Beneficial Ownership Reporting

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The Securities Exchange Act of 1934 (the "Act") and rules thereunder provide a comprehensive reporting regime for any person or group that acquires beneficial ownership[1] of a significant portion of a class of equity securities of a publicly traded issuer. The reporting required pursuant to the Act must be timely, complete and accurate. Material changes[2] in ownership as well as certain changes in the intention or purpose of the acquirer must also be reported. The staff of the Securities Exchange Commission ("SEC") may review an investment manager's ("Manager") emails as well as any public statements, such as published interviews, to test the veracity of any beneficial ownership reports submitted pursuant to the Act. Consequently, Chief Compliance Officers ("CCO") may consider testing for compliance with the Act as part of their routine compliance review, which should include instant message and email surveillance. Preparing for, monitoring and controlling who has access to the press should also be of paramount concern to the CCO for this and other purposes.

CCO's should also note that a signed agreement is not required for the SEC to determine that, for purposes of the Act, a group has been formed. Toward that end, the sharing of proprietary research or strategy with other financial institutions or investors in public companies should be monitored and periodically tested to determine whether a group[3] has been formed for purposes of the Act's beneficial

[1] Rule 13(d)-3 sets forth the definition of beneficial ownership for purposes of Section 13(d) and 13(g) of the Act. A beneficial owner ". . . includes any person, who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares: (1) Voting power which includes the power to vote, or to direct the voting of, such security; and/or (2) Investment power which includes the power to dispose, or to direct the disposition of, such security . . . . " We note that an investor that has the right to acquire beneficial ownership of securities within 60 days such as through the exercise of an option, right of conversion or otherwise is deemed to beneficially own such security for purposes of the Act.

[2] In the context of Schedule 13D, pursuant to Rule 13d-2(a) a material change includes a 1% change in ownership. Amendments must be filed "promptly."

[3] Rule 13d-5(b)(1) provides that "When two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer, the group formed thereby shall be deemed to have acquired beneficial ownership, for purposes of sections 13(d) and (g) of the Act, as of the date of such agreement, of all equity securities of that issuer beneficially owned by any such persons." The existence of a group may be proven by direct or circumstantial evidence. A formal written agreement is not necessary.

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reporting regime. Beneficial ownership reporting may be required of a Manager as part of a group even if that Manager's ownership is below the relevant reporting threshold.

These are among some of the lessons we have gleaned from a recent SEC Administrative Proceeding, *In the Matter of Jeffrey E. Eberwein*.[4]

Section 13(d)(1) of the Act and Rule 13d-1(a) require that any person or group who has acquired, directly or indirectly, beneficial ownership of more than 5% of a class of equity securities (which is registered pursuant to Section 12 of the Act) file a statement with the SEC that identifies the group members and the purpose of its acquisition. This requirement is satisfied by filing Schedule 13D within ten days[5] of crossing the 5% threshold.

Section 13(d)(3) of the Act provides that two or more persons acting as a partnership or other group, shall be deemed a "person" for filing purposes. Groups of persons collectively owning more than 5% of a class of equity securities cannot act together without disclosing their joint efforts.

Schedule 13D disclosure includes the identity of the acquirer (as well as all members of a group), a description of the purpose of the acquisition, including plans to alter the board of directors or any other material changes to the business.[6] This Schedule must be filled out truthfully and completely. Information disclosed on Schedule 13D will alert the marketplace of any rapid accumulation of shares that might indicate a potential change in control of the issuer. This information will likely have an effect on the issuer's valuation.

Certain institutional investors, including registered investment advisers, that acquired securities in the ordinary course of their business and without any purpose or intention of changing or influencing control[7] of the issuer may instead file a short-form Schedule 13G. This short-form disclosure places less burdensome disclosure requirements on certain passive investors. If circumstances change and an investor does have a control purpose then Schedule 13D must be filed within ten days.

Section 16(a) of the Act and rules thereunder require the disclosure of direct or indirect beneficial ownership[8] of greater than 10% positions on Form 3 within ten days. Changes of beneficial ownership must be filed on Form 4 within two business days; and annual statements are filed on Form 5. Beneficial

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[4] Securities Exchange Act of 1934 Release No. 80038/February 14, 2017; Administrative Proceeding File No. 3-17847 available at https://www.sec.gov/litigation/admin/2017/34-80038.pdf.

[5] The first calendar date after the trade date is day number one. See *Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting*, Question 103.10 (November 16, 2009) available at https://www.sec.gov/divisions/corpfin/guidance/reg13d-interp.htm.

[6] Material changes include "going private" transactions. See for example, https://www.sec.gov/news/pressrelease/2015-47.html.

[7] The definition of "control" found in Rule 12b-2 is relevant and includes "possession . . . of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." Activist investors often have a purpose of seeking to influence policies, management or actions of the issuer.

[8] Under Rule 16a-1(a)(1), the term "beneficial owner" means, with certain exceptions beyond the scope of this note, "any person who is deemed a beneficial owner pursuant to Section 13(d) of the Act and rules thereunder.

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ownership (including group membership) for purposes of Section 16(a) are determined using the legal standard found in Section 13(d).

In *Eberwein*, a group of activist investors acted in concert to alter the composition of the board of directors of several public companies and to effect significant corporate restructurings and other transactions and failed to properly or timely report their beneficial ownership pursuant to the statutory scheme described above.

For example, Heartland Advisors, Inc., a registered investment adviser ("Heartland"), owned 9.2% of Digirad, Inc. ("Digirad") and filed a revised Schedule 13G in February of 2012 certifying that it did not hold the shares of Digirad "for the purpose or with the effect of changing or influencing the control of the issuer." In early 2012, Heartland began to lobby Digirad to change its board of directors and nominated Charles Gilman and Jeffrey Eberwein who became board members in April of 2012. Consequently, the SEC concluded that Heartland should have filed a Schedule 13D once its Schedule 13G certification was no longer true.

Eberwein and Gillman, among others, formed a group in August 2012 to acquire shares in Aetrium, Inc. ("Aetrium"). The group filed a Schedule 13D on August 14, 2012 disclosing beneficial ownership of 16.7% of Aetrium's common stock. The group never fully disclosed its intentions in that Schedule 13D or in any of several subsequent amendments. Eberwein revealed in his email correspondence, however, that the group's plan was to sell off Aetrium's existing businesses, preserve existing net operating losses, and use Aetrium as a shell for acquisitions. Eberwein also gave a September 2012 newspaper interview that the SEC took note of. In that interview, Eberwein indicated that he had many ideas for how to create value for Aetrium shareholders. The SEC indicated that Eberwein failed to fully comply with Item 4 of Schedule 13D by "omitting to provide adequate and accurate disclosure of the purpose of the group's acquisition and holding of Aetrium securities."

During the first half of September 2012 Eberwein negotiated a shareholder group agreement with a 5.5% shareholder of NTS, Inc. ("NTS") on behalf of himself and others, including Gillman. The group did not file the required Schedule 13D until late October 2012. The group decided to wait an additional six weeks to sign the shareholder agreement to give group members more time to buy stock. The group filed a Schedule 13D on October 24, 2012 revealing its 12.7% ownership interest in NTS. The SEC cited the group for failing to timely file both Schedule 13D and Forms 3 and 4.

Finally, Gillman shared his proprietary research with Eberwein concerning Hudson Global, Inc. ("Hudson"). Gillman and Eberwein also strategized about how to bring about change on the Hudson board of directors. Gillman acted as part of a group of investors assembled by Eberwein but was not timely identified as a member of that group in relevant group Schedule 13D filings.

As a result of the violations summarized above, the respondents in Eberwein were subject to a cease and desist order and were required to pay civil penalties of varying amounts. The SEC notes that scienter or a guilty mind is not necessary to find a violation of the beneficial reporting requirements. The *Eberwein* matter provides a timely and useful overview of the many pitfalls that a Manager may encounter for failure to adhere to the Act's beneficial ownership reporting requirements; it also serves as a potential

guide for CCOs as they administer their regular compliance programs, including forensic email surveillance.

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