate Banking Committee from 1932 to 1934 which provided much of the legislative foundation for the Securities Exchange Act. See generally J. Seligman, The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance, Chapters 1 & 2 (rev'd ed.1995).

The defendants, nevertheless, declare that Congress intended otherwise. Specifically, the defendants state that

> Indeed, Congress considered but rejected an amendment to Section 16(a) that would have applied the reporting provisions of that subsection to any "group" of persons who held more than 5% of a class of registered securities. S. 2731, 89th Congress, 1st Session (1965).

(CCI Br. at 22 n.10). As far as we can determine, Senate bill 2731 was never "rejected," as the defendants assert. Rather, it was simply abandoned and never acted upon. Senate bill 2731 was introduced by Senator Williams and the concept embodied in S. 2731 later became the Williams Act, after the Commission worked with Senator Williams to revise the legislation. The specific provision concerning groups in Senate bill 2731 became Section 13(d)(3) of the Exchange Act when the Williams Act became law.[16]

Moreover, the legislative history also reveals that Senate bill 2731 was abandoned after the Commission sent a lengthy memorandum of its views on the bill to Congress. Calling the Commission's analysis "most helpful," Senator Williams introduced it into the Congressional Record "[s]ince I think it would prove most informative and useful to those active in the securities field." 112 Cong. Rec. 19003 (August 11, 1966). In its memorandum the Commission wrote, in pertinent part, that the bill would

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[16] See Seligman, The Transformation of Wall Street, Chapter 8 at 431-32; Romeo and Dye, Section 16 §1.03 at 1-41.

> amend Section 16(a) of the [Exchange] Act to provide that the term person therein shall be deemed to include two or more persons acting as a partnership, limited partnership, syndicate, or other group formed for the purpose of acquiring, holding, or disposing of securities of an issuer.

112 Cong. Rec. 19003. The Commission did not comment on this provision. Instead, it recommended that the provision be deleted. Id. at 19004.

The Commission did, however, comment upon what it described as a "like provision" of the bill that would have provided that two or more persons acting "as a partnership, limited partnership, syndicate, or other group * * * shall be deemed a 'person' for the purposes of" Section 10 of the Exchange Act. Id at 19004. The Commission noted that "[t]his provision is in effect an amendment to or enlargement of the existing definition of person in Section 3(a)(9) of the Act."[17] Id. at 19004. The Commission thought that definitions of terms used in the Act should be kept in one part of the Act. More importantly, the Commission thought the proposed expanded definition of person could be eliminated altogether because "[t]he term 'syndicate or other group' can be defined by the Commission, pursuant to its power under section 3(b) of the Act * * *." Id. In other words, the Commission, in essence, reported to Congress that no legislative action was needed to correct abuses by groups because the Commission

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[17] Section 3(a)(9) of the Exchange Act, 15 U.S.C. 78c(a)(9), defines "person" as "a natural person, company, government, or political subdivision, agency, or instrumentality of a government."

already had rulemaking authority to define terms under Section 3(b). Congress, thereafter, abandoned S. 2731.[18]

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[18] Defendants argue that "[d]isregard of the SEC's enlargement of Section 16(b) is particularly warranted since Congress has amended the Securities Exchange Act on numerous occasions since [court decisions requiring that a beneficial owner to have a pecuniary interest] and, in each instance, has left Section 16(b) unchanged" (CCI Br. at 22). "Congress' failure to disturb a consistent interpretation of a statute may provide some indication that 'Congress at least acquiesces in, and apparently affirms that [interpretation].'" quoting Manessor Southwestern Railway Co. v. Morgan, 486 U.S. 330, 338 (1988). Even if one were to assume, for the sake of argument, that Congress meant to endorse those cases which, prior to Rule 16a-1(a)(1), rejected the use of Section 13(d) concepts under Section 16, that does not speak to Congress' view of the Commission's authority to adopt the rule. Furthermore, Rule 16a-1(a)(1) has been on the books for nearly a decade and Congress has not acted to reverse it. This is indicative of Congressional acceptance of the rule. See, e.g., NLRB v. Bell Aerospace Co., 416 U.S. 267, 275 (1974); United States v. Correll, 389 U.S. 299, 304-05 (1967). And "it is noteworthy that no court has ever held the rule invalid." Touche Ross & Co. v. SEC, 609 F.2d 570, 578 (2d Cir. 1979).

CONCLUSION

For the foregoing reasons, the Court should hold that the Commission acted within its authority in adopting Rule 16a-1(a)(1).

Respectfully submitted,

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Dated: May 8, 2000

CERTIFICATE OF SERVICE

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