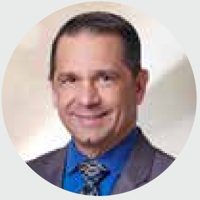
Proskauer

A Practical Guide to the Regulation of Hedge Fund Trading Activities

Team contacts



John R. Ingrassia
Partner
+1.202.416.6869
jingrassia@proskauer.com

Louis Rambo
Partner
+1.202.416.6878
lrambo@proskauer.com

Jonathan E. Richman
Partner
+1.212.969.3448
jerichman@proskauer.com

Frank Zarb
Partner
+1.202.416.5870
fzarb@proskauer.com

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.

Proskauer» A Practical Guide to the Regulation of Hedge Fund Trading Activities

Chapter 1: When Passive Investors Drift into Activist Status

Authors: Frank Zarb, Jonathan Richman, John Ingrassia and Louis Rambo

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 adviser.

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 as a class 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 that might border on business operational issues 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, other listed matters and "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 has taken steps to implement the plan. The threshold could be even lower if the fund is already reporting on a Schedule 13D. In that case, the SEC focuses on whether the new activities have rendered the existing Item 4 disclosure materially inaccurate or incomplete. If existing disclosure states that the fund is passive, any new discussions internally or with third parties about the company's operations, strategy or control could, in the SEC's view, trigger an amendment requirement on grounds that the fund is no longer "passive." 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 could, 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.

An SEC enforcement settlement in 2024 highlights the agency's focus on an investor's "control purpose," triggering the requirement to file on a Schedule 13D as opposed to a short-form 13G. At issue was HG Vora Capital Management's 5% interest in a public company, and whether HG Vora had complied with its obligations to supersede its existing filing with a long-form Schedule 13D filing within 10 days after no longer being "passive."

HG Vora filed on a Schedule 13G as of year-end 2021, disclosing it owned 5.6% of the company's stock. However, from January through mid-April 2022, HG Vora nearly doubled its interest to 9.9% of the total outstanding common stock, all held by an affiliated hedge fund that directly owned the shares. The SEC also noted HG Vora's additional economic exposure to the company through swap agreements.

According to the SEC order filed to reflect the settlement, the facts appear to be as follows. HG Vora had apparently considered ways the company could become more efficient, liquidate non-core business assets and develop a more efficient capital structure by issuing debt securities. The development of this view alone did not change HG Vora's status as a passive investor. Then it began conversations with a private-equity firm about providing asset-backed financing to the company — still not a control intent.

When did the firm move from passive to active status? On April 26, 2022, HG Vora "first considered making its own acquisition bid" with financial backing from the private-equity firm. As part of this potential bid, HG Vora "began drafting an offer letter" for all of the company's outstanding common stock. As part of this offer letter, the company included a "'placeholder' offer price of $85 per share." According to the SEC, it was "no later than" this date (May 6) that HG Vora shifted from a passive investor to an activist investor (with Schedule 13D filing obligations (under then -current rules)) within 10 days. It was seven days later, on May 13, when this letter and premium purchase price were transmitted to the public company, that HG Vora filed its Schedule 13D.

Getting back to our illustrative example, assume that Momentum, Adviser, GP and John Smith had previously filed a joint report on Schedule 13G because their shared beneficial ownership of Door's common stock exceeded 5% of the outstanding shares. The SEC recently amended its rules for filing and amending on Schedule 13G, and the new rules take effect on September 30, 2024.

Under the "old" and existing rules, 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.

Under the "new" rules that will apply beginning the end of September 2024, the Advisor would be entitled to file 45 days after the end of the calendar quarter, but Momentum and John Smith must file their 13G within 5 business days following the triggering event, which is the date that they exceeded 5%.

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, that analysis could change if Momentum took active steps toward seeking a merger partner for Door, such as contacting potential merger partners. The analysis could also change if Momentum had further communications with Residual, or even acted in parallel fashion with Residual, such that the SEC or a court could infer an agreement to act together in a Section 13(d) "group," an issue we address in the next section.

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."

In its 2022 rule proposals to amend its rules under Section 13(d), the SEC proposed to expressly state that "concerted action" among funds and other persons is sufficient to form a "group." In its final rules, the SEC backed down from those revisions but did not change its view that, under current rules, concerted action without an express agreement suffices to form a group.

Concerted action can be inferred, such as from parallel actions. Referring to our illustrative example, 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, a deliberate decision to act in concert with Residual or as Momentum's adopting an independent activist role. Of course, Momentum might merely be researching the viability of Residual's strategy by seeing whether any interest in a merger might exist. Such behavior would not necessarily reflect an agreement or concerted action.

On their joint Schedule 13G, Momentum and its affiliates responded by checking the box to disclaim "group" status, which is common. (Even if their mutual conduct is within a grey area on whether they have formed a group, 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 and include some disclosure of their plans under Item 4. 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 either Momentum or Residual, or both of them, plan to file on Schedule 13D. Momentum, which is currently reporting on a Schedule 13G, will have 5 business days from the trigger date 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. Residual would be filing for the first time on its Door holdings and would have 5 business days from the trigger date to file a 13D.

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 does not itself 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 might have violated conflict of interest policies at The Wall Street Journal, but he had not committed a crime. The Supreme Court upheld his conviction for wire fraud on grounds that he had "misappropriated" information belonging to his employer and that the misappropriation was a sufficient basis for his conviction. (The Supreme Court had not yet endorsed the misappropriation theory under the securities laws.)

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 it did not join the effort. Most importantly, Door did not expressly request that Residual keep Door's reaction to the idea in confidence and not use it for any other purpose. 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 might 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 might have effectively helped to increase the stock price, making a merger — Residual's objective — more difficult to achieve. Of course, Residual could 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 might 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")

Certain investments in both public and private companies can also trigger HSR filing requirements and the accompanying waiting period (typically 30 days) that must be observed prior to acquiring voting shares. If the fund's overall investment in voting stock and other assets exceeds $119.5 million effective March 6, 2024, (subject to annual increases) or more (or if it later crosses that threshold based on aggregate holdings in the issuer), the fund may trigger the HSR filing and waiting period requirement.

The passive investor exemption is not available for holdings of 10% or more of the 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. A fund that holds more than 10% of a company's voting securities cannot rely on the passive investor exception under the HSR rules, even if the investment is in fact 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 may not automatically be 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 potential filing requirements. 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 recommended 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 provided 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 arguably should not lose the exemption to the extent 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 likely would 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 HSR waiting period would need to be observed before shares valued above the reporting threshold in the aggregate could be acquired.

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.

Proskauer