

# SEC Issues Interpretive Guidance on Exchange Act Sections 13(d) and 13(g)

By Scott C. Budlong, Selina W. Tay and Gianna C.T. Quach<sup>1</sup>

On September 14, 2009, the Staff of the SEC's Division of Corporation Finance issued Compliance and Disclosure Interpretations (the "Interpretations") relating to beneficial ownership reporting under Sections 13(d) and 13(g) of the Securities Exchange Act of 1934 (the "Exchange Act").<sup>2</sup> The Interpretations supplant Part O of the Staff's July 1997 Manual of Publicly Available Telephone Interpretations, in some cases repeating prior guidance and in other instances addressing new questions.

While the Interpretations perhaps signal a mild tightening of the Staff's views, they do not break significant conceptual ground. Nonetheless, the Interpretations offer market participants an opportunity to refresh their understanding of the Section 13 beneficial ownership reporting scheme. This is an opportunity worth taking, given Section 13's return to prominence as a subject of recent SEC enforcement activity.<sup>3</sup>

We describe below the Interpretations we expect our clients to find most relevant.<sup>4</sup>

## Determinants of Beneficial Ownership

### Contingent Acquisition Rights

Rule 13d-3(d)(1) generally states that a person is deemed to beneficially own an equity security if the person has the right to acquire the security within 60 days, such as

by exercising an option or warrant or converting another security. Interpretation 105.02 confirms that an investor does not have beneficial ownership, however, when the right to acquire the equity security is contingent on the occurrence of an event outside the investor's control.

The Staff illustrates with the example of an investor (without control intent<sup>5</sup>) that receives the right to acquire more than five percent of a class of equity securities. The right is nominally exercisable within 60 days, but is conditioned on the effectiveness of a related registration statement to be filed by the issuer. The Staff states that this investor need not file a Schedule 13D or 13G until the registration statement has become effective, such that the acquisition right is definitively exercisable within 60 days.

### Variable-Rate Convertible Notes

Interpretation 104.04 considers the situation of an investor holding variable-rate convertible notes, where the number of shares acquirable within the next 60 days varies daily with the issuer's stock price. Such an investor must track movements in the conversion rate in order to determine whether the investor's beneficial ownership of the conversion shares has crossed the five-percent threshold (or, if the investor is already a Schedule 13D filer, has changed by

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"The Interpretations offer market participants an opportunity to refresh their understanding of the Section 13 beneficial ownership reporting scheme."

<sup>1</sup> Scott C. Budlong is a partner, and Selina W. Tay and Gianna C.T. Quach are associates, in the New York office of of Richards Kibbe & Orbe LLP.

<sup>2</sup> *Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting*, available at <http://www.sec.gov/divisions/corpfin/guidance/reg13d-interp.htm>.

<sup>3</sup> See, e.g., *In the Matter of Tracinda Corporation*, Release No. 34-58451 (Sept. 3, 2008), and *In the Matter of Perry Corp.*, Release No. 34-60351 (July 21, 2009). It is notable that the Staff does not use the Interpretations as a forum for commenting on the extent to which parties to a cash-settled derivative contract may be viewed as beneficially owning the underlying equity securities for purposes of Section 13. This was a central issue in *CSX Corp. v. The Children's Investment Fund Management* (S.D.N.Y. 2008), currently on appeal in the U.S. Second Circuit.

<sup>4</sup> Section 13 reporting is triggered by an investor exceeding five-percent beneficial ownership of a class of equity securities that the issuer has registered under Section 12 of the Exchange Act. Accordingly, for purposes of this memorandum, references to the Section 13 reporting threshold relate to beneficial ownership of more than five percent of a class of Section 12-registered equity securities.

<sup>5</sup> If a person has control intent, beneficial ownership is deemed to exist even if the acquisition right is not exercisable within 60 days. See Rule 13d-3(d)(1)(i).

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one percent or more and thus triggered a Schedule 13D amendment). The Staff's interpretive position means that holders of variable-rate convertible notes must carefully monitor their as-converted beneficial ownership positions.<sup>6</sup>

#### *Conversion Cap Limiting Beneficial Ownership Level*

Interpretation 105.03 confirms that a convertible instrument containing a "conversion cap" may relieve its holder of a Section 13 filing obligation by eliminating the holder's right to acquire more than five percent of the underlying equity class. The Staff states that to achieve this result, the conversion cap must be "binding and valid." Indicia of a cap's binding and valid status could include, for example, a prohibition on waiver; establishment of the cap in the security's certificate of designation or the issuer's governing documents; applicability of the cap to the security holder's affiliates and assigns; and/or the existence of a regulatory scheme that is the impetus for the cap.<sup>7</sup>

#### *American Depository Receipts*

Interpretation 101.04 reminds investors that American Depository Receipts are not considered a separate class of equity securities for purposes of calculating beneficial ownership under Section 13. Rather, a Section 13 reporting obligation is determined by reference to five-percent-or-greater beneficial ownership of the class of Section 12-registered equity securities underlying the ADRs.<sup>8</sup>

#### *Unintentionally Crossing the Five-Percent Threshold*

Interpretation 101.06 makes clear that an investor that unintentionally exceeds five-percent beneficial ownership—such as through a broker mistakenly purchasing more shares than ordered by the investor—

is required to file a Schedule 13D or 13G. This is the case even if the investor refuses to pay for and instructs the broker to sell the excess shares. "The absence of an intent to acquire in excess of five percent is not a consideration with respect to the applicability of Sections 13(d) and 13(g)."

#### **Deadline for Initial Schedule 13D Filing**

Rule 13d-1(a) requires an investor to file an initial Schedule 13D "within 10 days after the acquisition" that takes the investor above five-percent beneficial ownership. In Interpretation 103.05, the Staff indicates that the trade date is Day 1 for purposes of the filing deadline, meaning the initial Schedule 13D is due on T+9.<sup>9</sup>

#### **Switching from Schedule 13D to Schedule 13G**

Interpretation 103.07 states that the only type of investor that may switch from Schedule 13D to Schedule 13G is one that initially was eligible to file on Schedule 13G and later became required to report on Schedule 13D. The Staff cites Rule 13d-1(h), which provides that "any person who has filed a Schedule 13D . . . may *again* report its beneficial ownership on Schedule 13G" (Staff emphasis) if the investor becomes newly eligible to use Schedule 13G (e.g., by abandoning control intent).

By contrast, Interpretation 103.07 states that an investor that was originally required to report on Schedule 13D may not subsequently switch to Schedule 13G, even if the investor has now adopted passive intent. It is unclear why the Staff believes an originally passive investor that develops but then abandons control intent should be free to use Schedule 13G, while an investor that initially had control intent and subsequently abandons it should not be.<sup>10</sup>

<sup>6</sup> If the variable-rate convertible security contains a conversion cap as discussed in the next paragraph, the investor might be spared the need for monitoring.

<sup>7</sup> See Brief of the Securities and Exchange Commission, Amicus Curiae, in *Levy v. Southbrook International Investments, Ltd.*, 263 F.3d 10 (2d Cir. 2001), available at <http://www.sec.gov/litigation/briefs/2001/levy0301.pdf>.

<sup>8</sup> ADRs are exempt from class registration under Section 12 of the Exchange Act pursuant to Rules 12a-8 and 12g3-2(c). The class of equity underlying listed ADRs necessarily will be registered.

<sup>9</sup> While Interpretation 103.05 does not explicitly address the point, the same guidance presumably applies to a passive investor filing Schedule 13G pursuant to Rule 13d-1(c). That filing is also due "within 10 days after the acquisition" that takes the investor above five-percent beneficial ownership.

<sup>10</sup> Interpretation 103.07 does not explicitly state that an investor that was eligible to file initially on Schedule 13G but elected to use Schedule 13D may switch to Schedule 13G at a later time. Presumably, as long as this investor never was ineligible to use Schedule 13G during its time as a Schedule 13D filer (e.g., never adopted control intent), it should be able to switch to Schedule 13G.

## **Involuntary Changes in Beneficial Ownership Level**

### *Becoming a Reporting Person due to Decrease in Shares Outstanding*

Interpretation 103.08 concerns an investor that exceeds five-percent beneficial ownership due solely to a decrease in the number of the issuer's outstanding shares. The Staff advises that such an investor does have a Section 13 filing obligation but, because there was no "acquisition" of securities, may report on Schedule 13G within 45 days of calendar year-end pursuant to Rule 13d-1(d).<sup>11</sup>

### *Change in Reporting Person's Ownership Level due to Change in Shares Outstanding*

Interpretation 103.08 also discusses how a change in an issuer's share count may affect an investor that is already reporting under Section 13. For a Schedule 13D filer, the Staff confirms that Rule 13d-2(a) would require the investor to amend its Schedule 13D if the change in the number of outstanding shares caused a material increase or decrease in the investor's percentage beneficial ownership.<sup>12</sup> For an existing Schedule 13G filer, however, the Staff notes that Rule 13d-2(b) would eliminate the need for a year-end amendment.<sup>13</sup>

Interestingly, Interpretation 103.08 is silent on Rules 13d-2(c) and (d), which require an institutional or passive Schedule 13G investor to file an amendment if its beneficial ownership crosses 10 percent or thereafter increases or decreases by more than five percent of the class.

## **Amendments to Schedules 13D and 13G**

### *Short Sales*

Interpretation 104.01 acknowledges that a short sale normally does not alter an investor's beneficial ownership percentage, since it does not change the quantity of shares over which the investor has voting or investment power. The Staff reminds investors, however, that a short sale might otherwise need to be disclosed under one or more of Items 3 through 7 of Schedule 13D.<sup>14</sup>

### *Acquisition of Warrants*

Interpretation 110.01 advises that a Schedule 13D-reporting person that acquires warrants must amend its Schedule 13D to reflect the acquisition, even if the warrants are not exercisable within 60 days. The Staff states that this amendment is necessary to revise the reporting person's disclosures under Item 4(a) (plans to acquire additional securities) and Item 6 (contracts), and to file the warrant as an exhibit under Item 7.<sup>15</sup>

## **Schedule 13D Exit Filings**

### *Sale of Less than One Percent of Class*

Interpretation 104.05 concerns a Schedule 13D filer whose beneficial ownership falls to five percent or less due to a disposition representing less than one percent of the class.

The Staff explains that an investor must file a Schedule 13D amendment only to the extent that the decline in beneficial ownership to five percent or less constitutes a material change within the meaning of Rule 13d-2(a) or otherwise causes a material change to the previously filed Schedule 13D disclosure. It is therefore possible that a less-than-one-percent disposition taking the

<sup>11</sup> Such a filing would be necessary only if the investor still beneficially owned more than five percent of the class as of the end of the calendar year.

<sup>12</sup> Rule 13d-2(a) states that "an acquisition or disposition" of beneficial ownership in an amount equal to one percent or more of the class is "material" by definition. Interpretation 103.08 does explicitly say whether this per se materiality concept applies to a one-percent change in beneficial ownership caused only by a change in the number of outstanding securities.

<sup>13</sup> Rule 13d-2(b) generally requires an annual amendment to Schedule 13G to report changes to previously disclosed information, including with respect to percentage beneficial ownership. The rule further provides, however, that no annual amendment is required if the only change concerns percentage ownership and that change resulted solely from an increase or decrease in the issuer's outstanding securities.

<sup>14</sup> Interpretation 104.01 effectively repeats the guidance provided in Items O.9 and O.16 of the 1997 telephone interpretations.

<sup>15</sup> Interpretation 110.01 effectively repeats the guidance provided in Item O.12 of the 1997 telephone interpretations.

investor below the reporting threshold will not require an amendment.

That said, the Staff points out that the investor’s ongoing obligation to amend Schedule 13D to disclose material changes to previously reported information will continue until the investor has filed a final amendment stating the date on which it ceased to beneficially own more than five percent. An investor that drops to five-percent-or-less beneficial ownership thus may wish to file a voluntary exit amendment in order to terminate its reporting obligation.

*Sale of Securities between Record and Meeting Dates*

Interpretation 104.07 relates to a Schedule 13D-reporting investor that sells all of its shares prior to a shareholder meeting but after the related record date, thus retaining the right to vote the shares at the meeting. The Staff advises that while this investor must amend its Schedule 13D promptly under Rule 13d-2(a) to disclose the disposition of more than one percent of the outstanding class, the investor should not file an exit amendment until the shareholder meeting has occurred. This is because the investor’s voting power (as opposed to investment power) is not extinguished by the sale, but rather persists until the conclusion of the meeting.

**Scope of Schedule 13D Disclosure**

*“Securities of the Issuer” in Items 4(a) and 6*

Interpretation 110.03 confirms that the references to “securities of the issuer” in Items 4(a) and 6 of Schedule 13D include all of the issuer’s securities, whether or not the securities are of a class of equity, have voting rights or are registered under Section 12 of the Exchange Act. For example, a Schedule 13D-reporting person that has formulated a plan or proposal or entered into an agreement involving the acquisition of debt securities of the issuer must amend its Items 4 and 6 disclosures to the extent material.<sup>16</sup>

*Generic “Plan or Proposal” Disclosure under Item 4*

Interpretation 110.06 returns to a lesson from the SEC’s *Tracinda* enforcement action—generic Schedule 13D disclosure reserving the right to engage in an Item 4 transaction does not shield an investor from the need to amend its Schedule 13D if the investor later determines to undertake such a transaction. To illustrate, the Interpretation posits a Schedule 13D filer whose Item 4 disclosure states that it has no current plans to engage in any of the transactions enumerated in Items 4(a)-(j), but reserves the right to engage in such a transaction in the future. The investor later determines to take the issuer private and hires an investment bank to develop deal terms, although the investor has not yet approached management or formally initiated the transaction.

The Staff affirms that the above investor must amend its Schedule 13D because its existing Item 4 disclosure is no longer accurate—the investor has now formed a plan that would result in the delisting or deregistration of the issuer’s common stock, an event covered by Items 4(h) and (i). Moreover, the requirement to amend is triggered even though the investor has not yet formally commenced the going-private transaction. In the Staff’s view, “formulat[ing] a specific intention with respect to a disclosable matter” is sufficient to trigger the amendment obligation. (Of course, the question of whether and when a filer has developed a specific intention to act or has actually formed a plan or proposal remains highly fact-dependent.)

*Aggregate Disclosure of Purchase/Sale Prices under Item 5(c)*

Item 5(c) of Schedule 13D requires a reporting investor to describe any transactions in the subject class of securities effected within the past 60 days, including the date of the transaction, the amount of securities involved and the per-share price. Interpretation 110.08 recognizes that broker-dealers may execute trade orders in small increments and at multiple prices that may be as little as a fraction of a penny apart, and

<sup>16</sup> Interpretation 110.03 effectively repeats the guidance provided in Item O.14 of the 1997 telephone interpretations.

provide their clients with average instead of per-share prices.

The Staff advises that in this case, a Schedule 13D filer may satisfy Item 5(c) by using a weighted average price to report on an aggregate basis all purchases or sales within a one-dollar price range executed by a broker-dealer on the same day. A reporting person that chooses this approach must (i) specify, in a footnote or otherwise, the range of prices for each such one-dollar aggregate disclosure and (ii) undertake to provide, at the Staff's request, full information regarding the number of shares purchased or sold at each separate price.<sup>17</sup>

### **Schedule 13D and the Proxy Rules**

Interpretation 110.07 warns Schedule 13D filers to consider whether they are engaging in a proxy solicitation when their disclosure includes statements in opposition to management or a pending transaction. The Staff cautions that “[b]eneficial ownership reporting [under Section 13] was not intended to create an additional exception to the application of Regulation 14A.” Consequently, if Schedule 13D disclosure constitutes soliciting material and no exemption from the proxy rules is available,<sup>18</sup> the disclosure is subject to Rule 14a-12 and must be filed contemporaneously under cover of Schedule 14A. This potentially puts the Schedule 13D filer in a difficult situation, as only persons who actually intend to disseminate a proxy statement are permitted to engage in soliciting activities under Rule 14a-12.

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If you have questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed here.

### **Scott C. Budlong**

New York, NY  
212 530 1915  
sbudlong@rkollp.com

### **Selina W. Tay**

New York, NY  
212 530 1907  
stay@rkollp.com

### **Gianna C.T. Quach**

New York, NY  
212 530 1824  
gquach@rkollp.com

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<sup>17</sup> Interpretation 110.08 is consistent with the Staff's 2008 guidance on Form 4 reporting under Section 16 of the Exchange Act. See *Society of Corporate Secretaries & Governance Professionals*, SEC No-Action Letter (avail. June 25, 2008).

<sup>18</sup> Such an exemption conceivably could be available, for example, under Rule 14a-2(b)(1) if the investor meets the conditions to that rule.