



“Short Swing” Liability: Bombing the Golf Course?

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In “Short Swing” Liability: Bombing the Golf Course?”, the authors argue that the time has come to re-consider the application of Section 16(b) of the Securities Exchange Act of 1934 to 10% shareholders. The authors argue that the law’s strict liability regime, as it applies to these investors, results in significant societal costs, including market inefficiency and legal expenses, while the corresponding need for the law has markedly diminished in recent years. The authors cite structural changes in finance and capital formation, which have resulted in increasing amounts of investment capital being placed in the hands of non-insider professional investors; enhanced disclosure and recent new rules (such as Regulation FD), which have reduced the informational advantage of large investors; and flexible modern insider trading enforcement tools (including Rule 10b-5), which can deter and prosecute insider trading abuses more effectively and accurately than the “crude” instrument of Section 16. The authors propose possible modifications to reduce the societal costs, including raising Section 16(b)’s bright-line threshold for “control.” The authors note that any change in Section 16(b) need not eliminate the requirement for 10% investors to file Section 16 reports, which are important to the marketplace.

Now that Congress has decided that the time has come to look closely at the laws applying to hedge fund managers and other professional investors, Congress should also consider re-examining a legislative relic: Section 16(b) of the Securities Exchange Act of 1934, as it applies to these investors.

A quick summary: under Section 16(a) of the Exchange Act, most large stockholders (excluding, among others, mutual funds, pension plans and insurance companies) are required to promptly report their purchases and sales of a public company’s stock with the SEC once they own 10% of the issuer’s capital stock. Under the law’s Section 16(b), if a 10% stockholder both buys and sells the stock within a six month period – known as a “short swing transaction” - the issuer of the security (or another shareholder on behalf of the issuer) can bring suit to require the large shareholder to “disgorge” the profits to the issuer. Reports filed by insiders under Section 16(a) are instrumental in determining whether a “short swing” transaction has occurred under Section 16(b).

The stated purpose of Section 16 is to deter insiders (which include directors, officers and 10% stockholders) from acting on inside information. In order to address then existing limitations in attacking abusive insider trading practices, the 1934 Congress enacted a particularly blunt instrument: it set up a law with “strict liability.” Using Section 16’s “crude rule of thumb” (in the words of the law’s principal draftsman), an insider can be

subject to short swing liability under the law even if it does not actually possess inside information at the time it makes a trade.

Congress also made the mechanics of the rules tight and punitive. Any purchase can be matched with any sale within a six month period, looking both forward and backward. So if an existing large shareholder buys a stock in May, and then sells in November, the purchase (in May) can be matched with the sale (in November). Less intuitively but equally onerous, if a shrewd professional investor sells a portion of a large position at a market top (say an oil and gas company in May 2008) and then buys the stock back at a bottom (same company in November 2008), the transactions can be matched as well. In either example, it is easy to see how disgorgable profits can be very large indeed.

In practice the rules for many large passive stockholders result in a time-consuming, expensive and anxiety-provoking experience. Considerable time and money are spent worrying about the arcane application of Section 16(b), particularly for transactions that are less than “plain vanilla.” As derivative securities, transaction structures and fund organizations have become more complex, focus on 16(b) increasingly seems to occur when it’s too late and the “matchable” transactions have already occurred: far too many talented investors and their first class lawyers know that sinking feeling of having overlooked the application of the dreaded law. Pursued solely by entrepreneurial plaintiffs’ lawyers (but not – tellingly – the issuers or their shareholders), large investors are forced to pay handsomely for advice, to fight, to enter into settlement discussions and ultimately to “pay the piper.” Those pursued to trial have truly suffered: disgorgement awards have been in the tens of millions of dollars. Transactions that were intended to be profitable – and otherwise would be - end up being costly and painful.

The response in the marketplace has been that many investors are simply careful to avoid the potential for strict liability altogether. Many professional investors purchase only up to 9.9% of a company so they will not be subject to the Section 16 filing and liability regime. An inordinate number of Section 13G filings -- required for most passive holders of greater than 5% of an issuer’s outstanding stock -- reflect ownership of greater than 9% but less than 10%. Other investors focus on structuring transactions -- including purchasing shares through different vehicles -- in a manner that they hope avoids aggregation and potential 16(b) exposure. It wouldn’t surprise anyone if other investors simply (wrongfully) fail to report their purchases altogether to avoid detection and sights of Section 16 lawyers. The disclosure failures encouraged by Section 16 also touch another area of the Exchange Act: since investors acting together as a “group” can be attributed other group members’ holdings in determining whether a Section 16 filing is necessary, the incentive to avoid disclosure as a 10% group under Section 13 is surely stronger.

It goes without saying that shutting large investors out of the market and/or forcing them to pay legal bills instead of allocating that capital to investments (and/or forcing such investors to “go underground” altogether), can only result in market inefficiency. Investors with arguably the greatest level of homegrown insight into a particular equity security – professional investors with the largest well researched positions – are

perversely the *only* outside investors stymied by 16(b). Theorists would argue that these investors should be the ones promoting efficiency by selling at tops or buying at bottoms in large numbers or otherwise encouraging truer pricing through trading activities, but in a number of cases the law simply stands in the way. It is disturbing that a fair number of newly filed 13Gs in the 2008 fall market crisis revealed ownership of just under 10%.

So what societal purpose does Section 16(b) serve as it applies to large passive stockholders? Does it really make sense anymore? Are we bombing the forest to kill a fox (or – like a manic Carl Spackler in the film classic *Caddyshack* -- the golf course to kill a gopher)?

Preventing insider trading abuse is undoubtedly critical to the proper functioning of capital markets and the economy. Among other things, if the system is perceived to be “rigged,” confidence is reduced and market participants exit, resulting in greater inefficiencies and higher costs. In the 1934 congressional record, it was asserted that a key premise for the law as applied to large stockholders was the “unscrupulous employment of insider information by large stockholders who, while not directors and officers, exercised sufficient control over the destinies of their companies to enable them to acquire and profit by information not available to others.”

In today’s world, however, the vast majority of large stockholders have no greater access to material inside information than the ordinary investor. In recent years in particular, the growth of hedge funds has put significant amounts of private capital at the disposal of talented investors and - now more than ever - these investors have the wherewithal to build significant passive positions in public companies. Nevertheless, most hedge fund managers rely not on any special access to the issuer or its management, but on their own homework, analysis and intuition when deciding to build or dispose of an investment position.

Even today’s activist investors – who ultimately seek to influence or possibly control issuers - aren’t necessarily on the “inside.” Activist managers who have built up big positions in the hopes of exerting leverage on issuers regularly find themselves repulsed by management and “shut out” altogether. When, and if, an activist investor successfully initiates a constructive dialogue with an issuer, the investor is, as a matter of course, required to enter into a confidentiality or standstill agreement which addresses trading on the basis of any inside information.

The real world experiences of today’s professional investors stand in marked contrast to the testimony of Section 16’s principal draftsman, Tommy Corcoran, who - in 1934 Senate hearings on the proposed bill that ultimately became Section 16 – asserted that large stockholders were functionally equivalent to officers and directors:

Corcoran: Five percent is a lot in a modern corporation. Many corporations are controlled by 5 percent or 10 percent.

Senator Hamilton Fish Kean (R- NJ):...[The proposed law] applies to all corporations, and you are getting down to the point where you are interfering with the individual a good deal there. I agree with you with respect to the officers and directors.

Corcoran: A stockholder owning 5 percent is as much an insider as an officer or director. *Whether he is a titular director or not, he normally is, as a practical matter of fact, a director* [emphasis added]

Not only are Corcoran's assertions as to the "normal" status of large stockholders off-base in today's world, it is also noteworthy that disclosure rules – along with disclosure technology -- have been significantly enhanced since 1934, reducing the potential for large investors to have an informational advantage. This is particularly the case in the last ten years. Regulation FD, promulgated by the SEC in 2000, expressly restricts selective disclosure to particular investors who might meet privately with the company; material non-public information disclosed to one investor must be simultaneously disclosed to the public. The result is that public companies are now highly sensitive about ensuring that large holders do not receive – and cannot profit from – material nonpublic information. On the flip side, the SEC has continually improved the quality, quantity and timeliness of public reporting by issuers through its rule making process. In addition, the growth of the Internet has put such enhanced and timely information -- along with value-added research, data and analytics -- at the disposal of small investors. While large professional investors may still have more significant financial resources, enhanced disclosure has substantially leveled the playing field for all investors.

In addition, tools for insider trading enforcement have dramatically improved and expanded. It is noteworthy that until 1961 – when John F. Kennedy appointed activist SEC chairman William Cary – Section 16 was essentially the only provision of the federal securities laws expressly directed at insider trading; now a highly effective and flexible Rule 10b-5 as well as other laws, including the Insider Trading Sanctions Act of 1984 and the Insider Trading and Securities Fraud Enforcement Act of 1988, perform that critical function. In particular, the development of misappropriation theory and tipper/tippee liability – core theoretical underpinnings of insider trading enforcement based on Rule 10b-5 – puts large investors with any preferential access to inside information at significantly greater personal risk than under the Section 16 should they abuse that position. The 1984 and 1988 laws significantly increased penalties and expanded the scope of illegal activities. While one can quibble about whether the resources available to the SEC are truly sufficient and whether or not the volume of insider trading has actually increased, it is undeniable that the "crude rule of thumb" trumpeted by Tommy Corcoran in 1934 as necessary to deal with the problem has given way to significantly more modern, flexible and accurate tools. (Witness the elaborate sting - including the precedent-setting use of wiretaps – in the recent Galleon case). To that end, it is revealing that, in light of the focus on these modern tools, young corporate lawyers -- relative to the old timers down the hall -- barely appreciate the initial intent of Section 16 and its once-central role in our insider trading legal regime.

With the intellectual foundations for 16(b)'s application to large passive investors having thus been eroded, a re-examination of the old law seems in order. It is telling that the US

appears to be the only developed country in the world with a strict liability “short swing” regime, suggesting that lawmakers and regulators in sophisticated markets around the globe do not see the necessity for such a law and/or understand the drawbacks. Importantly, any changes in the law need not, and should not, eliminate the responsibility of 10% stockholders to promptly file reports of their trades under Section 16(a) of Exchange Act (i.e., generally within 2 days of purchases or sales). The information provided by Section 16(a) reports – accessible through EDGAR, Yahoo Finance and similar sites – has itself become valuable market information and an additional source of market efficiency. As other investors follow, stocks move up and down on the basis of information about whether large, knowledgeable and influential investors are buying or selling. In fact, if it is true that certain large investors do not file for fear they will become subject to Section 16(b) short swing liability, such a change would encourage even more transparency, as such investors would be less deterred from filing. Moreover, maintaining the requirement for 10% investors to file reports would still subject such transactions to public scrutiny if material insider information were conceivably involved. The harsh glare of public light was, in fact, as key premise for the enactment of 16(a) reporting obligations, and – particularly since the Internet makes the information contained in 16(a) reports readily accessible – this premise seems as compelling as ever.

Ironically, one little-discussed consequence of making hedge fund managers subject to registration with the SEC – a key goal of the Obama Administration’s recently proposed Private Fund Investment Advisers Registration Act - is that hedge fund managers may be able to avail themselves of a special exemption from Section 16. Current SEC regulations provide certain “registered investment advisors” with an exemption from both the reporting and liability provisions of Section 16. While expressly addressing situations where securities are “held for the benefit of third parties or in customer or fiduciary accounts in the ordinary course of business” this exception is now increasingly used as a basis for hedge fund managers that are registered as investment advisers under federal or state law (as well as the underlying funds in certain cases) to avoid filing Section 16 reports and thus potential Section 16 exposure. Leading 16(b) commentators support the proposition that securities held in hedge funds qualify a registered fund manager for this “fiduciary” exception on the basis that the partnerships are owned in large part by outside partners. Even so, the applicability of the exemption to hedge fund managers is largely untested and therefore the source of uncertainty and additional expense. Moreover, if the exception proved to definitively apply, it could deprive the public the benefit of valuable Section 16(a) reports.

This likely unintended effect of requiring hedge fund managers to register can be addressed by targeting the heart of the issue – and the reason why managers would surely embrace any exception: the confiscatory nature of short swing profit liability. At a minimum, policymakers should seriously consider whether the threshold for potential 16(b) liability should be modified to reflect a level commensurate to true “control.” Many other areas of securities law recognize that “control” is not a bright line test, but rather a function of facts and circumstances. For example, in determining whether outside investors are “affiliates” and therefore prohibited from serving on an issuer’s audit committee, Sarbanes-Oxley provides a safe harbor for investors below 10% but

permits the Board to determine whether a larger stockholder truly exercises “control.” Such a good faith determination by the Board – which sits in the best position of all to understand whether an outside investor truly has special access – might be one approach. On the other hand, if a bright-line number were preferable, such a level might be set meaningfully lower than 51% but still higher than 10% (with mandatory “carve-ins” below the level where control is determined to exist). It is noteworthy that a related area of securities regulation – Section 13 - already draws the line at 20%, permitting passive investors between 5% and 20% to file the less onerous Schedule 13G rather than a Schedule 13D. Moreover, thresholds in most “poison pills” (which protect corporations against hostile takeovers by penalizing stockholders who purchase shares above a pre-determined ownership level) are often set higher than 10%, indicating that corporations themselves see the potential for control existing at a level higher than implied by Section 16.

Either way – whether a higher “bright line” level was applied or boards were given discretion to determine when “short swing” liability kicked in -- such approaches would surely permit large passive investors significantly greater flexibility to enter the market. After witnessing a scary and (hopefully) generational drop in the stock market marked by an absence of buyers, such flexibility surely remains in the public interest.

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