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# Changes to 13D Disclosure Regime in the Pipeline?

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Over the last 12 months actions by activist investors have been the impetus behind significant fundamental restructurings at several publicly traded companies. These activist prompted restructurings have indirectly yielded two of this year's largest announced M&A transactions, the spin-off and subsequent $12.5 billion sale of Motorola Mobility to Google and the recently announced $37.8 billion sale of El Paso to Kinder Morgan. Despite, or perhaps because of, their recent success, activist investors may soon find that the rules governing their disclosure obligations in connection with the accumulation of interests, the obligation to file a Form 13D within ten days of beneficially owning more than 5% of a class of voting equity securities registered under Section 12 of the Exchange Act, may soon be overhauled.

The Securities and Exchange Commission (the "SEC"), in a broad-ranging Concept Release issued in July 2010, acknowledged that its staff is in the process of reviewing current disclosure requirements relating to holdings of financial instruments, including short sale positions and derivatives positions often utilized by activist investors to magnify their economic return. The results of this review are not yet known, but the SEC referenced it again in connection with the technical re-adoption without change of its beneficial ownership rules in July of this year, when the SEC acknowledged that its staff "is engaged in a separate project to develop proposals to modernize reporting" under Sections 13(d) and 13(g) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). While the July 2011 re-adoption merely reaffirmed the existing beneficial owner rules, these SEC footnotes suggest that much greater change may lay ahead. While the SEC has not set forth a proposed rule yet, the SEC staff is undoubtedly considering modifying the rules relating to the treatment of derivatives under the beneficial ownership rules and the timing of disclosure obligations once Form 13D filing obligations are triggered.

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**Treatment of Derivatives Under the Beneficial Ownership Rules**

Under existing Rule 13d-3, beneficial ownership exists when a derivative gives a person (i) voting or investment power over the underlying security or (ii) the right to acquire the underlying security within 60 days or the person holds such right to acquire with the purpose of changing or influencing control. Additionally, an anti-evasion prong is included in Rule 13d-3; beneficial ownership is deemed to exist if a derivative is used as part of a plan or scheme to evade the foregoing beneficial ownership reporting requirements. In practice, while options exercisable within 60 days are treated as bestowing their holders with beneficial ownership, common market practice is to not treat long ownership of cash-settled securities-based-swaps as beneficial ownership of the underlying security due to the absence of a contractual right to convert the swap into the underlying security.

In a recent high profile case, CSX Corp. v. The Children's Inv. Fund Mgmt., Judge Kaplan of the Southern District of New York found that an activist investor had intentionally used cash-settled total-return swaps as part of a plan or scheme to evade beneficial reporting requirements. On appeal, the U.S. Second Circuit Court of Appeals considered under what circumstances cash-settled total-return swaps could create beneficial ownership, but declined to opine on this question due to acknowledged disagreement within the panel. In a lengthy concurrence to that decision, Judge Ralph Winter argued that total-return swaps should not trigger beneficial reporting requirements absent an agreement or informal understanding between the long and short parties to the swap regarding the short party selling or voting the shares. Accordingly, the law regarding when cash-settled total-return swaps confer beneficial ownership on the long party remains unsettled in the Second Circuit.

Notwithstanding the current absence of clarity within the beneficial ownership rules under Rule 13d-3, public companies clearly view the use of derivative instruments, as a potential threat and have modified their takeover defense mechanisms accordingly. Shareholder rights plans, so-called "poison pills," now frequently pick-up a wide range of derivative

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instruments including total-return swaps in addition to direct ownership of equity securities. Standstill provisions, which are commonly included in confidentiality agreements negotiated with potential acquirors, and regulate the methods by which a potential acquiror can mount a takeover attempt, also frequently include derivative securities.

The unsettled nature of this issue, the increased prevalence of securities-based swaps and the SEC's actions in regulating securities-based swaps in other areas of the market make this issue ripe for attention when the SEC announces its plans to modernize Sections 13(d) and 13(g) of the Exchange Act.

**Timing of Reporting**

The Dodd-Frank Act also amended Section 13 of the Exchange Act to authorize the SEC to shorten the 10-day window in which greater than 5% beneficial owners must initially report their ownership of a company's publicly-traded equity securities on Form 13D. The 10-day period was established in 1968, and shortening this period had been the subject of legislative debate for decades. However, the SEC has been powerless to make a change since the 10-day period was explicitly set forth in the Exchange Act. So far the SEC has not taken any steps to shorten the 10-day reporting period, but given the latitude provided by the Dodd-Frank Act, and the general SEC trend towards shortening time periods for disclosure, they are undoubtedly considering doing so in connection with their modernization efforts.

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