

# CONVERSION CAPS – A PRIMER

Private equity investors – principally PIPEs funds – have inquired about using “conversion caps” in their investment agreements. Conversion caps, when used properly, allow these investors to avoid the burden of compliance with the reporting obligations under Exchange Act Section 13(d) and Section 16(a) and short swing profit rules under Section 16(b).<sup>1</sup> These laws are summarized as follows:

- Section 13(d) requires that each person who beneficially<sup>2</sup> owns more than 5% of any class of security registered under Section 12 of the Exchange Act must file with the SEC a Schedule 13D or Schedule 13G. The person must amend the Schedule 13D or 13G periodically until the person’s ownership in such securities is below 5%.
- Section 16(a) requires that each person who beneficially owns more than 10% of any class of security registered under Section 12 of the Exchange Act must file with the SEC a Form 3 reporting such person’s ownership in such registered security. That person must also file with the SEC a Form 4 by the end of the second day each time such security is bought or sold.
- Finally, Section 16(b) requires that each person who beneficially owns more than 10% of any class of security registered under Section 12 of the Exchange Act and then buy and sells, or sells and buys, such security within any six month period must disgorge to the issuer any profit from such transaction.<sup>3</sup>

A typical PIPEs transaction is an investment in an issuer’s convertible debt (such as notes or debentures) or convertible equity (such as preferred stock) and warrants. These securities are rarely registered under the Exchange Act, but the underlying security (typically common stock) usually is registered under the Exchange Act. When calculating the investor’s “beneficial ownership” in the issuer’s common stock, the investor must add up all of the common stock underlying the convertible debt or equity and warrants that

the investor has the right to acquire within 60 days.<sup>4</sup>

To avoid being trapped in violating Section 16 or Section 13(d), investors have utilized conversion caps. These conversion caps have been generally recognized by the SEC.<sup>5</sup> The U.S. Court of Appeals for the Second Circuit upheld a conversion cap in the context of a Section 16(b) claim.<sup>6</sup> In a brief filed in the case, the SEC set out general principles stating:

“While the Commission believes that conversion caps may be effective in principle, such provisions should be examined on a case-by-case basis to determine whether they are binding and valid. If a cap is not effective in constraining conversion rights, it is not a basis for finding limits on beneficial ownership.”

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“[W]e believe that such provisions must be examined on a case-by-case basis to determine whether they are binding and valid. Factors that may indicate that a conversion cap is illusory include whether the cap:

- is easily waivable by the parties (particularly the holder of the convertible securities);
- lacks an enforcement mechanism;
- has not been adhered to in practice; or
- can be avoided by transferring the securities to an affiliate of the holder.

“Factors that may indicate that a cap is binding include whether it:

- is provided in the certificate of designation or the issuer’s governing instruments;
- reflects limitations established by another regulatory scheme applicable to the issuer; or
- is the product of bona fide negotiations between the parties.”

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<sup>1</sup> Caps are also frequently used to limit an investor's ownership in certain regulated industries, such as insurance and banking.

<sup>2</sup> SEC Rule 13d-3(a) provides that:

“a beneficial owner of a security 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.”

The determination of beneficial ownership under Section 16 uses essentially the same definition.

<sup>3</sup> The rules under Section 16(b) provide for several exempt transactions that do not trigger disgorgement under Section 16(b).

<sup>4</sup> SEC Rule 13d-3(d)(1)(i) states, in part, that:

“A person shall be deemed to be the beneficial owner of a security . . . if that person has the right to acquire beneficial ownership of such security, as defined in Rule 13d-3(a) within sixty days, including but not limited to any right to acquire:

- A. through the exercise of any option, warrant or right;
- B. through the conversion of a security; . . .”

<sup>5</sup> BancBoston Capital Inc., No-Action Letter available August 10, 1987. The purpose of this conversion cap was to comply with stock holding limitations under the Bank Holding Company Act.

<sup>6</sup> *Levy v. Southbrook International Investments Ltd.*, 263 F.3d 10 (2001).