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Schulte's Michael Swartz Discusses Section 16(b) Litigation, Exemptions and Strategies for Hedge Fund Managers to Reduce Risks of Non-Compliance

Hedge fund managers' trading activities have been closely scrutinized by regulators for years for evidence of insider trading, market timing or other suspicious or illegal activity. Now, managers face another risk in trading: short swing profit litigation brought by civil plaintiffs, which has seen a significant upswing in recent years. Section 16(b) of the Securities Exchange Act, known as the short swing profit rule, is a strict liability rule designed to prevent the possibility of insider trading by imposing certain obligations and restrictions on directors, officers and greater than 10% beneficial owners of voting, equity securities registered under the Securities Exchange Act. Though less widely publicized than Rule 10b-5's prohibition against fraudulent insider trading, hedge fund managers should understand Section 16(b)'s restrictions as they can result in significant economic ramifications and civil liability for firms and their funds.

Faced with this potential litigation risk, hedge fund managers must ensure they make required filings as company insiders or beneficial owners and comply with available exemptions from these reporting obligations. The *Hedge Fund Legal & Compliance Digest* recently sat down with Michael Swartz, a partner at Schulte Roth & Zabel, to discuss how short-swing profit rule litigation is currently impacting hedge funds and what managers can do to mitigate the risk of litigation.

Analysis of Section 16(b) of the Securities Exchange Act, Exemptions and the Rule's Impact on Hedge Funds

How does Section 16(b) of the Securities Exchange Act impact hedge fund behavior?

Hedge fund managers, in particular their in-house counsel and compliance officers, spend a lot of effort attempting to make sure that they don't engage in transactions that implicate Section 16(b). That is more difficult than it sounds, because the rule is highly technical and sometimes counterintuitive.

Hedge funds are typically very aware of the 10% beneficial ownership threshold, and spend a great deal of time monitoring their positions to make sure they do not cross it or, if they do, that they don't engage in short swing trades. The only trades that are captured by the statute are those that take place within a period of less than six months. If you're sure you're going to buy on day one after the beneficial ownership threshold is crossed, but not sell within six months of that purchase, you're okay. However, we sometimes see managers get tripped up by the rule because certain actions seem like non-events from a trading perspective (such as amending or renewing a swap position that has expired), yet count as a Section 16(b) purchase or sale.

The 10% threshold is determined based on beneficial ownership, not just straight equity ownership. Counted in beneficial ownership are derivative securities if the holder has the right to convert them to stock within 60 days (or at any time if the holder is not passive). In addition, even if no single fund beneficially owns over 10% of an issuer's securities, plaintiffs often argue that related funds and their managers constitute a "group," in which case all the holdings of the group are added together for purposes of determining greater than 10% beneficial ownership.

What is the difference between Section 16(a) and Section 16(b)?

Section 16(a) contains reporting requirements. When you're over 10%, you have to report your trades on Forms 3, 4 and 5. Section 16(b) contains the disgorgement rule.

What does Section 16(b) of the Exchange Act contemplate?

Section 16(b) restricts officers and insiders of a company from making short-term profits at the expense of the firm. It's a strict liability, prophylactic rule designed to prevent the possibility of insider trading, even if you don't actually insider trade. It's significant that even if the fund does nothing wrong or isn't benefiting from insider information, if a fund violates its terms—if the fund purchases or sells securities within six months if it is a 10% beneficial owner—the fund has to disgorge all of its profits from those trades. The disgorgement goes beyond what the fund actually made. Certain case law says the rule is designed to deter potential insider trading, and so the disgorgement is as comprehensive a mechanism as possible.

In what situations does Section 16 affect hedge fund managers? What triggers Section 16(b) disclosure requirements?

Section 16 liability and disclosure requirements typically arise when funds have a greater than 10% ownership stake. It can be complicated to determine if you're a greater than 10% owner because managers have to figure exactly what counts toward the 10% rule—as certain securities aren't counted—and assess the group rule.

For hedge funds, a tricky issue is raised by the "director by deputization" situation. Because Section 16 also applies to directors and officers, courts have sometimes endorsed the theory that managers who appoint directors as their deputies to the boards of public companies are the functional equivalent of directors for Section 16(b) purposes. This can trip up managers because all non-exempt trades by directors are subject to disgorgement (regardless of their beneficial ownership level). Therefore, managers sometimes take comfort that Section 16(b) does not apply to them because they are not 10% beneficial owners, while the plaintiffs' bar may take a distinctly different view. Whether the director by deputization theory applies is a very fact specific inquiry.

Are there any exemptions for Section 16(b) filing obligations available to hedge fund managers? Can you explain the theory behind the Registered Investment Advisor Exemption to the rule and why fund managers should be cautious when assuming this exemption will apply to them?

Yes. The main exemptions are contained in Rule 16(a)(1). One of those exemptions is the Registered Investment Adviser Exemption, which provides that if managers meet the exemption's three-part test, then the manager's trading is not subject to Section 16(b). There has been a substantial amount of litigation over the last couple of years over the applicability of this exemption.

The three-part test consists of: 1) whether a manager is a registered investment adviser; 2) whether the manager is a passive investor; and 3) whether the securities are held for the benefit of third parties. The third party prong of the test is where plaintiffs' lawyers have focused in litigation. The plaintiffs' bar takes the position that because many hedge fund managers invest their own money alongside their investors, the funds are not managed for the benefit of third parties due to the hedge fund manager's money being in the fund.

We litigated this issue for a fund manager in California and won, since we were able to show that the exemption was met. However, in a case we did not litigate, a New York federal court found the exemption did not apply. Now there is a split between how the federal courts in California and New York analyze this issue, which is something that we continue to monitor.

Because of the split among the courts, hedge fund managers need to proceed cautiously and they should assume, until there is further clarification from the SEC or a resolution between the courts, that if they rely on the Registered Investment Adviser Exemption, there is a substantial risk that they will be sued.

What are the common pitfalls hedge fund managers face when relying on the Registered Investment Adviser Exemption?

Perhaps the biggest pitfall by hedge fund managers relying on the Registered Investment Advisor Exemption is assuming that the plaintiffs' bar will not determine that they are relying on the exemption, since managers do not publicly disclose that they are relying on it. Hedge fund managers who rely on the Registered Investment Adviser Exemption have taken the position that their trades are exempt under Section 16, so they do not report them, and they do not disgorge the profits from trading that would otherwise be subject to Section 16. Notwithstanding that, the plaintiffs' bar sometimes can deduce that a manager has been relying on the Registered Investment Advisor Exemption by reviewing changes in positions in Form 13F and Schedule 13G filings; they then sue the managers and the funds on the theory that trading is not exempt.

Structural differences in how funds are set up could impact whether courts view the manager as holding securities for the benefit of third parties. Although I think the better view is that all managers who are registered investment advisors meet the test, the best situation for a fund to take advantage of the Registered Investment Adviser exemption is for the funds to have an independent board of directors that is separate from the registered investment adviser, because that structure adds an additional level of separation between the manager and the funds.

Given how aggressive the plaintiffs' bar has been and the split in judicial decisions, from a litigation perspective, it's risky to rely on the Registered Investment Adviser exemption. As I mentioned, there are structures managers can use to reduce that risk, but there is no way to entirely eliminate the risk of being sued.

Section 16(b) Litigation

Are you seeing an increase in Section 16(b) litigation geared towards hedge funds?

Yes. I am definitely seeing more 16(b) litigation against hedge fund managers. There is a Section 16 plaintiffs' bar, and there are known regular players. Two firms, in particular, have really zeroed in on the Registered Investment Adviser exemption and have brought multiple suits on their monitoring of Form 13F and Schedule 13G filings. Not only have those lawyers sued multiple managers, but they have sued some managers multiple times for different investments. Another firm has been monitoring Issuers' Forms 8-Ks that report on settlements with managers. When the manager appoints an insider to the issuer's board, those lawyers bring suits based on the director by deputization theory.

What are some of the recent cases that have been brought regarding Section 16(b) violations against hedge fund managers?

The most significant recent Section 16(b) cases have centered on whether or not managers can rely on the Registered Investment Adviser Exemption. We litigated this issue in California and won. We were able to show for a manager based in San Francisco that the exemption was met and get the claims dismissed on that basis. Litigation on this issue in New York was unsuccessful at the motion to dismiss stage. There is a split now between how the California federal courts and the New York federal courts look at this issue. There has been follow-on litigation in which another judge in California found the exemption to apply, while another judge in New York found that it did not apply.

I should reiterate that because of this split, hedge fund managers need to proceed cautiously, and they should assume that there is a substantial risk of getting sued if they rely on the Registered Investment Adviser Exemption, until there is further clarification from the SEC or a resolution between the courts.

What are the implications of these cases?

Most obviously, there are implications on trading activity. For example, funds that previously thought it was appropriate to rely on the Registered Investment Adviser Exemption may still feel it's appropriate, but now there is an increased risk of litigation that may cause fund managers to question whether to rely on that exemption. The uncertainty has caused managers to not rely on that exemption.

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Exemption is for the funds to have an independent board of directors that is separate from the registered investment adviser.

What are the penalties/costs involved in this litigation?

Section 16(b) doesn't impose a penalty, per se. Managers and funds that fall within its terms have to disgorge all of their short swing profits. In reality, this can be extremely punitive because of the way the courts measure short swing profits. The disgorgement amount can be, and often is, well in excess of what the firm actually profited.

Another obvious cost is litigation cost. Managers or the funds pay their own counsels' fees, but they do not pay additional fees to plaintiffs' counsel. Rather, the company pays plaintiffs' counsel out of any disgorgement of short swing profits. For example, if the hedge fund disgorges $1 million and a plaintiff's counsel is to receive a $200,000 fee for identifying the claim and bringing the suit, that payment comes out of the money the hedge fund pays to the company. It is not an added cost on top of the disgorgement amount. However, as I mentioned, the manager or the funds (which of the two pays depends on the facts and circumstances of the trading) pays their own counsel's fees. We've found that in many of our cases that the hedge fund's legal expenses are subject to insurance coverage, although the amount of disgorgement is not.

Do you think this trend will continue? If so, why?

I do believe the trend will continue as long as the plaintiffs' bar is successful in the cases they bring. They have been very successful in bringing claims, so they will continue to bring litigation until there is some additional clarification from the SEC or a higher court.

Compliance

What are some steps hedge fund managers can take to ensure compliance with Section 16(b)?

Section 16(b) is highly technical and counterintuitive in a lot of ways; therefore, it is important for fund managers to consult with counsel who have special expertise in this area. For example, the Registered Investment Adviser exemption has seemed clearly applicable to managers and in-house counsel but, as we've discussed, there are instances where courts have found the exemption does not apply. Some managers may not realize that the courts in New York have taken the position that because a manager invests in a fund alongside investor money, they are not deemed to be holding securities for a third party.

Additionally, I would advise managers that they interpret their level of beneficial ownership broadly to include derivatives securities, common stock and, in some cases, swaps. Those managers who will be crossing 10%, whether in beneficial ownership or economics, should speak with counsel to discuss the fund's trading strategy, the positions they are holding and what might come up in the future to make sure they do not unwittingly trigger Section 16(b) liability, end up in litigation and be subject to paying disgorgement amounts that exceed their actual profits.

What can a manager do if it has violated Section 16(b)? What does internal remediation entail?

There are several things that managers can do internally to remediate liability. First and foremost, a manager can try to structure their trading so that they get through the remainder of the Section 16(b) period without any further liability by ensuring that no purchases and sales can be matched within less than six months of each other.

Resolving any Section 16(b) liability already incurred involves several judgment calls. If Section 16(b) liability is clear, the manager has little choice but to disgorge the short swing profits. However, the statute is highly technical and many times the manager has a defense to liability. In that event, the manager has to decide whether to seek to resolve the liability by bringing the issue to the company's attention (which is sometimes done) or wait and see if a plaintiff's lawyer ever identifies the issue.

The situation becomes even more complicated when a shareholder makes a demand on the company to bring a Section 16(b) claim. Shareholders have a right to bring suit in the event that the company does not resolve the claim within 60 days of receiving a demand. We have taken the view on occasion that plaintiffs' lawyers are not going to be particularly reasonable in seeking to resolve a claim, and so we have sometimes settled directly with the issuer within the 60-day investigation period. In those situations, the settlement amount paid to the issuer needs to reflect the strength of the Section 16(b) claim, or the shareholder who made the demand may challenge the settlement in court. Settling with the issuer directly does not eliminate the need to address a potential fee claim from the shareholder's counsel, who will contend they are entitled to a fee for having brought the matter to the issuer's attention. Settlement agreements with issuers typically provide that the issuer will pay any such counsel fees.

The individual who sends a demand letter is typically a shareholder, but the shareholder usually has little or no interest in the Section 16(b) claim since all disgorged profits go to the company. In reality, these cases are driven by the plaintiffs' bar, which can earn substantial fees for bringing or settling Section 16(b) cases. The SEC doesn't bring these cases.

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