

MEMO# 16647

October 10, 2003

COURT DECISION ON APPLICATION OF SECTION 16(B) OF THE EXCHANGE ACT TO INVESTMENT ADVISERS

[16647] October 10, 2003 TO: COMPLIANCE ADVISORY COMMITTEE No. 82-03 INVESTMENT ADVISER ASSOCIATE MEMBERS No. 23-03 INVESTMENT ADVISER MEMBERS No. 36-03 RE: COURT DECISION ON APPLICATION OF SECTION 16(B) OF THE EXCHANGE ACT TO INVESTMENT ADVISERS In late 2000, three federal court decisions issued by the Southern District of New York resulted in conflicting interpretations of how Section 16(b) of the Securities Exchange Act of 1934 should be applied to investment advisers.¹ The issue in each case involved whether an investment adviser should be treated as the beneficial owner of certain equity securities held in its customers' accounts in the ordinary course of business. In a recent appeal of one of those decisions, the Second Circuit Court of Appeals concluded that such shares should not be attributed to the investment adviser for purposes of determining whether the adviser is subject to the provisions of Section 16(b).² Section 16(b) and Rule 16a-1 Section 16(b) of the Exchange Act, in relevant part, prohibits "beneficial owners" of more than 10% of an issuer's equity securities from purchasing and selling securities of the issuer within any period of less than six months. This strict liability provision is commonly referred to as the short-swing profits rule. Section 16(b) permits the issuer or a shareholder acting on the issuer's behalf to seek disgorgement of any profits earned on such transactions. Rule 16a-1 under the Exchange Act generally defines the term "beneficial owner" for purposes of Section 16(b) as any person who is a beneficial owner under Section 13(d) of the Exchange Act. Section 13(d) in turn provides, in relevant part, that two or more persons may be treated as a single beneficial owner if they act as a "group" for the purpose of acquiring, holding or disposing of securities of an issuer. ¹ See Institute Memorandum to Compliance Advisory Committee No. 42-00, Investment Adviser Associate Members No. 39-00 and Investment Adviser Members No. 43-00 [12960], dated December 21, 2000. ² See *Egghead.com, Inc. v. Brookhaven Capital Management Co., Ltd., et al.*, 340 F.3d 79 (Aug. 8, 2003). A copy of this case is attached. ³ Specifically excluded from the Rule 16a-1 definition of beneficial owner are certain institutions that act as fiduciaries or custodians. In particular, the rule provides that certain persons – including registered investment advisers – and groups comprised solely of such persons will not be deemed to be the beneficial owner of securities that (i) are held for the benefit of third parties or in customer or fiduciary accounts in the ordinary course of business and (ii) were acquired "without the purpose or effect of changing or influencing control of the issuer."³ The SEC has recognized that, absent these exclusions, the rule could cause "undue interference with the day-to-day business of banks, brokers, dealers, investment advisers and other specified institutional fiduciaries and custodians," which typically hold large

numbers of securities on behalf of their customers. Second Circuit Decision A shareholder of Egghead.com brought a derivative action under Section 16(b) against two affiliated registered investment advisers, four customers of the advisers and two individuals affiliated with both the advisers and the customers. The plaintiff alleged that the defendants, acting as a group, collectively held more than 10% of the company's securities. On this basis, the plaintiff asserted that the defendants should be deemed to be a single beneficial owner subject to the prohibitions of Section 16(b). The plaintiff sought disgorgement to the company of several million dollars in profits earned by the defendants on short-swing transactions during 1997 and 1998. The plaintiff acknowledged that no individual defendant's holdings exceeded the 10% threshold required for Section 16(b) liability and that the group's ownership would not exceed that threshold unless Egghead.com shares held by the advisers in the ordinary course of business for customer accounts were deemed to be beneficially owned by the advisers. Accordingly, the sole issue raised in the appeal was whether, for the purpose of determining a group's status under Section 16(b), a registered investment adviser charged with being part of the group is deemed to be the beneficial owner of shares it holds in customer accounts. The Court looked to the plain language of Rule 16a-1(1)(v), which excludes from the definition of beneficial owner the shares that an investment adviser holds in customer accounts in the ordinary course of business that were acquired without the purpose or effect of influencing control of the issuer of those shares. The Court concluded that beneficial ownership of such shares is not attributable to the investment adviser, regardless of whether the adviser is acting independently or as part of a group. The Court next considered an argument advanced by the plaintiff in reliance on one of the district court decisions – namely, that the advisers, by becoming part of a group whose members did not satisfy the group exclusion in paragraph (1)(x) of Rule 16a-1, forfeited their ability to rely on the exclusion in Rule 16a-1(1)(v). The Court rejected this argument, determining that each of the exclusions set forth in paragraphs (1)(i) through (1)(xi) of the rule operates independently of each other exclusion. 3 Generally speaking, the persons listed in the rule are: (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 primarily for the benefit of government employees, or an endowment fund, (vii) in certain circumstances, a parent holding company or control person, (viii) a savings association, (ix) a church plan, (x) a group comprised solely of persons specified in sections (i) through (ix) above, and (xi) a group comprised solely of persons specified in sections (i) through (vii) above. 3 Rachel Graham Assistant Counsel Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (<http://members.ici.org>) and search for memo 16647, or call the ICI Library at (202) 326-8304 and request the attachment for memo 16647. Attachment (in .pdf format)

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