# 06-3771-cv

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

ANDREW E. ROTH derivatively on behalf of
BEACON POWER CORPORATION,

*Plaintiff - Appellant,*

v.

PERSEUS, L.L.C., PERSEUS CAPITAL, L.L.C., PERSEUS 2000 EXPANSION, L.L.C., PERSEUS INVESTMENT GROUP, INC., FRANK H. PEARL, JOHN DOES NOS 1-20 and BEACON POWER CORPORATION,

*Defendants- Appellees.*

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

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BRIEF OF THE SECURITIES AND
EXCHANGE COMMISSION, *AMICUS CURIAE*,
IN SUPPORT OF THE POSITION OF THE APPELLEES

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BRIEF OF THE SECURITIES AND
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## INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission submits this brief as *amicus curiae* to address important legal issues relating to the "short-swing" trading provision in Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78p(b). The objective of Section 16(b) is to deter certain corporate insiders - - officers, directors, and holders of more than ten percent of any class of an issuer's equity securities ("ten

percent holders") - - from trading in their companies' securities on the basis of inside information. Congress viewed short-swing trading -- purchases and sales occurring within a period of less than six months -- as a type of trading that posed a particular risk of misuse of inside information. Therefore, it provided in Section 16(b) that any profits realized by the insider from such trading shall inure to and be recoverable by the issuer.

Although Section 16(b) actions are brought only by issuers, and by shareholders seeking recovery for the issuer, Congress delegated to the Commission the responsibility of formulating rules exempting from Section 16(b) those transactions that, in the Commission's view, are "not comprehended within the purpose of" the section. The defendants in this case contend, and the district court agreed, that their acquisitions of stock of Beacon Power Corporation ("Beacon") were exempt under Commission Rule 16b-3(d), 17 C.F.R. 240.16b-3(d). The issues in this case are (1) whether the Commission had the statutory authority to adopt that exemption and (2) how to construe the exemption. As the agency that promulgated the rule, the Commission has a strong interest in the resolution of these issues.

## BACKGROUND

### A. The Statutory and Rule Provisions at Issue

Section 16(b) of the Exchange Act provides that "[f]or the purpose of preventing the unfair use of information which may have been obtained" by an

officer, director, or beneficial owner of more than 10% of a class of an issuer's equity securities, "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 be recoverable by the issuer. Recovery may be obtained "irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction." The section states, however, that "[t]his subsection shall not be construed to cover . . . any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."

At issue in this case is the exemption contained in Rule 16b-3(d). That rule exempts from Section 16(b) certain transactions in the issuer's equity securities by directors or officers - - two of the categories of Section 16(b) insiders. The rule, as it existed at the time of the transactions at issue here, exempted such transactions where the officer or director obtains "a grant, award or other acquisition from the issuer."1/ To qualify, either (1) the transaction must be approved by the board of directors of

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1/ The wording of the rule was changed in 2005. In its 2005 Release, *See Ownership Reports and Trading by Officers, Directors and Principal Security Holders,* Exchange Act Rel. No. 52202, 70 Fed. Reg. 46080 (Aug. 9, 2005) (" 2005 Release"), the Commission adopted a clarifying amendment (not relevant to the issues raised on this appeal) that made it clear that the rule applies to transactions irrespective of whether they are compensatory in nature. Section 16(b), and Rule 16b-3(d) as it existed at the time of the subject transactions, are reprinted in the Addendum (1A-2A).

the issuer, or a committee of the board of directors that is composed solely of at least two non-employee directors; or (2) the transaction must be approved or ratified by the affirmative votes of the holders of a majority of the securities of the issuer; or (3)the securities acquired must be held by the officer or director for a period of six months following the date of such acquisition.

**B. Facts Alleged in the Complaint**

Defendant Perseus, L.L.C. ("Perseus") is a merchant bank and private equity fund management company that makes investments through certain wholly-owned subsidiaries. Since 1997, Perseus has made a series of capital investments in Beacon through defendant Perseus Capital and defendant Perseus Expansion. As a result of these investments, in 1997 Perseus and its affiliates acquired more than ten percent of Beacon's common stock and secured representation on Beacon's board of directors, appointing Kenneth M. Socha, Senior Managing Director of Perseus, and Philip J. Deutch, Managing Director of Perseus, to serve as Beacon directors (A. 10-13).

The complaint alleges that on April 22, 2005, Perseus Capital and Perseus Expansion entered into an Investment Agreement with Beacon - - which Beacon's board of directors had approved the previous day - - whereby, over the succeeding four months in five separate tranches, Perseus Capital and Perseus Expansion acquired millions of shares of Beacon common stock and derivative securities from Beacon. Subsequently, Perseus Capital distributed to its members, including certain

members of Perseus Investors, one of whom was defendant Frank A. Pearl, four million shares of Beacon common stock on August 24, 2005 and approximately 3.5 million shares of Beacon stock on November 21, 2005.

The acquisition of Beacon stock from Beacon by Perseus Capital and Perseus Expansion allegedly can be matched with a sale of stock by members of Perseus Investors on August 25, 2005 (leading to profits disgorgeable, in the absence of an exemption from Section 16(b), by members of Perseus Investors) and a sale of Beacon stock by Pearl on November 23, 2005. The complaint requests that Perseus Investors disgorge $405,852 and that Pearl disgorge $186,325.

**C. The Decision of the District Court**

The district court dismissed plaintiff's complaint, holding that the defendants' acquisitions of Beacon common stock were exempt from Section 16(b) under Rule 16b-3(d). *Roth v. Perseus, L.L.C., et al.*, slip opinion, 2006 WL 2129331 (S.D.N.Y. July 31, 2006). In so holding, the court concluded that Rule 16b-3(d) does not prevent entities that function as directors through deputies - - directors by deputization of others to sit on the board - - from claiming the director exemption in the rule. *Roth v. Perseus*, 2006 WL 2129331, at *9.

The court also concluded that a director by deputization can claim the exemption irrespective of whether it also is a ten percent holder - - the third category

of Section 16(b) insider. Finally, the court disagreed with plaintiff's argument that the Commission lacked authority to adopt Rule 16b-3(d). *Id.* at *11.

**ARGUMENT**

## I. THE COMMISSION'S RATIONALE FOR ADOPTING RULE 16b-3(d).

When the Commission adopted Rule 16b-3(d) in 1996, it explained that the transactions covered by the rule - - officer and director acquisitions from the issuer - - do not appear to present the same opportunities for insider profit on the basis of non-public information as do insiders' transactions in the market. "Typically, where the issuer, rather than the trading markets, is on the other side of an officer or director's transaction in the issuer's equity securities, any profit obtained is not at the expense of uninformed shareholders and other market participants of the type contemplated by the statute." *Ownership Reports and Trading by Officers, Directors and Principal Security Holders,* Exchange Act Release No. 37260, 61 Fed. Reg. 30376, 30377 (June 14, 1996) ("1996 Adopting Release"). *See also* 2005 Release, 70 Fed. Reg. 46080

In addition, when the rule was proposed in 1995, the Commission stated, with respect to the gatekeeping procedures imposed by the rule, that "[t]he purpose of these [director and shareholder approval conditions] is to ensure that appropriate company gate-keeping procedures are in place to monitor any grants or awards and to ensure acknowledgment and accountability on the part of the company when it makes

such grants and awards." *Ownership Reports and Trading by Officers, Directors and Principal Security Holders*, Exchange Act Release No. 36356, 60 Fed. Reg. 53832, 53835 (Oct. 17, 1995) (1995 Proposing Release). To that end, Note 3 to the rule requires, with certain exceptions, that each specific transaction be approved to assure that the board focuses on each particular grant or award, and is accountable for authorizing each one.2/ Indeed, the basis for the exemption is that approved grants of securities are likely to be motivated by legitimate corporate objectives, as opposed to an attempt to profit from inside information. Having the board actually consider each specific transaction so there is "acknowledgment and accountability" as to what it is doing ensures that inside information will not be used. 1995 Proposing Release, 60 Fed. Reg. at 53835.

The Commission further noted that "states have created potent deterrents to insider self-dealing and other breaches of fiduciary duty." 1996 Adopting Release, Fed. Reg. 30377 at n.17, citing 3 *Fletcher Cyc. Corp.* § 837.60 (Perm. ed. 1994) and D. Block, S. Radin and N. Barton, *The Business Judgment Rule: Fiduciary Duties of Corporate Directors* 124-37 (4th ed. 1993). Thus, the Commission said, if a self-interested board

2/ The approval conditions also may be satisfied by approval of a plan pursuant to which the terms and conditions of each transaction are fixed in advance, such as a formula plan. *See* Rule 16b-3, Note 3.

disregards the corporation's interest and engages in self-dealing, it plainly breaches its fiduciary duty and may be held liable under state law.3/

By its terms, Rule 16b-3(d) exempts acquisitions only by officers and directors. It is inapplicable to acquisitions of an issuer's equity securities by ten percent holders who are not officers or directors. The reason for the exclusion of ten percent holders, as stated in the 1996 Adopting Release, is that, although "[o]fficers and directors owe certain fiduciary duties to a corporation. . . . which act as an independent constraint on self-dealing," such duties "may not extend to ten percent holders." Nevertheless, the release goes on to state that "new Rule 16b-3(d) is available to [a ten percent holder] who is also subject to section 16 by virtue of being an officer or director with respect to transactions with the issuer." 1996 Adopting Release, 61 Fed. Reg. at 30378. n.42.

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3/ The Commission further noted in the 1996 Adopting Release that "[t]here are also potential liability considerations under Rule 10b-5." 61 Fed. Reg. 30377 n.17. While this would not be so where an insider deals with a fully informed board which had not been deceived, or a fully informed shareholder electorate, it would apply to a securities transaction involving deception of the board and/or shareholders in obtaining the requisite approval. *See SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848, 850 (2d Cir. 1968) (finding a violation of Rule 10b-5 where insiders withheld material information from the issuer's stock options committee).

## II. THE ADOPTION OF RULE 16b-3(d) WAS WITHIN THE COMMISSION'S AUTHORITY.

A challenge to the validity of Rule 16b-3(d), similar to the challenge here, was recently rejected by the Ninth Circuit in *Dreiling v. American Express Company*, 458 F.3d 942 (2006). *See also Tinney v. Geneseo Communications, Inc.*, 457 F. Supp.2d 495, 503 (D. Del. 2006) (finding Rule 16b-3(d) valid). In upholding the rule, the court emphasized the Commission's conclusion that "'where the issuer, rather than the trading markets, is on the other side of an officer or director's transaction in the issuer's equity securities, any profit obtained is not at the expense of uninformed shareholders and other market participants of the type contemplated by the statute.'" 458 F.3d at 948 (*quoting* 1996 Adopting Release, 61 Fed. Reg. at 30377). The court gave "significant weight to the SEC's determination that board-approved insider-issuer transactions were 'not vehicles for the speculative abuse that section 16(b) was designed to prevent,' [1996 Adopting Release], 61 Fed. Reg. at 30377. . ." *Id* at 949.

For the reasons discussed below, we believe the *Dreiling* decision was correct.

### A. The Legislative History Shows that Section 16(b) was Enacted Principally to Prevent the Abuse of Inside Information By Insiders in Their Market Transactions with The Investing Public Rather than in Their Transactions with Issuers.

Plaintiff takes issue with the Commission's determination that officers' and directors' transactions with the issuer do not appear to present the same opportunities for insider profit on the basis of non-public information as do their transactions in

the market. As noted above, when adopting the rule the Commission stated that typically, where insiders trade with the issuer, rather than the trading market, any profit obtained is not at the expense of uninformed shareholders and other market participants of the type contemplated by the statute. *See* Adopting Release, 61 Fed. Reg. at 30377. Plaintiff argues that "[t]his finding is clearly inconsistent with Congress's belief." Without citation to any authority, plaintiff then declares that "[i]n fact, it was [transactions between the issuer and its officers and directors] that led to the passage of the statute in the first place" (Br. 27).

Plaintiff is wrong. The issuer, unlike trading investors, ordinarily is aware of the nonpublic information about its own affairs. And plaintiff cites no support for his version of Congress's intent because there is no such support. The Supreme Court has recognized that Congress was concerned with insiders' use of inside information in their *market* transactions. According to the Court, Congress's concern when it enacted Section 16(b) was that corporate "[i]nsiders could exploit information not generally available to others to secure quick profits," and "Congress recognized that shortswing speculation by stockholders with advance, inside information would threaten the goal of the Securities Exchange Act to 'insure the maintenance of fair and honest markets.'" *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 591-92 (1973) (*quoting* Exchange Act Section 2, 15 U.S.C. 78b). In the 1934 report summarizing the findings of its extensive investigation into stock exchange practices,

the Senate Committee on Banking and Currency, in a portion of the report entitled "Market Activities of Directors, Officers, and Principal Shareholders of Corporations," began by stating:

> Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, *to aid them in their market activities*.

*Stock Exchange Practices*, S. Rep. No. 1455, 73d Cong., 2d Sess. 55 (1934). (emphasis added). This Senate Report is replete with examples of corporate insiders who, armed with inside information, engaged in unfair trading with market participants. *Id.* at 55-68. *See also Blau v. Lamb*, 363 F.2d 507, 514-15 (2d Cir. 1966) (pointing to examples, found in the Senate reports, of the use of nonpublic information by officers, directors, and principal shareholders in their trades in the market as the reason Congress adopted Section 16(b)).4/

Not surprisingly, when the Senate Committee on Banking and Commerce reported to the full Senate the bill that, in large part, was to become the Securities Exchange Act of 1934, it pointed to the market activities of corporate insiders as the primary impetus for passage of what is now Section 16 of the Act. The report,

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4/ *See also* 2005 Release, 70 Fed. Reg. at 46080 ("Congress recognized that insiders may have access to information about their corporations not available to the rest of the investing public. By trading on this information, those persons could reap profits as the expense of less well informed investors.").

immediately after discussion of the parts of the bill designed to prevent manipulation by insiders, states:

> The bill further aims to protect the interests of the public by preventing directors, officers, and principal stockholders of a corporation, the stock of which is traded on exchanges, from speculating in the stock on the basis of information not available to others. . . [P]rofits realized from the purchase and sale, or the sale and purchase of an equity security within a period of less than six months are recoverable by the corporation. Such a provision will render difficult or impossible the kind of transactions which were frequently described to the 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.

S. Rep. 792, 73d Cong., 2d Sess. 8 (1934)(emphasis added). The report then goes on to describe some examples of the unfair use of inside information by officers, directors and principal shareholders in their market activities:

> In a particularly glaring instance, the chairman of the executive committee and another director *participated in a pool organized in trade in the stock of their own company when the stock was paying no dividends*. During the operation of the pool, which continued for a period of 2 years, they caused the company to resume the payment of dividends, more than 25 percent of which were received by the pool participants. . . . In another case, the president of a corporation testified that he and his brothers controlled the company with a 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. Many other instances were developed before the committee where insiders either personally or through the medium of holding companies participated largely in profits *derived from the use of information not procurable by the investing public.*

*Id.* at 8-9 (emphasis added).

Moreover, the statutory language itself is consistent with Congress' intent to prevent the speculative abuse that occurs where insiders, with the advantage of possessing inside information, trade with investors who are disadvantaged by the lack of equal information. Section 16(b) states that it was enacted "[f]or the purpose of preventing the *unfair* use of information" (emphasis added). As demonstrated by the legislative history, the unfairness referred to by Congress exists when insiders trade in the market with investors who do not have access to inside information. Such unfairness does not typically exist when the insiders of an issuer trade with the issuer. *See* 1996 Adopting Release, 61 Fed. Reg. at 30377; 2005 Release, 70 Fed. Reg. at 46082.

**B. Plaintiff's Argument Ignores or Unduly Minimizes Substantial Safeguards that Exist Under the Rule to Prevent Insider Abuses.**

1. In adopting Rule 16b-3(d), the Commission pointed out the significant protections that remain available under state fiduciary law:

> [T]he Commission believes that imposition of traditional state law procedural protections can be useful in further ensuring compliance with the underlying purposes of Section 16 by creating effective prophylactics against possible insider trading abuses.

60 Fed. Reg. at 53833.

Plaintiff complains, however, that Congress found these state law remedies to be inadequate to prevent insider trading. Plaintiff emphasizes this point by quoting the Ninth Circuit's decision in *Dreiling*, where it stated, 458 F.3d at 952 :

> Had the SEC justified Rule 16b-3(d) solely on the basis that state laws could fill the enforcement lacuna left by the rule, it would be invalid.

Plaintiff 's emphasis on *Dreiling* is misplaced because in that case the validity of Rule 16b-3(d) was upheld. Moreover, the Commission did *not* justify the rule *solely* on the basis that state law could be relied upon to reduce the risk of insider trading. As the *Dreiling* court stated in recognizing the significance of state law remedies:

> The SEC did not justify Rule 16b-3(d) *solely* on the grounds that state laws could replace §16(b) as the remedy for short-swing insider trading. Rather, the transactions covered by Rule 16b-3(d) were ones the SEC determined did not give rise to an intolerable risk of speculative abuse. *The SEC also noted that state laws on fiduciary duty and self-dealing might help remedy any residual speculative abuse that did occur. See* 61 Fed. Reg. at 30,381. *The SEC should not be penalized for explaining multiple reasons why the rule makes sense.*

458 F.3d at 952 (emphasis added). It was certainly reasonable, as the Ninth Circuit recognized, for the Commission to take into account the protections afforded by state fiduciary law.

2. The risk that a Rule 16b-3(d) transaction will be a vehicle for speculative abuse by an insider is also limited by the gatekeeping conditions the rule imposes on the transaction. The acquisition must be approved either by the issuer's board (or committee of two or more non-employee directors) or by the shareholders. The rule requires that each specific transaction be approved to assure that the board focuses on each particular grant or award, and is accountable for authorizing each one. These approval conditions "ensure that appropriate company gate-keeping procedures are in

place to monitor any grants or awards and to ensure acknowledgment and accountability on the part of the company when it makes such grants or awards." 1995 Proposing Release,60 Fed. Reg. 53835. Board or shareholder approval, furthermore, will remove the timing of the acquisition from the control of any one insider and also tend to ensure that the acquisition is for a legitimate corporate purpose. *See Gryl v. Shire Pharmaceuticals Group*, 298 F.3d 136, 145-46 (2d Cir. 2002).5/

### C. Plaintiff Misapprehends the Scope of The Commission's Exemptive Authority.

Plaintiff suggests (Br. 25-26) that the only transactions that the Commission has authority to exempt from Section 16(b) are those that present *no possibility whatsoever* of insider trading abuse. But Congress did not narrowly circumscribe the Commission's authority in that fashion. To understand why Congress believed it necessary to grant the Commission exemptive authority and the scope of that authority as envisioned by Congress, it is necessary to understand the automatic and rigorous consequences of the provision and what Congress sought to achieve.

To remedy speculative abuse, Congress focused on short-swing trading by insiders, believing that unfair use of information was most likely to occur in that type of trading. This does not mean, however, that Congress believed that short-swing

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5/ The *Gryl* decision, although not addressing the rule's validity, addressed, among other things, whether an employee benefit plan was sufficiently specific to meet the approval requirement of the rule.

trading was in and of itself wrong. Rather, it chose to allow recovery of all short-swing profits as a means of deterring trading that was abusive. The Supreme Court has repeatedly recognized that "'the only method Congress deemed effective to curb the evils of insider trading was a flat rule taking the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great.'" *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. at 592 (*quoting Reliance Electric Co. v. Emerson Electric Co.*, 404 U.S. 418, 422 (1972)). The Court has also observed:

> In order achieve its goals, Congress chose a relatively arbitrary rule capable of easy administration. The objective standard of Section 16(b) imposes strict liability upon substantially all transactions occurring within the statutory time period, regardless of the intent of the insider or the existence of actual speculation. This approach maximized the ability of the rule to eradicate speculative abuses by reducing difficulties in proof.

*Reliance Electric Co.*, 404 U.S. at 422 (*quoting Bershad v. McDonough*, 428 F.2d 693, 696 (7th Cir. 1970)). As explained by the Commission, a six-month period was chosen because:

> Short swing speculation is deemed to involve incentives and opportunities to profit improperly to a degree not present in connection with the long term investment and changes in investment position. The arbitrary period of six months was selected as roughly marking the distinction between short swing speculation and long term investment.

*Notice of Proposal to Adopt a Rule Exempting from the Operation of Section 16(b) Certain Acquisitions and Dispositions of Securities Pursuant to Mergers or Consolidations*, Exchange Act Release No. 4696, 17 Fed. Reg. 3177, 1952 SEC LEXIS 63 at *3 (April 9, 1952).

This type of remedy was described by its drafters as a "crude rule of thumb." *Hearings on Stock Exchange Practices before the Senate Committee on Banking and Currency*, 73d Cong., 1st Sess. pt. 15, 6557 (1934) (testimony of Thomas Corcoran as spokesman for the drafters of the Exchange Act). It can extract a high price, since it can deprive insiders of profits even in transactions that involve no abuse of inside information. Because of the strict liability nature of Section 16(b) in imposing liability without fault, "Congress itself limited carefully the liability imposed by §16(b)." *Foremost-McKesson, Inc. v. Provident Securities Co.*, 423 U.S. 232, 252 (1976). *See also Gollust v. Mendell*, 501 U.S. 115, 122 (1991); *Reliance Electric Co.*, 404 U.S. at 422-23, 425. "Even an insider may trade freely without incurring the statutory liability if, for example, he spaces his transactions at intervals greater than six months. When Congress has so recognized the need to limit carefully the 'arbitrary and sweeping coverage' of §16(b) . . . courts should not be quick to determine that . . . Congress intended the section to cover a particular transaction." *Foremost-McKesson, Inc.*, 423 U.S. at 252. *Accord Gollust*, 501 U.S. at 122; *See also* H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13 (1934).

Congress afforded protection against the statute's overreaching by vesting in the Commission the authority to exempt from Section 16(b) "any transaction or transactions which the Commission by rules and regulations may exempt as not

comprehended within the purpose of this subsection."6/ In adopting Rule 16b-3(d), as previously noted, the Commission was clear in explaining why the transactions it exempts generally do not lend themselves to the abusive use of inside information with which Section 16(b) is concerned.

This is not to say, however, that issuer-insider transactions exempted by the rule will never in any circumstance be susceptible to abuse of inside information. There could be a situation, for example, where a dominant insider is privy to inside information that he conceals from the board or shareholders in obtaining approval for a transaction. But even assuming such a deception could occur on occasion, that does not preclude the Commission from adopting a general exemption for issuer-insider transactions. The Commission's exemptive authority is not limited to transactions in which there is no possibility of insider trading abuse.

To the contrary, the Supreme Court has stated that "Congress sought 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*.'" *Foremost-McKesson, Inc.*, 423 U.S. at 243 (*quoting Reliance Electric Co.*, 404 U.S. at 422) (emphasis added). In adopting Rule 16b-3(d), the Commission concluded that the exempted transactions

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6/ In adopting Rule 16b-3, the Commission relied, not only upon the authority to adopt exemptive rules provided in Section 16(b) itself, but also on the Commission's general rulemaking authority found in Section 23(a) of the Exchange Act, 15 U.S.C. 78w(a), reprinted in the Addendum (3A). *See* 1996 Adopting Release, Exchange Act Rel. No. 37260, 61 Fed. Reg. at 30391.

did not pose a significant risk of abusive insider trading with less informed investors. To grant an exemption under these circumstances was an entirely appropriate approach. Section 16(b) imposes a relatively arbitrary remedy, which can ensnare innocent insiders who simply bought and sold securities within six months. While those effects on innocent insiders are unavoidable when short-swing trading occurs in contexts where unfair use of information is a significant risk, there is no reason to impose such liability in contexts where generally there is a diminished risk of unfair use of inside information. As the Ninth Circuit stated in its recent decision upholding Rule 16b-3:

> [Plaintiff's] position demands an airtight solution with "no possibility" of abuse Neither §16(b) nor its judicial gloss suggests, as [plaintiff ] does, that the SEC may *only* exempt transactions for which there is zero risk of speculative abuse. Rather, the Supreme Court has indicated that the SEC is free to exempt transactions for which the "*possibility* of abuse" is not "believed to be intolerably great." *Reliance Elec. Co.,* 404 U.S. at 422 (emphasis added). The SEC need not show that the transactions exempted from §16(b) pose absolutely no risk of speculative abuse. *Foremost-McKesson,* 423 U.S. at 244 (finding "unsatisfactory" the argument that the court must reject any reading of a statutory exemption to §16(b) that misses "some possible abuses of inside information."). . . . The relevant question is whether Rule 16b-3(d) exempts transactions for which the risk of speculative abuse is *intolerable* or, more broadly, in the words of the statute, whether the transaction is "not comprehended within the purpose of [§16(b)]."

*Dreiling v. American Express Company*, 458 F.3d 942, 950 (9th Cir. 2006).

Plaintiff mistakenly relies on case law that preceded *Chevron* deference.7/ Plaintiff cites *Perlman v. Timberlake*, 172 F. Supp. 246, 256 (S.D.N.Y. 1959), where the district court found former Rule X-16b-3 invalid in part because the court found it "difficult to see how the opportunity for short swing profits, present when the insider equipped with inside information goes out into the market place and buys, vanishes because armed with the same information, he goes to the corporation and buys . . ." Although not cited by plaintiff, this Court in *Greene v. Dietz*, 247 F.2d 689 (2d Cir. 1957), similarly questioned the validity of former Rule X-16b-3.8/ Neither decision is binding here. *Perlman* is a district court decision, and *Greene* expressed its doubts as to former Rule X-16b-3 in *dictum*. Moreover, plaintiff fails to note that in *Perlitz v. Continental Oil Co.*, 176 F. Supp. 219 (S.D. Tex. 1959), former Rule X-16b-3 was upheld.

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7/ *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

8/ Prior to September 1952, Rule X-16-3 exempted from Section 16(b) shares of stock acquired pursuant to bonus, profit sharing, retirement, thrift or similar plans meeting specific conditions. The rule was broadened in 1952 to exempt acquisitions of non-transferable options and stock acquired under stock options pursuant to a stock option plan meeting similar requirements. Following the decisions in *Greene* and *Perlman* the Commission proposed that the option-exercise exemption be deleted. *See Notice of Proposed Amendments of Rule 16b-3 Under The Securities Exchange Act of 1934*, Exchange Act Release No. 6111, 1959 WL 7146 (Nov. 5, 1959). The proposal was adopted in the following year. *See Adoption of an Amendment of Rule 16b-3 Under the Securities Exchange Act of 1934*, Exchange Act Release No. 6275, 1969 WL 7759 (May 26, 1960).

Furthermore, both *Greene* and *Perlman* appear to misapprehend the purpose of Section 16(b). Their views as to former Rule X-16b-3's validity were based on the incorrect belief that that any exemptive rule promulgated by the Commission that might allow any possibility of insider trading abuse was beyond the Commission's authority to adopt.

## III. TO THE EXTENT THAT AN ENTITY OR OTHER PERSON IS A DIRECTOR BY DEPUTIZATION OF ANOTHER TO SIT ON THE ISSUER'S BOARD, THE DEPUTIZING PERSON MAY TAKE ADVANTAGE OF THE RULE 16b-3(d) EXEMPTION, AND THAT PERSON MAY DO SO REGARDLESS OF WHETHER THE PERSON IS ALSO A TEN PERCENT HOLDER.

The defendants argue that they are entitled to rely on Rule 16b-3(d)'s exemption because Perseus was a Beacon director. While Perseus was not a named member of Beacon's board, defendants argue that Perseus deputized Deutch and Socha to represent its interests, and the interests of its affiliates, on Beacon's board. Thus, the defendants argue Perseus was a director by deputization. Plaintiff's argument in response appears to have two parts. First, plaintiff argues that a director by deputization may not avail itself of the Rule 16b-3(d) exemption. Second, he argues that, in any event, the exemption does not apply to a director by deputization that is also a ten percent holder. Both of these arguments lack merit.

### A. A Person Is a Director for Purposes of Rule 16b-3(d) Where It Has Expressly or Impliedly "Deputized" an Individual To Serve as Its Representative on a Company's Board Of Directors.

The "deputization theory" is a judicially developed doctrine that was adopted by the Supreme Court in *Blau v. Lehman*, 368 U.S. 403 (1962). The doctrine was adopted, not with respect to Section 16(b) exemptions, but rather in determining whether a person is an insider subject to Section 16(b) in the first place. Under the doctrine, "[a] person who has the power, by agreement or otherwise, to name another to be a corporate director is likely to have the same sort of access to inside information by reason of that relationship as any other insider . . ." *Interpretive Release on Rules Applicable to Insider Reporting and Trading*, Exchange Act Release No. 18114, 1981 WL 31301, at *5 (Sept. 24, 1981). In *Blau v. Lehman*, the plaintiff alleged that Thomas, a member of the firm of Lehman Brothers, a partnership, was deputized by Lehman Brothers to represent its interests by serving as a director of Tide Water Associated Oil Company, in whose stock Lehman Brothers traded. In assessing the validity of the deputization theory, the Supreme Court noted that "[t]he language of Section 16 does not purport to impose its extraordinary liability on any 'person,' 'fiduciary' or not, unless he or it is a 'director,' 'officer' or 'beneficial owner of more than 10 per centum of any class of any equity security'" of the issuer. 368 U.S. at 409. Since the Lehman firm was neither a ten percent holder nor an officer of Tide Water, the firm could only be liable under Section 16(b) if it was a director and, since it was

not formally a member of Tide Water's board, it could only be liable as a director through Thomas. *Id.* at 410.

Although Lehman was not "literally designated" as a director, the Court determined that Lehman

> could for purposes of §16 be a 'director' of Tide Water and function through a deputy, since §3(a)(9) of the [Exchange ] Act provides that 'person means . . . partnership'[9/] and §3(a)(7) that 'director' means any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated.' Consequently, Lehman . . . would be a 'director' of Tide Water, if as petitioner's complaint charged Lehman actually functioned as a director through Thomas, who had been deputized by Lehman to perform a director's duties not for himself but for Lehman.

368 U.S. at 409-10 (footnote omitted).

While the Commission has stated that it "does not propose to codify case law relating to deputization," it has recognized that under the deputization theory "a corporation, partnership, trust or other person can be deemed a director for purposes of section 16 where it has expressly or impliedly 'deputized' an individual to serve as its representative on a company's board of directors."*Ownership Reports and Trading by Officers, Directors and Principal Stockholders*, Exchange Act Release 26333, 53 Fed. Reg. 49997, 50000 (Dec. 13, 1988). The Commission has also clarified that the deputization theory is not limited to Section 16(b) but that "a person who designates

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9/ Section 3(a)(9) has since been revised to eliminate "partnership" from its definition of person, but continues to include "company."

another to be a director should be deemed a director for purposes [of the reporting provisions] of section 16(a)." *Id.* at 50001.10/

Although, as noted, the deputization doctrine was originally adopted to determine whether a person was a director within the meaning of the *statute*, the doctrine should similarly be applied in determining whether a person is a director within the meaning of Rule 16b-3(d). The Ninth Circuit in *Dreiling* so held. 458 F.3d at 952-53. The rationale underlying Rule 16b-3(d), as set forth in the 1996 Adopting Release, applies not just to named directors but also to directors by deputization. Like named directors, in transactions exempted by the rule the director by deputization deals with the issuer and not in the market, and thus there generally is no informational disadvantage as there might be in market transactions. The Commission also stated in its 1996 Adopting Release, as previously noted, that "states have created potent deterrents to insider self-dealing and other breaches of fiduciary

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10/ The Commission takes no position on whether a deputization occurred in this case. Whether or not a deputization has occurred is a question of fact. *Blau v. Lehmann*, 368 U.S. at 408-10. *See also Feder v. Martin Marietta Corp.*, 406 F.2d 260, 263-64 (2d Cir. 1969). "In determining whether a person has been deputized for purposes of section 16, the courts have looked at a variety of factors, focusing primarily on the alleged deputy's position of control within the deputizing entity and the deputy's independent qualifications to serve on the board of the issuing corporation." *Ownership Reports and Trading by Officers, Directors and Principal Stockholders*, Exchange Act Release 26333, 53 Fed. Reg. at 50000 (*citing Blau v. Lehmann, supra*; *Feder v. Martin Marietta Corp., supra.*) *See also Dreiling v. American Express*, 458 F.3d at 953-55.

duty." 61 Fed. Reg. at 30377 n.17. There is no question that the deputized director who actually sits on the board owes the company fiduciary duties. Moreover, not only is the person deputized to sit on the board precluded from engaging in self-dealing on his own behalf, he cannot allow the person who deputizes him to benefit at the expense of the company, even if the deputized director who directly owes a fiduciary duty to the company does not personally benefit. *See, e.g., Mosser v. Darrow*, 341 U.S. 267, 271-72 (1951). Likewise, a person who knowingly joins with the fiduciary in such a self-dealing transaction is liable to the beneficiary. *See, e.g., Jackson v. Smith*, 254 U.S. 586, 588-89 (1921). *See generally, Dirks v. SEC*, 463 U.S. 646, 660 (1983).

Also, as previously discussed, the rule requires that each specific transaction be approved to assure that the board focuses on each particular grant or award, and is accountable for authorizing each one. And board approval ensures that the timing of an acquisition is within the control of the board, and not any one insider, such that the transaction is likely to be undertaken for a legitimate corporate purpose. *See Gryl*, 298 F.3d at 145-46. In addition, when the director is a director by deputization, the board approving the transaction must be aware of the deputization. *Dreiling*, 458 F.3d at 954-55. These gatekeeping provisions afford protection in the case of directors by deputization, just as they do in the case of named directors.

### B. The Exemption Provided by Rule 16b-3(d) Is Available to a Director by Deputization that Is also a Ten Percent Holder.

Plaintiff argues that the Rule 16b-3(d) exemption is inapplicable to a director by deputization that is also a ten percent holder. The Commission's adopting release, however, specifically addresses the rule's application to ten percent holders who are directors, and it does so without drawing a distinction between named directors and directors by deputization. The release, in pertinent part, states:

> Rule 16b-3 does not provide an exemption for persons who are subject to section 16 solely because they beneficially own greater than ten percent of a class of an issuer's equity securities. Officers and directors owe certain fiduciary duties to a corporation. . . . Such duties, which act as an independent constraint on self-dealing, may not extend to ten percent holders. The lack of other constraints argues against making new Rule 16b-3 available to ten percent holders. *However, new Rule 16b-3 is available to such a person who is also subject to section 16 by virtue of being an officer or director with respect to transactions with the issuer.*

1996 Adopting Release, 61 Fed. Reg. at 30378 n.42 (emphasis added). The Commission's reasoning as to why Rule 16b-3(d) should apply to ten percent holders who are also officers or directors is apparent from the Adopting Release: as officers or directors, they are subject to the same fiduciary constraints placed on all officers and directors, and the rule's gatekeeping procedures outlined above are no less effective simply because an officer or director also happens to be a ten percent holder. Nor does the fact that a person is both a ten percent holder and a director *by deputization* undermine the basis for the exemption. The same policies underlying Rule 16b-3(d) that support application of the rule to a ten percent holder who is a *named* director apply to a ten percent holder who is a director by deputization.

Further, applying Rule 16b-3(d) to deputized directors who are also ten percent holders does not open the door to making this exemption available to all ten percent holders, as the plaintiff argues, because a ten percent holder might not be able to designate a director and because courts have established meaningful criteria for determining whether a person is a director by deputization. *See supra,* footnote 10.

## IV. THE COMMISSION'S INTERPRETATIONS OF SECTION 16(b) ARE ENTITLED TO *CHEVRON* DEFERENCE, AND ITS INTERPRETATIONS OF RULE 16b-3(d) ARE ENTITLED TO *SEMINOLE ROCK* DEFERENCE.

The Commission's determination that Rule 16b-3(d) transactions between the issuer and its officers or directors are not comprehended within the purpose of Section 16(b), and may thus be exempted, is entitled to *Chevron* deference, while its interpretations of Rule 16b-3(d), as applied to directors by deputization who are also ten percent holders, are entitled to *Seminole Rock* deference.

### A. The Commission's Interpretation of Section 16(b)'s Exemptive Authority to Include Transactions Between the Issuer and Its Officers and Directors is Not Comprehended Within the Purpose of Section 16(b) Is Entitled to *Chevron* Deference.

The Commission's interpretation of its rulemaking authority granted by Section 16(b) is entitled to controlling deference, so long as that interpretation is reasonable. As the Supreme Court recently summarized:

> In *Chevron* [*U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984)], this Court held that ambiguities in statutes within an agency's jurisdiction to administer are delegations of authority to the agency to fill the

> statutory gap in reasonable fashion. Filling these gaps, the Court explained, involves difficult policy choices that agencies are better equipped to make than courts. 467 U.S. at 865-866 . . . If a statute is ambiguous, and if the implementing agency's construction is reasonable, *Chevron* requires a federal court to accept the agency's construction of the statute, even if the agency's reading differs from what the court believes is the best statutory interpretation. *Id.* at 843-844, and n. 11 . . .

*National Cable & Telecommunications Assoc., v. Brand X Internet Services,* __ U.S. __, 125 S.Ct. 2688, 2699 (2005). This Court, in a recent decision upholding another exemptive rule promulgated by the Commission under Section 16(b), noted that "Congress explicitly delegated to the Commission the policymaking authority to exempt certain transactions 'as not comprehended within the purpose of this subsection,' and took the further step of admonishing the courts that the statute 'shall not be construed' otherwise." *Bruh v. Bessemer Venture Partners III L.P.*, 464 F.3d 202, 208 (2d. Cir. 2006) (*quoting* Section 16(b)).

The Commission rationale for exempting transactions between an issuer and its officers and directors reflects a reasonable interpretation of the statute, and therefore this interpretation, which was the product of notice and comment rulemaking,11/is entitled to *Chevron* deference. *See Bruh v. Bessemer Venture Partners III L.P.*, 464 F.3d

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11/ *See* 1995 Proposing Release, 60 Fed. Reg. 53833; 1996 Adopting Release, 61 Fed. Reg. at 30377, *Ownership Reports and Trading by Officers, Directors and Principal Stockholders*, Exchange Act Release No. 49895, 69 Fed. Reg. 35982 (Jun. 25, 2004)(the release proposing the 2005 amendments), and 2005 Release, 70 Fed. Reg. at 46080.

202, 214 (2d Cir.) (granting *Chevron* deference to the Commission's interpretations of Section 16(b) in upholding exemptive Rule 16b-7 because the interpretations presented in the Commission's *amicus* brief in that case had also been adopted by rulemaking.)12/

### B. The Commission's Interpretation of Rule 16b-3(d) - - A Rule Promulgated by The Commission - - with Regard to Its Application to Directors by Deputization And Ten Percent Holders Is Entitled to *Seminole Rock* Deference.

The Commission's interpretation of Rule 16b-3(d) as applied to directors by deputization and ten percent holders is entitled to *Seminole Rock* deference, another type of controlling deference, because the Commission is interpreting one of its own rules. "' Because applying an agency's regulations to complex or changing circumstances calls upon the agency's unique expertise and policymaking prerogatives, we presume that the power authoritatively to interpret its own regulations is a component of the agency's delegated lawmaking powers.'" *Bruh v. Bessemer*, 464 F.3d at 208 (*quoting Martin v. Occupational Safety & Health Review Comm'n*, 499 U.S. 144, 151 (1991)). Thus, the Commission's interpretation of Rule 16b-3(d) "becomes of controlling weight unless it is plainly erroneous or inconsistent with the regulation."

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12/ In *At Home Corporation v. Cox Communications*, 446 F.3d 403, 409 n.5 (2d Cir. 2006) this Court reserved the question of whether *Chevron* deference is due an interpretation of Section 16(b) adopted for the first time in an *amicus* brief. Likewise in this case, that issue need not be resolved.

*Bowles v. Seminole Rock & Sand Company*, 325 U.S. 410, 413-14 (1945). *See also Press v. Quick & Reilly, Inc.*, 218 F.3d 121, 128 (2d Cir. 2000) ("We are bound by the SEC's interpretations of its regulations in its *amicus* brief, unless they are 'plainly erroneous or inconsistent with the regulation[s].'"). The Commission's interpretation of Rule 16b-3(d) as covering directors by deputization who are also ten percent holders is consistent with the language and underlying purposes of the rule and is therefore reasonable.

**CONCLUSION**

For the foregoing reasons, the Commission urges this Court to hold (1) that the Commission acted within its authority in adopting Rule 16b-3(d) and (2)that, to the extent a person is a director by deputization of another to sit on the issuer's board, the deputizing person may take advantage of the rule's exemption and may do so regardless of whether the person is also a ten percent holder.

Respectfully submitted,

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January 2007

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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No. 06-3771-CV

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ANDREW E. ROTH derivatively on behalf of
BEACON POWER CORPORATION,

*Plaintiff - Appellant,*

v.

PERSEUS, L.L.C., PERSEUS CAPITAL, L.L.C., PERSEUS 2000 EXPANSION, L.L.C., PERSEUS INVESTMENT GROUP, INC., FRANK H. PEARL, JOHN DOES NOS. 1-20 and BEACON POWER CORPORATION,

*Defendants- Appellees.*

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CERTIFICATE OF SERVICE

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I, Allan A. Capute, am a member of the bars of Maryland and the District of Columbia, and I hereby certify that on 16th day of January, 2007, I caused to be served two copies of the BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, *AMICUS CURIAE*, IN SUPPORT OF THE POSITION OF THE APPELLEES on counsel for the parties of record at the addresses below, by Federal Express.

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*Defendants- Appellees.*

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CERTIFICATE OF COMPLIANCE
WITH FED. R. APP. P. 32(a)(7)(C)

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I hereby certify that, pursuant to Federal Rules of Appellate Procedure 29(d) and 32(a)(7)(C), the attached BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, *AMICUS CURIAE*, IN SUPPORT OF THE POSITION OF THE APPELLEES is proportionally spaced, has a typeface of 14 points, and contains approximately 7860 words. Because the brief exceeds the word limit of the Rule 32(a)(7)(C), the Commission has filed with its brief the MOTION OF THE SECURITIES AND EXCHANGE COMMISSION TO EXCEED THE WORD LIMITATION.

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No. 06-3771-CV

ANDREW E. ROTH derivatively on behalf of
BEACON POWER CORPORATION,

*Plaintiff - Appellant,*

v.

PERSEUS, L.L.C., PERSEUS CAPITAL, L.L.C., PERSEUS 2000
EXPANSION, L.L.C., PERSEUS INVESTMENT GROUP,
INC., FRANK H. PEARL, JOHN DOES NOS. 1-20 and
BEACON POWER CORPORATION,

*Defendants- Appellees.*

CERTIFICATE OF COMPLIANCE WITH LOCAL RULE 32(a)(1):
BRIEFS IN DIGITAL FORMAT

I certify that THE BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, *AMICUS CURIAE*, IN SUPPORT OF THE POSITION OF THE APPELLEES, as submitted in digital format, has been scanned for viruses as required by Local Rule 32(a)(1) and that no viruses have been detected using McAfee Enterprise VirusScan version 8.0i.

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Securities and Exchange Commission
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# STATUTORY ADDENDUM

Section 16(b) of the Securities Exchange Act of 1934,
15 U.S.C. 78p(b)

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 (other than an exempted security) or a security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) involving any such equity security within any period of less than six months, unless such security or security-based swap agreement was acquired in good faith in connection with a debt previously contracted, 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 or security-based swap agreement purchased or of not repurchasing the security or security-based swap agreement sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security or security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

Rule 16b-3(d) of the Securities Exchange Act of 1934,
17 C.F.R. 240.16b-3(d)

(d) Grants, awards and other acquisitions from the issuer. Any transaction involving a grant, award or other acquisition from the issuer (other than a Discretionary Transaction) shall be exempt if:

(1) The transaction is approved by the board of directors of the issuer, or a committee of the board of directors that is composed solely of two or more Non-Employee Directors;
(2) The transaction is approved or ratified, in compliance with section 14 of the Act, by either: the affirmative votes of the holders of a majority of the securities of the issuer present, or represented, and entitled to vote at a meeting duly held in accordance with the applicable laws of the state or other jurisdiction in which the issuer is incorporated; or the written consent of the holders of a majority of the securities of the issuer entitled to vote; provided that such ratification occurs no later than the date of the next annual meeting of shareholders; or
(3) The issuer equity securities so acquired are held by the officer or director for a period of six months following the date of such acquisition, provided that this condition shall be satisfied with respect to a derivative security if at least six months elapse from the date of acquisition of the derivative security to the date of disposition of the derivative security (other than upon exercise or conversion) or its underlying equity security.

Notes to § 240.16b-3

Note (1): The exercise or conversion of a derivative security that does not satisfy the conditions of this section is eligible for exemption from section 16(b) of the Act to the extent that the conditions of § 240.16b-6(b) are satisfied.

Note (2): Section 16(a) reporting requirements applicable to transactions exempt pursuant to this section are set forth in § 240.16a-3(f) and (g) and § 240.16a-4.

Note (3): The approval conditions of paragraphs (d)(1), (d)(2) and (e) of this section require the approval of each specific transaction, and are not satisfied by approval of a plan in its entirety except for the approval of a plan pursuant to which the terms and conditions of each transaction are fixed in advance, such as a formula plan. Where the terms of a subsequent transaction (such as the exercise price of an option, or the provision of an exercise or tax withholding right) are provided for in a transaction as initially approved pursuant to paragraphs (d)(1), (d)(2) or (e), such subsequent transaction shall not require further specific approval.