A cautionary tale
By Spencer Klein, Doron Lipshitz and David Schultz, O'Melveny & Myers
The Deal
August 3, 2009

On July 21, the Securities and Exchange Commission charged investment adviser Perry Corp. with a violation of Section 13(d) of the Securities Exchange Act of 1934 for failing to timely disclose that it had purchased beneficial ownership of more than 5% of the stock in a public company. The SEC’s order serves as a cautionary warning that, in the current period of enhanced regulatory scrutiny and in light of widespread criticism of the SEC’s recent enforcement efforts in the Bernard Madoff scandal and other cases, the SEC seems willing to take aggressive positions and institute enforcement actions against investors who allegedly violate disclosure requirements.

On July 24, 2004, Mylan Laboratories Inc. announced an agreement to acquire King Pharmaceuticals Inc. through a proposed merger that was subject to shareholder approval of both companies. Shortly following the merger announcement, Perry, which already held a significant position in King, entered into a series of "merger arbitrage" investments in which Perry stood to profit if the Mylan-King merger was consummated. After the proposed merger was announced, there was continued uncertainty in the market over whether the Mylan shareholders would approve the merger, in part because certain other Mylan shareholders -- including Carl Icahn -- were actively lobbying against approval. This continued market uncertainty likely increased the "spread" between the price of the King and Mylan shares (and therefore increased Perry's potential profit on the arbitrage investment).

While engaging in its arbitrage investments, Perry also acquired beneficial ownership of a substantial block of Mylan's shares (slightly less than 10%) that it intended to vote in favor of the proposed merger, while contemporaneously entering into a series of "swap" transactions that effectively eliminated any economic risk to Perry from owning the Mylan shares. In effect, Perry sought to "buy" roughly 10% of the Mylan vote in order to increase the likelihood that the Mylan-King merger would be approved so that it would profit from its arbitrage investments. Perry had an incentive not to disclose its Mylan holdings because disclosure would likely have been perceived by the market as increasing the likelihood that the Mylan-King merger would be approved, thereby reducing Perry's potential profit on its arbitrage investment.

Pursuant to Rule 13d-1(a) under the Exchange Act, any investor who acquires beneficial ownership of more than 5% of a class of SEC-registered equity securities must file a Schedule 13D reporting its ownership within 10 days of the 5% acquisition. In lieu of filing a Schedule 13D, under Rule 13d-1(c), an investor can file a Schedule 13G, requiring much less detailed disclosure, if it acquires less than 20% of the class and has not acquired the securities with the purpose or effect of changing or influencing the control of the issuer, nor in connection with or as a participant in any transaction having such purpose or effect. However, under Rule 13d-1(b), an institutional investor is permitted to file a Schedule 13G within 45 days after the end of the calendar year in which it made a 5% acquisition, rather than within 10 days after the acquisition under Rule 13d-1(c), if the institutional investor acquired the shares (i) in the ordinary course of business and (ii) not with the purpose or effect of changing or influencing the control of the issuer, nor in connection with or as a participant in any transaction having such purpose or effect. Perry concluded that it was permitted to defer public disclosure of its position in Mylan in reliance on Rule 13d-1(b) until February 2005 because it believed that it had satisfied both prongs of the Rule 13d-1(b) test by holding the Mylan shares "in the ordinary course of business" and without the purpose or effect of changing or influencing Mylan's control since Mylan was to be the company surviving the merger with King and no change of control of Mylan was going to occur.

The SEC determined that Perry's reliance on Rule 13d-1(b) to defer disclosure of its position was inappropriate because its acquisition of Mylan's securities was not in the ordinary course of Perry's business. In so doing, the SEC clarified that the purpose of the "ordinary course of business" prong of the Rule 13d-1(b) exemption was to permit qualified institutional investors an exception to the ordinary 10-day disclosure requirement where the investor is acquiring securities for passive investment or ordinary market-making purposes as part of their routine business operations (such as stock exchange specialists...
and market makers). The SEC's order makes clear that the exemption does not apply when investors acquire beneficial ownership of securities with the purpose of influencing the management or direction of the issuer -- such as acquiring securities for the purpose of voting in favor of a merger -- since, in the SEC's view, such activities are not in the ordinary course of business.

Beyond demonstrating an increased level of assertiveness in the SEC's enforcement activities for allegations of violations of disclosure requirements, this case provides some important lessons to investors that are potentially subject to similar disclosure requirements.

First, the "ordinary course of business" exception, which has sometimes been relied on by institutional investors to defer their 13(d) disclosures, is not available when the investor is making a 5% acquisition with the purpose of influencing the management or direction of the issuer or the outcome of a transaction. Even if the strategies employed are consistent with the investor's regular business activities, the SEC's order makes clear that such actions will not be interpreted to fall within the "ordinary course of business" exception for purposes of Rule 13d-1(b).

Second, if a 13(d) disclosure decision is being made in situations where other sophisticated parties have opposing interests, investors should consider the possibility that such other parties may call to the SEC's attention instances of potentially delayed or inadequate disclosure (or nondisclosure) and that the SEC may be sensitive to such whistle-blowing notifications. While it is unknown whether another Mylan shareholder, Mylan management or anyone else agitated for SEC enforcement action in this case, investors with opposing interests or other agendas may not hesitate to alert the SEC to potential violations.

Lastly, it is noteworthy that the SEC's order focused exclusively on the "ordinary course of business" prong of the Rule 13d-1(b) exception and did not address the second prong of the Rule 13d-1(b) exception, which provides that, in order to defer disclosure, the securities must be held without the purpose of changing or influencing "control" of the issuer. In what could be viewed as a regulatory sleight of hand, the SEC's order provided that Perry did not hold the Mylan shares in the ordinary course of business because the shares were held with the purpose of influencing the "management or direction" of the issuer or "affecting or influencing the outcome of a transaction." However, the SEC did not rule on whether Perry held the Mylan shares with the purpose of changing or influencing "control" of Mylan, and one may conclude from the SEC's order that it did not view Perry's actions as influencing control given the structure of the merger as discussed above. As such, it seems possible that under facts similar to those in Perry, an investor beneficially acquiring more than 5% but less than 20% of an issuer's shares could disclose its position on a less detailed short-form Schedule 13G within 10 days after such acquisition pursuant to Rule 13d-1(c) (which only requires that shares not be held with the purpose of changing or influencing control of the issuer but does not contain the additional requirement that the shares be held in the ordinary course of business) rather than complying with the more detailed disclosure requirements of Schedule 13D within the same 10-day period.

Spencer Klein and Doron Lipshitz are partners and David Schultz is a counsel in the New York office of O'Melveny & Myers LLP. They are members of the firm's mergers and acquisitions practice group.