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ALERT MEMORANDUM

The SEC's Proposed Changes to Beneficial Ownership Reporting: Implications for Market Participants

March 15, 2022

On February 10, 2022, the Securities and Exchange Commission (the "SEC") issued for public comment proposed rules that will, if adopted, significantly affect how investors report their beneficial ownership on Schedules 13D and 13G.[1] The principal changes would:

- accelerate the filing deadlines for Schedules 13D and 13G beneficial ownership reports;
- clarify the circumstances under which two or more persons have formed a "group" that would be subject to beneficial ownership reporting obligations; and
- expand the definition of beneficial ownership to include certain cash-settled derivative securities.

In this memo, we summarize the proposed changes and the implications for issuers, activists, financial institutions, and other market participants.

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[1] SEC Release Nos. 33-11030; 34-94211 (Feb. 10, 2022), available at https://www.sec.gov/rules/proposed/2022/33-11030.pdf (the "Release")

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Proposed Changes to Filing Windows

The SEC's proposed rules would accelerate the deadlines for filing initial and amended beneficial ownership reports on Schedules 13D and 13G. To offset some of the administrative burden of the new accelerated deadlines, the SEC also is proposing to allow Schedule 13D and 13G filings (and related amendments) to be submitted as late as 10 p.m. eastern time on the last filing date.

Current Filing Deadlines

A person or group that acquires beneficial ownership of more than 5% of a class of equity securities registered under section 12 of the Securities Exchange Act of 1934 (the "Exchange Act") or that has lost the eligibility to file on Schedule 13G is required under Rule 13d-1 to file a Schedule 13D within 10 days of the date of the applicable triggering event. Rule 13d-1 also permits certain investors—Qualified Institutional Investors[2] (or "QIIs"), Exempt Investors and Passive Investors—to file on the shorter form Schedule 13G. The rules currently provide that (i) in the case of QIIs and Exempt Investors, the initial Schedule 13G filing is required to be made within 45 days after the end of the year in which beneficial ownership exceeded 5% (or, in the case of QIIs, within 10 days after the end of a calendar month where beneficial ownership exceeded 10%) and (ii) in the case of Passive Investors, the filing is required to be made within 10 days of acquiring beneficial ownership of more than 5%.

Amendments to Schedule 13D, which are triggered by a material change in the facts set forth in the Schedule 13D on file, are currently required under Rule 13d-2 to be made "promptly" following the triggering event. While "promptly" is not defined, many practitioners have advised clients to file within one business day following the triggering event, with two business days generally being seen as the latest date for timely filing.

Schedule 13G filers are currently required to file amendments to Schedule 13G in connection with *any* change in the information previously reported on Schedule 13G, and such filing is required to be made within 45 days after the end of the calendar year in which such change occurred. Additionally, QIIs and Passive Investors are required to file amendments to Schedule 13G upon (i) exceeding 10% beneficial ownership or (ii) a 5% increase or decrease in beneficial ownership. Such amendments are required to be filed by QIIs within 10 days after the end of the month in which the triggering event occurred and by Passive Investors "promptly" following such triggering event.

[2] "Qualified Institutional Investors" refers to the institutional investors that are qualified to report on Schedule 13G, in lieu of Schedule 13D and in reliance upon Rule 13d-1(b), including broker-dealers, insurance companies, investment advisers registered under Section 203 of the Investment Advisers Act of 1940, a parent holding company or control person (if certain conditions are met), an employee benefit plan or pension fund that is subject to the provisions of the Employee Retirement Income Security Act of 1974, a savings association as defined in Section 3(b) of the Federal Deposit Insurance Act, a church plan that is excluded from the definition of an investment company under Section 3(c)(14) of the Investment Company Act of 1940, non-U.S. institutions that are the functional equivalent of any of the institutions listed in Rules 13d-1(b)(1)(ii)(A) through (I), so long as the non-U.S. institution is subject to a regulatory scheme that is substantially comparable to the regulatory scheme applicable to the equivalent U.S. institution, and groups of these institutional investors.

"Exempt Investors" refers to persons holding beneficial ownership of more than 5% of a covered class at the end of the calendar year, but who have not made an acquisition of beneficial ownership subject to Section 13(d).

"Passive Investors" refers to beneficial owners of more than 5% but less than 20% of a covered class who can certify under Item 10 of Schedule 13G that the subject securities were not acquired or held for the purpose or effect of changing or influencing the control of the issuer of such securities and were not acquired in connection with or as a participant in any transaction having such purpose or effect. These investors are ineligible to report beneficial ownership pursuant to Rules 13d-1(b) or (d) but are eligible to report beneficial ownership on Schedule 13G in reliance upon Rule 13d-1(c).

Proposed Amendments to Filing Deadlines

The proposed amendments would substantially shorten filing deadlines as described below.[3]

- Shorten the filing deadline for the initial Schedule 13D from 10 days after the date on which a person or group acquires more than 5% of a class of equity securities registered under Section 12 of the Exchange Act (or a "covered class") to 5 days (Rule 13d-1(a));
- Shorten the filing deadline for the initial 13D required to be filed by certain persons who are no longer eligible to report on Schedule 13G from 10 days to 5 days (Rules 13d-1(e), (f) and (g));
- Shorten the deadline for the filing of the initial Schedule 13G for QIIs and Exempt Investors to 5 business days following the last day of the month in which beneficial ownership first exceeds 5% of a covered class from 45 days after the end of the calendar year in which beneficial ownership exceeded 5% (Rules 13d-1(b) and (d));
- Shorten the deadline for Passive Investors to file an initial Schedule 13G from 10 days to 5 days after the acquisition of beneficial ownership of more than 5% of a covered class (Rule 13d-1(c));
- Require that amendments to Schedule 13D be made within one business day following the date of a material change (instead of the undefined "promptly" as currently provided) (Rule 13d-2(a));
- Require that amendments to Schedule 13G be made within 5 days after the last day of the month in which a *material* change occurred instead of within 45 days after the calendar year-end in which *any* change occurred (Rule 13d-2(b));
- Shorten the time period in which a QII is required to amend Schedule 13G filings after exceeding 10% beneficial ownership of a covered class or a 5% increase or decrease in beneficial ownership of a covered class from 10 days after the last day of the month in which the triggering event occurred to 5 days following the triggering event (Rule 13d-2(c)); and
- Require Passive Investors to amend Schedule 13G filings after exceeding 10% beneficial ownership of a covered class or a 5% increase or decrease in beneficial ownership of a covered class one business day after the triggering event (instead of "promptly" thereafter as currently provided) (Rule 13d-2(d)).

The Release includes a table[4] summarizing the above changes, which is reproduced in Exhibit A to this memo.

Implications of Proposed Changes

The SEC's proposed amendments meaningfully shorten the filing deadlines for both Schedule 13D and Schedule 13G filers, while eliminating the need for Schedule 13G filers to amend them to reflect immaterial changes. In support of the amendments tightening the filing deadlines, the Release notes: the technological changes to the filing process from 1968 (when the filing deadlines were initially established) to today (when filing by EDGAR is mandated and essentially instantaneous); the SEC's stated goal of preventing informational asymmetry between buyers and sellers of a covered class; and that the proposed amendments bring U.S. securities law in line with beneficial ownership reporting in other jurisdictions.

As a counter to the SEC's position, critics have noted that shortening the filing deadline will make the accumulation of meaningful stakes and subsequent waging of campaigns less attractive to activists whose ability to acquire shares at a lower price prior to disclosing their acquisitions on Schedule 13D will be

[3] *See* the Release, pgs. 6-7.

[4] *See* the Release, pgs. 9–10.

significantly limited. These critics further contend that the changes effected by these activists benefit shareholders more broadly, and therefore shortening the filing deadlines may adversely affect shareholders.

Activists, however, have been able to effect corporate change with relatively modest stakes, often with beneficial ownership of less than 5%, by waging PR battles and wooing institutional investors and pension funds[5] or sometimes just by threatening to acquire shares.[6] As such, it would seem likely that activism will continue, though activists may pick their battles a bit more carefully to ensure they are able to get the desired returns. Traditionally, activists have tended to disproportionately focus their efforts on companies with a market cap of $1 billion or less. If the proposed amendments take effect, we may see activists shift their efforts to larger cap companies where stakes of a meaningful dollar amount can be accumulated without triggering Schedule 13D reporting requirements, allowing activists greater flexibility with timing their disclosure.[7]

Changes to Group Formation Standards

The Release proposes potentially significant changes to the test for determining when two or more persons have formed a "group" that would be subject to beneficial ownership reporting. The proposed rules would also expand the "group" concept to include so-called "tipper-tippee" relationships, in which a prospective Schedule 13D filer informs another person in advance of the Schedule 13D filing, and the latter acquires shares in the issuer.

Modifications to Rule 13d-5(b)

Section 13(d) of the Exchange Act imposes filing obligations on any single "person" who beneficially owns more than 5% of a covered class of equity securities. Sections 13(d)(3) and 13(g)(3) of the Exchange Act provide that, when two or more persons "act as" a "group" for the purpose of acquiring, holding, or disposing of equity securities, such group will be deemed a "person" for Section 13(d) purposes (and therefore, like any other person, may be required to file a beneficial ownership report if the group's ownership crosses the reporting threshold). Rule 13d-5(b)(1) further provides that a "group" is deemed to beneficially own all equity securities owned by the members of the group. The purpose of these provisions, and the "group" concept generally, is to prevent evasion of Section 13(d) disclosure requirements by persons, acting together, who individually do not own more than 5% of an issuer's equity securities but collectively do.

In deciding whether investors have formed a "group" for Section 13(d) purposes, a number of courts have found that a group can be formed only if an express or implied agreement exists among its purported members.[8] This is in part based on the language of Rule 13d-5(b)(1), which states that "[w]hen two or more persons ***agree to act*** together" for one of four enumerated purposes (acquiring, holding, voting or disposing of equity securities), the group formed as a result is deemed to have acquired beneficial ownership of the equity securities owned by all its members.

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[5] *See, e.g.*, *Calstrs's Crucial Phone Call Eased Path for Activists' Exxon Win,* Bloomberg, *available at* https://www.bloomberg.com/news/articles/2021-06-18/calstrs-s-crucial-phone-call-eased-path-for-activist-s-exxon-win (June 18, 2021).

[6] *See, e.g.*, *Activist Carl Icahn Seeks Seats on FirstEnergy's Board,* Bloomberg, *available at* https://www.bloomberg.com/news/articles/2021-03-08/activist-carl-icahn-is-said-to-seek-seats-on-firstenergy-s-board (March 9, 2021).

[7] Note, however, the expense of activist/proxy contests at large market cap companies. *See supra* note 5; *see also* Hirsch, Lauren. *The largest proxy battle ever is coming to a head on Tuesday*, CNBC, *available at* https://www.cnbc.com/2017/10/09/pg-proxy-battle-nelson-peltz-procter-gamble-board-decision.html (Oct. 10, 2017).

[8] In the Release, the SEC cited the following cases in support of this proposition: Corenco Corp. v. Schiavone & Sons, Inc., 488 F.2d 207, 217 (2d Cir. 1973) ("absent an agreement between [the defendants] a 'group' would not exist."); CSX Corporation v. Children's Inv. Fund Mgmt. (UK) LLP, 562 F. Supp. 2d 511 (S.D.N.Y. 2008) (referring to a "requisite agreement" when offering an analytical framework to be applied in assessing whether or not a group had been formed).

In the SEC's view, according to the Release, an agreement among group members is not a necessary element of group formation. Accordingly, the proposal overhauls Rule 13d-5(b) to track the statutory text of Section 13(d)(3) and Section 13(g)(3), *i.e.*, to state that two or more persons who "act as" a group will be treated as a group, without a predicate agreement, express or implied, among them. It is not clear what conduct would meet the "act as" standard, but the Release states that "concerted actions by two or more persons for the purpose of acquiring, holding or disposing of securities of an issuer are sufficient to constitute the formation of a group."

Whether this is a shift at the margins or a sea change is unclear. Group formation in any particular case has been and will remain a facts and circumstances test. Even prior to the Release, many courts have found a group to exist without any direct evidence of an agreement among its members.[9] Rather, in those cases, an agreement was often inferred based on the purported group members' conduct, which suggested they were acting in concert (and not just in parallel) with respect to acquiring, holding or disposing of securities. But the absence of any requirement for an agreement among group members, together with statements in the Release, may suggest a more significant expansion of the group concept. This will create uncertainty for market participants, particularly activist funds invested in a stock alongside other activist funds.

"Tipper-Tippee" Relationships

The proposed amendments also expand the "group" concept to include so-called "tippees" of Schedule 13D filers. More specifically: if a person who is or will be required to file a Schedule 13D informs another person about the filing in advance, and the second person acquires shares, then both the filer and the recipient of the information will be deemed to have formed a group. The language of the proposed rule limits its application to circumstances where the filing person makes the disclosure "with the purpose of causing [the tippee] to acquire equity securities." However, since this will be judged in hindsight, market participants would be well advised not to rely too heavily on this limitation.

It is unclear what Section 13(d) policy objectives this change is intended to further. The proposed rule would apply in circumstances in which a Schedule 13D will or is required to be filed, so the concerns the "group" concept is intended to address—the evasion of beneficial ownership reporting—are presumably not present (though the proposed changes could accelerate the filing timeline). If the tippee is otherwise acting as a group member with the Schedule 13D filer (which may become easier to establish under the proposed rule changes described above), then group disclosure would already be required for the tippee. It is hard to see how one is engaged in group-like activity simply by trading based on the knowledge that a Schedule 13D will be filed (even though one could, and in the Release the SEC does, imagine the *quid pro quo* that may at least be implied by the Schedule 13D filer's disclosure).

It appears in fact the proposed change is driven by insider trading type concerns—the Release notes the SEC's desire to "enhance investor confidence" and "promote accurate price discovery in the capital markets." Undoubtedly, sellers in these trades would have liked to know a Schedule 13D filing was imminent. But it is hard to distinguish this information asymmetry from what occurs in the filer's own accumulation prior to a Schedule 13D filing (and indeed even prior to crossing the filing threshold). From the perspective of insider trading, the law imposes no obligation on the buyer to disclose its own plans. And it is generally understood that a market participant who has developed its own material "outside information" (which, in these cases, is often

[9] In the Release, the SEC cited the following cases in support of this proposition: SEC v. Savoy, 587 F.2d 1149 at 1162; Fin. Gen. Bankshares, Inc. v. Lance, 1978 WL 1082, at *9 (D.D.C.1978); Hallwood Realty Partners, LP v. Gotham Partners, LP, 286 F.3d 613, 618 (2d Cir. 2002); Gen. Aircraft Corp. v. Lampert, 556 F.2d 90, 95 (1st Cir. 1977).

simply the Schedule 13D filer's own plans) can permit select others to trade on it.

Group Exemptions

The SEC has proposed two new exemptions from group status: first, to mitigate the risk that the expanded "group" definition would chill otherwise appropriate and beneficial shareholder engagement, a proposed new exemption for certain concerted actions among shareholders that do not have the purpose or effect of changing or influencing control of the issuer; and second, a proposed new exemption for agreements governing derivative securities entered into in the ordinary course of business and without a control purpose or effect.

Exemption for Certain Concerted Actions

Proposed Rule 13d-6(c) provides that two or more persons may engage with other shareholders or the issuer without being regulated as a group, so long as:

- the communications are not undertaken with the purpose or effect of changing or influencing control of the issuer (and are not made in relation to any transaction having that purpose or effect); and
- the persons involved have independently determined to take the actions in question—they are not directly or indirectly obligated to take them (*e.g.*, pursuant to the terms of a cooperation agreement or joint voting agreement).

As examples of the types of shareholder activity that are not deemed to be undertaken to change or influence control of the issuer, the Release refers to "institutional investors or shareholder proponents communicat[ing] and consult[ing] with one another regarding an issuer's performance or certain corporate policy matters involving one or more issuers,"[10] and "engaging directly with the issuer's management or coordinating their voting of shares at the issuer's annual meeting with respect to one or more company or shareholder proposals." [11]

The Release makes clear, however, that the proposed exemption would not change the SEC's existing view that most proxy solicitations specifically calling for a change of control of an issuer, such as "a contested election of directors, a sale of the issuer or the restructuring of the issuer," [12] would have the purpose or effect of changing or influencing control.

Exemption for Certain Derivatives Agreements

Under proposed Rule 13d-6(d), parties who enter into an agreement governing a derivative security will not be deemed to have formed a group with respect to the securities underlying the derivative, provided that the agreement:

- is a bona fide purchase and sale agreement entered into in the ordinary course of business; and
- was not entered into with the purpose or effect of changing or influencing control of the issuer (or in connection with a transaction having such purpose or effect).

While the SEC explains that the exemption is designed to assist investors who enter into derivatives agreements with financial institutions that act only as a counterparty to such investors,[13] the utility of the proposed exemption is significantly limited by the exclusion of derivatives where one party may have a control purpose or effect, leaving parties to those transactions to general principles applicable to group formation, as further interpreted by the SEC in the Release. Even for those without a control purpose or

[10] The Release, pg. 95.
[11] *Id.*
[12] The Release, pg. 97 n.149.
[13] *See* the Release, pg. 96 ("investors in an equity-based derivative security may need to, in order to acquire the derivative security, enter into an agreement governing the terms of such instrument with a financial institution that, in the ordinary course of its business, acts as a counterparty to such investors. To offset any risk exposure to that derivative security, including any obligations that may arise at settlement, the financial institution may accumulate the reference equity security in a covered class and hold such reference security for the duration of the agreement.")

effect, the exemption as proposed raises a number of interpretive uncertainties that might further limit its utility, including:

- What does it mean for a derivatives transaction to be entered into in the ordinary course of business? Although, as the Release suggests, the SEC may have intended this requirement to apply only to the financial institution counterparty, this should be made explicit in the proposed rule as it would be particularly challenging to determine whether a non-financial party has entered into a derivatives agreement, especially regarding third-party equity, in the ordinary course of business. Even if so limited, however, the ordinary course requirement would create needless uncertainty for the financial institution counterparty. Financial institutions often enter into customized (and sometimes novel) derivatives transactions. In short, the control purpose or effect condition makes the ordinary course condition unnecessary.[14]
- Why does the exemption limit itself to purchase and sale agreements setting forth the terms of the derivative? While some derivatives may be documented in that fashion, the phrasing of the exemption raises unnecessary interpretive questions based on the characterization of the agreement setting forth the derivative. And the SEC has not offered guidance as to when such an agreement might not be bona fide, raising additional uncertainty for those seeking to rely on the exemption.

At minimum, for an exemption from group characterization for derivative transactions to have a meaningful benefit for financial institution counterparties, the exemption should be available where the non-financial institution party represents to the financial institution party that it does not have the proscribed intent. This simpler and more clear exemption would permit the financial institution to provide services to a segment of its clients (*i.e.*, Passive Investors) without the uncertainty of group characterization and the possibility that its unrelated activities, as market maker or otherwise, might lead to significant Section 16 short-swing profit exposure. And the passive non-financial institution party would either have beneficial ownership of the securities underlying the derivative transaction applying general principles (*e.g.*, a derivatives transaction that could be physically settled within 60 days) or would not (*e.g.*, a cash settled only derivative that does not convey beneficial ownership under general principles), thereby fulfilling the SEC's stated objectives of providing the market timely information where appropriate.

Implications under Section 16

Section 16 of the Exchange Act requires a beneficial owner of more than 10% of a covered class,[15] as well as officers and directors of an issuer of such securities, to disclose information about their securities transactions and holdings in such securities. For purposes of Section 16, "10% holders" are identified as persons deemed "beneficial owners" of more than 10% of the issuer's securities as defined under Section 13(d) and the rules thereunder.[16] Accordingly, if a person is a 10% beneficial owner as determined pursuant to Section 13(d) and the rules thereunder, the person is also deemed a 10% holder under Section 16. This includes persons who are deemed to be 10% holders for Section 16 purposes by virtue of being a member of a "group" that beneficially owns more than 10% of a covered class of securities for Section 13(d) purposes. Given this alignment, the SEC's proposed amendments to Rules 13d-3, 13d-5 and 13d-6 would

[14] *See* In the Matter of Perry Corp., Release No. 34-60351 (July 21, 2009), in which the SEC determined that Schedule 13G was unavailable to a filer that used a derivative as part of a merger arbitrage strategy because it was not in the ordinary course of business.

[15] Section 16 does not apply to the securities of a foreign private issuer, as defined in Rule 3b-4 under the Exchange Act.

[16] *See* Rule 16a-1(a)(1) under the Exchange Act.

directly impact the 10% holder analysis for Section 16 reporting purposes.

The Release argues that because the 10% holder reporting requirement under Section 16 has the same purpose as Regulation 13D-G, which is to identify persons who can influence or control the issuer as the result of equity ownership, the SEC will apply the standards of Section 13(d) and the rules thereunder, as proposed to be amended, to identify 10% holders for Section 16 purposes.

Changes relating to Cash-Settled Derivatives

Typical cash-settled only derivatives do not constitute beneficial ownership under existing general principles because the long party to the derivative does not obtain, by virtue of that derivative, any power to vote or dispose of the referenced equity securities or the right to acquire at any time in the future the actual securities due to the cash-settled only nature of the transaction. The holder is entitled only to economic exposure with respect to the reference security.

Proposed Rule 13d-3(e), however, would deem holders of certain cash-settled derivative securities to be the beneficial owners of the reference securities, regardless of whether the holder has the power to vote or dispose of, or direct the voting or disposition of, the underlying security or to acquire the referenced security in the future pursuant to the derivative.

Specifically, proposed Rule 13d-3(e)(1) would provide that a holder of a cash-settled only derivative security is deemed the beneficial owner of equity securities in the covered class referenced by the derivative security if such person holds the derivative security with the purpose or effect of changing or influencing the control of the issuer of such class of equity securities, or in connection with or as a participant in any transaction having such purpose or effect. Under the proposal, the number of shares beneficially owned would potentially change on a daily basis under a complicated delta-based formula.[17]

In the Release, the SEC notes its view that the persons who acquire and hold cash-settled derivative positions with the purpose or effect of changing or influencing control of the issuer may seek to use their position to influence the voting, acquisition or disposition of any shares the financial institution counterparty may have acquired as its hedge, whether directly or indirectly, and the derivative holder's counterparty might have an economic incentive for voting in accordance with the preference of the derivative holder—or, alternatively, refraining from voting and reducing the number of shares needed to accomplish the holder's objective. Furthermore, the SEC asserted that holders could be in a position to acquire any reference securities that the financial institution counterparty may acquire as part of its hedging activities.

Importantly, the scope of this new proposed rule does not include security-based swaps since the SEC is limited in its authority to alone deem beneficial ownership due to a security-based swap position.[18] The SEC also noted in the Release that security-based swaps meeting certain (often lower) thresholds would be required to be disclosed under a new regime the SEC has separately proposed.[19]

Under current law, parties to cash-settled derivative transactions need to carefully analyze those transactions to determine whether the long party has

[17] To calculate the number of shares based on a cash-settled only derivative security that would be deemed to be beneficially owned, the person would need to calculate the greater of (i) the product obtained by multiplying (a) the number of reference securities, by (b) the delta of the derivative security and (ii) the number obtained by (x) dividing the notional amount of the derivative security by the most recent closing market price of the reference equity security, and then (y) multiplying such quotient by the delta of the derivative security. For these purposes, the "delta" is the ratio that is obtained by comparing (A) the change in value of the derivative security to (B) the change in the value of the reference equity security. If a derivative security does not have a fixed delta, the delta needs to be calculated on a daily basis.

[18] *See* the Release, pg. 65 n.110, and Section 13(o) of the Exchange Act.

[19] *See* SEC Release No. 34-93784 (Dec. 15, 2021), available at https://www.sec.gov/rules/proposed/2021/34-93784.pdf.

beneficial ownership by virtue of, for example, (i) it having the power to vote or dispose of, or direct the voting or disposition of, the underlying securities, (ii) it having the right to acquire the underlying securities, (iii) the transaction being viewed as a scheme to evade under Rule 13d-3(b), or (iv) the parties to the derivative transaction acting as a group. The SEC acknowledges that these general principles might cause a long party to a cash-settled only derivative to have beneficial ownership directly or by virtue of being part of a group, but proposes to fill a perceived gap, presumably existing because these other analyses are facts and circumstances based. Thus the SEC is requiring all long holders of cash-settled only derivatives who otherwise have a control purpose or effect to view themselves as beneficial owners based on these perceived abuses by a subset of the market rather than addressing any gaps through interpretations of existing rules to distinguish between circumstances where the long party to a cash-settled only derivative has beneficial ownership under these general principles and where the long party simply has economic exposure (and thus not true beneficial ownership).

If adopted, this proposal raises a number of significant questions for users of cash-settled only derivatives who otherwise have a control purpose or effect, including:

- Because as noted above beneficial ownership under Section 13(d) is used also for determining insider status under Section 16 for 10% holders, will long parties shift to security-based swaps, which are excluded from the beneficial ownership calculation, and disclose those positions instead under the alternative regime for security-based swaps being proposed by the SEC?
- Will long parties have the sophistication to measure on a daily basis the change in delta (which is more relevant to the party hedging the transaction than the long party) and the operational capability to file regular amendments to their Schedule 13Ds by virtue of their deemed beneficial ownership changing potentially on a daily basis? Even if the long parties could do this, will the market understand and benefit from these frequent amendments?
- Will those who use economic gains on previously established cash-settled only derivatives to help fund or offset the costs of seeking positive changes to companies with entrenched management still have the needed incentives to take steps to benefit shareholders overall through their activities?

Item 6 and Item 7 Reporting

The SEC has proposed amendments to Item 6 of Schedule 13D, which includes contracts, arrangements, understandings or relationships with respect to securities of the issuer subject to the report, to clarify that the disclosure is required of *all* derivative securities that use the registered class of equity security as a reference security, including security-based swaps and other cash-settled derivative securities. For many market participants, this clarification will not result in a change from their existing disclosure posture, but for others who had read Item 6 more narrowly, disclosures of these derivative securities would clearly be required if the proposal is adopted.

While the scope of Item 7, which requires the filer to include as exhibits certain contracts disclosed in Item 6, is not being proposed to be changed, the SEC has requested comment on whether Item 7 should be revised to explicitly require the filing of cash-settled derivative instruments as an exhibit and whether Item 6 should be further revised to require a full description of any cash-settled derivative's material terms, either of which would result in a more substantial departure from current market practice.

Key Takeaways and Implications

- The SEC's proposed amendments meaningfully shorten the filing deadlines for both Schedule 13D and Schedule 13G filers. While the impact on activist investors will be the most high profile change, Schedule 13G filers, particularly QIIs, will need to be mindful of tighter deadlines and more frequent testing of triggering events for Schedule 13G reporting.
- For activist and other engaged investors, the shortened Schedule 13D filing window will reduce the number of shares that can be accumulated before a position is announced. Proposed changes to treatment of cash-settled derivatives under Schedule 13D (along with the separately proposed reporting regime for security-based swaps) likely will also reduce the economic exposure to an issuer that these investors can obtain before announcing their position. This will increase acquisition costs and reduce returns, which may make certain campaigns financially unattractive, shift focus to larger cap issuers, and reduce overall levels of activism (though we expect shareholder activism will remain robust). This may also have the (perhaps unintended) consequence of disproportionately reducing the returns of activists who have the strongest track record in improving stock price performance, as these are the investors whose presence, once announced, tends to lead to the most significant increases in market price.
- The proposed amendments significantly expand the concept of "beneficial ownership" (namely by capturing certain cash-settled derivatives where there is a control intent) and the scenarios in which two or more persons are deemed to have formed a "group". New exemptions intended to soften the impact of this expansion are fairly narrow and raise their own interpretive questions. These developments could have a number of unintended consequences under a variety of instruments and other agreements (from poison pills to long-term incentive plans, employment agreements, and debt instruments) that incorporate SEC rules and interpretations regarding beneficial ownership and group status. Issuers and investors alike will need to carefully consider the potential impact of these changes on such arrangements that are in effect today and when they are adopted going forward.
- The SEC's proposed exemption from group characterization for certain derivatives entered into without a control intent likely will be difficult to administer in practice and, as proposed, is unlikely to provide the certainty intended by the SEC.
- The proposed amendment to Rules 13d-3, 13d-5 and 13d-6 impact the calculation of who is a 10% beneficial owner for Section 16 purposes, which will increase the number of persons who are required to make Section 16 filings and who are subject to short-swing profit liability and short sale prohibitions under Section 16(b) and Section 16(c).

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APPENDIX A

Issue	*Current Schedule 13D*	*Proposed New Schedule 13D*	*Current Schedule 13G*	*Proposed New Schedule 13G*
Initial Filing Deadline	Within 10 days after acquiring beneficial ownership of more than 5% or losing eligibility to file on Schedule 13G. Rules 13d-1(a), (e), (f) and (g).	Within five days after acquiring beneficial ownership of more than 5% or losing eligibility to file on Schedule 13G. Rules 13d-1(a), (e), (f) and (g).	QIIs & Exempt Investors: 45 days after calendar year-end in which beneficial ownership exceeds 5%. Rules 13d-1(b) and (d). Passive Investors: Within 10 days after acquiring beneficial ownership of more than 5%. Rule 13d-1(c).	QIIs & Exempt Investors: Five business days after month-end in which beneficial ownership exceeds 5%. Rules 13d-1(b) and (d). Passive Investors: Within five days after acquiring beneficial ownership of more than 5%. Rule 13d-1(c).
Amendment Triggering Event	Material change in the facts set forth in the previous Schedule 13D. Rule 13d-2(a).	No amendment proposed.	All Schedule 13G Filers: Any change in the information previously reported on Schedule 13G. Rule 13d- 2(b). QII & Passive Investors: Upon exceeding 10% beneficial ownership or a 5% increase or decrease in beneficial ownership. Rules 13d-2(c) and (d).	All Schedule 13G Filers: Material change in the information previously reported on Schedule 13G. Rule13d- 2(b). QII & Passive Investors: No amendment proposed.
Amendment Filing Deadline	Promptly after the triggering event. Rule 13d-2(a).	Within one business day after the triggering event. Rule 13d-2(a).	All Schedule 13G Filers: 45 days after calendar year-end in which any change occurred. Rule 13d-2(b).	All Schedule 13G Filers: Five business days after month-end in which a material change occurred. Rule 13d-2(b).

			QIIs: 10 days after month-end in which beneficial ownership exceeded 10% or there was, as of the month-end, a 5% increase or decrease in beneficial ownership. Rule 13d-2(c). Passive Investors: Promptly after exceeding 10% beneficial ownership or a 5% increase or decrease in beneficial ownership. Rule 13d-2(d)	QIIs: Five days after exceeding 10% beneficial ownership or a 5% increase or decrease in beneficial ownership. Rule 13d-2(c). Passive Investors: One business day after exceeding 10% beneficial ownership or a 5% increase or decrease in beneficial ownership. Rule 13d-2(d).
Filing "Cut- Off" Time	5:30 p.m., Eastern time. Rule 13(a)(2) of Regulation S-T.	10 p.m., Eastern time. Rule 13(a)(4) of Regulation S-T.	All Schedule 13G Filers: 5:30 p.m., Eastern time. Rule 13(a)(2) of Regulation S-T.	All Schedule 13G Filers: 10 p.m., Eastern time. Rule 13(a)(4) of Regulation S-T.