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ENFORCEMENT

Enforcement Action on Section 13(d) Disclosure Requirements For Institutional Investors Clarifies Exception for 'Ordinary Course of Business'

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In a settled enforcement action instituted July 21, 2009, the SEC provided significant guidance on the filing obligations of institutional investors under Section 13(d) of the Securities Exchange Act of 1934. Specifically, the guidance addresses the meaning of the ''ordinary course of business'' prong of Rule 13d-1(b)(1)(i) and reflects an expansive interpretation of Section 13(d). The SEC's administrative order found that the respondent, a registered hedge fund adviser, Perry Corp., should have filed a Schedule 13D within 10 days of acquiring beneficial ownership of more than 5 percent of the shares of Mylan Inc. and was not entitled to rely on the deferred filing option for institutional passive investors under Rule 13d-1(b). Consequently, institutional investors will need to assess carefully their filing obligations when acquiring substantial positions in companies for other than purely passive or ordinary market making activities. The case is *In the Matter of Perry Corp.*, File No. 3-13561 (SEC July 21, 2009), http://sec.gov/litigation/admin/2009/34-60351.pdf, (41 SRLR 1408, 7/27/09).

Section 13(d) of the Exchange Act

Under Section 13(d), generally, any person who acquires beneficial ownership of more than 5 percent of a registered class of shares must disclose the acquisition

and information required by Schedule 13D within 10 calendar days. Schedule 13D's reporting requirements are fairly detailed: among other things, Schedule 13D filers are required to disclose the purpose of the transaction, including any plans or proposals relating to a proposed merger involving the issuer, and to provide prompt updates for certain events.

Under limited circumstances, detailed in Rule 13d-1(b), qualified institutional investors that exceed the 5-percent threshold may disclose their acquisitions on a short-form Schedule 13G within 45 days of the end of the calendar year in which the 5-percent threshold was reached. This exception is only available if the institutional investor acquired the securities ''in the ordinary course of his business and not with the purpose nor with the effect of changing or influencing the control of the issuer.''[1]

The Facts as Set Forth in the SEC's Order

According to the SEC's order, on July 26, 2004, Mylan announced an agreement to acquire King Pharmaceuticals Inc. in a stock-for-stock merger, subject to shareholder approval. According to the order, Perry engaged in a merger arbitrage strategy, shorting Mylan stock and buying King stock, which would yield a profit on the spread between the price of King's shares and the merger price, if the merger was consummated. According to the order, a ''prominent activist investor'' (Carl Icahn) then acquired a large block of Mylan shares and announced his opposition to the merger. In an effort to counteract the opposition, Perry began acquiring more Mylan stock primarily from two banks in conjunction with ''swap'' transactions, the net effect of which was to provide Perry with the ability to vote Mylan shares but without any economic risk of share ownership. Perry crossed the 5-percent threshold on September 24, 2004.

According to the order, Perry consulted with counsel regarding its filing obligations under Section 13(d) and ultimately received advice that it need not file a Schedule 13D and instead could report on the deferred short-form Schedule 13G. The advice concluded that Perry's ownership in an acquiring company to vote in favor of a merger would not amount to ''influencing control'' of the issuer and appears to have assumed, without specific analysis, that the circumstances of the investment were ''in the ordinary course'' of Perry's business.

According to the order, in November 2004, the activist investor announced an intent to make a tender offer for Mylan. Perry then received legal advice that, in view of the tender offer, Perry could be said to hold Mylan shares with the purpose or effect of influencing control of Mylan and, accordingly, Perry filed a Schedule 13D to report its ownership in Mylan shares.

The SEC's Analysis of 'Ordinary Course'

The SEC's order finds that Perry should have filed a Schedule 13D within 10 days of crossing the 5-percent threshold as it did not qualify for the deferred short-form Schedule 13G. The order does not challenge Perry's qualification under the first prong of Rule 13d-1(b) (*i.e.*, that Perry's ownership of shares in an *acquiring* company (Mylan) to vote in favor of a merger, as opposed to the target company (King), did not amount to ''influencing control'' of the issuer). Rather, the order finds that the circumstances of Perry's investments were not ''in the ordinary course'' of Perry's business.

The SEC's order emphasizes the ''pivotal'' importance of Section 13(d), stating that it is ''not a mere 'technical'' reporting provision,'' but rather ''a regulatory scheme that may represent the only way that corporations, their shareholders and others can adequately evaluate . . . the possible effects of a change in substantial shareholdings.'' Order ¶ 30 (citing *SEC v. Drexel Burnham Lambert, Inc.*, 837 F. Supp. 587, 607 (S.D.N.Y. 1993)). Since the order then provides the SEC's first significant guidance on the meaning of ''ordinary course'' of business, we set forth the relevant language from the order below:

> Irrespective of whether transactions of this type are routine for an institutional investor, reliance on Rule 13d1-1(b)(1)(i) based on the ''ordinary course of business'' provision is inappropriate when transactions of the type executed by Perry are undertaken. The exception . . . is available only where such investors are acquiring securities for passive investment or ordinary market making purposes as part of their routine business operations.
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> When institutional investors acquire . . . the beneficial ownership of securities with the purpose of influencing the management or direction of the issuer or affecting or influencing the outcome of a transaction – such as acquiring securities or an interest in securities, for the purpose of voting those securities in favor of a merger – the acquisition of those securities cannot be said to be in the ''ordinary course of [the institutional investor's] business. . . . [W]hen institutional investors rapidly accumulate securities of an acquirer after the announcement of a business combination transaction with the intent to ensure completion of a merger by the acquirer, the legislative purpose of Section 13(d) is defeated in the absence of full disclosure. When such acquisitions are made, or when such institutional investors act in concert with the management or advisors of one of the parties to the transaction to ensure completion of the merger, those institutions are ineligible to certify that the securities were acquired and are held in the ''ordinary course of [the institutional investor's] business''. . . .

Order ¶¶ 33-34.

The order imposes a cease and desist order, a censure and a $150,000 penalty.

Implications of the Order

This case is significant in several respects. First, it demonstrates that this Commission is taking a broad approach to interpretation of its disclosure requirements generally and those under Section 13(d) in particular. Accordingly, after acquiring more than 5 percent of a public company's shares, it is critical for investors to determine their Schedule 13D/13G eligibility and to report ownership on the correct form. Even if an investor is not seeking to influence ''control'' of the issuer, if an investor is seeking to influence the management or direction of the issuer or affect the outcome of a shareholder vote or transaction, ownership should be reported on Schedule 13D within the 10-calendar day filing deadline. It should be noted that the SEC recently communicated to Congress a request that the deadline

[1] *See* Rule 13d-1(b)(1)(i).

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for Schedule 13D filings be shortened, likely to 5 calendar days.[2]

Second, the SEC's order raises some questions. The order purports to turn solely on the ''ordinary course'' of business prong and does not find that ownership in an acquiring company amounts to ''influencing control'' of the issuer. However, the order's analysis of ''ordinary course'' specifically rejects any reference to the institutional investor's business (''[i]rrespective of whether transactions of this type are routine for an institutional investor. . .''). Rather, the order conflates the two prongs of the test — the fact that negates the ''ordinary course'' prong is the acquisition of shares ''with the purpose of influencing the management or direction of the issuer or affecting or influencing the outcome of a transaction. . . .'' In other words, by acquiring more than 5 percent of any company to influence management or the outcome of a shareholder vote, you may not be seeking to ''influence control,'' but you are not acting in the ''ordinary course'' of your business. This raises the question of whether there really remain two separate prongs to the test.

Third, it is noteworthy that the SEC pursued this matter as an enforcement case. According to the order, Perry relied on legal advice in an area lacking significant precedent or guidance. The SEC's determination to pursue an enforcement case under these circumstances is yet further evidence of the heightened level of regulatory scrutiny under this Commission.

Finally, the SEC did not address the ultimate issue of the propriety of so-called ''vote-buying'' (*i.e.*, the acquiring of voting power without attendant investment risk) the issue that was initially raised in all the publicity surrounding the merger dispute in 2004.

[2] *See* Rich Edson, *SEC Gives 'Wish List' of 42 Changes It Wants In Securities Law*, Fox Business, July 16, 2009, (last visited July 27, 2009).