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Corporate Governance Group

Client Alert

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SEC PROPOSES TO RE-ADOPT BENEFICIAL OWNERSHIP REPORTING RULES TO CLARIFY THEIR APPLICATION TO SECURITY-BASED SWAPS

In a release published on March 17, 2011 (the “Release”),¹ the Securities and Exchange Commission proposed to re-adopt – *without change* – its existing beneficial ownership reporting rules in order to “preserve the[ir] application” to persons who buy or sell security-based swaps after the July 16, 2011 effective date (the “Effective Date”) of new Section 13(o) of the Securities Exchange Act of 1934. Exchange Act Section 13(o), which was added by Section 766 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, provides that:

“ . . . a person shall be deemed to acquire beneficial ownership of an equity security based on the purchase or sale of a security-based swap, *only to the extent that the Commission, by rule, determines . . . that the purchase or sale . . . provides incidents of ownership comparable to direct ownership of the equity security, and that . . . the purchase or sale . . . be deemed the acquisition of beneficial ownership of the equity security.*” (emphasis added).

In the Release, the SEC expresses concern that “absent rulemaking under Section 13(o),” Section 766 of the Dodd-Frank Act “may be interpreted to render the beneficial ownership determinations” made under the Exchange Act prior to the Effective Date inapplicable to persons buying and selling security-based swaps. This would in turn enable an investor who utilizes security-based swaps to “accumulate an influential or control position” in an issuer without public disclosure. The SEC’s proposal to re-adopt – *without change* – the relevant portions of Exchange

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¹ See Release No. 34-64087 entitled “Beneficial Ownership Reporting Requirements and Security-Based Swaps,” which is available on the SEC website at <http://sec.gov/rules/proposed/2011/34-64087.pdf>.

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Act Rules 13d-3 and 16a-1 is intended “solely to preserve the regulatory status quo” by clarifying that “persons who purchase or sell security-based swaps will remain within the scope of these rules to the same extent as they are now.”

Comments on the proposal are due by April 15, 2011.

Application of Existing Beneficial Ownership Rules to Security-Based Swaps

Exchange Act Section 13(d) requires a person or group that acquires “beneficial ownership” of more than 5% of the voting stock of an issuer to publicly disclose its holdings, together with its intentions with respect to the issuer and its management. Any person who is the “beneficial owner” of more than 10% of an issuer’s equity securities (as well as each officer and director of such issuer) is required to file reports with the SEC disclosing its beneficial ownership and any transactions in the issuer’s equity securities under Exchange Act Section 16(a). Further, Exchange Act Section 16(b) requires any such statutory insider to disgorge any profit (referred to as “short-swing profits”) earned by the insider from the purchase and sale, or sale and purchase, of the issuer’s equity securities within a six-month period.

Exchange Act Rules 13d-3 and 16a-1 currently define “beneficial ownership” to include a variety of circumstances that the SEC believes already capture, where appropriate, ownership of shares that are the subjects of security based swaps. While acknowledging that “the use of security-based swaps has not been frequently disclosed in Schedule 13D and 13G filings,” the Release indicates that re-adoption of these rules will both (x) “provide the certainty and protection that market participants have come to expect with the existing disclosures required by the rules promulgated under Sections 13(d), 13(g) and 16(a)” and (y) “further the policy objectives of and foster compliance with these rules upon the effectiveness of Section 13(o).”

Specifically, re-adoption of these rules is intended by the SEC to confirm that the reporting of beneficial ownership may be required for purposes of both Exchange Act Sections 13(d) and 16 “in cases where a security-based swap [(i)] confers voting and/or investment power (or a person otherwise acquires such power based on the purchase or sale of a security-based swap), [(ii)] grants a right to acquire an equity security, or [(iii)] is used with the purpose or effect of divesting or preventing the vesting of beneficial ownership as part of a plan to evade the reporting requirements ...” Similarly, the Release recognizes that “[b]ecause an insider’s opportunity to profit through a security-based swap is no different from the opportunity to profit through transactions in any other fixed-price derivative security,” for purposes of the short-swing profits provisions of Exchange Act Section 16(b), “holdings and transactions in security-based swaps that are fixed-price derivative securities can provide incidents of ownership comparable to direct ownership of the underlying equity security”

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