Regulatory Change: 2015 Diagnosis, 2016 Prognosis

Schulte Roth & Zabel's leading securities litigation practice

HAMLIN LOVELL

THFJ visited the New York office of Schulte Roth & Zabel LLP (SRZ) and met with partners from the firm's Securities Litigation Group. With offices in New York, Washington DC and London, SRZ is a leading law firm serving the alternative investment management industry.

SRZ is among only a handful of law firms to have successfully defended a federal securities fraud class action all the way through trial to a jury verdict of no liability. The lawyers in the firm's leading securities litigation practice routinely handle complex multi-year matters involving high-profile financial and investment management companies and their officers involved in investigations and cases.

In recent years, regulation has become a leviathan, riddled with traps for the unwary that can lead to arbitrary, disproportionate and perverse sanctions. Elsewhere, the lack of clearly defined rules creates uncertainty over areas such as determining investor collusion or defining bribery. The absence of preventative policies and procedures is increasingly sufficient for sanctions, without any actual or intended wrongdoing.

SRZ is helping clients navigate through these treacherous waters, where one omitted policy or wrong step can suddenly result in managers being caught in the net of many other regulations. The firm's litigators are always thinking laterally about how clients could be impacted by regulations that have federal criminal, regulatory civil and private civil dimensions, sometimes involving multiple regulators, self-regulatory organisations and multiple plaintiffs. Hedge fund managers also need to think laterally about how their firm-wide positions over multiple investment vehicles, and/or across the capital structure of an investee company, could be aggregated for regulatory purposes.

SRZ's Litigation Group includes nine former Assistant U.S. Attorneys and two former Securities and Exchange Commission (SEC) officials. When THFJ met with the SRZ partners, the discussion was led by Howard Schiffman, co-chair of the Litigation Group and a former SEC Division of Enforcement trial attorney. Joining Schiffman were SRZ partners contributing in their specialist areas – Eric A. Bensky, Brian T. Daly, Harry S. Davis, William H. Gussman, Jr., David K. Momborquette, Gary Stein and Michael E. Swartz. Other key members of the securities litigation practice include Martin L. Perschetz, co-chair of the Litigation Group and a former federal prosecutor, and Charles J. Clark, litigation partner and a former SEC official who recently joined the firm.

The SRZ partners touched on the following nine hot topics during the informative discussion.

INSIDER TRADING: *NEWMAN* IS NOT AN END GAME

SRZ attorneys recently updated and expanded the Insider Trading Law and Compliance Answer Book 2016, a book published by Practising Law Institute and edited by Harry Davis.

Schiffman believes the seminal *Newman* judgment was the biggest securities law issue in 2015. "After *Newman* held that the remote tippees in that case were not liable, the government was pressured to meet a higher standard of proof of pecuniary benefit", Schiffman explains. Adds Davis, "*Newman* is a hot-button issue about breach of duty and the way courts look at it. There has to be a tangible personal benefit to the tipper and the downstream tippee must know of it".

The SRZ lawyers said they did not think that the Justice Department would succeed in its attempt to have *Newman* reversed, and the Supreme Court's denial of the government's appeal proved that prediction correct. Now that *Newman* is final, some former convictions have been overturned, such as that of SAC Capital's Michael Steinberg.

Newman Impact to Be Reduced Not Reversed

However, there is no cause for complacency. Schiffman believes the impact of *Newman* could be reduced in several ways. "*Newman* could be more narrowly interpreted, with the benefit to tippers re-defined in a narrower range; other judgments could supersede *Newman*; and the courts could limit the impact of *Newman*". Already Schiffman has seen signs of this in the Ninth Circuit (covering Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon and Washington), and he admits that "the defense bar had hoped for a higher standard of proof".

Additionally, "*Newman* is only binding in the Second Circuit (New York, Connecticut and Vermont)", Davis points out and, accordingly, "the SEC could bring many of its cases in other jurisdictions in order to attempt to avoid the impact of *Newman*". Moreover, the Department of Justice could seek to prosecute insider trading under the umbrella of other statutes, Stein explains, and try to "argue that personal benefit does not apply" under those laws. But the SEC has no jurisdiction to enforce these criminal laws.

Overseas Collaboration

And outside the United States, different rules apply – Greenlight Capital's David Einhorn fell afoul of the UK rules but not the then US rules. The United States is often characterised as "the world's policeman" in matters of defence, and increasingly many US regulators seem to have extraterritorial ambitions, now including the SEC. Indeed, Davis points out how "the SEC acts as a conduit for investigations elsewhere, such as FCA investigations, which go through the SEC Office of International Affairs". This unit has been issuing subpoenas initiated by regulators from countries including the United Kingdom, France, Spain and Brazil. "The only country we would not expect to see involved is Switzerland, as their secrecy laws could preclude them from reciprocating", opines Davis.

Private Civil Claims

Separately from any criminal or civil actions instigated by US or overseas regulators, private parties (including hedge funds) can bring their own claims against alleged inside traders on a civil basis (though any disgorgements to the SEC are typically offset against those paid to private claimants). In addition, funds are increasingly opting out of securities class actions and bringing individual actions in an effort to maximise recoveries. Swartz counsels that on the defense side, "we are seeing more cases being brought against funds in a wider range of areas."

Credit and Debt Markets

Additionally, insider trading now reaches well beyond public equity markets, in particular, into credit and debt markets. Schiffman has seen "allegations of insider trading in bankruptcy cases in relation to equitably subordinating a claim". What is perhaps most surprising, he adds, is that even after companies have "cleansed" the market by disclosing material non-public information, in accordance with trading protocols, "there can still be allegations that information might have been shared with informal, ad hoc committees of creditors that might be involved with out-of-court restructurings". Momborquette concurs with all of this: "Though *Newman* gets tremendous focus, we do not see them taking the foot off the gas on insider trading, which remains a big focus of SEC examinations and enforcement. We see no sign that the volume of civil insider trading cases is going down".

HIGH-FREQUENCY TRADING (HFT) RELATED ACTIONS

Yet Momborquette does entertain the possibility that market manipulation-related actions "could at some stage replace insider trading as the core focus for the SEC". Schiffman recently handled a big investigation "that raises very significant issues". Next year, he anticipates some "gigantic sell-side HFT cases, as the SEC is really concerned with HFT". The cases are likely to focus on specific aspects of HFT where there is potential for market abuse. There is no general campaign against HFT and some associated practices (such as exchange rebates for liquidity providers) are not a major issue, as Schiffman thinks the SEC has historically said these are appropriate if disclosed.

Spoofing in Focus

Says Momborquette, "The SEC is very active concerning spoofing, or placing orders with no intent of executing those that are cancelled later on". Indeed, a few weeks after we spoke to Momborquette, commodities trader Michael Coscia was found guilty in a landmark spoofing trial. But of course, there are always legitimate reasons for cancelling orders. Schiffman explains that algorithmic trading is now so ubiquitous that "at least 90 per cent of all orders are cancelled, for good reason in some cases, and the SEC will start asking why they were cancelled". Davis thinks one legitimate reason for order cancellation could be "fill or cancel" orders that are either filled or cancelled in order to permit the participant to execute at another venue. Davis adds that the SEC recognises order cancellation can be a normal response to market movement. "If a trader has offers in eight markets, and one hits the offer, it is natural to cancel the other seven", reasons Davis.

But Schiffman expects that "order cancellation may be the subject of more significant cases soon, as in some cases, spoofing and order cancellation can be seen as manipulative". In particular, Schiffman thinks spoof orders "placed before market opening time that are cancelled at the open could attract particular scrutiny, as at this time of day, the market can be particularly sensitive to order imbalances". (Such as those occurring on the hugely volatile morning of 24 August 2015.)

Latency Focus

Moving on to another aspect of HFT, the faster trading per se is not a concern; however, cases where latency can give some participants an informational advantage are being looked at. "Cases based on latency making profits would be ground-breaking", says Schiffman. Though he is not yet sure who may be targeted, or how, he thinks cases could be brought under front-running or best execution rules.

Multiple Parties

As well as multiple potential bases for HFT cases, Bensky sees HFT investigations touching multiple parties. "As regulators investigate the sell side, big clearing firms and prime brokers (PBs) processing trades and orders from funds are under pressure to police and monitor conduct, trading, order activity and so on", he says. SRZ has plenty of experience advising and representing all of these market participants, as well as funds.

SEC EXAMS, INVESTIGATION AND ENFORCEMENT

Regulation is all-pervasive, even when it appears that there is a "loophole". For example, an adviser located in Florida, who manages less than $100 million and has fewer than five clients, can avoid registering with the SEC (because its assets under management are too low) and with its local state regulator (because they have a small number of clients). Yet this small, unregistered manager will still be covered by a web of regulations. Daly cautions, "Marketplace rules pull you in, so the anti-manipulation marketplace rules policed by the CME and FINRA, the general anti-fraud rules under state and federal law, and numerous other provisions of the federal securities laws can all be relevant". And of course, the SEC can still be drafted in for ad hoc enforcement actions. The vast majority of hedge funds in the United States are subject to SEC examinations, which are intrusive by nature, but do they have to be adversarial and hostile? Ambitious and high-calibre SEC officials (some of whom have extensive private sector experience) are assiduous and tenacious in seeking out potential grounds for enforcement – which can even include historical errors that were remedied years ago.

Handling Adversarial Processes

Schiffman began his career in SEC enforcement and finds that the exam process, which he once remembers as a constructive process of encouraging improvements, has become "very hostile as an adjunct to the enforcement process". Davis is concerned that examinations and enforcement are no longer separate, and has seen "regular collaboration" between

the two. Sometimes, information obtained in the exams is used by enforcement staff for investigations that need not be bound by the clean exam. For Davis, this is a double act – with exam staff as detectives and enforcement staff as the district attorney.

Schiffman thinks that the whole ethos has shifted from a constructive to an adversarial approach. "The SEC enforces actions for every single violation and prosecutes everything, never giving a little fish back. Fewer small cases were prosecuted in the old days", he says.

Chief Compliance Officers' (CCOs) Liability Without Complicity

Another new departure is that CCOs can be on the hook even without any personal complicity. "Historically, CCO actions were targeted when they were complicit in violations, such as knowing that false statements appeared in DDQs or RFPs, and often problems arose when CCOs wore many hats such as COO, CFO or front office", Schiffman recalls. Now, the BlackRock Advisors LLC (April 2015) and SFX Financial Advisory Management Enterprises Inc. (June 2015) cases show how CCOs that wore only one hat (and were not involved in any misconduct) were still prosecuted for having inadequate policies and procedures. "The BlackRock case related to a conflict involving a portfolio manager, and the CCO was accused of being deficient in setting up policies and procedures", Schiffman explains.

Meanwhile, the SFX case involved a president and principal misappropriating money, which was possibly due to a lack of policies on dual signing. "In this case a CCO even took action, fired the president and referred the case to the prosecutor's office. Yet the CCO still became a defendant on the basis that different policies and procedures could have prevented the violation", he says. That both cases were settled (BlackRock paid $12 million and its CCO $60,000; SFX paid $150,000 and its CCO $25,000), and not litigated, does not alter the fact that CCOs are being held to a very high standard of liability for defining policies. "This is a 'sea changer' because historically CCOs would have needed to have intimate involvement in the fraud", says Schiffman.

Stein thinks the new policy is counterproductive, as it is "now hard to recruit and retain qualified CCOs", and that is even before Registered Investment Advisers' (RIAs) CCOs may need to accept AML responsibilities (see below). A measure of how controversial the new policies are is that SEC Commissioner Daniel Gallagher took the highly unusual step of dissenting from the BlackRock and SFX settlement decisions (his dissent was later rebutted by Commissioner Luis Aguilar).

SEC Raising Its Game

Though Gallagher has left and Aguilar is scheduled to leave the SEC to join law firms, Schiffman finds "the SEC continues to attract top talent, especially as it now pays more. The SEC has a dedicated and hard-working staff, including graduates of top law schools".

In particular, the SEC has augmented its industry and computer staff, which can now analyse trading data much more effectively to identify cases of potential market manipulation. Schiffman respects the SEC's IT capabilities, which he describes as being "light years ahead, and relevant to the cybersecurity case we are working on that involved Ukrainians allegedly hacking into newswire services to get prior knowledge of earnings releases".

If In Doubt, Prosecute!

Davis thinks that the incentive structure for regulators is tilted in favour of prosecuting if in any doubt: "The natural inclination is to look for violations and bring actions, because the SEC will not get criticised for pursuing a case too doggedly. But if it fails to detect a problem that later surfaces, it will get hauled before a congressional committee. The SEC never gets called before committees when it brings cases, only if it fails to bring a case". This seems to parallel former UK FCA chief Martin Wheatley's statement that regulators should "shoot first, ask questions later". Wheatley now admits that he regrets saying this, but his epithet aptly describes the attitude of many regulators.

Controversy over SEC Tribunals

The SEC's internal administrative tribunals, which use its own judges, are perceived to give the regulator an unfair advantage over legal forums (such as federal court trials) where the SEC has had a much lower success rate. Schiffman, who recently won a case against the SEC for a client, recalls with some delight how "the SEC had a rough go of it in federal court". There have even been allegations that SEC judges were improperly pressured into ruling in favour of the regulator, although its own review found no bias. There are now two categories of challenges to the SEC's judicial (or, some would say, quasi-judicial) process. The legal argument that the tribunals are unconstitutional, and therefore illegal, is currently being litigated but is not likely to prevail, Schiffman reckons. However, the equitable argument is already being listened to and there are several proposals – to give more rights to defendants, have more discovery and provide the ability to appeal. The SEC thinks this will be more costly and time-consuming, but Schiffman thinks these proposals are "a step in the right direction and further changes will be made as the process evolves".

Longer Lookbacks

As if the SEC was not busy enough finding current violations, reformed transgressors continue to be seen as violators in the eyes of the SEC. They can be punished for past actions, and Daly has noticed "in examinations, the SEC is now asking for longer lookbacks to see amendments to policies such as expenses and client charges. This can be unfortunate as managers who have cleaned up their act and improved their procedures years before may still be held up by the SEC for what preceded that".

SELF REGULATORY ORGANISATIONS (SROs) – EXAMS AND FINES

Registered Investment Advisers (RIAs) do not have SROs, but those financial market participants that do have SROs go through examinations, which entail different challenges and complications. National Futures Association (NFA) exams are a whole different ball game, Daly finds. "The NFA examiners are professionals with very different exam goals; the NFA examination process focuses on risk management and comes at fiduciary duties from that angle, which can be quite different

from the SEC's approach", he says. The NFA can also act as a messenger for other regulators, referring funds to the Commodity Futures Trading Commission (CFTC) if it suspects a firm may have violated the commodity exchange act.

Futures exchanges are licensed by the CFTC as SROs, and they are reviewed annually by the government agencies. "This means that the exchanges must carry out their own enforcement function; several of the exchanges have made a number of litigation hires from the criminal bar (such as former district attorneys and public defenders) to create a real prosecutorial enforcement division", Daly points out. Violations pursued by the exchanges have included position limit breaches, and "market participants are often taken by surprise by the severity of the sanctions", he adds. A particularly complicated area is Exchanges for Related Positions (EFRPs), whereby over-the-counter (OTC) securities are exchanged for physical instruments or futures, often involving exchanges between listed futures, or options, and OTC swaps or options. "The rules are in a state of flux and are hard to understand for brokers, with many traps for the unwary, leading the CME Group to bring enforcement cases", Daly warns.

ACTIVISTS IN CONCERT?

A new area of focus for the SEC is potential collusion between funds, including activist funds, particularly where they may appear to be acting together to put a company into play. If one fund puts a company into play, and other fund(s) subsequently invest, the SEC supposition may be that there was some form of collusion. "It is a very difficult area, and they have not done anything yet", notes Schiffman, whose colleague, Charles Clark, recently joined SRZ's Washington DC office. Prior to entering private practice, Clark spent nine years in the SEC's Division of Enforcement, investigating and prosecuting some of the SEC's most significant matters, and upon being named assistant director, supervised the SEC's investigation into Enron Corp.

Clearly, any casual analysis of 13F filings shows that many hedge funds, or other funds, can coincidentally hold the same positions, without there being any links between the managers. The SEC has not yet defined criteria for determining whether or not funds have any agreements to act in concert or in parallel, but the concern is only over any concerted action that has not been disclosed.

Failing to disclose acting in concert is serious enough in itself, and funds deemed to be acting in concert could also be caught in the net of other rules that apply to any investor above certain ownership thresholds.

Short Swing Profit Rule

One example is the Section 16(b) short swing profit rule. Explains Swartz, "If the aggregate beneficial ownership of a single fund or group of funds exceeds 10 per cent, then any profits made by each fund or group member within a six-month time period must be disgorged and given to the investee company". The short swing profit rule can operate in perverse ways because 'profits' are calculated by subtracting the lowest purchase price from the highest sale price (including short sales - although most shorting by Section 16 insiders is prohibited) within any period of less than six months, whether or not the investor has made any overall profit. Not only can funds be required to disgorge more than their actual profits; those who have lost money on an investment can also be liable so long as sufficient share price volatility has occurred for some sale prices to exceed some purchase prices.

A federal appeals court has stated that the rule is "arbitrary and sweeping", but it continues to apply. Naturally companies do not necessarily want to bring these claims against their investors, but shareholders have standing to bring them derivatively on the company's behalf, and plaintiffs' lawyers are well incentivised to monitor closely any potential claims as they may receive between 10 and 25 per cent of the disgorgements.

Plaintiffs' lawyers are becoming increasingly sophisticated at identifying these types of potential claims. Swartz adds, "There's a real danger of funds being improperly accused of being a group and therefore having their ownership aggregated for purposes of calculating whether the 10-per cent threshold has been crossed."

According to Gussman,"funds have to be particularly careful to avoid acting as a group in distressed situations because the company itself might approach a group of funds with common economic interests to engage in discussions with the company". In that situation, plaintiffs' lawyers are likely to point to any communications between the funds as evidence of a group, and argue that the funds' holdings should be aggregated to determine whether they are subject to the 10 per cent threshold.

The essential distinction in these cases is between those investors who coincidentally have the same economic objectives but have not reached any agreement or understanding with each other, and those who have actually agreed to work together with regard to the company's securities. "Funds can find it surprisingly difficult to establish that they did not act as group" notes Swartz.

Antitrust Disclosure Implications

Swartz goes on to say that funds acquiring or increasing a stake can also put them on the radar of federal antitrust laws, such as the Hart-Scott-Rodino (HSR) competition law which requires owners of more than $76.3 million of stock to file with the FTC and DOJ for antitrust approval. This is nothing new to activist funds but in August 2015 the FTC brought a complaint and entered a consent decree with Third Point, alleging that the manager improperly tried to make use of the 'investment only' exemption whilst contemplating running a proxy contest, as well as making statements intended to influence Yahoo's management. This case shows that the government interprets the scope of the 'investment only' exemption narrowly and arguably increased the range of activities that will be deemed inconsistent with passive investment intentions. Two FTC Commissioners, Maureen K. Ohlhausen and Joshua D. Wright, dissented, as they fear the case may discourage investor advocacy, amongst other things.

Swartz notes that, like Third Point, other hedge funds have fallen foul of HSR because they did not believe their investments had any competition implications and they had no intention of acquiring the investee company. Swartz does not think that the antitrust regulators are "seriously concerned about holdings above the threshold that are not associated with any plans for corporate activity," but cautions that, in a rigidly rules-based regulatory system, the letter and not the spirit of the law is what counts. The crucial point is that "it is a technical rule to comply with, and fines of $16,000 per day can mount up to millions if HSR filings are not made", Swartz warns. Yet another trap for the unwary.

Liability for Investee Company Statements

Going beyond HSR disclosures, investors with large stakes can also be deemed to control a company – and are then held responsible for misstatements made by investee companies. In one case, Schiffman successfully brought a motion to dismiss a case where a fund client owned 47 per cent. "The court agreed that the fund did not sufficiently control the issuer", Schiffman is pleased to report.

RULE 105 SHORT SELLING

2015 has continued the pattern of the SEC bringing a number of cases under Rule 105 of Regulation M relating to short selling in advance of a secondary offering. Davis says that there have been "a tremendous number of Rule 105 cases brought against hedge funds, estimating that there have been at least 70 such cases brought since the Rule's adoption". This is a very technical rule, under Regulation M, which prohibits firms shorting a firm commitment underwritten secondary offering during the Rule 105 period (typically five days before its pricing) from participating in the offering (unless one of the Rule's exceptions applies). Like many others, Rule 105 is a strict liability law with no intent or knowledge requirement. Sanctions include not only disgorgement of profits but also penalties that can run into the millions. SRZ sees five to 10 new actions every year, and lawyers there view it as "a trap for the unwary that can easily be landed in, despite benign intent".

BRIBERY AND MONEY LAUNDERING

Uncertain Reach of FCPA Often Not Tested in Court

The Foreign Corrupt Practices Act (FCPA) remains a focus for both the SEC and the DOJ, with the SEC's Enforcement Division building a dedicated unit. So far, it has mainly charged non-financial companies, including many non-US companies, with making improper payments to government officials who may have influenced contract wins. But breaches of the act are not clearly defined, and unpaid internships, offered to an offspring of a client, were deemed improper in one case. "No dollar figure determines whether any gifts, entertainment or 'wining and dining' constitutes a bribe. Even small amounts could be viewed as an inducement on the eve of a big deal", Stein warns. Yet gratuities of larger value could be disregarded if there is no quid pro quo. "Ultimately the courts decide if it is a bribe", says Stein – but only if the matter gets to court. Stein is often surprised to see companies settling on the basis of defensible allegations, and he points out that individuals have often won when they have challenged the DOJ.

Expanding Coverage of Anti-Money Laundering (AML) Rules, and Scope of AML Violations

THFJ recently published SRZ's Alert on the US Department of Treasury's (DOT) Financial Crimes Enforcement Network's (FinCEN) Proposed Rule for all registered investment advisers to be covered by many aspects of AML rules, including establishing an AML program and making suspicious activity reports. "This is another looming area of potential CCO liability", says Bensky, as RIAs will need to designate an AML compliance officer, who can be held responsible for any shortcomings.

When RIAs are required to comply with AML rules (probably beginning in 2016), AML is likely to be interpreted more imaginatively in relation to other financial institutions. Bensky warns that "AML has been used in an ever increasingly expansive way, with almost anything defined as an AML violation". He adds, "the government has viewed AML violations very broadly to bring actions against sell-side firms, leading to enforcement actions".

Expanding SEC Purview

The FinCEN proposals to give the SEC exam authority for AML purposes as part of regular exams also extend the SEC's purview into the realm of criminal law. Daly, who helps firms with examinations, finds this surprising. While the higher-level laws and rules are overseen by the DOJ and FinCEN, "the SEC is now asserting jurisdiction over AML", he says.

FINES AND PRIME BROKER LIABILITY

The escalating level of fines, now running into billions of dollars, is perceived as disproportionate in some quarters. Fines go to the general US Treasury, so, unlike some lawyers seeking damages in civil cases, SEC officials do not have any personal financial incentive to levy fines, nor do fines add to the SEC budget.

Schiffman is not opposed to financial penalties as any matter of principle. Record-breaking corporate fines imposed by the SEC "are fair enough if illicit profits have been made, but in many cases the fine is completely disconnected from any profits made, which means you are punishing the wrong person", he explains. In some cases, firms have even been fined following losses. "In the Knight Capital case, it made a mistake, lost money, and then the shareholder fines of $12 million mean it was punished twice", recalls Schiffman. His argument is simply that fines should be proportionate to profits. "If the corporation did not make any gain, it is bad policy, and makes no sense, to fine it and punish the wrong person". Therefore, Schiffman argues that "the LIBOR fines make no sense, as there was no impact on the marketplace and banks may not have made any money". The motivation for the fines was "a race to the top in fines, to make them bigger and bigger, because regulators know it is hard for the banks to fight their own regulator", he thinks.

Prime Broker Liability

If banks and brokers are loath to dispute regulatory fines, they can, and should, fight civil cases. For instance, Schiffman represented Goldman Sachs in a FINRA dispute resolution arbitration brought by hedge fund Walrus

Master Fund Limited and Adam D. Sender in 2011. The statement of claim requested more than $60 million in damages and alleged that claimants suffered losses resulting from liquidating securities positions to meet risk calls during the October 2008 financial crisis. The March 2015 arbitration award denied all of the claimant's claims, and assessed forum fees against the claimant, handing Goldman Sachs a resounding victory.

The significance of this case is that, however hostile the broader environment may appear, "there are still situations when a corporate defendant can go to trial and prevail", says Schiffman, who has nearly always seen PBs acting within the terms of their agreements. Even in 2008, Schiffman did not notice any "force majeure" clauses invoked by PBs in order to override the terms of a contract. He has also been on the other side of cases where PBs have not followed terms, and he is litigating one such case now.

Schiffman and SRZ are highly sought after because "we have practiced in the PB space for a long time", he reflects. Schiffman considers SRZ to house "pre-eminent PB lawyers who act for many of the PBs and have tried the most PB cases of anyone". Schiffman has been trying PB cases for over 20 years, all over the United States, including in Arizona and California. State laws do not vary much, he has found, so the individual contracts are more relevant. Some jurisdictions are, however, "more hospitable to corporate defendants", and Schiffman recalls Arizona as one where plaintiffs were well received. Equally, Schiffman has had successes "even in unfriendly jurisdictions with unsympathetic courts".

PBs can be vulnerable to opportunistic litigation simply because "the PB is often the only solvent party left in cases of frauds or blow-ups, where the money manager may have nothing left", Schiffman explains. He says he has generally been "very successful at avoiding PB liability, and has been involved in many Madoff- and Petters-related cases". But he observes that PBs have sometimes incurred losses and cautions that "changes in state law on fraudulent conveyance have lowered the bar for PB liability". Essentially, there is no longer any need to prove intent, knowledge or co-conspiracy. An entirely innocent PB, who knows nothing of a fraud, "could be trapped just because it received money from the wrongdoer". Though Schiffman might not agree with this, naturally he respects the law.

APPRAISAL STATUTES ("MINORITY SQUEEZE OUTS")

In general, it seems that regulation is hampering funds, but in a few areas it can help them. Swartz identifies appraisal statutes as potentially offering very attractive risk/reward for hedge funds that do not vote in favour of a takeover bid and seek an appraisal rather than the agreed upon merger consideration. In appraisal actions, courts seek to determine the fair value of the target's shares exclusive of any value arising from the merger itself, such as deal-specific synergies. And, under Delaware law, funds receive 5 per cent interest from the effective date of the merger through the date of payment or judgment.

The determination of fair value can be higher or lower than the merger consideration but, in Delaware, judges have found fair value to equal or exceed merger consideration in 85 per cent of the cases litigated to a decision. So, "while appraisal actions need to be carefully selected, typically the worst case is you get the share price plus interest because it's very unlikely that a court concludes that the deal price exceeded fair value," Swartz says. The best case is that holdouts may get a premium over the original offer plus interest.

Like most cases, these tend to get settled, as there is risk involved and it is expensive to hire expert witnesses for the process but, "as appraisal litigation increases, and the stakes become greater and greater, expectations of favourable settlements could fade as both sides dig in," adds Gussman. (In the United States, expert witnesses can command six or seven figure fees.) When market valuations are drifting upwards, the passage of time plays into funds' hands as the reference point for appraisals is at the closing of the transaction, not when the deal was signed. "If market or industry conditions have improved in the interim, then valuations will tend to be higher. In any event, 5 per cent is not too shabby after six years of near-zero interest rates," notes Swartz.

Conclusion

Schiffman reckons regulation follows a pendulum-like movement, noting, "we are past the high point of regulatory fever post-2008, and the pendulum is starting to drift back a bit, but it moves slowly and is still at a high pitch". Law firms, regulators and financial firms will be busy for many years to come. **THFJ**

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