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CAPITAL MARKETS & SECURITIES | INVESTMENT MANAGEMENT

SENATE INTRODUCES BILL TO INCREASE OVERSIGHT OF ACTIVIST INVESTORS

By: Park Bramhall, Esq.

On March 17, 2016, Senators Tammy Baldwin (D-Wis.) and Jeff Merkley (D-Ore.) introduced bill S 2720 ("S 2720") in the Senate Banking, Housing and Urban Affairs Committee.[1] Named the "Brokaw Act" after a small Wisconsin town that went bankrupt purportedly as the result of the intervention of an out-of-state hedge fund, S 2720 would result in increased oversight of activist investors[2] by, among other things, (i) significantly shortening the Schedule 13D filing window from ten calendar days to two business days; (ii) expanding the definition of "group" in an effort to increase disclosure by so-called activist investor wolf packs; (iii) amending the definition of beneficial ownership to capture securities in which an investor has a direct or indirect pecuniary interest such as cash-settled equity derivatives; and (iv) requiring the disclosure of short positions in excess of 5%. In addition, because the issue of whether a person is a 10% beneficial owner for purposes of Section 16 of the Exchange Act of 1934 (the "Exchange Act") is determined in accordance with the beneficial ownership rules set forth in Section 13 of the Exchange Act[3], S 2720 could also increase the number of activist investors subject to the Section 16 short-swing trading rules.

Reducing The Schedule 13D Filing Window To Two Business Days

The Section 13 beneficial ownership reporting rules were adopted as part of the Williams Act, which was enacted in 1968 in response to the growing use of cash tender offers as a means of achieving corporate takeovers.[4] In that context, the Section 13 beneficial ownership reporting rules were intended to provide the investing public prompt notice whenever a person or group acquires more than 5% of any class of an issuer's voting stock registered under Section 12 of the Exchange Act by requiring the person or group acquiring such shares to file an ownership report on Schedule 13D within ten calendar days of crossing that threshold. The ten-day filing window, however, has long been criticized on the grounds that it permits aggressive investors to secretly continue to increase their ownership stake prior to the filing deadline[5] More to the point, since an issuer's stock price will frequently move in response to a Schedule 13D filing, the criticism is that the ten-day "buying window" allows Schedule 13D filers to acquire additional shares at the "artificially low" pre-Schedule 13D announcement price. In addition, as reported by the *Wall Street Journal*, certain activist hedge funds have leveraged the pre-announcement buying window to build alliances (or so-called wolf packs) by "tipping off" other institutional investors regarding their plans in advance of filing their Schedule 13Ds, and using the expected post-announcement increase in stock price to effectively "pay" these investors to join their side in their campaign against the target company.[6] S 2720 attempts to limit these perceived abuses by reducing the filing window from the current ten calendar days to two business days.[7]

Expanding The Definition Of Person

S 2720 also attempts to restrict the operations of wolf packs by adopting language that would make it easier to establish that several investors were acting as a "group."[8] The significance of this change is that under the existing Section 13(d) rules, parties that are deemed to be members of the same group are required to aggregate their holdings when determining whether the 5% Section 13(d) and 10% Section 16 reporting thresholds have been crossed.

Interestingly, S 2720 accomplishes this by adding the defined term "person" to Rule 13d-3 rather than amending Rule 13d-5(b)(1), which provides that a group is established "[w]hen two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer."[9] In particular, S 2720 provides that the term "person" includes (i) "2 or more persons acting as a partnership, limited partnership, syndicate, or other group, or **otherwise coordinating the actions** of the persons" and "a hedge fund or a group of hedge funds or persons that are, as determined by the Commission, **working together** to evade the requirements of section 13(d), 13(g), or 13(s) of the Act" (emphasis added).[10]

Expanding The Definition Of Beneficial Ownership

In light of their origin as part of the Williams Act, the Section 13(d) beneficial ownership rules focus on the

degree to which a person may exercise voting or investment control over a security. In particular, under Rule 13d-3, a person is deemed to beneficially own any security over which such person has or shares voting power or investment control, which is defined as the power to "dispose, or to direct the disposition of" a security[11], as well as any equity security underlying a derivative if the person is granted the right to obtain voting or investment control over such underlying security within 60 days.[12]

One of the criticisms arising from this focus on voting and investment power is that the current Section 13(d) beneficial ownership rules do not capture derivative securities that only provide economic exposure to a covered security, and therefore permit investors to "hide their ownership" of a company's securities by using cash-settled equity derivatives such as total return swaps ("**TRSs**"). The basis for this criticism is the fact that the "short party" to a TRS[13], which is frequently a major financial service institution that is in the business of offering TRSs as a product or service, will typically hedge its exposure by acquiring the referenced security in amounts identical to those referenced in the TRS.[14] While such hedging will eliminate the short party's economic interest in the referenced securities, the short party will still be the beneficial owner of those shares and therefore have the right to vote them.[15] In this context, the concern here is that to the extent the short party is in the business of attracting repeat swap business, it may have an incentive to vote the shares comprising its hedge in favor of the positions the "long party" advocates.[16] Notwithstanding the preceding, the SEC has taken the position that cash-settled equity derivatives do not result in the long party gaining beneficial ownership of the shares acquired to hedge the short party's economic exposure.[17]

In this context, S 2720 would address this perceived gap in the Section 13(d) beneficial ownership rules by providing that a person will also be deemed to beneficially own any equity security in which it has or shares a "pecuniary or indirect pecuniary interest."[18]

Disclosure Of Short Positions

Under current SEC guidance, short positions are not considered when determining an investor's beneficial ownership on the grounds that a short interest does not change the amount of securities over which a person has "voting or investment power."[19] That said, while short positions may not change an investor's voting or investment power, they may affect an investor's economic incentives, particularly in situations where the value of the short position outweighs the investor's long position. Accordingly, to prevent investors from secretly betting against companies that they are invested in,[20] S 2720 would amend Section 13 of the Exchange Act by adding Section 13(s)[21] and Rule 13d-1(a)[22] to require investors acquiring a direct or indirect short interest[23] representing more than 5 % of an issuer's voting securities to file a disclosure document within two business days of crossing that threshold.

Conclusion

If enacted in its current form, S 2720 would significantly alter the regulatory landscape for activist investors. We will continue to monitor S 2720, as well as any similar legislative developments. In the interim, please contact any of the attorneys listed, or any other member of Lowenstein Sandler's Capital Markets & Securities Group or Investment Management Group, for further information on the matters discussed in this Client Alert.

contacts

Please contact any of the attorneys named below for more information on this matter.

Investment Management

Robert G. Minion, Esq.
646 414 6930
rminion@lowenstein.com

Peter D. Greene, Esq.
646 414 6908
pgreene@lowenstein.com

Richard Bernstein, Esq.
646 414 6842
rbernstein@lowenstein.com

David L. Goret, Esq.
646 414 6837
dgoret@lowenstein.com

Scott H. Moss, Esq.
646 414 6874
smoss@lowenstein.com

Capital Markets & Securities

Peter H. Ehrenberg, Esq.
212 204 8697
pehrenberg@lowenstein.com

Steven M. Skolnick, Esq.
973 597 2476
sskolnick@lowenstein.com

John D. Hogoboom, Esq.
646 414 6846
jhogoboom@lowenstein.com

Alan Wovsaniker, Esq.
973 597 2564
awovsaniker@lowenstein.com

Park S. Bramhall, Esq.
646 414 6925
pbramhall@lowenstein.com

[1] The text of S 2720 is available here.

[2] S 2720 accomplishes its stated goal of increasing the oversight of activist investors primarily by amending the Section 13(d) rules to expand the range of situations in which an investor would be required to file a beneficial ownership report on Schedule 13D. Passive investors, however, are generally able to file a short-form beneficial ownership statement on Schedule 13G in lieu of a Schedule 13D, and therefore the brunt of the impact of S 2720 will be borne by activist investors. In particular, under Rule 13d-1(b), certain institutional investors that acquire securities in the ordinary course of their business and not with the purpose nor with the effect of changing or influencing the control of the issuer are permitted to file a Schedule 13G. Similarly, under Rule 13d-1(c), any other person who acquires securities without the purpose or effect of changing or influencing the control of an issuer and beneficially owns less than 20% of any class of the issuer's voting stock registered under Section 12 of the Exchange Act may also file a Schedule 13G.

[3] See Rule 16a-1(a)(1).

[4] See *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 22 (1977). In introducing the legislation on the Senate floor, the sponsor, Senator Williams, stated:

> This legislation will close a significant gap in investor protection under the Federal securities laws by requiring the disclosure of pertinent information to stockholders when persons seek to obtain control of a corporation by a cash tender offer or through open market or privately negotiated purchases of securities. 113 Cong. Rec. 854 (1967). *Id.* at 26.

[5] Advisory Committee on Tender Offers, SEC, Report of Recommendations (July 8, 1983), reprinted in Fed. Sec. L. Rep. (CCH) No. 1028 (Extra Edition) 21 ("The 10-day window between the acquisition of more than a 5% interest and the required filing of a Schedule 13D was found to present a substantial opportunity for abuse, as the *acquiror* [sic] 'dashes' to buy as many shares as possible between the time it crosses the 5% threshold and the required filing date.").

[6] See Susan Pulliam, Juliet Chung, David Benoit and Rob Barry, "Activist Investors Often Leak Their Plans to a Favored Few", The Wall Street Journal, March 26, 2014, accessible here. The counterargument against closing the 10-day buying window is that it is needed to incentivize institutional investors to make the investments required to force target companies to implement the changes proposed by such investors. See, e.g., Joshua Gallu, "Secret Corporate Raids to Get Harder Under SEC Rule Change," Bloomberg, February 22, 2011 (quoting William Ackman as saying that closing the ten-day window would decrease the number of activist investors challenging corporate management because "[i]f forced to disclose the position, the opportunity to buy at an attractive price disappears").

[7] See S 2720 § 2(a)(1).

[8] See Press Release "U.S. Senators Tammy Baldwin and Jeff Merkley Introduce Legislation to Strengthen Oversight of Activist Hedge Funds" (March 17, 2016) (the "**Press Release**"), under the heading "Protect Businesses from Wolf Packs," accessible here. Note that while the Press Release indicates that S 2720 "reforms the definition of 'person or group'," it does not modify the definition of "group" set forth in Rule 13d-5(b)(1). We assume that the statement reflects the senators' belief that a finding that two or more persons are the same "person" for purposes of Rule 13d-3 is functionally equivalent to a finding that those same persons were a group under Rule 13d-5(b)(1), but would note that a determination that two or more persons are the same person may have different implications than if those persons were determined to be members of the same group. For example, while Rule 13d-4 permits "[a]ny person [to] expressly declare in any statement filed that the filing of such statement shall not be construed as an admission that such person is, for the purposes of section 13(d) or 13(g) of the [Exchange Act], the beneficial owner of any securities covered by the statement;" it is unclear how Rule 13d-4 should be applied if two or more persons are deemed to be the same person. In contrast, the formation of a group under Rule 13d-5(b) is treated as the formation of a new person, which is deemed to have acquired beneficial ownership of all securities owned by its members. See Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting Compliance and Disclosure Interpretation 105.06, accessible here.

[9] Rule 13d-5(b)(1) provides that "[w]hen two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer, the group formed thereby shall be deemed to have acquired beneficial ownership, for purposes of sections 13(d) and (g) of the Act, as of the date of such agreement, of all equity securities of that issuer beneficially owned by any such persons."

[10] See S 2720 § 2(b)(2).

[11] See Rule 13d-3(a).

[12] See Rule 13d-3(d). The 60-day rule is a function of the fact that the Securities and Exchange Commission ("**SEC**") has historically viewed only the near-term right to acquire voting or investment power over a security as the equivalent of having current voting or investment power over the security. In particular, when discussing why it decided to adopt the 60-day rule and not to extend beneficial ownership to include the right to acquire at any time, the SEC stated that it was:

> mindful that as the point in time in which the right to acquire may come to fruition is extended into the future, the relation of the right's ability to influence control is correspondingly attenuated. When sixty days or less are left until the right to acquire may be exercised, the Commission believes that the ability of the holder of such right to affect control is sufficient to warrant the imposition of an obligation to file under Rule 13d-1.

See "Filing and Disclosure Requirements Relating to Beneficial Ownership," Exchange Act Release No. 14692 (April 21, 1978) at *15; see also Brief of Amicus Curiae the Securities and Exchange Commission (No. 00–7630) at 17-18.

[13] Under a typical cash-settled TRS, two parties enter into an agreement that seeks to replicate the positions of a long and a short investor in a particular stock. In general, the short party will agree to pay the long party cash flows based on the performance of an agreed-upon number of shares of stock in exchange for payments by the long party based on the interest that accrues at a negotiated rate on an agreed principal amount (the "**notional amount**") — which is typically the value of the stock at the time the transaction is agreed on and may be recalculated periodically — and any decrease in the market value of the stock. More to the point, the long party receives from the short party an amount equal to the sum of any cash distributions, such as interest or dividends, that it would have received had it held the shares plus the increase in the value of the shares in the relevant period, while the short party generally receives from the long party an amount equal to the decrease in the value of the shares in the relevant period plus the interest accrued on the notional amount. The payments occur on "refixing dates" that recur throughout the duration of the TRS as specified by the contract. See *CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp.2d 511, 520 (S.D.N.Y. June 11, 2008) (the "**CSX Case**").

[14] *Id.* at 521-522.

[15] *Id.* at 522.

[16] *Id.* Following the CSX Case, it would be unusual to find a short party willing to do this given the potential risk that the short party could be found to have formed a group with the long party by "agreeing" to vote the shares in this manner. That said, it should be noted that after the TRS is unwound, the shares composing the hedge would, as a general matter, no longer be needed by the short party. While the short party is under no obligation to sell the shares to the long party, the long party would have a number of advantages over any other prospective buyer of such shares by virtue of the fact that it is in a pre-existing relationship with the seller, and would know exactly when the shares became available for sale. See id. at 523.

[17] "The [SEC] Division [of Corporation Finance] believes that Rule 13d-3, properly construed, is narrower in coverage than the statute. As a general matter, economic or business incentives, in contrast to some contract, arrangement, understanding, or relationship concerning voting power or investment power between the parties to an equity swap, are not sufficient to create beneficial ownership under Rule 13d-3. We start with the recognition that a standard cash-settled equity swap agreement, in and of itself, does not confer on a party, here the investment fund, any voting power or investment power over the shares a counterparty purchases to hedge its position." Letter from Brian Breheny, Deputy Director of the Division of Corporation Finance, to Judge Kaplan, 2008 WL 7055479 (June 4, 2008) at *2.

[18] See S 2720 § 2(b)(1). The definitions of "pecuniary interest" and "indirect pecuniary interest" are substantially similar to the corresponding definitions set forth in Rule 16(a)(2)(i)- (ii).

[19] See Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting Compliance and Disclosure Interpretation 104.01 ("**C&DI 104.01**"), accessible here.

[20] See Press Release under the heading "End Secret 'Net Shorts' by Requiring Derivative Disclosure." That said, it should be noted that the Section 13(d) rules already require the disclosure of short interests in certain circumstances. In particular, Item 6 of Schedule 13D requires the disclosure of any contracts, arrangements, understandings or relationships with respect to securities of the applicable issuer, and Rule 13d-2(a) and C&DI 104.01 stand for the proposition that the initiation of a short position may trigger a requirement to file an amendment to an existing Schedule 13D. Consequently, the primary impact of S 2720 is that it would require short interest disclosure in the following additional circumstances: (i) by any investor that would not otherwise be required to file either a Schedule 13D or 13G; (ii) by passive investors eligible to file a Schedule 13G; and (iii) by any investor obtaining short exposure through cash-settled equity derivatives.

[21] See S 2720 § 2(c).

[22] See S 2720 § 2(a)(1).

[23] See S 2720 § 2(c). Under S 2720, a person will be deemed to have a short interest in a security if the person has the opportunity to profit from, or share in any profit derived from, any decrease in the value of the security including, but not limited to, as a result of taking the short position of a cash-settled derivative.