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ENFORCEMENT

Section 13 and Section 16 Enforcement Actions — A Guide for Staying in Compliance

By Eleazer Klein and Adriana Schwartz

Investors in U.S. public companies have many regulatory issues to consider when building their positions, not the least of which are the reporting and profit disgorgement rules under Sections 13(d) and 13(g) and Section 16 of the Securities Exchange Act of 1934, as amended (the ″Exchange Act″). It is important for shareholders, officers and directors to understand when the filing requirements are triggered and how to comply with them, especially in light of the continued focus on this area by the Securities and Exchange Commission (the ″SEC″). Like many other areas that attract SEC scrutiny, most violations of Sections 13 and 16 are undoubtedly the result of a lack of familiarity with, or a misunderstanding of, the rules rather than a decision to intentionally violate them. In other words, these violations are preventable.

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Summary of Enforcement Actions

There have been numerous enforcement actions by the SEC involving Sections 13 and 16. Most recently, in February 2017, the SEC announced a cease-and-desist order against a group of investors for multiple violations between 2012 and 2014 of the Section 13(d) rules with respect to their positions in five microcap companies. The conduct leading to the order included alleged failures to switch from Schedule 13G to Schedule 13D when the investors could no longer be deemed to be ″passive,″ failures to adequately and accurately disclose on Schedule 13D the group's plans with respect to certain issuers, failures to file on Schedule 13D as a group with greater than 5 percent beneficial ownership and failures to timely amend Schedule 13D to disclose group holdings. The SEC also found violations of Section 16(a) for failures to timely make Section 16 filings on Forms 3 and 4.

In addition, in March 2015, the SEC announced three cases where it had charged eight officers, directors or major shareholders for failure to update Schedule 13D disclosures to reflect material changes, including plans to take the applicable issuer private and changes in beneficial ownership of 1 percent or more. One of the three cases included charges related to late Section 16 filings. The lateness of these filings was apparent from the trigger dates for the filings that were months or years prior to the time the filings were made. However, the SEC also reviewed the Schedule 13E-3 filings related to the going private transactions and determined that the reporting persons were engaged in specific activities that, in the SEC's view, represented a material change from the information previously reported in the reporting persons' 13D Item 4 disclosure. These cases put tension on the already difficult question of when investment managers should amend a Schedule 13D filing in connection with a transaction, such as a going private transaction or merger.

In September 2014, the SEC announced charges against officers, directors and major shareholders of public companies for failure to timely file reports under Sections 13 and 16, as well as against certain public companies for contributing to these failures or failing to report delinquencies of their insiders. Prior to the 2014 actions, the SEC's focus primarily had been limited to cases where the Section 13(d) or 13(g) or Section 16 violation was not the center of the action but had come to light in connection with charges related to other issues. Although the SEC has indicated that this new enforcement initiative is geared toward finding repeat violations, it was quite clear that in the SEC's view a failure to adhere to the reporting obligations is a violation of the rules and subject to enforcement action regardless of whether or not the violation is intentional.

A Guide for Staying in Compliance

Sections 13(d) and 13(g) Sections 13(d) and 13(g) of the Exchange Act are aimed at informing issuers and investors of rapid accumulations of the issuer's securities. In that regard, Sections 13(d) and 13(g) generally require a ″beneficial owner″ that acquires more than 5 percent of a class of voting ″equity securities″ registered under Section 12 of the Exchange Act (″Subject Securities″) to file a Schedule 13D with the SEC within 10 days of any such acquisition, or if eligible, a Schedule 13G within the time periods specified by the applicable rules. [Section 13(d) of the Exchange Act.]

What Are Subject Securities? In order for a security to trigger Section 13(d) or 13(g) reporting requirements, it must, at a minimum: (1) be an equity security; (2) have voting rights; and (3) be registered under Section 12 of the Exchange Act or otherwise be specified in Section 13(d). [Equity securities which would have been required to be registered under Section 12 except for the exemption contained in Section 12(g)(2)(G), equity securities issued by a closed-end investment company registered under the Investment Company Act of 1940 and equity securities of a Native Corporation pursuant to Section 37(d)(6) of the Alaska Native Claims Settlement Act are also covered by Section 13(d).]

What Is Beneficial Ownership? Under Rule 13d-3(a), ″a beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise has or shares voting power and/or investment power with respect to such security. Voting power includes the power to vote, or to direct the voting of, a security, whereas investment power includes the power to dispose, or the power to direct the disposition, of a security.

Rule 13d-3(d)(1)(i) provides that a person is deemed to be the beneficial owner of a security if that person has the right to acquire beneficial ownership of that security within 60 days. For example, a person is deemed to beneficially own equity securities that the person has the right to acquire within 60 days by virtue of: (1) the exercise of any option, warrant or right; (2) the conversion of any security; or (3) the power to revoke a trust, discretionary account or similar arrangement. One important exception to the 60-day rule provides that any person who has a right to acquire beneficial ownership of a security with the purpose or effect of altering or influencing control of the issuer, or in connection with or as a participant in any transaction having such purpose or effect (in other words, an activist or non-passive investor), is deemed to be a beneficial owner of the security immediately at the time of acquisition of the derivative security without having to wait for the passage of 60 days.

Notably, a person does not beneficially own Subject Securities underlying a derivative security if the right to acquire the underlying Subject Security is subject to material contingencies outside the person's control and which cannot be waived (e.g., the requirement to obtain a governmental approval or the effectiveness of a registration statement). Such a right does not create beneficial ownership until the contingency is satisfied even where these material contingencies could be met within the 60-day period. Similarly, material closing conditions (other than ordinary course closing conditions) outside the purchaser's control, generally must be fulfilled before the purchaser will be deemed to have beneficial ownership of Subject Securities. With respect to securities acquired in the ordinary course of trading, the SEC has expressed the view in its Compliance and Disclosure Interpretations relating to Sections 13(d) and 13(g) under the Exchange Act that beneficial ownership is acquired on the trade date and not the settlement date of a securities transaction.

Section 13(d)(3) provides that when two or more persons act as a group for the purpose of acquiring, holding, voting or disposing of an issuer's securities, that group is deemed to be a ″person,″ and the beneficial ownership of the group members will be aggregated for purposes of determining if the group and its members are subject to the reporting requirements. In light of this requirement, it is of particular importance for shareholders to monitor their interactions and relationships with other shareholders so as not to inadvertently create a group or the appearance of a group. This is a difficult area because the agreement giving rise to group status need not be written. Whenever entering into a contractual agreement with another shareholder, especially shareholders' agreements, lock-up agreements and similar arrangements, one must be careful to not inadvertently create a group.

How Do You Calculate Beneficial Ownership? To determine whether the 5-percent threshold is crossed, a potential filer should divide the total number of shares of the Subject Security beneficially owned by the filer (including the total number of shares of such class of the Subject Security that the filer has the right to acquire within 60 days (or at any time for a non-passive filer)) by the total number of shares of such class of the Subject Security that are outstanding plus the total number of shares of such class of the Subject Security that the filer has the right to acquire within 60 days (or at any time for a non-passive filer) that are not currently outstanding.

Schedule 13D and Schedule 13G: What Must Be Filed and When?

Schedule 13D Section 13(d) of the Exchange Act requires a beneficial owner that acquires more than 5 percent of a class of Subject Securities to file on Schedule 13D unless eligible to file on Schedule 13G. The initial Schedule 13D filing must be made within 10 calendar days of crossing the 5-percent threshold.

Amendments must be made ″promptly″ upon any material change in the information previously reported.

''Promptly'' is not defined in the rules, but has generally been interpreted to mean not more than two business days. An acquisition or disposition of 1 percent or more of the class of securities is deemed to be a material change requiring an amendment. Another common amendment trigger is any material change to a filer's plans or proposals with respect to the issuer (under Item 4 of Schedule 13D). And, as the SEC made clear in the March 2015 enforcement actions, an amendment may be required before a definitive plan is formed as long as there is a material change to the information previously reported.

Schedule 13G: Rule 13d-1(b) Qualified Institutional Investors Certain institutional investors (e.g., registered investment advisers, registered investment companies and registered brokers or dealers and their parent entities or control persons, provided the control persons do not exceed the ownership thresholds set forth in the rule) may file on Schedule 13G as long as they have acquired the Subject Securities in the ordinary course of business and neither with the purpose nor with the effect of changing or influencing the control of the issuer. The initial Schedule 13G is generally required to be filed within 45 days after the end of the calendar year if the beneficial ownership of the reporting person(s) exceeds 5 percent as of Dec. 31. However, if the reporting person's beneficial ownership exceeds 10 percent as of the last day of any month prior to the end of the calendar year, the reporting person's initial Schedule 13G must be filed within 10 days after the end of that month.

Amendments are required: (1) within 45 days of the end of the calendar year if, as of Dec. 31, there is any change in the information previously reported (unless the only change is a change in the percentage beneficially owned solely as a result of a change in the number of shares of the class outstanding); (2) within 10 calendar days after the end of any month in which beneficial ownership exceeds 10 percent as of the end of the month; and (3) once over 10 percent, within 10 calendar days of the end of any month in which beneficial ownership increases or decreases by more than five percent as of the end of the month.

Schedule 13G: Rule 13d-1(c) Passive Investors Investors that are not one of the types of institutional investors permitted to file under Rule 13(d)-1(b) may file under Rule 13d-1(c) as long as they have not acquired the Subject Securities with the purpose, or with the effect of, changing or influencing control of the issuer and their beneficial ownership does not constitute 20 percent or more of the class of Subject Securities. The initial Schedule 13G is required within 10 calendar days of crossing 5 percent beneficial ownership.

Amendments are required: (1) within 45 days of the end of the calendar year if, as of Dec. 31, there is any change in the information previously reported (unless the only change is a change in the percentage beneficially owned solely as a result of a change in the number of shares of the class outstanding); (2) ″promptly″ upon crossing 10 percent beneficial ownership; and (3) once over 10 percent, ″promptly″ after beneficial ownership increases or decreases by more than 5 percent.

Schedule 13G: 13d-1(d) Exempt Investors Investors who are or become the beneficial owner of more than 5 percent of a class of Subject Securities but who have not made an ″acquisition″ subject to Section 13(d) are required to file on Schedule 13G rather than Schedule 13D (e.g., those who become the beneficial owner of more than 5 percent of a class of Subject Securities as a result of a stock buy-back or those who owned the Subject Security prior to the Subject Security becoming registered under Section 12 of the Exchange Act). This comes up most often where an issuer's securities are held, such as by a private equity or venture capital fund, prior to the issuer's initial public offering (concurrently with which the securities will become registered under the Exchange Act). This provision is available regardless of control, intent or ownership level. The ability to file under 13d-1(d) is lost if the investor acquires more than 2 percent of the class of Subject Securities within any 12-month period. The initial Schedule 13G filing is required within 45 days of the end of the calendar year if beneficial ownership exceeds 5 percent as of the end of the calendar year.

Amendments are required within 45 days of the end of the calendar year if, as of Dec. 31, there is any change in the information previously reported (unless the only change is a change in the percentage beneficially owned solely as a result of a change in the number of shares of the class outstanding).

Section 16

Section 16 was enacted by Congress as a prophylactic measure to deter and punish insider trading. The main components of Section 16 are the reporting requirements of Section 16(a) and the profit disgorgement rules of Section 16(b), which are each discussed below. Section 16(c) restricts the ability of those subject to Section 16 to hedge their positions and accordingly Section 16(c) should be reviewed before engaging in any shorting or other hedging activity.

Reporting Obligations Under Section 16(a) All directors and executive officers of a company with a class of voting, equity securities registered under Section 12 of the Exchange Act and all ″beneficial owners″ of more than 10 percent of a class of voting equity securities registered under Section 12 of the Exchange Act (″10 percent holders″) (collectively, ″Insiders″) are subject to the provisions of Section 16. This is true of executive officers and directors regardless of the percentage of the securities owned and even if they own no securities. This can have implications for investors that are not 10-percent holders to the extent that they take seats on the board of directors of a public company. Not only are the directors themselves subject to Section 16, but the investor can be deemed a director itself through the ″director-by-deputization″ doctrine. This doctrine states that an entity that places a person on the board of directors, barring appropriate information barriers, can itself be deemed a director for Section 16 purposes. Thus, for example, an investor that owns less than 10 percent but succeeds, by proxy contest or negotiation, in having its employee designee placed on the board must consider whether it may be subject to Section 16 as a result.

In determining who is subject to Section 16, ″beneficial ownership″ for the most part is determined in the same way it is under Section 13(d). Therefore, a Schedule 13D or 13G filer that is a greater-than-10-percent beneficial owner also will likely be subject to Section 16 reporting. Section 16(a) requires Insiders to report promptly their initial ownership of all equity securities of the issuer, as well as any derivative securities that can be exercised, exchanged or converted into equity securities of the issuer or that derive their value from equity securities of the issuer, in which the Insider has a ″pecuniary interest″ and any changes in the reported interest. Rule 16a-1(a)(2)(i) defines ″pecuniary interest″ as the ″opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject securities.″

Initial reports are generally required to be filed on Form 3 within 10 days of becoming an Insider, except that an Insider of an issuer that is registering securities for the first time under Section 12 of the Exchange Act must file no later than the effective date of the registration statement. Most changes in pecuniary interest are required to be filed on Form 4 within two business days of the acquisition, disposition or other reportable change in pecuniary interest that triggers the filing requirement. A Form 5 must be filed within 45 days of the issuer's fiscal year end to report transactions that took place in the prior year that should have been reported but were not and certain transactions exempt from 16(b). If there are no transactions required to be filed on a Form 5, no such filing is required to be made.

Profit Disgorgement Under Section 16(b) Historically of greater concern for Insiders are the requirements under Section 16(b) to disgorge to the issuer any profits earned from the purchase and sale (or sale and purchase) of any reported security within less than six months of each other, regardless of whether the Section 16(b) Insider actually traded on material nonpublic information. The profit disgorgement rules are not policed by the SEC; instead, cases in this area are overwhelmingly brought by private plaintiff's counsel who receive a percentage of the profits recovered for the issuer. Adding bite to this penalty, courts calculate the ″profits″ to be disgorged pursuant to Section 16(b) in an onerous manner, whereby all possible profits are recovered by matching the lowest purchase price paid in the matchable six-month period against the highest sale price in that period. In this way, it is irrelevant for purposes of the calculation whether an Insider actually profited from its transactions and, as a result, Insiders affected by the provision frequently have to disgorge more money than they earned from the trades in question. For example, an investor who purchased 100 shares of a company's stock at $2, sold those 100 shares at $1 per share and then purchased another 100 shares of the same company's stock four months later at $10 per share, only to sell them a month later at $5, would in reality have lost $600 over the course of six months, but under the Section 16(b) method of profit calculation, that investor would be forced to disgorge a ″profit″ of $300.

There has been a significant uptick in the number of Section 16(b) cases brought against hedge funds and their managers and control persons over the past several years. These cases are often based on new and novel theories of recovery highlighting the fact that investors have to very carefully consider their trading activity whenever they approach or cross 10 percent beneficial ownership or could otherwise be in a position where they could arguably be subject to Section 16.

While a brief summary of the rules may appear straightforward enough, the possibilities for specific facts and circumstances that can complicate the analysis are endless. Accordingly, each set of facts must be carefully analyzed to ensure compliance with the rules and avoid unwanted scrutiny and possible enforcement action by the SEC or others.