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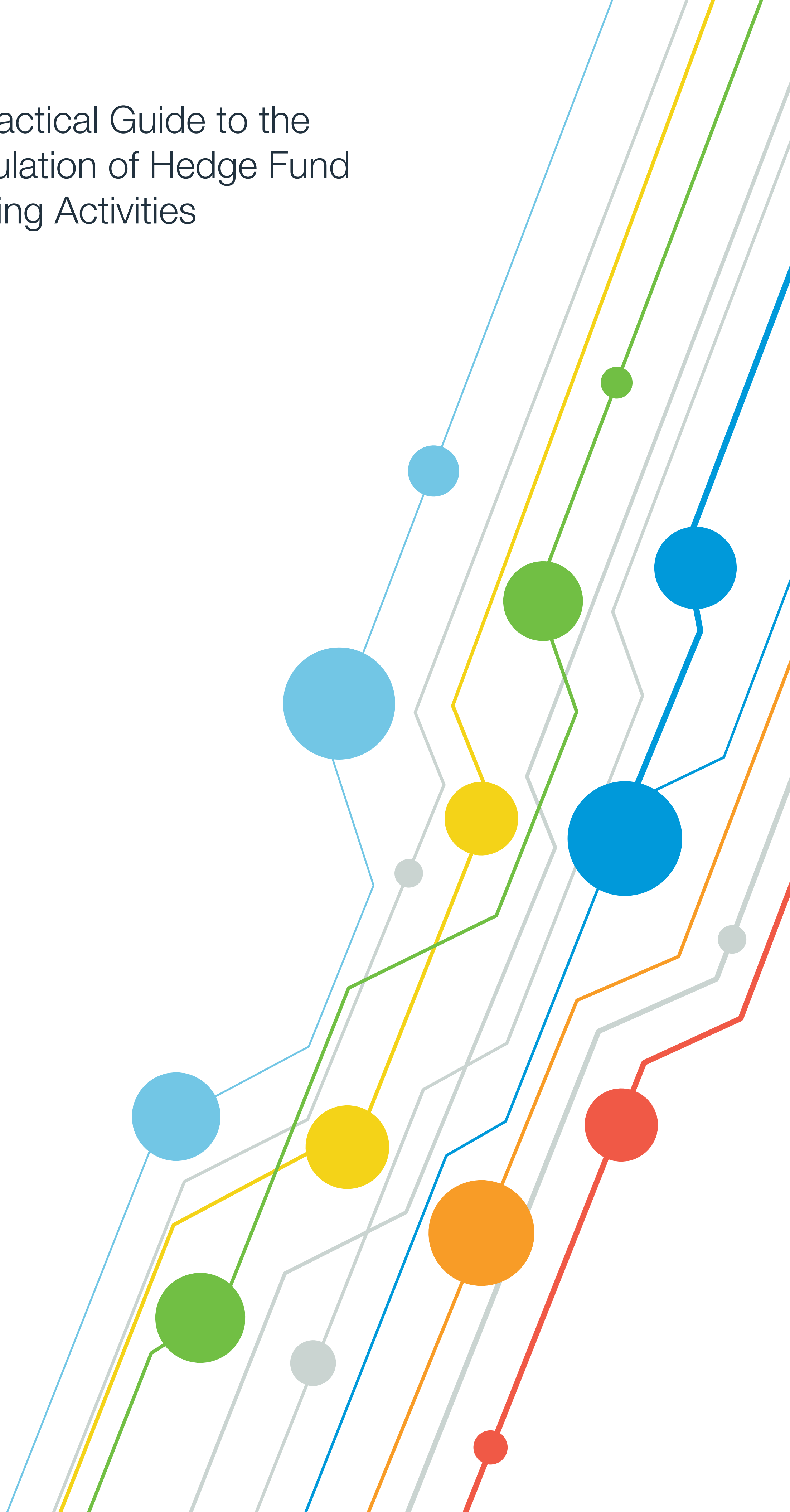
A Practical Guide to the Regulation of Hedge Fund Trading Activities



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Proskauer's Practical Guide to the Regulation of Hedge Fund Trading Activities is being offered as a service to our clients and friends. It is designed only to provide general information on the topics actually covered. It is not intended to be a comprehensive summary of legal issues or developments, treat exhaustively the subjects covered, provide legal advice or render a legal opinion. Thus, it is not intended to provide legal advice to any particular fund or in connection with any specific transaction, and it should not be relied upon in making a decision or taking a course of action that implicates regulatory issues.

Executive Summary

The trading activities of hedge funds raise a number of complex issues under the federal securities laws. **Proskauer's Practical Guide to the Regulation of Hedge Fund Trading Activities** offers a concise, easy-to-read overview of the trading issues and questions we commonly encounter when advising hedge funds and their managers. It is written not only for lawyers, but also for investment professionals, support staff and others interested in gaining a

quick understanding of the recurring trading issues we tackle for clients, along with the solutions and analyses we have developed over our decades-long representation of hedge funds and their managers.

The Guide will be published in installments (with previews of future installments) so that our readers may focus on each chapter, ask questions and provide any comments.

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A Practical Guide to the Regulation of Hedge Fund Trading Activities

Chapter 1: When Passive Investors Drift into Activist Status

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Chapter 1: When Passive Investors Drift into Activist Status

Many funds that are not "activist" funds nonetheless from time to time want to engage with other investors about a portfolio company's performance. For example, it may be that earnings are lagging and another investor asks for a meeting to discuss the causes, as well as perhaps proposed solutions. Such interactions with other investors and with management can cause the fund to be viewed as seeking to influence the management of the company and subject the fund to heightened "activist" regulatory requirements. This chapter provides a summary of the heightened regulatory requirements and how they might be triggered. It does so by tracing through a hypothetical example that follows a relatively typical fact pattern.

The heightened regulatory requirements may include, among other things, having to:

- file a long-form Schedule 13D instead of a short form Schedule 13G;
- comply with reporting requirements under Section 16 (as well as become subject to potential short swing liability);
- address potentially complex insider trading issues; and
- comply with Hart-Scott-Rodino filing requirements.

Scenario

In considering these requirements, we will be tracing through the following factual scenario. Momentum Fund L.P. and its sister fund, Momentum II, L.P. (together, "Momentum"), and their adviser, Momentum Fund Adviser, L.L.C. ("Adviser"), invest in companies that make products used in the residential building industry. The general partner of Momentum, Momentum GP, L.L.C. ("GP"), has delegated its voting and investment authority to Adviser, which authority it has the right to revoke following a 61-day advance written notice. John Smith, the founder of the Momentum group of companies, is the sole manager of Adviser and sole member of Momentum GP. Adviser's only direct relationship with Momentum is its advisory agreement with Momentum GP. Adviser is a registered investment adviser.

On January 15th of this year, Smith was contacted by Residual Fund ("Residual") about a shared portfolio company, Door Technologies, Inc. ("Door"). Neither Momentum nor Residual is an activist fund. Door's common stock is traded on Nasdaq. Momentum has a 5.4% interest in the outstanding common stock of Door, and Residual has a 4.9% interest. Residual pointed out to Smith that Door's common stock price has lagged behind the market for the past 24 months and it blames Door's lack of scale, believing that the company should find a merger partner. In particular, Residual asked Smith to look for possible partners and make introductions to the company. Residual reported that it had met with company management in the recent past and tried to convince them of the strategy. While Door management has not rejected the idea, it has neither concurred with Residual nor committed to finding a suitor.

Schedules 13G and 13D

We begin our analysis with implications under Section 13(d) of the Exchange Act of Residual's approach to Momentum. Momentum, Adviser, GP and Smith have jointly filed a Schedule 13G, since it beneficially owns more than 5% of Door's common stock. Under Section 13(d) and related SEC rules, any person who acquires "beneficial ownership" of more than 5% of a public company's outstanding voting equity must file a Schedule 13G or 13D reporting such beneficial ownership. That is the case, at least, so long as the company's common stock is registered as a class under the Exchange Act, as it must be if it is listed on a stock exchange. Schedule 13G is a short form and requires little substantive disclosure, other than to quantify the reporting person's beneficial ownership. Because of the limited disclosure, Schedule 13G is also less likely to trigger a requirement to file an amendment. Accordingly, non-activist funds routinely file on Schedule 13G and try to make sure they remain eligible.

The requirement to file on Schedule 13G or 13D is based on the concept of "beneficial ownership." Beneficial ownership is based on investment control (sole or shared power to buy, sell or transfer) and/or voting control. It includes the right to acquire the shares within 60 days, encompassing, for example, a stock option that is exercisable within 60 days. In our case, Adviser alone as a practical matter has investment and voting control over the stock, and its advisory agreement cannot be cancelled except upon 61 days' notice. Nonetheless, we would advise that Momentum and GP join Adviser on the Schedule 13G because they arguably still retain beneficial ownership, for reasons that will be detailed in a later installment of this series focusing on Section 13(d) requirements.

Change or Influence Control of Issuer

Schedule 13G is available to all passive funds whose beneficial ownership is less than 20%. In particular, it is available to funds that acquired the shares "not with the purpose nor with the effect of changing or influencing the control of the issuer." The SEC has a broad view of the types of activities that could show such a "control purpose." The SEC has indicated that a person that is merely solicited by another person engaged in activist activity (without joining their efforts) remains "passive," as does a person that engages the issuer or other investors on certain general corporate governance topics, such as executive compensation or confidential voting.

However, the SEC has also stated that a fund that focuses on other corporate governance topics that implicate control, such as poison pills and board structure, could lose "passive status," depending on the circumstances. Activities that if completed are likely to facilitate a change in control will, in every case, result in loss of "passive status." Such activities could include, for example, seeking to replace members of the board or promoting or engaging in a significant business transaction. (There is one exception where an activist fund may report on a Schedule 13G if it acquired its shares before the IPO.)

The SEC did not address the implications of engaging with the company on ordinary operational matters that do not normally implicate control, such as marketing initiatives or product lines. It depends on the facts, including the frequency of these discussions, but such discussions should not normally result in the loss of passive status. Indeed, they are the types of matters that a buy-side analyst might be expected to address. An analyst's perspective would be to maximize the value of the enterprise, not to influence management or control.

Any fund engaging with the company, of course, should be mindful that any such engagement could easily land it in a grey area on the question of whether it has a control intent, and the risk depends on all of the facts (including internal emails), as well as the motivation of the person seeking to question the fund's status as a passive investor. Any discussions with the company that might border on business operational issues should be carefully scripted.

Description of Plans

Schedule 13D requires substantive disclosure, and part of that disclosure focuses on the same activities that would have caused the fund to lose eligibility to continue reporting on Schedule 13G. This disclosure is required by Item 4 of Schedule 13D and is often problematic for funds seeking to influence an outcome for the company, as they are not yet ready to communicate publicly about their plans. Item 4 requires the fund to "[s]tate the purpose or purposes of the acquisition of securities of the issuer, . . . [and] describe any plans or proposals which the reporting

Getting back to our illustrative example, assume that Momentum, Adviser, GP and John Smith had previously filed a joint report on Schedule 13G because their shared beneficial ownership of Door's common stock exceeded 5% of the outstanding shares. The SEC recently amended its rules for filing and amending on Schedule 13G, and the new rules take effect on September 30, 2024.

Under the "old" and existing rules, as a registered investment adviser, Adviser would be entitled to file its Schedule 13G at the beginning of the next following year, but Momentum and John Smith must file their Schedules 13G within 10 days, so they typically would all file together within the 10- day timeframe.

Under the "new" rules that will apply beginning the end of September 2024, the Advisor would be entitled to file 45 days after the end of the calendar quarter, but Momentum and John Smith must file their 13G within 5 business days following the triggering event, which is the date that they exceeded 5%.

Residual has not filed on Schedule 13G because it does not have greater than 5% of Door's outstanding stock.

Momentum and Adviser agree to meet with Residual, and Residual explains its strategy for putting Door "on the block." Residual has met with management, which has been non-committal about the idea, insisting that its current business plan focusing on internal growth should bear results within the next 12 months. Momentum says nothing, and Smith speaks to the fund's counsel after returning to his office.

Counsel to Momentum explains that Momentum has done nothing so far to trigger conversion from a Schedule 13G to a 13D. Merely listening to another investor alone should not form the basis of a "control intent." It also should not trigger a "control intent" if Momentum asked Residual questions about its thinking and about its plans. As noted above, the SEC has stated that a fund does not lose its passive status merely because it has been solicited by another investor and listens to a proposal. Asking questions to better understand the proposal should not change the conclusion.

However, that analysis could change if Momentum took active steps toward seeking a merger partner for Door, such as contacting potential merger partners. The analysis could also change if Momentum had further communications with Residual, or even acted in parallel fashion with Residual, such that the SEC or a court could infer an agreement to act together in a Section 13(d) "group," an issue we address in the next section.

Status as Group

In addition, if the two funds were to agree about their plans for Door, the two funds could be considered to be a Section 13(d) "group." A "group" is formed "when two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer." The resulting "group" is deemed to beneficially own the shares held by each fund — here, a total of 10.3% of the outstanding shares. If the group members' combined holdings in aggregate exceed 5%, each member has to make a filing, even if its own holdings are under 5%. Thus, if a fund that beneficially owns 3% forms a group with another fund that owns 4%, both funds have to file. The Schedules 13G and 13D ask that the reporting person check a box as to whether or not it is part of a Section 13(d) "group."

In its 2022 rule proposals to amend its rules under Section 13(d), the SEC proposed to expressly state that "concerted action" among funds and other persons is sufficient to form a "group." In its final rules, the SEC backed down from those revisions but did not change its view that, under current rules, concerted action without an express agreement suffices to form a group.

Concerted action can be inferred, such as from parallel actions. Referring to our illustrative example, if Momentum, for example, started calling industry contacts to look for a merger partner for Door, those actions could be interpreted as reflecting an agreement to join forces with Residual, a deliberate decision to act in concert with Residual or as Momentum's adopting an independent activist role. Of course, Momentum might merely be researching the viability of Residual's strategy by seeing whether any interest in a merger might exist. Such behavior would not necessarily reflect an agreement or concerted action.

On their joint Schedule 13G, Momentum and its affiliates responded by checking the box to disclaim "group" status, which is common. (Even if their mutual conduct is within a grey area on whether they have formed a group, many filers will continue to disclaim group status to preserve a defense that no group has actually been formed.) If Momentum, Smith, GP, Adviser and Residual were a "group," they would likely continue to file individual reports, but disclose their aggregate beneficial ownership and include some disclosure of their plans under Item 4. Although it is possible to report as a "group" and remain on Schedule 13G, the "active" objectives of the "group" in this case likely would mean filing on Schedule 13D.

If Residual and the Momentum reporting persons decide that they must file on Schedule 13D and/or as a "group," they would be well-advised to coordinate to ensure that their filings are consistent.

If, in our example, Momentum, GP, Smith and Adviser did not respond to Residual in substance, they would not be considered to be part of a group with Residual. If they wished to remain on Schedule 13G and to avoid "group" status, any further conversations with Residual should be carefully scripted by counsel.

However, assume that either Momentum or Residual, or both of them, plan to file on Schedule 13D. Momentum, which is currently reporting on a Schedule 13G, will have 5 business days from the trigger date to file a Schedule 13D, and it will be frozen from voting its shares or acquiring more shares until the date that is 10 days following the filing of the Schedule 13D. Residual would be filing for the first time on its Door holdings and would have 5 business days from the trigger date to file a 13D.

Item 4 of the Schedule 13D should include some disclosure about the effort to find a buyer for Door, and that disclosure should be carefully drafted (perhaps with a blend of sufficient information and sufficient generality) to anticipate possible future developments, thereby potentially deferring the need for additional amendments in the near future. One potential benefit of providing Item 4 disclosure is that it would help to publicize the effort to find a merger partner, potentially resulting in more inquiries from third parties. In addition, the disclosure could, in effect, pressure management to cooperate with the funds' strategy.

We turn now to Exchange Act Section 16 obligations and potential liability.

Reporting and Liability under Exchange Act Section 16

Persons who are subject to reporting and liability under Section 16 include the company's senior officers and directors, as well as beneficial holders of more than 10% of its outstanding shares. Whether a fund is active or passive is not directly relevant to reporting and liability under Section 16. However, as noted above, discussions among the two funds could result in the formation of a "group" for Section 13(d) purposes, and the equity holdings of a "group" are aggregated to determine whether the parties cross the 10% threshold that triggers Section 16. In our example, if they were a "group," the Momentum group and Residual would in aggregate beneficially own 10.3% of Door's outstanding common stock. Because the combined holdings of Momentum and Residual are over 10%, each fund would become subject to reporting and liability under Section 16. In addition to filing an initial report on Form 3, each fund would have to file a Form 4 each time it bought or sold stock. Each fund also would be exposed to potential liability for any profit that resulted from a non-exempt purchase and a non-exempt sale that took place while the fund was a 10% holder, and within a six-month period. The fund's liability would be limited to its "pecuniary" (meaning, economic) interest in the shares subject to the purchase and sale. Each of the funds would only have liability for its own trades, assuming that neither had any economic interest in the other.

The filing persons for the Forms 3 and 4 are the same persons who filed the Schedule 13G or 13D. That is because the "beneficial ownership" test is the same for filing reports under Section 16 as it is for filing reports under Section 13(d). However, the holdings each party reports may vary, and depend on each person's relative economic interest in the company's common stock. Thus, if Adviser's interest in the common stock is limited to a performance fee, it would be required to report only the number of shares that correspond with that interest, and its potential liability under Section 16(b) would be limited in the same proportion. As a practical matter, it's normally difficult if not impossible to translate each person's proportionate economic interest

This last point is best illustrated if we assume that Momentum agreed with Residual to find a merger partner and that Door eventually endorsed the effort. This information is almost certainly material, non public information. In other words, the disclosure of the issuer's acquiescence in the effort alone could cause an increase in the market price of Door's common stock in anticipation of a takeover offer. However, possessing material, non-public information, without more, does not necessarily mean that the funds cannot purchase or sell common stock.

In the United States, except in the context of tender offers, trading on the basis of material, non-public information does not itself violate the law. There must be fraud, deceit or another breach of duty in order for a violation of the federal securities laws to occur. For example, the information must have been obtained in breach of a fiduciary duty or a duty of trust and confidence owed to shareholders or the company (where the breach is by an insider of the company), or owed to any other source of information (for example, the duty that an employee owes to his or her employer). In one well-known case ultimately considered by the Supreme Court, R. Foster Winans was a Wall Street Journal columnist responsible for the "Heard on the Street" column. As it does today, the column discusses individual public companies, and its contents can impact the price of a stock positively or negatively. Mr. Winan's leaked information about his articles to a stockbroker and to his roommate prior to publication, which resulted in trading profits. His defense to insider trading charges was that he might have violated conflict of interest policies at The Wall Street Journal, but he had not committed a crime. The Supreme Court upheld his conviction for wire fraud on grounds that he had "misappropriated" information belonging to his employer and that the misappropriation was a sufficient basis for his conviction. (The Supreme Court had not yet endorsed the misappropriation theory under the securities laws.)

In our scenario, we mentioned earlier in our discussion of Section 16 that Momentum purchased a call option before any public disclosure of the funds' efforts to identify a merger partner for Door. Almost certainly, the funds have information that is material, as well as non-public. However, it is not clear that Momentum obtained that information as a result of a violation of any fiduciary or other duty. Residual willingly provided Momentum with information on its plans to find a merger partner, and did not ask Momentum to keep the information confidential and not use it for trading purposes. Momentum thus does not appear to have breached any duty to Residual, although this is an evidentiary issue that could be disputed by a regulator or in court. In reaching a conclusion that no duty was breached, it would be helpful that Residual provided the information to Momentum without violating any internal requirements or policies, or an implied or express confidentiality agreement. In our example, Door did not object to Residual's merger idea, but it did not join the effort. Most importantly, Door did not expressly request that Residual keep Door's reaction to the idea in confidence and not use it for any other purpose. There were no express agreements between Door and Residual. Thus, Door's reaction to Residual's merger idea arguably was not communicated to Momentum in breach of duty.

By relying on this analysis in executing its trades, Momentum would be taking some risk. As is often the case in the context of insider trading, some arguments might support an insider trading claim. Depending on the details, one could argue that Residual had an implied duty to Door to keep Door's lack of express opposition to the merger efforts in confidence, although it might be difficult for that argument to succeed even if Door were to support the position. One could also argue that, by not requiring Momentum to enter into an express confidentiality/no-trading agreement, the Residual officials who spoke to Momentum breached a duty to Residual's own investors. Such an argument might posit that Momentum's purchase of the call option might have effectively helped to increase the stock price, making a merger — Residual's objective — more difficult to achieve. Of course, Residual could respond that, if it had required confidentiality and a no-trading agreement, Momentum would have been reluctant to cooperate, and that Momentum's cooperation was valuable to Residual and its investors. In addition, even if Residual's officers could be deemed to have breached a duty to Residual's investors, anyone seeking to hold Momentum liable for insider trading would still need to show that Momentum had known (or should have known) of the Residual officers' breach of duty — including that the

Residual officers had received some type of personal benefit for the breach.

In advising our clients, we consistently recommend a conservative approach when it comes to insider trading issues. That is because the mere public announcement of even an informal SEC investigation could significantly negatively impact a fund. A conservative approach means not engaging in any trades even if there are reasonable arguments that information is not material and/or that no duty has been breached. In addition to business reputational issues, the risks include SEC enforcement, which can include injunctions, fines and other penalties, such as disgorgement. The Department of Justice could pursue criminal charges against the fund or individuals.

If a trade occurs privately with an identified buyer rather than on the public markets, there is an opportunity to enter into a "big boy" letter. That is a letter signed by the buyer in which the buyer represents that it knows that the seller might have material, non-public information that it is not sharing with the buyer and waives any right to pursue a claim based on it. These letters can be helpful as a practical matter, as they reduce the likelihood that a buyer will bring a lawsuit or complain to regulators, or even possibly that a buyer will succeed in court. However, such waivers of rights under the federal securities laws are not enforceable as a matter of law, so that the letter could not technically be used as a defense in court or in a regulatory action.

There are a few other potential traps to keep in mind. First, the insider trading laws of other countries differ from ours, and some of them more simply proscribe trading on material, non-public information, without regard to whether a breach of duty has occurred. The European Union's Market Abuse Regulation (the "MAR"), for example, prohibits trading on material, non-public information as long as the trader knows or has reason to know that the information is non-public. The MAR applies not only to trading within the EU, but also to any securities that are listed for trading on an EU market. Thus, for example, if a stock is cross-listed in the United States and the EU, the MAR applies even to transactions on the U.S. exchange. Under the MAR, Momentum's purchases of Door common stock likely would amount to illegal conduct. Accordingly, it is important to assess whether other jurisdictions are implicated in the trading, and what laws might apply in those jurisdictions. In the Residual/Momentum scenario, all transactions take place in the United States, and Door's stock is not cross-listed on any non-U.S. exchange, so the laws of any other jurisdiction should not be implicated.

State laws within the United States must also be considered, because they also do not necessarily have the breach-of-duty condition that the federal securities laws require.

Finally, even under federal law in the United States, the rules governing insider trading are more stringent in the tender offer context than in the non-tender-offer situation described above. The SEC's Rule 14e-3 provides that, if any person has taken "a substantial step or steps" to commence a tender offer (or has already commenced a tender offer), Section 14 of the Exchange Act prohibits any other person who has material, non-public information relating to that tender offer to buy or sell the potential target's securities if such person knows or has reason to know that the information is non-public and has acquired it directly or indirectly from someone associated with either the potential offeror or the potential target. Unlike in the non-tender-offer context, no breach of duty or other type of deception is required. Assume, for example, that Door had commenced initial conversations with a potential merger partner, that the potential partner had begun discussions with banks about financing a tender offer and had hired an attorney who put together deal scenarios that included a friendly tender offer and that Residual had learned this information and conveyed it to Momentum. In this situation, the SEC could take the position that Rule 14e-3 was triggered. The more stringent rules would apply to Momentum and to Residual even if they had not introduced the potential merger partner to Door.

Hart-Scott-Rodino ("HSR")

Certain investments in both public and private companies can also trigger HSR filing requirements and the accompanying waiting period (typically 30 days) that must be observed prior to acquiring voting shares. If the fund's overall investment in voting stock and other assets exceeds $119.5 million effective March 6, 2024, (subject to annual increases) or more (or if it later crosses that threshold based on aggregate holdings in the issuer), the fund may trigger the HSR filing and waiting period requirement.

The passive investor exemption is not available for holdings of 10% or more of the issuer's voting stock. An exemption is sometimes available to "passive investors" that beneficially own 10% or less of the company's voting securities. The "passive investor" test in the HSR context is not the same as the passive investor threshold for filing on Schedule 13G discussed above, but the tests are substantially similar. An investor that does no more than simply hold shares for investment purposes may rely on the exception, but any activities beyond that — other than merely casting routine votes — could invite scrutiny. As a practical matter, an investor that is filing on Schedule 13D will have a difficult time justifying "passive investor" status for HSR purposes. A fund that holds more than 10% of a company's voting securities cannot rely on the passive investor exception under the HSR rules, even if the investment is in fact purely passive. If the position increases as a result of a company buy back plan or some other event over which it had no control, the HSR filing requirement may not automatically be triggered. But, any acquisition of additional shares — even a single share — potentially may trigger the filing requirement and necessitate at least a review of the potential filing requirements. Penalties for violating the filing requirement can be severe and regularly approach and exceed $1 million. In one recent case, the FTC brought an enforcement action against an investment manager that acquired less than 10% of the shares of Yahoo. The manager relied on the passive investor exemption but had filed on Schedule 13D, based, among other things, on efforts to communicate with the company and other shareholders about recommended changes to senior management and the board.

In our Momentum/Residual illustrative example, both funds own less than 10% of Door's outstanding shares, and accordingly, both potentially could rely on the passive investor exemption — depending on their investment intent. There is no "group" aggregating for HSR purposes as there is for Section 13(d) and Section 16 purposes. Residual has clearly engaged in sufficient activity to put the validity of its reliance on the exemption into question. Momentum, on the other hand, is not likely to lose the exemption provided it does not respond to Residual's initial entreaties to coordinate efforts. Just as in the Section 13(d) context, if it did not respond to Residual but spoke with potential merger partners to test out the idea as a matter of diligence, it arguably should not lose the exemption to the extent a regulator or court agreed with Momentum's explanation of the facts. Once Momentum did increase its involvement beyond merely listening to Residual (e.g., by looking for a merger partner without expressly agreeing to help Residual) however, it would find itself in similar circumstances. The FTC likely would take the position that a filing obligation has been triggered, even if neither fund has yet filed on Schedule 13D. (Among other things, each fund would have up to 10 days after the triggering event to file the Schedule 13D). In that case, the required filing would need to be made with the FTC and DOJ, and the 30-day HSR waiting period would need to be observed before shares valued above the reporting threshold in the aggregate could be acquired.

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Chapter 2:
Insider Trading: Focus on Subtle and Complex Issues

the Supreme Court vacated and remanded the judgment on a separate issue (whether the non-public information that underlay the conviction was the government's "property" for purposes of the statute). When the case returned to the Second Circuit in 2022, the Supreme Court's ruling on the "property" issue required overturning the conviction on that ground. Nevertheless, two of the three judges on the panel wrote a separate "concurrence" to criticize the first panel's original holding that insider-trading liability can be established under § 1348 without proof that the tipper had received a personal benefit and that the tippee had known about it. Those two judges objected to the "asymmetry" between liability under the securities laws and liability under § 1348. This "concurrence" could cause prosecutors and courts to think harder about whether § 1348 can be used to avoid some of the difficult issues of proof under the securities laws.

Tender Offers

There is one other exception in the U.S. where the law does essentially require parity of information between the buyer and seller, and that is in the context of a tender offer. The SEC's Rule 14e-3 provides that, if any person has taken "a substantial step or steps" to commence a tender offer (or has already commenced a tender offer), Section 14 of the Exchange Act prohibits any other person who has material, non public information relating to that tender offer to buy or sell the potential target's securities if such person knows or has reason to know that the information is non-public and has acquired it directly or indirectly from someone associated with either the potential offer or the potential target. Assume, for example, that a fund manager has learned indirectly about a potential merger. Assume also that a potential merger partner had begun discussions with banks about financing a tender offer and had hired an attorney who put together deal scenarios that included a friendly tender offer. The manager may have liability under Rule 14e-3 after trading on the information, or, at least, the SEC may take such a position, even if the manager traded on the information without any breach of duty.

Certain state laws could also create liability (at least in enforcement actions, rather than private damages suits) for trading based on MNPI even without a breach of duty. Some state Attorneys General have used state laws (such as the Martin Act in New York) to threaten enforcement actions based on general principles of unfairness where parity of information did not exist.

Laws Outside the U.S.

Beware if your transaction has contacts with jurisdictions outside the United States. The insider trading laws of other countries differ from ours, and, as noted above, some of them more simply proscribe trading on MNPI, without regard to whether a breach of duty has occurred. The European Union's Market Abuse Regulation (the "MAR"), for example, prohibits trading on material, non-public information as long as the trader knows or has reason to know that the information is non-public. The MAR applies not only to trading within the EU, but also to any securities that are listed for trading on an EU market. Thus, for example, if a stock is cross-listed in the United States and the EU, the MAR applies even to transactions on the U.S. exchange. While the MAR does not yet appear to have been enforced as to U.S. trading of a cross-listed security, you do not want to be the poster child for a first-ever enforcement action.

What Is "Material?"

Analysis of materiality is complex in part because there are multiple approaches, all of which should be considered. The first approach is to consider the rather open-ended language contained in the opinions of federal courts. The Supreme Court has stated that materiality depends on whether there is a substantial likelihood that a reasonable shareholder would consider the information important in deciding whether to buy, sell or hold the securities. The information need not be dispositive — i.e., the investment decision need not turn on it. But it needs to be something a reasonable investor would consider significant. An alternative formulation is whether the reasonable investor would have viewed the information as having significantly altered the "total mix" of information made available. These are thoughtful and logical formulations, but often unhelpful in solving difficult problems. And the Supreme Court has repeatedly refused to draw bright lines, because it considers materiality to be fact-specific.

Second, there is a balancing test for uncertain future events. The Supreme Court has held that materiality depends on a balance of the indicated probability that the event will occur and the anticipated

when news about the adverse news about the solar panel producers is disclosed, the information about the solar-panel producers would appear to have been material to the turbine-blade producers. Moreover, the SEC takes the position that awareness of MNPI suffices to establish its use, so the fund manager who has MNPI might not succeed in contending he or she relied on other information in making the trading decision and did not "use" the MNPI.

The "Mosaic Theory" — When Immaterial Facts Complete a Puzzle

The "mosaic theory" is the view that collecting individual pieces of immaterial non-public information cannot violate the laws against insider trading, even if those pieces of information effectively add up to material insight into trading decisions. Indeed, by definition, if the information in question is not material, then there can be no insider trading liability. The problem in implementing this theory is being certain that the information in question is not material.

The "mosaic theory" has some logic, but the SEC has not endorsed it in the context of insider trading. It has adopted it in a related area of the law: Regulation FD. Regulation FD prohibits public companies from selectively disclosing MNPI to analysts and investors. In adopting Regulation FD, the SEC stated that "an issuer is not prohibited from disclosing a non-material piece of information to an analyst, even if, unbeknownst to the issuer, that piece helps the analyst complete a "mosaic" of information that, taken together, is material."

Let's consider an example that illustrates the "mosaic theory" as well as how issues of materiality can be intertwined with the other elements of insider trading, such as whether the information is non-public. Assume that it is public knowledge that significant tariffs will be imposed on the importation of specialized rubber that is not currently available in the United States. A fund manager has invested equity in a public company that manufactures Zamboni machines that groom the ice at skating rinks. It is public knowledge that the specialized rubber in question is often used in Zamboni tires, as it results in superior performance. A fund employee calls an acquaintance who works as a salesman at the public company and learns that the company in fact uses the rubber to manufacture its tires. The manager shorts the common stock of the company, anticipating a price drop when the increased price of the rubber causes an increase in manufacturing costs and a decrease in revenue and profit. Did the fund manager violate the federal insider trading laws (especially if the shorts prove profitable)?

Is confirmation that the company uses the rubber in question "non-public," given that it is known that some manufacturers use the rubber in their tires because it improves performance? Assume also that the company in question is only one of four manufacturers of ice clearing machines in the world and that it produces the most high-end, and most expensive, models. The probability that the company uses the rubber is therefore high. On the other hand, the company's oral confirmation to the manager removes any uncertainty and changes the information from speculative to certain. Thus, the only non public information is the final confirmation from the company. A conclusion that the information is already "public" would appear to be clearer if the manufacturer provides the information on the tire ingredients to anybody who calls its customer service number.

Even if the information were non-public, is it material? The nature of the ingredients that the company uses to make its tires is arguably immaterial in isolation. The information provided trading insight only when coupled with the high probability that the company uses the rubber in question and the already public news about the proposed tariffs. On the other hand, one could argue that the oral confirmation about the composition of that particular company's tires became material in light of the news about anticipated tariffs.

While it is not the focus on this sub-section, there may also be arguments that there was no breach of duty or misappropriation when the company employee confirmed the identity of the rubber to the fund manager, depending on the facts and circumstances. Indeed, as noted above, Regulation FD does not preclude a company from disclosing *immaterial* information even if, unbeknownst to the employee, it completes a "mosaic" that provides material trading insight. Also, Regulation FD does not apply to all employees but only to senior officials or persons who regularly communicate with investors or the press. If the employee in question was both unaware of the materiality of the information and outside the scope of Regulation FD (i.e., was not a senior official or a

person who regularly communicates with investors or the press), there would seem not to have been any breach of Regulation FD.

We advise clients not to rely on the "mosaic theory" except where non-materiality is clear-cut. The SEC has not formally endorsed the theory in the context of insider trading, and it relies on determinations of "materiality" that are subject to after-the-fact second guessing. Some of the "expert network" firms have purported to rely on this approach by collecting non-material information that could, in the aggregate, provide useful investment guidance. The SEC has focused on a handful of these firms in the course of insider trading investigations.

Is the Information "Public"?

The analysis of whether information is "public" or "non public" in some cases determines whether a manager can trade on material information. For example, assume that a technology company, perhaps accidentally, makes available select elements of a new product in background materials prepared for an industry conference. The information is included in the conference materials that are provided to participants to review later; it is not part of the actual presentation at the conference. An institutional investor that specializes in this area of technology discovers the information in the background materials but doubts that many other investors have noticed it. The information is clearly in the public domain, but is it really "public" for purposes of the federal insider trading laws?

Just as there is no absolute rule requiring parity of information between buyer and seller, there is no rule requiring that the dissemination of material information has actually reached both buyer and seller at the time of a trade. The focus instead is the degree or manner to which the information has become available to the trading market and the amount of time the market has had to absorb it.

In the context of Regulation FD, the SEC has identified two prongs to the analysis of this question, mainly focusing on what information is "non-public." Of course, what is "public" for purposes of insider trading is not necessarily "public" for Regulation FD purposes, and vice versa. For purposes of the insider trading laws, the information need only be sufficiently publicly available to avoid being considered "non public," while under Regulation FD, the information must be publicly disclosed "in a manner reasonably designed to provide broad, non exclusionary distribution of the information to the public." Further, under Regulation FD, the bar should be a higher one because the company is in control of the manner in which it releases the information, and the policy objective is to ensure that every investor has a fair opportunity to access the information.

Nonetheless, as a benchmark, it is useful to understand what is "public" for purposes of Regulation FD. If information is sufficiently available for these purposes, it should normally also be for insider trading purposes. For Regulation FD purposes, a filing on a Form 8-K is always enough, normally coupled with a press release. If a conference is webcast with open access, a statement made at the conference should be "public" if there was adequate advance notice of the conference. Unconfirmed market rumors are not enough because rumors are not the same as confirmed information, nor are social media posts sufficient unless investors have a reasonable expectation and practice of finding material information in the location where the posts are made. For example, the SEC has stated that a company's posting of financial information on Facebook should suffice if the company has provided notice that it will post such information in that location and investors actually expect to find it there and, in practice, do find it there.

Depending on the manner of dissemination, the SEC might also focus on whether the information has had time to reach the marketplace.

We now return to the example summarized above, where new product information was included in the background materials for the conference. The information arguably is "public." However, a plaintiff or regulator may contend that the unexpected inclusion of the product information among the conference materials does not render the information immediately "public," absent the passage of time. Such conference materials are often viewed only later by conference participants to learn more about a specific subject. On the other hand, some participants, like the manager in our example, will be motivated to review the materials expeditiously. Moreover, the materials may be available only to the conference attendees rather than the public at large (unless the company later posts them on its website), and the conference site is not an official governmental site nor a site that

necessarily sees a lot of "traffic." With the passage of time, however, the information should become more clearly "public."

Extinguishing MNPI

Sometimes fund managers obtain information that they don't want to have. For example, it is not as unusual as one would think for a manager to obtain information by receiving an accidental email from a public company or statement by a company officer, or the company may have deliberately communicated to the manager information about a potential debt offering, hoping the investor will participate. We are often asked how to "cleanse" the information, meaning how to reverse the fact that the fund has the information.

If a manager obtains MNPI, it is frozen from trading. There are two ways to cleanse the information: (1) the company can publicly disclose the information, and/or (2) the information could become stale. If the issuer discloses the information (or the portion of the information that it views as material), then the manager's knowledge might be cleansed (although the fund itself needs to be comfortable that the issuer has disclosed all MNPI, regardless of what the issuer thinks). Information can become stale because the company disclosed it in the ordinary course or because sufficient time has elapsed to make the information out of date (although factual questions could arise about whether old information is or is not still material). For example, if the manager received a preview of quarterly earnings before the quarterly earnings conference, the information is cleansed once the company holds its quarterly earnings conference.

"Big Boy" Letters

If a trade occurs privately with an identified buyer rather than on the public markets, there is an opportunity to enter into a "Big Boy" letter. That is a letter signed by the buyer in which the buyer acknowledges that the seller may have material non public information that it is not sharing with the buyer, and the buyer waives any right to pursue a claim based on it, as well as any assertion of detrimental reliance on the non-disclosure. These letters can be helpful as a practical matter, as they reduce the likelihood that a buyer will decide to bring a lawsuit or complain to regulators. However, waivers of rights under the federal securities laws are not enforceable as a matter of law, so the general waiver of claims may not be available for use as a defense in court or in a regulatory or criminal action. Section 29(a) of the Exchange Act states that "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of the [Exchange Act] or of any rule or regulation thereunder. . . shall be void." Moreover, the government is not a party to a "Big Boy" letter, so it would not be contractually bound by the letter in any event.

Elements of the letter, however, might provide a defense to a traditional insider trading fraud claim, because "deception" and "reliance" are both elements of such a claim. The disclosure of the possibility of having material non-public information can undermine a claim of "deception," and the non reliance language would tend to undermine "reliance." The strength of these arguments is less than clear, depending on the circumstances, and some state laws might have exceptions for situations where one party has "peculiar knowledge" unavailable to the other party.

Nevertheless, a "Big Boy" letter, where it is possible to obtain one, can be helpful even if it does not eliminate risk. As a practical matter, we believe that it is more likely to be helpful in the context of civil litigation than it is in a regulatory or criminal matter.

Now It Gets Complicated: An Illustrative Scenario

We now focus on specific problems and challenges that fund managers confront with frequency. In doing so, we will run through a factual scenario involving fictional entities.

The Scenario

Assume that Emerging Growth, LLC has a 9% equity stake in Unicorn Pharmaceuticals, a small public company listed on NASDAQ. Unicorn's most promising drug in development is Cressacilin. In developing Cressacilin, Unicorn is using a new advanced-technology process called "Incubus," which is faster and more efficient than previously used methods.

Emerging Growth uses a software developer for its own trading and compliance software, called SoftDevCo. A representative from SoftDevCo was working in Emerging Growth's offices and was chatting with one of the fund manager's employees. The SoftDevCo representative mentioned that she

had heard rumors in the industry that Incubus has some defects and that some drug developers have already had to suspend development while they consider whether to give the software developer more time to fix it or whether to abandon the new process.

The representative did not have specifics. Emerging Growth isn't sure whether Unicorn is using Incubus but believes it likely that Incubus is the only software option at this point for the new development process and that Unicorn is therefore using it, too. Emerging Growth also cannot be sure of the accuracy of the information the representative has provided, as it was qualified as "rumor," and the representative lacked specifics.

Despite the uncertainties, Emerging Growth would like to sell (or sell short) Unicorn to hedge against the risk that Unicorn will be forced to suspend development of its principal drug. Can Emerging Growth sell Unicorn's stock?

Materiality

There can be no insider trading unless (among other things) the information about the Incubus software problem is material to Unicorn. One could posit that the information about the software defect is immaterial to Unicorn. The information does not relate directly to Unicorn; the information was merely "rumor;" and, if the rumor is accurate, Emerging Growth is not sure whether Unicorn is using Incubus. Under this analysis, using the "mosaic theory," Emerging Growth could take the position that it has simply combined new non material information with already public material information about the drugs under development at Unicorn.

But this is where the "mosaic theory" often begins to fall apart. If the information about the software defect is correct, and if it applies to Unicorn because Unicorn in fact uses the same software as the other companies subject to the rumor, is the information really immaterial? In hindsight, let's assume the information is correct, and the defect proves catastrophic to Unicorn, whose stock price plummets. In hindsight, the information will appear material (especially because Emerging Growth has perhaps made a lot of money — or avoided substantial losses — by selling or shorting Unicorn's stock), and arguments could be made along those lines. As noted above, information about a future event can be discounted by the probability of its occurring. In this case, the future event is that Unicorn will be forced to suspend development because it uses the defective software, and there is substantial uncertainty as to both the reliability of the information and its applicability to Unicorn. However, even discounted by uncertainty that the information is relevant to Unicorn, the magnitude of the contingent event (if it occurs) would be enormous because the drug in question is critical to Unicorn's success, so there would be arguments that the information is material. While the arguments in favor of materiality may not prevail, the outcome would be less than certain.

Is the Information Non-Public?

If the information about the potential difficulties with the software is in the public domain, it may be sufficiently public to eliminate any insider trading risk. The information need not necessarily be widely disseminated. It need only be sufficiently in the public domain under all the circumstances such that it is no longer considered "non-public." The information about the software defect may be sufficiently public if it has been reported, for example, in the trade press. Let's assume it has not been reported as "hard news," but the same rumors that Emerging Growth heard from its software developer have been reflected in the online trade press and/or blog posts. That might not suffice to make the information public, since unconfirmed speculation is not the same as the hard facts.

Breach of Duty/Misappropriation

In order for there to be insider trading, there has to be a breach of duty to the issuer or a breach of duty to the source of the MNPI under the "misappropriation theory."

Was there a breach of duty? Emerging Growth did not obtain the information about the software defect from Unicorn, but rather from a third party. That means that the fund manager did not receive it as a result of a breach of fiduciary duty at the issuer of the equity (Unicorn), the first basis for insider trading liability. An officer of Unicorn was not involved, so no one at Unicorn breached his or her fiduciary duty in providing the information to Emerging Growth.

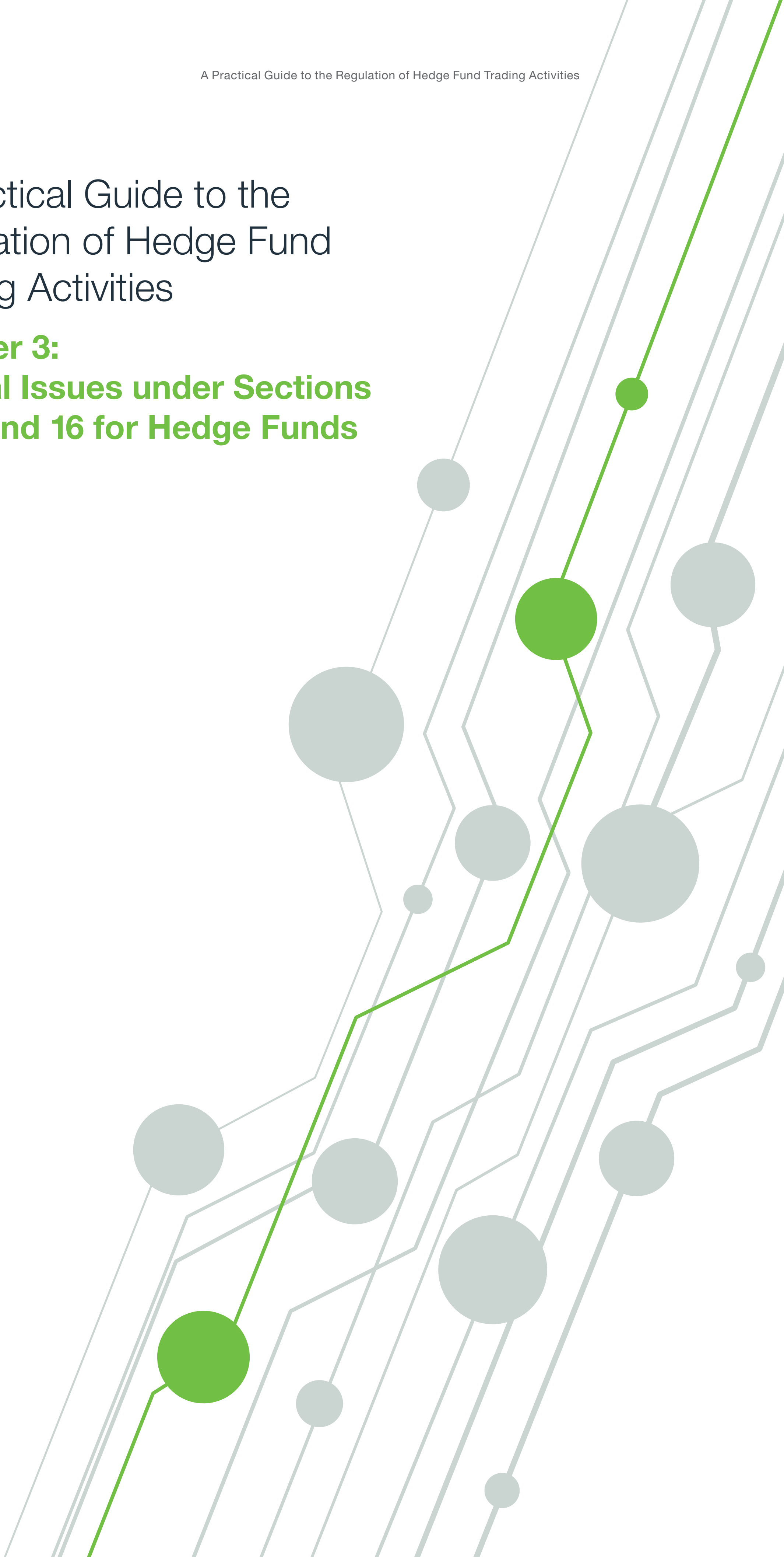
The only possible basis for Emerging Growth's potential liability is the "misappropriation theory" — a potential breach of duty to the source of the information (SoftDevCo).

as to compliance with the federal securities laws. In advising our clients, we consistently recommend a conservative approach when it comes to insider trading issues.

The mere public announcement of even an informal SEC investigation could have a significant negative impact on a fund and its manager. A conservative approach means not engaging in any trades even if there are reasonable arguments that information is not material and/or that no duty has been breached. In addition to business reputational issues, the risks include SEC enforcement, which can include injunctions, fines and other penalties, such as disgorgement. The Department of Justice could pursue criminal charges against the fund manager or specific individuals. We want our clients to know the defenses to claims of insider trading, but, more importantly, we want them to have a basic understanding of the law so as to be able to avoid being in a position where they need defenses. Once a client needs defenses, the larger game — the ability to engage in business with a sterling reputation — might already be lost.

Proskauer» A Practical Guide to the Regulation of Hedge Fund Trading Activities

Chapter 3: Special Issues under Sections 13(d) and 16 for Hedge Funds



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Chapter 3: Special Issues under Sections 13(d) and 16 for Hedge Funds

The filing requirements and liability provisions under Sections 13(d) and 16 of the Exchange Act continue to challenge hedge funds, due to sometimes opaque law and complex trading patterns. Effective in 2024, the SEC shortened the deadlines for filings under Section 13(d) and have conducted enforcement "sweeps" focusing on late and improper filings, so this is a good time to get up-to-speed on the requirements. An enforcement sweep is an enforcement case brought against multiple unrelated defendants based on similar violations of the same set of rules.

Although the requirements under Sections 13(d) and 16 differ, they are also inter-connected. In this chapter, we trace through various scenarios to illustrate recurring issues, discussing in each case both sets of requirements. We discuss them together, because in our experience that is how real-world issues tend to materialize and are resolved.

In Chapter 1, available here [link], we summarized the basics of Sections 13(d) and 16. We will not repeat that summary here, but will instead focus on recurring issues (and solutions) that we see from our clients. We also highlight important legal developments.

In brief summary, Section 13(d) is triggered when a person acquires beneficial ownership of more than 5% of the voting equity of a company that is registered under Section 12 of the Exchange Act (generally, but not exclusively, a company whose equity is listed on an exchange). Such a person must publicly file information that includes the person's aggregate beneficial ownership on a Schedule 13G or 13D (for these purposes, "person" includes both individuals and legal entities such as partnerships, LLCs, and corporations).

Section 16 is triggered when a person acquires beneficial ownership of more than 10% of an issuer's outstanding voting equity that is registered under Section 12 of the Exchange Act. Such a person must publicly file a very brief statement disclosing the person's overall beneficial ownership of any class of the issuer's equity securities (Form 3), followed by reports of any actual or deemedpurchases or sales of equity securities following the filing of Form 3. If any non-exempt purchase and sale (or sale and purchase) within a six-month period resultsin a "profit" (as calculated under the SEC's rules), this profit must be disgorged to the issuer. Although issuers generally do not actively pursue such claims, a private bar of "Section 16(b) plaintiffs" actively monitor filings on Forms 3 and 4, and may pursue the matter, incentivized by the promise of a cut in any recovery owed to the issuer.

The scope of both Section 13(d) and Section 16 may cover a person whose holdings and those of its affiliates do not by themselves exceed the 5% or 10% thresholds. That can occur if the investor is part of a Section 13(d) "group," which is deemed to have acquired beneficial ownership of all of its members' equity in the aggregate (or, in some cases, that is deemed to be a "director-by-deputization" through a representative serving on the issuer's board of directors).

in our scenario that Opportune Investments has reported its TechCo holdings on Schedule 13G based on its “passive” investor status. A “passive” investor is essentially an investor that does not actively seek to influence the issuer on operational or strategic matters. What if the CEO of TechCo reaches out to John Smith to gauge his reaction to a new business plan? What if Smith reaches out to the CEO to discuss a new possible business strategy or leadership changes? Would either of those events result in the loss of “passive” status and compel disclosure on Schedule 13D? In isolation, neither scenario would necessarily require the loss of “passive” status. These questions also are addressed more fully in Chapter 1, but we note that, while a reporting person relying on the “passive” filer exemption to file on Schedule 13G has more latitude to avoid unwanted disclosures, it too can face difficult disclosure and other questions on the requirement to convert to a Schedule 13D based on engagement with the issuer on operational or corporate strategy.

“Grandfathered” 13G Filings

However, there is a method for remaining on a Schedule 13G that does not depend on the reporting persons’ control intent or status as a “passive” investor. If the reporting persons qualify for the “grandfathered” 13G approach to reporting, they may remain on Schedule 13G even if they are not passive. In other words, Opportune Investments could actively engage with the issuer’s management or even have one or more board representatives and remain on

the short-form schedule. However, in order to qualify for the “grandfathered” 13G, the reporting persons must generally have acquired their shares before

the company became public and not have acquired 2% or more of the outstanding shares in any rolling 12-month period. The 12-month period may reach back to the period before the IPO, when the number of shares outstanding is typically a smaller number.

Assume that Fund A acquired its shares two years before TechCo’s IPO, and that, while it purchased shares in the IPO, those purchases represented only 1% of the total number of shares outstanding (using the specific methods for calculating percentages under these provisions). Fund A, along with Adviser and GP, could file a “grandfathered” 13G until such time that it has acquired 2% or more in any rolling 12-month period, regardless of their control intent or any representation Adviser may have on TechCo’s board. The calculations here can be tricky, so discuss them with counsel.

Practice Point: Before initially filing a Schedule 13G or 13D, first analyze whether the reporting persons qualify for a “grandfathered” 13G, which will limit the scope of future reporting. If so, continue to monitor for acquisitions of beneficial ownership within a 12- month period, using as the denominator in that calculation the number of shares outstanding 12 months prior to the acquisition of additional beneficial ownership.

RIA Exemption

Some fund advisers rely on an exemption for registered investment advisers to remain on Schedule 13G. This “RIA exemption” requires that the reporting person remain “passive” and that it acquired the securities in the ordinary course of business. The exemption permits the adviser to file on a Schedule 13G rather than a Schedule 13D, and to follow a more lenient schedule for filings and amendments. In most cases, filing persons are not required to make an initial filing until 45 days after the end of the calendar quarter following their exceeding the 5% ownership threshold, and then only if they still beneficially owned more than 5% as of the end of the current quarter.

What makes this exemption less useful than it appears on its face is that it is available only to the adviser itself. While the SEC has not directly addressed this issue, market practice is that the exemption is not available to an advised fund that by itself owns at least 5% or files as a member of a 31(d) group, or for affiliates of the adviser, such as a general partner. If the adviser is not affiliated with the advised fund (e.g., the adviser is sub-advising a fund sponsored by another adviser), this should not be an issue, since the unaffiliated third party that controls the fund’s investments will be responsible for the fund’s filing obligations (if any), and the adviser can use the exemption for its own filings. In our scenario, it would make sense for Adviser to use the RIA exemption in calculating its beneficial ownership of the shares held by Fund C, since Fund C (as compared to Funds A and B) is sponsored and managed by an unaffiliated third party, and

the sponsor of Fund C will presumably make an independent filing for purposes of Section 13(d) if Fund C holds more than 5% of the issuer's shares. But if the adviser is under common control with the fund, such that the adviser and the fund would normally make a joint filing, the exemption may be of little use under current practice. The funds and GP cannot use the exemption, so that they would have to file Schedule 13G on a different legal basis (or a Schedule 13D) within 5 business days after acquiring beneficial ownership of more than 5%. In this scenario, it normally makes sense for the adviser to join that earlier filing made in the 5-day period, in order to avoid having to make a second filing (for the adviser alone) after the end of the quarter.

Limiting the Scope of Reporting Under Section 16

If a person is subject to Section 13(d) and Section 16, then there are appropriate ways to limit the scope of the reported securities, thereby limiting the likelihood that transactions in those securities will have to be reported on Form 4, or, in the case of Section 16(b), subject the reporting persons to short-swing liability.

As compared to the rule governing whether a person is subject to Section 16 in the first instance, the rules on which securities and transactions must be reported are not based solely on voting or investment power, but rather include an economic, or "pecuniary," interest component. While there is no practical way to implement a "blocker" to preclude pecuniary interest, there are exemptions from pecuniary interest. For these purposes, the principal exemption provides that an entity lacks pecuniary interest based solely on a performance fee governed by net capital gains and/or net capital appreciation generated from the portfolio or from the fiduciary's overall performance over a period of one year or more, where the issuer's securities account for no more than 10% of the market value of the portfolio.

In our scenario, for example, assume that Adviser is entitled to a standard management fee and performance fee from Fund C, which meet the exemption's criteria. Assume also that the security in question is TechCo common stock, and that TechCo holdings represent only 4% of the market value of the portfolio. Adviser and the other filing persons would not have to report Fund C's TechCo holdings or Fund C's transactions in those holdings. Accordingly, such transactions could not be the basis for short swing liability under Section 16(b).

If the reporting persons had another economic interest in Fund C, other than the performance and management fee, they would still have to report the TechCo common stock based on that other interest. As a practical matter, the economic relationship between the adviser and an affiliated fund is often broader than a management and performance fee, such that the exemption may frequently not be available.

Practice Point: If you are managing a fund that was sponsored and is otherwise controlled by a third party, consider structuring the management and performance fees to avoid reporting and liability under Section 16 by limiting the performance periods to one year or greater and otherwise complying with the requirements of the exemption.

"Group" Status: How to Avoid it

A Section 13(d) group's shares are aggregated for the purpose of determining whether its members have crossed the 5% threshold under Section 13(d) and the 10% threshold under Section 16.

Thus, for example, in our scenario outlined above, assume that Fund A holds 4% of the outstanding shares of TechCo, and therefore, by itself, is not subject to either regulatory regime. However, if Opportune Investments enters into an agreement with an unaffiliated second fund to influence the operations or corporate strategy of TechCo, then the unaffiliated fund's shares are aggregated with Fund A's shares in determining whether the thresholds have been crossed. If the other fund holds 2% of the outstanding shares, both would be subject to Section 13(d) and would have to file on Schedule 13D or 13G. If the other fund held 7% of the outstanding, both would become subject to Section 16 as well because they would hold in excess of 10% together. It is, accordingly, a focus of many funds that are not "activist" funds to avoid communications with other investors that may result in the formation of a "group."

As addressed in more detail in Chapter 1, whether or not funds have crossed the line between "group" and "non-group" can be a difficult determination. The test under SEC rules is not specific. It is when "two or more persons agree to act together for the purpose

of acquiring, holding, voting or disposing of equity securities of an issuer." Because the test is based on facts and circumstances, it is not surprising that although there is clarity at each end of the spectrum between group and non-group, there are degrees of uncertainty in the middle. For example, there clearly is a "group" if one fund manager agrees with another fund manager to advocate with management for a change in corporate strategy. On the other hand, there clearly is not a "group" if one fund manager simply tells another investor how it intends to change an issuer's corporate strategy, without receiving any kind of commitment in return. Everything in between is a gray area.

In its most recent rule amendment proposals, the SEC had proposed to amend its rules to clarify that concerted action alone could be sufficient to establish a 13(d) group. The SEC backed off that part of its proposals but the proposal nonetheless at least in some degree reflects its interpretation of existing rules.

Practice Point Where practicable, substantive communications with other fund managersr should be prepared with the involvement of counsel.

When "group" status is unclear, there is a middle ground. Some practitioners take the position that they are not part of a group, but then in preparing a Schedule 13D to be conservative provide the disclosure that would be required if there were a group (e.g., aggregate ownership amounts).

Registered investment advisers have a tool available to help avoid becoming subject to Section 16 as a result of "group" status. There is an exemption that can permit the exclusion from the calculation of a group's aggregate holdings shares beneficially owned by a registered investment adviser. In order to qualify, the adviser must be "passive." In addition, the shares must also be "held for the benefit of third parties or in customer or fiduciary accounts in the ordinary course of business." Although the precise meaning of this language is somewhat unclear, conservative practice is to assume that the manager and its affiliates cannot have a direct or indirect equity stake in the advised fund, other than perhaps a de-minimis limited partnership stake. Most standard separately-managed accounts, or "SMAs," should qualify.

Accordingly, in our scenario, it would be prudent to assume that Opportune Investment's TechCo holdings in Fund A must be aggregated with those held by other third-party members of a "group," since Adviser, GP and John Smith have a material equity stake in Fund A. If the shares were instead held in Fund C, the shares likely should not be included in the group calculation, because neither Adviser nor its affiliates have an equity stake in Fund C.

Practice Point: Determine early on whether shares managed by an investment adviser can be excluded from the "group" beneficial ownership calculation.

A hedge fund manager can always team up with other fund managers that do not beneficially own an issuer's shares without the risk of a group being formed, since a group can only be formed with a person that beneficially owns at least one share. In these circumstances, it is important to keep in mind that if a fund manager later does acquire shares, a group would be formed immediately at that point, if the agreement or concerted activity establishing the group remained active. And the fund manager that does beneficially own the issuer's equity may have its own disclosure obligations if it is subject to Section 13(d) or Section 16 on its own, regardless of whether a group is formed.

Practice Point: A person or entity that does not own any voting equity securities of an issuer cannot be a member of a "group" for purposes of Sections 13(d) and 16.

It is also possible to terminate a group through formal action, and the group would end immediately upon the termination of the agreement or understanding forming the group if the substance of the relationship forming the group is also terminated.

Would the individuals who control the GP or Adviser be considered part of the "group"? Any of the individuals who are listed as reporting persons on the filing (or should have been listed) under Section 13(d) likely would also be deemed part of the "group." Any control persons of such reporting persons could also be deemed members of the group, depending on the circumstances.

Using Derivatives: The Benefits and The Traps

The impact of derivatives on Section 13(d) reporting and on Section 16 reporting and liability can at times be a source of confusion. Fund managers are sometimes confused about whether and when derivatives count toward the 5% and 10% beneficial ownership thresholds, if and when reports must be filed, and as of what dates (and times) Section 16(b) liability is assessed.

Cash-Settled Derivatives Normally Don't Count Toward the 5% and 10% Thresholds

Stock-settled derivatives work like options or warrants. If there is a right to acquire stock within 60 days, beneficial ownership over the stock attaches at that point for purposes of the Section 13(d) determination. If the derivatives are effectively out-of-the-money, beneficial ownership would still attach, unless perhaps the derivatives are so out-of-the-money that any right to acquire stock is meaningless, but that is a fact intensive analysis. Any other material impediment or contingency to the right to acquire equity would effectively delay beneficial ownership until that contingency has been resolved. For example, assume that the payment of equity under a derivative instrument was contingent upon a default by a third party on outstanding debt – beneficial ownership would not ordinarily attach until the party had defaulted, or at least until a default appeared reasonably likely.

Cash-settled derivatives normally do not count toward the thresholds under Sections 13(d) and 16. This is because they do not convey any voting or ownership right in actual equity, nor do they involve a contractual right to acquire equity in the future.

In the SEC's 2023 amendments to the rules governing Section 13(d) compliance, the SEC determined not to adopt a proposal to count cash-settled derivatives toward beneficial ownership, absent any agreement or understanding that would provide the investor with a right to acquire equity, or otherwise voting or investment power. An example might be where the investor has an understanding with the counterparty bank that it will sell the shares that the bank owns as a hedge when the cash-settled swap is unwound.

At least in contested situations, such as a contest for corporate control, issuers have sought to demonstrate that an investor that acquired cash-settled derivatives has informal understandings or arrangements with the counterparty banks to vote the equity that they (counterparties), have accumulated to hedge the instruments, and/or perhaps even to deliver such equity upon settlement as a voluntary accommodation to the investor.

Public issuers have also argued, in one notable case with success, that investors using cash- settled instruments have violated the Section 13(d) anti-evasion provision, which prohibits any "plan or scheme" to evade the reporting requirements of that section. If derivatives are used to avoid exceeding the 5% or 10% thresholds, there is a risk that another party will be motivated to make arguments based on this provision. Because the arguments on this subject are entirely factual, we would not expect the SEC to raise the anti-evasion provision absent an objective red flag. However, this would not stop a Section 16(b) plaintiff from making the argument, with or without evidence.

Disclosure of Cash-Settled Swaps

If an issuer is reporting on Schedule 13G, there is no requirement to disclose cash-settled derivative transactions. On Schedule 13D, however, while the derivative transactions do not add to the reporting person's overall level of beneficial ownership, the derivative contracts must be disclosed in the textual disclosure, including, under most circumstances, the material terms. In its 2023 rule amendments, the SEC amended Schedule 13D to clarify that all cash settled derivatives must be disclosed under Item 6 of Schedule 13D.

Practice Point: Cash-settled derivatives generally do not add to beneficial ownership, but avoid any informal understandings with counterparties with respect to the shares the counterparties accumulate to hedge their risk.

Practice Point: Cash-settled derivatives ordinarily have no impact on disclosure in a Schedule 13G. However, derivative instruments must be disclosed in the textual disclosure of Schedule 13D.

Going back to our illustrative scenario, assume that while Opportune Investments is generally a passive investor, it is approached by the manager to another fund, Momentum Advisers, about a portfolio company

that they have in common, DownUnder Products, an Australian issuer whose common stock is listed on the NYSE. DownUnder is a "foreign private issuer," and as such, its insiders are not subject to Section 16. However, DownUnder's stockholders are subject to Section 13(d). Momentum has a 5.1% stake in DownUnder. The issuer has been consistently underperforming the market. Momentum, an activist investor that believes that DownUnder's performance can be improved, has so far failed to convince the company to change its corporate strategy. Accordingly, it hopes to band together with other investors to add pressure for a change in course, and, if necessary, to remove management.

Assume further that John Smith, principal of Opportune, after being contacted by Momentum, meets with its principals and listens to its proposed strategy for DownUnder. Smith does not respond to Momentum, and accordingly the meeting itself should not make Opportune and Momentum part of a "group," nor should it undermine Opportune's "passive" status. However, following the meeting, Opportune decides to start accumulating more shares of DownUnder common stock, and in the following two weeks increases its stake from 3% to 4.7%. At the same time, Opportune enters into cash-settled derivatives to increase its economic exposure to DownUnder to about 6%.

Because Opportune's beneficial ownership does not exceed 5%, and it is not part of a "group" with Momentum, it need not file any reports under Section 13(d). However, the moment that Opportune decided to join in a group with DownUnder, the group would have an aggregate stake of 9.8%, and both fund managers would have to file on Schedule 13D, given the "activist" purpose of the group.

Assume, however, that Opportune does not join with Momentum, but does acquire even more shares of DownUnder common stock, so that its beneficial ownership reaches 5.2%. If Opportune files on Schedule 13G based on its "passive" position, it need not disclose the derivative transactions. But should it file on Schedule 13D instead, even though it has not agreed to act together with Momentum, or otherwise engaged in traditional "activist" activities? The timing of Opportune's rapid accumulation of DownUnder's common stock and acquisition of derivative positions following its meeting with Momentum could be circumstantial evidence that Opportune is acting in concert with Momentum. That is particularly the case if Opportune later votes its shares in favor of a proxy contest or other initiative undertaken by Momentum. Arguably, Opportune may merely be increasing its economic exposure as a good investment in light of the activist activity by Momentum.

The answer would require consideration of all of the facts and circumstances, as well as what future plans Opportune may have. One additional word of caution: If Momentum has not publicly disclosed its intentions (e.g., in an amendment to its 13D), then there could be insider trading issues with Opportune's equity purchases following its meeting with Momentum (see Chapter 2).

The Second Circuit Provided Additional Clarity on How Derivatives Are Treated for Section 16 Reporting and Liability

Unlike for purposes of determining the 5% or 10% thresholds under Sections 13(d) and 16, transactions in both cash-settled and stock-settled derivatives must be reported under Section 16(a) for investors subject to Section 16, and can lead to short-swing liability under Section 16(b). However, determining when to report these transactions, and when liability can attach, can be frustratingly opaque.

In a 2018 decision, *Olagues vs. Perceptive Advisors LLC*, the Second Circuit Court of Appeals decided a case that provided some clarity on Section 16 reporting and liability for derivative transactions.

Most significantly, the Court's decision appears to have been guided by the need for clear, predictable rules for analyzing Section 16 liability in the context of complicated derivative transactions.

The defendant fund manager in *Olagues* purchased put options and wrote call options guaranteed by the Options Clearing Corporation on the common stock of a publicly-traded issuer. As the expiration date of the calls and puts approached, the calls were out of the money. The fund manager allowed the puts, which were in the money, to be automatically exercised under OCC rules, and that exercise brought the fund manager's beneficial ownership below 10%. The calls expired unexercised.

SEC rule 16b-6(d) specifies that the writer of a call option is liable for the premium it pays upon expiration of the option if it is a 10% holder both at the time of writing and the expiration of the call option.

The court clarified several questions involving the application of Section 16 to derivatives transactions. The principal question in the case was whether the fund was still subject to Section 16 as a 10% holder at the time that the calls expired.

The court agreed that the defendants' exercise of the put options immediately decreased their beneficial ownership below 10%, so that they were no longer 10% holders at the moment that the call options expired. The plaintiffs had argued that beneficial ownership did not change as a result of the exercise of the puts until the settlement date.

Practice Point: For purposes of Section 13(d), under ordinary circumstances involving derivatives, beneficial ownership changes as of the trade date and time, not the settlement date.

Chapter 4: . . . But Don't Forget HSR! Key Requirements and Timing Considerations of Hart-Scott-Rodino

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