14-3800-cv

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

ROBERT LOWINGER,

Plaintiff-Appellant,

THOMAS E. NELSON, individually and behalf of all others similarly situated, ROCK SOUTHWARD, Derivatively on Behalf of Himself & All Others Similarly Situated,

(*For Continuation of Caption See Reverse Side of Cover*)

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

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, *AMICUS CURIAE*

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(*For Continuation of Caption See Next Page of Cover*)

and on behalf of all others similarly situated, GOLDRICH COUSINS P.C. 401(k) PROFIT SHARING PLAN &TRUST, IRVING S. BRAUN, Individually, EDWARD CHILDS, Derivately on Behalf of Himself and All Others Similarly Situated, KATHY REICHENBAUM, Individually and on behalf of all others similarly situated, JUN YAN, on behalf of herself and all others similarly situated, ELBITA ALFONSO, VICKY JONES, PHYLLIS PETERSON, JERRY RAYBORN, on behalf of themselves and all others similarly situated, EDWARD VERNOFF, JUSTIN F. LAZARD, on behalf of himself and all others similarly situated, SYLVIA GREGORCYZK, on behalf of herself and all others similarly situated, PETER BRINCKERHOFF, GARRETT GARRISON, DAVID GOLDBER, individually and on behalf of all others similarly situated, KEVIN HYMS, individually and on behalf of all others similarly situated, RICHARD P. EANNARINO, Individually and on behalf of all others similarly situated, PETER MAMULA, Individually and on behalf of all others similarly situated, KHODAYAR AMIN, on behalf of himself and all others similarly situated, ELLIOT LEITNER, individually and on behalf of all others similarly situated, BARBARA STEINMAN, on behalf of herself and all others similarly situated, HOWARD SAVITT, on behalf of himself and all others similarly situated, CHAD RODERICK, EUGENE STRICKER, individually and on behalf of all others similarly situated, STEVE SEXTON, Individually and on behalf of all others similarly situated, KEITH WISE, Individually and on behalf of all others similarly situated, JONATHAN R. SIMON, JAMES CHANG, individually and on behalf of all others similarly situated, SAMEER ANSARI, individually and on behalf of all others similarly situated, DARRYL LAZAR, individually and on behalf of all others similarly situated, MICHAEL LIEBER, individually and on behalf of other members of the general public similarly situated, THOMA J. AHRENDTSEN, AARON M. LEVINE, Individually, and on behalf of all others similarly situated, KAREN CUKER, individually and on behalf of all others similarly situated, BRIAN GRALNICK, individually and on behalf of all others similarly situated, JENNIFER STOKES, Individually and On Behalf of All Others Similarly Situated, VERNON R. DEMOIS, Jr., Individually and On Behalf of All Others Similarly Situated, HAL HUBUSCHMAN, Derivately on Behalf of Facebook, Inc.,, EDWARD SHIERRY, Individually and On Behalf of All Others Similarly

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Situated, JANIS FLEMING, WILLIAM COLE, Derivatively on Behalf of Facebook, Inc., STEVE GRIFFIS, HOLLY MCCONNAUGHEY, Derivatively on Behalf of Facebook Inc., GAYE JONES, Derivatively on Behalf of Facebook Inc., LIDIA LEVY, on behalf of herself and all others similarly situated,

Plaintiffs,

v.

MORGAN STANLEY & CO. LLC, GOLDMAN SACHS & CO., FACEBOOK, INC., a Delaware corporation, MORGAN STANLEY & CO. LLC,

Defendants-Appellees,

BARCLAYS CAPITAL INC., MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED, ERSKINE B. BOWLES, JAMES W. BREYER, DAVID SPILLANE, DAVID A. EBERSMAN, ALLEN & COMPANY LLC, BMO CAPITAL MARKETS CORP., BLAYLOCK ROBERT VAN LLC, DONALD E. GRAHAM, C.L. KING & ASSOCIATES, INC., REED HASTINGS, CABRERA CAPITAL MARKETS, LLC, CASTLEOAK SECURITIES, L.P., PETER A. THIEL, CITIGROUP GLOBAL MARKET, INC., MARK E. ZUCKERBERG, COWEN AND COMPANY, LLC, CREDIT SUISSE SECURITES (USA) LLC, SHERYL K. SANDBERG, DEUTSCHE BANK SECURITIES INC., CIPORA HERMAN, E TRADE SECURITIES LLC, ITAU BBA USA SECURITIES, INC., LAZARD CAPITAL MARKETS LLC, LEBENTHAL & CO., LLC, LOOP CAPITAL MARKETS LLC, M.R. BEAL & COMPANY, MACQUARIE CAPITAL (USA) INC., MURIEL SIEBERT & CO., INC., OPPENHEIMER & CO., INCORPORATED, PACIFIC CREST SECURITIES LLC, PIPER JAFFRAY & CO., RBC CAPITAL MARKETS, LLC, RAYMOND JAMES & ASSOCIATES, INC., SAMUEL A. RAMIREZ & COMPANY, INC., STIFEL, NICOLAUS & COMPANY, INC., THE WILLIAMS CAPITAL GROUP, L.P., WELLS FARGO SECURITIES, LLC, WILLIAM BLAIR & COMPANY, L.L.C., GOLDMAN SACHS & CO., NASDAQOMX GROUP, INCORPORATED, LAWRENCE CORNECK, Individually and on behalf of all others similarly situated, JILL D. SIMON, CITIGROUP GLOBAL MARKETS INC., MERRILL

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LYNCH, PIERCE FENNER & SMITH INCORPORATED, ALLEN & FACEBOOK (sic) LLC, WILLIAM BLAIR & FACEBOOK (sic) LLC, M.R. BEAL & FACEBOOK (sic), COWEN AND FACEBOOK (sic) LLC, STIFEL NICHOLAS & FACEBOOK (sic) INCORPORATED, SAMUEL A. RAMIREZ & FACEBOOK (sic) INC, KEVIN HICKS, individually and on behalf of all others similarly situated, LINH LUU, individually and on behalf of all others similarly situated, HARVEY LAPIN, Individually and On Behalf of All Others Similarly Situated, KING & ASSOCIATES, INC., DAVID E. (sic) EBERSMAN, NICK E. TRAN, THE NASDAQ STOCK MARKET L.L.C., a Foreign Limited Liability Company, NASDAQ STOCK MARKET, INCORPORATED, NASDAQ OMX GROUP, INCORPORATED, UMA M. SWAMINATHAN, ROBERT GREIFELD, ANNA M. EWING, J.P. MORGAN SECURITIES LLC, MORGAN STANLEY & CO. LLC, MARC L. ANDREESSEN, FACEBOOK, INC., a Delaware corporation,

Defendants.

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FOR THE SECOND CIRCUIT

ROBERT LOWINGER,

Plaintiff-Appellant,

v.

MORGAN STANLEY & CO. LLC, GOLDMAN SACHS & CO., FACEBOOK, INC., a Delaware Corporation, and J.P. MORGAN SECURITIES LLC,

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

INTEREST OF THE COMMISSION

The Securities and Exchange Commission submits this brief as *amicus curiae* in response to the invitation of the Court. The Commission has a strong interest in ensuring that the rule determining beneficial ownership under Section 13(d) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. 78m(d), and the rules governing short-swing profits under Section 16(b) of that Act, 15 U.S.C. 78p(b), are properly interpreted and that their objectives are carried out. The parties assert conflicting interpretations of those provisions, and the Commission submits this brief setting forth its views.

STATEMENT OF THE CASE

Robert Lowinger appeals the district court's dismissal of his complaint in this matter arising out of the events surrounding Facebook, Inc.'s initial public offering ("IPO"). Lowinger seeks to hold the IPO's lead underwriters—Morgan Stanley and Company LLC, J.P. Morgan Securities LLC, and Goldman Sachs and Company (collectively, "the Underwriters")—liable under Section 16(b) of the Exchange Act for short-swing profits they allegedly received in connection with their sales and purchases of shares in the offering. Section 16(b) provides for the recovery by the issuer, in an action brought by the issuer or by a security holder of the issuer, of profits realized by a statutory insider (an officer, director, or more than ten percent beneficial owner) from the sale and purchase, or the purchase and sale, of the securities of the issuer when both transactions take place within six months.

The complaint alleges that the Underwriters were "beneficial owners" of shares held by certain Facebook shareholders who were selling shares in the IPO (the "Selling Shareholders") because those shareholders and the Underwriters were part of a "group" that was created by lock-up agreements entered into by the Selling Shareholders and the Underwriters. The lock-up agreements prevented the Selling Shareholders from selling additional shares for a period of time following the IPO. Because the Selling Shareholders were beneficial owners of more than ten percent of Facebook's stock, the complaint asserts that the members of the alleged group, including the Underwriters, were statutory insiders, and that the Underwriters were, thus, subject to Section 16(b).

In order to prevail under this theory, Lowinger must establish that the lock-up agreements, which are a standard feature of IPOs, were, on their own, sufficient to create a group that would make the Underwriters beneficial owners of the shares that are subject to the lock-up and, as a result, subject to Section 16(b). And even if such standard lock-up agreements, on their own, could have that effect, Lowinger would also have to establish that the Underwriters were ineligible for certain exemptions from Section 16(b) for trades made by underwriters in connection with a *bona fide* underwriting.

The district court addressed only the first issue and dismissed the complaint on the grounds that the lock-up agreements did not make the Underwriters beneficial owners of the shares held by the Selling Shareholders. Lowinger appealed and, following briefing and oral argument, this Court invited the Commission to address two questions touching on both issues:

> (1) "[w]hether, in the context of an IPO, a 'lock-up' agreement between an underwriter and shareholders to restrict the sale of an issuer's stock immediately following the initial public offering constitutes an agreement 'to act together for the purpose of acquiring, holding, voting or disposing of equity securities,' [Exchange Act Rule 13d-5(b)(1),] 17 C.F.R. § 240.13d-5(b)(1), such that the parties to the agreement may" be treated as members of a group for purposes of determining beneficial ownership of the securities under Exchange Act Sections 13(d) and 16(b); and

> (2) "[w]hether an underwriter who, in connection with an initial public offering, (a) obtains but does not disclose material non-public information about an issuer and (b) profits based on open-market trades in the stock of the issuer before and after that information becomes public, has not 'acquire[d] securities through his participation in good faith in a firm commitment underwriting,' [Exchange Act Rule 13d-3(d)(4),] 17 C.F.R.§ 240.13d-3(d)(4), or has not 'participat[ed] in good faith' in the business of distributing securities, [Exchange Act Rule 16a-7, 17 C.F.R.] § 240.16a-7[.]"

As discussed below, the Commission believes that:

> (1) although the creation of a "group" for purposes of Sections 13(d) and 16(b) depends on the specific facts and circumstances of any given case, a typical lock-up agreement executed between shareholders and underwriters as part of an underwritten public offering, standing alone, would not be sufficient to establish such a group; and
>
> (2) an underwriter is entitled to rely on the exemptions provided by Exchange Act Rules 13d-3(d)(4) and 16a-7, even though the underwriter has obtained material non-public information, so long as the underwriter's purchases and sales are made in connection with the underwriter's participation in a *bona fide* underwritten public offering.

A. Statutory and Regulatory Scheme

"Section 16 of the Exchange Act was designed both to provide the public with information on securities transactions and holdings of corporate officers, directors, and principal shareholders, and to deter those individuals from profiting on short-term trading in the securities of their corporations while in possession of material, non-public information." Ownership Reports & Trading by Officers, Directors, and Principal Stockholders, Exchange Act Rel. No. 34-26333, 53 Fed. Reg. 49997, 49998 (Dec. 13, 1988) ("Proposing Release").

Section 16(a) requires officers, directors, and "beneficial owner[s] of more than 10 percent of any class of" registered securities to file disclosure statements with the Commission. 15 U.S.C. 78p(a)(1).

Section 16(b) provides for the recovery by the issuer, in an action brought by the issuer or on behalf of the issuer by a security holder, of profits realized by those same individuals from the sale and purchase, or the purchase and sale, of the securities of the issuer when both the purchase and sale, or the sale and purchase, take place within a period of less than six months.[1] Congress intended that section to "prevent[] the unfair use of information which may have been obtained by [an insider] by reason of his relationship to the issuer." 15 U.S.C. 78p(b). And it classifies "directors, officers and beneficial owners as those presumed to have access to inside information." *Foremost-McKesson, Inc. v. Provident Secs. Co.*, 423 U.S. 232, 243 (1976); *accord Morales v. Quintel Entm't, Inc.*, 249 F.3d 115, 121 (2d Cir. 2001) (Section 16(b) reaches those "presumed to have access to confidential corporate information not generally available to other participants in the public market"); Ownership Reports and Trading by Officers, Directors and

[1] Section 16(b) does not "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 . . . involved."

Principal Security Holders, Exchange Act Rel. No. 34-28869, 56 Fed. Reg. 7242, 7244 (Feb. 21, 1991) ("Adopting Release") ("Section 16, as applied to ten percent holders, is intended to reach those persons who can be presumed to have access to inside information because they can influence or control the issuer as a result of their equity ownership."); *see also* S. Rep. No. 73-1455, at 55 (1934) ("beneficial owners" language prevents "the unscrupulous employment of inside information by large stockholders who, while not directors and officers, exercised sufficient control over the destinies of their companies to enable them to acquire and profit by information not available to others").

To prevent insiders from abusing their position, Section 16(b) "imposes a form of strict liability . . . rendering them liable to suits requiring them to disgorge their profits even if they did not trade on inside information or intend to profit on the basis of such information." *Gollust v. Mendell*, 501 U.S. 115, 122 (1991); *accord Gibbons v. Malone*, 703 F.3d 595, 599 (2d Cir. 2013) (Section 16(b) "operates mechanically, with no required showing of intent to profit" but "offers merely the prophylactic remedy of disgorgement." (internal quotation marks omitted)). In fact, as the Supreme Court has observed, "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." *Reliance Electric Co. v. Emerson Electric Co.*, 404 U.S.

418, 422 (1972); *see also* Thomas Lee Hazen, 4 *Treatise on the Law of Securities Regulation*, §13.2 ("The legislative history reveals congressional recognition of such a great potential for abuse of inside information so as to warrant the imposition of strict liability.").

Although beneficial owners of more than ten percent of an issuer's stock are subject to Section 16(b), Congress did not define beneficial owner. *See Levy v. Southbrook Int'l Invs., Ltd.*, 263 F.3d 10, 14 (2d Cir. 2001). Instead, Congress left that task to the Commission, which adopted Exchange Act Rule 16a-1, 17 C.F.R. 240.16a-1. Under that provision, the term means "any person who is deemed a beneficial owner pursuant to section 13(d) of the [Exchange] Act and the rules thereunder." 17 C.F.R. 240.16a-1(a); *see also* Adopting Release, 56 Fed. Reg. at 7244.

Section 13(d) requires any person acquiring beneficial ownership of five percent or more of a corporation's common stock to disclose certain information. *See* 15 U.S.C. 78m(d). Exchange Act Rule 13d-3(a) thereunder describes a "beneficial owner" as "any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares: (1) Voting power . . . ; and/or (2) Investment power which includes the power to dispose, or to direct the disposition of, such security." 17 C.F.R. 240.13d-3(a). Further, under Section 13(d)(3), "[w]hen two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer," that group is deemed a single person for purposes of Section 13(d). 15 U.S.C. 78m(d)(3); *see also* Hazen, 4 *Treatise on the Law of Securities Regulation*, §13.1 ("Under section 13(d), a group of persons acting together will count as one person for the purpose of computing the ownership threshold."). Thus, "[w]hen two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer, the group formed thereby shall be deemed to have acquired beneficial ownership, for purposes of Sections 13(d) . . . of all equity securities of that issuer beneficially owned by any such persons." Exchange Act Rule 13d-5(b)(1), 17 C.F.R. 240.13d-5(b)(1). For purposes of Section 16, the group itself would not be a separate person, but in determining status as a ten percent holder, the securities beneficially owned by the group must be included in the calculation by each individual member of the group. *See* Adopting Release, 56 Fed. Reg. at 7245 n. 54.

Commission rules implementing Sections 13 and 16 also contain exceptions to the beneficial ownership requirements for good-faith underwriting. Rule 13d-3(d)(4) provides that "[a] person engaged in business as an underwriter of securities who acquires securities through his participation in good faith in a firm commitment underwriting . . . shall not be deemed to be the beneficial owner of such securities until" forty days after it is acquired. 17 C.F.R. 240.13d-3(d)(4). And under Rule 16a-7 (together with Rule 16a-10), purchases and sales "made in connection with the distribution of a substantial block of securities" are exempt from Section 16(b) liability when "[t]he person effecting the transaction is engaged in the business of distributing securities and is participating in good faith, in the ordinary course of such business" and the security involved is "purchased in good faith . . . for the purpose of stabilizing the market price of securities . . . being distributed or to cover an over-allotment or other short position created in connection with such distribution." 17 C.F.R. 240.16a-7; *see* 17 C.F.R. 240.16a-10 (making securities transactions exempted from Section 16(a) reporting by Rule 16a-7 likewise exempt from Section 16(b)'s short-swing profit rule).

Other regulations also "permit underwriters and syndicate members to conduct [certain] stabilizing transactions" designed to "prevent[ ] or retard[] a decline in the market price of a security to facilitate an offering." Anti-Manipulation Rules Concerning Securities Offerings, Rel. Nos. 33-7375 & 34-38067, 62 Fed. Reg. 520, 535 (Jan. 3, 1997); *accord* Amendments to Regulation M: Anti-Manipulation Rules Concerning Securities Offerings, Rel. Nos. 33-8511 & 34-50831, 69 Fed. Reg. 75774, 75779 n.58 (Dec. 17, 2004) ("Regulation M Release"). The Commission has also explained that underwriting agreements typically "allow[] the managing underwriter to 'oversell' the offering, *i.e.*, establish a short position beyond the number of shares to which the underwriting commitment relates." *Id.* at 75780. To cover the syndicate short positions, underwriters may exercise what is commonly called an overallotment or "Green Shoe" option that allows them to purchase additional shares from the issuer at the public offering price, or they may cover "by purchasing shares in the market once secondary trading begins." *Id.* Such activities "facilitate public offerings and do not lend themselves to the speculative abuse Section 16 was designed to prevent." Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Exchange Act Release No. 34-37260, 61 Fed. Reg. 30376, 30383 (June 14, 1996) ("Amending Release"); *see also* Regulation M Release, 69 Fed. Reg. 75774, 75779-80.

B. Facts[2]

1. To facilitate Facebook's IPO, the Selling Shareholders and the Underwriters executed typical lock-up agreements.

Facebook's May 18, 2012 IPO was underwritten by a syndicate of "more than two dozen banks and investment firms" led by the Underwriters. Complaint, ¶ 14 (A-18).[3] Before the IPO, the Selling Shareholders—who in the aggregate owned more than 10 percent of Facebook's common stock—executed so-called

[2] Because this appeal concerns a motion to dismiss, the facts alleged in the complaint are assumed to be true.

[3] "A-" refers to the Joint Appendix filed by the parties along with the relevant page numbers.

lock-up agreements with the Underwriters. *Id.* at ¶¶ 16-17 (A-19). Such agreements are common because they prevent pre-IPO shares from flooding and destabilizing the market for newly issued shares. *See* Initial Public Offerings: Lockup Agreements, Fast Answers, U.S. Securities & Exchange Commission, available at http://www.sec.gov/answers/lockup.htm (June 26, 2015).

The lock-up agreements here were likewise intended "to control the supply of Facebook shares available to the market, which, in turn was expected to provide support for the trading price of Facebook common stock." Complaint, ¶ 16 (A-19). Specifically, the agreements prohibited the Selling Shareholders from "sell[ing] or otherwise dispos[ing] of any Common Stock or securities convertible into or exchangeable into Common Stock" for a specified period without co-lead underwriter Morgan Stanley's consent. *Id.* at ¶¶ 15, 17 (A-19). The agreements were disclosed in Facebook's Prospectus and Registration Statement. *See* Facebook Prospectus, Form 424 B4, pg. 163 (A-46); Amend. No. 5 to Form S-1 Registration Statement, pg. A-1 to B-5) (May 3, 2012) (A-73-82); *see also In re Facebook, Inc., IPO Secs. & Derivative Litig.*, 986 F. Supp.2d 544, 548-49 (S.D.N.Y. 2014).

2. The Underwriters advised investors that they might execute transactions designed to facilitate Facebook's IPO.

Facebook's Prospectus and Registration Statement additionally advised that, "[i]n order to facilitate [the IPO], the underwriters may engage in transactions that stabilize, maintain or otherwise affect the price of the Class A common stock." Amend. No. 8 to Form S-1, pg. 166 (May 16, 2012) (A-43). As noted above, such underwriter transactions are permissible. *See supra* at pp. 9-10. Also consistent with market practices, Facebook advised investors that "the underwriters may sell more shares than they are obligated to purchase under the underwriting agreement, creating a short position" and cover those positions by exercising a Green Shoe option or "by purchasing shares in the open market." Amend. No. 8 to Form S-1, pg. 166 (A-43). The offering documents also disclosed that the Underwriters' transactions might "raise or maintain the market price of the . . . stock above independent market levels or prevent or retard a decline in [the] market price." Amend. No. 8 to Form S-1, pg. 166 (A-43).

3. Before the IPO, the Underwriters received nonpublic information concerning Facebook's revenue projections.

In connection with the IPO, the Underwriters had access to nonpublic information concerning Facebook. *See* Complaint, ¶¶ 19, 22-32 (A-20-23). In March and April 2012, Facebook shared with the Underwriters its "internal revenue forecasts of $1.1 to 1.2 billion for 2Q12 and $5 billion for fiscal year 2012." *Id.* at ¶ 20 (A-20). That information was "incorporated into materials used by the Underwriters to market the Facebook IPO to investors in a road show commenced on May 7, 2012." *Id.* at ¶¶ 20-21 (A-20).

That same day, due to increased mobile usage and "'certain product decisions' made by Facebook," the company "revised its revenue estimates downward" to the "low end of the $1.1 to $1.2 billion range" and projected that the 2012 estimate would "be 3% to 3.5% lower than the previously forecasted $5 billion." Complaint, ¶ 22 (A-20-21). Facebook immediately shared those concerns with Morgan Stanley. *Id.* at ¶¶ 22-24. (A-20-21).

On May 9, Facebook amended its Registration Statement, advising potential investors as follows:

> Based upon our experience in the second quarter of 2012 to date, the trend we saw in the first quarter of [daily active users] increasing more rapidly than the increase in number of ads delivered has continued. We believe this trend is driven in part by increasing usage of Facebook on mobile devices where we have only recently begun showing an immaterial number of sponsored stories in News Feed, and in part due to certain pages having fewer ads per page as a result of product decisions.

Complaint, ¶ 25 (A-20-21). As the district court explained, "[s]imilar to the consolidated complaint filed in the securities class action" before that court, the complaint here "alleges this disclosure was false and misleading because it failed to sufficiently disclose 'that these factors had already materially impaired Facebook's revenue.'" *In re Facebook, Inc., IPO Secs. & Derivative Litig.*, 986 F. Supp.2d at 547 (quoting Complaint, ¶ 26 (A-22)).

"[I]mmediately after" filing that amendment, Facebook called "select investment bankers and their securities analysts, including the Underwriters" and advised them that Facebook believed it was "going to come in the lower end of [the] $1.1 to $1.2 [billion] range for Q2 based upon the trends we described in the disclosure." Complaint, ¶¶ 27, 30 (internal quotation marks and emphasis omitted) (A-22-23). Thereafter, the Underwriters "revised their Facebook 2Q12 estimates," and according to a report cited in the complaint, shared that information with "only a few 'major clients[.]'" *Id.* at ¶¶ 31, 38 (A-23, 25). Others—including retail investors—did not learn those facts until the market closed on the day of the IPO. *Id.* at ¶¶ 33-34, 36 (A-24-25).

4. The Underwriters oversold Facebook's IPO.

Due to significant retail investor demand, between "May 17 and 18, 2012, the underwriters sold 484,418,657 shares of Common Stock to the public at prices ranging from $38 to $42.05 per share, including 63 million shares in short sales pursuant to their over-allotment or [Green Shoe] option." Complaint, ¶¶ 33-34 (A-24).

After trading closed on May 18, "[r]eports of the decline in Facebook's expected revenues began to emerge" and investors became aware that the Underwriters "had cut their revenue estimates in advance of the IPO." Complaint, ¶ 36 (A-25). On May 21, the first trading day thereafter, Facebook's stock price declined to "$34.03 on extremely high volume reflecting a decline of more than 10% from the" IPO price. *Id.* at ¶ 37 (A-25). The next day, the decline continued and Facebook's stock "closed at $31 per share, again on extremely high volume." *Id.* at ¶ 39 (A-26).

During that period, the Underwriters declined to exercise their Green Shoe option to cover their short positions. *See* Complaint, ¶¶ 37, 41-42 (A-25-26). Instead, the Underwriters purchased shares on the secondary market "at prices lower than $38.00 per share." *Id.* at ¶ 41 (A-26). As a result, the Underwriters "made a profit of about $100 million with the bulk of that profit being made on" May 21. *Id.* at ¶ 42 (A-26).

C. Procedural History

The events surrounding the Facebook IPO have spawned multiple lawsuits that have been consolidated in the district court. *See In re Facebook, Inc.*, 986 F. Supp.2d at 547.

This action was filed on June 12, 2013, after Facebook declined to seek recovery under Section 16(b) of the Underwriter's alleged short-swing profits. Complaint, ¶ 49 (A-28). The complaint alleges that through the lock-up agreements, the Underwriters and Selling Shareholders agreed "to act together for the purpose of acquiring, holding, voting or disposing of [Facebook's] Common Stock." *Id.* at ¶ 18 (A-19). As a result, the complaint claims, the Underwriters and Selling Shareholders became a group, with each member deemed to beneficially own each other member's Facebook stock and rendering them all insiders subject to Section 16(b)'s short-swing profits rule. *Id.* at ¶¶ 15-18 (A-19-20). It further alleges that the Underwriters were not engaged in a good-faith underwriting because, among other things, they possessed material inside information. *See id.* at ¶¶ 19-35 (A-20-24). The complaint seeks to require the Underwriters to disgorge to Facebook "about $100 million" in short-swing profits. *See id.* at ¶ 42 (A-26).

The Underwriters moved to dismiss the complaint for failure to state a claim. *See In re Facebook, Inc.*, 986 F. Supp.2d at 546. They argued that they did not form a group and, in any event, were exempt from Section 16(b) liability because their purchases and sales were in connection with a good-faith underwriting.

On May 2, 2014, the district court granted the motion to dismiss on the grounds that the complaint failed to sufficiently allege that the Underwriters and Selling Shareholders formed a group. *Id.* at 555. The group allegation rested entirely on the lock-up agreements, and the district court found those agreements insufficient to establish a group because the Selling Shareholders and Underwriters had not agreed to jointly acquire, hold, vote, or dispose of stock. *Id.* at 552-54. To the contrary, the district court observed, while the agreements committed the Selling Shareholders to abstain from selling shares, the Underwriters "were under no reciprocal agreement." *Id.* at 552. Indeed, the Underwriters were obliged to—and did—sell Facebook stock. *See id.* The district court also found that "[b]ecause lock-up agreements are standard industry practice," on their own they are "insufficient to establish a Section 16(b) group." *Id.* at 553. The district court declined to reach the alternative argument that the Underwriters' transactions were exempt as part of a good-faith underwriting. *Id.* at 554. Later, the district court denied Lowinger's motion for reconsideration. *See In re Facebook, Inc., IPO Secs. & Derivative Litig.*, 43 F. Supp.3d 369 (S.D.N.Y. 2014).

On October 1, 2014, Lowinger appealed the district court's decisions dismissing the complaint and denying reconsideration. The parties subsequently filed briefs, and this Court heard oral argument.

DISCUSSION

I. A Typical Lock-Up Agreement, Standing Alone, is Insufficient to Establish a Group for Section 13(d) or Section 16(b) Purposes.

Although the creation of a "group" for purposes of Sections 13(d) and 16(b) depends on the specific facts and circumstances of any given case, a typical lock-up agreement executed by shareholders for the benefit of the underwriters as part of an underwritten public offering, standing alone, is not sufficient to establish such a group. Lock-up agreements are common in connection with underwritten public offerings, and they do not present the kinds of risks that Sections 13(d) and 16(b) are intended to address.

As noted, when two or more persons "act as" a group for the purpose of acquiring, holding, or disposing of equity securities of an issuer, the group is deemed a "person" under Section 13(d)(3). Similarly, in determining status as a more-than-ten-percent holder for Section 16 purposes, the securities beneficially owned by the group must be included in the calculation by each individual member of the group. A group is deemed to acquire beneficial ownership as of the date that the group members "agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer." Rule 13d-5(b)(1). An agreement does not have to "be expressly memorialized in writing." *Wellman v. Dickinson*, 682 F.2d 355, 363 (2d Cir. 1982). Instead, there must be "'sufficient direct or circumstantial evidence to support the inference of a formal or informal understanding between [the parties]' for the purpose of acquiring, holding, or disposing of securities." *Hallwood Realty Partners, L.P. v. Gotham Partners, L.P.*, 286 F.3d 613, 617 (2d Cir. 2002) (quoting *Wellman*, 682 F.2d at 363).

Applying that standard, this Court has held that while a lock-up agreement "may bear upon" the question of whether a group exists, evidence of coordination and testimony demonstrating that parties joined together to acquire, hold, or dispose of securities are more likely to demonstrate the existence of a group. *Quintel Entm't*, 249 F.3d at 127; *see also Hallwood Realty Partners*, 286 F.3d at 618 (affirming decision finding no group based on record that included evidence of prior relationships between parties, trading patterns, discussions, and other circumstantial factors). That approach is consistent with the Commission's long established position that a lock-up agreement may help evidence the existence of a group. *Cf*. Brief of Securities and Exchange Commission, *Amicus Curiae, Morales v. Quintel Entm't, Inc.*, No. 99-9374 (2d Cir.) (March 2000), at p. 27 ("Whether a lock-up provision constitutes an agreement for the purposes of creating a Section 13(d) group depends on the facts and circumstances of any given case.").

At the same time, the Commission does not believe that a typical lock-up agreement executed between shareholders and underwriters as part of an underwritten public offering, standing alone, is sufficient to demonstrate the existence of a group for purposes of Sections 13(d) or 16(b). As the district court correctly concluded, lock-up agreements are a common fixture of the IPO process. *In re Facebook, Inc.*, 986 F. Supp.2d at 553; *see also see also* David A. Westenberg, *Initial Public Offerings: A Practical Guide to Going Public* § 18:12 (1st ed. 2011); Anita Indira Anand, *The Efficiency of Direct Public Offerings*, 7 J. SMALL & EMERGING BUS. L. 433, 456 (Fall 2003) ("In traditional offerings, underwriters insist on lock-up agreements."); John J. Jenkins, *Recirculation of a Preliminary Prospectus: Statutory Basics and Analytical Techniques for Resolving Recirculation Issues*, 55 BUS. L.J. 135, 171 n.163 (Nov. 1999) ("[U]nderwriters typically insist on receiving 'lock-up' agreements from insider shareholders."); NYSE/NASD IPO Advisory Comm., Report & Recommendations of a committee convened by the NYSE, Inc. & NASD at the request of the U.S. Securities and

Exchange Commission (May 2003), at p. 16, *available at* http://www.finra.org/ sites/default/ files/Industry/p010373.pdf ("Underwriters routinely require directors, officers and certain pre-IPO shareholders of an issuer to enter into lock-up agreements that restrict their sale of company shares for a specified period, typically six months"). Indeed, the Commission's website advises investors that, "[b]efore a company goes public, the company and its underwriter typically enter into a lockup agreement to ensure that shares owned by these insiders don't enter the public market too soon after the offering." Initial Public Offerings: Lockup Agreements, Fast Answers, U.S. Securities & Exchange Commission, available at http://www.sec.gov/answers/lockup.htm (last checked June 26, 2015).

Such lock-up agreements do not raise Section 13(d) or Section 16(b) concerns. Section 13(d) is intended to "alert investors in securities markets to potential changes in corporate control and . . . provide them with an opportunity to evaluate the effect of these potential changes." *Wellman*, 682 F.2d at 365; *accord Quintel Entm't., Inc.*, 249 F.3d at 124-25 (actual control purpose not required to trigger Section 13(d), but that section is intended "to alert the market to large acquisitions that threaten *potential* shifts in corporate control" (internal quotation marks omitted) (emphasis in original); *see also* Brief of the SEC, *Amicus Curiae, Morales v. Quintel Entm't, Inc.,* at p. 20 ("There is no doubt that the purpose of Section 13(d) is to require disclosure of information by persons who have acquired a substantial interest, or increased their interest in equity securities of a company by a substantial amount . . . so that investors might assess the potential for changes in corporate control and adequately evaluate the company's worth." (internal quotation marks omitted)). And the corresponding beneficial ownership rule "prevent[s] a group of persons who seek to pool their voting or other interests . . . from evading" Section 13(d)'s disclosure regime. *Wellman*, 682 F.2d at 366 (quoting S. Rep. No. 550, 90th Cong., 1st Sess. 8 (1967)).

Typical lock-up agreements between shareholders and underwriters have nothing to do with potential control, long-term ownership, or evading disclosure rules. Rather, they facilitate the offering process by "maintain[ing] an orderly market" and preventing a rush of pre-IPO shares from "exerting substantial downward pressure on the market price of the newly issued shares." Westenberg, *Initial Public Offerings: A Practical Guide to Going Public* § 18:12; *see* Jenkins, *Recirculation of a Preliminary Prospectus: Statutory & Basic Analytical Techniques for Resolving Recirculation Issues*, 55 BUS. L.J. at 171 n.163 (agreements "promote an orderly market for a new issue and to guard against insider sales shortly after an offering"). Such agreements, like the ones here, are also publicly disclosed. *See* Facebook Prospectus, Form 424 B4, pg. 163 (A-46); Amend. No. 5 to Form S-1 Registration Statement, pg. A-1 to B-5) (A-73-82).

Further, as explained in greater detail below, because underwriters merely act as short-term conduits for the distribution of securities, temporary lock-up agreements between underwriters and shareholders do not lend themselves to the type of abuse that Section 16 was designed to prevent. *See infra* at pp. 24-25.

Thus, the Commission believes that, standing alone, typical lock-up agreements between shareholders and underwriters executed in connection with an underwritten public offering are not sufficient to establish a group for purposes of Section 13(d) or 16(b). That does not mean, however, that a lock-up agreement will never itself establish or constitute supporting evidence of the establishment of a group. Atypical language in the lock-up agreement, or other facts and circumstances outside of the lock-up agreement, could demonstrate that the parties to an agreement share a common purpose sufficient to establish a group. *See, e.g.*, Brief of the SEC, *Amicus Curiae*, *Morales v. Quintel Entm't, Inc.*, at p. 27 (recognizing that lock-up agreements that "have the effect of making shares unavailable for sale to those who might seek to compete for or to influence corporate control" might form the basis for a group). Instead, as the Commission previously explained, "whether a lock-up provision creates a Section 13(d) group depends on the specific facts and circumstances of any given case." *Id.* at 26.

II. Section 16(b)'s Short-Swing Profit Rule Does Not Apply to Sales and Purchases Made Pursuant to a Bona Fide Underwriting.

An underwriter is entitled to rely on the exemptions provided by Exchange Act Rules 13d-3(d)(4) and 16a-7, even though the underwriter has obtained material non-public information, so long as the underwriter's purchases and sales are made in connection with the underwriter's participation in a *bona fide* underwritten public offering.

As noted above, Rule 16a-7 (together with Rule 16a-10) exempt from Section 16(b) liability any purchases and sales in connection with an offering where "[t]he person effecting the transaction is engaged in the business of distributing securities and is participating in good faith" in such a distribution and the security is "purchased in good faith" as part of that business. Similarly, Rule 13d-3(d)(4) temporarily exempts from the beneficial ownership calculation securities that an underwriter acquires "through his participation in good faith in a firm commitment underwriting."

Together, those rules provide that "an underwriter's purchase and sale of securities pursuant to an underwriting will be exempt from Section 16 in all but the most unusual circumstances." Peter J. Romeo and Alan L. Dye, *Section 16 Treatise & Reporting Guide*, § 7.14 (4th ed. 2012). When it proposed Rule 16a-7, the Commission explained that such unusual circumstances do not include *bona* *fide*—or good-faith—underwriting activity. Specifically, the proposing release stated:

> Distributions by underwriters and selling group dealers would be excluded for reasons similar to those supporting exclusion of transactions by liquidating agents. Underwriters and selling group dealers are conduits for securities in a distribution and their ownership is generally brief. Although they may have access to inside information in some cases, their market activity generally is constrained by other rules. As long as they act in those capacities, rather than as investors, there is no need for a [Section 16(a)] report.

Proposing Release, 53 Fed. Reg. at 50004 (footnote omitted). The same standard applies to transactions exempted from Section 16(b). *See* 17 C.F.R. 240.16a-10 ("[A]ny transaction exempted from . . . section 16(a) . . . shall be likewise exempt from section 16(b)."); Hazen, 4 *Treatise on the Law of Securities Regulation*, §13.2 (Section 16(b)'s reach parallels Section 16(a)'s coverage). As the proposing release indicates, an underwriter's transactions are exempt from Section 16 liability as long as the underwriter acts as a conduit—that is, as a *bona fide* underwriter—rather than as an investor. Proposing Release, 53 Fed. Reg. at 50004. Further, even when so exempt, as the release explains, an underwriter remains "constrained by other rules," *id.*, meaning that an underwriter could simultaneously be exempt from Section 16(b) and liable for violating other rules. By contrast, sham transactions, where an underwriter is simply a disguised investor or engages in purchases and sales for a purpose other than to conduct an orderly underwriting, are not exempted. *See id.*

An underwriter's access to material non-public information does not affect eligibility for the Rule 16a-7 exemption. To the contrary, that rule is explicitly framed as an exemption from a short-swing profit regime that would otherwise apply to underwriters and other "insiders, who are presumed to possess material information about the issuer." *Gwozdzinsky v. Zell/Chilmark Fund, L.P.*, 156 F.3d 305, 308 (2d Cir. 1998) (internal quotation marks and footnote omitted); *accord Foremost-McKesson, Inc.*, 423 U.S. at 243; *see also* Adopting Release, 56 Fed. Reg. at 7244 (explaining that "Section 16, as applied to ten percent holders, is intended to reach those persons who can be presumed to have access to inside information"). The above-quoted proposing release also notes that the underwriter exemption was being adopted even though underwriters "may have access to inside information in some cases." Proposing Release, 53 Fed. Reg. at 50004.

That judgment rests on the Commission's assessment that, despite potential access to inside information, an underwriter's sales and purchases—including the common practice of overselling an offering and engaging in permitted syndicate covering transactions in the secondary market—"do not lend themselves to the speculative abuse Section 16 was designed to prevent." Amending Release, 61 Fed. Reg. at 30383; *see also* Romeo & Dye, *Section 16 Treatise & Reporting Guide*, § 6.03 (an underwriter's "involvement in the distribution of securities is unlikely to be motivated by, or to present an opportunity for, speculative abuse").

To the contrary, as discussed above, such activities are designed to "facilitate public offerings." Amending Release, 61 Fed. Reg. at 30383; *see also* Regulation M Release, 69 Fed. Reg. 75774, 75779-80 (discussing common underwriting practices designed to facilitate offerings). And consistent with that policy and despite presumed access to inside information, Rule 16a-7 broadly "exempts an underwriter's transactions in the secondary market that are intended to stabilize the market price in connection with a distribution." Romeo & Dye, *Section 16 Treatise & Reporting Guide*, § 7.14.

The complaint here does not appear to allege that the underwriting itself was a sham or that the Underwriters entered into it for a purpose other than the orderly distribution of Facebook stock. Rather, the complaint essentially alleges that the Underwriters may have violated the antifraud provisions of the securities laws and, therefore, should be considered not to have been acting in good faith. *See In re Facebook, Inc., IPO Secs. & Derivative Litig.*, 986 F. Supp.2d at 547 ("Similar to the consolidated complaint filed in the securities class action," the complaint here alleges that Facebook's amended registration statement earnings disclosure "was false and misleading[.]"). But that would disregard the fact that, "Congress . . . has left some problems of the abuse of inside information to other remedies," such as "general antifraud statutes that proscribe fraudulent practices by insiders." *Foremost-McKesson, Inc.*, 423 U.S. at 255; *see also Perine v. William Norton &*

Co., Inc., 509 F.2d 114, 120-21 (2d Cir. 1974) (noting that, "[o]ther provisions of the securities laws provide adequate protection against the underwriter's misuse of information obtained as a result of the underwriting relationship itself."). It would likewise conflict with the language in the Rule 16a-7 proposing release, which expresses an intent to exempt *bona fide* underwriting activities from Section 16 liability while leaving underwriters "constrained by" and potentially liable for violations of "other rules." Proposing Release, 53 Fed. Reg. at 50004.

CONCLUSION

For the foregoing reasons, the Commission urges the Court to conclude that: (1) typical lock-up agreements entered into with underwriters in connection with an offering are not sufficient, on their own, to establish a group for purposes of Section 13(d) or Section 16(b); and (2) an underwriter is entitled to rely on the exemptions provided by Exchange Act Rules 13d-3(d)(4) and 16a-7, even though the underwriter has obtained material non-public information, so long as the underwriter's purchases and sales are made in connection with the underwriter's participation in a *bona fide* underwritten public offering.

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August 2015

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