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Client Alert

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SEC Issues Guidance Regarding Schedule 13G Filings Following ValueAct Settlement of HSR Violation Claims

Clarifies That Disqualification From Relying on "Investment-Only" Exemption Under HSR Rules Does Not Preclude Filing of "Passive" Schedule 13G

Provides Examples of Shareholder Communications With Management That Would Not Disqualify Shareholder From Filing Schedule 13G

On July 14, 2016, the Division of Corporation Finance (the "Staff") of the Securities and Exchange Commission ("SEC") issued interpretive guidance clarifying that a shareholder that is disqualified from relying on the "investment-only" exemption under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended ("HSR Act"), is not necessarily precluded from filing a "passive" Schedule 13G to disclose beneficial ownership in excess of 5% of the outstanding shares of a portfolio company. The Staff's guidance, which was issued as Compliance and Disclosure Interpretation No. 103.11 ("C&DI 103.11"), is a reminder to investors that the constructions of passive intent under the HSR Act and SEC reporting regimes are distinct and should not be confused.

By way of background, the HSR Act requires an acquiring person to notify an issuer, to file a notification with the Federal Trade Commission ("FTC") and the Department of Justice, Antitrust Division ("DOJ"), and to observe a waiting period if as a result of a proposed acquisition of voting securities the acquiring person[1] would hold voting securities of such issuer in excess of certain thresholds, the lowest being $78.2 million in market value for 2016. The filing and waiting period requirements are intended to give the antitrust agencies an opportunity to review the transaction and determine whether it would be anticompetitive in nature and to enjoin the transaction if it may violate the antitrust rules. However, there is an exemption from these requirements that applies to acquisitions of 10% or less of an issuer's outstanding voting securities if the acquisition is "solely

[1] The HSR Act and SEC reporting regimes also measure control differently, which often results in different filing persons and different aggregation of ownership.

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for the purpose of investment." As long as an acquiring person stays below the 10% threshold and is passive under HSR Act rules and regulations with respect to its investment, it is not subject to the issuer notification, filing and waiting period requirements because of this "investment-only" exemption.

Under the HSR Act reporting regime, voting securities are acquired or held "solely for the purpose of investment" if the acquiring person "has no intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer." This intent-based exemption has historically been construed strictly and narrowly by the FTC. The FTC has identified various activities that will almost always disqualify an acquiring person from relying on the "investment-only" exemption. These actions were listed in the FTC's Statement of Basis and Purpose in 1978 as examples of conduct that could be viewed as evidence of an intent inconsistent with investment purpose and include (i) nominating director candidates to the board of the company, (ii) proposing corporate action requiring shareholder approval, (iii) soliciting proxies, and (iv) having a controlling shareholder, director, officer or employee serving as an officer or director of the company (the "SBP Activities"). Beyond these activities, the FTC will look at the specific facts and circumstances when determining whether other types of activities and communications disqualify an acquiring shareholder from relying on the "investment-only" exemption.

More recently, in connection with the FTC's settlement with Third Point, LLC ("Third Point") in August 2015 regarding alleged violations by Third Point of the premerger reporting obligations under the HSR Act with respect to its acquisitions of stock of Yahoo!, the FTC viewed actions taken by Third Point that were beyond the scope of the overt public actions classified as SBP Activities to be inconsistent with an "investment-only" intent. These actions, which in the FTC's view disqualified Third Point from relying on the "investment-only" exemption, included (i) internally deliberating the possible launch of a proxy fight for directors at Yahoo!, (ii) contacting potential board candidates, and (iii) drafting correspondence to Yahoo! to announce that Third Point was prepared to seek representation on the board of directors of Yahoo!. Despite policy concerns raised in the dissenting opinion in the Third Point case that this narrow construction of the HSR Act exemption "is likely to chill valuable shareholder advocacy" and the practical difficulties and uncertainty created by the majority decision, shareholders must be cognizant of the potential effect of these additional disallowed activities when accumulating a meaningful position in a portfolio company.

Separately, under the reporting requirements of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), any shareholder that is directly or indirectly the beneficial owner of more than 5% of the

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outstanding shares of a class of equity securities registered under Section 12 of the Exchange Act is required to file a Schedule 13D with the SEC. However, the SEC's rules generally permit a shareholder that is otherwise required to file a Schedule 13D to instead file a short-form Schedule 13G (as long as the shareholder owns less than 20% of the outstanding securities) to the extent the shareholder is "passive" with respect to such investment. For SEC reporting purposes, a shareholder is considered to be "passive" as long as it has not acquired the securities "with any purpose, or with the effect, of changing or influencing the control of the issuer, or in connection with or as a participant in any transaction having that purpose or effect."

We generally advise our clients that they should assume they will not be able to rely on the "investment-only" exemption for HSR Act purposes once they file a Schedule 13D with respect to an investment in a portfolio company, particularly when it contains the standard Item 4 language reserving the right to take any and all action to influence management. However, having a "passive" intent for SEC reporting purposes and being a passive Schedule 13G filer does not necessarily mean an investor can also rely on the "investment-only" exemption for HSR Act reporting purposes. Conversely, as explained in C&DI 103.11, a shareholder disqualified from relying on the "investment-only" exemption under the HSR Act is not necessarily ineligible to file a passive Schedule 13G with the SEC.

The specific question addressed in C&DI 103.11 is as follows:

> **Question:** The Hart-Scott-Rodino ("HSR") Act provides an exemption from the HSR Act's notification and waiting period provisions if, among other things, the acquisition of securities was made "solely for the purpose of investment," with the acquiror having "no intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer." Does the fact that a shareholder is disqualified from relying on this HSR Act exemption due to its efforts to influence management of the issuer on a particular topic, by itself, disqualify the shareholder from initially reporting, or continuing to report, beneficial ownership on Schedule 13G?

The Staff's answer to this question is "no," the inability to rely on the HSR Act exemption would not automatically preclude a shareholder from filing a Schedule 13G. Instead, the shareholder's eligibility to file a passive Schedule 13G in lieu of a Schedule 13D will depend, among other things, "on whether the shareholder acquired or is holding equity securities with the purpose or effect of changing or influencing control of the issuer" and "this determination is based upon all the relevant facts and circumstances." The Staff elaborated that the subject matter of the shareholder's communications with company management may be dispositive in

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determining whether a shareholder is eligible to file a passive Schedule 13G, and the "context in which the discussions occur is also highly relevant." The Staff provided the following three examples:

- Generally, engagement with an issuer's management on executive compensation and social or public interest issues (such as environmental policies), without more, would not preclude a shareholder from filing on Schedule 13G so long as such engagement is not undertaken with the purpose or effect of changing or influencing control of the issuer and the shareholder is otherwise eligible to file on Schedule 13G.

- Engagement on corporate governance topics, such as removal of staggered boards, majority voting standards in director elections, and elimination of poison pill plans, without more, generally would not disqualify an otherwise eligible shareholder from filing on Schedule 13G if the discussion is being undertaken by the shareholder as part of a broad effort to promote its view of good corporate governance practices for all of its portfolio companies, rather than to facilitate a specific change in control in a particular company.

- By contrast, Schedule 13G would be unavailable if a shareholder engages with the issuer's management on matters that specifically call for the sale of the issuer to another company, the sale of a significant amount of the issuer's assets, the restructuring of the issuer, or a contested election of directors.

While these specific examples are highly instructive when applied to an analysis of whether a shareholder is "passive" for SEC reporting purposes, we caution investors that all the facts and circumstances should be reviewed when determining whether a Schedule 13G may be filed. In addition, the "passivity" analysis for SEC reporting purposes should not be confused with the strict construction of "passive" intent under the HSR Act regime, especially in light of the FTC's narrow interpretation of the "investment-only" exemption in the Third Point case.

From an HSR Act standpoint, the consequences of failing to file a premerger notification could be severe. The maximum potential penalty for failing to file is $16,000 per day until the offender complies with the rules; however, the maximum penalty will be raised to $40,000 per day effective August 1, 2016 and may be applied retroactively to violations that occur prior to August 1, 2016.

Notably, the Staff issued C&DI 103.11 just two days after the DOJ obtained a record fine of $11 million and injunctive relief against

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ValueAct Capital Master Fund, L.P. and its affiliates ("ValueAct") in connection with its acquisition of over $2.5 billion of Halliburton and Baker Hughes shares without complying with the HSR Act notification requirements. According to the complaint, ValueAct purchased these shares with the intent to influence both companies' decisions in connection with their proposed merger and therefore could not rely on the "investment-only" exemption under the HSR Act.

It is critical for investors building meaningful positions in their portfolio companies to consult with counsel experienced in these areas regarding their acquisition programs and the types of activities and communications, whether public or behind-the-scenes, in which they seek to engage with respect to each portfolio company. Given the Staff's increased focus on appropriate reliance on the "passivity" exemption for SEC reporting under the Exchange Act, the FTC's narrow construction of the "investment-only" exemption under the HSR Act and the severe monetary consequences for failure to comply with the HSR Act's premerger notification requirements in the absence of an applicable exemption, investors should be especially mindful of the various SEC and FTC filing requirements and a review of their compliance procedures is recommended.

For more information, please contact the Olshan attorney with whom you regularly work or any of the attorneys listed below.

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