Client Alert

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SEC Charges Directors, Officers and Major Investors for Failing to Update Disclosures Prior to Announcements of Going Private Transactions

By Michael O'Bryan and Rose Zukin

On March 13, 2015, the U.S. Securities and Exchange Commission announced settlement proceedings against officers, directors, and major shareholders of several companies that were recently taken private for failing to update their stock ownership disclosures in a timely manner. The SEC emphasized that persons in such positions and filing such disclosures must update their disclosures if there are material changes in facts described in the disclosures, and may be required to do so even before a plan to take a company private is formulated.

REQUIREMENTS TO DISCLOSE AND UPDATE BENEFICIAL OWNER'S HOLDINGS AND INTENTIONS

The SEC charged eight insiders with violations of Section 13(d) of the Securities Exchange Act of 1934 (the "Exchange Act").[1] Section 13(d) requires any person who acquires beneficial ownership of more than 5 percent of a class of a public company's equity securities to file a Schedule 13D (commonly referred to as a "beneficial ownership report").[2] Item 4 of Schedule 13D requires disclosure of, among other things, the purpose(s) of the acquisition, including any plans to cause a merger, reorganization, going-private transaction[3] or other extraordinary corporate transaction.

Amendments to a Schedule 13D must be filed "promptly" whenever there is a material change in the facts contained in the Schedule 13D. For these purposes, the SEC deems information to be material if "there is a substantial likelihood that a reasonable investor would attach importance [to the information] in deciding whether to buy or sell" related securities. An acquisition of one percent or more of a class of securities is deemed material. The narrative responses to line item requirements in Schedule 13D (such as Item 4 with respect to plans and proposals) must also be amended for material changes, though there is no bright line as to what constitutes such a change.

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[1] In the settlement orders, the SEC also cited the failures of the insiders in some cases to properly update or comply with filing obligations under Section 16(a) of the Exchange Act, which requires officers, directors, and beneficial owners of more than 10 percent of a class of equity securities of a public company to report their holdings and transactions. The requirements of Section 16(a) do not apply to foreign private issuers.

[2] The SEC did not discuss the exception to the Schedule 13D filing requirements that allows some persons, generally limited to passive investors, to disclose their beneficial ownership on the more abbreviated Schedule 13G.

[3] In this context, a "going private" transaction—filed on a Schedule 13E-3 with the SEC—refers to, among other things, a transaction involving an affiliate of the company that results in the company's shares being delisted from a national securities exchange or becoming eligible for termination of registration pursuant to Section 12 of the Exchange Act.

FAILURES TO AMEND QUALITATIVE DISCLOSURES

Significance of Qualitative Disclosures

In the settlements, the SEC focused on the failures of the insiders to update the qualitative disclosures made in response to line item requirements of Schedule 13D. The SEC noted that "generic" disclosure indicating that the insider is reserving the right to engage in Item 4 actions must be amended both "when a plan with respect to a disclosable matter has been formulated" and also, even before a plan has been formulated, when a "material change [has occurred] in the facts set forth in" a prior Schedule 13D.

The SEC noted that each of the insiders had taken "a series of significant steps that, when viewed together, resulted in a material change from the disclosures that each had previously made in their Schedule 13D filings." The SEC elaborated by stating that some of the insiders had "determined the form of the transaction …, obtained waivers from preferred shareholders, and assisted with shareholder vote projections," while other insiders had "informed company management of their intention to privatize the company and formed a consortium of shareholders to participate in the going private transaction."

Settlements

In one settlement, the insider disclosed in his initial Schedule 13D that he "may acquire or dispose of the [shares] in market transactions or negotiated purchase transactions from time to time but does not have current plans that relate to or would result in any of the [Item 4] actions." Several years later, as part of a consortium, the insider proposed a going private transaction in a letter to the company, and later amended his Schedule 13D and filed a Schedule 13E-3 containing additional information with respect to the transaction. The SEC concluded that the amendment to the Schedule 13D was filed late because the insider's intentions had materially changed, he was no longer considering a sale of shares, and he had taken "significant steps" to "further" the going private transaction, including:

- Studying the feasibility of the transaction;
- Reviewing other going private transactions involving China-based issuers; and
- Discussing a going private transaction with two other significant shareholders who ultimately joined the consortium.

In another settlement, the insider stated in its pre-transaction Schedule 13D that it had acquired shares in a company for "investment purposes," had no present plans or proposals with respect to the Item 4 actions, and had "no present intention of reviewing or reconsidering" this position. A little over four years later, the insider amended its Schedule 13D to state that it was "evaluating" a potential going private transaction and would support a reverse stock split that effectively would take the company private; shortly thereafter, the company completed a going private transaction. The SEC concluded that the insider's obligation to update its Schedule 13D had arisen prior to that time, when the insider's previously disclosed intention had changed. In support of its conclusion, the SEC noted that the insider had taken a "series of steps in furtherance of undertaking a going-private transaction," including:

- Informing management that it would support the company going private;
- Assisting the company with respect to enabling the going private transaction, including by securing waivers from certain shareholders; and
- Discussing with management strategies for taking the company private.

In both of these settlements, the SEC noted that the company's proxy statement with respect to the going private transaction indicated that the insiders had begun to "consider" or "seriously consider" a going private transaction at a time far prior to the filing of an amended Schedule 13D.

GOING FORWARD

The settlements show that care must be taken both in preparing initial beneficial ownership reports and in updating those reports.

- ***Avoid Late Filing***. Beneficial owners are required to update beneficial ownership reports promptly to reflect any material changes in either the size of their holdings or the qualitative disclosures they made previously in response to line item requirements of Schedule 13D.
- ***When to Update Existing Disclosure—Formulation of Plan***. If an owner formulates a plan with respect to any of the Item 4 actions, then the owner must amend its existing Schedule 13D to describe such plan. The exact time at which that obligation arises is not always clear, but disclosures may be reviewed and the existence of a plan may be inferred from the facts and circumstances.
- ***When to Update Existing Disclosure—Before Formulation of Plan***. An obligation to update may arise even *before* a plan has been formulated, if necessary to correct prior disclosures that are no longer accurate. For example, generic disclosure included in a Schedule 13D may be worded too narrowly or too broadly, such that an action taken by a beneficial owner with respect to stock held may require an amendment. There is no bright line for when such a change is "material," but the SEC has indicated that there is a lower threshold for determining whether there has been a material change in previously reported facts than there is in determining whether a plan has actually been formulated. Accordingly, a filer should prepare its initial Schedule 13D carefully, to minimize the potential for having to make amendments prior to actually formulating a plan.
- ***SEC's Review of Going Private Transactions***. The SEC's review of the disclosures for these purposes may take place after a going private transaction has been announced or consummated, and so will be completed with the benefit of hindsight, putting more pressure on decisions with respect to the timing of disclosures in beneficial ownership reports.

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