

SEC Proposes to Amend Beneficial Ownership Reporting Requirements

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On February 10, 2022, the SEC adopted a proposal to make significant changes in the rules requiring investors to report their ownership of shares of U.S. publicly traded companies. Under Sections 13(d) and 13(g) of the Securities Exchange Act of 1934, investors who own more than five percent of a company's stock are required to publicly report such ownership on Schedule 13D or Schedule 13G.

As recommended by some corporate governance advocates, the SEC has proposed to shorten the deadlines for filing Schedules 13D and 13G, require that certain derivative securities be counted for purposes of calculating beneficial ownership, and change what constitutes a group for purposes of filing Schedule 13D.

Not only would these proposals increase the reporting and compliance burdens for investors, but they could also change the dynamics of certain contests for control and expand the number of persons subject to the short-swing profit rules of Section 16 of the Securities Exchange Act.

Deadlines for Schedules 13D and 13G beneficial ownership reports

Currently, the general rule is that investors must report an acquisition of beneficial ownership of more than five percent of the stock of a publicly traded company no later than 10 calendar days after crossing the five percent threshold. As pointed out in the SEC's proposing release, this 10-day deadline has not been updated since Section 13(d) was first adopted in 1968, when SEC filings were made in paper and stocks were traded without the benefit of modern information technology. Certain commentators have argued that the 10-day window gives activist investors an unfair advantage in today's market, as they can use the window to build up their position without having to publicly disclose their purchases. The 10-day window can decrease the activist's costs because the company's stock often increases in price after a Schedule 13D is filed, and the 10-day window can allow them to take advantage of potentially lower prices. On the other hand, companies generally would prefer a shorter reporting window so that they have more visibility into their shareholder base.

It is less clear what non-activist investors would prefer, but SEC Chair Gary Gensler framed the considerations of timing of Schedule 13D filings in terms of "information asymmetries" impacting general investors in the market. He stated in a press release that "[i]nvestors currently can withhold market-moving information from other shareholders for 10 days after crossing the five percent threshold," and that "[t]he filing of Schedule 13D can have a material impact on a company's share price, so it is important that shareholders get that information sooner."

The SEC's proposal would shorten the initial deadline for filing Schedule 13D from 10 days to five days. In addition, it would change the deadlines for amendments to Schedule 13D from "promptly" after the triggering event to within one business day after the triggering event.

The proposed amendments would also shorten the initial deadline for filing Schedule 13G. For Schedule 13G filers who are qualified institutional investors or exempt investors,¹ the proposed amendments would shorten the initial filing deadline from 45 days after the end of the year to five business days after the end of the month in which the investor beneficially owns more than five percent of the company's stock. For Schedule 13G filers who are passive investors² beneficially owning less than 20 percent of the company's stock, the proposed amendments would shorten the initial filing deadline from 10 days to five days after crossing the five percent beneficial ownership threshold.

The filing deadline for amendments to Schedule 13G would also be shorter under the SEC's new proposal. The SEC's proposal would change the filing requirements from 45 days after the year in which any change occurred to five business days after the month in which a material change occurred. In addition, for Schedule 13G amendments that must be filed as a result of an investor exceeding 10 percent beneficial ownership of a company's stock or as a result of an investor exceeding a five percent increase or decrease in beneficial ownership of a company's stock, qualified institutional investors must file such amendments within five business days, and passive investors must file such amendments within one business day.

Requiring some 13D filers to amend filings within one business day to reflect material changes might not be too onerous. Other filers are likely to find the one business day deadline problematic.

Reporting and disclosure of derivative securities

In general terms, an investor is deemed to beneficially own a security when the investor has or shares direct or indirect power over the voting or disposition of the security. Having the right to acquire such power within 60 days is also deemed to constitute beneficial ownership. Under current law, cash-settled derivatives are not counted for purposes of beneficial ownership reporting because, technically, they do not confer power over the voting or disposition of the reference securities. However, companies have sometimes complained that holders of derivatives have significant influence over the behavior of their counterparties or the trading prices of the stock. In its discussion of its proposed amendments, the SEC notes that holders of cash-settled derivative securities may have the incentives to influence the outcome of a vote and may be able to exert economic power through the potential impact of their actions on the stock price.

The SEC's proposed amendments would expand the definition of beneficial ownership for purposes of reporting to cash-settled derivatives, other than security-based swaps, if they are held with the purpose or effect of changing or influencing the control of the issuer, or in connection with or as a participant in any transaction having such purpose or effect. The proposed amendments also provide a formula for

¹ A "qualified institutional investor, as used in the SEC's proposing release, is a specified institutional investor who acquired its stock in the ordinary course of business and not with the purpose or effect of, nor in connection with or as a participant in any transaction having the purpose or effect of, changing or influencing the control of the company. An "exempt investor," as used in the release, is one who acquired its interest prior to the company becoming publicly traded. Both qualified institutional investors and exempt investors may report on Schedule 13G instead of Schedule 13D.

² A "passive investor," as used in the release, is one that holds beneficial ownership of less than 20 percent of the publicly traded stock and did not acquire the securities with any purpose or effect of, nor in connection with or as a participant in any transaction having the purpose or effect of, changing or influencing the control of the company. Passive investors may report on Schedule 13G instead of Schedule 13D.

calculating the number and percentage of the reference securities for purposes of beneficial ownership reporting.

The inclusion of cash-settled derivatives in the calculation of beneficial ownership could significantly change the dynamics of some contests for corporate control by requiring investors to become 13D filers before their actual stock ownership crossed the five percent threshold, as well as disclosing interests that might be adverse to those of other stockholders.

In addition, the proposed amendments would revise Item 6 of Schedule 13D to require a reporting investor to disclose interests in all derivative securities that use the issuer's stock as a reference security, whether or not the derivative securities are held with the purpose or effect of changing or influencing the control of the issuer. This could force the disclosure of "collars" and similar arrangements for limiting potential losses, which might be used by investors solely for the purpose of limiting their exposure to market risk.

Formation of a "group" for purposes of beneficial ownership reporting

The SEC's proposed amendments would change the circumstances in which investors are deemed to form a group for purposes of beneficial ownership reporting. Under the proposed amendments, among other things, an investor acts as a group with another person if the investor shares with another market participant, with the purposes of causing such other person to acquire stock in the same company, the non-public information that a Schedule 13D filing will be made. This is aimed at forcing disclosure of the tacit coordination of so-called "wolf-pack" investors.

The proposed amendments also state that investors are a group if they "act as a group." In discussing the proposed amendments, the SEC writes that such rule is "intended to remove the potential implication that an express or implied agreement among group members is a necessary precondition to the formation of a group" for purposes of beneficial ownership reporting.

The proposed amendments would also exempt certain investors from constituting a group for beneficial ownership reporting purposes. Under the proposed amendments, investors would not form a group merely by communicating with each other without the purpose or effect of changing or influencing control of the issuer. Also, persons who enter into derivative agreements in the ordinary course of their business would not be deemed to form a group by virtue of the derivative agreement.

Implications for Section 16 reporting and short-swing profit recovery

Section 16 of the Securities Exchange Act requires beneficial owners of more than 10 percent of a public company's securities to report their initial acquisition of such ownership to the SEC on a Form 3 and generally requires the reporting of subsequent purchases and sales on a Form 4 before the end of the second business day following the transaction. So-called short-swing profits (the price difference between a sale and a purchase that take place within a six-month period) are recoverable by the company, including in a derivative suit on behalf of the company. By increasing the number of ways an investor might be deemed a 10 percent beneficial owner, the proposed amendments potentially increase the number of persons who might have Section 16 reporting obligations and who might incur liability for short-swing profits. In this regard, questions might easily arise as to whether an investor held more than 10 percent and was, therefore, subject to Section 16 based on ownership of a cash-settled derivative or participation in a group.

Comment period

The SEC will take public comments on its proposed amendments for 60 days before drafting a final rule, and not everything currently in the proposed amendments will remain in the final rule. The final rule will also be subject to a vote by the Commissioners. Currently, there are four Commissioners, three of whom are Democrats and one of whom is Republican. The Republican Commissioner, Hester Peirce, voted against the SEC's proposed rule.

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