Proskauer

A Practical Guide to the Regulation of Hedge Fund Trading Activities

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

Executive Summary

The trading activities of hedge funds raise a number of complex issues under the federal securities laws. Proskauer's **Practical Guide to the Regulation of Hedge Fund Trading Activities** offers a concise, easy-to-read overview of the trading issues and questions we commonly encounter when advising hedge funds and their managers. It is written not only for lawyers, but also for investment professionals, support staff and others interested in gaining a quick understanding of the recurring trading issues we tackle for clients, along with the solutions and analyses we have developed over our decades-long representation of hedge funds and their managers.

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

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A Practical Guide to the Regulation of Hedge Fund Trading Activities

Chapter 1:
When Passive Investors Drift into Activist Status

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Chapter 1:
When Passive Investors Drift into Activist Status

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

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

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

Scenario

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

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 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 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, and other listed matters, as well as other "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 is already reporting on a Schedule 13D. In that case, in the SEC's view, any new discussions internally or with third parties about the company could compel disclosure if they reflect that the existing disclosure under Item 4 is materially outdated. 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 likely would, 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.

Getting back to our example, assume that Momentum, Adviser, GP and John Smith had previously filed a joint report on Schedule 13G because their beneficial ownership of Door's common stock exceeded 5% of the outstanding shares. 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.

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, it would not necessarily take an express agreement to change that result, as an agreement could be inferred, such as from parallel actions following the meeting. 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, or as Momentum adopting an independent activist role. Of course, Momentum might merely be researching the viability of Residual's strategy by seeing if there could be interest in a merger, which would not necessarily reflect an agreement. Clearly, however, if there is an agreement between Momentum and Residual it would reflect a control intent, since any efforts to influence management to engage in a merger or other extraordinary corporate transaction would, in the SEC's view, amount to a classic control intent.

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." On their joint Schedule 13G, Momentum and its affiliates responded by checking the box to disclaim "group" status, which is common. (Even if they have arguably reached an agreement or understanding, 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. 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 Momentum and Residual agree to coordinate in looking for potential buyers for Door. Agreement upon a joint plan to seek acquirers for Door would trigger the requirement to file a Schedule 13D. Momentum, which is currently reporting on a Schedule 13G, will have 10 days 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. Although they could file a joint Schedule 13D, Momentum and Residual normally would each make its own filing, disclosing combined beneficial ownership in addition to its individual ownership levels.

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 alone does not 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 may have violated conflict of interest policies at The Wall Street Journal, but he had not committed a crime. The Supreme Court 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.

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 nor did it join the effort. Most importantly, Door did not expressly request that Residual keep Door's reaction to the idea in confidence. 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 may 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 may have effectively helped to increase the stock price, making a merger – Residual's objective – more difficult to achieve. Of course, Residual may 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 may 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")

Investments in public (and private) companies can also trigger HSR filing requirements, and the accompanying waiting period (typically 30 days) that must be observed prior to purchasing shares. If the fund's overall investment in equity and other assets is $84.4 million (subject to annual increases) or more (or if it later crosses that threshold based on its aggregate holdings in the issuer), then the fund may trigger the HSR filing requirement.

Passive investor exemption not available for holdings of 10% or more of an 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 – though it is not inconceivable. A fund that holds more than 10% of a company's voting securities cannot rely on the passive investor exception, even if the investment is 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 is not automatically 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 applicable rules.

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 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 so long as 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 should not lose the exemption so long as 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 could 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 waiting period would need to be observed before additional shares could be acquired. There is also an avenue to shorten the required waiting period by up to about two weeks if the FTC or DOJ has completed its review of the acquisition.

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

In the next chapter, we dive deeper into the law of insider trading as it applies the to hedge fund trading, including updates in case law and SEC enforcement perspectives.

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A Practical Guide to the Regulation of Hedge Fund Trading Activities

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

Authors: Frank Zarb and Jonathan Richman

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 equity offering and brought the fund "over the wall," meaning that the information is embargoed until the offering is public. However, in many cases, insider trading issues are more subtle and complex. 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 mills that generate electricity?

In this chapter, we summarize the law that applies to insider trading issues, including the practical impact, if any, of the relatively recent and widely-publicized Supreme Court and Second Circuit 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 sources rather than directly from a public company to gain insight; to inform their investment, using vendors or generated/analyzed 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, 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 and 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;
- 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. It is usually applied where the information came from a source other than the company. In other words, no breach of fiduciary duty to the company or its shareholders is involved, because the person who traded on the information did not receive 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.)

What About All the Fuss in the Press About Insider Trading and Frustrated Prosecutors?

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 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 probably 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 that has been applied by a few lower courts to criminal prosecutions without the government having 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, 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 the appellate court 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.

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 offeror or the potential target. Assume, for example, that a fund 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 fund 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 fund traded on the information without any breach of duty.

Further, 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"?

One of the most difficult problems faced by funds is determining whether information is material. At the far end of the spectrum the analysis is easy. Learning the company's dress code is immaterial. Getting advance information on quarterly earnings is material. For some reason, the information in question is nearly always somewhere in between.

Analysis of materiality is confusing 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 nonpublic 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.

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 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 principal 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 fund 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. If the shorts prove profitable, did the fund violate the federal insider trading laws?

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 fund 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 material 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, though, 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, depending on the facts and circumstances. Indeed, as noted above, Regulation FD provides for a company to disclose immaterial information even if, unbeknownst to the employee, it completes a "mosaic" that provides material trading insight.

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 fund 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 have 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 fund 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 funds obtain information that they don't want to have. For example, it is not as unusual as one would think for a fund 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 fund information about a potential equity 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 fund 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 fund'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 fund 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 funds 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's portfolio managers. The SoftDevCo representative mentioned that she had heard rumor 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 short Unicorn to hedge against the risk that Unicorn will be forced to suspend development of its principal drug. Can Emerging Growth short 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 in any event. 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 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 would 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 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, and accordingly did not breach 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 fund 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 are counterarguments. One is that SoftDevCo shared the information with Emerging Growth as a "friendly heads-up," but 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 seems somewhat 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 were 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 expect that the SEC or DOJ may take this view, depending on the accuracy of the "rumor" and how widespread it had become. 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. Another question is whether Emerging Growth was a "tippee" of the information, subject to tippee liability. That could be the case if SoftDevCo received the information about the software defect as a result of a breach of duty or misappropriation. However, given that Emerging Growth was not aware of any such breach (according to this hypothetical), it should not be subject to tippee liability.

Some of these same issues are reflected in funds' 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.

Extinguishing MNPI

What if Emerging Growth, deciding not to trade on the basis of the rumor about the software defect, instead wishes it had never received the information in the first place? In other words, possessing the information could inhibit the fund 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 extinguishing information, and their relative merits, depend on the facts and circumstances in each case.

In this case, several ways might be available to extinguish 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, 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 in order 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 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

Because it is difficult to execute a short sale in a private transaction, let's 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 funds 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.

That is because the mere public announcement of even an informal SEC investigation could have a significant negative impact on 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. We want our clients to know the defenses to claims of insider trading, but, more important, 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.

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

In the next chapter, we 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.

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. Although the requirements under these provisions 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, 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 all of the issuer's equity securities (Form 3), followed by reports of any actual or deemed purchases or sales of equity securities. 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. Vigilant "Section 16(b) plaintiffs" 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" that acquires 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 around 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 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? (Just this past August, the Second Circuit clarified the application of Section 16 to derivatives).

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 adviser 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 the 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 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.

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.

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, note that 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 of the derivative security could indirectly amend or waive.

Delegating Investment or Voting Power to Third Party

The "affiliate" concern is normally most prominent when the adviser and general partner are under common control, and the latter imposes a "blocker" by delegating its investment and voting power to the adviser, terminable only upon 61-days' notice. Even if the general partner has delegated its voting and investment authority to an adviser, it arguably could have some ability to change or eliminate the terms of the delegation if the GP and the adviser are under common control. In our scenario, GP may seek to ensure that Adviser 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 and its general partner successfully delegate voting and investment power to an investment adviser, they will nonetheless remain subject to liability based on trades executed at the direction of the adviser. 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 adviser 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 hedge funds 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 some funds, 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 "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 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 size of the board, as well as other factors, such as how many votes each member has, 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 excluding an individual 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, 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 recently 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? 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.

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 the beginning of the calendar year 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 year.

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 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 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 the 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 10 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 10-day period, in order to avoid having to make a second filing (for the adviser alone) after the end of the year.

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 soley 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. 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 agrees with another fund to advocate with management for a change in corporate strategy. On the other hand, there clearly is not a "group" if one fund simply tells another fund 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. Where practicable, communications with other fund advisers 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 adviser cannot have a direct or indirect equity stake in the advised fund, other than perhaps a de-minimis limited partnership stake.

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 can always team up with other funds 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 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 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 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 forming the group if the substance of the agreement 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 would also likely be deemed members of the group.

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 advisers 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. Nonetheless, the controversy around derivatives and Section 13(d) has traditionally been focused on cash-settled instruments. 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.

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.

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 adviser 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 funds 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 Just 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 decision this past August, *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 funds 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 allowed the puts, which were in the money, to be automatically exercised under OCC rules, and that exercise brought the fund'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»

A Practical Guide to the Regulation of Hedge Fund Trading Activities

Chapter 4:
Key Requirements and Timing Considerations of Hart-Scott-Rodino

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Chapter 4: Key Requirements and Timing Considerations of Hart-Scott-Rodino

The Hart-Scott-Rodino Act and Section 8 of the Clayton Act may not receive the same level of focus and attention in the context of Hedge Fund investing as other reporting regimes, but they should. They impose a mandatory filing regime on hedge funds and their managers that carries significant civil penalties for non-compliance.

HSR Act Basics: Your Investments May Trigger a Filing Obligation

The Hart-Scott-Rodino Antitrust Improvements Act of 1976 ("HSR Act") can become a trap for the unwary as hedge fund managers focus their attention on requirements under the Sections 13(d) and 16 of the Securities Exchange Act of 1934 ("Exchange Act"), not realizing that filing requirements under the HSR Act may also apply. The HSR Act requires investors, *and their targets*, to make a premerger notification (the "HSR Act Notification") filing and observe a 30-day waiting period (15 days in the case of a cash tender offer) prior to making certain voting share acquisitions, including acquisitions of minority holdings. The investor may not acquire the shares prior to observing the full waiting period, or prior to the early termination of the waiting period ("Early Termination") by the Federal Trade Commission ("FTC"). Effective April 3, 2019, the minimum threshold for reporting under the HSR Act is $90.0 million (the thresholds adjust annually). The threshold applies to the current market value of the investor's aggregate holding after giving effect to the planned upcoming investment, including shares previously acquired. There are exceptions to the notification requirement discussed below under "Common HSR Act Exemptions."

HSR Act Filing Thresholds (which adjust annually):

Value of Aggregate Holding[1]	Notification Requirement (Unless Exempt as provided below)
$90.0 million or less	Filing not required
Above $90.0 million but not more than $359.9 million	Required only if "size-of-person" test met: • The investor has total balance sheet assets (as of its most recent balance sheet) or annual sales/revenue (as of its most recently completed fiscal year) of $180.0 million or more (prior to giving effect to the planned acquisition), and the target has $18.0 million or more in (i) total balance sheet assets (as of its most recent balance sheet) or annual net sales/revenue from manufacturing (as of its most recently completed fiscal year), or (ii) total balance sheet assets if not engaged in manufacturing (as of its most recent balance sheet); or • The investor has total balance sheet assets (as of its most recent balance sheet) or annual sales/revenue (as of its most recently completed fiscal year) of $18.0 million or more (prior to giving effect to the planned acquisition), and the target has $180.0 million or more in total assets (as of its most recent balance sheet) or annual net sales/revenue (as of its most recently completed fiscal year).
Above $359.9 million	Filing required

Practice Point: Carefully monitor transaction values, in order to know when a threshold is about to be crossed. The HSR Act may require that a HSR Act Notification be made and that a waiting period be observed prior to acquiring certain voting shares, including follow-on share acquisitions.

HSR Act Statistics

The filings of HSR Act Notifications in the general corporate context are routine and common. The Antitrust Division of the U.S. Department of Justice ("DOJ") and the Federal Trade Commission ("FTC") reported receiving 2,052 HSR Act Notifications during fiscal year 2017, up about 12 percent from fiscal year 2016. Agency antitrust challenges to filed transactions, however, have been the exception and not the rule. Early Termination is requested and granted in the majority of transactions. In fiscal year 2017, Early Termination was requested in 77.9 percent of the transactions filed, and it was granted in approximately 78.6 percent of those transactions. Under the HSR Act, HSR Act Notifications (including their contents and documents submitted with the filings) are confidential, not subject to public disclosure, and exempt from Freedom of Information Act ("FOIA") request requirements. Even the mere fact that a party has made an HSR Act notification is confidential. However, in transactions where Early Termination is granted, the FTC publishes a notice on its website, which notices are regularly tracked by the investment community. The publication of the Early Termination notice does not disclose the contents of the filing or details about the investment, other than the names of the investor and the target. Accordingly, investors typically do not request Early Termination, and instead observe the full HSR Act waiting period when maintaining confidentiality is important.

Practice Point: Do not request Early Termination of the HSR Act waiting period when confidentiality is an issue.

[1] Current holdings are valued at the lowest closing price in last 45 days. Newly acquired holdings are valued at the acquisition price.

What Triggers the HSR Act Filing Requirement?

Though typically thought of as a pre-merger requirement, the HSR Act's broad reach captures many other types of investments and other transactions. These can include joint ventures, minority investments, non-strategic transactions, stock grants and conversions, warrant and option exercises, incremental purchases, formations, IP licenses and asset acquisitions.

The general rule is that a person or entity that is an "Ultimate Parent Entity" under the HSR Act (discussed below) may be required to make an HSR Act Notification and observe the applicable waiting period before consummating an acquisition. The HSR Act potentially applies where, as a result of the acquisition, the acquiring Ultimate Parent Entity would hold assets, equity interests in a limited partnership or limited liability company, or voting securities of a corporation, if valued in an aggregate amount in excess of the reporting threshold. Structure matters, however, and the concept of an "acquiring person or entity" in the HSR Act context will often be different than it is under other regulatory regimes.

There is no "group" concept in the HSR Act or context, so acting in concert with another firm typically does not impact the filing obligation analysis – though it may have other implications under the antitrust laws more generally (and may have impact under the Securities Exchange Act of 1934). The filing person in the HSR Act Notification context is the "Ultimate Parent Entity" under HSR Act rules. The application of the Ultimate Parent Entity concept is unique to the HSR Act in that it does not typically require the aggregation of multiple funds under common management. In the case of a hedge fund structured as a limited partnership (or limited liability company) where no single limited partner has a 50 percent or greater economic interest in the fund, the fund is treated as its own Ultimate Parent Entity and the fund would be the filing entity under the HSR Act. This stems from the HSR rule addressing control with respect to limited liability companies and limited partnerships. Under the rule (16 CFR 801.1(b)(1)(ii)), control is defined as "having the right to 50 percent or more of the profits of the entity, or having the right in the event of dissolution to 50 percent or more of the assets of the entity". The rules for non-U.S. entities turns on whether the entity issues securities that allow the holders to vote for the election of a supervisory board of directors. If the answer is yes, then the entity is treated as a corporate entity for HSR purposes – meaning that control is based on holding 50 percent or more of the voting stock. If the answer is no, then the entity is treated as a non-corporate entity for HSR purposes and the control rule discussed above for limited liability companies and limited partnership applies.

The implications of this can be substantial, as it may mean that investments by multiple commonly managed funds, acting side-by-side, can be disaggregated when assessing whether the HSR Act thresholds are exceeded. This will sometimes mean that aggregate positions exceeding the HSR Act threshold are not subject to reporting at all but can also result in *multiple filings* wherein more than one fund will exceed the filing threshold. Another implication of the silos of interests under the HSR Act is that movement of positions *between* funds under the same manager potentially could trigger filing obligations.

For example, consider a hedge fund manager with funds I, II and III, where each fund is a limited partnership and no fund has a limited partner with a 50 percent or greater interest. Each of funds I, II and III is its own Ultimate Parent Entity under the HSR Act, and each fund's investment is analyzed separately to determine its filing obligation. If the hedge fund manager decided to cause the funds to invest a total of $300 million in a new target company, there would be several potential filing outcomes to consider, depending on how the $300 million investment is allocated among the three funds. If the investment were evenly split among the three funds, there would be a separate filing obligation for each fund's $100 million acquisition, and a total of three filings would be required. If the $300 million were split between two funds, then two filings would be required; and if allocated to just one fund, only one filing would be required. In the same structure, a hypothetical $120 million total investment could result in a single filing if made by one fund, but also could result in no filing if allocated evenly among the three funds such that each fund's acquisition would be below the HSR Act reporting threshold. Consider also the case where a single $85 million investment in an issuer results in no

HSR Act Notification obligation, but where as a result of the aggregation rules, HSR Act Notification would be required prior to a follow-on investment of $10 million or more by the same fund. Note that the rules contain a prohibition on devices to avoid HSR Act filing obligations, and therefore structural decisions should be HSR Act agnostic.

In each transaction where an entity submits an HSR Act Notification, the target must also submit a filing[2]. The start of the waiting period is not dependent on the target's filing. The HSR Act waiting period begins to run on the day that the investor submits its HSR Act Notification. The HSR Act filing enables the antitrust enforcement agencies (FTC and DOJ) to review the transaction, investigate, and address potential antitrust violations before the transaction closes. The HSR Act requires all persons or entities that make an HSR Act Notification as an acquiring person or entity to pay a filing fee to the FTC, as follows:

- $45,000, if the size-of-transaction is valued at greater than $90.0 million but less than $180.0 million;
- $125,000, if the size-of-transaction is valued at $180.0 million or greater, but less than $899.8 million; and
- $280,000, if the size-of-transaction is valued at $899.8 million or greater.

Special rules apply to the acquisition of interests in limited liability companies and limited partnerships (as is typically the case in secondary transactions). Acquisitions of such interests are subject to an HSR Act Notification only where the acquisition results in the acquirer having the right to 50 percent or more of the profit distributions of the target limited liability company or limited partnership, or 50 percent or more of the target limited liability company or limited partnership's assets upon its dissolution.

Special rules also apply to the acquisition of non-voting securities such as options, warrants and swaps. As HSR Act's coverage does not extend to non-voting securities of a corporation, the acquisition of other types of securities or other interests does not often trigger a reporting obligation - absent an unusual feature, such as the right to vote for the election of directors. Conversion of such securities into voting stock may be a triggering event, so consider the HSR Act prior to conversions.

Practice Point: Carefully consider the Ultimate Parent Entity and aggregation rules to determine whether the investment has crossed HSR Act notification triggers. An understanding of the application of the rules is necessary to monitor properly the HSR Act triggering thresholds. Also, consider the HSR Act when converting to voting stock from a convertible security, as doing so may increase your applicable holdings.

The "Passive Investor" and other Common HSR Act Exemptions

The HSR Act exempts investments made "solely for the purpose of investment" that fall below 10 percent of the target corporation's outstanding voting stock.[3] The FTC takes a narrow view of the passive investor exemption and has said that any intent at the time of the acquisition to influence the basic business decisions of the company or to participate in management renders the exemption inapplicable, without regard to actions taken or not taken and without regard to the investor's actual ability to effect influence.

13D filers will be unlikely to successfully claim passive investor status under the HSR Act. 13G filers should make an independent determination of whether their intent is sufficiently passive to qualify for passive investor treatment under the HSR Act. The 13G filing is not controlling on the FTC. The FTC does not consider the mere voting of the issuer's stock to be

[2] The fund/investor is required under the rules to provide notice to the target of the fact that an HSR Act Notification is being submitted for the acquisition of its securities. The target is required to submit its own HSR Act filing in response to receiving the required notice.

[3] As discussed earlier, acquisitions of minority interests in limited liability companies and partnerships are not subject to HSR reporting.

inconsistent with the passive investor exemption, but acts that go beyond this low level of participation will remove the availability of the exemption. Such acts may include:

- Nominating a candidate for the board of directors;
- Proposing corporate action requiring shareholder approval;
- Soliciting proxies;
- Having a director, officer or employee serve as an officer or director of the issuer; and
- Being a competitor of the issuer.

The FTC staff has generally considered some or all of the following factors in investigations relating to the passive investor exemption:

- Closeness in time of the purchase to the announcement of the company's offer for control;
- Dollar amount of the total investment;
- Adoption of anti-takeover defenses by the company;
- Approaches to potential lenders for financing an acquisition of control; and
- Preparation of analyses and pro forma financials of a combination of the buyer and the target company – for instance, where a strategic investor acquires a minority interest in a competitor with an intent to gain control.

Enforcement actions for failure to file HSR Act Notification due to improper reliance on the passive investor exemption are not uncommon. In one enforcement action, the FTC alleged that the investor contacted senior management with ideas to improve shareholder value and made requests to be appointed to the board of directors. In an earlier matter, a company was considering a combination with a competitor, and thus its intent was not "solely" for the purpose of investment. In that case, the companies were competitors who had previously discussed the possibility of combining. In another enforcement action, a company's acquisition of stock in a competitor similarly did not qualify under the passive investor exemption, because the companies were competitors and were considering and taking steps towards a possible business combination.

In another matter, a hedge fund invested in Yahoo and, relying on the HSR Act passive investor exemption made an Exchange Act Schedule 13D filing, and the fund's management sent a letter to management demanding changes in both the board of directors and company leadership.

The investor also contacted individuals to gauge their interest and willingness to become CEO of the company or a potential board candidate; assembled an alternate slate for the board; and internally discussed the possible launch of a proxy battle for directors of the company. Notably, there was no indication that the hedge fund succeeded in placing representatives on the board or otherwise exercised control or influence over the company.

In finding that this conduct turned the hedge fund into an active investor, the Director of the FTC's Bureau of Competition said "the test for the investment-only exemption is the acquirer's intention, and that determination may not turn on any particular conduct." The enforcement action is a reminder of the agency's narrow view of the passive investor exemption, the challenge of creating a strong evidentiary record weighing in favor of the applicability of the exemption, and therefore the need to make an HSR Act Notification in all but the clearest cases of passive investments. The agency will look not only at steps taken post-investment, but also at evidence of the investor's plans at the time of or prior to the investment, in making its assessment.

Consider the scenario wherein an investor makes a protective Schedule 13D filing, and arguably could have filed a Schedule 13G, but there may have been potential risks based on, for example, conversations with management relating to operational issues. Relying on the HSR Act's passive investor exemption in the Schedule 13D context is potentially risky, as the FTC is likely to construe a Schedule 13D filing in any context, even as a protective measure, as presumptive evidence that the investor's intent is not consistent with the HSR Act passive investor exemption.

Consider further an investor that acquires voting shares of a corporation whose aggregate value exceeds the HSR Notification threshold but is not subject to the HSR Act Notification requirements because of its reliance on the passive investor exemption. The investor's subsequent change in intent and its acts demonstrating an intent other than passive (such as suggesting board action) do not retroactively negate the availability of the exemption. Such acts do not require an HSR Act Notification (provided the investor's intent was in fact passive at the time it took advantage of the passive investor exemption). However, any subsequent voting share acquisitions following non-passive acts would mean that the investor would no longer qualify for the passive investor exemption. For instance, a 9 percent position acquired under the passive investor exemption would not require a filing, even if the investor later changes its investment intent and becomes active. The filing obligation would not arise unless and until the investor acquired additional shares – for the acquisition of voting shares of a corporation is the HSR triggering event in this context.

The HSR Act rules also exempt acquisitions of businesses that do not have sufficient ties to the U.S. Generally, an investment in a non-U.S. business is not subject to HSR Act reporting unless the business has sales or assets in the U.S. above the HSR Act reporting thresholds.

Practice Point: Passive means passive – avoid strained interpretations of the exemption. If you have filed a 13D, as a practical matter the HSR Act passive investor exemption may not be available. 13G filers should make an independent determination of whether their intent is sufficiently passive to qualify for passive investor treatment under the HSR Act, as the 13G filing would not be controlling on the FTC.

Special HSR Act Rules for Tender Offers

As stated above, cash tender offers (but not stock-for-stock exchange offers), including non-U.S. tender offers, are afforded a shortened 15-day waiting period, versus the typical 30-day waiting period for most transactions. The investor may make the HSR Act Notification immediately after it has made public – in newspapers or other media – its intention to make a tender offer, and the investor does not need to wait until filing its registration and tender offer statements. In the case of a privately held company, a letter to shareholders may satisfy the public announcement requirement. The target of the tender offer must prepare and submit its own HSR Act filing within ten days of the investor's submission; however, as with any open market purchase, the start of the waiting period is not dependent on the target's filing. The HSR Act waiting period begins to run on the day that the investor submits its HSR Act Notification. A tender offer for HSR Act purposes may be a public or private tender offering but must qualify under Section 14 of the Exchange Act, or under the laws of the jurisdiction in which the offer was made.

Practice Point: Cash tender offers have shorter HSR Act waiting periods.

HSR Act Filing Contents

The HSR Act Notification includes information and documents relating to the planned acquisition and the parties involved, including the transaction agreement if there is one, revenue data classified under a classification system used by the FTC (the North American Industrial Classification System), and information relating to certain controlled entities, shareholders and investments. The HSR Act Notification and its contents are confidential, are not subject to FOIA requests, and may not be shared with other agencies. Unless Early Termination is requested by either party, and granted, the fact of the filing of HSR Act Notification remains confidential. However, if Early Termination is requested and granted, the grant is reported on the FTC website and in the Federal Register, with the names of the parties appearing in the notice.

Practice Point: HSR Act filings are confidential and not subject to public disclosure or FOIA requests, but Early Termination grants are made public.

HSR Act Investigations

While antitrust/HSR Act investigations of minority positions in public companies are not common, both the FTC and DOJ have the authority to conduct such investigations where warranted and will consider, for instance, the extent of holdings in competitors and the potential for coordinated action or information flow between competitors. This is especially the case where there is board representation with respect to two or more competitors in an industry (see the section below on interlocking directorates). If the FTC or DOJ requests and receives clearance to investigate the transaction, it will open a preliminary investigation and begin to investigate through voluntary requests for information to the parties and interviews of customers, competitors and other knowledgeable or interested persons. At the conclusion of the preliminary investigation, the reviewing agency may:

- grant Early Termination;
- allow the waiting period to expire without action;
- request the acquirer to withdraw/re-submit the HSR Act filing to restart the waiting period; and/or
- if unresolved issues remain, issue a Request for Additional Information and Documentary Material, commonly referred to as a "Second Request" or phase two investigation.

Practice Point: While FTC investigations of minority investments are rare, be aware to "red flag" factors that could result in an FTC investigation. Most filings clear in 30 days or less.

Failures to Make the Required HSR Act Notification

The HSR Act Notification requirements are not always clear or obvious, and sometimes are missed. The reasons for missed filings include the complexity of the coverage rules, the ambiguity that sometimes exists in valuations as applied against the threshold, and the various exemption and aggregation rules. Investors sometimes miss filing obligations triggered by scenarios outside the traditional M&A context, including incremental acquisitions (coupled at times with substantial increases in stock price), subsequent notification thresholds, conversions, and even stock acquisitions made by a company's officers or directors.

There are numerous examples of inadvertent failures to make an HSR Act Notification for warrant exercises and stock conversions, including with respect to executive compensation plans.

Other examples include fund managers committing their funds to investments outside the scope of the firm's typical investment strategy and that exceed the reporting thresholds – possibly for the first time and with no prior experience with the requirements of the HSR Act. One common scenario that leads to missed filings is when an investor that relied on the passive investor exemption HSR Act Notification (i.e., where it holds 10 percent or less of the voting shares of the target) becomes an active investor or increases its holdings in the target above 10 percent without filing before acquiring additional shares.

There is a long history of enforcement for missed filings under the HSR Act, sometimes with significant penalties: a missed filing comes with a maximum fine of $42,530 per day. The FTC typically brings one or two HSR Act enforcements each year. The fines can be substantial, and in some cases, have exceeded a million dollars. More commonly, the parties correct missed filings by submitting a corrective filing with no resulting penalty or enforcement action. This is because the FTC historically has followed the "one-free-bite" approach – whereby a first-time inadvertent failure to file results in a stern warning, but no fines if the filer comes forward voluntarily and promptly after discovering the missed filing. In most cases of a first time, inadvertent failure to file, the FTC will not recommend a penalty, but will insist that the offender put a policy in place to ensure compliance with future filing obligations. Both conditions must be met for the leniency to apply.

The agency seeks civil penalties for repeat offenders. To avoid incurring a substantial fine, hedge fund managers should keep their lawyers involved and remember that many kinds of investments can trigger the requirement to file a HSR Act Notification. Intentional failures to file are met typically with strong enforcement and significant penalties. Repeated inadvertent failures to file are likewise typically the subject of enforcement actions – on the basis that the first failure should have resulted in a more careful approach going forward.[4]

[4] HSR Act Enforcement Actions (updated July 31, 2018): (https://www.ftc.gov/system/files/attachments/procedures-submitting-post-consummation-filings/enforcement_Actions_final_updated_july_2018.pdf).

In the case of a missed filing, the FTC will investigate the transaction and violation with an eye toward potential enforcement. When determining whether to take action, the FTC will consider a number of factors. These include whether the violation resulted from simple negligence or something more; whether there have been multiple missed filings; whether the parties submitted the corrective filing promptly within a reasonable time after discovering the violation; whether the parties realized a benefit from their failure to file; and whether the parties have implemented adequate measures to prevent future violations.[5]

Practice Point: Filing triggers are not always obvious. Consider potential HSR Notification requirements in all trades to avoid potential enforcement actions. Build in systems to timely spot filing triggers (factoring in the waiting period). Compliance Manuals should account for the HSR Act.

HSR Act Compliance Programs and Enforcement

While no compliance program is perfect, more safeguards will reduce not only the likelihood of a violation but also the likelihood that the FTC will seek a steep penalty. Best practices include implementation of training programs with antitrust counsel; monitoring of company dealings for HSR Act purposes; establishing HSR Act compliance personnel with strict sign-off authority before executing trades; and inclusion of HSR Act provisions in your Compliance Manual and on acquisition checklists. HSR Act Notification must be submitted, *and the 15- or 30-day waiting period (as applicable) must be observed*, before the trade may be executed. If a trade is executed before the waiting period runs (even if not settled), there may be an HSR Act violation if the resulting aggregate holding is valued above the reporting threshold.

In one notable enforcement action, the DOJ settled with an investment firm for an agreed $720,000 penalty for failing to comply with the HSR Act. The case involved the HSR Act filing rules applicable when a company acquires the stock of the same company at two or more different times. The rules permit investors to make subsequent voting stock acquisitions of the same issuer for up to five years while relying on a previously filed HSR Act notification. The government alleged that the firm made two reportable acquisitions of Scientific Games Corporation voting stock: one in 2007 and a second one in 2012. Although a filing was made in 2007 for the first acquisition of Scientific Game Corporation voting stock, the five-year grace period expired in February 2012, several months prior to the second reportable transaction. Under the rules, a second filing was required.

The FTC settled a matter relating to an investor that acquired shares of Coca Cola on numerous occasions and as a result held voting securities valued in excess of the reporting threshold without having filed under the HSR Act. Based on the violations, the investor agreed to pay a civil penalty of $480,000.

When an investor acquired voting securities of Symetra Financial Corporation by exercising warrants without first submitting the required HSR Act Notification, the FTC's Premerger Notification Office did not recommend a civil penalty. However, when shortly thereafter the investor converted USG Corporation notes into voting securities valued in the aggregate with prior holdings at more than $950 million, the agency brought an enforcement action and imposed the maximum civil penalty, totaling $896,000. The requirements to file a HSR Act Notification are not always obvious or easy to spot – there are very few cases of intentional violations of the HSR Act. The investor acquired the convertible notes in 2008, five years prior to conversion in a non-reportable transaction, and not all conversions are reportable.

Practice Point: Act enforcement is Active. Avoid inadvertent failures to file by having effective HSR Act compliance policies and procedures in place. If you missed a filing deadline, discuss with counsel the best approach to avail yourself of the "one-bite" relief.

[5] The FTC Post Consummation Review Process: https://www.ftc.gov/enforcement/premerger-notification-program/post-consummation-filings-hsr-violations/ftc-post.

Director Overlaps and Clayton Act Section 8

Clayton Act Section 8 is particularly relevant for hedge fund managers taking minority positions in competing companies and seeking board representation. Under the statute, no person, or representative of the same person or entity, is permitted to serve simultaneously as a director or officer of competing companies, but there are carve-outs and exceptions. Cross-board membership among two or more competing portfolio companies under common control (i.e. majority held) does not trigger the Clayton Act Section 8 prohibition since the companies would no longer be deemed competing independent economic actors under the antitrust laws.

To account for the minimal impact on competition likely to flow from interlocking directorates wherein the competitive sales of the companies are sufficiently small, Section 8 does not prohibit interlocks where the total competitive sales are below certain de minimis levels.[6] The prohibitions of Section 8 are also limited to cases in which each of the companies has, under the current thresholds, capital, surplus and undivided profits of more than $36,654,000. Where the carve-outs do not apply and the companies in fact compete, Section 8 strictly prohibits director interlocks. The statute also permits directors and officers whose appointments were not prohibited at the time of appointment to continue to serve for up to a year after the Section 8 thresholds are exceeded. The revised Clayton Act Section 8 thresholds, therefore, can potentially eliminate an existing violation which is not the case with the HSR Act threshold revisions.

In a matter implicating the prohibition on director overlaps, Tullett Prebon PLC and ICAP PLC restructured their proposed transaction in response to the DOJ's concerns.[7] Both are UK interdealer brokers that are also active in the U.S., and the transaction as originally envisioned would have resulted in ICAP obtaining the right to appoint a member to Tullett Prebon's board of directors after Tullett Prebon acquired ICAP's voice brokerage business. Because ICAP and Tullett Prebon would remain competitors post-transaction with respect to ICAP's remaining businesses, the proposed board seat constituted an interlocking directorate – or common directorship between competing companies – in violation of Clayton Act Section 8.

The consideration for the acquired business was stock of the buyer – Tullett Prebon – and thus ICAP would have had a 19.9 percent interest in Tullett Prebon while also having the right to nominate a member of Tullett Prebon's board post-transaction. This, according to the DOJ, constituted an interlocking directorate between competitors in violation of Clayton Act Section 8. To satisfy the DOJ's concerns, the parties agreed with the DOJ that all of the Tullett Prebon shares issued in the transaction would go directly to ICAP's existing shareholders rather than to ICAP.

The DOJ has mounted other challenges to director interlocks, though such actions are less common than HSR Act enforcement actions. In a matter involving the merger of Andrew into CommScope brought in 2007, the DOJ employed Section 8 to prohibit interlocks that would have resulted from the merger. The merger would have brought along Andrew's 30 percent minority interest in Andes Industries – a third party competitor to CommScope. CommScope and Andes were competitors with respect to drop cable (i.e., coaxial cable used to connect television transmission systems to customers' premises and equipment). To resolve the DOJ's concern the parties agreed that, as part of the merger, CommScope would divest Andrew's minority holding in Andes.

[6] Under the current thresholds in effect as of March 2019, the carve-out is available where the competitive sales of either company represent less than 2 percent of its total sales, or are less than $3,656,400; or where the competitive sales of each company represent less than 4 percent of its total sales.

[7] Tullett Prebon and ICAP Restructure Transaction after Justice Department Expresses Concerns about Interlocking Directorates: https://www.justice.gov/opa/pr/tullett-prebon-and-icap-restructure-transaction-after-justice-department-expresses-concerns.

In a high-profile matter in 2009, a member of the boards of Google and Apple agreed under pressure from the FTC to resign the Google post. This issue arose amid concerns that the arrangement violated Section 8 because of competition between the companies with respect to a variety of services.[8]

Practice Point: Consider Section 8 when accepting board positions at portfolio companies – this should be part of your standard checklist. Consider the Clayton Act Section 8 prohibition against interlocking directorates in all cases that could result in common board membership between independent competitors, such as overlapping board membership either by an individual or by representatives of the same investment firm.

Chapter 5: Rule 105 of Regulation M and Tender Offer Rules

[8] Statement of Bureau of Competition Director Richard Feinstein Regarding the Announcement that Google CEO Eric Schmidt Has Resigned from Apple's Board; https://www.ftc.gov/news-events/press-releases/2009/08/statement-bureau-competition-director-richard-feinstein-regarding.

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A Practical Guide to the Regulation of Hedge Fund Trading Activities

Chapter 5: Rule 105 of Regulation M and Tender Offer Rules

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Chapter 5:
Rule 105 of Regulation M and Tender Offer Rules

Rule 105 of Regulation M may create more anxiety among compliance professionals in the hedge fund industry than any other SEC rule. It is a "strict liability" regime, meaning that you can be found in violation even if the infraction was an innocent error resulting in little profit. The SEC has historically brought actions based on such errors, and it has methodically brought a series of new actions every couple of years. This article explains the law of Rule 105, and includes some illustrative examples. It summarizes some of the past enforcement activity, and makes some predictions about the SEC's current approach.

Although unrelated to Regulation M, this article ends with a side note on the federal tender offer rules. We do not mean the "large set" tender offer rules under Section 14(d) of the Exchange Act, which apply to a tender for the shares of publicly-listed securities. Rather, we address the "small set" of rules under Section 14(e), which apply to tenders for private company equity. It is these rules that (sometimes rather unpredictably) become relevant to hedge fund transactions.

What ties these two substantively unrelated sets of rules together? Both are notorious for funds unwittingly drifting into technical violations, and both are practice areas where the SEC has been known to proceed based on unintentional, technical violations.

How Does Rule 105 of Regulation M Work?

The SEC adopted Rule 105 to prevent manipulation in the pricing of a firm commitment registered public offering of equity securities. The concern is that short selling just prior to pricing could artificially depress the offering price. Thus, the rule focuses on restricting short selling during a "restricted period" in advance of pricing. More specifically, the rule only applies under the following circumstances:

1. There is a registered offering of securities for cash, meaning a registration statement was filed with the SEC, and the offering was undertaken on a firm commitment basis, so the underwriter is obligated to purchase the entire offering from the issuer;
2. The hedge fund intends to purchase shares from the underwriter or other offering participant; and
3. The hedge fund wishes to engage in a "short sale" in the "restricted period" immediately prior to the pricing of the registered offering.

In order to fully understand when Rule 105 applies, it is necessary to understand in more detail the meaning, in this context, of "securities," "short sale," and "restricted period." After briefly summarizing the meaning of these terms, we will provide illustrative scenarios.

As to "securities," the short sales and the registered purchases have to involve the same security to trigger the rule, not a derivative involving that security, such as an option or warrant. Thus, for example, if the hedge fund sells short publicly-traded options to acquire the common stock of the issuer, that would not implicate Rule 105.

Practice Point: This part of Regulation M does not "mix and match" equity securities and securities convertible into such equity securities, so that short sales of one does not implicate purchases of the other in connection with a registered public offering.

For the definition of "short sale," the rule borrows the definition from a different regime that regulates short sales, Regulation SHO. For those purposes, a short sale includes:

- Any sale covered with a borrowed share;
- Any assignment of a short position;
- Any sale where the firm is net short or flat; and
- Any sale of a security that the firm does not own, with a few exceptions involving situations where the firm has a right to acquire the security.

Practice Point: Any sale covered by a borrowed share is a short sale, even if the fund and/or its affiliates are net long, looking across the platform, or across the "independent trading aggregation unit" if applicable as explained below.

Although a transaction in a derivative cannot be the basis of a Rule 105 violation, a derivative position (such as an option or warrant) can be relevant to determining whether or not a firm is "net short" at the time of a sale, and could cause an otherwise long sale to be characterized as a short sale.

A firm must look across all of its affiliated funds and managed accounts to determine if it is flat or net short the security in question. This is the case unless it has an "independent trading aggregation unit," which generally means that the unit trades independently of its affiliates outside of the unit. This approach is available only to larger firms as a practical matter. If two funds have a common portfolio manager or team, then they cannot qualify as independent aggregation units.

Although a firm should always determine its net short status across all of the accounts that it manages as described above, it should also consider whether each individual fund or client purchasing the security is not net short, as the SEC could take the position that the individual fund or client may be deemed to have violated the rule on a stand-alone basis, even though such a position in our view would not be supported by the rule.

Practice Point: In order to rely on the "independent trading aggregation unit" exception, a detailed analysis should be undertaken of the levels of separation between the units in question, particularly with respect to up-the-chain supervisory and investment management functions.

"Restricted period" is the shorter of: (a) the period beginning 5 business days before the pricing of an offering and ending at pricing; and (b) the period beginning at the initial filing of the registration statement and ending at pricing. The period in (a) is the one that typically applies, particularly in the context of a shelf offering where the registration statement had been filed long before. The calculation of the 5-business day period can be tricky, since if the pricing occurs before the market closes, that day does not count toward the 5-business day period.

There is a narrow exception to Rule 105, called the "bonafide purchase exception," if the fund shorted during the restricted period and prior to pricing makes open market purchases of the security in at least the same quantity as the short sale during regular trading hours, subject to other detailed conditions

Rule 105: Illustrative Scenarios

Scenario 1: XYZ, Inc., a company listed on the NYSE, prices a firm commitment underwritten public offering before the market closes on Wednesday, August 11. Momentum Capital Fund, LP, a hedge fund, wishes to participate. Momentum is in aggregate 20,000 shares long the common stock of XYZ, but it nonetheless executed a strategy on August 4th in which it sold 10,000 shares, and covered with borrowed shares. Can it participate in the offering?

The offering is a firm commitment underwritten public offering, which is the type of offering relevant for purposes of Rule 105. The sales of shares settled with borrowed shares on August 4th count as short sales under the rule, even though Momentum was net long at the time by 20,000 shares. That is because any sale of a borrowed share is by definition a short sale. But is a short sale on the 4th a disqualification, or is it outside the 5-business day restricted period? Because the offering priced before market close on the 11th, that day is not counted as the first day of the restricted period look-back. Accordingly, the restricted period runs back to and including August 4, the day of the short sales. Momentum may not participate in the offering.

Scenario 2: ABC, Inc., another NYSE listed company, engages in a PIPE transaction, selling 500,000 shares of common stock in a private placement to three funds, including Momentum. The private placement closes on September 1st, and the resale registration is filed, and becomes automatically effective, on September 2nd. As is common among PIPE transactions, the resale registration permits the investors to resell in the open market, but does not contemplate that they will use an underwriter to resell shares. Momentum engaged in short sales on August 31st. Has Momentum violated Rule 105?

Because the registration is not an underwritten public offering, Rule 105 would not apply, and the short sales do not violate Regulation M.

Scenario 3: PQR, Inc., another NYSE listed company, engages in a firm commitment underwritten primary offering of 1,000,000 shares of common stock. Momentum intends to purchase 100,000 shares in the public offering. ABC files the registration statement, it becomes automatically effective, on December 2nd, and the deal prices the next day. Momentum engaged in short sales on December 1st. Has Momentum violated Rule 105?

It has not violated Rule 105. While the default "restricted period" is usually 5 business days prior to pricing, the rule provides that the period is the shorter of 5 business days or the period between filing the registration statement and pricing. In this case, the registration statement was filed on December 2, and the deal priced on December 3, so the restricted period runs from December 2 to December 3. Short sales on December 1 did not occur during the restricted period.

The answer would be different if, instead of filing a new registration statement on December 2, PQR undertook a shelf takedown on that date, based on a shelf registration statement that had been filed months earlier. In that case, the default of 5 business days would apply.

Practice Point: If the issuer files a new registration statement, the restricted period may be shorter, in some cases as short as one day, between the filing of the registration statement and pricing. However, if the issuer uses an existing shelf and engages in a "take down" instead, the default 5 business days would apply.

Enforcement of Rule 105

As noted above, the SEC historically has focused on Rule 105 nearly every year since it was amended in 2008. It has brought more than 40 actions in the past five years, including against 25 firms as part of an enforcement sweep in 2014 and 2015, focused solely on violations of the Rule. However, its most recent actions were brought in 2017.

In one case in 2015, the fund's adviser implemented new software for identifying short sales, and the results were transmitted to the fund's prime broker. The prime broker based its compliance with Rule 105 on those communications from the fund's adviser. However, trades were routinely misidentified as "short" or not "short." Even though the trades were the result of a software error, the SEC pursued the matter, and the fund's adviser settled for a $4.25 million penalty, and disgorged over $240,000 of trading gains and interest.

In 2017, the SEC settled a case against the adviser to a large hedge fund that had apparently relied on separate "aggregation units" among separate accounts with separate portfolio managers and portfolio personnel, each of which maintained its own accounts. However, the adviser maintained several firm accounts for trading activity, including risk management and hedging in relation to the entire platform. Compensation for the management personnel over the firm accounts was premised, in part, on the performance of individual accounts. Management personnel had the ability to review each separate account's portfolio holdings and trading activity and also had the authority to set the trading strategies with respect to the firm accounts.

The SEC can learn of violations of the rule in a number of ways, but the most common way is through its inspections of a prime broker or registered investment adviser. While Rule 105 regulates the broker and not the fund or its adviser, the SEC typically would charge the adviser for "causing" the broker's violation.

As noted above, the SEC has brought a steady stream of enforcement actions based on violations of Rule 105 dating back to the amendment of the Rule in 2008. More recently, however, the SEC has brought far fewer Rule 105 actions, with the last such action being filed in 2017. This likely reflects the attitude of Chairman Clayton that strict liability for technical violations of the federal securities laws, where it is difficult to discern investor harm, like Rule 105 violations, are often better handled by a deficiency notice from the SEC's Office of Compliance Inspections and Examinations (OCIE), which inspects registered investment advisers and is not part of the SEC's Enforcement Division, rather than an enforcement action.

We expect that, under Chairman Clayton, the SEC will likely focus its enforcement actions on larger or intentional violations, and decide not to expend resources on small, unintentional violations. However, a fund adviser involved in the latter category of violations – and hoping to avoid formal agency enforcement action – should formulate a strategy for addressing the violations, which may involve updates to compliance procedures and, in very rare circumstances, self-reporting to the SEC. Moreover, keep in mind that the SEC has a five-year statute of limitations to seek penalties or disgorgement. Even if the current Commission is less likely to bring a Rule 105 action, a future Commission may take a different, more aggressive approach

Practice Point: While we believe that the current SEC is less likely to bring formal charges based on small, unintentional violations, it is important to carefully consider a strategy for updating compliance procedures and communicating with the agency. Even in the current regulatory environment, even a small, technical violation can result in an enforcement proceeding if it is not handled optimally.

The firm's response should be carefully tailored based on the details of a given violation. Questions to ask when a violation is detected include:

- What was the profit from the related trading activity?
- Are our current compliance procedures effective?
- Can we tell regulators with assurance that there have been no prior violations, and that there is no pattern?
- Are there improvements to our procedures that we can implement now to assure regulators that the most recent violation is unlikely to recur?
- While very rare and subject to an intensive facts-and-circumstances analysis, should we consider reporting the violation to the SEC staff? Have we recently completed an OCIE exam, or is there one forthcoming, and if so should we contact our lead examiner?

The Tender Offer Rules

The tender offer rules that at times apply to hedge fund firms are the "small set" tender offer anti-fraud rules, not the "large set" tender offer rules that apply to tenders for generally exchange-traded equity. The "small set" Regulation 14E rules, established under Exchange Act Section 14(e), are relatively skeletal, and are designed prophylactically to avoid actions that could violate the general anti-fraud rule. These rules can be triggered when a fund's adviser offers to purchase limited partnership or other equity interests from its own investors or from the investors in another fund, where the offer amounts to a "tender offer." Whether or not there is a "tender offer" depends on a number of factors, including whether the fund adviser offers a single price and imposes a short deadline for responding. The most significant of the rules (if applicable) would require:

- The tender offer to remain open for at least 20 business days;
- The fund adviser and its affiliates not to purchase any shares outside of the tender offer during its pendency; and
- The tender offer to remain open for 5 or 10 business days (depending on the facts) following a material change in its terms.

If in doubt, many fund advisers comply with these requirements, because they typically are not burdensome. The general anti-fraud rules also apply, so fund advisers should be careful about avoiding misleading disclosures, material omissions, or terms that exert pressure on investors, such as “first come, first served” acceptances of tenders.

Practice Point: If a fund adviser is offering to purchase equity interests from even a small number of its own investors or those of another fund, it should consider the applicability of the “small set” tender offer rules.

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A Practical Guide to the Regulation of Hedge Fund Trading Activities

Chapter 6: When Passive Hedge Funds Decide to Become Activist

Author: Frank Zarb

Chapter 6:
When Passive Hedge Funds Decide to Become Activist

Passive hedge funds are increasingly considering active roles when they are dissatisfied with the management of specific portfolio companies. After describing such a scenario, the author discusses the steps a dissatisfied fund can take short of a full-scale proxy fight. He then closes with some important decisions a fund must make in that full-scale option.

Passive hedge funds increasingly are taking on activist roles at one or more portfolio companies. While this is an expected part of a broader trend toward increasing shareholder activism, such funds are not typically interested in becoming activist funds generally, but rather in using all the tools available to rectify perceived deficiencies at an under-performing portfolio company. Hedge funds are the most active proxy contest dissidents, representing more than half of campaigns brought against Russell 3000 companies in 2018.[1] Many, if not most, of these insurgent hedge funds are "activist" funds, although passive hedge funds have increasingly considered activist roles with respect to specific portfolio companies.[2]

This article is the sixth chapter of a series of articles on regulatory issues impacting hedge fund equity trading (the "Trading Manual Series").[3] As compared to the first chapter in that series, which addressed scenarios where a fund inadvertently drifts into "activist" status for regulatory purposes, this chapter addresses scenarios where the fund makes a deliberate decision to assume an activist role and to address regulatory issues.

There are a variety of methods for a hedge fund to assume an activist role. A hedge fund could take a limited approach and merely engage privately with management or publicly criticize management. Neither strategy would trigger the SEC's proxy rules, although the efforts could require the fund to file a Schedule 13D to replace a pre-existing 13G filing. Along the same lines, the fund may follow a proxy rule exemption to announce how it intends to vote on the company's — or another shareholder's — proxy proposal, and why. Or the fund could play a larger role, by launching what we describe below as a "mini-proxy contest," or even a full- scale proxy contest, or a tender offer.

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1 The Conference Board, Proxy Voting Analytics (2015-2018), at 171.

2 Over the past several years, the number of campaigns brought by "infrequent activists" has increased, with "infrequent activist" defined as a firm that has brought five or fewer campaigns since the beginning of 2014. Review and Analysis of 2018 U.S. Shareholder Activism, Harvard Law School Forum on Corporate Governance and Financial Regulation (April 5, 2019), at Section E.

3 All six chapters of A Practical Guide to the Regulation of Hedge Fund Trading Activities are *available at* https://www.proskauer.com/report/a-practical-guide-to-the- regulation-of-hedge-fund-trading-activities.

The Scenario

Consider the following scenario to be used for illustrative purposes. Software Fund, LP has been a long-term investor in Alliance Cloud, Inc., which is traded on Nasdaq. As the beneficial owner of 4.1% of the company's outstanding shares, the fund is Alliance's third largest investor. The company's stock price has lagged the market for the past two years, trading flat or slightly down during that period, when the rest of the market has surged. Software Fund believes that the company has focused on developing the wrong products, or the wrong updates to existing products, and has a weak marketing department. Over the past year, Software Fund has engaged in several private discussions with management. Management has listened, nodded in apparent agreement, and stated that it would make sure that the company's board was fully briefed. Management has not provided any substantive feedback, pointing out that if it were to communicate material, non-public information to the fund, the fund would be precluded from trading and the company would be in violation of the SEC's Regulation FD.

While the company's lead independent director did indeed attend the fund's last meeting with the company several months ago, and the company replaced its marketing head three months ago, the company has not, in the fund's view, sufficiently addressed the deficiencies that the fund has outlined. The fund believes that a major change in direction is required and has lost confidence in the company's board and management. It has concluded that it must take its efforts "to the next level" if it is to see any results. The fund's principals have called in outside counsel to review the options. The company's annual shareholder's meeting is scheduled to take place in five months and the fund is considering ways to put decisive pressure on the company in the context of that meeting.

Regulatory Backdrop of The Scenario

In this scenario, the regulatory considerations could be more complex than they are, since Software Fund beneficially owns less than 5% of the company's outstanding shares. As noted in Chapters 1 and 3 of the Trading Manual Series, if the company beneficially owned more than 5% (individually or together with a "group"), it would be subject to Exchange Act Section 13(d), and even meeting with management on operational and strategic issues could compel the filing of long-form Schedule 13D. If the fund owned in excess of 10%, its transactions in equity and derivatives would be subject to Section 16 reporting and short-swing profits liability. Based on its current beneficial ownership, it need not be concerned about either of those two regulatory regimes.

Software Fund, however, does need to consider Hart- Scott-Rodino ("HSR"). A "passive investor" that has not crossed the 10% threshold need not file. The fund's engagement with management to date, however, may be inconsistent with the HSR "passive investor" exemption. The good news is that the fund has not acquired any new shares and the value of its common stock holdings has not crossed the $90 million HSR reporting threshold for 2019. An HSR filing is not necessary at this point.[4]

What we are left with are the different strategies that Software Fund can follow under the federal proxy rules. The proxy rules have to be followed if either the company or any other person decides to "solicit" votes for or against any proxy proposal presented by anyone at either the annual or a special meeting of shareholders. Proposals may, for example, seek to remove members of the board of directors and replace them with the proponent's own candidates. Or they may seek to influence actions to be taken in connection with proposals made by the company, such as by soliciting shareholders to vote against the company's "say-on-pay" proposal.[5]

[4] *See* Chapter 4 in the Trading Manual Series, *Key Requirements and Timing Considerations of Hart-Scott-Rodino*.

Software Fund has a smorgasbord of choices, beginning with options that involve limited effort and expense, as well as little publicity, to others that involve substantial publicity, effort, and/or expense. The fund may engage only in the more limited options, often referred to as "activism light," and stop there, or may rely on a limited option as a first step in a larger campaign. Among the numerous proxy-rule exempt solicitations that are brought each year, relatively few are brought by hedge funds, so for Software Fund to pursue activism-light to the exclusion of a formal proxy contest would be outside the norm, but it may very well make sense to a passive fund "dabbling" in activism.[6]

The principal options for such a first, limited step include the following, which could be pursued individually or in combination:

- publication of a statement in the press or other public forum about how the fund intends to vote on a proxy proposal, and why (the "Publication Exemption");
- submission of a generally non-binding shareholder resolution to be included in the company's proxy materials (the "Shareholder Proposal Submission"); and
- private communications with up to 10 other investors to encourage them to vote a certain way on one or more of the company's or another shareholder's proxy proposals (the "Ten-Investor Exemption").

The first alternative, the Publication Exemption, is the most simple and straightforward. Software Fund can publicly express how it intends to vote and why. One of the fund's principals could provide an interview in which he or she explains that the fund intends to vote against board members because of operational and strategic blunders, and the failure of management to provide satisfactory responses in private meetings with the fund. Or if the fund desires, it could issue a press release or print advertisements in newspapers — or even rent a billboard on the Long Island Expressway. While the fund could couple this strategy with other "solicitations" that come within a proxy rule exemption — such as making a Shareholder Proposal Submission — it could not follow up with a full-scale proxy contest. Statements made in reliance upon the Publication Exemption, however, are not subject to the federal proxy anti-fraud rule, which would take some of the force out of the company's efforts to hinder the fund with charges that its statements are materially misleading. That is because the proxy anti-fraud rule is the most obvious basis for such claims, at least in federal court, the only other options being state anti-fraud rules.

The Shareholder Proposal Submission rules require the company to include on its proxy card a proposal submitted by a shareholder that has held shares worth at least $2,000 in market value for at least one year, so long as the shareholder has complied with specified procedures. The principal drawback to this approach is that companies are permitted to exclude proposals on a wide range of subject matters, including most operational and strategic issues. Moreover, while the company may not exclude many general corporate governance proposals, it may exclude a proposal to nominate a candidate for the board or to recommend a vote against one of the company's nominees.

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[5] A company's say-on-pay proposal is a required advisory proposal that asks shareholders to express support (or disapproval) of the company's executive compensation package.

[6] The Conference Board, Proxy Voting Analytics (2015-2018), at 190.

Accordingly, Software Fund could not compel the company to include in its proxy materials proposals to change its product mixture or reform its marketing department. Nor could it compel the company to include a proposal to nominate its own candidate for the board. However, if a shareholder's complaint about the company is about general corporate governance or executive compensation, a proposal by the shareholder on the subject likely would have be included in the company's proxy materials. While most shareholder proposals must be drafted as recommendations to the board (i.e., even if adopted by shareholders, the company would not be legally required to implement the proposal), many proposals need not be mere recommendations, so long as the "mandatory" shareholder proposal is permitted under state law. Finally, the fund could solicit votes in favor of its shareholder proposal without filing a proxy statement.

The Ten-Investor Exemption can be used effectively to influence the vote on one or more of the company's proxy proposals if other large or institutional investors hold a significant proportion of the outstanding shares and are receptive to communications by other investors. For example, if 10 investors in Alliance Cloud collectively hold 46% of the outstanding shares, such a campaign could be effective. One downside of this approach is that Software Fund would have to be careful (and well scripted) in discussions with other investors so as not to form a Section 13(d) "group." If such a group were formed, Software Fund's 4.1% beneficial ownership would be aggregated with the shares beneficially owned by other members of the "group" in determining whether the threshold has been crossed for purposes of filing a Schedule 13G or 13D, as well as for reporting and incurring liability under Section 16. For example, assume that Software Fund approaches Momentum Investors, which holds 2% of the company's outstanding shares. If Momentum agrees with Software Fund to oppose the company's candidates for the board, then a "group" has arguably been formed. That "group" would hold 6.1%, subjecting both funds to Section 13(d) reporting. Because each investor is trying to influence a proxy vote, they would both have to file on long-form Schedule 13D. A 13D has disclosure requirements, including a narrative on the filer's "plans or proposals" relating to the portfolio company.

The other drawback of using the Ten-Investor Exemption is that if the approach to other investors fails to garner sufficient support, it is difficult to convert the campaign to a full-scale proxy contest. A full-scale contest by definition involves soliciting an indefinite number of investors, not just 10, and would arguably undermine the initial reliance on the Ten-Investor Exemption to cover the insurgent shareholder's initial solicitation efforts. Thus, as a practical matter, a fund using the Ten-Investor Exemption should try to rule out any interest in elevating the effort if it fails. It often is unclear whether 10 other investors approached by an investor will be willing to make time for a meeting, and if they do, whether they will be receptive.

Another exemption is the "Junior Proxy Contest Exemption," which requires a greater effort than the three listed above and is subject to restrictions that could undermine Software Fund's efforts. Under this exemption, an investor that is unaffiliated with the company may solicit an indefinite number of other shareholders, so long as it does not seek to obtain executed proxy cards. As a practical matter, this means that the exemption is more useful in opposing a proxy proposal made by the company or another shareholder, rather than furthering the investor's own proposal. For example, assume that the investor wishes to oppose the re-election of three members of the board's compensation committee, as well as the company's say- on-pay proposal. That investor could approach an indefinite number of shareholders, so long as it does not seek the revocation of any proxies that have been executed. Under this exemption, an investor with over $5 million in the target company's securities must file a notice with the SEC, as well as any written materials used in the solicitation. (An investor with less than $5 million need not file a notice or written materials.) Because the use of this exemption assumes a widespread solicitation, it is likely to require more effort and expense than the three "activism light" methods noted above. If this exemption is relied upon, the rules preclude converting the effort into a formal proxy contest.

The First Level of The Decision Tree

In our scenario, Software Fund has the resources to commence a formal proxy contest, but it is reluctant to do so without first trying less extensive methods. For one thing, certain of Software Fund's own investors may not react favorably to the publicity associated with a full-scale activist campaign. Furthermore, its principals lack experience in mounting activist campaigns, so they would face a steep learning curve. Software Fund accordingly decides to start with alternatives short of a full-scale proxy contest.

Submitting a shareholder proposal to the company is not appealing, since the company would be able to exclude a proposal addressing its grievances — product strategy and marketing.

Nor does it make sense to utilize the Ten-Investor Exemption. There are only four institutional investors other than Software Fund with material positions in Alliance Cloud. One of the four is affiliated with the company, and unlikely to support an activist campaign. Another of the four has been known to take substantial short positions, so its interests may not be aligned with those of Software Fund. The remaining two may be interested, but their last reported beneficial ownership levels were only 2.5% and 3% of the outstanding shares, respectively. Furthermore, the principals of Software Fund do not have a relationship with those investors, so there is no way to predict whether they will be receptive to being approached. In addition, use of the Ten-Investor Exemption could likely foreclose the launch of a full-scale proxy contest.

At least as a first step, Software Fund does find appealing the use of the Publication Exemption, the exemption for statements made in a public forum where an investor states how it intends to vote and why. In order to exert maximum pressure on the company, the fund wants to generate some publicity, and perhaps hint that it could launch a proxy battle. The founder of Software Fund has scheduled an interview on a business talk show the following week, along with a handful of press interviews. Together with its PR consultant, the fund has prepared a set of talking points, which state that the fund may oppose nominees for the company's board of directors at the upcoming annual shareholders meeting, explain the fund's criticisms of the company's marketing and product strategies, and describe the company's non-responsiveness to date. While the company has not yet filed or mailed its proxy statement for its annual shareholders meeting, it will inevitably include nominations of candidates for its board, so the fund's statements about targeting board seats could be viewed as a "solicitation" under the proxy rules. After this initial publicity campaign, the fund can talk to the company to see if it will be more responsive to its grievances. If not, it will consider whether to take the next step.

Software Fund's public statements have limited success. The financial press's interest in the fund's criticism of the company is less than overwhelming, and the company appears to have taken it in stride. The fund's statements in opposition to the company's board candidates may create publicity that generates pressure on the company, but it is not likely to have a practical effect. The fund is not at this point overtly threatening to nominate its own candidates for the board. While the company has a policy that a director who does not receive a majority of the votes must submit his or her resignation, the board has authority to decline to accept the resignation.[7] Further, there is some skepticism among members of management that a passive hedge fund would actually launch a proxy battle at the annual meeting.

[7] Under the laws of many states, a director who is not approved at the annual meeting can "holdover" until his or her successor is elected or appointed. Many companies, including most Fortune 500 companies, have adopted a majority voting standard for director elections, as well as a policy for what happens if a director does not receive majority approval. Counsel of Institutional Investors, FAQ: Majority Voting for Directors (2019). Typically, under such policies, a director's resignation needs to be accepted based on various factors.

A few other investors reach out to Software Fund, however, in response to the latter's publicity campaign. One institutional investor (the third of the four described above) tells Software Fund that it had the same concerns over the company's product strategy, and has additional concerns about the company's cost structure, including its executive compensation package. Another institutional investor stated that it sees some basis for Software Fund's critique of the company, and is keeping an open mind, but lacks special expertise in software development, and accordingly is reluctant to second-guess the decisions made by management, noting that management is respected and experienced in the industry.

The Second Phase of an Activist Campaign

With little confidence in the long-term success of Alliance Cloud, Software Fund decides that it has to either ramp up its efforts in a material way, or accept its losses and sell its position. There is a deadline, since the company — like nearly all companies — has an advance notice requirement in its bylaws if a shareholder intends to solicit proxies for a proposal to be presented at its annual meeting. The fund would have to comply with this requirement if it were to propose its own board nominees to replace those nominated by the company. The notice is due in 30 days, and it must be accompanied by additional information about the fund's board nominees, as well as about the fund's beneficial ownership of the company's common stock, and any related derivatives. The fund's counsel advises submitting the package to the company early, so there is time to respond to any deficiencies identified by the company.

Software Fund also considers a step short of a formal proxy contest: The Junior Proxy Contest Exemption for soliciting an indeterminate number of shareholders without seeking a proxy card. It could make use of this exemption without preparing or filing a proxy statement, and without complying with the company's advance notice bylaws. The fund could reach out to a large number of shareholders with its critique of the company, and make a voting recommendation on the company's board nominees, but would lack the ability to collect actual proxy votes (or revocations of votes) for the company's nominees. Furthermore, it would not be able to nominate its own candidates. As a result, the effort would be mostly cosmetic; while it may t be possible to preclude one or more of the company's directors from receiving majority support, the fund could not guarantee any actual changes in the board's composition. Any such board changes would merely shrink the existing board, not add new directors with a different point of view. Of course, the fund could recommend "no" votes for any other proposals made by the company, including its say-on-pay proposal, and those efforts could actually lead to the failure of such proposals.

Using the Junior Proxy Contest Exemption, it would not be possible to convert the campaign into a full-scale proxy fight, and all written solicitation materials would have to be filed with the SEC. While use of this exemption would relieve the fund of having to prepare and file a formal proxy statement, it would have few other advantages compared to a full-scale proxy fight, while requiring the fund to incur many of the same costs. Software Fund's main concern about this alternative is that it would be "toothless" since it would not actually result in a material change to the composition of the board. It could threaten the company's say-on-pay proposal, but the fund's criticisms of company management are not focused on executive compensation.

Software Fund decides to prepare for a full-scale proxy contest. A major benefit of focusing on a formal proxy contest is that the fund can start its campaign without restriction (other than the federal anti-fraud rules), even well before it prepares and files a proxy statement. Once the fund intends in good faith to file a proxy statement, there are no restrictions on its ability to orally solicit other shareholders. Written solicitations are also permitted, but must be filed with the SEC, where they will be subject to monitoring by the staff. This permissive use of oral and written solicitations remains available even if — and up to the time when — the fund later decides not to proceed with the proxy contest (or file a proxy statement), as a result of a settlement or otherwise. Another benefit is that the fund's announced intention of mounting a proxy contest, coupled with concrete steps (e.g., the submission of written advance notice in compliance with the company's bylaws), will exert maximum pressure on management, and could lead to a settlement between the company and the fund before actually investing significant money and effort in the formal proxy campaign.

In addition to procedural steps, including the submission of a notice to the company and preparation of a proxy statement, the fund will have important decisions to make about the scope and nature of the proxy contest. These include the following:

Decide whether the fund should seek to replace a minority of the board or a majority. Contests for control of a majority of the board are statistically less likely to succeed, but, if successful, bring greater assurance that the fund's goals will be achieved. However, even a single, well-respected director can have a significant impact. Proctor and Gamble, Inc., for instance, credited activist investor Nelson Peltz and his firm, Trian Fund Management, with improvements in profitability after Mr. Peltz joined the board following a proxy fight.[8] Among proxy contests brought in 2018, the vast majority sought one or more seats on the company's board of directors, and about a quarter of those sought board control.[9]

Identify director candidates. Should the fund nominate candidates from among their friends and insiders? Independent, well-respected candidates could be more appealing to other investors in seeking their support, but inclusion of one or more insiders can help to ensure that the fund's objectives remain in focus. If the board includes insiders of the fund, the fund's ability to trade the company's common stock will be restricted, and there may be additional restrictions under Exchange Act Section 16:

- Identify any elements that could inhibit the proxy contest, such as the existence of a "shareholder rights plan," which could limit the acquisition of additional securities, and any provisions of a trust indenture, or other agreement or instrument that may be triggered by the acquisition of control;
- Identify and retain members of the "deal team." Essential team members include a proxy advisory firm, to help identify and communicate with other investors, a law firm, and a financial advisor if there are financial or restructuring issues. Other non-legal strategic advisors may become involved; and
- Consider whether to seek a settlement with the company, and, if so, the timing of such an effort, and the terms upon which the fund might be willing to settle. The most common outcome of proxy contest is a settled resolution.[10]

Conclusion

Engaging in shareholder activism involves a complex set of factors and considerations that even the most experienced investors can find challenging. The interplay of these considerations could be even more challenging for a fund that lacks experience in such campaigns. This is particularly the case if one were to include issues involving Exchange Act Sections 13(d) and 16, as well as HSR, which were assumed away in our scenario. Nonetheless, an inexperienced investor will gain a working level of experience from even a single, limited campaign. Once the fund has publicly engaged with a portfolio company, it should be taken more seriously in the future, and could move quickly if it decides to try again.

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[8] *See, e.g.,* "P&G CEO Taylor, activist investor Peltz laugh off proxy battle as stock soars," Cincinnati Business Courier, Sept. 20, 2019.
[9] The Conference Board, Proxy Voting Analytics (2015-2018), at 170.
[10] The Conference Board, Proxy Voting Analytics (2015-2018), at 180.

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