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Client Memorandum

Analysis of New SEC Interpretations of Exchange Act Sections 13(d) and 13(g)

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The staff of the Division of Corporation Finance of the Securities and Exchange Commission (the "SEC") published, on Sept. 14, 2009, its Compliance and Disclosure Interpretations ("CDIs") relating to Sections 13(d) and 13(g) under the Securities Exchange Act of 1934 (the "Exchange Act")[1]. These CDIs replace the prior interpretations relating to Sections 13(d) and 13(g) contained in the July 1997 Manual of Publicly Available Telephone Interpretations. The CDIs are in question-and-answer format and include both previous interpretations and new guidance from the SEC.

The publication of these CDIs demonstrates the SEC's continued focus on Section 13 compliance as well as a move toward more strict application of its provisions. Coupled with recent SEC actions raising Section 13 violations, investors need to be increasingly vigilant in their Section 13 compliance and to be familiar with the SEC's guidance.

This Memorandum provides a summary of the more noteworthy CDIs. The CDIs can be viewed in their entirety at http://sec.gov/divisions/corpfin/guidance/reg13d-interp.htm.

New Noteworthy CDIs

Reporting Obligations

- *Inadvertently Crossing 5%.* A person inadvertently crossing the 5% beneficial ownership threshold[2] still must file a Schedule 13D or 13G, even if caused solely because of an error by its broker and even if the person immediately instructs its broker to sell the excess shares and refuses to pay for the excess shares. The absence of an intent to acquire more than 5% of the class is irrelevant to the determination of whether a filing must be made.[3] This is a prime example of the SEC applying a strict reading of the rules regardless of intent or consequence.

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[1] In general, Section 13(d) requires beneficial owners of more than 5% of a voting equity security registered under Section 12 of the Exchange Act to report their beneficial ownership either on Schedule 13D or, if eligible, on a short form Schedule 13G within 10 days after crossing the 5% threshold and requires the amendment of such reports upon certain prescribed material changes in the information previously reported. Persons deemed to have beneficial ownership of a security as defined in Rule 13d-3(a) of the Exchange Act include "any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise has or shares" voting power and/or investment power with respect to such security. Voting power includes the power to vote, or to direct the voting of, a security, whereas investment power includes the power to dispose, or the power to direct the disposition, of a security.

[2] For purposes of this Memorandum all references to 5% beneficial owners refer to owners of a class of voting equity securities registered under Section 12 of the Exchange Act requiring reporting pursuant to Section 13(d) of the Exchange Act.

[3] Question 101.06.

- *Obligations Arising from a Change in the Number of Outstanding Securities.* Pursuant to Rule 13d-1(d), a security holder that "becomes" a greater than 5% beneficial owner as a result of a change in the aggregate number of outstanding securities (rather than as a result of an acquisition) may file a Schedule 13G to enter the reporting system pursuant to Rule 13d-1(d).[4] In these CDIs, the SEC clarified that if the security holder influenced or controlled this change in the aggregate number of outstanding securities, then Rule 13d-1(d) would not be available.[5] Additionally, this CDI reminded filers that a security holder already reporting on Schedule 13D at the time of a decrease or increase in the number of outstanding securities is required to file an amendment to report any "material change" in its beneficial ownership regardless of whether it has taken any action to cause such change in its previously reported ownership.[6] The CDI did not clearly state whether a change in beneficial ownership of more than 1% resulting from an increase or decrease in the number of outstanding securities would be deemed to be *per se* material in a manner similar to acquisitions and dispositions.

- *Amendments Upon Dropping Below the 5% Threshold.* Prior SEC positions have suggested that an amendment to an existing Schedule 13D is required upon a filer's beneficial ownership falling to 5% or less. The SEC clarified in the CDI that this amendment is required only if the change is material in accordance with Rule 13d-2(a). However, if no amendment is filed at such time due to the absence of materiality, the holder will need to continue to monitor its amendment obligations under Rule 13d-2(a) until an exit Schedule 13D is filed.[7] In view of this position, consideration should be given to filing a voluntary final Schedule 13D amendment upon dropping below the 5% beneficial ownership threshold to avoid the need for future monitoring of amendment obligations.

- *Amendment Obligations for Trades After Record Dates.* In a particularly interesting interpretation, and one that can have implications to filers trading around record dates, the SEC indicated that when a security holder sells all of its shares after a voting record date for a shareholder meeting (and thus transfers investment power over the securities but not voting power as to the meeting absent a specific agreement to do so) the holder should *not* file its final amendment to Schedule 13D until the end of the shareholder meeting, because the security holder still retains voting power over the reported securities. However, the security holder must amend its Schedule 13D to disclose a greater than 1% disposition of investment power at the time of the sale and reflect that the holder retains the voting power with respect to the securities. Only after the shareholder meeting should the security holder file its final amendment.[8]

- *Date Filing Obligation Arises*. The obligation to file a Schedule 13D and Schedule 13G for passive investors within ten days of crossing the 5% beneficial ownership threshold is measured from the trade date, not the settlement date, of a securities transaction.[9]

- *Relevant Date for Information in Filing*. The information included in a Schedule 13D (such as ownership percentages and trade history) should be current through the date of filing and should not be limited to information that is current as of the trigger date of the filing.[10] Therefore, the cover page numbers need not reflect the number as of the trigger date and the Item 5(c) trading history need only look back sixty days from the filing date. This interpretation clears up confusion as to the relevant information dates but can be burdensome for filers because of the need to have current information as of the time of filing.

[4] This filing is due within 45 days after the end of the calendar year in which the person became a greater than 5% beneficial owner, if the person remains a greater than 5% beneficial owner as of the end of such calendar year.

[5] Question 103.08.

[6] A security holder already reporting on Schedule 13G may not have an amendment obligation depending on the circumstances.

[7] Question 104.05.

[8] Question 104.07.

[9] Question 103.05.

[10] Question 110.05.

- *Switching from Schedule 13D to Schedule 13G*. The SEC clarified the provisions of the rules which indicate that the only person who can switch from a Schedule 13D to a Schedule 13G is one that was initially "eligible" to file on Schedule 13G and was later required to file a Schedule 13D.[11] The use of the word "eligible" is notable and the CDI does not specifically address whether a filer that was eligible to file an initial Schedule 13G but actually filed voluntarily on Schedule 13D can later switch to a Schedule 13G so long as it is not required to file on Schedule 13D at such time. A person that was initially required to file on a Schedule 13D is not permitted to switch to a Schedule 13G unless it first exits the reporting system and becomes "eligible" to re-enter the reporting system on Schedule 13G.[12] This interpretation is noteworthy in that it is not obvious what policy reason is furthered by the distinction between an initial Schedule 13G filer being able to switch to a Schedule 13D and back to a Schedule 13G and an initial Schedule 13D filer being ineligible to switch to a Schedule 13G.

- *Officers and Directors Ineligible for Schedule 13G*. In general, officers and directors are ineligible to file a Schedule 13G as passive investors pursuant to Rule 13d-1(c).[13]

- *Failure to File Amendments*. If a filer discovers that it failed to file any required amendments to Schedule 13D or Schedule 13G, it should promptly file any such amendments. Multiple omissions to amend may be included in a single cumulative amendment.[14] Curing the omissions does not necessarily affect determinations of liability for the prior failures.

- *Aggregating Reported Trades*. Investors are often faced with the burden of needing to report a significant number of trades in response to the 60-day trading history required under Item 5(c) of Schedule 13D. This is particularly burdensome in cases where broker-dealers execute trade orders in small increments and at multiple prices that may be as little as a fraction of a penny apart. In a manner consistent with the relief previously granted in connection with Section 16 reporting, the SEC stated that a reporting person that effects multiple open market purchases or sales on the same day, in its item 5(c) disclosure, may aggregate trades effected on the same day within a $1.00 range while reporting the weighted average price for the transactions reported on each line, specifying in a footnote the range of prices for the reported transactions and undertaking to provide upon request by the SEC staff, the issuer, or a security holder of the issuer, full information regarding the number of shares purchased or sold at each separate price.[15] This mirrors the position previously taken by the SEC in the Society of Corporate Secretaries & Governance Professionals No-Action Letter (available June 25, 2008) with respect to Form 4s filed under Section 16 of the Exchange Act.

Activist/Group Activities

- *Generic Item 4 Disclosure.* The SEC made clear its position that a statement in Item 4 of Schedule 13D that a reporting person has no current plans to engage in any of the types of transactions enumerated in Item 4(a)-(j), but reserves the right to engage in such transactions in the future, will not exempt the reporting person from amending its Schedule 13D if in the future the reporting person forms a specific plan or proposal with respect to any such matters. There is no clear answer as to when exactly a plan or proposal is formed, but the SEC noted that the execution of a formal agreement or commencement of a transaction is not required in order for a plan or proposal to have been formed.[16] A recent example of the SEC applying this position was articulated in the September 2008 cease-and-desist order settlement *In the Matter of Tracinda Corporation* (Kerkorian).[17] As a result of this CDI, all Schedule 13D filers, particularly activist investors, are reminded of the need to carefully monitor their Item 4 disclosure to determine when and if amendments will be required.

[11] Question 103.07.

[12] Question 103.07.

[13] Question 103.04.

[14] Question 104.03.

[15] Question 110.08.

[16] Question 110.06.

[17] Release No. 34-58451 (Sept. 3, 2008).

- *Applicability of Proxy Rules.* The SEC cautioned that a Schedule 13D filer must analyze its disclosure and attached exhibits to determine whether any disclosures or communications included in a filing reasonably constitute proxy soliciting material, in which case the reporting person will be required to comply with the proxy rules (unless an exemption to these rules is available).[18] As a result, activists that set forth their views about company governance or other matters in a Schedule 13D filing will need to evaluate carefully whether the proxy rules could be implicated.

- *Group Formation.* Investors frequently struggle with determining which activities may be indicative of group formation. The SEC indicated that the retention of an investment advisor to represent several shareholders to influence the outcome of an issuer's rights offering is evidence of the formation of a group under Section 13(d)(3) and Rule 13d-5(b).[19] This interpretation highlights the importance of monitoring all activity to determine whether a group has been formed.

Beneficial Ownership

- *Divesting Beneficial Ownership.* The SEC clarified that a holder can divest itself of beneficial ownership by delegating voting and investment power to a third party, such as an investment advisor, so long as the security holder delegates all authority to vote and dispose of its securities to the third party and the security holder cannot rescind the voting or investment authority granted to such third party within 60 days.[20] Presumably, the ability to rescind these powers even after 60 days would not divest a holder of beneficial ownership if the holder has the intent to influence control of the issuer. Reporting persons in any case should be mindful of, and give consideration to, any actions that could be viewed as designed to evade the reporting requirements of Section 13(d), which could violate Rule 13d-3(b).[21] The court in *CSX Corp. v. The Children's Investment Fund Management (UK) L.L.P.*[22] based its finding of beneficial ownership on the evasion standard of this rule.

- *Variable-Rate Converts.* Due to the constant changes in the number of underlying securities, variable-rate convertible securities require the holder constantly to monitor the percentage of the underlying common shares which the security is convertible into to determine if the applicable filing and amendment triggers have been crossed.[23] To avoid this burden, consideration should be given to inserting a blocker provision (discussed in the next bullet point) into these convertible instruments.

- *Conversion Cap Blockers.* Binding and valid provisions that block the ability of a holder to acquire greater than 5% beneficial ownership (such as a provision in an issuer's governing documents prohibiting conversions of a security if the holder would beneficially own greater than 5% of the underlying common shares upon conversion) may allow a holder to avoid filing obligations.[24] The SEC previously has indicated factors that it will consider in determining the validity of such blockers. Factors that may indicate a blocker is not valid and binding include whether the blocker "is easily waivable by the parties (particularly the holder of the convertible securities); lacks an enforcement mechanism; has not been adhered to in practice; or can be avoided by transferring the securities to an affiliate of the holder."[25] Factors that may indicate that a blocker is valid and binding include whether the blocker "is provided for in the certificate of designation or issuer's governing documents; reflects limitations

[18] Question 110.07.

[19] Question 107.01.

[20] Question 105.04.

[21] Rule 13d-3(b) states that "[A]ny person who, directly or indirectly, creates or uses a trust, proxy, power of attorney, pooling arrangement or any other contract, arrangement, or device with the purpose of effect of divesting such person of beneficial ownership of a security or preventing the vesting of such beneficial ownership as part of a plan or scheme to evade the reporting requirements of section 13(d) or (g) of the Act shall be deemed for purposes of such sections to be the beneficial owner of such security."

[22] *CSX Corp. v. The Children's Investment Fund Management (UK) L.L.P.*, 562 F. Supp. 2d 511 (S.D.N.Y. 2008).

[23] Question 104.04.

[24] Question 105.03.

[25] Securities and Exchange Commission, Amicus Curiae in *Levy v. Southbrook International Investments, Ltd.*, 263 F. 3d 10 (2d Cir. 2001).

established by another regulatory scheme applicable to the issuer; or is the product of bona-fide negotiations between the parties."[26]

- *Conditions to Acquisition of Beneficial Ownership.* If an investor has the right to acquire greater than 5% beneficial ownership within sixty days but the acquisition is subject to a condition outside the control of the investor (such as the effectiveness of a registration statement), then a filing obligation does not arise until the condition is removed or comes within the investor's control.[27]

- *American Depository Receipts.* American Depository Receipts, or ADRs, are not considered a separate class of equity securities for purposes of calculating beneficial ownership under Section 13(d). Therefore, ownership of greater than 5% of the outstanding ADRs of an issuer does not necessarily trigger a Section 13(d) reporting obligation. Only beneficial ownership of greater than 5% of the deposited voting equity securities registered under Section 12 of the Exchange Act, including ownership of such securities through ADRs, triggers a filing obligation.[28]

Existing Noteworthy Interpretations

- *Short Sales.* Short sales do not change a reporting person's beneficial ownership calculation. However, short sales may need to be reflected in, or trigger an amendment obligation with respect to, Items 3 through 7 of Schedule 13D unless the short sales do not result in any material change to the facts previously reported in the reporting person's Schedule 13D.[29] For example, short sales may be reflective of a material change in the reporting person's plans or proposals previously reported in Item 4, requiring an amendment to Schedule 13D.

- *Debt Securities*. The references to "securities" in Item 4(a) and Item 6 of Schedule 13D require inclusion of information as to all securities of the issuer, even debt securities.[30]

The SEC did not take the publication of the CDIs as an opportunity to clarify its position with respect to whether, or under what circumstances, parties to cash-settled, total return equity swaps could be deemed to beneficially own the equity securities underlying their swap positions. This question was at the center of the recent highly publicized proxy fight between CSX Corporation and The Children's Investment Master Fund and 3G Fund L.P. and continues to be unsettled. This case is currently on appeal to the U.S. Court of Appeals for the Second Circuit.

Although many of the CDIs reiterate views of the SEC that practitioners have learned through informal conversations with the SEC or confirm the views practitioners have taken as a result of analyzing the relevant rules and related guidance, the CDIs are helpful in formalizing the SEC staff's position and placing them in an organized fashion.

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[26] Id.

[27] Question 105.02.

[28] Question 101.04.

[29] Question 104.01.

[30] Question 110.03.

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