

## Alert

### SEC Issues Proposing Release to Readopt Beneficial Ownership Rules as They Relate to Security-Based Swaps

March 25, 2011

On March 17, 2011, the Securities and Exchange Commission (the “SEC”) issued a release (the “Release”) proposing to readopt, without change, the beneficial ownership rules with respect to security-based swaps, including portions of Rule 13d-3 and Rule 16a-1 of the Securities Exchange Act of 1934 (the “Exchange Act”).<sup>1</sup> The purpose of the Release was to make clear that Section 766 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) would not supersede existing beneficial ownership rules relating to security-based swaps.

Section 766 of the Dodd-Frank Act, effective on July 16, 2011, adds new Section 13(o) to the Exchange Act and provides that for purposes of Section 13 and Section 16 of the Exchange Act, security-based swaps confer beneficial ownership “*only* to the extent that the Commission, by rule, determines . . . . that the purchase or sale of the security-based swap, or class of security-based swap, provides incidents of ownership comparable to direct ownership of the equity security, and that it is necessary to achieve the purposes of this section that the purchase or sale of the security-based swaps, or class of security-based swap, be deemed the acquisition of beneficial ownership of the equity security” (emphasis added). The SEC was concerned that the language of Section 766 could be interpreted to mean that in the absence of rule making by the SEC, no security-based swap would confer beneficial ownership under Section 13 or Section 16 of the Exchange Act. Therefore, in order to preserve the application of the current beneficial ownership rules to persons who purchase or sell security-based swaps, the SEC is proposing to readopt the existing rules.

The Release reaffirms a number of relevant Section 13(d) beneficial ownership rules under which a party to a security-based swap may be deemed to have beneficial ownership of the equity security underlying the security-based swap, including: (i) where a security-based swap, by its terms or otherwise, gives a person voting or investment power over the underlying security<sup>2</sup>; (ii) where a security-based swap is used with the purpose or effect of divesting or preventing the vesting of beneficial ownership as part of a plan or scheme to evade the beneficial ownership reporting requirements<sup>3</sup>; and (iii) where a security-based swap, by its terms or otherwise, gives a person the right to acquire the underlying security within 60 days or the person holds such right to acquire with the purpose or effect of changing or influencing control of the issuer.<sup>4</sup>

Similarly, the Release proposes to readopt, without change, the relevant portions of the Section 16 rules, including: (i) Rule 16a-1(a)(1) which uses the beneficial ownership tests of Section 13(d) to determine whether

<sup>1</sup> SEC Release No. 34-64087 (March 17, 2011).

<sup>2</sup> Rule 13d-3(a).

<sup>3</sup> Rule 13d-3(b).

<sup>4</sup> Rule 13d-3(d)(1).

a person is subject to Section 16 as a greater than 10 percent beneficial owner and (ii) Rule 16a-1(a)(2) in order to maintain the existing reporting obligations applicable to security-based swaps and the pecuniary interest and short-swing profit analysis related to them.

The Release makes clear that the proposed readoption is intended only to preserve the “status quo” and is “neither intended nor expected to change any existing administrative or judicial application or interpretation of the rules.”<sup>5</sup> Accordingly, the Release does not address the decision in *CSX Corp. v. The Children’s Investment Fund Management (UK) L.L.P.*<sup>6</sup> where the court found the defendants to have beneficial ownership of the equity securities underlying certain cash-settled, security-based swaps based on the evasion standard of Rule 13d-3(b). The SEC further notes in the Release that “[w]hile the use of security-based swaps has not been frequently disclosed in Schedule 13D and 13G filings, we are proposing to readopt Rules 13d-3(a), (b) and (d)(1) and the relevant portions of Rules 16a-1(a)(1) and (a)(2) to further the policy objectives of and foster compliance with these rules upon the effectiveness of Section 13(o).”<sup>7</sup> However, the Release does go on to remind Schedule 13D filers party to security-based swaps that they “remain subject to the obligation to comply with Items 6 (“Contracts, Arrangements, Understandings or Relationships With Respect to Securities of the Issuer”) and 7 (“Material to be Filed as Exhibits”) and provide disclosures relating to the security-based swap depending upon the security-based swap’s terms. In addition, beneficial owners who file a Schedule 13G pursuant to Rule 13d-1(b) or otherwise rely upon Rule 13d-1(b) to govern a future reporting obligation may be required to make disclosures on Schedule 13D instead based upon their purchase or sale of a security-based swap. See *In the Matter of Perry Corp.*, Release No. 34-60351 (July 21, 2009).”<sup>8</sup>

While the Release does not propose any current changes to Section 13, it discloses that the “staff is engaged in a separate project to develop proposals to modernize reporting under Exchange Act Sections 13(d) and 13(g).”<sup>9</sup>

Release No. 34-64087 can be viewed in its entirety at <http://www.sec.gov/rules/proposed/2011/34-64087.pdf>.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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<sup>5</sup> Release No. 34-64087 at note 8.

<sup>6</sup> *CSX Corp. v. The Children’s Investment Fund Management (UK) L.L.P.*, 562 F. Supp. 2d 511 (S.D.N.Y. 2008). See also, “Swaps and Section 16: Reporting and Liability Issues,” SRZ Activist Investing Developments, Winter 2009, available at <http://www.srz.com/Swaps-and-Section-16-Reporting-and-Liability-Issues-03-16-2009/>.

<sup>7</sup> Release No. 34-64087 at 20.

<sup>8</sup> Release No. 34-64087 at note 55. For a discussion of *In the Matter of Perry Corp.*, see also, “SEC Enforcement: Enhanced 13(d) Scrutiny and Merger Arbitrage,” SRZ Activist Investing Developments, Summer 2009, available at <http://www.srz.com/SEC-Enforcement-Enhanced-13d-Scrutiny-and-Merger-Arbitrage-08-27-2009/>.

<sup>9</sup> Release No. 34-64087 at 7.

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