

## Beneficial Ownership Reporting and the Brokaw Act

April 8, 2016

On March 17, 2016, Senators Tammy Baldwin (D-WI) and Jeff Merkley (D-OR) introduced legislation that, if enacted into law and implemented accordingly, would dramatically change the course of beneficial ownership reporting for purposes of the federal securities laws. Referred to as the Brokaw Act,<sup>1</sup> the legislation is reportedly named for a small town in Wisconsin that went bankrupt after an out-of-state hedge fund closed a paper mill that provided jobs to the town for over 100 years.<sup>2</sup> The aim of the bill is to increase transparency and strengthen oversight of activist hedge funds,<sup>3</sup> and it could potentially provide companies with the ability to respond more quickly to takeover threats.

This client alert will address at a high level the changes to the beneficial ownership reporting system proposed by the Brokaw Act, briefly touch upon the potential impact of the Brokaw Act, if enacted, and highlight its current legislative status.

### *Beneficial Ownership Reporting Rules*

Subject to certain exceptions, Securities and Exchange Commission (“SEC”) rules currently require beneficial owners of more than 5% of a registered class of equity security to file a beneficial ownership report on Schedule 13D to disclose such ownership interests. The Schedule 13D must be filed with the SEC within 10 days after the beneficial owner crosses the 5% threshold. The Brokaw Act would direct the SEC to shorten this period to two business days and require disclosure of short interests representing more than 5% of the class of equity security.

In addition to tightening the reporting period and requiring disclosure of short interests, the Brokaw Act would direct the SEC to amend the definition of beneficial ownership for purposes of Section 13(d) of the Securities Exchange Act of 1934, as amended (“Exchange Act”). Currently, security holders have beneficial ownership over securities if they have voting and/or investment power over the securities. The Brokaw Act would extend the definition of beneficial ownership to any person who has a pecuniary or indirect pecuniary interest in the security, both of which are defined by the proposed legislation. The Brokaw Act would also provide additional guidance as to the calculation of beneficial ownership when the beneficial owner has interests in derivative securities. Such guidance includes instructions for how to calculate beneficial ownership when the beneficial owner holds both long and short interests in the same security. For example, the beneficial owner would not be able to calculate the beneficial ownership interest by using a net calculation; instead, such beneficial owner would be required to use the greater percentage of its short interest or its long interest and calculate beneficial ownership in accordance with existing Exchange Act Rule 13d-3(d)(1).

<sup>1</sup> Brokaw Act, S. 2720, 114<sup>th</sup> Cong. (2016).

<sup>2</sup> *U.S. Senators Tammy Baldwin and Jeff Merkley Introduce Legislation to Strengthen Oversight of Activist Hedge Funds*, (Mar. 17, 2016), available at <https://www.merkley.senate.gov/news/press-releases/us-senators-tammy-baldwin-and-jeff-merkley-introduce-legislation-to-strengthen-oversight-of-activist-hedge-funds>.

<sup>3</sup> *Id.*



Finally, the Brokaw Act would define “person” for purposes of beneficial ownership reporting 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.” The term would also include a hedge fund or a group of hedge funds or persons that are, as determined by the SEC, working together to evade the beneficial ownership reporting requirements.

## ***Potential Impact of the Brokaw Act***

### *Increased Transparency*

Perhaps the greatest potential impact of the Brokaw Act stems from the increased transparency that would result to both issuers and the market. This includes transparency through expedited reporting, clearer disclosure of a beneficial owner’s position in an issuer’s securities through the reporting of derivative and short interests, and reporting of coordinated activity captured by the definition of “person.”

By shortening the reporting period between the time that a beneficial owner crosses the 5% threshold and the time that such beneficial owner is required to file a Schedule 13D, the Brokaw Act would mitigate one of the perceived drawbacks of the current beneficial ownership reporting rules. In this regard, the 10-day reporting period allows an activist, or group of activists, to build a larger stake in an issuer’s securities before making public disclosure of such interest, which may cause a company to be delayed in implementing any potential anti-takeover strategies.<sup>4</sup> In today’s governance climate, very few companies actually implement a poison pill.<sup>5</sup> A company that has fully briefed its board on the effects of the poison pill and prepared all of the paperwork in advance may choose to keep the pill “on the shelf” rather than implement it. This strategy is no doubt partially a result of ISS’s voting policy of recommending “withhold” votes for directors if a company has implemented a poison pill without

<sup>4</sup> Similarly, the premerger notification requirements of the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (“HSR”) may not necessarily provide sufficient notice for issuers to implement anti-takeover strategies. In this regard, activists and potential acquirers may be eligible to rely on an exemption from the requirement to make an HSR notice filing or may simply fail to make such a filing. *But see*, Arthur F. Golden, et al, *Does ValueAct Have Implications for Institutional Shareholders?*, Harvard Law School forum on Corporate Governance and Financial Regulation, (Apr. 7, 2016), available at <https://corpgov.law.harvard.edu/2016/04/07/does-valueact-have-implications-for-institutional-shareholders/> (discussing a \$19 million enforcement action against ValueAct by the U.S. Department of Justice based on allegations that ValueAct did not qualify for the passive investor exemption from filing under the HSR).

<sup>5</sup> As reported by ISS, “As of Dec. 31 of last year, only 19 companies in the S&P 500, and 175 in the rest of the R3000, maintained *any sort* of poison pill, shareholder approved or not. Over the course of 2015, there was a 1.6 percentage point drop in the number of companies with a pill in place in the S&P 500, and a 2.6 percentage point drop in companies with a pill in the R3000. These numbers are more substantial considering how few companies maintained pills at the beginning of 2015.” ISS Governance Insights, *What’s (Really) Hot: A QuickScore Analysis of 2015’s Real Governance Trends*, (Jan. 8, 2016), available at <http://www.issgovernance.com/governance-exchange/governance-insights/#1452866844042-c6b24eea-1b36>.



shareholder approval.<sup>6</sup> If a perceived takeover threat emerges, a company can quickly take the pill off the shelf, tailor it as necessary, and implement the pill with prompt board action before the takeover threat acquires a significant stake in the company. If the Brokaw Act were enacted and implemented accordingly, corporate boards would have a better “heads up” for tailoring and then implementing their poison pills.

In addition, while current SEC beneficial ownership reporting rules cover only securities over which a person has voting and/or investment power, including securities for which the person has the right to acquire voting and/or investment power within 60 days, the Brokaw Act would elicit more complete disclosure of a person’s interests in the securities of an issuer. In this regard, the Brokaw Act would require disclosure of a person’s pecuniary or indirect pecuniary interests in the issuer’s securities, i.e., any direct or indirect opportunity a person has to profit from, or share in any profit derived from, a transaction in the subject security, including through both long and short positions and through family members, thereby eliciting a more complete picture of a person’s overall position in an issuer’s securities. For example, a beneficial owner would not be able to conceal the fact that its long position in a security is outweighed by its short position in the same security. Such information could be very important for a company to communicate to its shareholders in a proxy fight.

Finally, by expanding the definition of “person” to capture two or more persons coordinating actions for the purpose of acquiring, holding, or disposing of securities of an issuer, seeking to control or influence the issuer, or evading designation as a “person,” the Brokaw Act targets “wolf packs.” “Wolf pack” is the term generally given to activists who do not explicitly agree to act together as a “group,” as such term is defined under Exchange Act Rule 13d-5(b)(1), but who nonetheless choose to coordinate actions and act in parallel with one another. If a wolf pack falls into the Brokaw Act’s definition of “person,” disclosure of the wolf pack’s collective stake in an issuer’s securities above the 5% threshold would be required. Therefore, issuers would be better informed about concerted activity in the acquisition of their securities.

### *Market Consequences and Other Considerations*

While the expedited reporting and enhanced disclosure requirements of the Brokaw Act would provide issuers, retail investors, and the rest of the market with a more complete picture of hedge fund and other activist investor perceptions of an issuer’s securities, allowing all such stakeholders to adapt appropriately, it remains to be seen exactly how the market would respond to such changes. For example, will hedge funds and other activist investors be discouraged from acquiring meaningful positions in certain issuers, or will they create and adopt new investment strategies in response to the new disclosure requirements? What will be the overall effect of expedited reporting and the reporting of short positions on the price of an issuer’s securities? Whatever its impact, the Brokaw Act’s attempt to modernize the beneficial ownership reporting rules in today’s technological, fast-paced marketplace

<sup>6</sup> ISS United States Summary Proxy Voting Guidelines, (Feb. 23, 2016), at 12, available at <http://www.issgovernance.com/file/policy/2016-us-summary-voting-guidelines-23-feb-2016.pdf>.



assumes that the reporting beneficial owners will almost always be sophisticated, experienced investors able to quickly comply with the reporting requirements, and perhaps this is accurate given the intent of Schedule 13D filers. If it is not, or if disclosures are too complex or too evolving, results may include late filings of Schedules 13D.

## *Legislative Status*

Before the Brokaw Act can attempt to fulfill its intended purpose or provide any benefit to issuers and the market, it must first successfully move through Congress. Assigned to the Senate Banking, Housing, and Urban Affairs Committee, the Committee's Chairman, Richard Shelby (R-AL), must determine whether the legislation will move past the committee stage. The legislation is co-sponsored by Senator Elizabeth Warren (D-MA)<sup>7</sup> and Senator and presidential candidate Bernie Sanders (I-VT) and already has strong populist appeal due to the closing of the Wisconsin paper mill. Further, in light of its potential benefits to issuers, the legislation should also have conservative pro-business support. Notably, however, prior appeals to the SEC for similar reform to the beneficial ownership reporting rules have not been successful,<sup>8</sup> and according to at least one source, the prognosis of the Brokaw Act being enacted is only 2%.<sup>9</sup> The legislation may nevertheless be one to watch as the public becomes more aware of it. For updates on the Brokaw Act's movement through the legislative process, refer to [www.govtrack.us](http://www.govtrack.us) or contact one of the authors listed below.

## **Contact Information**

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<sup>7</sup> Both Senator Warren and Senator Merkley are members of the Senate, Banking, Housing, and Urban Affairs Committee to which the legislation is assigned.

<sup>8</sup> See, e.g., Letter to Elizabeth M. Murphy, U.S. Securities and Exchange Commission, (Mar. 7, 2011), from Wachtell, Lipton, Rosen & Katz, available at [http://www.wlrk.com/docs/Letter\\_to\\_the\\_SEC\\_re\\_%2013\(d\)\\_final%20version\).pdf](http://www.wlrk.com/docs/Letter_to_the_SEC_re_%2013(d)_final%20version).pdf).

<sup>9</sup> The website, <https://www.govtrack.us/congress/bills/114/s2720>, reports a 2% prognosis of the Brokaw Act being enacted. As reported by the website, factors considered in determining this prognosis include the committee to which the legislation was referred, the fact that at least two co-sponsors serve on the committee to which the legislation was referred, and the fact that the sponsor is a member of the minority party.

