

UPDATES

SEC Charges Investment Adviser with Schedule 13D Reporting Violations

October 7, 2020

The U.S. Securities and Exchange Commission (SEC) recently entered into an enforcement settlement with a registered investment adviser (Adviser) managing five private funds (Funds) for violating the “beneficial ownership” reporting requirements of Section 13(d) of the Exchange Act and Rule 13d-2 thereunder.¹ More specifically, the SEC determined that the Adviser failed to timely file two amendments to its Schedule 13D, reporting its beneficial ownership of shares of common stock in a prosthetics care company (Company). The Adviser failed to timely amend its Schedule 13D to disclose that (i) it changed its intent with respect to potentially acquiring the Company and (ii) it subsequently liquidated its position in the Company. Without admitting or denying the SEC’s findings, the Adviser agreed to cease and desist from causing other violations of beneficial ownership reporting provisions and pay a fine of \$100,000. This investigation may signal a renewed interest by SEC enforcement staff in disciplining market participants for violations of beneficial ownership reporting requirements, even where the conduct at issue involves essentially technical violations. As such, it is prudent for investment advisers to review their processes and procedures to ensure they are designed to comply with beneficial ownership reporting requirements.

Schedule 13D Reporting Obligations

Pursuant to Section 13(d) of the Exchange Act, any person (including any entity) who is the “beneficial owner” of more than 5% of any class of equity securities registered under Section 12 of the Exchange Act,² other than a class of equity securities that does not have voting rights, is subject to beneficial ownership reporting requirements set forth in Section 13(d) and (g) of the Exchange Act and the rules promulgated thereunder (namely, filing Schedule 13D or, generally if passive, Schedule 13G). A person is deemed to beneficially own a security if he or she, whether directly or indirectly, has sole or shared voting or investment power with respect to the security. A person is also deemed to beneficially own any securities that he or she has the right to acquire beneficial ownership of within 60 days if the investment is passive. Any person who acquires a security with the purpose or effect of changing or influencing control over the issuer is deemed to be the beneficial owner of such securities immediately upon such acquisition without regard to the 60-day timeframe.

An initial report on Schedule 13D is required to be filed with the SEC within 10 days of the acquisition of beneficial ownership of more than 5% of a class of registered voting securities. An amendment to a Schedule 13D should be filed “promptly”³ to report material changes in the information disclosed. For example, material changes include, but are not limited to, an acquisition or disposition of beneficial

ownership of 1% or more of the class of securities and any other changes that a reasonable investor would consider important to their decision to buy or sell the security in question. This duty to amend continues until such time as the person files a Schedule 13D reporting that it ceases to beneficially own in excess of 5% of the class of securities.⁴

Adviser's Conduct at Issue

In 2016 a general partner of the Adviser (GP) discussed the possibility of acquiring the Company with one of its officers. The SEC alleged that the GP inferred from that discussion that purchasing a significant amount of the Company's stock would make an offer to acquire the Company more credible. The Funds proceeded to purchase over 5% of the Company's stock and reported its transactions on a Schedule 13D. The Funds disclosed that the transactions were for "investment purposes" and that "based on [the Funds] review and/or discussions with management, the [Funds] may explore a possible acquisition or restructuring of the Issuer."⁵ Despite the Funds purchasing over 5% of the Company's common stock, the Company's management expressed it was not interested in being acquired. Over the course of the next three years, discussions between the Adviser and the Company dwindled, and the Adviser did not take significant additional steps to acquire the Company. However, the SEC alleged that in 2019, the Adviser changed its intent with respect to the Company. Over the course of a few weeks, the Adviser conferred with an external consultant regarding liquidating its position in the Company, including through one or more block trades. The SEC alleged that "by no later than June 17," the Adviser "had abandoned its interest in acquiring [the Company], formulated a definitive intention to liquidate the entirety of its [Company] holdings, and taken steps to liquidate its [Company] shares." However, the Adviser did not file a Schedule 13D amendment disclosing this "material change." In this regard, the SEC repeated its guidance that "Generic, boilerplate disclosure that indicates the filer is reserving the right to engage in any of the kinds of transactions enumerated in Item 4(a)-(j) of Exchange Act Rule 13d-101 must be amended promptly when a material change occurs in the facts previously reported." In addition, once the Adviser proceeded to sell over 4% of the Company's shares in July, the Adviser did not file an amendment to its Schedule 13D reporting the sales.

Despite the Adviser's general practice of involving outside counsel in connection with securities transactions, the Adviser did not retain counsel to analyze its Section 13(d) reporting obligations prior to liquidating its position in the Company. Only after one of the Adviser's compliance employees discovered the error did the Adviser retain counsel to evaluate its reporting obligations and file a Schedule 13D amendment over two months late disclosing that it no longer owned the Company's stock.⁶ The SEC noted that the Adviser subsequently implemented a procedure to address its compliance with Section 13(d) requirements.

Takeaways

The SEC's enforcement action is a warning to investment advisers, including advisers to private funds, of a renewed SEC focus to institute disciplinary actions for failure to comply with reporting requirements and that even a single, late Schedule 13D filing can create enforcement risk. Accordingly, advisers should continue to assess their internal disclosure control processes and procedures as well as train personnel to ensure that deal teams and compliance (i) understand their beneficial reporting obligations and (ii) communicate new business developments and transactions that may trigger reporting obligations to outside counsel so that they are disclosed, if necessary, in a manner that is timely and complies with the SEC's rules. Outside counsel should be retained as soon as practicable when

engaging in discussions with management of public companies, especially discussions pertaining to extraordinary corporate transactions, as analysis with respect to intent for purposes of Schedule 13D is highly fact specific. Finally, outside counsel should be informed in advance of plans to effect securities transactions in order to evaluate whether the planned transactions could trigger additional reporting obligations or other collateral issues.

¹ In the Matter of WCAS Management Corporation, Exchange Act Release No. 89914 (Sept. 17, 2020), available at <https://www.sec.gov/litigation/admin/2020/34-89914.pdf>.

² In addition to their application to equity securities that are registered under the Exchange Act, the beneficial ownership reporting requirements of Section 13(d) and (g) also apply to “any equity security of an insurance company which would have been required to be so registered except for the exemption contained in Section 12(g)(2)(B), as well as any equity security issued by a closed-end investment company registered under the Investment Company Act of 1940 or any equity security issued by a Native Corporation pursuant to Section 1629c(d)(6) of Title 43” of the U.S. Code. See Section 13(d)(1) of the Exchange Act.

³ Rule 13d-2 does not specify the number of days a filer has to amend its Schedule 13D; however, it is advisable for the beneficial ownership report to be amended within two business days of any material changes to the information previously reported.

⁴ See Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting, Question 104.05 (Sept. 14, 2009), available at <https://www.sec.gov/divisions/corpfin/guidance/reg13d-interp.htm>.

⁵ Welsh, Carson, Anderson & Stowe XII, L.P. Schedule 13D (Jul. 20, 2016), available at https://www.sec.gov/Archives/edgar/data/722723/000090445416001324/s13d_072216-hanger.htm.

⁶ Welsh, Carson, Anderson & Stowe XII, L.P. Amendment No. 1 to Schedule 13D (Sept. 6 2019), available at https://www.sec.gov/Archives/edgar/data/722723/000090445419000624/s13da_090619-hanger.htm.

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