The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 12960

December 21, 2000

RECENT LITIGATION UNDER SECTION 16 OF THE EXCHANGE ACT INVOLVING INVESTMENT ADVISERS AND THEIR CLIENTS

[12960] December 21, 2000 TO: COMPLIANCE ADVISORY COMMITTEE No. 42-00 INVESTMENT ADVISER ASSOCIATE MEMBERS No. 39-00 INVESTMENT ADVISER MEMBERS No. 43-00 RE: RECENT LITIGATION UNDER SECTION 16 OF THE EXCHANGE ACT INVOLVING INVESTMENT ADVISERS AND THEIR CLIENTS Three recent cases federal court cases decided in the Southern District of New York have involved the interpretation of Sections 16 and 13(d) of the Securities Exchange Act of 1934 and Rules 16a-1 and 16a-2 thereunder.1 Each of these cases have, to date, only involved the court ruling on a motion to dismiss filed by the defendants in response to being sued for disgorgement under Section 16(b) of the Exchange Act. While the court has denied each such motion, in doing so it has provided additional guidance regarding the interpretation of the reach of Section 16 and 13(d) and the rules thereunder. Interestingly, as discussed below, in two of these cases, these sections were interpreted differently. BACKGROUND SECTION 16(b) Section 16(b) of the Exchange Act, which is aimed at preventing an insider's unfair use of information obtained as a result of a relationship to a company, prohibits directors, officers, and beneficial owners of more than 10% of the equity shares of an issuer from purchasing and selling shares of the issuer within any period of less than six months. It is a strict liability provision under which an insider's profits will be subject to disgorgement, irrespective of whether the insider actually had material nonpublic information about the issuer. Such disgorgement action may only be brought by the issuer or other shareholder on behalf of the issuer – not by the Securities and Exchange Commission. 1 See Strauss v. Kopp Advisory, et al., 98 Civ. 7493 (S.D.N.Y. Sept. 30, 1999); Rosen v. Brookhaven Capital Management Co., Ltd. et al., 99 Civ. 9397 (S.D.N.Y. Sept. 29, 2000); and Morales v. Adept Technology, Inc., Kopp Holding Company, et al., 00 Civ. 0957 (filed Nov. 22, 2000). Copies of these cases may be obtained by calling the ICI Library at (202) 326-8304 and request the attachment for memo 12960. 2RULE 16a-1 Rule 16a-1 under the Exchange Act defines "beneficial owner" for purposes of Section 16(b) as any person who is deemed a beneficial owner pursuant to Section 13(d) of the Exchange Act. Expressly excluded, however, are those securities holdings of eleven listed institutions2 that (1) are held in fiduciary or customer accounts maintained for the benefit of third parties in the ordinary course of business and (2) were acquired "without the purpose or effect of changing or influencing the issuer." Such qualifying shares are not counted for purposes of calculating whether the 10% threshold of Section 16(b) has been exceeded. SECTION 16 LITIGATION In each of the three cases discussed below, the court was, in part, faced with the issue of whether beneficial ownership of securities by an

institution that otherwise would qualify for an individual institutional exemption under Rule 16a-1(a) nonetheless falls within the scope of Section 16's prohibitions by being part of a "group"3 that includes non-exempt members. STRAUSS V. KOPP ADVISORS In Strauss, a registered investment adviser and its parent, a registered investment company, the president of these entities, and twenty unnamed defendants that are accounts managed by the other defendants were sued by a shareholder of Digital Link Corporation. The complaint alleges that between February and October 1998, the defendants, acting as a "group," collectively held between 25% and 37% of Digital common stock and engaged in transactions prohibited by Section 16(b). Based upon such violation the plaintiff sought disgorgement of the defendants' profits. In response to the complaint, the defendants filed a motion to dismiss arguing that, as a matter of law, they cannot qualify as beneficial owners of Digital securities and, therefore, are not liable under Section 16(b). According to the court, the determination of what constitutes a Section 16(b) "beneficial owner" is subject to a two-tier analysis: "The section 13(d) definition of beneficial ownership is used . . . to determine status as a ten percent holder; once status is determined, the reporting and short-swing profit provisions of section 16 apply only to those securities in which the insider has a pecuniary interest." With respect to the issue of beneficial ownership, the defendants argued that the registered investment adviser, parent company, and investment company defendants qualify for the exclusions set forth in Rule 16a-1(1)(v), (vii), and (iv), 2 These eleven, generally speaking, are as follows: (i) a registered broker or dealer; (ii) a bank; (iii) an insurance company; (iv) a registered investment company; (v) a registered investment adviser; (vi) an employee benefit plan subject to ERISA or maintained for the benefit of government employees, or an endowment fund; (vii) a parent holding company or control person; (viii) a savings association; (ix) a church plan that is excluded from the definition of an investment company under the Investment Company Act; (x) a group, provided that all members of such group qualify as persons enumerated in subsections (i) through (ix); and (xi) a group, provided that all members are persons specified in (i) through (vii). 3 Rule 16a-1defines "beneficial owner," in part, by reference to Section 13(d) of the Exchange Act. For purposes of this discussion, it is important to note that Section 13(d)(3) of the Exchange Act provides that, "When two or more persons act as a . . . group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a 'person' for the purposes of [Section 13(d)]." 3respectively, and therefore are not beneficial owners under Section 16. According to the court, however: The Kopp defendants' reliance on these Rule 16a-1 exclusions . . . ignores the fact that the Complaint alleges that the defendants were part of a "group" that included John Does Nos. 1 through 20. Under Rule 16a-1(a)(1)(ix), each member of an alleged group must be a person or institution that qualifies for one of the enumerated exclusions. Otherwise, the entire group loses the exemption. . . Here, even if the individual Kopp defendants were excluded from the ten percent beneficial ownership calculation pursuant to Rule 16(a)(1) . . . the Does are not excluded under Rule 16a-1 and, consequently, the entire group loses its exclusion. The court next considered the second-tier of its analysis: Rule 16a-1(a)(2).4 According to the court, under this tier, "the Section 16(b) disgorgement obligations only apply to those securities in which the ten percent holder has a direct or indirect pecuniary interest. The defendants argued that because their interest in Digital's securities derives entirely from asset- based fees, they are, as a matter of law, not beneficial owners of Digital securities, and, therefore, not liable under Section 16(b). In response the court noted that "Rule 16a-1(a)(2)(ii) does not provide that investment advisers with asset-based remuneration cannot be beneficial owners for Section 16(b) purposes, but rather that asset-based compensation alone does not constitute pecuniary interest for section 16 purposes. The examples of pecuniary interest set forth in the Rule are clearly intended to be nonexclusive." The court concluded that the plaintiff was entitled to attempt to establish,

through discovery, that the defendants had a pecuniary interest in the Digital securities by other means besides asset-based advisory fees. Accordingly, the defendants' motion to dismiss was denied. ROSEN V. BROOKHAVEN CAPITAL MANAGEMENT In this case, various investment adviser and limited partnership defendants that owned more than 10% of the stock of Egghead.com were sued under Section 16 of the Exchange Act. The plaintiffs alleged that the defendants constituted a group under Section 13(d) of the Act; that such group owned more than 10% of the stock of Egghead.com; that the group engaged in certain short-swing stock transactions within a six-month period; and they are liable for at least $7 million in disgorgeable profits from such trading.5 4 Pursuant to Rule 16a-1(2)(ii)(C), the term "indirect pecuniary interest" when used to determine beneficial ownership "shall include, but not be limited to . . . a performance-related fee, other than an asset-based fee, received by any broker, dealer, bank, insurance company, investment company, investment adviser, investment manager, trustee or person or entity performing a similar function; provided however, that no pecuniary interest shall be present where: (1) the performance-related fee, regardless of when payable, is calculated based upon net capital gains and/or net capital appreciation generated from the portfolio or from the fiduciary's overall performance over a period of one year or more; and (2) equity securities of the issue do not account for more than ten percent of the market value of the portfolio. A right to a nonperformance-related fee alone shall not represent a pecuniary interest in the securities." 5 As discussed below, though, like the Strauss case, this Section 16 case was filed in the Southern District of New York, a different judge heard the case and expressly declined to follow the holding and rationale of Strauss. 4With respect to the issue of the defendants acting as "group," the plaintiff argued that Rule 16a-1(a)(1)(v), which provides an exclusion from the term "beneficial owner" for any registered investment adviser, is limited to investment advisers acting independently. As a result, the plaintiff argued that an adviser loses this exemption and cannot qualify under Rule 16a-1(a)(1)(x) if it becomes part of a group whose other members are not among those enumerated as eligible for exemption. By contrast, the defendants argued that the exclusions in Rule 16a-1(a)(1) are not mutually exclusive and that, notwithstanding the existence of a group, an investment adviser (or other exempt institution) should not lose its exemption when another exclusion otherwise applicable, such as the group exclusion, is not available. Accordingly, the issue presented to the court was whether beneficial ownership of securities by an institution that otherwise would qualify for an exemption from obligations under Section 16 of the Act nonetheless falls within the scope of that Section if the institution becomes part of a group that includes any non-exempt members. After noting that "nothing precisely on this point in the Act or related SEC Rules addresses this narrow question," the court found "that the investment adviser exemption provided for under subsection (v) is not vitiated by subsection (x) because the adviser may be part of a group for Section 13(d) purposes."6 Having concluded that individual defendants could avail themselves of individual exclusions in Rule 16a-1(a)(1), notwithstanding that such defendants may also be a "group" under Section 13(d), the court then turned to the remaining open question: whether the defendants acquired the securities with the purpose or effect of changing or influencing control of Egghead or engaging in any other impermissible activities. On this issue, the court considered the defendants' Schedule 13D filings7 and concluded that it was unable to determine the defendants' full intent or motivation at the time of filing Schedule 13D.8 Accordingly, to give the plaintiffs the opportunity, through investigation and discovery, to divine the defendants' purpose and intent in acquiring the shares of Egghead, the court denied the defendants' motion to dismiss. 6 In so holding, the court declined to follow the holding and rationale of Strauss, which the court noted had "determined that Rule 16a-1(a)(1)(x) required that each member of the alleged group be a person or institution that qualifies for one of the exemptions or 'the entire group loses the exemption.'" 7

According to the defendants' Schedule 13D, "The persons named [in the Schedule] intend to communication with [Egghead] management regarding its financial condition, management and business plan, with a view to formulating suggestions for improvement, and may seek to be included in the present board of directors . . . " 8 The court noted that the defendants were unable to cite any case in which a court, upon motion to dismiss, granted relief finding that, as a matter of law, a particular form of disclosure was sufficient to satisfy the filing requirement of Schedule 13D. 5MORALES V. ADEPT TECHNOLOGY, INC., KOPP HOLDING COMPANY, ET AL. The most recent Section 16 case was decided after the Rosen case by the same judge who issued the opinion in the above discussed Strauss case.9 Not surprisingly, the court follows the reasoning of the earlier Strauss case on the consequence of "group" status under Rule 16a- 1(a)(1): This Court's previous reasoning in Strauss is dispositive of the issue present by the Kopp defendants regarding the definition of group under a Section 16(b) analysis and need not be repeated at this juncture.10 With respect to the issue of whether the defendants had any pecuniary interest in the subject securities, the defendants provided the court a sworn affidavit stating that they had no such interest and they denied receiving any remuneration other than an asset-based management fee. The court, however, characterized these statements as "self-serving" and "insufficient to preclude plaintiff from having an opportunity to discover potential conflicting facts." Because the court found that, as in Strauss, the plaintiff "is entitled [to] an attempt to establish, through discovery, that the Kopp defendants had a pecuniary interest in the subject securities," the court denied the defendants' motion to dismiss. * * * * Tamara Reed Associate Counsel 9 The court's decision in this case on the defendants' motion to dismiss does not include a summary of the facts of the case. 10 A footnote to this portion of the decision states that "the Court has reviewed Judge Marrero's decision in Rosen v. Brookhaven Capital Management . . . and respectfully adheres to its earlier analysis in Strauss."
