Proskauer

Proskauer Hedge Fund Trading Guide

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

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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.

In **Chapter 3: Special Issues under Sections 13(d) and 16 for Hedge Funds**, we summarize the SEC's recent Section 13(d) amendments — the most significant amendments to these rules in decades — and dive deeper into reporting and liability issues under these Sections of the Exchange Act from the straightforward recurrent issues, traps for the unwary and new developments for hedge funds.

Chapter 1: When Passive Investors Drift into Activist Status

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

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

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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**, 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 deemed purchases 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 results in 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 managers should be prepared with the involvement of counsel.

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

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

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

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

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

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

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

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

Using Derivatives: The Benefits and The Traps

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

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

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

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

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

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

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

Disclosure of Cash-Settled Swaps

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

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

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

Going back to our illustrative scenario, assume that while Opportune Investments is generally a passive investor, it is approached by the manager to another fund, Momentum Advisers, about a portfolio company that they have in common, DownUnder Products, an Australian issuer whose common stock is listed on the NYSE. DownUnder is a “foreign private issuer,” and as such, its insiders are not subject to Section 16. However, DownUnder’s stockholders are subject to Section 13(d). Momentum has a 5.1% stake in DownUnder. The issuer has been consistently underperforming the market. Momentum, an activist investor that believes that DownUnder’s performance can be improved, has so far failed to convince the company to change its corporate strategy. Accordingly, it hopes to band together with other investors to add pressure for a change in course, and, if necessary, to remove management.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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