CHECKPOINTS:

THE CONSEQUENCES OF CROSSING VARIOUS OWNERSHIP THRESHOLDS WHEN INVESTING

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This memorandum outlines certain considerations associated with the acquisition of different levels of ownership of a U.S. company, including some of the approaches used in determining such "ownership":

- **Sections 13 and 16 of the Securities Exchange Act of 1934, as amended (the "Exchange Act")**

  - Schedule 13D. A Schedule 13D is required to be filed with the SEC by any person or group[1] who acquires, or has the right within 60 days to acquire, "beneficial ownership" of more than 5% of a class of voting equity registered under the Exchange Act.

    - Beneficial ownership is based on the power to vote or dispose of the security, *not* participation in economic benefits.

    - Instead of a Schedule 13D, the investor may qualify to file a Schedule 13G (which requires less disclosure)[2] if (i) it does not intend to influence the control of the issuer and (ii) it either (x) owns less than 20% of the class of security or (y) is one of certain specified types of investors.

    - The filing and timing requirements are summarized on Exhibit A.

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For the current version of this memo, click here.
For the current version of *The Acquisition of Control of a United States Public Company*, click here.

[1] Defined to include 2 or more persons who agree to act together for the purpose of acquiring, holding, voting or disposing of securities.

[2] Unlike Schedule 13D, Schedule 13G does not require disclosure of (i) certain information regarding the identity and background of the investor, (ii) the source and amount of funds or other consideration, (iii) a detailed discussion of the purpose of the transaction, including certain plans or proposals of the investor, (iv) recent transactions in the class of securities being reported on, and (v) contracts, arrangements, understandings or relationships with respect to securities of the issuer.

- Form 13F. Every institutional investment manager[3] exercising investment discretion[4] over $100 million or more publicly traded securities is required to file a report on Form 13F within 45 days after the end of each calendar quarter.

- Form 13H. An investor can become subject to the Form 13H reporting requirements if it exercises investment discretion[5] over one or more accounts and effects broker-dealer transactions in aggregate equal to or greater than (i) $20 million or 2 million shares in one day or (ii) $200 million or 20 million shares in one calendar month. While Form 13H filings are processed through the SEC's EDGAR system, once filed, the submissions are not accessible through the SEC's website or otherwise publicly available.

- Section 16. Officers, directors and beneficial owners of more than 10% of a class of equity registered under the Exchange Act (determined in the same manner as under Section 13(d)) are subject to Section 16 thereof.

    - Persons subject to Section 16 are liable for the disgorgement of "short-swing profits"[6] and are prohibited from selling short any equity security of the issuer.

    - The filing and timing requirements are summarized on Exhibit A.

➢ **Other Securities Law Issues**

- "Affiliate" Status. The determination of affiliate status is a fact-specific analysis, but investors who hold more than 10% of an issuer's equity or otherwise possess significant influence over management (including rights relating to the appointment of directors or officers) are frequently considered to be an "affiliate" of the issuer. Consequences of being an affiliate include:

    - *Resales Generally*. Securities held by an affiliate of an issuer (*i.e.*, whether or not originally issued in a registered transaction) may not be resold unless the resale is registered under the Securities Act of 1933, as amended, or subject to an exemption from its registration requirement.

[3] Institutional investment managers include any entity investing in or buying and selling securities for their own account and any person exercising investment discretion with respect to the account of another person. Institutional investment managers do not include natural persons investing in or buying and selling securities for their own account.

[4] A person exercises "investment discretion" with respect to an account "if, directly or indirectly, such person (A) is authorized to determine what securities or other property shall be purchased or sold by or for the account, (B) makes decisions as to what securities or other property shall be purchased or sold by or for the account even though some other person may have responsibility for such investment decisions, or (C) otherwise exercises such influence with respect to the purchase and sale of securities or other property by or for the account as the [SEC], by rule, determines".

[5] Determined in the same manner as for purposes of Form 13F.

[6] Broadly construed to include any profit from any sale and purchase or purchase and sale of equity securities of the issuer occurring within a 6-month period.

- *Rule 144*. The Rule 144 safe harbor for exempt resales is only available to affiliates of an issuer if the volume limitation, current public information, manner of sale and filing requirements of the rule are satisfied.

- *Director Independence*. Above 10%, the investor would not be eligible for the safe harbor in paragraph (e)(1)(ii) of Exchange Act Rule 10A-3. As a result, directors of a listed issuer appointed by the investor may not qualify as "independent" under that rule or the applicable stock exchange rules.

- *Second-Step Acquisition*. A subsequent acquisition of the company by an investor deemed an affiliate would be subject to Rule 13e-3 of the Exchange Act and to the "Entire Fairness" standard of judicial review, which impose greater disclosure requirements and scrutiny on such transactions and increase the difficulty of defending and settling stockholder litigation.

- Reporting Investors. If the investor is subject to the Exchange Act reporting requirements, potential disclosure obligations include:

  - *Form 8-K*. The investor may need to file a Form 8-K with respect to the investment if the amount paid for the securities exceeds 10% of its consolidated assets.

  - *Company Financial Statements*. Under Rule 3-09 of Regulation S-X, the investor would need to include in its financial statements separate financial statements for the company if (i) the investor accounts for its stake in the company on the equity method (discussed below) and (ii) the company meets either of the investment-to-assets or income-to-income tests for significance at the 20% level.

➢ **HSR**

- Subject to the "passive investment" exception,[7] the 30-day waiting period following an HSR notification must be observed prior to (i) the acquisition of $70.9 million of voting securities or assets of the company if either the investor or the company has assets or annual sales[8] of at least $141.8 million and the other party has assets or annual sales of at least $14.2 million or (ii) any acquisition involving more than $283.6 million of voting securities or assets of the company.[9]

[7] Available to investors holding 10% or less of the company's voting securities who have no intention of influencing the company's management.

[8] When determining the assets or annual sales for purposes of the size of person test, the sales and assets of all entities, both domestic and foreign, controlled by the ultimate parent entity must be included, whether or not consolidated into the ultimate parent entity's financial statements.

[9] The filer must aggregate the value of the voting securities of all of the issuers controlled by the ultimate parent entity of the acquired entity that the acquiring entity (or its ultimate parent entity) will hold as a result of the acquisition. For example, if the acquiring person holds voting securities of one subsidiary company and plans to acquire voting securities of the parent or a different subsidiary of the same parent, it must aggregate these holdings to determine the value of the securities acquired. Similarly, all of the acquisitions made by entities that are controlled by the same ultimate parent entity must be aggregated.

- The obligation to report under the HSR Act depends on the size of the "person" involved. "Person" is defined as the "ultimate parent entity" of the investor or the company, which is in turn defined as the company, individual or entity that controls a party to the transaction and is not itself controlled by anyone else. Control is established by having beneficial ownership[10] of 50% or more of the outstanding voting securities of a person.

- Once a notification has been filed, the investor has one year from the end of the waiting period to cross the threshold stated in the filing,[11] and once the investor crosses that threshold, it may continue to acquire voting shares of the company up to the next threshold for 5 years from the end of the waiting period.

- The information filed pursuant to the HSR Act is not made public, except as may be relevant to an administrative or judicial proceeding. However, if a request for early termination of the 30-day waiting period is granted, that fact will be published on the FTC's website.

➢ **Tax and Accounting**

- Dividends Received Deduction. If the investor has at least a 20% interest in the company, it may deduct 80% of any dividends it receives from the company. Below 20%, it may deduct 70% of such dividends and at or above 80% it may deduct 100% of them.

    - These ownership percentages are calculated by the "vote and value" of the stock owned by the investor.

- NOLs. If the investment, together with other stock turnover occurring within 3 years before or after the investment, gives rise to an "ownership change",[12] the company will be limited in its ability to use any net operating losses and certain other tax attributes.

- Equity Method Accounting. An investor subject to U.S. GAAP that owns 20% or more of the company's voting stock (but not control of the company) is presumed to have significant influence over the company and is generally required to account for its investment on the equity method by including its proportionate share of the company's net income/loss in its income statement.

[10] Although the term "beneficial ownership" is not defined, the rules provide that indicia of beneficial ownership include the right to receive an increase in the value of the voting securities, the right to receive dividends, the obligation to bear the risk of loss and the right to vote the stock.

[11] There are 5 different notification thresholds: (1) $70.9 million; (2) $141.8 million; (3) $709.1 million; (4) 25%, if the value of voting securities to be held is greater than $1.4181 billion; and (5) 50%, if the value of voting securities to be held is greater than $70.9 million.

[12] An ownership change occurs when the percentage of a company's stock owned by one or more stockholders who directly or indirectly own more than 5% of the company's common stock increases by more than 50% within a 3-year period.

- REIT Ownership Limit. If the company is a REIT, among the other qualification requirements imposed by the federal tax code is a prohibition against 5 or fewer individuals owning directly or indirectly more than 50% of the company's outstanding stock. To ensure this requirement is always satisfied, most REITs include in their articles of incorporation an ownership limit that prohibits any person from acquiring ownership in excess of 9.8% or 9.9% of any class of stock.

    - This tax test is based on the value of the stock owned and employs a look-thru method of constructive ownership that generally treats the owners of an entity as owning their proportionate share of the stock owned by the entity in calculating the stock ownership ultimately attributable to individuals.

    - While the ownership restrictions of some REITs go further and aggregate the ownership of entities having common management (*e.g.*, the securities law concept of "beneficial ownership"), the tax rules do not require that. As a result, depending on the particulars of a REIT's organizational documents, there is the possibility that multiple funds with common management but sufficiently diffuse upstream ownership could acquire an aggregate amount of stock significantly in excess of the ownership limit applicable to individuals.

➢ **Other**

- Anti-Takeover Statute. For Delaware corporations, if the transaction results in the investor owning more than 15% of the company's voting stock without board approval, DGCL 203 can significantly impair the investor's ability to pursue a second-step acquisition in the subsequent 3 years.

    - Crossing this threshold is only relevant to investors that may be interested in a business combination with the company.

    - Under DGCL 203, "ownership" of stock means that a person, together with its affiliates and associates, beneficially owns such stock, has the right to acquire or vote such stock, or is party to an agreement, arrangement or understanding to acquire, hold, vote or dispose of such stock.

    - For companies incorporated elsewhere, the details of any business combination statute may differ. In addition to or in lieu of a business combination statute, some states have "control share" statutes that restrict an investor's ability to vote shares acquired in a transaction that takes it over certain thresholds, unless approved by the company's board. Companies may also have similar provisions in their organizational documents.

- Poison Pill. Triggers and mechanics vary from plan to plan. While there are different calculational approaches, a recent trend is to include derivative positions in the determination of beneficial ownership. Some plans also aggregate the positions of persons acting in concert.

- Stockholder Approval. If the transaction involves a new issuance by a listed company, stockholder approval may be required by the exchange rules. Generally, both NYSE and NASDAQ require stockholder approval of issuances of common stock, or securities convertible into or exercisable for common stock, equal to 20% or more of the common stock or voting power outstanding before the issuance, or that would result in a change of control of the company. NASDAQ generally takes the position that any issuance that puts a stockholder over 20% results in a change of control. NYSE does not provide official guidance on what it considers a change of control, which may be influenced by the extent of any accompanying board representation or governance/approval rights.

- Control. In the absence of other large stockholders of the company, a significant minority stake could cause the investor to be deemed a controlling stockholder, imposing upon it fiduciary duties to the company's other stockholders and requiring it to deal with the company at arm's-length, which can complicate efforts to realize synergies between their two businesses. In addition, depending on the drafting and context, change of control provisions in the company's contracts, including employee compensation arrangements and debt instruments, could be triggered well below the 50% threshold.

- Industry Regulation/National Security. For some companies, a significant enough acquisition could require approval under industry-specific rules or (in the case of foreign investors) CFIUS. National security review is based on the acquisition of "control," which in turn depends on the power (whether or not exercised) to "determine, direct or decide important matters" affecting the company.

- Derivatives. The treatment of derivatives in the contexts described in this memo can be complex and uncertain, and this analysis is in part driven by the extent to which the applicable instrument decouples economic ownership from voting rights. One area of recent attention has been the circumstances under which disclosure of derivative positions is required.

    - *Exchange Act Sections 13 and 16*. It is generally agreed that cash-settled derivatives do not give rise to beneficial ownership under Section 13(d). Item 6 of Schedule 13D requires reporting persons to disclose contracts they are party to "with respect to any securities of the issuer," which could include derivative positions. However, this disclosure obligation only applies if the investor is otherwise subject to 13D reporting. For persons subject to Section 16 reporting, required disclosures include "securities with a value derived from the value of an equity security".

    - *Advance Notice Bylaws*. In addition to the treatment of derivatives under a company's poison pill, an advance notice bylaw may require disclosure of derivative positions as a condition to making a stockholder proposal or nominating a candidate for the board.

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Exhibit A

Exchange Act Sections 13 and 16 - Filing and Timing Requirements

13D

- Initial filing must be made within 10 days after crossing 5%.
- Amendments must be made "promptly" following a "material change" (including an increase or decrease of 1% or more).

13G – filers under the "less than 20%" test

- Initial filing must be made within 10 days after crossing 5%.
- Amendments must be made (i) within 45 days following the end of each calendar year of any change (other than resulting solely from change in the number of outstanding securities) and (ii) promptly after crossing 10% and, thereafter, promptly following any increase or decrease of more than 5%.

13G – filers qualifying as specified investors[13]

- Initial filing must be made (i) within 45 days following the end of each calendar year or (ii) within 10 days after the end of the first month in which the investor crosses 10%.
- Amendments must be made (i) within 45 days following the end of each calendar year of any change (other than resulting solely from change in the number of outstanding securities) and (ii) within 10 days after the end of the first month in which the investor crosses 10% and, thereafter, within 10 days after the end of the first month in which the investor's beneficial ownership increases or decreases by more than 5%.

"Cooling-Off" Period

- If a 13G filer subsequently loses its eligibility to file on Schedule 13G, it must file a Schedule 13D within 10 days and, until the expiration of the 10th day after filing such Schedule 13D, is prohibited from voting the subject shares or acquiring any additional equity securities (of any class) of the issuer or any controlling person.

[13] Generally including brokers, dealers, banks, insurance companies, investment companies, investment advisers and employee benefit plans that, in each case, acquired the securities in the ordinary course of business and has notified any account holder on whose behalf it holds more than 5% of a potential reporting obligation.

Section 16 Reports

- Initial filing on Form 3 must be made within 10 days of becoming subject to Section 16.

- Changes in beneficial ownership (unless pursuant to certain exempt transactions) must be reported on Form 4 within 2 business days.

- A report on Form 5 must be filed within 45 days after the end of the issuer's fiscal year covering all exempt transactions and transactions that should have been reported on a Form 4 but were not.