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Beneficial Ownership of Equity Derivatives and Short Positions –
A Modest Proposal to Bring the 13D Reporting System into the 21st Century

As we have previously written, ever more creative and complicated non-traditional structured and derivative arrangements that create economic exposure to publicly traded securities have moved from the fringes to the mainstream. Investors are now using swaps and other equity derivatives – including long and short position swaps and derivatives – to exert influence over corporate decisionmaking with little or no apparent duty to disclose the existence or nature of these positions or their plans with respect to the relevant issuers. Moreover, investors have increasingly used such interests to de-couple the traditionally integrated voting and economic interest in public companies. These phenomena directly implicate the policies underlying traditional disclosure requirements, but they have thus far – at least in practice – not resulted in helpful or meaningful disclosure within the framework of current securities laws and regulations, particularly those found in § 13(d) of the Securities Exchange Act of 1934 (the “Exchange Act”)¹ and the related rules.

Practitioners and commentators alike have noted with increasing urgency the need for federal securities regulations to take account of these now hidden transactions. This paper sets forth a modest but critical proposal to amend current securities regulations to cover both (a) arrangements that create economic exposure to publicly traded securities, and (b) short interests in public securities. Only by amending current securities regulations to take account of these now common transactions will the antifraud and disclosure mandate of our existing securities laws be realized in the context of the ever-increasing complexity of financial instruments and arrangements.

Section 13(d)

The principal disclosure requirement concerning substantial accumulations of publicly traded securities is found in § 13(d) of the Exchange Act² and the rules thereunder. “[T]he purpose of section 13(d) is to alert the marketplace to every large, rapid aggregation or accumulation of securities, regardless of technique employed, which might represent a potential shift in corporate control.” *GAF Corp. v. Milstein*, 453 F.2d 709, 717 (2d Cir. 1971). To effectuate this purpose, Exchange Act Rule 13d-1 requires that “[a]ny person” (or two or more persons acting as a group) who “directly or indirectly” acquires “beneficial ownership” of more than 5% of a class of any registered security must disclose the information required on Schedule 13D, including the amount of such beneficial ownership.³ Moreover, such persons or groups must also disclose the purpose for the relevant acquisition and any plans or proposals with regard to certain extraordinary transactions involving the issuer.

¹ 15 U.S.C. § 78m(d).

² 15 U.S.C. § 78m(d).

³ 17 C.F.R. § 240.13d-1.

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The efficacy of this disclosure regime is contingent on an appropriate definition of “beneficial ownership.” That is because, as noted above, § 13(d)’s disclosure requirements are triggered only when a person is deemed to beneficially own the relevant security. But “beneficial ownership,” as currently defined by SEC rules, captures only those arrangements that provide an investor with either voting or investment power over the relevant security. Specifically, Rule 13d-3⁴ provides:

- (a) For the purposes of sections 13(d) and 13(g) of the Act a beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares:
- (1) Voting power which includes the power to vote, or to direct the voting of, such security; and/or,
 - (2) Investment power which includes the power to dispose, or to direct the disposition of, such security.

Derivative positions such as options, warrants and convertible securities trigger disclosure requirements only in certain, limited, circumstances.⁵ And non-traditional instruments that provide investors solely with economic exposure to publicly traded securities (without any voting or investment power) – such as stock accumulation rights, equity swaps and other synthetic arrangements whose value is derived from publicly traded securities – largely fall outside of the current § 13(d) regime, even as their consequences for market participants and issuers are profound and generally as equally significant as actual accumulations of direct ownership.

Sophisticated investors have no shortage of methods to gain economic exposure to publicly traded securities without having to acquire voting or investment control over those securities; and such investors are increasingly structuring transactions specifically to avoid § 13(d)’s disclosure obligations. However, these complex instruments often have substantial effects on the securities and issuers involved. The counterparties to these arrangements will often hedge their positions by buying or selling the underlying securities, which may have material effects in the trading of the relevant security. Moreover, these synthetic arrangements are often just a precursor to accumulating the underlying security for purposes of exercising control over corporate policy. These arrangements often neutralize investors’ exposure to movements in the market for the underlying stock (and indeed are often specifically designed for this purpose), thereby allowing an investor to quickly accumulate shares when he or she is ready to exercise the desired control without sensitivity to any market movements caused by this rapid accumulation. And indeed, counterparties are often ready and willing to provide investors with the securities accumulated for purposes of hedging, further facilitating the investor’s rapid accumulation of the underlying securities.⁶ These arrangements therefore directly implicate the principles underlying

⁴ 17 C.F.R. § 240.13d-3.

⁵ See 17 C.F.R. § 240.13d-3(d)(1).

⁶ Several recent examples of these dynamics have gained public attention. See David Marcus, *The Unbearable Emptiness of Voting*, *The Deal* (February 1, 2008); Andrew Ross Sorkin, *A Loophole Lets a Foot in the Door*, *The New York Times*, Dealbook (January 15, 2008); see also Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. Cal. L. Rev. 811 (2006), and Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 Iowa J. Corp. L. 681 (2007).

the § 13(d) disclosure regime. Yet the current beneficial ownership definition means that an entire set of investors has been able to evade § 13(d)'s full disclosure mandate.

The solution is simple: expand the current definition of beneficial ownership to cover all forms of ownership and other economic arrangements that have substantial effects on the markets for publicly traded securities and the corporate governance of their issuers. The changes proposed herein follow from concepts already established in other areas of the federal securities laws, including in particular § 16 of the Exchange Act and the rules thereunder.⁷ The definition of beneficial ownership would include not only arrangements that create voting or investment power in a registered security, but also any direct or indirect pecuniary interest in the relevant security. The purpose of this expansion is to capture all forms of economic interest in publicly traded securities.

Thus, Rule 13d-3's "beneficial ownership" definition should be expanded to include "any derivative instrument which includes the opportunity, directly or indirectly, to profit or share in any profit derived from any increase in the value of the subject security."⁸ "Derivative instruments" should include, subject to certain exceptions:

Any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege or a settlement payment or mechanism at a price related to an equity security, or similar instrument with a value derived in whole or in part from the value of an equity security, whether or not such instrument or right shall be subject to settlement in the underlying security or otherwise.

By expanding beneficial ownership to include these arrangements, the underlying securities to which such derivative instruments relate would then be counted in determining whether an investor has triggered § 13(d)'s 5% reporting threshold. Once § 13(d)'s reporting threshold is triggered, investors in such derivative arrangements, like any other reporting person, would have to detail the nature of the arrangements entered into to acquire beneficial ownership of the subject security, as well as any plans and proposals the investor has with respect to the relevant issuer. Investors would no longer be able to evade § 13(d)'s disclosure mandates – and the full disclosure, anti-fraud and fairness policies embodied in it – merely by avoiding trading in the underlying securities and entering into other arrangements with nearly identical economic effect and market impact.

Short Interests

Expanding Rule 13d-3's definition of beneficial ownership to capture a broader set of arrangements and transactions would solve only part of the problem with the current disclosure regime. Notwithstanding the SEC's broad authority to prevent fraud and the SEC's spe-

⁷ 15 U.S.C. § 78p.

⁸ Rule 13d-3's beneficial ownership definition should also be amended to include, consistent with § 16 of the Exchange Act, indirect interests such as securities held by family members in the reporting person's household, securities held by a partnership of which a reporting person has a general partnership interest, the reporting person's interest in securities held by trusts and certain performance-based fee arrangements.

cific power under § 10(a)⁹ of the Exchange Act to regulate short sales, there is currently no law or regulation that generally mandates the disclosure of large short positions. However, the policy underlying § 13(d)'s traditional disclosure requirements applies with equal force to such interests.

Net short positions have direct and material effects on the trading in securities, including when equivalent short positions are established through derivative instruments.¹⁰ Moreover, investors with substantial short positions, or their derivative equivalents, are increasingly taking a more activist role in corporate policy and governance. Because no disclosure mandate exists, the investing public and issuers have no way of knowing when such circumstances exist or that the incentives of these activist investors are actually aligned *against* value-maximizing corporate policies.¹¹

A new 13(d)-like disclosure requirement should therefore be established for investors with substantial short positions. Such a "short interest" rule would level the playing field between investors by requiring the same type of disclosure for any significant interest in a security, whether long or short. And such disclosure would help to prevent the securities fraud and manipulation that can result from large, undisclosed short interests, especially by those investors who take a public and vocal role in corporate policy.

A short interest rule should largely follow the framework of the rules promulgated under § 13(d). In particular, such a rule should require:

Any person who, after acquiring directly or indirectly a short interest in any equity security of a class which is specified in paragraph (i) of Rule 13d-1, has directly or indirectly a short interest representing more than five percent of the class shall, within 10 days after the acquisition, file with the Commission, a statement containing the information required by Schedule 13S.

"Short interest" should include all agreements and understandings that allow an investor to profit from a loss in value of the subject security, thereby capturing traditional short sales as well as derivative positions:

For purposes of this short interest rule, a person shall be deemed to have a short interest in a security if such person directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has the opportunity to profit or share in any profit derived from any decrease in the value of the subject security.

⁹ 15 U.S.C. § 78j(a).

¹⁰ As noted above, the counterparties to such derivative positions will often hedge their position through market transactions. Puts or equity swaps that replicate short positions will, therefore, often lead to substantial sales in the subject security.

¹¹ For example, a shareholder in a company who has spoken out against an acquisition requiring the vote of the acquiring company's shareholders could have a net short position in the target company. Or more directly, net short shareholders may speak out against legislation or other regulatory actions that would be beneficial to the company whose shares they have shorted.

The proposed expansion of “beneficial ownership” under § 13(d) and the proposed “short interest” rule would close significant gaps in the current securities disclosure regime. Both investors and issuers benefit from full disclosure of all significant securities positions that can have a material impact on corporate governance and policies. With the increased innovation and creativity in derivative instruments and short positions by sophisticated investors, gaps in the current regulatory regime have become more evident than ever before. It is time for those gaps to be filled.

The full text of proposed amendments and additions to the Exchange Act rules to address these matters is attached.

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Proposed Form of Amendment to 13d-3

§ 240.13d-3 Determination of beneficial owner.

(a) For the purposes of sections 13(d) and 13(g) of the Act a beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares:

(1) Voting power which includes the power to vote, or to direct the voting of, such security; and/or,

(2) Investment power which includes the power to dispose, or to direct the disposition of, such security; and/or,

(3) Direct or indirect pecuniary interest in such security.

(b) Any person who, directly or indirectly, creates or uses a trust, proxy, power of attorney, pooling arrangement or any other contract, arrangement, or device with the purpose or effect of divesting such person of beneficial ownership of a security or preventing the vesting of such beneficial ownership as part of a plan or scheme to evade the reporting requirements of section 13(d) or (g) of the Act shall be deemed for purposes of such sections to be the beneficial owner of such security.

(c) All securities of the same class beneficially owned by a person, regardless of the form which such beneficial ownership takes, shall be aggregated in calculating the number of shares beneficially owned by such person.

(d) Notwithstanding the provisions of paragraphs (a) and (c) of this rule:

(1)(i) A person shall be deemed to be the beneficial owner of a security, subject to the provisions of paragraph (b) of this rule, if that person has the right to acquire beneficial ownership of such security, as defined in Rule 13d-3(a) (§ 240.13d-3(a)) within sixty days, including but not limited to any right to acquire: (A) Through the exercise of any option, warrant or right; (B) through the conversion of a security; (C) pursuant to the power to revoke a trust, discretionary account, or similar arrangement; or (D) pursuant to the automatic termination of a trust, discretionary account or similar arrangement; provided, however, any person who acquires a security or power specified in paragraphs (d)(1)(i)(A), (B) or (C), of this section, with the purpose or effect of changing or influencing the control of the issuer, or in connection with or as a participant in any transaction having such purpose or effect, immediately upon such acquisition shall be deemed to be the beneficial owner of the securities which may be acquired through the exercise or conversion of such security or power. Any securities not outstanding which are subject to such options, warrants, rights or conversion privileges shall be deemed to be outstanding for the purpose of computing the percentage of outstanding securities of the class owned by such person but shall not be deemed to be outstanding for the purpose of computing the percentage of the class by any other person.

(ii) Paragraph (d)(1)(i) of this section remains applicable for the purpose of determining the obligation to file with respect to the underlying security even though the option, warrant, right or convertible security is of a class of equity security, as defined in § 240.13d-1(i), and may therefore give rise to a separate obligation to file.

(2) A member of a national securities exchange shall not be deemed to be a beneficial owner of securities held directly or indirectly by it on behalf of another person solely because such member is the record holder of such securities and, pursuant to the rules of such exchange, may

direct the vote of such securities, without instruction, on other than contested matters or matters that may affect substantially the rights or privileges of the holders of the securities to be voted, but is otherwise precluded by the rules of such exchange from voting without instruction.

(3) A person who in the ordinary course of his business is a pledgee of securities under a written pledge agreement shall not be deemed to be the beneficial owner of such pledged securities until the pledgee has taken all formal steps necessary which are required to declare a default and determines that the power to vote or to direct the vote or to dispose or to direct the disposition of such pledged securities will be exercised, provided, that:

(i) The pledgee agreement is bona fide and was not entered into with the purpose nor with the effect of changing or influencing the control of the issuer, nor in connection with any transaction having such purpose or effect, including any transaction subject to Rule 13d-3(b);

(ii) The pledgee is a person specified in Rule 13d-1(b)(ii), including persons meeting the conditions set forth in paragraph (G) thereof; and

(iii) The pledgee agreement, prior to default, does not grant to the pledgee;

(A) The power to vote or to direct the vote of the pledged securities; or

(B) The power to dispose or direct the disposition of the pledged securities, other than the grant of such power(s) pursuant to a pledge agreement under which credit is extended subject to regulation T (*12 CFR 220.1 to 220.8*) and in which the pledgee is a broker or dealer registered under section 15 of the act.

(4) A person engaged in business as an underwriter of securities who acquires securities through his participation in good faith in a firm commitment underwriting registered under the Securities Act of 1933 shall not be deemed to be the beneficial owner of such securities until the expiration of forty days after the date of such acquisition.

(e) The term *pecuniary interest in any security* shall mean the opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject security.

(f) The term *indirect pecuniary interest in any security* shall include, but not be limited to:

(1) Any derivative instrument which includes the opportunity, directly or indirectly, to profit or share in any profit derived from any increase in the value of the subject security, including a person's right to acquire the subject security through the exercise or conversion of any derivative instrument, whether or not presently exercisable;

(2) Securities held by members of a person's immediate family sharing the same household; provided, however, that the presumption of such beneficial ownership may be rebutted;

(3) A general partner's proportionate interest in the portfolio securities held by a general or limited partnership. The general partner's proportionate interest, as evidenced by the partnership agreement in effect at the time of the transaction and the partnership's most recent financial statements, shall be the greater of:

(i) The general partner's share of the partnership's profits, including profits attributed to any limited partnership interests held by the general partner and any other interests in profits that arise from the purchase and sale of the partnership's portfolio securities; or

(ii) The general partner's share of the partnership capital account, including the share attributable to any limited partnership interest held by the general partner.

(4) A performance-related fee, other than an asset-based fee, received by any broker, dealer, bank, insurance company, investment company, investment adviser, investment manager, trustee or person or entity performing a similar function; provided, however, that no pecuniary interest shall be present where:

(i) The performance-related fee, regardless of when payable, is calculated based upon net capital gains and/or net capital appreciation generated from the portfolio or from the fiduciary's overall performance over a period of one year or more; and

(ii) Equity securities of the issuer do not account for more than ten percent of the market value of the portfolio. A right to a nonperformance-related fee alone shall not represent a pecuniary interest in the securities;

(5) A person's right to dividends that is separated or separable from the underlying securities. Otherwise, a right to dividends alone shall not represent a pecuniary interest in the securities; and

(6) A person's interest in securities held by a trust.

(g) The term *derivative instrument* shall mean any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege or a settlement payment or mechanism at a price related to an equity security, or similar instrument with a value derived in whole or in part from the value of an equity security, whether or not such instrument or right shall be subject to settlement in the underlying security or otherwise, but shall not include:

(1) Rights of a bona fide pledgee of securities to sell the pledged securities;

(2) Rights of all holders of a class of securities of an issuer to receive securities pro rata, or obligations to dispose of securities, as a result of a merger, exchange offer, or consolidation involving the issuer of the securities;

(3) Rights or obligations to surrender a security, or have a security withheld, upon the receipt or exercise of a derivative security or the receipt or vesting of equity securities, in order to satisfy the exercise price or the tax withholding consequences of receipt, exercise or vesting;

(4) Interests in broad-based index options, broad-based index futures, and broad-based publicly traded market baskets of stocks approved for trading by the appropriate federal governmental authority;

(5) Interests or rights to participate in employee benefit plans of the issuer held by employees or former employees of the issuer; or

(6) Options granted to an underwriter in a registered public offering for the purpose of satisfying over-allotments in such offering.

(h) The term *immediate family* shall mean any child, stepchild, grandchild, parent, stepparent, grandparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, and shall include adoptive relationships.

Proposed Form of Short Interest Disclosure Rule

Short interest.

(a) Any person who, after acquiring directly or indirectly a short interest in any equity security of a class which is specified in paragraph (i) of Rule 13d-1, has directly or indirectly a short interest representing more than five percent of the class shall, within 10 days after the acquisition, file with the Commission, a statement containing the information required by [Schedule 13S (§ 240.13s-101).]

(b) For purposes of this rule, a person shall be deemed to have a short interest in a security if such person directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has the opportunity to profit or share in any profit derived from any decrease in the value of the subject security, including with respect to:

(1) An interest resulting from transactions in the subject security, including but not limited to a person's sale of such security when such person does not own the subject security;

(2) Any derivative instrument as defined in Rule 13d-3(g);

(3) An interest resulting from securities transactions by members of a person's immediate family, as defined in Rule 13d-3(h), sharing the same household; provided, however, that the presumption of such short interest may be rebutted;

(4) A general partner's proportionate interest in the securities transactions by a general or limited partnership. The general partner's proportionate interest, as evidenced by the partnership agreement in effect at the time of the transaction and the partnership's most recent financial statements, shall be the greater of:

(i) The general partner's share of the partnership's profits, including profits attributed to any limited partnership interests held by the general partner and any other interests in profits that arise from the purchase and sale of the partnership's portfolio securities; or

(ii) The general partner's share of the partnership capital account, including the share attributable to any limited partnership interest held by the general partner.

(5) A performance-related fee, other than an asset-based fee, received by any broker, dealer, bank, insurance company, investment company, investment adviser, investment manager, trustee or person or entity performing a similar function; provided, however, that no pecuniary interest shall be present where:

(i) The performance-related fee, regardless of when payable, is calculated based upon net capital gains and/or net capital appreciation generated from the portfolio or from the fiduciary's overall performance over a period of one year or more; and

(ii) Interests resulting from transactions in the securities of the issuer do not account for more than ten percent of the market value of the portfolio. A right to a nonperformance-related fee alone shall not represent a pecuniary interest in the securities;

(6) A person's interest in securities transactions by a trust.

(c) Any person who, directly or indirectly, creates or uses a trust, proxy, power of attorney, pooling arrangement or any other contract, arrangement, or device with the purpose or effect of divesting such person of a short interest in a security or preventing the vesting of such short inter-

est as part of a plan or scheme to evade the reporting requirements of this rule shall be deemed for purposes of this rule to have a short interest in such security.

(d) All securities of the same class subject to a short interest by a person, regardless of the form which such short interest takes, shall be aggregated in calculating the number of shares in which such person has a short interest.

(e) Notwithstanding the provisions of paragraphs (b) and (d) of this rule:

(1) A person shall be deemed to have a short interest in a security, subject to the provisions of paragraph (c) of this rule, if that person has the right to acquire a short interest in such security, as defined in [paragraph (b) of this Rule], within sixty days, including but not limited to any right to acquire: (i) Through the exercise of any option, warrant or right; (ii) pursuant to the power to revoke a trust, discretionary account, or similar arrangement; or (iii) pursuant to the automatic termination of a trust, discretionary account or similar arrangement; provided, however, any person who acquires a security or power specified in paragraphs (e)(1)(i), (ii) or (iii), of this section, with the purpose or effect of changing or influencing the control of the issuer, or in connection with or as a participant in any transaction having such purpose or effect, immediately upon such acquisition shall be deemed to have a short interest in the securities which may be sold through the exercise of such security or power. Any securities not outstanding which are subject to such options, warrants, rights or privileges shall be deemed to be outstanding for the purpose of computing the percentage of outstanding securities of the class shorted by such person but shall not be deemed to be outstanding for the purpose of computing the percentage of the class by any other person.

(2) Paragraph (e)(1) of this section remains applicable for the purpose of determining the obligation to file with respect to the underlying security even though the option, warrant, or right is of a class of equity security, as defined in Rule 13d-1(i), and may therefore give rise to a separate obligation to file.