Hedge Fund Alert

A periodic update on trends and developments affecting the industry

Traps for the Unwary: Section 16 Issues for Hedge Fund Managers to Consider

Highlights

- Section 16 of the Securities Exchange Act of 1934 (the “Exchange Act”) applies not only to directors and officers but also to institutional investors. Institutional investors have been subject to numerous lawsuits under Section 16 seeking hundreds of millions of dollars in damages for engaging in “short-swing” transactions – that is, purchases and sales, or sales and purchases within six months.

- An institutional investor can become subject to Section 16 in two ways:
  o by having a representative serve on the Board of Directors of the issuer;
  or
  o by acquiring 10% of the issuer’s stock or being deemed part of a group that collectively owns more than 10% of the issuer’s stock.

- Key questions include:
  o When does having a representative serving on the Board of Directors cause an investor to be subject to Section 16?
  o What activities by an investor can make it part of a group?
  o When a group is found to exist, who is deemed to be part of the group for purposes of the 10% ownership requirement of Section 16?
  o What rights to acquire stock, short of actual ownership, cause that stock to be deemed to be owned by the investor for purposes of the 10% ownership requirement?

Introduction

Many hedge fund managers manage more than one fund: many managers advise offshore as well as onshore funds, act as sub-advisors and/or manage separate accounts. In addition, some managers have explicit or implicit understandings with other funds or managers regarding particular stock issues. Each of these relationships needs to be analyzed to determine whether a particular investment must be grouped for purposes of Section 16 with other internal positions, third-party positions or even positions taken by the fund’s clients. The analysis of the issues is highly fact-specific and the governing statutes, regulations and rules discussed in this Hedge Fund Alert are complex.
Therefore, the purpose of this Hedge Fund Alert is to provide a general outline of some of the issues managers should be considering in determining whether transactions by their funds will give rise to liability under Section 16.

Section 16 Principles

Section 16 applies to every person who is directly or indirectly the “beneficial owner” of more than 10% of any class of equity security that is registered pursuant to Section 12 of the Exchange Act, or who is an officer or director of the issuer of such security (each, an “Insider”). Private investment funds generally become subject to Section 16 by appointing a director to the board of a company or by directly or indirectly acquiring beneficial ownership of more than 10% of any class of equity security registered pursuant to Section 12 of the Exchange Act.

Section 16(b) requires an Insider to disgorge any profit realized from any purchase and sale, or any sale and purchase, of any equity security of such issuer within a period of six months (so called “short swing trading”). This disgorgement of profit is required irrespective of any intention by the Insider. Short swing trading is not prohibited by Section 16(b), so while violation of Section 16(b) will result in the likely loss of all profits realized, it is not a criminal offense. Section 16(b) is enforced by issuers and an active group of plaintiff’s lawyers.

For purposes of determining whether a shareholder is a 10% “beneficial owner,” the rules look to whether a person, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has or shares (i) voting power, which includes the power to vote, or direct the voting of, such security, and/or (ii) investment power, which includes the power to dispose, or direct the disposition of, such security. This test of beneficial ownership is the same as the test that applies for purposes of Section 13(d) of the Exchange Act, which requires the beneficial owner of 5% or more of a class of a publicly traded security to file a Form 13D or Form 13G. Accordingly, a person can be the “beneficial owner” of an equity security subject to Section 16 by virtue of its holding of privately placed convertible bonds, warrants or certain derivative instruments.

When securities are acquired without the purpose or effect of changing or influencing control of the issuer, Rule 16a-1(a)(1) provides that an investment company registered under Section 8 of the Investment Company Act of 1940 and any person registered as an investment advisor under Section 203 of the Investment Advisers Act of 1940 or under the laws of any state shall not be deemed the beneficial owners of securities held for the benefit of third parties or in customer or fiduciary accounts in the ordinary course of business. Note that this exemption applies to the investment company or investment advisor, as applicable, not to the clients of the advisor or the entities actually managed by the advisor. This exemption is not available if the securities are acquired with the purpose or effect of changing or influencing control of the issuer. Whether securities are held with the purpose or effect of changing or influencing control of an issuer is a question of fact that must be analyzed in each situation.

Though the analysis of who is a director and whether an entity beneficially owns 10% of a class of equity security may seem straightforward, in practice it is not. First, a fund that has a right to acquire securities within 60 days, through options, warrants, convertible securities, futures contracts or other derivative securities, may be deemed to “own” the common stock underlying the derivative security for purposes of determining whether it
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has crossed the 10% ownership threshold. Second, a fund can be deemed to be a director for purposes of Section 16 if it has a representative on the board of a company and is deemed to have “deputized” the director. Thus, a fund that appoints someone to the board of directors of a public company may be subject to Section 16 even if it does not beneficially own 10% of the issuer’s equity securities. Third, under Section 13 and Section 16, various entities can be “grouped” for the purpose of determining if the applicable beneficial ownership threshold has been crossed. In this case, a fund could be subject to Section 16 even if it does not have representation on the board and does not, by itself, beneficially own 10% of the issuer’s equity securities.

Aggregation of Ownership

As noted above, persons and entities can be grouped for purposes of the 10% beneficial ownership threshold. There is no bright line test for what constitutes a group. Questions that might be asked include:

- Has the fund agreed to act with any other person or persons for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer?
- Is the agreement formal or informal?
- Does the agreement bind any party to a particular course of action?
- Has the agreement been reduced to writing?

Plaintiffs often point to informal, non-binding relationships between parties as evidence that the investors have formed a group for purposes of Section 13(d). Case law identifies various factors courts look to, either independently or in conjunction with other factors, in deciding whether a group has been formed. Groups have been found where investors coordinated actions in furtherance of a common objective, where a close relationship exists between investors pursuing a common objective and where investors communicated concerning the terms of purchases and dispositions of securities. The determination of whether a group exists is a question of fact that can only be analyzed based upon the totality of the circumstances.

The limited partnership, limited liability company, corporation or other entity that actually holds a security is generally deemed the “beneficial owner” of the securities, even though a manager actually makes the voting and investment decisions. Additionally, the entities and individuals making voting or investment decisions for the holder of securities are likely to be deemed beneficial owners of the securities. It should be noted that more than one person or entity can be deemed the “beneficial owner” of the same securities. Further, the relationships among all of these entities need to be analyzed to determine whether they have formed a group for purposes of Section 16 (and Section 13). The key point is that even if an entity does not by itself own more than 10% of an issuer’s stock, it may be deemed part of a group that does surpass the threshold and is therefore subject to the trading restrictions of Section 16.

Issues for Hedge Funds to Consider

Advisors, the funds they manage and the clients who invest in funds or enter into contractual arrangements for the management of accounts need to be cognizant of the broad scope of the beneficial ownership rules. Funds and their advisors should carefully consider the aggregation rules and their application to the following:
• the relationship between onshore and offshore funds
• the relationship between separate funds under common management
• the relationship of the manager to any sub-advised funds
• the relationship between separate accounts under common management
• the relationship between the manager, the fund and the fund investors
• the relationship between multiple parties who may share voting and/or investment power
• the existence of co-investment rights
• whether derivative securities owned by a fund, any accounts managed by the advisor and/or the manager’s own accounts need to be included in the calculation of securities owned for purposes of determining whether an entity beneficially owns more than 10% of an issuer’s securities

The answers to these questions may not be simple. Each fund complex has its own unique fact pattern that must be analyzed separately. Slight variations in the contractual arrangements governing the funds and the advisor can produce markedly different results under Section 16. This analysis should be performed by someone who is familiar with Section 16 and the rules and case law interpreting them.

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