IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 04-35715

THOMAS R. DREILING, a shareholder of INFOSPACE, INC.,

Plaintiff-Appellant,

v.

AMERICAN EXPRESS TRAVEL RELATED SERVICES COMPANY, INC.,

Defendant-Appellee,

and

INFOSPACE. INC., a Delaware corporation,

Nominal Defendant-Appellee.

On Appeal from the United States District Court
for the Western District of Washington

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, *AMICUS CURIAE*, IN PARTIAL SUPPORT OF EACH PARTY

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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 corporate insiders 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 their shareholders, Congress delegated to the Commission the responsibility of formulating rules exempting from Section 16(b) transactions that, in the Commission's view, are "not comprehended within the purpose of" Section 16(b). The defendant in this case contends, and the district court agreed, that its acquisition of stock was exempt under Commission Rule 16b-3(d), 17 C.F.R. 240.16b-3(d). The issues in this case are whether the Commission had the authority to adopt that exemption in its present form, a matter patently of great interest to the Commission, and how the exemption should be construed, a matter as to which the Commission, as the rule's promulgator, likewise has a plain interest. 1/

1/ Although the Commission could have filed this brief on a timely basis as a matter of right, see F.R.A.P. 29(a), it did not do so. On March 18, 2005, the Court authorized the Commission to file this brief out of time on April 5, 2005.

BACKGROUND

A. The Statutory and Rule Provisions at Issue

Section 16(b) of the Exchange Act provides "For 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 an class of any 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 or the beneficial owner of any security of 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 where an officer or director of the issuer obtains a "a grant, award or other acquisition from the issuer." To qualify, the transactions must be either: (1) approved by the board of directors of the issuer, or a committee of the board of directors that is composed of at least two non-employee directors; (2) approved or ratified by the affirmative votes of the holders of a majority of the securities of the issuer; or (3)the securities acquired are held by the officer or

director for a period of six months following the date of such acquisition. 2/

B. Facts and Proceedings Below

The plaintiff in this case, Thomas R. Dreiling, is a shareholder of InfoSpace, Inc. He alleges that American Express Travel Related Services, Inc. ("TRS") was a director of InfoSpace and, while in that capacity, within a six month period, "engaged in a purchase and corresponding sales, and/or sales and a corresponding purchase of InfoSpace stock" and that TRS "profited from the corresponding purchases and sales and/or sales and purchases of InfoSpace stock." 3/ TRS, as a corporation, was not elected a member of the InfoSpace board, but Dreiling claims it served in that capacity by deputizing one of its executive officers, David C. House, to sit on the board and represent its interests. House did not himself own or trade in any InfoSpace stock.

By letter dated September 17, 2003, Dreiling made a statutory demand on InfoSpace. The letter stated that TRS "should be compelled to disgorge the profits made through the purchase and sales of InfoSpace stock within a six month period from February 25, 2000 through August 24, 2000," adding that TRS was liable for the

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2/ The complete text of Section 16(b) and Rule 16b-3(d) are reprinted in the Addendum (1A-2A).

3/ TRS acquired stock in Infospace after that company merged with a company called Prio, Inc., in which TRS owned a substantial amount of stock.

recovery of short-swing profits as an insider through its representation on the board of InfoSpace by House. In a response dated November 14, 2003, counsel for InfoSpace rejected Dreiling's demand, stating that House did not "in any way" represent TRS on the board of InfoSpace.

Dreiling then brought this action under Section 16(b) on November 26, 2003. Dreiling's First Amended Complaint, filed on December 15, 2003, alleges that from January 21, 2000 through May 21, 2001 TRS was, for purposes of Section 16(b), a director of InfoSpace through House, whom it "deputized" "to represent its interests on InfoSpace's Board of Directors." It further alleges that "[w]ithin periods of less than six months, [TRS] engaged in purchases and corresponding sales and/or sales and a corresponding purchase of InfoSpace stock." It also alleges that TRS failed to report these transactions as required by Section 16(a) of the Exchange Act, thereby tolling the two-year statute of limitations.

The district court dismissed Dreiling's amended complaint, finding that the defendant's acquisition of InfoSpace securities was exempt under Rule 16b-3(d). On appeal, Dreiling contends that the Commission exceeded its authority when it promulgated Rule 16b-3(d). Alternatively, Dreiling argues that the Rule 16b-3(d) exemption should not apply where, as alleged here, the director is not a person sitting

on the board, but rather is a director by virtue of having deputized a person to sit on

the board.

ARGUMENT

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

A. The Transactions Exempted by Rule 16b-3 Are Not Comprehended Within the Purposes of Section 16(b), Which Seeks to Prevent the "Unfair" Use of Inside Information.

In arguing that the Commission exceeded its authority when it promulgated Rule 16b-3(d), Dreiling would like to make it appear that Section 16(b) was principally concerned with reining in any form of self-interested securities transaction by officers and directors, while Rule 16b-3 unleashes them. This argument, however, overstates the purpose of Section 16(b) and mischaracterizes the effect of Rule 16b-3(d).

The Supreme Court has stated that 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 that "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. 78). In the 1934 report that summarized 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," stated:

> Among the most vicious practices unearthed at the hearing before the subcommittee was 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). The 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* S. Rep. 792, 73d Cong., 2d Sess. 9 (1934); *Blau v. Lamb*, 363 F.2d 507, 514-15 (2d Cir. 1966).

The statutory language itself shows that Congress sought to suppress the speculative abuse where insiders with the advantage of possessing inside information traded with investors who were disadvantaged by the lack of equal information. This is why Congress stated that Section 16(b) was enacted "for the purpose of preventing the *unfair* use of information" (emphasis added).

To remedy this 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 trading was in and of itself wrong. Rather, it chose to allow recovery of all short-swing profits realized by specified insiders trading in their own stock, in order to deter that trading which 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. v. Emerson Electric Co., 404 U.S. at 422 (*quoting Bershad v. McDonough*, 428 F.2d 693, 696 (7th Cir. 1970)). 4/

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

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4/ As summarized 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 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.

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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 Section 16(b) can be harsh 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) (*quoting Bershad v. McDonough*, 428 F.2d at 696). *See also Gollust v. Mendell*, 501 U.S. 115, 122 (1991); *Reliance Electric Co. v. Emerson Electric Co.*, 404 U.S. at 422-23. "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. v. Provident Securities Co.*, 423 U.S. at 252. *See also Gollust v. Mendell*, 501 U.S. at 122; H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13 (1934).

Of particular relevance, Congress protected against 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." Congress made clear that "[t]he expressed purpose of [Section 16(b)] is to prevent the unfair use of inside

information. The Commission may exempt transactions not falling within this purpose." S. Rep. No. 792, *supra* at 21. 5/

In adopting the current version of Rule 16b-3(d), 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:

> Generally, these transactions do not appear to present the same opportunities for insider profit on the basis of non-public information as do market transactions by officers and directors. 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 Rel. No. 37260, 61 Fed. Reg. 30376, 30377 (June 14, 1996). *See* 3D Harold Bloomenthal & Samuel Wolff, *Securities & Federal Corporate Law* §21:66.55 (WestLaw 2004) ("Market transactions present opportunities for profit based upon non-public information in a way that transactions with the issuer do not.").

There is no basis for this Court to dispute the Commission's conclusion. "[T]he well-reasoned views of the agencies implementing a statute 'constitute a body

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5/ 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 Ownership Reports*, Exchange Act Rel. No. 37260, 61 Fed. Reg. at 30391.

of experience and informed judgment to which courts and litigants may properly resort for guidance.'" *United States v. Mead Corp.*, 533 U.S. 218, 227 (2001) (*quoting Bragdon v. Abbott*, 524 U.S. 624, 642 (1998)). Thus, where, as here, "Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation. Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843-44 (1984). *See also United States v. O'Hagan*, 521 U.S. 642, 673 (1997).

Indeed, Dreiling does not dispute the common-sense proposition that, in general, an issuer knows any inside information that its officers or directors know, so that an issuer is typically not at an informational disadvantage in dealing with its insiders. Instead, he misstates the rule, contending that the rule allows a corporate board of directors to give its blessing to *any* transaction that would otherwise be subject to suit under Section 16(b) (Brief of the Plaintiff-Appellant, p. 9). But that simply is not the case. Rule 16b-3(d) is available only to exempt transactions between an officer or director and the issuer. It only applies in a limited type of transaction in which the risk of abuse is inherently limited.

The risk that a transaction will be a vehicle for speculative abuse by an insider is also limited by the conditions the rule imposes on those transactions. Either the

acquisitions must be approved by the issuer's board (or committee or non-employee directors) or by the shareholders, or the insider must hold the securities for six months. Board or shareholder approval will remove the timing of the acquisition from the control of any one insider and also tend to assure that the acquisition is for a legitimate corporate purpose. *See Gryl v. Shire Pharmaceuticals Group*, 298 F.3d 136, 145-46 (2d Cir. 2002).

This is not to say that issuer-insider transactions will never in any circumstance involve abuse of inside information. There may be situations, 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 these deceptions might occur on occasion, that does not preclude the Commission from adopting a general exemption for issuer-insider transactions. While Dreiling would have this Court believe that Section 16(b) states that it was enacted "for the purpose of preventing any unfair use of information" by corporate insiders (*see* Brief of the Plaintiff-Appellant, pp. 9, 14, 17, 35-36, 38). But the word *any* does not appear in the provision's introductory sentence. 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). 6/ In adopting current Rule 16b-3(d), the Commission concluded that the exempted transactions did not pose a significant risk of abusive insider trading with less informed investors. This was a highly appropriate approach, while Dreiling's approach is not. Section 16(b) imposes a harsh and 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. 7/

Dreiling also argues that insiders obtaining securities from an issuer may engage

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6/ Relying on *Kern County Land Co.*, 411 U.S. at 600, Dreiling contends that Section 16(b) liability must be extended to the acquisition of InfoSpace stock by TRS unless there is "absolutely no possibility" of any abuse (Brief of the Plaintiff - Appellant, p. 17). *Kern* announced no such rule. Indeed, a very similar argument was addressed by the Court in *Foremost-McKesson, Inc.*, 423 U.S. at 252, where also relying on *Kern, supra,* at 595 and *Reliance Electric Co.*, 404 U.S. at 424, the plaintiff argued that where any "alternative construction" of Section 16(b) is possible, liability must be imposed. To this argument, the Court responded noting that the Court declined to impose liability in either case, "thus recognizing that serving the congressional purpose does not require resolving every ambiguity in favor of liability under §16(b)." *Foremost-McKesson*, 432 U.S. at 252.

7/ The Commission noted that "There are also potential liability considerations under Rule 10b-5 [17 C.F.R 240.10b-5]." 61 Fed. Reg. 30377, n.17. If such a transaction involved unfair use of information, the transaction would likely be subject to such liability. *See SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848, 850 (2d Cir. 1968).

in other forms of abusive conduct. For example, Dreiling posits two scenarios in which officers or directors, privy to inside information, receive securities from the issuer on favored terms, and then sell them in the market after full disclosure of the true facts is made. Typically, however, the issuer will also know this information at the time of the acquisition, so there is no fraud in the acquisition. Nor does the later sale, which takes place after the inside information is disclosed, involve fraud.

Of course, there could be other insider misconduct in these scenarios. They may involve self-dealing in breach of the officer's or director's fiduciary duties. While Dreiling contends that Section 16(b) is designed to prevent such abusive conduct, such self-dealing generally does not involve insider trading and is not what Section 16(b) was directed at. As the Commission noted when it revised Rule 16b-3(d):

> An insider's breach of fiduciary duty to profit from self-dealing transactions with the company is a concern of state corporate law. Generally, states have created potent deterrents to insider self-dealing and other breaches of fiduciary duty." *Id.* at n.17, citing 3 *Fletcher Cyc. Corp.* § 837.60 (Perm. ed. 1994); D. Block, S. Radin and N. Barton, *The Business Judgment Rule: Fiduciary Duties of Corporate Directors* 124-37 (4th ed. 1993).

Ownership Reports, Exchange Act Rel. No. 37260, 61 Fed. Reg. at 30377. Thus, if a self-interested board disregards the corporation's interest and engages in self-dealing or sweetheart deals, it plainly breaches its fiduciary duty and may be held liable under state law.

Dreiling contends that state fiduciary law does not generally apply to these sorts

of transactions, and that Section 16(b) is needed as a substitute. But he misunderstands the fiduciary law the Commission talked about in its adopting release. He cites *Freeman v. Decio*, 584 F.2d 186, 196 (7th Cir. 1978), as supposedly proving that that there is only limited state fiduciary law for abusive transactions between an insider and the issuer. But what *Freeman* was dealing with was whether Indiana would recognize a derivative action on behalf of a corporation for breach of a supposed fiduciary duty owed by an insider for transactions between the insider *and shareholders in a market transaction*. The New York Court of Appeals had recognized such an action in *Diamond v. Oreamuno*, 24 N.Y.2d 494, 301 N.Y.S.2d 78, 248 N.E.2d 910 (1969). As the *Freeman* court stated, this was an innovative departure from usual state law fiduciary standards, which both before and after *Diamond*, did not recognize an obligation by insiders to disclose to shareholders with whom they traded material non-public information, much less a right of a corporation to sue the insiders.

The Commission, however, was not talking about the application of state fiduciary law to transactions between insiders and *shareholders*. It was talking about dealings between insiders and *issuers*, since that is all Rule 16b-3 exempts. There is no question that insiders who unfairly deal with their corporation can be subject to suit under state fiduciary law for abusive self-dealing. Even commentators heavily relied on by Dreiling agree that "[s]tate corporate law is sufficient to regulate self-dealing or breaches of fiduciary duty where directors improperly award securities to themselves

(or improperly approve awards to other directors or officers)." 3D Harold S. Bloomenthal & Samuel Wolff, *Securities and Federal Corporate Law* §21:66.55 (WestLaw 2004). *See also* William Meade Fletcher, *Fletcher Cyclopedia of Private Corporations* §1040 (WestLaw 2004) ("The business judgment rule does not protect corporate fiduciaries who engage in self-dealing or make decisions affected by inherent conflict of interest."). In short, self-dealing abuses in insider-issuer transactions are adequately covered by state law.

Dreiling posits one other example of possible insider abuse. He states that TRS could, within six months of acquiring InfoSpace shares in the merger, learn from House, its alleged representative on the board, that InfoSpace is overvalued in the market and sell its shares in the market to unwitting investors. This would be fraud, but not a type of fraud at which Section 16(b) was directed. The abuses at which Section 16(b) was directed involved short-term, in-and-out trading by insiders. *Kern County Land Co.*, 411 U.S. at 591-92. This contemplated a purchase and subsequent sale, or sale and subsequent purchase, in which the paired transactions presented the potential for the "unfair use of information" by transacting with investors who are at an informational disadvantage. This could occur in the case of a purchase and subsequent sale, where the insider purchases from a person who is at an informational disadvantage and then, within six months, sells after the information has become public. Dreiling's scenario, in contrast, involves an insider who happened to hold

stock (and may have for years) and dumps the stock on an unsuspecting market when he learns of bad news. Congress did not intend Section 16(b) to protect against all forms of improper corporate management. Nor was Section 16(b) ever intended to protect against all forms of insider trading.

B. Rule 16b-3(d) Is Not Invalid Because It Attempts to Achieve a Measure of Simplicity and Flexibility.

Dreiling argues that in adopting current Rule 16b-3(d), the Commission was motivated solely by the desire to achieve regulatory simplicity and flexibility. This contention totally ignores the Commission's explanation that it did not believe issuer-insider transactions, at least under the gatekeeping conditions in the new rule, present a significant risk of the abuses Section 16(b) is concerned with.

The release also evaluated the administrative issues generated by the 1991 version of Rule 16b-3, which it replaced. It noted that the 1991 rule proved to be so cumbersome and difficult to comply with that it discouraged participation in corporate incentive plans. Given the diversity, complexity, and constantly changing nature of such plans, a new regulatory regime was required that would allow for flexibility. Current Rule 16b-3 was thus designed to "facilitate the operation of employee benefit plans [and] broaden exemptions from Section 16(b) short-swing profit recovery *where consistent with statutory purposes* * * * ." *Ownership Reports and Trading by Officers, Directors and Principal Security Holders,* Exchange Act Release No. 37260, 61

Fed. Reg. at 30376 (emphasis added). Just as in Section 16(b) itself "Congress chose a relatively arbitrary rule capable of easy administration," *Reliance Electric Co. v. Emerson Electric Co.*, 404 U.S. at 422 (*quoting Bershad v. McDonough*, 428 F.2d 693, 696 (7th Cir. 1970)), it is appropriate for the Commission to take ease of application into account in crafting exemptions, so long as it is consistent with the statute's purpose. 8/

8/ In his brief, Dreiling quotes Peter J. Romeo & Alan L. Dye, *Comprehensive Section 16 Outline* 350 (2003), for the proposition that in order to gain regulatory flexibility and simplicity "there was a 'price paid': 'the loss of some protections against speculative abuse.'" But Romeo and Dye go on to state that "This loss, however, does not appear to have had much impact. Because the rule exempts only transactions with the issuer, it generally does not provide an opportunity for insiders to engage in speculative abuse at the expense of market participants." Romeo & Dye, *Section 16 Outline* 350.

C. The Commission's Judgment in Adopting Rule 16b-3 Is Entitled to Full *Chevron* Deference.

Dreiling argues that the Commission's revision of Rule 16b-3 is not entitled to *Chevron* deference because it represents an interpretation of Section 16(b) that is different from that the Commission adopted in 1991 (Brief of the Plaintiff-Appellant, p. 40-41). The Supreme Court, however, has made clear that where a statute does not speak to an issue unambiguously, "legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute." *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. at 843-44. This is so even if the agency is changing its statutory interpretation. *Smiley v. Citibank (South Dakota), N.A.*, 517 U.S. 735, 740-41 (1996). *See, e.g., Chevron*, 467 U.S. at 857-58. Thus, "the mere fact that an agency interpretation contradicts a prior agency position is not fatal." *Smiley v. Citibank*, 517 U.S. at 742. Indeed, *Chevron* itself approved a rule that changed after a change in administrations. 467 U.S. at 857-58. Only "[s]udden and unexplained change, * * * or change that does not take account of legitimate reliance on prior interpretation, * * * may be 'arbitrary, capricious [or] an abuse of discretion.' But if these pitfalls are avoided, change is not invalidating, since the whole point of *Chevron* is to leave the discretion provided by the ambiguities of a statute with the implementing agency." *Smiley v. Citibank*, 517 U.S. at 741 (citations omitted).

While the 1996 version of Rule 16b-3 changed the exemptive conditions of the rule, Rule 16b-3 has long been available to exempt acquisitions of securities by officers and directors, based on satisfaction of appropriate regulatory conditions designed to protect against the abuses at which Section 16(b) was directed. 9/ The Commission was careful to explain when it adopted current Rule 16b-3 that its prior method of exempting insider acquisitions of issuer securities - - which required all such acquisitions take place pursuant to an approved written employee benefit plan - - simply did not work and actually discouraged some insiders from acquiring issuer securities through employee benefit plans. *Ownership Reports,* Exchange Act Release No. 37260, 61 Fed. Reg. at 30376-78. After careful study, notice, and public comment, the Commission adopted the current rule that takes a new approach to addressing the same issue. The new Rule 16b-3 generally allows officers or directors to acquire issuer securities where certain standards and certain objective gate-keeping provisions are in place to safeguard against the abuse of inside information. *Id.* at 30377. This is not a case where the Commission made a "sudden and unexplained change." Indeed, the Commission never changed its interpretation of Section 16(b) at all.

9/ *See* Exchange Act Release No. 392 (1935). *See also* Peter Romeo and Alan L. Dye, *Section 16 Treatise and Reporting Guide* §14.01 (2d ed. 2004).

II. TO THE EXTENT A PERSON IS A DIRECTOR BY DEPUTIZING ANOTHER TO SIT ON THE BOARD, THE DEPUTIZING PERSON IS SUBJECT TO SECTION 16(b), AND MAY RELY ON RULE 16b-3(d), BUT ONLY TO THE EXTENT THE BOARD APPROVING THE TRANSACTION IS AWARE OF THE DEPUTIZATION, AN ISSUE OF FACT IN THIS CASE.

The other issue in this case is whether TRS may rely on Rule 16b-3, even though it was a director of InfoSpace solely by virtue of the fact that it had allegedly deputized House to act on its behalf on the board. The parties dispute whether there was a deputization, an issue of fact on which the Commission has no knowledge and will not comment. Dreiling does, however, contend that as a matter of law Rule 16b-3(d) is not available to directors who function through deputies. We believe that is incorrect, although we do agree with Dreiling that the board (or shareholders) approving an acquisition by a director operating through deputization must be aware of the deputization, a matter of fact which is in dispute in this case.

The "deputization theory" is a judicially developed doctrine that was adopted by the Supreme Court in *Blau v. Lehman*, 368 U.S. 403 (1962). Under the theory, "[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 as a director of Tide Water Associated Oil Company, in whose stock Lehman Brothers traded. In assessing the validity of the deputization theory, the Court noted that, since Lehman was neither a more than ten percent owner nor an officer of Tide Water, the firm could only be liable under Section 16(b) if Lehman was a director. Furthermore, because Lehman was not formally a member of Tide Water's board, the firm could only be liable as a director through Thomas. *Id.* at 409. Although it was not "literally designated" as a director, the Court determined 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'[10/] 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. 11/

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

11/ While the Commission has stated that it "does not propose to codify case law relating to deputization," it has recognized that "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

But whether or not a "deputization" has transpired is a question of fact. *Blau v. Lehman*, 386 U.S. at 408-09. *See also Feder v. Martin Marietta Corp.*, 406 F.2d 260, 263 (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. *See Blau v. Lehman*, 368 U.S. at 410; *Feder v. Martin Marietta Corp.*, 406 F.2d at 264-65. *See also* Peter J. Romeo & Alan L. Dye, *Section 16 Treatise and Reporting Guide* §2.04[4][a] (2d ed. 2004) (discussing relevant factors in determining the existence of a deputization).

Dreiling claims that the Commission's rationales for Rule 16b-3(d) do not apply to directors by deputization. Specifically, Dreiling argues that (1) Rule 16b-3(d) is based on the supposition that acquisitions from the issuer by insiders are compensation and directors through deputization, usually other corporations, do not receive compensation; (2) that state law fiduciary duties serve as no protection as to directors by deputization because such directors are not subject to state law fiduciary duties; and (3) that the approval by the board of the acquisition of InfoSpace stock by the defendant could serve no gatekeeping function in this case, or other cases, where,

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Fed. Reg. 49997, 50000 (Dec. 13, 1988).

as claimed, the members of the board were not aware that TRS was a director because, as claimed, they did not know that House had been deputized by TRS.

As to the first of these contentions, when Rule 16b-3(d) was adopted the Commission contemplated its application to all acquisitions from an issuer that met the objective gatekeeping requirements set forth in the rule (such as board or shareholder approval), regardless of whether the acquisitions have a compensatory purpose or not. *Ownership Reports,* Exchange Act Release No. 37260, 61 Fed. Reg. at 30378-79. *See also Memorandum of the Securities and Exchange Commission, Amicus Curiae, in Support of Appellees' Petition for Rehearing or Rehearing En Banc*, at *4, *filed in, Levy v. Sterling Holding Co., LLC.*, 314 F.3d 106, 124 (3d Cir. 2002), *cert. denied*, 540 U.S. 947 (2003), *available at,* www.sec.gov/litigation/briefs/levy-sterling022703.htm.

As to the second contention, Dreiling cites no authority for the proposition that state law fiduciary duties prohibiting self-dealing do not apply to directors who do not actually sit on the board of a company but who operate through a deputy who sits on the board and who is working on their behalf. There is no question, however, that the person actually sitting on the board owes the company fiduciary duties. Not only can that person not engage in self-dealing on their own behalf, they cannot allow another to benefit at the expense of the company, even if the fiduciary does not personally benefit. *See, e.g., Mosser v. Darrow*, 341 U.S. 267, 272 (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).

Dreiling's third contention does have merit. The Commission agrees that board or shareholder approval is not effective as a gatekeeping provision where the members of the board or shareholders are unaware that a person acquiring stock, in this case TRS, is a director. When it proposed the current rule, the Commission stated, "[t]he purpose of these [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). To that end, Note 3 to 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. Since the basis for the exemption is that approved grants of securities are likely to be motivated by legitimate corporate objectives, and not by an attempt to profit from inside information, it is important that the board actually consider each specific transaction, and that it evidence "acknowledgment and accountability" as to what it is doing.

If in this case, other members of the board did not know that House had been deputized to represent the interest of TRS on the InfoSpace board, as claimed by Dreiling, then the board would have no way of knowing that TRS was a director and that TRS, through House, had access to inside information. As such, the other members of the board of InfoSpace would have no reason for special vigilance as to the acquisition of InfoSpace stock by TRS, and the board would not effectively serve its gatekeeping function and ensure accountability. It is, therefore, imperative, for the purposes of Rule 16b-3(d), that the members of any corporate board know when another person serving on the same board is deputized by another person or entity to carry out its interests. Whether the board had such knowledge is a question of fact as to which the parties dispute, and as to which the Commission expresses no view.

CONCLUSION

For the foregoing reasons, Commission urges this Court to hold that the Commission acted within its authority in adopting Rule 16b-3(d) and that, to the extent a person is a director by "deputization," exemptive Rule 16b-3(d) only applies to that person where the board approving the transaction to be covered by the rule is aware that the deputizing person is a director.

Respectfully submitted,

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