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SEC Proposes Rules to Update and Revise Beneficial Ownership Reporting

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Securities and Capital Markets / Mergers & Acquisitions

On February 10, 2022, the Securities & Exchange Commission ("SEC") published proposed rules to update and revise the beneficial ownership reporting requirements applicable to persons who own greater than 5% of a class of public company stock.

The four principal changes to the rules would:

i. accelerate the deadlines for initial filings and amendments to beneficial ownership reports on Schedules 13D and 13G;

ii. expand the definition of beneficial ownership to deem holders of certain cash-settled derivatives as beneficial owners;

iii. clarify the definition of "group" and group activities that trigger beneficial ownership reporting and provide exemptions from beneficial ownership reporting for certain communications and activities that do not have the purpose or effect of influencing control of a company; and

iv. require that Schedules 13D and 13G filings use structured, machine readable data.

The proposed changes to the filing deadlines would be the first amendments to such deadlines in over 40 years.

For companies that are the targets of activist investors, the proposed rules could facilitate companies' ability to identify accumulations earlier and preemptively engage with their investor base to address stockholder concerns, while also providing the markets with greater transparency around certain stock accumulations and ownership.

For reporting persons that are required to file beneficial ownership reports, the proposed rules' shortened reporting deadlines and inclusion of certain cash-settled derivatives (other than cash-settled security-based swaps, which are excluded from the proposed expansion of beneficial ownership reporting) that may be considered beneficially owned could necessitate an evaluation by filers of their compliance protocols and procedures for gathering and accurately and timely reporting information on Schedules 13D and 13G.

1 Background

The beneficial ownership reporting requirements were introduced in 1968 and were designed to be an early warning system that could alert investors and public companies of persons who had acquired a substantial equity interest in a public company over a short period of time. Generally, the reporting rules require investors who own greater than 5% of a public company's equity securities to disclose their ownership positions by publicly filing beneficial ownership reports on Schedule 13D or, if eligible, on the shorter form Schedule 13G.

In discussing the proposed rule amendments, SEC Chairman Gary Gensler stated that the proposed rules would address decades-long criticism of the beneficial ownership reporting rules and filing deadlines, which have resulted in certain informational asymmetries that may impact share prices and potentially harm investors.

The Commission indicates that the proposed rules seek to address criticisms of the 10-day filing deadline for initial beneficial ownership reports, concerns by target companies about undisclosed hedge fund activism and "group" behavior that may not be captured timely or accurately under current beneficial ownership reporting rules, and concerns about the unknown degree of potential influence that may be exercised by holders of certain cash-settled derivatives.

2 Proposed Amendments

Filing Deadlines

Schedule 13D

- The proposed amendments would shorten the initial filing deadline for a Schedule 13D to five days from 10 days after acquiring greater than 5% of a class of a public company's equity securities. Amendments to 13D filings would be required to be filed within one business day after the triggering event rather than the existing requirement to amend "promptly," which has not previously been defined under the rules.

Schedule 13G

- *Passive investors* filing pursuant to Section 13d-1(c) of the Securities Exchange Act of 1934 (the "Exchange Act"). The proposed amendments would shorten the initial filing deadline to five days from 10 days after acquiring greater than 5% of a class of a public company's equity securities.
- *Qualified Institutional Investors ("QIIs")* filing pursuant to Section 13d-1(b) and *Exempt investors* filing pursuant to Section 13d-1(d) of the Exchange Act. The proposed amendments would shorten the initial filing deadline to five business days after the end of the month in which the ownership interest was acquired from the current deadline of 45 days after the end of the calendar year in which the interest was acquired.

  The general amendment trigger for all 13G filers would be changed to "material changes" from the current requirement for "any" change to the information previously reported. Notably, all 13G filers would be required to amend five business days after the

month-end in which the material change occurred instead of the current annual amendment requirement to amend by February 14th.

Passive Investors would have one business day to amend after exceeding a 10% ownership interest, or a 5% increase or decrease in such ownership thereafter, instead of the existing requirement for passive investors to amend "promptly". QIIs would have five days to amend after exceeding a 10% ownership interest, or a 5% increase or decrease in such ownership thereafter, instead of the current requirement for QIIs to amend 10 days after month-end.

Proposed Rule Accommodation

To accommodate the shortened filing timelines, the proposed amendments would include extensions of the filing cut-off times for all 13D and 13G filings from 5:30 p.m. Eastern Time to 10:00 p.m. Eastern time.

Expanded Definition of Beneficial Ownership for Certain Cash-Settled Derivatives; Clarification of Schedule 13D Item 6 Derivatives Disclosure: The proposal seeks to broaden the definition of beneficial ownership to include holdings of certain cash-settled derivative securities if the holder holds the derivative security with the purpose or effect of changing or influencing control of the issuer of the underlying security. This provision expressly excludes cash-settled security-based swaps ("equity derivatives"). Although holders of the cash-settled derivatives that would be subject to the proposal would not have express legal power under the derivative instruments to vote or dispose of the underlying securities, the proposal notes that such persons may nonetheless possess economic power that could be used to impact the stock price of the underlying security or otherwise influence control of the company (although the proposal is unclear on how a cash-settled derivative that is not an equity derivative could be used in this manner). The proposal acknowledges the challenge of defining whether holdings of cash-settled derivatives that are not equity derivatives could be used to influence corporate control, and seeks comments on whether any final rules should provide guidance regarding a control purpose or effect in the context of cash-settled derivative holdings. In addition, the Commission's proposal implies that the proposed rules would clarify that disclosure about derivatives in Item 6 of Schedule 13D is required and would remove any implication that a person is not required to disclose interests in *all* derivative contracts and securities that use an issuer's equity security as a reference security. This proposed disclosure requirement would represent a change in current practice, which may engender challenges to this aspect of the proposed rule amendments.

Clarifications on Group Status: The SEC's proposed amendments would clarify further when two or more persons will be deemed to have formed a "group" for purposes of beneficial ownership reporting. First, if a person discloses information to another person about an upcoming Schedule 13D filing and that person subsequently purchases securities in the covered class for which the Schedule 13D will be filed, then such persons would be considered to be members of a "group." Second, the proposed rule amendments would add a new exemption to allow investors to communicate and consult with each other, jointly engage with

issuers, and execute certain transactions without being considered a group *provided* such activities are done without the purpose or effect of influencing control of the issuer.

New Structured Data Requirements: Finally, the SEC's proposed amendments include a requirement for 13D and 13G filings to be formatted using a structured, machine-readable data language, which would facilitate investors' and markets' access and ability to analyze the information disclosed in the reports.

In her dissenting statement, Commissioner Hester Pierce articulated an opposing view of the need for and impact of the aforementioned proposed rule changes.

3 Key Takeaways

Key implications of the proposed rules if adopted and possible areas for comment are:

- Enhanced Transparency and Timely Notice of Changes in Beneficial Ownership. By shortening initial and amendment filing deadlines, the proposed amendments may provide companies and the markets with greater transparency, while at the same time reducing the ability of investors to maintain the confidentiality of their trading strategies. The proposed rules may also better equip a company to respond earlier to activity in the ownership of its stock and allow it to engage preemptively with its investor base earlier, for example, when faced with stockholder concerns.
- Impact on the Use of Certain Cash-settled Derivative Products and Clarification of Derivatives Disclosure in Schedule 13D. The potential impact of the proposal's expansion of the definition of beneficial ownership to capture holders of certain cash-settled derivatives is unclear but is posited in the proposal as a means by which companies could potentially assess the direct *and indirect* owners and persons that could assert influence or control. Additionally, the proposed rule changes that would require disclosure in Schedule 13D of all derivatives that use the issuer's equity security as a reference security would constitute a change in market practice.
- Enhanced Compliance Protocols Around Beneficial Ownership Filings & "Group" Activity. If adopted, the shortened timelines in the proposed amendments, as well as new clarifications on group status and requirements for filing formats, will likely be accompanied with greater SEC scrutiny of filer compliance with any new beneficial ownership rules. Schedule 13D and 13G filers should begin to assess and consider in advance of any rule adoption, their policies and procedures around reporting and discern how they would comply with possible new reporting requirements. Such an assessment might include an evaluation of compliance protocols governing their engagement and communications with other shareholders of an issuer in advance of an investment in the issuer's securities, and their filing and disclosure timelines and procedures.

  Comments on the proposal are due by April 11, 2022 (which is 60 days after the issuance of the release by the Commission) or 30 days after publication of the release in the Federal Register, whichever is later.

If you have any questions concerning the material discussed in this client alert, including the process of submitting comments on the proposed release, please contact the following members of our Securities and Capital Markets and Mergers & Acquisition practices:

Securities and Capital Markets

Bruce Bennett	+1 212 841 1060	bbennett@cov.com
Kerry Burke	+1 202 662 5297	kburke@cov.com
Mellissa Campbell Duru	+1 202 662 5659	mduru@cov.com
David Engvall	+1 202 662 5307	dengvall@cov.com
Matt Franker	+1 202 662 5895	mfranker@cov.com
Sarah Griffiths	+1 212 841 1013	sgriffiths@cov.com
David Martin	+1 202 662 5128	dmartin@cov.com
Brian Rosenzweig	+1 212 841 1108	brosenzweig@cov.com
Kevin Banifatemi	+1 212 841 1011	kbanifatemi@cov.com

Mergers & Acquisitions

Leonard Chazen	+1 212 841 1096	lchazen@cov.com
Catherine Dargan	+1 202 662 5567	cdargan@cov.com
Stephen Infante	+1 212 841 1039	sinfante@cov.com
J. D. Weinberg	+1 212 841 1037	jweinberg@cov.com

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