The SEC Issues New Guidance on Reporting of Group Members' Beneficial Ownership of Other Group Members' Securities

On January 3, 2014, the SEC provided new guidance on when an individual must report beneficial ownership of equity securities of other members of a "group" for purposes of filings under Section 13. The SEC clarified that mere formation of a group is not enough to establish that a group member individually beneficially owns securities held by other group members. The SEC advised that it views a right of a group member to designate the nomination of one or more director nominees for whom the other group members have agreed to vote as conveying beneficial ownership to the rightholder. The new guidance alters how issuers will calculate certain investors' beneficial ownership disclosure in proxy statements and registration statements and consideration of 1933 Act Rule 506(d) disqualifications; it may also be relevant to an analysis of conversion caps or similar provisions in convertible instruments.

On January 3, 2014, the Securities and Exchange Commission (SEC) issued new Compliance and Disclosure Interpretations (CDIs) that impact the calculation of an individual's beneficial ownership of equity securities of other members of a "group" for certain purposes under Exchange Act Section 13.[1] The new CDIs clarify that merely entering into a voting agreement or other arrangement that establishes formation of a "group" under Rule 13d-5(b), without more, is not sufficient to establish a group member's beneficial ownership of shares held by other group members.[2] Prior to the new guidance, many practitioners and some courts took the contrary view that each group member was always attributed with ownership of other group members' equity securities.

The new CDIs provide two examples of provisions in a voting agreement that would establish a group member's beneficial ownership of equity securities of other group members: (1) an irrevocable proxy in favor of that particular group member to vote other group members' shares, or (2) a right by that group member to designate the nomination of one or more director nominees for whom the other group members have agreed to vote, because the agreement gives the person the right to direct the voting. While the first example has long been understood to require reporting,[3] the second example was a clarification which changes current practice.

As briefly mentioned above, prior to the new guidance many practitioners and at least some courts believed that mere group formation automatically established each group member's beneficial ownership of the equity securities of the other group members under Section 13. As a result, many practitioners would always report each group member's beneficial ownership of equity securities as including the

[1] CDI #105.06.
[2] The group is deemed to have acquired, by operation of Rule 13d-5(b), beneficial ownership of the shares beneficially owned by its members.
[3] Q&A No. 7 to Exchange Act Release No. 13291 (February 24, 1977).

shares of other group members. The prior view was based on guidance in a 1991 Exchange Act Release,[4] in which the SEC stated that, "for purposes of determining status as a ten percent holder under Section 16 of the Exchange Act, the securities beneficially owned by the group must be included in the calculation by each individual member of the group." Section 16a-1 provides that "the term 'beneficial owner' shall mean any person who is deemed a beneficial owner pursuant to Section 13(d) of the [Exchange] Act and the rules thereunder. . . ." Rule 13d-3(a) defines beneficial ownership under Section 13 and for purposes of Section 16 as including voting power or investment power over equity securities. The SEC is, however, interpreting the definition of beneficial ownership contained in Rule 13d-3(a) differently for purposes of reporting beneficial ownership on Schedule 13Ds compared to the determination of who is a "10% beneficial owner" under Section 16. In fact, the new CDIs expressly acknowledge the conflict, but fail to resolve it, noting that "the analysis is different for Section 16 purposes" and citing the text in the 1991 Exchange Act Release quoted above.

The new guidance will not impact who is required to file a Schedule 13D, because the rules regarding group formation are not changed and it does not affect when those filings are required to be made. As noted above, this guidance does not change who will be subject to Section 16 as a "10% beneficial owner." It would seem unlikely that this interpretation will have a significant impact on secondary applications of the Section 13(d) beneficial ownership standard, such as credit agreement change-of-control provisions or rights plan triggers. Also, the group is still attributed beneficial ownership of all securities of each member of the group.

However, the new guidance impacts the calculation of an individual's beneficial ownership of equity securities for reporting in securities filings. Thus, it alters how issuers will calculate and report investors' beneficial ownership disclosure in proxy statements and registration statements, and the calculation of 1933 Act Rule 506(d) disqualifications. The new guidance may also be relevant to an analysis of the applicability of conversion caps or similar provisions in convertible instruments in some cases.

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[4] Section II.B.3 of Exchange Act Release No. 28869 (February 8, 1991).