



SIDLEY UPDATE

Proposed Legislation Would Increase 13D and Other Securities Disclosure Requirements for Hedge Funds and Others

Senators Tammy Baldwin (D-Wis.) and Jeff Merkley (D-Ore.) have formally introduced legislation entitled the Brokaw Act¹ (S. 2720) that seeks principally to increase transparency and strengthen oversight of activist hedge funds by, among other things, reducing the Schedule 13D filing window from 10 calendar days to two business days for all investors; expanding the definition of beneficial ownership for all investors to cover securities in which an investor has a direct or indirect pecuniary interest; defining the term “person” for the purposes of beneficial ownership reporting to explicitly include hedge funds; and requiring the disclosure of short positions in excess of five percent for all investors. Although the bill faces significant hurdles in moving through Congress, it nevertheless has considerable support among influential U.S. senators, including Elizabeth Warren (D-Mass.) and Bernie Sanders (I-Vt.).

Shortening the Schedule 13D Reporting Window

Currently, an initial report on Schedule 13D must be filed with the U.S. Securities and Exchange Commission (SEC) within 10 days of the acquisition of more than five percent of a class of registered voting securities. Some market participants have long criticized this window for allegedly allowing too much time for investors to accumulate significant ownership stakes in U.S. public companies before filing a Schedule 13D and for allowing activist investors to tip off other investors regarding their plans before making a public disclosure on Schedule 13D. In this light, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) authorized the SEC to shorten the window for filing, but the SEC has not yet amended its rules accordingly. The Brokaw Act, as proposed, would implement such change by shortening the 10-day filing window to two business days.

Expanding the Definition of “Beneficial Ownership”

The Brokaw Act would also expand the definition of “beneficial ownership” for purposes of Section 13(d) of the Securities Exchange Act of 1934 (Exchange Act). Currently, the definition of “beneficial ownership” includes the power, directly or indirectly, to vote or dispose of an equity security (and the right to acquire such power in 60 days, if passive, or at any time, if activist); it does not include a purely economic interest in the security. The Brokaw Act would expand the definition of beneficial ownership to include a “pecuniary or indirect pecuniary interest in such security,” which the proposed legislation further defines. Thus, persons would be required to

¹ The name of the proposed legislation relates to a town in Wisconsin affected by the activist takeover of the Wausau Paper Company.

include in their beneficial ownership calculation derivative instruments such as cash-settled swaps that do not provide the holder with any voting or investment power (or the right to acquire such power) over the underlying equity security but do afford the holder with economic exposure to the underlying equity security.

If the proposed legislation is enacted, it would mark a significant change to the historical view of the treatment of cash-settled swaps under Section 13(d). The general understanding is that synthetic long positions by means of cash-settled swaps do not confer voting or investment power over the underlying shares, so that the holder of the swap is not a beneficial owner within the meaning of Section 13(d).² Although there are situations where cash-settled swaps could confer beneficial ownership to the swap counterparty with the long exposure, particularly if the swap has been used as part of a scheme to evade the reporting requirements of Section 13(d) or (g) of the Exchange Act,³ the consensus remains that cash-settled swaps should not confer beneficial ownership over the underlying shares. Moreover, Section 13(o) of the Exchange Act, added by Dodd-Frank, provides that a person shall be deemed to beneficially own an equity security underlying a security-based swap “only to the extent that the Commission, by rule, determines.” In response to this delegation of authority, the SEC to date has only readopted, without change, the provisions in Rules 13d-3 and 16a-1 under the Exchange Act that define “beneficial ownership,” signaling that the conventional view of beneficial ownership of securities underlying security-based swaps remains unchanged.

Expanding the Definition of “Person”

The Brokaw Act also seeks to restrict the concerted efforts of activist hedge funds by defining “person” for purposes of beneficial ownership reporting to include hedge funds as well as the coordination of certain activities among two or more persons. Specifically, the Brokaw Act would define “person” to include

two or more persons acting as a partnership, limited partnership, syndicate, or other group, or otherwise coordinating the actions of the persons, for the purpose of (i) acquiring, holding, or disposing of securities of an issuer; (ii) seeking to control or influence the board, management, or policies of an issuer; or (iii) evading, or assisting others in evading, designation as a ‘person.’⁴

The definition would also separately include a hedge fund or a group of hedge funds or persons working together as determined by the SEC. Under the proposed language, the definition of a “hedge fund” would come from Section 13(h) of the Bank Holding Company Act of 1956.⁵ But in the absence of further guidance, it is unclear what factors the SEC will use to determine whether hedge funds are working together.

² This position is supported by the brief for the Division of Corporation Finance of the SEC as amicus curiae, *CSX Corp. v. Children’s Investment Fund Management (UK) LLP*, 562 F.Supp.2d 511, 518 (S.D.N.Y. 2008).

³ *CSX Corp. v. Children’s Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511 (S.D.N.Y. 2008) (summarized in a Sidley Update, available [here](#)).

⁴ Note that this definition is very similar to the definition of “group” as used for purposes of Sections 13(d) and (g) of the Exchange Act, which is defined in Rule 13d-5(b)(1) under the Exchange Act as being formed “[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.”

⁵ Section 13 of the Bank Holding Company Act of 1956 defines “hedge fund” and “private equity fund” together, as follows: an issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a–1 et seq.), but for section 3(c)(1) or 3(c)(7) of that Act [15 U.S.C. 80a–3(c)(1), (7)], or such similar funds as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule, as provided in subsection (b)(2), determine. 12 U.S.C. § 1851(h)(2).

Disclosure of Short Positions

Finally, the Brokaw Act would expand the disclosure and reporting requirements to require investors acquiring a direct or indirect short interest representing more than five percent of a registered class of equity security to file the equivalent of a Schedule 13D within two business days of such acquisition. Under the proposed legislation, a beneficial owner would not be permitted to net out its short interest from its long interest but would be required to use the greater percentage of its short or long interest to calculate beneficial ownership in accordance with Rule 13d-3(d)(1) of the Exchange Act. Notably, Dodd-Frank separately requires that the SEC adopt rules providing for the disclosure of short positions on at least a monthly basis. To date, the SEC has not adopted rules requiring such disclosures or provided any public comments as to when it intends to adopt the new rules.

In sum, the Brokaw Act, if enacted as proposed, would significantly change the current regulatory regime for reporting beneficial ownership of U.S. public companies, including hedge funds that file on Schedule 13D, and would also establish new requirements to disclose significant short positions.

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