Proskauer

A Practical Guide to the Regulation of Hedge Fund Trading Activities

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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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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 persons may have which relate to or would result in" the acquisition of additional securities by the fund, an extraordinary corporate transaction, a change in the board of directors, other listed matters and "similar" actions.

For purposes of Item 4 disclosure, a generalized discussion or "brainstorming" about the company and its business strategy is not a "plan." For example, it should not be a "plan" if the fund prepares a slide deck outlining several strategic options that the company might pursue. However, as the fund narrows its strategy to one or two options, it risks the SEC taking the position that there was a "plan." The SEC has taken the position that a strategy need not be definitive in order to trigger a disclosure requirement, at least where the fund has taken steps to implement the plan. The threshold could be even lower if the fund is already reporting on a Schedule 13D. In that case, the SEC focuses on whether the new activities have rendered the existing Item 4 disclosure materially inaccurate or incomplete. If existing disclosure states that the fund is passive, any new discussions internally or with third parties about the company's operations, strategy or control could, in the SEC's view, trigger an amendment requirement on grounds that the fund is no longer "passive." For example, assume that the fund's current disclosure under Item 4 of Schedule 13D provides that the fund holds its shares solely for investment purposes. If the fund has decided to approach the company to discuss strategic options, that could, in the SEC's view, trigger a requirement to amend the disclosure, even if the fund was not pressing any one particular strategic option. The SEC has made clear that the standard boilerplate disclosure that the fund "may" engage in specified activities is not sufficient if the fund has decided to pursue any such activities. That said, the SEC's enforcement decisions are discretionary, and it may well decide not to pursue litigation where the disclosure decisions in question are consistent with market practice.

Proposals

A "proposal" also may trigger disclosure under Item 4 of Schedule 13D. A "proposal" is generally any proposal that is made to the company or to another investor. Discussions with another investor to vet an idea with the other investor should not be viewed as a proposal, but the distinction between "vetting" and making a definitive "proposal" may be subject to varying interpretation.

An SEC enforcement settlement in 2024 highlights the agency's focus on an investor's "control purpose," triggering the requirement to file on a Schedule 13D as opposed to a short-form 13G. At issue was HG Vora Capital Management's 5% interest in a public company, and whether HG Vora had complied with its obligations to supersede its existing filing with a long-form Schedule 13D filing within 10 days after no longer being "passive."

HG Vora filed on a Schedule 13G as of year-end 2021, disclosing it owned 5.6% of the company's stock. However, from January through mid-April 2022, HG Vora nearly doubled its interest to 9.9% of the total outstanding common stock, all held by an affiliated hedge fund that directly owned the shares. The SEC also noted HG Vora's additional economic exposure to the company through swap agreements.

According to the SEC order filed to reflect the settlement, the facts appear to be as follows. HG Vora had apparently considered ways the company could become more efficient, liquidate non-core business assets and develop a more efficient capital structure by issuing debt securities. The development of this view alone did not change HG Vora's status as a passive investor. Then it began conversations with a private-equity firm about providing asset-backed financing to the company — still not a control intent.

When did the firm move from passive to active status? On April 26, 2022, HG Vora "first considered making its own acquisition bid" with financial backing from the private-equity firm. As part of this potential bid, HG Vora "began drafting an offer letter" for all of the company's outstanding common stock. As part of this offer letter, the company included a "'placeholder' offer price of $85 per share." According to the SEC, it was "no later than" this date (May 6) that HG Vora shifted from a passive investor to an activist investor (with Schedule 13D filing obligations (under then -current rules)) within 10 days. It was seven days later, on May 13, when this letter and premium purchase price were transmitted to the public company, that HG Vora filed its Schedule 13D.

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 into specific numbers of shares, so typically each reporting person reports the total number of shares held by the fund, and then disclaims to the extent of its economic interest.

Turning again to our example, assume that over the last several weeks Momentum has been selling down its interest in Door to trim its holdings in light of the poor market performance of the stock. The fund has not, however, sold any shares after agreeing to coordinate efforts with Residual. In fact, at that point, encouraged by its discussions with Residual and hoping its anticipated Schedule 13D filing will be viewed as indicating that Door may be "in play" and boost the stock price, Momentum buys a call option, which is a "purchase" for the purposes of Section 16. Under Section 16, the purchase of an option or any other derivative is considered to be a "purchase" or "sale," depending on the nature of the derivative, even though the underlying common stock has not been acquired or sold, and the later exercise of the option or other derivative is not counted. Because any sales transactions occurred before Momentum became a 10% holder, there are no non-exempt sale transactions to match with the "purchase" resulting from the acquisition of the call option. For liability purposes, Section 16 liability focuses only on the trades that occur while the reporting person is a 10% holder and not on trades that occur beforehand or afterwards.

If Momentum had sold shares after becoming a 10% holder, there would be a recoverable profit as a result of the two matchable trades the sale of common stock and the purchase of the option to the extent that the sale prices exceeded the purchase prices. Liability would be enforced by mostly individual attorneys who make their livelihood in notifying companies of transactions that they believe should result in a "disgorgement" to the company based on Section 16(b). Any payment goes to the company, but the attorney may be entitled to a percentage as an "attorney's fee."

The funds would remain subject to Section 16 until either the "group" has ended, or their aggregate beneficial holdings fall to 10% or below.

It is worth keeping in mind that a fund that is not a 10% holder could nonetheless be subject to Section 16 if a director on the company's board, among other things, represents the fund's interests, even if the fund had not appointed the director. The concept is based on facts and circumstances, but the fund could become a "director by deputization", subject to Section 16.

Insider Trading: Rules 10b-5 and 14e-3

One of the most difficult problems faced by funds is determining whether information is material. In this case, in their first meeting, Residual, as a significant shareholder, informed Momentum that it was looking for a merger partner and that it had met with management, which was not opposed to the effort, though not supportive either. Is that material information that should preclude Momentum from making further trades in Door common stock? The answer depends on all of the circumstances, but, in this case, it is possible that the information could in hindsight be considered material by a regulator or by a court, and it is likely that the SEC would argue in favor of materiality if the public release of the information appears to have actually impacted the stock price. On the one hand, the fact that a holder of 4.9% of Door's outstanding common stock wants the company to merge does not mean that the effort will succeed. Generally, in evaluating the materiality of an event, the importance of the information may be discounted by its probability of materializing. In other words, the materiality of the information that Momentum received from Residual can be discounted by the odds against a merger actually materializing. On the other hand, Door's stock price has been stagnant, and an acquirer could potentially agree to pay a premium to the current trading price, so the markets may well react favorably to the possibility of a merger.

When considering information like the information that Momentum initially received from Door, it is helpful to bear in mind that most of the information belonged to Residual, i.e., its plan to find a merger partner. Only one small subtle piece of information derived from the issuer which is that Door when approached did not expressly reject the idea of a merger. This small, subtle piece of information may be too unclear to be considered, alone, to be material. It is unclear whether, even if material, Momentum's use of this information in making trading decisions would violate the federal securities laws.

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.

Proskauer

A Practical Guide to the Regulation of Hedge Fund Trading Activities

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

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

Many hedge funds routinely face insider trading concerns as they trade equity or debt. Sometimes these issues are fairly obvious, such as where the fund has learned material, non-public information or MNPI directly from the company. Perhaps the company solicited the fund as an investor in a new debt offering and brought the fund manager "over the wall." However, in many cases, insider trading issues are more subtle and complex.

For example, the recent case *SEC v. Panuwat* has been highly publicized because it involves the SEC's first enforcement action against "shadow trading." A corporate officer learned that his company would be acquired by another company, and he promptly purchased options in a third-party company. The third party company was not a competitor or business partner of the officer's company, but *(i)* the two companies allegedly shared a similar market space, *(ii)* market analysts had speculated that the third-party company's stock price could be affected by an acquisition of the target company, *(iii)* the SEC's expert witness also testified that an acquisition of the target could be expected to have a spillover effect on the third-party company's stock price, and *(iv)* the third-party company's stock price did in fact rise by 7.7% when the target's acquisition was announced. The SEC sued the officer on the theory that he had "misappropriated" material, non-public information about the target's impending acquisition from his employer and that the non-public information was material to the third-party company. In April 2024, the SEC prevailed in a jury trial. It is unclear whether the verdict will be appealed.

In this chapter, we summarize the law that applies to insider trading issues, including the practical impact, if any, of the relatively recent court decisions. We then trace through a factual scenario to focus on more complex issues, including:

- **Third-Party Sourcing:** When a fund learns information from a source other than the issuer of the equity or debt in question, such as from a supplier, as noted in the example above;
- **Big Data (a derivative of third-party sourcing):** When fund managers gather information from outside sources rather than directly from a public company to gain insight and inform their investment, using vendors or information generated internally.

For example, "web scraping" or "spidering" refers to the practice of gathering data from websites using software. Big data also includes information from credit and debit card receipts, geolocational data, information from IoT, satellite imagery and information from app developers for cell phones;

- **Mosaic Theory:** When a fund gathers a piece of immaterial information that, when combined with other public information, completes a mosaic that provides material trading insight. For example, assume that one of your employees took a photo of the CEO of a public company walking to his car in the evening wearing an Abu Dhabi baseball cap, thereby perhaps providing some confirmation of market rumor that the company is doing a deal with an oil company in that country;

- **Shadow Trading:** When a person trades the securities of Company B because the person expects its stock price to be affected by material, non-public information about Company A;
- **Hot Potatoes:** Handling non-public information that you possess but don't want to have;
- **"Almost" Public Information:** Material information that is theoretically accessible by the public but is not obvious, such as where an issuer posts the information in an unexpected website location. An example is when, several years ago, the CEO of Netflix posted new growth in monthly online viewing data on his personal Facebook account without having given notice that the market could find this information in that place; and
- **"Big Boy" Letters:** Where the buyer acknowledges that the seller may have MNPI and purports to waive its right to such information.

Today's Insider Trading Laws: Quick Primer

Before we get to more current, complex issues, here is a brief synopsis of the insider trading laws as they stand today.

Bases for Insider Trading Liability

In the United States, with a few exceptions, trading on the basis of material, non-public information does not —without more — violate the law. This distinguishes the United States from other countries such as the UK, where the laws effectively require that buyer and seller have parity of information. In the U.S., there must be fraud, deceit or some other 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 the source of the information even if the source is not an insider (for example, the duty of confidentiality that an employee owes to his or her employer).

"Classical Theory"

The "classical theory" of insider trading involves a breach of fiduciary duty to the issuer and its shareholders. This situation occurs when a company insider provides material, non-public information to an investor without authorization to do so. For example, assume that a vice president for investor relations meets with a personal friend and hints at a down quarter before quarterly earnings have been released, expecting or suspecting that the friend will trade on the information. The friend then trades. The officer clearly breached his fiduciary duty to his company's shareholders by tipping his friend.

"Misappropriation Theory"

The "misappropriation theory" is an alternative basis for insider trading claims. Under this theory, the duty at issue is owed to the source of the non-public information, even if the source is not the corporation or an insider. Thus, no breach of fiduciary duty to the company or its shareholders needs be involved because the person who traded on the information might not have received the information directly or indirectly from a company insider. One well-known case involved R. Foster Winans, 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. Winans leaked information about his articles to a stockbroker and to his roommate prior to publication, and they traded profitably on the news. Mr. Winans' defense to insider trading charges was that he may have violated conflict-of-interest policies at *The Wall Street Journal,* but he had not committed a crime because he had not obtained MNPI from a corporate insider. The Court of Appeals for the Second Circuit upheld his conviction on grounds that he had "misappropriated" information belonging to his employer and that the misappropriation was a sufficient basis for his conviction. (The court speculated, however, that misappropriation might not have occurred if the *Journal* itself had traded on the information because the information belonged to the *Journal* — although the court observed that no self respecting news organization would do such a thing.) The Supreme Court affirmed the conviction under the wire-fraud statute and split 4-4 on the securities-law conviction because the Court had not yet developed the misappropriation theory of insider trading.

The *Panuwat* "shadow trading" case also illustrates how the "misappropriation theory" can play out. In denying Panuwat's pretrial motion for summary judgment, the court held that a jury could find that Panuwat had breached his duty to his employer on both contractual and common-law agency grounds.

Panuwat was bound by his employer's insider-trading policy which specifically prohibited trading the securities of *any* public company based on information learned from his employment. He also was bound by a confidentiality agreement. But in addition, and apart from those agreements, Panuwat had a duty under his employment relationship not to use his employer's non-public information for his personal benefit without telling his employer that he intended to do so. The court therefore concluded that a jury could find that Panuwat misappropriated his employer's confidential business information when he traded on it.

What About All the Fuss About "Pecuniary Interest" in the Headlines A Few Years Ago?

For insider trading prosecutions in the Second Circuit, which includes New York, it temporarily became significantly more difficult for the government to prevail in a criminal insider trading case under the federal securities laws. That is because the Second Circuit, in its 2014 "*Newman*" decision, held that, in proving a breach of duty by a tipper providing the information to a tippee, the government had to prove that the tipper received a tangible personal benefit "of some consequence," such as something of economic or "pecuniary" value — and the tippee could not be held liable for trading on the tip unless he or she knew of the tipper's breach of duty, including the tipper's receipt of the personal benefit. The required "nature" of the personal benefit went to the Supreme Court in 2016 in the "*Salman*" case, and the Supreme Court rejected the "*Newman*" decision "to the extent [it] held that the tipper must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift to family or friends." The *Salman* case thus undermined one aspect of the *Newman* decision.

A subsequent Second Circuit decision in 2018 in the "*Martoma*" case undermined another aspect of *Newman*, which had held that where the personal benefit to the tipper is inferred from the nature of the relationship between the tipper and tippee (as, for example, in a gift-giving situation), "a meaningfully close personal relationship" is required. *Martoma* held that the requisite relationship between the tipper and the tippee can be established through proof "either that the tipper and tippee shared a relationship suggesting a *quid pro quo* or that the tipper gifted confidential information with the intention to benefit the tippee."

The combination of *Salman* and *Martoma* has eased the burden of proof in criminal insider trading cases against tippers and their direct tippees, but neither *Salman* nor *Martoma* undercut what the *Martoma* court called "the central question in *Newman*": A tippee must have *known* (or at least been reckless in not knowing) that there was a breach of fiduciary duty in providing MNPI in exchange for a personal benefit. While this burden might not create a big hurdle in cases involving direct tippees, it could prove insurmountable in cases involving remote tippees.

Tippees at the end of a long chain might have no idea of what happened at the top of that chain between the tipper and the direct tippee. If the government cannot prove the remote tippees' knowledge (or their conscious avoidance of knowledge), the prosecution will fail — as it did on appeal in *Newman*.

More Stringent Laws Might Apply

The Sarbanes-Oxley Act added a new criminal insider trading provision (18 U.S.C. § 1348) that has been applied by a few lower courts to criminal prosecutions without requiring the government to prove some of the elements in a traditional insider trading case, such as knowledge of a personal benefit to the tipper. In one recent case in New York (*United States v. Blaszczak*), the defendants were acquitted of the traditional insider trading charges but convicted under the new law. The new law is modeled after the mail and wire fraud statutes and subjects to criminal prosecution:

> Whoever knowingly executes, or attempts to execute, a scheme or artifice to defraud any person in connection with . . . any security of an issuer with a class of securities registered under section 12 of the [Exchange Act] or to obtain, by means of false or fraudulent pretenses, representations or promises, any money or property in connection with . . . any security of an issuer with a class of securities registered under section 12 of the [Exchange Act] . . . .

It remains to be seen whether appellate courts will agree with the lower court judges' interpretations and whether prosecutors will use the new law more frequently to try to avoid some of the doctrinal constraints under traditional insider trading law.

The *Blaszczak* case illustrates the uncertainty. The Second Circuit, in a split 2-1 decision, affirmed the conviction under the insider-trading statute, but 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 magnitude of the event for the issuer if the event does occur. In other words, the less likely the occurrence, the less likely the materiality. But if the contingent event would be enormously significant to the issuer (for example, a merger), materiality might exist even at a lower level of probability than would be the case for a less-significant event.

Third, there is the quantitative test, expressed as a percentage of assets or revenues. In some respects, the SEC has sanctioned the use of quantitative tests, at least in certain circumstances. For example, the requirement to disclose civil litigation in periodic reports is qualified by an exception where the "amount involved" does not exceed 10% of current assets. Where available, quantitative measures are important factors in many analyses of materiality, often the most important. However, the SEC has made clear that quantitative measures cannot alone determine materiality. For example, assume that a retailer's revenues have dropped 1% for the quarter in a period where sales should have been strong given the overall economic environment. The drop occurred because the company was having inventory problems resulting from its adoption of new inventory software that is dysfunctional. While the 1% drop may not be material to the company in isolation, two related, intangible facts likely are material. First, the fact that sales are declining when they should be increasing. Second, the fact that the company is experiencing inventory problems that may continue into the future. The SEC thus applies qualitative as well as quantitative considerations; it does not necessarily view quantitative results in isolation. Courts also reject quantitative bright lines. For example, the Third Circuit recently held that a jury could rationally view information about only 2% of an issuer's revenues as material for purposes of an insider trading conviction.

Finally, another factor is the anticipated impact on stock price. If the event is anticipated to impact the stock price, that factor suggests materiality. Because markets are not perfect, nor always rational, stock price should not always be a significant factor. We have all heard the warning that materiality is judged in hindsight, meaning that a material change in stock price could create a strong presumption of materiality. Indeed, the SEC enforcement cases focusing on compliance with Regulation FD some years ago did pay a lot of attention to stock price movements.

Because materiality is so fact-specific and is viewed in hindsight, after the trading has produced a profit or avoided a loss, we often counsel our clients to avoid making trading decisions based on the conclusion that specific non-public information is not material. In some cases, the information might objectively be viewed as immaterial, but an objective interpretation is not always possible, and we frequently cannot help but feel that, if our clients are so interested in the information that they are asking us about it, then they themselves might consider the information to be material.

Shadow Trading

As noted at the beginning of this article in the discussion of the recent case of SEC v. Panuwat, shadow trading is where a person trades the securities of Company B because the person expects that Company B's stock price will be affected by material, non-public information about Company A. Assume, for example, that a fund learns from one of its consultants that companies that produce solar panels are having a down quarter due to developments and trends that logically should impact sales of other renewable energy products. Can the fund short the common stock of a portfolio company that produces the blades for wind turbines that generate electricity? The analysis could focus on at least two issues.

First, can the fund properly use information obtained from its consultant when making trading decisions? Without breach of a legal duty to refrain from using the information for one's personal benefit or for other than specified purposes, there can be no liability for insider trading. The analysis often depends on factors such as the terms of any agreements between the manager and its consultant or whether the manager had reason to believe the consultant was breaching a duty to third parties (such as the solar-panel producers) in providing the information to the manager.

Second, is the information about makers of solar panels material to a producer of wind-turbines blades, or is the connection is too speculative or attenuated to be considered material? If the fund does trade, the fact pattern might suggest that it believed the information material, unless the manager relied on other information as well in making its trading decision. And, as always, materiality can be judged in hindsight, so, if the blade producer's stock price falls 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).

- The manager did not "misappropriate" the information either, in the traditional sense of the word. The SoftDevCo representative willingly provided the information to Emerging Growth — let's assume the representative hoped to give Emerging Growth a heads-up as a major investor in Unicorn and to retain its goodwill. However, there could be counterarguments, depending on the details and nuances. While it seems like a stretch, it would not be unsurprising to hear a regulator argue that while SoftDevCo shared the information with Emerging Growth as a "friendly heads-up," it expected Emerging Growth to hold it in confidence, or, at least, it did not intend that Emerging Growth would use the information for any specific purpose (e.g., trading Unicorn's equity). This argument seems inconsistent with the fact that the information was "rumor," something rarely shared in confidence, and with the fact that the representative was trying to be helpful to Emerging Growth. Nonetheless, if the information had been provided in express or implied confidence, one could argue that Emerging Growth's use of the information to trade shares of Unicorn for its own benefit amounts to a misappropriation of SoftDevCo's information because Emerging Growth breached a potential duty of confidence owed to SoftDevCo. We are not saying that we expect that the SEC or DOJ would take this position, but, in past cases, those agencies have taken the position that a duty of confidentiality was implied from the circumstances and past practice and that such duty of confidence restricted use of the information.

Some of these same issues are reflected in fund managers' use of "Big Data" to make trading decisions, although the analysis is more complex. "Big Data" also involves obtaining information about an issuer from third parties (or at least from outside sources, such as the Internet) rather than from the issuer itself. We elaborate on that subject below.

Cleansing MNPI

What if Emerging Growth, decides not to trade on the basis of the rumor about the software defect and instead wishes it had never received the information in the first place? In other words, possessing the information could preclude the fund manager from ordinary-course trading decisions, such as perhaps acquiring additional shares of Unicorn when the price dips with an overall market decline. The options for cleansing information, and their relative merits, depend on the facts and circumstances in each case.

In this case, several ways might be available to cleanse the information. Emerging Growth could obtain confirmation that the rumor about Incubus's defect is false, or Emerging Growth could confirm that Unicorn does not use Incubus, or Unicorn or some other company that uses Incubus might disclose the problem with Incubus and its potential impact on product development, or Emerging Growth could wait for the information to become stale in some other way. Perhaps Emerging Growth could approach Unicorn in hopes that Unicorn would confirm that the information is false, or investigate the question. Perhaps one of the other issuers that are experiencing problems with Incubus could disclose the information, but even if it identified such issuers, Emerging Growth lacks control over their disclosure practices. The problem with waiting for information to become stale is that it is hard to predict when that time will arrive. It could occur in the short term, such as if the Incubus software developer expressly denies the rumors, or it could take longer, such as when an issuer that uses Incubus discloses problems with the software or alternatively discloses the timely success of its product.

Big Data: More Information from Third-Party Sources

"Big Data" refers to the efforts to refine and analyze data available from sources other than the issuer of the equity in question to assist in investment decisions. As noted above, this is a unique application of the analysis where an investor receives potentially material information from third parties, rather than from the issuer, either by buying the data from a vendor or generating and analyzing it in-house. Sources of data may include e-commerce receipts and credit-card transaction data, geolocational data, satellite images, sensors from internet-connected machines or smart devices, data from cell phone apps and online data collected via "screen scraping" (or "web scraping" or "spidering").

Assume, for example, that Emerging Growth has also invested in a public company named Small Business Loans, Inc., which (unsurprisingly) makes loans to small businesses. Emerging Growth engages a "Big Data" firm, BD Enterprises, which gathers information from a variety of sources to gain a better understanding of trends in small-business practices for raising capital. BD Enterprises in turn uses a combination of all of the sources noted above in gathering and analyzing data for Emerging Growth.

Let's assume that Emerging Growth uses the data and analyses it receives from BD Enterprises in deciding to increase its investment in Small Business Loans, as well as in other companies involved in the same industry. Six months later, Emerging Growth sees solid capital gains and takes some profits.

Is Emerging Growth taking any risk in using the analyses provided by BD Enterprises to buy common stock in Small Business Loans and related businesses? As in the example above, where Emerging Growth obtained information relevant to Unicorn from a vendor, this isn't a classic breach of fiduciary duty case because the information did not come from the issuers of the equity being purchased. No officer or director of an issuer provided the information to BD Enterprises. Here as well, the only possible basis for insider trading liability is the "misappropriation theory." Since Emerging Growth obtained the information through a legitimate commercial relationship with BD Enterprises, it would not seem to have misappropriated anything — at least on initial consideration.

There is a risk, however, and it derives not from the relationship between Emerging Growth and BD Enterprises, but from how BD Enterprises gathered the information. The law in this area is still developing, but, in theory, BD Enterprises could be found to have misappropriated the data upon which Emerging Growth relied.

How can Emerging Growth be exposed to liability in these circumstances? Let's focus on "web scraping," as an example. Assume that BD Enterprises "scraped" relevant data from the website of an online business that provided relatively small but quick revolving loans to small businesses. This business model is different from Small Business Loan's model, but the business is similar, and the client base is comparable. The "scraped" data tends to show that clients of the online business are taking out fewer loans, but that loans are growing in size, suggesting growth in Small Business Loan's business involving larger, stand-alone loans.

The online business's website has several paragraphs of "terms of use," which could limit use of the website to the business's own marketing and sales. Many websites have terms that preclude "web scraping," such as the following craigslist term:

> USE: You agree not to use or provide software (except for general purpose web browsers and email clients, or software expressly licensed by us) or services that interact or interoperate with CL, e.g., for downloading, uploading, posting, flagging, emailing, search or mobile use. Robots, spiders, scripts, scrapers, crawlers, etc. are prohibited, as are misleading, unsolicited, unlawful and/or spam postings/email. You agree not to collect users' personal and/or contact information ("PI").

It is unclear whether a given website will enforce such a term, or at this point, whether a court will view it as being enforceable, or whether violation of this term of use would be sufficient to amount to a "misappropriation" for insider trading purposes. There are weighty policy issues involved, including the open nature of the Internet, as well as proprietary, privacy and property rights. Nonetheless, although we are not aware of an insider trading case against a Big Data vendor or its client, one could imagine an argument that BD Enterprises somehow deceived the online business's website when it entered the website under the guise of a legitimate business purpose but then proceeded to scrape the site in violation of the "terms of use." If BD Enterprises did misappropriate information from the website, and if Emerging Growth knew or was reckless in not knowing about BD Enterprise's misappropriation, then Emerging Growth could theoretically be held liable by trading on MNPI obtained from the online business through BD Enterprise's breach of duty.

Other "terms of use" could also be relevant. In addition, there is a laundry list of possible legal violations, each of which may (or may not) form the basis of a "misappropriation". These include, for example, violations of copyright laws, the Computer Fraud and Abuse Act, privacy laws and/or common-law conversion or trespass.

Does it insulate the fund manager from liability if it engages a third party to gather the data, so that any legal violations are committed by the vendor? It might help but may not prove a solid firewall, for a variety of legal and practical reasons that are beyond the scope of this chapter. For insider trading purposes, however, the fund manager might not be insulated if it knows or is reckless in not knowing about the vendor's misappropriation. Any fund manager or other potential trader that wishes to obtain trading information from a third-party vendor should therefore engage in appropriate due diligence before hiring the vendor and in monitoring the vendor's activities.

In April of last year, craigslist obtained a $60.5 million judgment against a real-estate listings site that had allegedly received scraped craigslist data from an independent vendor. In addition, craigslist reached a $31 million settlement and stipulated judgment with Instamotor, an online and app-based used-car listing service, over claims that Instamotor had scraped craigslist content to create listings on its own service and sent unsolicited emails to craigslist users for promotional purposes.

We recommend that investors ensure that agreements with vendors include appropriate representations and other terms, and that they conduct due diligence, asking the following types of questions:

- Who is the vendor? Is it credible, established, respected?
- What are the vendor's data sources?
- Where is the data coming from, government or private sources?
- What is the nature of the data? What techniques does the vendor use?
- Personal identifying information ("PII")? Child PII? Sensitive Information?
- Any MNPI or other "confidential" information? (Spot-check!)
- Is the vendor collecting the same data for anybody else?
- Has there been any litigation involving the vendor or its sources?
- How does the vendor provide the data? Is the vendor a collector, packager, analyzer, aggregator?
- Does the vendor have the right to provide the data to you? Consider requesting documentation and indemnity.
- If using drones, does the vendor employ or contract with drone operators possessing proper commercial licenses acting in compliance with state and federal laws and NTIA best practices?
- Does the vendor have adequate insurance?

Does the Vendor spider? If so:

- Do the targeted websites have restrictive "terms of use?" Does the vendor check regularly?
- Does the vendor use technology to simulate the creation of any user accounts?
- Does the vendor circumvent any "captchas" or similar technologies?
- Does the vendor respect the "robots.txt" parameters?
- Does the vendor identify its "User-Agent" in the site logs?
- How does the vendor structure IP addresses for spidering?
- Does the vendor throttle/pause/alternate times to simulate human interaction?

"Big Boy" Letters

Assume that Emerging Growth instead decides to sell some of its common stock in Unicorn after hearing the rumor about the Incubus software defect. Emerging Growth finds a single buyer for a block representing 2% of the outstanding common stock of Unicorn. Because Emerging Growth may have material, non public information about the development software (and is also a 9% equity holder in Unicorn), it asks the buyer to execute a "Big Boy" letter that waives any claims and disclaims reliance on the omission of any material, non-public information. For the reasons discussed above, the waiver of claims may not have any definitive protective effect. However, it may have some protective properties, and it could dissuade the buyer from pursuing legal action.

Concluding Thoughts

The scenarios described above, even with their variations, present complex issues under the federal insider trading laws. While we describe these issues to help fund managers to better identify and understand the insider trading questions that they face routinely, we do not intend to suggest that any fund trade where there is any material uncertainty 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 this Chapter, we address the following questions, among others:

- How can an investor structure an investment to avoid acquisition of a level of "beneficial ownership" that subjects the investor to Section 13(d) and/or Section 16?
- If subject to Section 13(d) or Section 16, how can an investor structure an investment or its engagement with the issuer or with other investors to limit the scope of the transactions that it must report (and thereby also limit its exposure to liability)?
- How to avoid exceeding 5% or 10% beneficial ownership as a "group" (where one investor's beneficial ownership can be aggregated with that of others)?

When does an investor become a beneficial owner of securities through derivatives, what types of derivatives are reportable, and can derivatives help an investor increase its economic exposure to an issuer without corresponding disclosure?

The Illustrative Scenario

In considering these requirements, we will be tracing through the following scenario:

"Adviser" is a registered investment adviser with Opportune Investments, and serves as fund manager to Fund A, Fund B, and Fund C. Adviser is an LLC with nine managing members. The general partner of Fund A and Fund B is GP. GP is also an LLC, and is controlled by five managing members (for purposes of this chapter, we refer to the managing members of each of the Adviser and GP as their "board"). Three members serve on both boards. The Adviser was founded by John Smith, who serves on the boards of both Adviser and GP. Mr. Smith has a direct economic interest in Funds A and B, but Fund C is owned entirely by third parties. Adviser receives a management and performance fee (in the form of an incentive allocation or carried interest) from Funds A, B, and C. GP's principals have limited partnership interests in Funds A and B, but not Fund C. In our illustrative scenario, GP has delegated voting and investment authority to Adviser.

The funds are generally "passive" investors, meaning that, while representatives of Adviser talk to management from time-to-time, neither the Adviser nor the GP ever have a representative on the board of directors of Opportune Investments' portfolio companies, nor do they ordinarily try to influence business operations or corporate strategy.

Legitimate Steps to Avoid Beneficial Ownership

Avoiding beneficial ownership, and reporting obligations under Sections 13(d) and 16 has significant benefits. So long as an investor's level of beneficial ownership of the issuer's equity securities remains below the threshold triggers, the investor can be "activist" without reporting obligations under those sections.

Practice Point: An investor that avoids triggering the reporting thresholds under Sections 13(d) and 16 can engage in activist activities without corresponding reporting obligations, but beware of inadvertently forming a "group," as discussed more fully below.

The Section 13(d) beneficial ownership definition applies in determining both whether a person is subject to Section 13(d), and files on Schedule 13G or 13D, as well as whether it is subject to Section 16 (if the person is not otherwise subject to Section 16, including as an officer, director, or a "director-by- deputization"). Thus, any individual or entity that has direct or indirect voting or investment power over more than 5% of a voting equity security, or will have such power within 60 days, must file on Schedule 13D or 13G. If such beneficial ownership exceeds 10%, that person would also be subject to Section 16.

A person that wishes to avoid becoming subject to Section 13(d) or 16 could potentially effectively "block" beneficial ownership through a variety of methods, most typically "contractual blockers" and "board blockers." We also address the use of derivatives.

Contractual Blockers

The most common method for blocking beneficial ownership is to use a contractual restriction that precludes the person from voting or exercising investment power over the issuer's equity securities within 60 days. These types of restrictions have been blessed by the SEC, although there are nuanced considerations as to their effectiveness. A very common approach is to include language in the relevant agreement to block the exercise of warrants or the conversion of convertible securities if the exercise or conversion would result in greater than 5% or 10% beneficial ownership. Another approach is for one entity to delegate to another entity the investment and voting authority over the securities, terminable only upon 61-days' notice.

Contractual blockers have one thing in common: They rely in the rule that a right to voting or investment power more days in the future does not confer beneficial ownership. One caveat to that rule is that a person who acquires securities "with the purpose or effect of changing or influencing the control of the issuer" is deemed to acquire beneficial ownership immediately regardless of any delay in acquiring investment or voting power. In our scenario, for example, assume that Fund A acquired 4% of the outstanding shares of TechCo, Inc., a publicly-traded company listed on Nasdaq. It also acquired warrants to purchase an additional 2% of TechCo's shares. While the warrants are out-of- the-money, they are exercisable immediately.

Referring once more to our illustrative example: In negotiating the warrants, Fund A ensured that the warrant agreement contained a "blocker" that precluded any exercise to the extent that it would result in Fund A becoming beneficial owner of more than 4.9% of the outstanding voting equity securities of the issuer.

If properly drafted, this type of approach should be effective. The fact that the warrants are out-of-the-money is not relevant to the beneficial ownership analysis. However, if Fund A is not a passive investor and is seeking to control the issuer, it could be deemed to have beneficial ownership of the shares underlying the warrant, notwithstanding the blocker provision.

The effectiveness of this approach can become less clear, however, if investors are affiliated with the issuer. Assume, for example, that Adviser has appointed two representatives to the TechCo board of directors, out of nine total directors. In this scenario, does Adviser have indirect control over its own blocker? In other words, if Adviser wanted to escape the restrictions of the blocker, could it influence TechCo to amend or terminate the agreement? The answer would depend on all of the facts and circumstances. While we expect that there is market practice implementing blockers in these circumstances, it is helpful to understand and be sensitive to the potential vulnerability in structuring the terms. The SEC or a court may be reluctant to respect a blocker provision that the holder could indirectly amend or waive.

Practice Point: Contractual blockers have one thing in common: They rely in the rule that a right to voting or investment power more days in the future does not confer beneficial ownership. One exception to the 60-day rule is that a person who acquires securities "with the purpose or effect of changing or influencing the control of the issuer" is deemed to acquire beneficial ownership immediately regardless of any delay in acquiring investment or voting power. Accordingly, a contractual blocker may not be effective in those circumstances.

Delegating Investment or Voting Power to Third Party

The "affiliate" concern is normally most prominent when the fund manager and general partner are under common control, and the latter imposes a "blocker" by delegating its investment and voting power to the fund manager, terminable only upon 61-days' notice. Even if the general partner has delegated its voting and investment authority to the fund manager, it arguably could have some ability to change or eliminate the terms of the delegation if the GP and the manager are under common control. In our scenario, GP may seek to ensure that the manager has full voting and investment discretion, and that the relationship cannot be modified or terminated except upon 61-days' notice. That arrangement, however, could be questioned, as GP and Adviser have overlapping boards of directors, and are arguably both influenced by John Smith.

Practice Point: If a blocker has been negotiated between two entities that have elements of common control, consider mitigating related concerns when the terms of the arrangement are negotiated, such as by requiring the consent of an independent third party to materially amend the blocker terms.

At least for purposes of liability under Section 16(b), there is case law suggesting that even if a fund manager and its general partner successfully delegate voting and investment power to a third-party investment manager, they will nonetheless remain subject to liability based on trades executed at the direction of the third-party manager. That is the case even though, for purposes of Section 13(d), the general partner would not necessarily be considered to be a beneficial owner required to report on Schedule 13D or 13G.

Board Blockers

In the absence of a "blocker," the individuals who ultimately control the general partner and/or fund manager would normally be reporting persons on a Schedule 13D or 13G, in addition to the entities comprising the general partner and the adviser. In our example outlined above, the GP is controlled by a five- member board, and it may want to avoid having each individual listed as a reporting person on the Schedule 13D or 13G. Having individuals included as reporting persons on the filing can have substantive consequences, as discussed in more detail below.

Some fund managers take the position that if ultimate control is shared by three or more individuals, none have beneficial ownership because no single individual can direct voting or investment decisions without the concurrence of at least one other individual. This "rule of 3's" is no longer relied upon by many fund managers, after the staff of the SEC cast doubt on the approach without formally addressing it. But the approach can be more confidently applied in some circumstances. For example, if the board has 20 members with equal voting power, it would seem reasonable to take the position that no one member individually has voting or investment authority. In other words, while reliance on the "rule of 3's" may carry some risk, on a board of 20 or more the ability of a single director to have material influence is extremely diluted. There is not a magic number (e.g., we made up 20 members for our example).

The point is that, in our view, the bigger the board, the less risky it should be to rely on the approach suggested by the weakened "rule of 3's."

In some cases, one or two board members will have a disproportionate amount of influence, even if their voting authority on paper is the same as other members. In that case, it may be factually supportable to name only one or two members of the board, without any need to refer to the "rule of 3's." In our case, John Smith is the founder, and likely has significant influence on the boards of Adviser and GP. It may be prudent to include Smith as a reporting person for purposes of Section 13(d) and Section 16, even if the other board members are excluded based on the overall size of the board.

Indeed, Smith's disproportionate level of influence on the board could help to justify excluding his fellow board members as having beneficial ownership and as filing persons.

Practice Point: The strength of any reliance on a "board blocker" is based in the facts and circumstances, so focus should be on the facts, which may include the size of the board, how many votes each member has or whether a member has a veto rights, as well as how much de- facto influence each member has.

Effects of Naming Individuals on Schedule 13D or 13G

Are there really benefits to avoiding inclusion of individual insiders as reporting persons on Schedule 13G or 13D? There may or may not be benefits. If the individual is filing on Schedule 13G, which has little disclosure, it would not seem to matter, other than as to whether the individual is exposed to theoretical liability for any material misrepresentations in the filing, or for timing and other procedural errors.

If the person is, or may in the future, file on Schedule 13D, there can be substantive benefits to excluding an individual as a reporting person. Item 4 of Schedule 13D requires that each reporting person disclose any "plans or proposals" that he or she has with respect to the issuer. Thus, if an individual is reporting on a Schedule 13D, any interaction that he or she has with the issuer could raise a question as to whether those activities must be disclosed in an amendment. However, even if an individual is not a reporting person on the filing, the same information likely will have to be disclosed. First, any plans formed by the individuals that control the entities that are filing persons may need to be disclosed as plans formed on behalf of those entities. And second, an instruction to Schedule 13D states that when a reporting person is an entity, most of the same information required to be disclosed with respect to that entity must also be disclosed with respect to its control persons, including the beneficial ownership of securities by those control persons, or any material "plans and proposals" with respect to the issuer covered by Item 4.

The most consistently significant benefit of concluding that an individual need not be included as a filing person on a Schedule 13G or 13D is that it could serve as a predicate for a position that the person need not file reports under Section 16, if the overall level of aggregate beneficial ownership exceeds 10%. Because the same definition of beneficial ownership applies to both Sections 13(d) and 16 for purposes of determining who is required to file under either provision, once a person becomes a reporting person under Section 13(d), that person by definition becomes subject to Section 16 once the reporting entity with which the individual is affiliated becomes subject to that section. And if a person is subject to the reporting requirements of Section 16(a), he or she is also subject to short-swing liability requirements of Section 16(b).

Referring to our illustrative scenario, assume that Fund A acquired another 2% of the common stock of TechCo, raising Fund A's overall beneficial ownership to 6%. Because Opportune Investments is passive, Fund A, GP and Adviser would file on short-form Schedule 13G. If it is unlikely that Opportune Investment's passive status would change or that it would become subject to Section 16, and if there are only a handful of members, it might make sense conservatively to include all of the board members of both GP and Adviser as reporting persons on the Schedule, as there is little apparent downside. A less conservative approach would be to include Smith as the only reporting individual, on the basis of his disproportionate influence over both boards. In either scenario, Fund A, GP, and Adviser would generally each be a reporting person.

Derivatives

Cash-settled derivatives can be used to gain economic exposure to a security without acquiring beneficial ownership, and thereby avoid triggering reporting obligations under Sections 13(d) and/or 16, if structured properly. Of course, once subject to Section 16, derivative transactions, even if cash-settled, must be reported, and can result in short-swing liability. The Second Circuit Court of Appeals has provided additional clarity on the sometimes complex relationship between derivative transactions and beneficial ownership, as well as when a purchase and sale is deemed to occur for liability purposes. We address this topic more fully below, under "Using Derivatives: The Benefits and Traps."

Limiting the Scope of Transactions Reported

If a person is subject to reporting under Section 13(d), there are approaches that can help that person report on short-form Schedule 13G and avoid the more extensive disclosure (and updating requirements) of Schedule 13D. In addition, for a person subject to Section 16, there are approaches that can limit the scope of the shares reported.

Benefits of Short-Form Schedule 13G

As reviewed in more detail in Chapter 1, most non-activist funds try to stay on Schedule 13G because of its limited disclosure and (in some circumstances) more lenient filing deadlines or triggers. In particular, as noted above, Schedule 13D (unlike Schedule 13G) requires disclosure of a reporting person's "plans" or "proposals" with respect to the issuer, and this disclosure requirement can be a constant source of subtle and complex questions as to whether and when an amendment is required. In some cases, the requirement would appear to call for disclosure of a transaction before the parties ideally would want to make such disclosure.

Assume, for example, that Opportune Investments has reported the TechCo holdings held by Fund A and Fund B on Schedule 13G. What if Adviser decides to sell the entire position, and starts calling potential buyers? What if Adviser instructs its broker to sell all of the shares at a particular price? These actions would generally not require an amendment to Schedule 13G. But if the investor has filed a Schedule 13D, it would be a more difficult analysis. These questions are addressed more fully in Chapter 1, but for our purposes here it is sufficient to recognize that a reporting person on a Schedule 13D can face difficult disclosure questions when its plans with respect to the issuer change.

However, even if reporting persons have filed on Schedule 13G, they still need to monitor their plans and proposals with respect to the issuer. Assume 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

Proskauer