

Equity Ownership Concepts Under the U.S. Securities Laws: A Review for Hedge Funds and Other Investors

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Consider a hedge fund (“Fund”) that establishes an equity position in a U.S. public company (“Company”).² Among the myriad legal issues Fund may encounter are those relating to its degree of ownership of Company stock.

Several of the most important regulatory schemes embedded in the U.S. securities and other investment-related laws apply once a specified level of equity ownership has been crossed. For example, various ownership-based regulations might require Fund to: (i) publicly report share acquisitions or sales; (ii) publicly disclose any control intentions it might have with regard to an issuer; (iii) file with the SEC quarterly portfolio holdings information; (iv) disgorge profits from “short-swing” trading in an issuer’s shares; (v) disclose short sales and positions to the SEC; (vi) seek federal government approval for further share acquisitions; and/or (vii) consider the applicability of state anti-takeover statutes.

As if the profusion of ownership-based regulatory systems didn’t complicate Fund’s life enough, the ownership thresholds that subject an investor to regulation vary. Different degrees of ownership trigger distinct regulatory consequences. More fundamentally, the concept of “ownership” itself may differ from one scheme to another.

This memo offers some help with the complexity. We review below the ownership-based regulatory thresholds Fund is most likely to face, setting forth their differences and highlighting their interaction. In particular, we consider the equity ownership thresholds that trigger:

- Disclosure obligations under Section 13 of the Securities Exchange Act of 1934 (the “Exchange Act”) (Part A);
- Insider trade reporting and disgorgement liability under Section 16 of the Exchange Act (Part B);
- The SEC’s short sale disclosure rules (Part C);
- Limits on share acquisitions under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the “HSR Act”) (Part D); and
- Delaware’s business combination statute (Part E).

In conclusion, Part F sets out a few hypothetical scenarios showing how the above ownership-based regulatory schemes interact, in sometimes intricate fashion.³

A. SECTION 13 OF THE EXCHANGE ACT

Section 13 of the Exchange Act provides for disclosure obligations based on “beneficial

Memorandum

June 8, 2009

“Several of the most important regulatory schemes embedded in the U.S. securities laws apply once a specified level of equity ownership has been crossed.”

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² For illustrative purposes, this memo posits a hypothetical hedge fund as the investor. The concepts we discuss apply equally to other types of investors.

³ This memo focuses on the types and levels of ownership that would cause Fund to become subject to a particular regulatory scheme, rather than on the substance of the regulation itself. For example, while we analyze the meaning of five-percent beneficial ownership under Section 13 of the Exchange Act, we don’t go into detail about the specific Schedule 13D or 13G disclosure requirements to which Fund becomes subject due to exceeding that ownership level. For a more thorough treatment of the substantive requirements triggered by crossing various ownership thresholds, see our memorandum dated December 11, 2008, *Establishing, Maintaining and Exiting a Minority Equity Position: U.S. Securities Law Considerations for Hedge Funds*, available at www.rkollp.com.

ownership” of an issuer’s equity securities. The Section 13 concept of beneficial ownership is critical to an understanding of ownership-based securities regulation in the United States. This is due partly to Section 13’s own importance in the functioning of the U.S. equity markets, and partly to the fact that other elements of the U.S. securities regulatory framework borrow from Section 13’s standards.

Sections 13(d) and (g)

Sections 13(d) and (g) of the Exchange Act and their associated rules apply to Fund if it acquires, directly or indirectly, **beneficial ownership** of more than five percent of a class of **equity securities**. Crossing the five-percent beneficial ownership threshold would require Fund to file with the SEC an ownership report on Schedule 13D or Schedule 13G. The filing is due within 10 days after the transaction taking Fund above five percent; subsequent material changes in Fund’s degree of beneficial ownership (or other facts) would occasion amendments to the initial report. The disclosure obligations imposed by Sections 13(d) and (g) are central to the U.S. equity markets, in that they are designed to alert the investing public and the issuer to rapid accumulations of securities by persons who could potentially affect control of the issuer.

Equity Securities. The disclosure regimes of Sections 13(d) and (g) are triggered by an investor that acquires beneficial ownership of five percent or more of a class of “equity securities.” Rule 13d-1(i) primarily defines that term as equity securities of a class that is registered pursuant to Section 12 of the Exchange Act.⁴

Section 12 requires a class of securities to be registered in either of two scenarios. Section 12(b) requires registration of any class of securities that will be listed on a U.S. national securities exchange.⁵ Alternatively, Section 12(g) mandates registration when a class of

equity securities is held of record by at least 500 persons and the issuer has total assets exceeding \$10 million. A class of equity securities that is registered for either of these reasons is a class of “equity securities” for purposes of Sections 13(d) and (g). Thus, while Fund typically will engage in the five-percent beneficial ownership analysis with respect to the stock of listed issuers, Fund might need to undertake the same analysis regarding a non-listed issuer with a class of equity securities that was otherwise widely held.

EXAMPLE A-1. Company has assets of \$400 million and a class of common stock owned of record by 510 persons, consisting of Company’s founders, employees and initial equity sponsors, including Fund. Fund beneficially owns 4.5% of the outstanding common stock. Company hopes one day to do an IPO, but for the moment remains unlisted and thus hasn’t had to register its common stock under Section 12(b) of the Exchange Act. Due to its assets and number of investors, however, Company has registered its common stock under Section 12(g).

Company’s chief financial officer, who owns 3% of Company’s outstanding common stock, decides to diversify his investment portfolio and agrees to sell half his shares to Fund. When Fund makes this purchase from the CFO, Fund’s beneficial ownership of Company common stock will increase from 4.5% to 6%. Fund will thus need to file a Schedule 13D or Schedule 13G to report its acquisition of greater-than-five-percent beneficial ownership of a class of Company’s equity securities.

Non-Voting Securities Aren’t “Equity Securities.” The link between Section 12 class

⁴ Note that registration under the Exchange Act is distinct from registration under the Securities Act of 1933 (the “Securities Act”). The former relates to registering a class of listed or otherwise widely-held securities, as a result of which the issuer becomes subject to the Exchange Act’s periodic disclosure requirements. The latter relates to registration of a transaction—i.e., a public offering of securities—on the form of registration statement prescribed by the SEC under the Securities Act. It is often the case that an issuer undertakes Exchange Act class registration and Securities Act transaction registration in tandem—for instance, at the time of an IPO—but the concepts remain distinct.

⁵ For purposes of Section 12(b), “national securities exchange” currently includes 10 exchanges, among which are the New York Stock Exchange, the Nasdaq Stock Market and the American Stock Exchange. The term doesn’t include inter-dealer quotation systems such as the OTC Bulletin Board, the Pink Sheets or the Yellow Sheets.

registration and Section 13 “equity security” status is broken in the case of non-voting equity securities. Rule 13d-1(i) provides that equity securities without voting rights—even if registered as a class under Section 12—are not considered equity securities for purposes of Sections 13(d) and (g). This reflects the fact that the Section 13 disclosure regime is focused on eliciting information from equity investors who may be able to change or influence control of the issuer; ownership of non-voting securities presumably doesn’t confer that power.

The term “non-voting” isn’t defined by statute or rule. It is generally understood, however, to apply to securities that have no more than the minimum voting rights prescribed by state law or stock exchange rules.⁶

EXAMPLE A-2. Under the law of Company’s state of incorporation, holders of Company’s Class A preferred stock have the right to vote on any amendment to Company’s charter that would materially adversely affect them. Company’s Class A preferred has no voting rights other than this statutorily-imposed minimum. The Class A preferred shares should be considered non-voting for purposes of Sections 13(d) and (g).

EXAMPLE A-3. Company’s Class B preferred stock normally carries no voting rights. By its terms, however, the Class B preferred obtains certain voting rights following a default in Company’s dividend payment obligations. The Class B preferred should be considered non-voting until and unless such a default has occurred, at which point the Class B voting rights will have become non-contingent.

Beneficial Ownership. Under Rule 13d-3(a), a “beneficial owner” of a security is any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has or shares:

- “voting power,” which means the power to vote or direct the voting of the security; and/or
- “investment power,” which means the power to dispose or direct the disposition of the security.

To calculate its percentage beneficial ownership of a class of Company’s equity securities, Fund would look to the number of securities of the class outstanding (not counting any securities held by or for the account of Company).⁷ Rule 13d-1(j) allows Fund to rely on Company’s most recent Exchange Act report for purposes of ascertaining the number of shares outstanding, unless Fund knows or has reason to believe the number in the report is inaccurate.

Equity Securities Obtainable within 60 Days.

Under Rule 13d-3(d), a person is generally deemed to beneficially own an equity security if the person has the right to acquire beneficial ownership of that security within 60 days. This means that if Fund holds an instrument—for example, a warrant, option, subscription right or convertible note—that is exercisable for or convertible into underlying Company stock within the next 60 days, Fund will be treated as already beneficially owning the underlying stock for purposes of Sections 13(d) and (g).

Conversion into common stock is assumed with respect to Fund but not with respect to any other investors. That is, the numerator and denominator in Fund’s percentage ownership calculation include the underlying equity securities that Fund—and only Fund—has the right to acquire during the next 60 days.

EXAMPLE A-4. Company’s most recent Form 10-Q indicates 1 million shares of common stock outstanding, as well as \$50 million principal amount of notes immediately convertible into common stock at \$25 per share. Fund acquires 60,000 shares of common stock and \$5 million principal amount of the convertible notes. On this basis, Fund is deemed to beneficially own 21.7% of Company’s common stock:

⁶ See, e.g., *Santa Fe Gaming Corp. v. Hudson Bay Partners, L.P.*, 49 F. Supp. 2d 1178, 1183-84 (D. Nev. 1999).

⁷ Section 13(d)(4). Securities held by or for the account of Company might include, for example, treasury shares or shares that Company has repurchased (even if not placed in treasury) to fund a stock option plan. See SEC Division of Corporation Finance, *Manual of Publicly Available Telephone Interpretations*, Item O.5 (July 1997).

60,000 shares held outright by Fund
+ 200,000 shares Fund may acquire within
60 days by converting its notes
260,000

÷ 1,200,000 shares deemed outstanding for
purposes of Section 13

.217 Fund's deemed beneficial ownership of
outstanding shares

EXAMPLE A-5. Same facts as above, but Fund also holds call options to purchase 30,000 shares of outstanding Company common stock. The options by their terms are exercisable at any time of Fund's choosing, but are so far out of the money that Fund currently has no intention of exercising. The economic irrationality of exercising the options, however, doesn't alter the fact that Fund is legally free to do so immediately; Fund is thus deemed to beneficially own 24.2% of Company's common stock:

60,000 shares held outright by Fund
200,000 shares Fund may acquire
within 60 days by converting its notes
+ 30,000 shares Fund may acquire within
60 days by exercising its call options
290,000

÷ 1,200,000 shares deemed outstanding for
purposes of Section 13

.242 Fund's deemed beneficial ownership of
outstanding shares

Note that the divisor remains 1,200,000 (rather than increasing to 1,230,000) because the 30,000 shares underlying the call options are already outstanding.

There is an important caveat to the 60-day deemed ownership rule. An investor won't be tagged with beneficial ownership if the right to receive underlying equity—although nominally exercisable within 60

days—is subject to conditions outside the investor's control that cast doubt on the 60-day timeframe or, indeed, on the investor's ability to receive any equity at all.

EXAMPLE A-6. Fund holds convertible notes representing 10% of Company's underlying common stock. The notes are immediately convertible; provided, that Fund must give Company at least 75 days' advance notice before effecting a conversion that would result in Fund beneficially owning more than 4.99% of Company's common stock. Fund's ownership of convertible notes doesn't currently result in Fund beneficially owning 5% or more of Company's common stock; the prior notice condition to exercise effectively puts Fund outside the scope of the 60-day deemed beneficial ownership rule.

EXAMPLE A-7. Fund holds convertible notes representing 6% of Company's underlying common stock. The notes are convertible without further conditions once the stock's 10-day average closing price equals or exceeds \$5.25 per share. Through Friday, May 29, 2009, the closing price has never exceeded \$4. On the morning of Monday, June 1, however, Company announces an exciting product innovation and the stock price jumps. The stock closes between \$5.30 and \$5.50 each day during the period June 1–5.

As of the close of trading on June 5, Fund's ownership of convertible notes doesn't yet result in Fund beneficially owning any of Company's common stock, since the last five days' closing prices, though a great improvement over the past, won't have produced a 10-day average closing price of \$5.25 or above. Now, however, Fund must monitor the closing price on a daily basis to determine if it will be deemed to beneficially own the shares at the close of trading on June 12, 2009 (the last day in the 10-trading day sequence beginning June 1) or some date thereafter.

EXAMPLE A-8. Fund holds convertible notes representing 10% of Company’s underlying common stock. The notes are immediately convertible; provided, that Company has the right to deliver cash instead of shares in satisfaction of the conversion notice. Fund’s ownership of convertible notes doesn’t result in Fund beneficially owning any of Company’s common stock, since Fund doesn’t control the circumstances in which it will, if ever, receive shares.

Group Issues. A person that doesn’t have five-percent beneficial ownership of a class of equity securities may nonetheless become subject to Section 13(d) or (g) through membership in a “**group**” that has, in the aggregate, crossed the five-percent threshold. A group is formed when two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of an issuer’s equity securities.⁸ If the investor is part of a group, beneficial ownership of the securities by all other group members will be aggregated for purposes of Sections 13(d) and (g) with any shares the investor otherwise beneficially owns. The group concept is designed to prevent individuals from avoiding an obligation to file a Schedule 13D or 13G “by dividing control over a block of stock so that no one person [has] control over five percent individually but as a group [have] agreed to act in concert.”⁹

Analyzing whether a group exists requires close attention to facts and circumstances, and often won’t be a clear-cut exercise. A mere relationship among persons, absent an agreement to act in concert, shouldn’t indicate the formation of a group. On the other hand, an agreement doesn’t need to be written or

otherwise formally expressed in order to evidence formation of a group.¹⁰ One leading case held that the following factors showed the existence of a group: (i) a common plan or goal shared by the investors; (ii) a pattern of parallel and continued share purchases by the investors over a relatively short period of time; (iii) correlation of the investors’ activities and communications through a common agent; and (iv) claims of shareholder support by the investors at a meeting with company management.¹¹

Section 13(f)

Section 13(f) of the Exchange Act requires “institutional investment managers” to report their holdings to the SEC on a quarterly Form 13F. This filing reports the manager’s holdings and their fair market value as of the end of the most recently completed quarter, and is due 45 days after the quarter’s end.¹²

Unlike its cousins Sections 13(d) and (g), Section 13(f) doesn’t refer to a percentage beneficial ownership standard for purposes of determining whether an investor has a filing obligation. Rather, a Form 13F must be filed by any institutional investment manager that exercises “**investment discretion**” over “**Section 13(f) securities**” having an aggregate market value of at least \$100 million as of the last day of any calendar month.¹³

Investment Discretion. Rule 13f-1(b) provides that an institutional investment manager exercises “investment discretion” with respect to an account if the manager:

- is authorized to determine which securities are bought or sold for the account; or

⁸ Rule 13d-5(b)(1) .

⁹ *Calvary Holdings, Inc. v. Chandler*, 948 F.2d 59, 64 (1st Cir. 1991) .

¹⁰ See, e.g., *Texasgulf, Inc. v. Canada Dev. Corp.*, 366 F. Supp. 374, 403 (S.D. Tex. 1973); and *Morales v. Quintel Entertainment, Inc.*, 249 F.3d. 115, 124 (2d Cir. 2001) .

¹¹ *Champion Parts Rebuilders, Inc. v. Cormier Corp.*, 661 F. Supp. 825, 850 (N.D. Ill. 1987).

¹² An “institutional investment manager” is an entity that invests in or buys and sells securities for its own account, or a natural person or entity that exercises investment discretion over the account of any other natural person or entity.

¹³ An institutional investment manager need not be an SEC-registered investment adviser in order to be subject to the Form 13F filing requirement. See SEC Division of Investment Management, *Frequently Asked Questions About Form 13F*, Questions 3 and 5 (May 2005).

- makes decisions about which securities are bought or sold for the account, even though another person has responsibility for those investment decisions.

Section 13(f) Securities. “Section 13(f) securities” are publicly traded equity securities that are identified in the Official List posted quarterly on the SEC’s website. Generally, the Official List includes exchange-traded stocks, equity options and warrants, shares of closed-end investment companies and certain convertible debt securities. Shares of open-end investment companies (i.e., mutual funds) aren’t Section 13(f) securities; shares of exchange traded-funds are.

Special rules apply to the reporting of options and warrants that are Section 13(f) securities. For example, an investment manager reports on Form 13F only those options held, rather than written, by the manager.¹⁴ A short position in a Section 13(f) security isn’t a holding for purposes of Section 13(f) and thus isn’t reportable.

Aggregate FMV of \$100 Million. Rule 13f-1(a)(1) provides that an institutional investment manager becomes subject to the Form 13F filing regime if the manager exercises investment discretion with respect to accounts holding Section 13(f) securities with a fair market value of at least \$100 million on the last trading day of any calendar month. In that case, the manager has to file a Form 13F within 45 days after the last day of that calendar year, and then within 45 days after the last day of each of the first three calendar quarters of the subsequent calendar year.

EXAMPLE A-9. Fund first meets the \$100 million FMV threshold on the last trading day of July 2009. Fund will file its initial Form 13F for the quarter ending December 31, 2009, and that filing will be due by February 14, 2010. Fund will file at least three subsequent Forms 13F, i.e., for the quarters ended March 31, June 30 and September 30, 2010, in each case not later than 45 days after quarter-end.

Whether Fund must continue filing Forms 13F after the four quarterly filings mentioned above will depend on the FMV of Fund’s portfolio of Section 13(f) securities during calendar 2010. If the portfolio meets the \$100 million threshold on the last trading day of any calendar month in 2010, Fund will need to file a Form 13F for the quarter ended December 31, 2010 and the first three quarters of 2011.

B. SECTION 16 OF THE EXCHANGE ACT

Section 16 of the Exchange Act is intended to discourage the misuse of nonpublic information by corporate insiders. The statute seeks to do this in two ways. Section 16(a) requires any person or entity that beneficially owns more than 10 percent of a class of Section 12-registered equity securities (as well as the company’s directors and officers) to publicly report to the SEC their holdings of, and certain transactions in, the company’s equity and derivative securities. Section 16(b) then allows the company to recover any short-swing profits that the 10-percent beneficial owner (or director or officer) gains from buying and selling the company’s equity and/or derivative securities during a given six-month period.

In light of its aims, Section 16 approaches the concept of beneficial ownership somewhat differently than Section 13 does. In determining whether an investor is a greater-than-10-percent owner and thus within Section 16’s scope, Section 16 borrows Section 13’s control-based definition of beneficial ownership. Once an investor is subject to Section 16, however, the statute’s operative provisions introduce a new notion of beneficial ownership based on the economic incidents of share ownership.

Is Fund Subject to Section 16?

Solely for purposes of determining whether Fund is a greater-than-10-percent beneficial owner, Section 16 adopts the Section 13(d) definition of “beneficial ownership.” Thus, in considering whether its equity

¹⁴ *Id.*, Question 43.

position in Company subjects Fund to Section 16, Fund will follow the same analysis described in Part A above, substituting 10 percent for five percent as the relevant beneficial ownership threshold. (See Rule 16a-1(a)(1).)

Operation of Section 16

If Fund is subject to Section 16, a second definition of beneficial ownership takes over for purposes of the reporting obligations set forth in Section 16(a) and profit disgorgement liability under Section 16(b). Under this second definition, beneficial ownership is attributed to “any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has or shares a direct or indirect **pecuniary interest** in the [issuer’s] equity securities.” The term “pecuniary interest” is defined as “the opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject securities.” (See Rule 16a-1(a)(2).)

Section 16’s disparate definitions of beneficial ownership mean that the number of securities considered beneficially owned for purposes of determining whether an investor is subject to Section 16 may differ from the number applied for transaction reporting and profit disgorgement purposes.

EXAMPLE B-1. Company has 10 million shares of common stock outstanding. Fund owns 10,000 shares. Fund has also obtained from Investor A an irrevocable proxy for the sole purpose of voting Investor A’s 1 million shares at an upcoming shareholders’ meeting. Fund thus has voting and/or dispositive power over 1.01 million shares. As calculated under Section 13(d), Fund beneficially owns 10.1% of Company’s common stock. Fund therefore must file an initial beneficial ownership report (on Form 3) under Section 16(a).

To determine the number of shares to be reported as beneficially owned on the Form 3, Fund now assesses its “pecuniary interest” in Company common stock. Since Fund merely holds a proxy to

vote Investor A’s 1 million shares—and thus has no “opportunity to profit or share in any profit from a transaction in” those shares—Fund’s pecuniary interest is limited to, and Fund’s Form 3 would only report, the 10,000 shares Fund actually owns. Similarly, Fund’s potential liability for short-swing trading profits under Section 16(b) would attach only to these 10,000 shares (or any additional shares in which Fund later acquired a pecuniary interest).

EXAMPLE B-2. Company has 10 million shares of common stock outstanding. Fund owns 10,000 shares. On June 1, 2009, Fund acquires Company convertible notes representing 1 million underlying shares. The notes are convertible at the holder’s option at a fixed conversion price beginning January 1, 2012. Since Fund has no right to convert the notes within the next 60 days, Fund isn’t deemed to beneficially own the 1 million underlying shares of common stock. Thus, Fund’s acquisition of the convertible notes doesn’t make Fund subject to Section 16.

On July 1, 2009, Fund purchases 1 million shares of common stock in the market. Fund has now surpassed 10-percent beneficial ownership and must file a Form 3. The filing will report not only the 1.01 million shares Fund owns outright, but also the convertible notes in which Fund has a pecuniary interest.

Group Issues

As noted in Part A above, a person may become subject to the Section 13(d) reporting system through membership in a group that has, in the aggregate, crossed the five-percent beneficial ownership threshold. The same group concept applies at the 10-percent beneficial ownership level for determining whether an investor has become subject to Section 16. An investor won’t have a Section 16(a) reporting obligation or Section 16(b) disgorgement liability for another group member’s trades, however, if the

investor doesn't have a pecuniary interest in the transacting member's securities. (See Rule 16a-2.)

C. SHORT POSITION REPORTING

An institutional investment manager subject to the Form 13F reporting regime is also required, under Exchange Act Rule 10a-3T, to disclose weekly its shorting activities in Section 13(f) securities. This disclosure is made to the SEC (but not the public) on Form SH. In determining whether it has effected a short sale disclosable on Form SH, Fund must look to the ownership concepts found in Regulation SHO ("Reg. SHO") under the Exchange Act.

Short Sales

Rule 200(a) of Reg. SHO states that the sale of a security can be a "short sale" for either of two reasons: (i) the seller doesn't own the security being sold; or (ii) the sale is consummated by the delivery of a security borrowed by, or for the account of, the seller.

"Ownership" Under Reg. SHO

Rule 200(b) of Reg. SHO describes the circumstances in which a seller is considered to "*own*" a security.

Types of Ownership. Instances of ownership recognized by Rule 200(b) range from the simple case in which an investor currently holds a security to situations in which the investor has exercised a legal right to obtain the security but hasn't yet taken delivery. More specifically, Rule 200(b) states that a person owns a security if the person: (i) has title to it (directly or through an agent); (ii) owns a security that is convertible or exchangeable for it, and has tendered for conversion or exchange; (iii) owns an option to acquire it, and has exercised the option; (iv) owns rights or warrants to subscribe for it, and has exercised the rights or warrants; (v) holds a security future contract to purchase it, has received notice that the position will be physically settled and is irrevocably bound to receive the underlying security; or (vi) has purchased or entered into an unconditional contract to purchase the security, but hasn't yet received it.

"Ownership" Depends on Being Net Long. Rule 200(c), however, adds a critical qualification: an investor is deemed to "own" securities only to the extent the investor has a net long position. In other words, if an investment manager is simultaneously long and short in the same securities (e.g., has a boxed position), Reg. SHO treats the manager as owning only the positive delta, if any, between the long and short positions.

EXAMPLE C-1. Fund is long 1 million shares of Company at Broker A and has a 0 position at Broker B. Fund orders Broker B to sell 100,000 shares. As Fund is net long, Fund "owns" the 100,000 shares to be sold. Thus, the sale would be short only if Broker B planned to settle the trade with borrowed shares. In order to avoid a need for Broker B to borrow shares, and thus avoid short sale status for the trade, Fund would need to arrange a mechanism whereby long shares from its Broker A account could be transferred to Broker B in time for delivery to the purchaser on the settlement date.

EXAMPLE C-2. Fund is short 1 million shares at Broker A and long 100,000 shares at Broker B. Fund orders Broker B to sell 100,000 shares. This is a short sale of 100,000 shares; Fund is deemed to "own" no shares at the time of the sell order, because Fund doesn't have a net long position.

D. THE HSR ACT

The HSR Act generally states that any person proposing to acquire voting securities or assets of a U.S. company exceeding \$65.2 million in value (as determined by HSR rules) must give advance notice to the U.S. Federal Trade Commission and the Antitrust Division of the U.S. Department of Justice. Specifically, the HSR Act provides that, unless exempted, "no *person* shall acquire, directly or indirectly, any voting securities or assets of any other person, unless both persons file notifications ... and the waiting period has expired" if, as a result of the

proposed acquisition, the acquiror would “**hold**” assets or “**voting securities**” exceeding the specified threshold.¹⁵

Beneficial Ownership as Conceived by the HSR Act

The HSR Act employs the highlighted terms above to arrive at its own distinct concept of beneficial ownership. The HSR concept overlaps but differs from its Section 13 homonym.

Attributes of HSR Beneficial Ownership. Rule 801.1(c) under the HSR Act provides that a person “holds” securities if it has “beneficial ownership” of them. Unlike Section 13 of the Exchange Act, however, the HSR Act doesn’t define beneficial ownership. Rather, the Statement of Basis and Purpose accompanying the FTC’s HSR implementing rules suggests that “the existence of beneficial ownership is to be determined in the context of particular cases with reference to the person or persons that enjoy the indicia of beneficial ownership.”¹⁶ These indicia, which encompass both economic and control elements, include (i) the right to obtain the benefit of any increase in value or dividends, (ii) the risk of loss of value, (iii) the right to vote or determine who may vote the stock and (iv) investment discretion (including the power to dispose of the stock). There is no bright-line test as to whether any particular element of ownership is given more weight or whether all elements must be present for beneficial ownership to be found. The pivotal question is at what point the transfer of ownership rights and obligations is complete enough for the buyer to be viewed as having obtained beneficial ownership.¹⁷

Limited Concept of “Person.” The HSR Act also differs from the Section 13 approach to beneficial ownership in its eschewal of a group-type concept. Under Rule 801.1(a)(1), “person” means an “ultimate

parent entity” and all entities that it controls directly or indirectly. All positions held by entities with a common ultimate parent will be attributed solely to the parent for purposes of threshold calculations; the controlled entities are effectively ignored. Similarly, unrelated entities acting in concert aren’t viewed as a single person.

Limited Concept of “Voting Securities.” The HSR Act has a more limited approach than Section 13 with regard to equity securities covered by the statute. The HSR Act is directed at holdings, among other things, of “voting securities,” which Rule 801.1(f)(1)(i) effectively defines as securities entitling their holder to vote for the election of directors of the issuer. Since convertible securities (including options and warrants) don’t confer a present right to vote, the HSR Act doesn’t treat them as voting securities. Thus, a person holding an immediately exercisable option or warrant wouldn’t be a beneficial owner of the underlying stock for purposes of the HSR Act, notwithstanding the fact that it would be deemed to have beneficial ownership of those securities for Section 13 purposes. However, prior to converting into or exercising for any voting securities, the relevant parties must comply with the notification and waiting period requirements under the HSR Act if the conversion or exercise would result in the investor holding in aggregate voting securities with a value exceeding the applicable HSR threshold.

EXAMPLE D-1. Fund is interested in purchasing 10 million shares of Company’s common stock at \$7 per share. Investor A owns 80% of the limited partnership interests in Fund and serves as Fund’s general partner with sole investment and voting discretion over Fund’s investment portfolio. Investor A is therefore Fund’s “ultimate parent entity” and is deemed to “hold” any securities

¹⁵ U.S.C. §18a(a). The HSR Act provides specific rules on how to value securities or assets for purposes of the applicable threshold. An investor that otherwise has an HSR notification obligation might qualify for the passive investor exemption. This exemption applies when an acquisition of voting securities is “made solely for the purpose of investment” and results in the investor holding 10 percent or less of the issuer’s outstanding voting securities. See Rule 802.9.

¹⁶ 43 Fed. Reg. 33,450, 33,458 (July 31, 1978).

¹⁷ See *Premerger Coordination: The Emerging Law of Gun Jumping and Information Exchange*, ABA Section of Antitrust Law (2006), at 18.

owned by Fund. Because Fund would acquire more than \$65.2 million worth of Company voting securities if it purchased the 10 million shares, Investor A would have to make an HSR notice filing and abide by the waiting period before permitting Fund to consummate the purchase.

EXAMPLE D-2. Same facts as above, but Fund is purchasing only 5 million shares of common stock and Investor A is also the ultimate parent entity of a sister fund (“Sister Fund”) that is also interested in purchasing 5 million shares of Company’s common stock at \$7 per share. Because Fund is acquiring less than \$65.2 million worth of voting securities, Investor A does not need to make an HSR notice filing prior to Fund’s purchase of its 5 million shares. However, if Sister Fund wants to purchase its 5 million shares on the next day, Investor A will need to make an HSR notice filing and abide by the waiting period before Sister Fund may effect its purchase. This is because Investor A will be deemed to own all of the shares owned by Fund and Sister Fund, which together would be worth more than \$65.2 million.

EXAMPLE D-3. Fund owns 5 million shares of Company common stock valued for HSR purposes at \$10 per share, which coincides with the current market price of the shares. Fund owns warrants to purchase 2 million additional shares at an exercise price of \$5. Fund is its own ultimate parent entity. To date, Fund has not been required to make an HSR notice filing because it has acquired voting securities—i.e., the 5 million shares of common stock—with a value of only \$50 million.

Fund now wants to exercise its warrants. Before doing so, Fund must add the “HSR values” of both the shares it already owns (\$50 million) and the shares it will acquire upon exercise (\$20 million, i.e., 2 million shares x \$10) in order to determine if it must make a notice filing and abide by

the waiting period before acquiring the warrant shares. Because the combined value of Fund’s existing shares and its warrant shares will exceed \$65.2 million, Fund in fact will need to take those steps.

E. SECTION 203 OF DELAWARE GENERAL CORPORATION LAW

Many state legislatures have enacted laws to impede unsolicited acquisitions of significant equity positions in companies incorporated in the state. These laws take different forms, but are typically triggered upon an investor’s attainment of specified equity ownership levels, frequently in the range of 10 or 20 percent. An example is Section 203 of the Delaware General Corporation Law (“DGCL 203”), which fuses Exchange Act ownership concepts with its own distinct features.

DGCL 203 requires an “*interested stockholder*” to satisfy certain board and/or shareholder approval procedures before engaging in a “business combination” with the issuer. Under DGCL 203(c)(5), an interested stockholder generally means any person that owns 15 percent or more of the issuer’s outstanding voting stock. An “*owner*,” in turn, is defined under DGCL 203(c)(9) as a person that, individually or with or through any of its affiliates or associates:

- Beneficially owns stock, directly or indirectly;
- Has (A) the right to acquire stock (whether such right is exercisable immediately or only after the passage of time) pursuant to any agreement, arrangement or understanding, or upon the exercise of conversion rights, exchange rights, warrants or options; or (B) the right to vote stock pursuant to any agreement, arrangement or understanding; or
- Has any agreement, arrangement or understanding, for the purpose of acquiring, holding, voting or disposing of stock, with any other person that beneficially owns stock.

DGCL 203 uses a broader definition of ownership than Section 13, primarily due to its treatment of instruments that are convertible into or exchangeable for stock. While beneficial ownership under Section 13 exists when a person has the right to acquire an issuer's stock within 60 days, ownership for purposes of DGCL 203 includes the right to acquire an issuer's stock "after the passage of time," without reference to any cut-off date.¹⁸ On the other hand, DGCL 203 echoes the Section 13 "group" concept in its attribution of shared ownership to stockholders who agree to act together in "acquiring, holding, voting or disposing of stock."

EXAMPLE E-1. Company has 10 million shares of common stock outstanding. Fund owns no shares directly but on June 1, 2009, Fund acquires Company convertible notes representing 2 million underlying shares. The notes are convertible at the holder's option beginning January 1, 2012. Although Fund has no right to convert the notes within the next 60 days (and thus beneficially owns no Company common stock as far as Section 13 is concerned), DGCL 203 deems Fund to beneficially own the 2 million underlying shares of common stock. Because that number of shares represents 16.7% of Company's outstanding class of common stock, Fund is an interested stockholder (i.e., $2,000,000 \div 12,000,000 = .167$).

EXAMPLE E-2. Company has 10 million shares of common stock outstanding. Fund holds 1.4 million shares. Investor A holds 200,000 shares. Fund and Investor A enter into an agreement to vote in the same way on all matters for which Company's board seeks shareholder approval. As a result of this voting agreement, Fund is deemed to own the common stock held by Investor A. Fund's consequent deemed ownership of 1.6 million shares, or 16% of Company's common stock, makes each of Fund and Investor A an interested stockholder.

F. PLAYING WITH THE PUZZLE

The reader who has stayed with us has doubtless realized that the various ownership-based regulatory schemes described above can interact in complex ways. The following illustrations are a handful of the many that one could imagine.

EXAMPLE F-1. Power of Attorney to Vote Common Stock; Acquisition of Convertible Notes (Section 13 and Section 16)

Company has 10 million shares of common stock outstanding. Investor A owns 11% of that amount, or 1.1 million shares. Investor A grants Fund a power of attorney authorizing Fund to vote Investor A's shares. Fund holds no shares of its own.

For purposes of Section 13, Fund's voting power over 1.1 million shares makes Fund the beneficial owner of 11% of Company's outstanding common stock. Fund thus must file a Schedule 13D or Schedule 13G reporting this ownership position. Fund has also become subject to Section 16 reporting and disgorgement obligations; Fund's Form 3, however, indicates a zero ownership position because Fund does not have a pecuniary interest in Investor A's shares (and does not beneficially own any shares other than through the power of attorney).

Fund then purchases Company convertible notes representing 6.5% of Company's underlying common stock. The notes are immediately convertible at a fixed price; provided, that their terms prohibit Fund from effecting a conversion that would result in Fund beneficially owning more than 9.99% of Company's common stock unless Fund has given Company at least 75 days' advance notice of the planned conversion.

Fund's ownership of convertible notes doesn't currently result in Fund beneficially owning the underlying shares for purposes of Section 13,

¹⁸ DGCL 203 is similar to Section 13 in terms of calculating Fund's as-converted percentage beneficial ownership. The numerator and denominator include the underlying shares of common stock that Fund, and only Fund, has the right to obtain upon conversion or exchange. See DGCL 203(c)(5).

since the 75-day prior notice requirement effectively puts Fund outside the scope of the 60-day deemed beneficial ownership rule (i.e., the 75-day advance notice requirement applies because the conversion of the notes combined with Fund’s beneficial ownership of Investor A’s 11% interest would result in Fund beneficially owning more than 9.99% of Company’s common stock). Fund therefore doesn’t need to amend its Schedule 13D to report a change in beneficial ownership; it would amend its Schedule 13D only if it thought its convertible notes acquisition was otherwise a “material” change from the information presented in Fund’s last Schedule 13D. Fund does, however, need to file a Form 4 to report the acquisition of a derivative security.

One month later, Investor A revokes its power of attorney. Fund now must amend its Schedule 13D to show: (i) the disposition of voting authority over Investor A’s 11% position; and (ii) Fund’s acquisition of beneficial ownership of 6.5% of Company’s shares, since the convertible notes can now be converted without prior notice and are thus acquirable within 60 days (i.e., revocation of the power of attorney means that Fund no longer beneficially owns the 11% position held by Investor A; Fund’s conversion thus wouldn’t result in Fund piercing the 9.99% beneficial ownership cap; and the 75-day advance notice provision therefore isn’t implicated).

EXAMPLE F-2. Group Ownership of Common Stock (Section 13, Section 16, HSR and DGCL 203)

Fund, Investor A and Investor B beneficially own 4%, 6% and 7%, respectively, of Company’s outstanding common stock. Fund, Investor A and Investor B become a Section 13(d) “group” by entering into an agreement that for the next 12 months they will vote, acquire and dispose of

their shares according to a majority vote among themselves. Each member of the group is deemed to beneficially own 17% of Company’s outstanding common stock. Fund therefore becomes subject to Section 13(d) reporting and Section 16 reporting and disgorgement obligations. Investors A and B were previously subject to Section 13(d) reporting obligations because each already beneficially owned more than 5% of Company’s common stock. Now, however, Investors A and B are also subject to Section 16 reporting and disgorgement obligations, since their membership in a Section 13(d) group has caused each to become a beneficial owner of more than 10% of Company’s common stock.

If Fund, Investor A or Investor B seeks to acquire additional shares of Company stock, each—or the “ultimate parent entity” of each—will perform its own HSR analysis based on its own holdings. Unless any of the three investors share a common ultimate parent entity, no other investor’s holdings will be relevant for any single investor’s HSR purposes.

DGCL 203, however, does have a group ownership concept similar to that of Section 13(d). Because each of Fund, Investor A and Investor B will be deemed to have acquired ownership of 17% of Company’s outstanding shares, each will be deemed to have become an “interested stockholder” upon formation of the group.

EXAMPLE F-3. Acquisition and Exercise of Convertible Notes (Section 13, Section 16, DGCL 203 and HSR)

Company has 10 million shares of common stock outstanding. On June 1, 2009, Fund acquires convertible notes representing 2 million underlying shares with a market value of \$75 million. The notes are convertible at Fund’s discretion beginning on the second anniversary of their

purchase (i.e., on June 1, 2011). On the date of acquisition, Fund isn't deemed to beneficially own the 2 million underlying shares for purposes of Sections 13(d) and (g) and Section 16 because Fund has no right to acquire the shares within 60 days. Similarly, because the notes aren't voting securities, no HSR notice filing was required prior to Fund's acquisition of the notes.

For purposes of DGCL 203, however, Fund is deemed to beneficially own the 2 million underlying shares of common stock because the notes are convertible "after the passage of time." Since the shares represent 16.7% of the Company's outstanding class of common stock (i.e., $2,000,000 \div 12,000,000 = .167$), the note purchase on June 1, 2009 has made Fund an interested stockholder under DGCL 203.

We now skip ahead to April 2, 2011, which is 60 days before the second anniversary of Fund's purchase of the convertible notes. At this point, assuming the notes still represent 16.7% of Company's outstanding shares, Fund becomes subject to Section 13 reporting and Section 16 reporting and disgorgement obligations. Fund thus must file a Form 3 and Schedule 13D (or potentially a Schedule 13G).

If Fund wants to convert the notes on or after June 1, 2011, Fund will first need to determine if conversion will cause it to own more than \$65.2 million (or the then-adjusted HSR threshold) of voting securities. If so, Fund will need to make an HSR notice filing and respect the waiting period before it can convert the notes and acquire the underlying shares. Finally, if Fund did not receive appropriate board approval for the transaction that resulted in it becoming a DGCL 203 interested stockholder (i.e., the purchase of the convertible notes on June 1, 2009), Fund will need to consider whether its acquisition of shares through the note conversion is a "business combination" as defined in DGCL 203(c)(3), and thus

would require board and shareholder approval. In this case, the conversion in fact would not be a business combination, since DGCL 203(c)(3)(iii) (A) excludes from that term's scope an issuance of shares to an interested stockholder "pursuant to the exercise, exchange or conversion of securities . . . that were outstanding prior to the time that the interested stockholder became such."

Assuming the HSR rules permit Fund to exercise the notes and the notes still represent 16.7% of Company's outstanding shares, Section 16 will require Fund to report the transaction on a Form 4. Fund would need to amend its Schedule 13D to report the exercise only if Fund determined that the exercise was a "material" change to the information presented in its last Schedule 13D; that is, Fund would not need to amend its Schedule 13D to report any change in its percentage beneficial ownership of Company stock, because Fund was already deemed (as of April 2, 2011) to own all of the shares underlying the convertible notes and would have filed a Schedule 13D to report that beneficial ownership.

EXAMPLE F-4. Sale from Long Position When Fund is Net Short (Reg. SHO, Rule 10a-3T and Section 13(d))

Fund owns 100,000 shares of Company common stock, representing 8% of the total shares outstanding. Fund also has a short position in 200,000 Company shares. Fund reports its beneficial ownership on a Schedule 13D. Even if the short sales are disclosed in the text of the Schedule 13D, Section 13(d) doesn't permit Fund to net its short position against its long position. Fund's Schedule 13D thus reports 8% beneficial ownership.

Fund now sells 40,000 shares. Fund settles the trade by delivering shares from its long position (i.e., reducing its long position from 100,000 to 60,000 shares). Under Reg. SHO, this trade is a

short sale because it is effected when Fund is net short in Company shares. That is, the sale will be marked as short even though Fund's broker settles the trade with shares taken from Fund's long position rather than with borrowed shares. As a consequence, Fund will report its sale of 40,000 shares as a short trade (assuming it exceeds the de minimis exception) on Fund's next Form SH.

Section 13(d), on the other hand, does distinguish between a sale that is "short" due to being settled with borrowed shares and a sale that is "short" due merely to occurring at a moment when Fund is net short in Company stock. If Fund settles the trade out of its long position (i.e., reduces its long position from 100,000 to 60,000 shares), Fund's beneficial ownership of Company stock will decrease by more than 1% of the outstanding class, as a result of which Rule 13d-2 will require Fund to disclose the sale and its decreased beneficial ownership position in an amendment to Schedule 13D. By contrast, if Fund settles the trade with borrowed shares, Fund's beneficial ownership will not change—Fund will continue to hold 100,000 shares, notwithstanding its eventual obligation to return the 40,000 borrowed shares to the share lender when Fund closes out its short position. In this case, Fund would need to amend its Schedule 13D only if Fund determined that the short sale was otherwise a "material" change to the information presented in its last Schedule 13D; that is, Fund might conclude that the short sale necessitated a Schedule 13D amendment, but that conclusion wouldn't be based on any actual decrease in Fund's percentage beneficial ownership of Company stock.

* * *

In assessing the scope of its ownership-based reporting and other obligations under the U.S. securities laws, an equity investor must be attuned not only to varying percentage thresholds, but also to the different ways "ownership" is conceived from one regulatory scheme

to another. We would be pleased to consult with any investor about its particular situation.

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