99-7478

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

MARK FEDER, Derivatively on behalf of IVAX Corporation,
Plaintiff-Appellant,

v.

PHILIP FROST and FROST-NEVADA, Limited Partnership,
Defendants-Appellees.

On Appeal from the United States District Court
for the Southern District of New York

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE

DAVID M. BECKER
General Counsel

JACOB H. STILLMAN
Solicitor

SUSAN S. McDONALD
Senior Litigation Counsel

ANGEL YANG
Attorney

Securities and Exchange Commission
Washington, D.C. 20549

Of Counsel
MEYER EISENBERG
Deputy General Counsel

TABLE OF CONTENTS

TABLE OF CONTENTS (CONTINUED)

Page

TABLE OF AUTHORITIES

TABLE OF AUTHORITIES (CONTINUED)

Cases **Page**

Commission Releases

Statutes and Rules

Securities Exchange Act of 1934, 15 U.S.C. 78a, et seq.

TABLE OF AUTHORITIES (CONTINUED)

Statutes and Rules (Continued) **Page**

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 99-7478

MARK FEDER, Derivatively on behalf of IVAX Corporation,

Plaintiff-Appellant,

v.

PHILIP FROST and FROST-NEVADA, Limited Partnership,

Defendants-Appellees.

On Appeal from the United States District Court
for the Southern District of New York

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE

The Securities and Exchange Commission submits this brief as amicus curiae in response to the invitation of the Court.

STATEMENT OF THE ISSUE

In this action brought under Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78p(b), against an insider of a publicly held company to recover "short-swing" profits from transactions in his company's securities, the complaint

alleges that the insider made purchases of stock in the company within six months of sales of such stock by another corporation in which he had a substantial ownership interest and a controlling influence. The question presented is whether the insider had an indirect pecuniary interest within the meaning of Rule 16a-1(a)(2)(ii), 17 C.F.R. 240.16a-1(a)(2)(ii), in the stock sold by the second company and accordingly was the beneficial owner of that stock and liable under Section 16(b) for his proportionate share of profits realized from the transactions.

STATEMENT OF THE CASE

A. Nature of the Case

Plaintiff Mark Feder, a shareholder of the publicly held IVAX Corporation, filed a complaint on behalf of IVAX seeking recovery, under Section 16(b) of the Exchange Act, 15 U.S.C. 78p(b), of "short-swing" profits allegedly realized by defendants Philip Frost and the Frost-Nevada Limited Partnership ("FNLP," an entity wholly owned by Frost). Frost was a statutory insider of IVAX. The complaint alleged that Frost and FNLP, sometimes collectively referred to as "Frost," derived profits recoverable under Section 16(b) when Frost bought shares of IVAX within six months of sales of IVAX stock by North American Vaccine, Inc. ("NAVI"), another corporation in which Frost had a substantial ownership interest (17.3%) and allegedly a controlling interest (50.8%) by virtue of an

agreement among NAVI shareholders to which Frost and FNLP were parties. The plaintiff seeks recovery of the portion of profits corresponding to Frost's percentage interest in NAVI, that is, 17.3%.

The district court dismissed the complaint under Fed. R. Civ. P. 12(b)(6) for failure to state a claim on which relief could be granted. In ruling for the defendants, the district court concluded that Frost did not "realize" any profits within the meaning of Section 16(b) from NAVI's sales of IVAX stock because the benefit to Frost from NAVI's sales was too indirect to constitute the realization of profits by him under the statute. The district court expressed the view that the defendant must have "cash in hand" in order to be deemed to have realized a profit. It is unclear why the court did not apply Rule 16a-1(a)(2), 17 C.F.R. 240.16a-1(a)(2), which defines the statutory term "beneficial owner" as used in this context to include an indirect pecuniary interest. See Rule 16a-1(a)(2)(ii), 17 C.F.R. 240.16a-1(a)(2)(ii). The court appears to have misread the rule as not applicable here and, in addition, seems to have suggested that the rule might be beyond the Commission's statutory authority. The district court did not consider an argument made by the defendants as an alternative basis for dismissal, i.e., that Frost qualifies for the safe harbor of Rule 16a-1(a)(2)(iii), 17 C.F.R. 240.16a-1(a)(2)(iii), under which a shareholder is deemed not to have a pecuniary interest in the

portfolio securities held by a corporation or similar entity in which the person owns securities if the shareholder is not a controlling shareholder of the entity and does not have or share investment control over the entity's portfolio.

B. Facts 1/

IVAX is a publicly held corporation whose shares are traded on the American Stock Exchange. IVAX is a holding company with subsidiaries primarily involved in the research, manufacture, marketing and distribution of pharmaceuticals. It is undisputed that Frost is the Chairman and Chief Executive Officer of IVAX and -- even apart from any beneficial ownership he may have of IVAX shares held by NAVI -- beneficially owns 15,484,734 shares, or approximately 12.8%, of IVAX's common stock, including shares owned by FNLP. According to the complaint, Frost beneficially owns the shares owned by FNLP because Frost is the sole limited partner of FNLP, a Nevada limited partnership, and the sole general partner of FNLP is Frost-Nevada Corporation (a non-party), of which Frost is the sole shareholder, director and officer.

1/ Except where otherwise specified, the facts are as stated in the complaint. On a motion to dismiss for failure to state a claim the facts alleged in the complaint must be taken as true and construed in favor of the pleader. See Scheuer v. Rhodes, 416 U.S. 232, 236 (1974); Atlantic Mutual Insurance Co. v. Balfour MacLaine International Ltd., 968 F.2d 196, 198 (2d Cir. 1992).

Frost is also a shareholder and a director of NAVI, a Canadian corporation whose stock is traded on the American Stock Exchange. NAVI is involved in the research, manufacturing, production and marketing of vaccines to prevent infectious diseases. Frost and FNLP collectively own 17.3% of NAVI's common stock. Frost and FNLP are parties to a shareholders' agreement, along with another shareholder of NAVI. The complaint alleges that, together, the parties to the agreement own a total of 50.8% of NAVI's common stock. The complaint states (JA 5 2/) that as a result of the shareholders' agreement the parties to the agreement, including Frost and FNLP, had "'effective control of the Company [NAVI] [which] enables them to determine the policies and direct the operations of the Company.'" (quoting from a Schedule 14A proxy statement filed by NAVI with the Commission on April 17, 1997). 3/

2/ "JA" references are to the joint appendix filed by the parties in this case.

3/ The proxy statement itself indicates that the parties to the agreement own 56.6% of NAVI's common stock, a higher percentage than that alleged in the complaint. See Attachment A to this brief at 8.

Neither the proxy statement nor the shareholders' agreement was attached to the complaint. However, because both are referred to in the complaint and are public documents filed with the Commission, the court may properly consider both documents on a motion to dismiss. Kramer v. Time Warner, Inc., 937 F.2d 767, 773-74 (2d Cir. 1991).

The shareholders' agreement, dated January 17, 1990, 4/ states that the shareholders that are parties to the agreement are Frost, FNLP and IVAX, referred to in the agreement as the "Frost Group," and a fourth shareholder, BioChem.5/ Attachment B at 1. The agreement provides that the Frost Group and BioChem each elect an equal number of directors to the board of directors of NAVI, and an additional director satisfactory to both groups of directors. Id. at 3. The proxy statement referred to above states that the board of directors of NAVI has eleven members. Attachment A at 1. Thus, the Frost Group and BioChem control the entire board -- each selects five directors and the two groups then agree on the eleventh.

The complaint alleges that sales by NAVI and purchases by Frost of IVAX stock yielded short-swing profits that are recoverable under Section 16(b). The plaintiff alleges that NAVI's stock sales are attributable to Frost because, by virtue of the shareholders' agreement, Frost has effective control of NAVI, including the

---

4/ A copy of the agreement, Attachment B to this brief, was filed with the Commission as an exhibit to NAVI's registration statement on Form S-4 filed in January 1990.

5/ It is not alleged that Frost had any ownership or control interest in BioChem.

power to determine its policies and to direct its operations. Therefore, plaintiff argues, Frost is the beneficial owner of IVAX shares held by NAVI, and profits resulting from sales of IVAX stock by NAVI are thus attributable to Frost to the extent of his percentage ownership of NAVI.

The complaint "matches" two sets of transactions in IVAX stock -- sales by NAVI and purchases by Frost -- which it alleges resulted in profits of "at least $500,000" and "at least $2.5 million," respectively. Frost's 17.3% proportionate share of the total $3 million of these identified alleged short-swing profits would be approximately $500,000. Specifically, the complaint alleges that on October 23, 1995, Frost and/or FNLP purchased 110,000 shares of IVAX for $2,494,000. Within six months, between October 1, 1995 and December 31, 1995, NAVI sold 156,916 shares of IVAX for about $4.3 million. Then, between January 1, 1996 and March 31, 1996, NAVI sold an additional 193,084 shares of IVAX common stock for approximately $5.2 million. 6/ Within six months, and prior to June 27, 1996, Frost and/or FNLP purchased another 200,000 shares of IVAX stock for

---

6/ Frost states in his brief (at 5) that he recused himself from the NAVI board of directors' vote in which it was decided that NAVI would sell the IVAX securities.

about $3 million. The foregoing are the transactions on which the plaintiff bases his allegation of short-swing profits of "at least" $500,000 and $2.5 million.7/

C. Proceedings in the District Court

The defendants moved to dismiss the complaint, pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure, on the ground that plaintiff failed to allege that defendant Frost purchased and sold IVAX stock within a six-month period and thus failed to state a cause of action for which relief can be granted. The defendants argued that Frost realized no short-swing profits because (1) Frost and FNLP had no pecuniary interest in the IVAX stock sold by NAVI and (2) Frost did not receive the proceeds of NAVI's sale of IVAX shares, and therefore any profit from NAVI's sales was not realized by Frost.

The district court granted defendants' motion to dismiss the complaint, holding that Frost did not "realize" any profits from NAVI's sales of IVAX stock. JA 27. The district court noted that although Frost, as the Chairman, CEO and 12% owner of IVAX, clearly meets the statutory definition of an IVAX insider, the matching sales were effected by NAVI. JA 26. The district court concluded that

---

7/ The plaintiff alleges that subsequently, on July 11 and 12, 1996, Frost and/or FNLP purchased 90,000 shares of IVAX common stock for $1,315,050. The complaint asserts that the matching of these purchases with additional sales by NAVI, Frost or some other Frost-controlled entity, which the plaintiff might be able to identify through discovery, may yield additional short-swing profits.

Frost, as a matter of law, did not profit from NAVI's sales of IVAX stock because Frost did not have "cash in hand" to disgorge. JA 27. The district court rejected plaintiff's argument that Frost's "profits" were an "economic effect"-- the increased value of NAVI -- and that Frost benefitted from this increased value because of the NAVI shares he owned. JA 26-27. In rejecting plaintiff's argument, the district court stated that it was unclear to the court "how this defendant could be required to disgorge this `economic effect.'" JA 27.

The district court also rejected plaintiff's argument that the Rule 16a-1(a)(2) definition of "beneficial owner" ("any person * * * who, directly or indirectly, * * * has or shares a direct or indirect pecuniary interest in the equity securities") controls the determination of whether profits were realized for the purposes of Section 16(b). JA 27 n.6. The district court, based on an apparent misreading of the rule, held that this definition "is to be used solely for determining whether a person" is a statutory insider and, since there was no dispute that Frost is a statutory insider, the court held that the Rule 16a-1(a)(2) definition was inapplicable. Id. 8/ The court also stated: "Defendants point out that section 16(b) imposes liability for

---

8/ The court appears to have confused the definition in Rule 16a-1(a)(2) with the definition in Rule 16a-1(a)(1). Rule 16a-1(a)(1), which applies the beneficial ownership standards of Section 13(d), applies solely for purposes of determining whether a person is a statutory insider as a beneficial owner of more than 10% of a class of registered equity securities.

any profit realized by a ten percent beneficial owner, and argue that liability under 16(b) cannot be expanded by the definition in 16a-1(a)(2)." Id.

SUMMARY OF ARGUMENT

The Commission believes that: (1) a person who has a substantial ownership interest and controlling influence in a corporation, by virtue of his stock ownership and a shareholders' agreement such as the NAVI shareholders' agreement in this case, is not entitled to the safe harbor of Rule 16a-1(a)(2)(iii) and accordingly may, depending on the circumstances, be deemed to have an indirect pecuniary interest in the portfolio securities held by that corporation; and (2) based on the circumstances alleged in the complaint in this case, Frost had an indirect pecuniary interest, as defined in Rule 16a-1(a)(2), in the IVAX stock sold by NAVI, so as to make him the beneficial owner of his proportionate share of that stock and thus liable under Section 16(b) for profit realized from those transactions, unless he can show that, notwithstanding the inference of control over NAVI's decision to sell that arises from the shareholders' agreement here, he in fact could not have caused or prevented NAVI's sales.

ARGUMENT

AN INSIDER UNDER SECTION 16(b) HAS AN INDIRECT PECUNIARY INTEREST IN THE PORTFOLIO SECURITIES BOUGHT OR SOLD BY A CORPORATION IN WHICH HE HAS A SUBSTANTIAL OWNERSHIP INTEREST AND A CONTROLLING INFLUENCE, UNLESS HE CAN SHOW THAT IN FACT HE COULD NOT HAVE CAUSED OR PREVENTED THE SECURITIES TRANSACTIONS.

A. Background

Section 16(a) of the Exchange Act, 15 U.S.C. 78p(a), requires that certain corporate insiders -- persons who beneficially own more than ten percent of a company's registered equity securities and officers and directors of the issuer of such securities -- file an initial beneficial ownership report with the Commission within ten days of acquiring insider status. Such insiders must also file a report within ten days of the end of any month in which any change occurs in their beneficial ownership. 9/ Section 16(b) of the Exchange Act, 15 U.S.C. 78p(b), provides, in relevant part:

9/ The Commission has adopted rules that provide for deferred reporting or exemptions from reporting for certain types of transactions. See, e.g., Rule 16a-3(f)(1), 17 C.F.R. 240.16a-3(f)(1); and Rule 16a-9, 17 C.F.R. 240.16a-9.

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer... within any period of less than six months ... shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months.

Under this provision, insiders are liable for "any profit realized by" them from the short-swing purchase and sale, or sale and purchase, of the company's securities within a six-month period. See Gollust v. Mendell, 501 U.S. 115, 121 (1991). The insider was deemed to be capable of structuring his transactions so as to avoid liability. See Bershad v. McDonough, 428 F.2d 693, 696 (7th Cir. 1970), cert. denied, 400 U.S. 992 (1971). Section 16(b) is a strict liability provision and the insider is liable for any profit, regardless of whether he acted on the basis of non-public information in effecting the transactions. Gollust v. Mendell, 501 U.S. at 122. The Commission is not authorized to enforce Section 16(b); rather, the issuer, or a holder of its securities suing on its behalf, may bring an action against an insider to recover profits from short-swing transactions. Id.

The Supreme Court has held that "where alternative constructions of the terms of Section 16(b) are possible, those terms are to be given the construction that best serves the congressional purpose of curbing short-swing speculation by corporate insiders." Reliance Electric Co. v. Emerson Elec. Co., 404 U.S. 418, 424 (1972). Section 16(b) was intended "to squeeze all possible profits out of stock transactions" by insiders (Smolowe v. Delendo Corp., 136 F.2d 231, 239 (2d Cir.), cert. denied, 320 U.S. 751 (1943)) and, accordingly, the courts compute profit on short-swing transactions so as to maximize the plaintiff's recovery (Blau v. Lehman, 286 F.2d 786, 791 (2d Cir. 1961), aff'd, 368 U.S. 403 (1962)).

The Exchange Act does not define the term "beneficial owner" either for purposes of determining initially whether a person has insider status as a ten percent beneficial owner under Section 16(a) and (b), or for purposes of determining whether a change in beneficial ownership has occurred so as to require a report to be filed under Section 16(a) and whether any such change resulted in the realization of profits under Section 16(b). Although Section 3(b) of the Exchange Act, 15 U.S.C. 78c(b), expressly authorized the Commission to adopt rules defining

terms in the Act, 10/ prior to 1991 the Commission did not do so for the term "beneficial owner" and interpretation of the term for Section 16 purposes developed in the courts. See Rel. No. 34-26333, 42 SEC Docket 570, 574 (1988).

In 1988, the Commission proposed rules under Section 16 to, among other things, define "beneficial owner." Id. The proposing release explained that the rules were being proposed, in part, because "[u]ncertainty as to the status of indirect interests in securities of the issuer, such as ownership of derivative securities and holdings of the immediate family, trusts, corporations, and partnerships, has raised requests for a definition." Id. Two definitions were regarded as necessary because different considerations are relevant to determining initially who meets the definition of insider by being a ten percent beneficial owner, and subsequently what transactions need to be reported under Section 16(a) as effecting a change in beneficial ownership and potentially incurring liability under Section 16(b). Id.

10/ Section 3(b) provides in relevant part: "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 * * * and other terms used in this title, consistently with the provisions and purposes of this title." This Court has recognized that Section 3(b) gives the Commission the "power to define 1934 Act terms in [a] manner consistent with [the] Act." C.R.A. Realty Corp. v. Crotty, 878 F.2d 562, 565 (2d Cir. 1989).

The rules were adopted in final form in 1991. Release No. 34-28869, 48 SEC Docket 234-277 (1991). Rule 16a-1(a), 17 C.F.R. 240.16a-1(a), contains both definitions of the term "beneficial owner." 11/ The first, in Rule 16a-1(a)(1), 17 C.F.R. 240.16a-1(a)(1), applies "[s]olely for purposes of determining whether a person is a beneficial owner of more than ten percent of any class of equity securities * * *." As the Commission explained in the adopting release, this first definition "define[s] ten percent holders under section 16 as persons deemed ten percent holders under section 13(d) of the Exchange Act and the rules thereunder." 48 SEC Docket at 236. 12/ This definition "is used only to determine status as a ten percent holder." Id. Once that status is determined, or if a person has insider status as an officer or director, the second definition comes into play, and the reporting and short-swing profit provisions of Section 16 "cover only those

---

11/ Although the rule is denominated with the prefix "16a," it "shall not be limited to Section 16(a) of the Act but shall also apply to all other subsections under Section 16 of the Act." Rule 16a-1.

12/ The Commission decided to incorporate the broad definition of beneficial owner in Section 13(d), 15 U.S.C. 78m(d), into Section 16 for purposes of determining ten percent holder status because, as stated in the proposing release, "Congress, in applying Section 16 to ten percent holders, intended to reach those persons who could be presumed to have access to insider information because of their interest in the issuer's securities," and the Commission deemed the Section 13(d) definition, which "turn[s] on the person's potential for control," to be appropriate for ten percent holder determination under Section 16. See 42 SEC Docket at 574.

securities in which insiders have or share a direct or indirect pecuniary interest" (id. at 237), as defined in Rule 16a-1(a)(2), 17 C.F.R. 240.16a-1(a)(2).

Rule 16a-1(a)(2) defines the term "beneficial owner" for all purposes "[o]ther than" to determine whether a person is a ten percent holder. Under Rule 16a-1(a)(2), "the term 'beneficial owner' shall mean any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has or shares a direct or indirect pecuniary interest in the equity securities" (emphasis added). 13/ The term "pecuniary interest" is defined in Rule 16a-1(a)(2)(i), 17 C.F.R. 240.16a-1(a)(2)(i), to "mean the opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject securities." The "pecuniary interest" test was designed to "codify the courts' emphasis on pecuniary interests and deem that indirect pecuniary interests are

---

13/ The proposing release in 1988 explained that the Commission proposed to define beneficial ownership by reference to "pecuniary interest" because it interpreted case law developed under Section 16(b) to have relied on pecuniary interest as the primary factor in determining whether an insider was liable for profits from transactions, noting that by defining beneficial ownership "in terms of pecuniary interest" the Commission was "thereby codifying case law." 42 SEC Docket at 574 & n.57 (citing Whittaker v. Whittaker Corp., 639 F.2d 516 (9th Cir.), cert. denied, 454 U.S. 1031 (1981); Whiting v. Dow Chemical Co., 523 F.2d 680 (2d Cir. 1975). In Whittaker, profits made in the account of a mother, who was an invalid, were attributed to her adult son, the insider, because he had power of attorney, was her sole heir, and had the power to use her money for his benefit, such as by taking interest free loans from her account. In Whiting, transactions in a wife's inherited stock holdings, maintained in a separate account in her name, were attributed to her insider husband because the couple lived together, both benefitted from her assets, and they shared a joint investment plan.

sufficient to establish a reporting obligation and the potential for short-swing profit recovery with respect to those securities." 42 SEC Docket at 574. 14/

Rule 16a-1(a)(2)(ii), 17 C.F.R. 240.16a-1(a)(2)(ii), then provides that "[t]he term 'indirect pecuniary interest' in any class of equity securities shall include, but not be limited to" several situations, including: "(A) Securities held by members of a person's immediate family sharing the same household, provided, however, that the presumption of such beneficial ownership may be rebutted; * * * (B) A general partner's proportionate interest in the portfolio securities held by a general or limited partnership * * * [;] (C) A performance-related fee, other than an asset-based fee, received by any broker, dealer [or several other financial management professionals] * * * [;] (D) A person's right to dividends that is separated or separable from the underlying securities. * * * [;] (E) A person's interest in securities held by a trust * * * [;] (F) A persons' right to acquire equity securities

---

14/ As the Commission acknowledged in the proposing release in 1988, by including "indirect" pecuniary interest, the definition under Rule 16a-1(a)(2), 17 C.F.R. 240.16a-1(a)(2), goes beyond most of the previous judicial decisions. 42 SEC Docket 574 n.57. However, two decisions had held that an "indirect" pecuniary interest was sufficient to make an insider responsible for Section 16(b) profits (Altamil Corp. v. Pryor, 405 F. Supp. 1222, 1225-1226 (S.D. Ind. 1975); Marquette Cement Mfg. Corp. v. Andreas, 239 F. Supp. 962, 967 (S.D. N.Y. 1965)). Further, other decisions, such as those in Whittaker and Whiting (see n.13), while not explicitly acknowledging that they were bringing indirect ownership interests within the purview of Section 16, in fact did so. See Peter J. Romeo and Alan L. Dye, Section 16, Insider Reporting and Short-Swing Liability § 4.03 at 4-24 n.16 (1994); Note, "Beneficial Ownership" Under Section 16(b) of the Securities Exchange Act of 1934, 77 Colum. L. Rev. 446, 454-460 (1977).

through the exercise or conversion of any derivative security, whether or not presently exercisable."

The rule does not specifically address the circumstance of an insider's ownership of securities through a corporation, except to provide a "safe harbor" under which in certain circumstances an insider is deemed not to have a pecuniary interest in the portfolio securities held by a corporation in which he is a shareholder. Thus, Rule 16a-1(a)(2)(iii), 17 C.F.R. 240.16a-1(a)(2)(iii), provides:

> A shareholder shall not be deemed to have a pecuniary interest in the portfolio securities [15/] held by a corporation or similar entity in which the person owns securities if the shareholder is not a controlling shareholder of the entity and does not have or share investment control over the entity's portfolio.

The rule provides a safe harbor from attribution of corporate holdings for shareholders who are not controlling shareholders of the corporation and do not have or share investment control over the corporation's portfolio securities. According to the adopting release, "controlling shareholder" refers to a shareholder that has the power to exercise control over the corporation by virtue of his securities holdings. 48 SEC Docket 237 n.49. The release stated that the rule does not distinguish between public and nonpublic corporations. 48 SEC Docket 237.

15/ "Portfolio securities" means "all securities owned by an entity, other than securities issued by the entity." Rule 16a-1(g), 17 C.F.R. 240.16a-1(g).

Thus, Rule 16a-1(a)(2) does not prescribe any circumstance in which an insider shall be deemed to have a pecuniary interest in the portfolio securities of a corporation in which he is a shareholder, but instead precludes the finding of such an interest if the requirements of the safe harbor are met. Whether or not a pecuniary interest exists in other circumstances involving an insider's ownership of stock in a corporation that owns securities of the issuer of which he is an insider must be analyzed by reference to relevant principles that may be derived from the statutory purpose, other portions of the rule and from case law, to the extent it has not been superseded by the 1991 rules. 16/

B. Frost Does Not Qualify For The Safe Harbor.

Frost does not come within the protection of the safe harbor for corporate holdings (Rule 16a-1(a)(2)(iii)) because he fails to meet at least one of the two requirements that must be met to satisfy the safe harbor. Frost is a "controlling shareholder" of NAVI; in the words of the adopting release, he has "the power to exercise control over [NAVI] by virtue of [his] securities holdings" (48 SEC Docket at 237 n.49). The NAVI proxy statement relied on by the plaintiff expressly states that the shareholders' agreement gives the Frost Group and

---

16/ In addition, deference should be given to the Commission's interpretation of its rule. See Thomas Jefferson Univ. v. Shalala, 512 U.S. 504, 512 (1994) ("We must give substantial deference to an agency's interpretation of its own regulations.").

BioChem "effective control of [NAVI] and enables them to determine the policies and direct the operations of the Company." The defendants argue that Frost's control does not come from his securities holdings in NAVI, but from the shareholders' agreement. However, it seems apparent that his substantial holdings in NAVI (17.3%) are the basis for the shareholders' agreement. Since the safe harbor has two requirements, both of which must be met to come within its purview, and Frost fails to meet the first, the safe harbor is not available to Frost.

C. Frost Presumptively Had An Indirect Pecuniary Interest In The Ivax Shares Owned By NAVI.

Once it has been determined that Frost does not come within the safe harbor, it must be determined whether his interest in the IVAX shares owned by NAVI comes within the meaning of "indirect pecuniary interest" in Rule 16a-1(a)(2)'s definition of "beneficial owner." Prior to the 1991 rule revisions, insiders having stock interests through another publicly held corporation had generally not been held liable for profits resulting from transactions by those corporations. See 42 SEC Docket 575 n.70 ("holdings generally have not been attributed to the individual shareholders of a corporate shareholder, except in situations involving

closely held corporations."); Mayer v. Chesapeake Insurance Co., 877 F.2d 1154, 1159 (2d Cir. 1989), cert. denied, 493 U.S. 1021 (1990). 17/

However, in at least one case, Blau v. Mission Corp., 212 F.2d 77, 80 (2d Cir.), cert. denied, 347 U.S. 1016 (1954), the insider was held liable for profits from sales of portfolio securities by a publicly held corporation of which the insider had control through 60% ownership. See also Whiting v. Dow Chemical Co., 523 F.2d 680, 686 (2d Cir. 1975) ("In a traditional sense, in the absence of a statutory definition, a beneficial owner would be a person who does not have legal title to the securities but who is, nevertheless, the beneficiary of a trust or a joint venture, or is a shareholder in a corporation which owns the shares." (emphasis added).

In any event, the result in Mayer and other cases seems to have been largely influenced by the assumption that even large shareholders of publicly held companies usually do not have control of the company's operations and investment decisions . See Mayer, 877 F.2d at 1159 (stating that, in contrast to the situation

---

17/ In Mayer, this Court held that an insider was not liable for profits from portfolio stock transactions of a company in which he was a shareholder, stating that "the insider's benefit as a director or as a shareholder of the transacting corporation [i]s too indirect to make him responsible for disgorgement of profits under Section 16(b)." 877 F.2d at 1160. Although the insider was chairman, president and CEO of each of several affiliated public corporations, and held 35% to 38% of their stock, the Court held that he was not liable for stock transactions by them because he "individually received no direct benefit from the sale of the * * * shares." 877 F.2d at 1162.

present in that case, "[w]here the insider has absolute control over the transactions and directly benefits from the profits, he is liable under [Section] 16(b)."). Where there is no control, the potential for abuse of inside information is obviously remote, but where control is present, so is the potential for abuse -- and Section 16(b) was designed to prevent such abuse by "squeezing all profit" from transactions in which there was potential for abuse.

As the Supreme Court stated in Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 594 (1973), in the context of determining whether a transaction should be deemed a "purchase" or "sale" for Section 16(b) purposes, "[i]n deciding whether borderline transactions are within the reach of [Section 16(b)], the courts have come to inquire whether the transaction may serve as a vehicle for the evil which Congress sought to prevent * * *." Since there is obvious opportunity for abuse of inside information if an insider may "escape section 16(b) liability because certain transactions were performed by another corporation over which the [insider] exercised control" (Synalloy Corp. v. Gray, 816 F. Supp. 963, 971 (D. Del. 1993)), such transactions should be attributed to the insider where he has control over the transacting corporation, whether publicly or privately held, and controls that company's purchases and sales of its portfolio securities. Otherwise, "[e]very time an insider bought for his own account and then

sold from the account of a controlled corporation, the insider could trade on inside information and escape liability nevertheless." Id. In the Synalloy case, the court attributed to the insider sales made by a corporation of which the insider had control through 80% ownership. Id. See also Popkin v. Dingman, 366 F. Supp. 534, 538-541 (S.D. N.Y. 1973) (holding that the insiders, who owned 4.8% and 14% respectively of the transacting corporation, were not liable under Section 16(b) because they "could not control or prevent the sale" (366 F. Supp. at 538) of the securities). Cf. 4 Fed. Sec. L. Rep. ¶ 26,101.034 (1993) (collecting cases, including Kern, in which insiders have been held not liable for profits resulting from "involuntary transactions" (in other words, transactions over which they did not have control) because the courts deemed that no purchase or sale occurred and noting that "a common thread in the cases in which no short-swing liability is assessed has been the involuntary nature of the participation of the alleged short-swing traders.").

Cases that were decided before the Commission adopted a definition of "beneficial owner" in 1991 did not interpret Rule 16a-1(a)(2), which provides that "pecuniary interest" includes the opportunity indirectly, as well as directly, to profit or share in any profit derived from a transaction in the subject securities. Indeed,

this Court in Mayer recognized that the new rules would include an indirect pecuniary interest test.

The defendants argue that the Commission lacked authority to adopt Rule 16a-1(a)(2), 17 C.F.R. 240.16a-1(a)(2), to the extent it expands liability beyond what was recognized under prior case law. However, as noted above, Section 3(b) of the Exchange Act, 15 U.S.C. 78c(b), expressly authorizes the Commission to define terms used in the Act. Further, as discussed in n.14, some courts had, prior to 1991, recognized that "indirect" pecuniary interests would give rise to beneficial ownership for profit realization purposes. See also Blau v. Mission, cited above at p. 20. Moreover, as recognized in a treatise on Section 16(b), "to assure that insiders do not evade Section 16(b) liability through the use of indirect forms of ownership (including illegal ones, such as parking arrangements)[footnote omitted], it clearly is necessary to encompass indirect interests" within the scope of pecuniary interest for Section 16(b) profit realization determination. Romeo & Dye, §4.03 at 4-24.

Guidance as to whether insiders should be held liable for transactions in the corporate context under the 1991 rules may be gleaned by comparing an indirect interest through a corporation with the treatment of partnerships. Rule 16a-1(a)(2)(ii), 17 C.F.R. 240.16a-1(a)(2)(ii), specifically provides that "indirect"

pecuniary interest includes "[a] general partner's proportionate interest in the portfolio securities held by a general or limited partnership." This rule seems to codify the settled understanding under prior law. In Blau v. Lehman, 368 U.S. 403 (1962), the Supreme Court held that a partner in Lehman Bros. who was an insider of a corporation, Tide Water, was not personally liable for the entire amount of profits realized by Lehman Bros. on transactions in Tide Water, nor could the partnership itself be held liable by virtue of the individual partner's status as an insider. Id. at 411-414. 18/ However, the Court expressed no disagreement with the lower court's holding, which was not at issue in the Supreme Court, that the partner was liable for "his share of the Tide Water transaction profits," despite the fact that he had "specifically waived his share." Id. at 407. Thus, it seems to be

---

18/ In their brief to this Court, the defendants quote out of context language from this portion of the Blau v. Lehman decision to support their apparent contention that the Commission's Rule 16a-1(a)(2), 17 C.F.R. 240.16a-1(a)(2), is invalid insofar as it ascribes beneficial ownership based on an "indirect" pecuniary interest. See Defendants' Br. at 14-15 ("'Congress can and might amend § 16(b) if the Commission would present to it the policy arguments it has presented to us, but we think that Congress is the proper agency to change an interpretation of the [Securities Exchange] Act unbroken since its passage, if the change is to be made.'" (alteration in original)). The Supreme Court made that statement in Blau v. Lehman in rejecting the contention that the partnership itself should be deemed an insider even though it was neither an officer, a director nor a ten percent holder, and that "forfeiture of profits should be extended to include all persons realizing 'short swing' profits who either act on the basis of 'inside' information or have the possibility of 'inside' information." 368 U.S. at 410-412. The Court noted that Congress had considered and rejected this very argument when it adopted the Exchange Act and instead limited the scope of Section 16 to officers, directors and ten percent beneficial owners. Id. at 411-412.

recognized both under the 1991 rule and under prior case law that, in the partnership context, regardless of a general partner's ability to cause or prevent the transactions, that partner is liable for his proportionate share of any profit in securities of the issuer realized by the partnership. This bright-line rule in the partnership context can be explained by the nature of the participation a general partner has in the management of a partnership and the fact that a partner owns a percentage of the assets of the partnership (including securities owned by the partnership), whereas a shareholder in a corporation -- other than a controlling shareholder -- might not participate in management and a shareholder does not own the corporation's assets. See generally Popkin v. Dingman, 366 F. Supp. at 539-541 (discussing these "differences in the nature of corporate and partnership form").

In this case, the Commission believes that an inference arises from the shareholders' agreement that Frost, as a controlling shareholder, could have caused or prevented NAVI's sales of IVAX stock. However, it is conceivable that the facts, if further developed, would show otherwise. Accordingly, consistent with the statutory purpose of Section 16(b) to prevent the unfair use of information which may have been obtained by the insider by reason of his relationship to the issuer, and the resultant importance placed by the courts on the voluntary versus

involuntary nature of a transaction, we believe that in this case, where the safe harbor is not available, Frost should be liable for his proportionate share of the profits from the short-swing transactions, unless he can show that in fact he could not cause or prevent NAVI's transactions in portfolio securities.

The fact that Frost himself did not receive "cash in hand" from NAVI's sales of IVAX is not determinative of whether he realized profit from the transactions, as the district court mistakenly believed. For one thing, implicit in the term "indirect" pecuniary interest is the possibility that the profit realized may consist of indirect pecuniary benefit. Further, even before the 1991 rules, it was recognized that profit need not consist of "cash in hand." See Heli-Coil Corp. v. Webster, 352 F.2d 156, 167-68 & n.14 (3d Cir. 1965) (holding that in order to constitute "profit realized by" an insider under Section 16(b), the pecuniary gain need not be "cash in hand" but must be more than a mere hope or anticipation of gain).

Finally, the defendants are wrong in seeming to argue (Br. 14-18) that the definition of "beneficial owner" in Rule 16a-1(a)(2) is relevant only to determining reporting obligations under Section 16(a) and that liability for profits under Section 16(b) should be determined here only by interpreting the terms "profit" and "realized." It is true that Section 16(b) uses the term "beneficial owner" only in referring to a ten percent holder -- that is, statutory insider -- and does not expressly

state that beneficial ownership is to be used in determining whether "profit" was "realized by" the insider in a transaction. However, the case law has established that in order to determine liability for profits realized it is necessary to determine whether the insider has a pecuniary interest in, and therefore beneficial ownership of, the securities that were traded. See, e.g., Mayer v. Chesapeake Insurance Co., 877 F.2d 1154, 1160-1161 (2d Cir. 1989), cert. denied, 493 U.S. 1021 (1990). Rule 16a-1(a)(2) was intended to define "beneficial owner" for this purpose, among others. The definition in that rule is the relevant one for determining liability under Section 16(b) because the profits that are recoverable are those that come from the purchase and sale of securities that the insider beneficially owns. Moreover, it is apparent from the proposing and adopting releases that the Commission did not intend that, if an insider is the beneficial owner, he could nevertheless avoid liability by a determination that he somehow did not realize the profits that resulted from the trade. See 42 SEC Docket at 574; 48 SEC Docket at 237.

CONCLUSION

For the foregoing reasons, the Court should, in reviewing the district court's order dismissing the complaint for failure to state a claim on which relief can be granted, apply the Commission's interpretation of Rule 16a-1(a)(2) set forth in this brief.

Respectfully submitted,

DAVID M. BECKER
General Counsel

JACOB H. STILLMAN
Solicitor

SUSAN S. McDONALD
Senior Litigation Counsel

ANGEL YANG
Attorney

Of Counsel
MEYER EISENBERG
Deputy General Counsel

Securities and Exchange Commission
Washington, D.C. 20549

MARCH 2000

CERTIFICATE OF COMPLIANCE WITH TYPE-VOLUME LIMITATION

I certify that according to the word processing program with which this brief was prepared, WordPerfect 8, this brief contains 6,955 words and uses proportionally spaced 14-point type, except for the footnotes, which use 12-point type.

Angel Yang

Angel Yang