

Proposed Amendments Schedule 13D - Part Two

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As noted in our related blog post, the Security and Exchange Commission (the “SEC”) has proposed amendments (the “Amendment”) to Schedules 13D and 13G of the Securities Exchange Act of 1934, to modernize its reporting rules and improve the speed and substance of the information made available to the public. As of this post, rule changes have not yet been adopted, but the SEC’s stated date for final action, April 2023, is fast approaching. So, we thought it would be good to refresh memories on the proposals and see if there are any takeaways for current practice.

Takeaways for Current Practice: First, while one may reasonably debate the proposed inclusion of cash settled derivatives in determining a person’s ownership level, we believe it is worth considering the disclosure of derivative instruments (including cash-settled, security-based swaps and other derivatives settled exclusively in cash) which use the issuer’s securities as a reference security under current Item 6 of Schedule 13D. Currently, Item 6 is broadly written and could reasonably be read to include this type of disclosure.

Second, we believe that the discussion of the concept of a “group” in the Amendment is useful because it makes it clear that investors should be permitted to communicate and consult with each other, engage with issuers, and execute certain transactions without being treated as a “group.” Of course, the trick is in trying to discern which activities do or do not cross the line.

Third, the Amendment’s view that an explicit agreement is not needed to form a group, aligns with the approach taken by some courts, and it is a good reminder that substance will likely trump form. So, if you are coordinating to achieve a control purpose, whether or not pursuant to an express agreement, you are likely a group, and should disclose your group status.

Refresher on Statutory Requirements: The Securities Exchange Act of 1934 (commonly called the “Exchange Act” or the “1934 Act”) is a wide-ranging law that regulates secondary trading of securities in the U.S., namely those transactions which occur after an initial offering and most often between non-issuing parties. Section 13 of the Exchange Act, the section of the proposed Amendment, regulates public company reporting requirements for their owners (and those with voting and/or investment control and authority, collectively the “Beneficial Owners” as further defined in

Rule 13d-3 of the Exchange Act). Included in those reporting requirements are obligations for Beneficial Owners to file Schedules 13D and 13G reports when and if they gain significantly large ownership positions in a single security.

Most Beneficial Owners must report to the SEC, using a Schedule 13D, when they acquire more than 5% in a publically traded security or sufficiently increase their voting authority in that security after having crossed the 5% threshold. The intent of the rule is to provide the marketplace with important investment information, namely that some of the publicly traded company's shareholders are positioned to make changes in the control of the company and/or for a possible corporate takeover. Beneficial Owners who directly or indirectly reach the 5% threshold typically must complete a Schedule 13D to report key relevant information to the public including: (i) the name of the public security held, (ii) information about the Beneficial Owner that has acquired the large stake (including the name, address, and citizenship or place of organization of each), (iii) the source of the funds for that acquisition, (iv) the intent in taking such a large stake in the company, (v) the exact number and % of shares held, (vi) any agreements, arrangements or other terms connected to the acquisition (including whether voting and investment power is held solely by the reporting Beneficial Owner or shared with others), and (vii) documents supporting the reported information (including a list of any transactions in the securities over the last 60 days). The current Schedule 13D deadlines, typically give investors 10 calendar days to make their filings and they are required to promptly file amendments for all material changes.

Some Beneficial Owners that would otherwise be required to file a full Schedule 13D, meet requirements which indicate they do not intend to exercise control over the security, despite their 5% or greater holding and may instead file a Schedule 13G. The Schedule 13G is a shorter, abbreviated, less intrusive and less burdensome disclosure than the Schedule 13D. Beneficial Owners, such as Exempt Investors, Qualified Institutional Investors or Passive Investors (as further defined in Rule 13(d)-1 of the Exchange Act) who do not intend to exercise control over the publicly trade security, despite their 5% or larger holding may qualify for the relevant exemptions to file only the Schedule 13G. In addition, to the lower and less intrusive disclosure requirements of the Schedule 13G, its deadlines for Qualified Institutions and Exempt Investors (although not for Passive Investors) are far more generous than the Schedule 13D requirements, with most filings due annually, within 45 days of the end of the calendar year in which they exceed the 5% threshold.

As detailed in a second Foley post (found [here](#)) the Amendment will significantly shorten filing deadlines for Beneficial Owners. Additionally, as further described here, the new SEC Amendment expands what instruments count toward the 5% trigger necessitating a need to file a Schedule 13D or 13G, and adjusts the definition of a "group" under Section 13 of the Exchange Act.

Treatment of Cash Settled Derivatives: Under the current Rule 13d, cash-settled derivatives are not treated as counting toward a Beneficial Owner's 5% threshold for purposes of Schedule 13D. This approach is based on the fact that holders of a cash-settled derivative do not have a right to acquire or vote the underlying shares, and without voting or dispositive power over the underlying shares there is no beneficial ownership to report. Options, warrants or a convertible security, on the other hand, do have a direct right to either acquire and/or vote the shares held, hence the SEC has treated those as counting toward the 5% Beneficial Owner threshold.

Under a portion of the proposed Amendment (specifically paragraph (e) of Rule 13d-3), however, cash-settled derivatives, acquired with the intent to control, will be counted toward the Schedule 13D threshold. As proposed, the SEC would count the beneficial ownership status of the referenced shares of the cash-settled derivatives (other than security-based swaps) toward beneficial ownership

for Section 13D reporting purposes. The SEC explains that although cash settlement derivatives do not have direct ownership or voting rights, there are a myriad of instances where such derivative holders have and do influence corporate control and thus directly implicate the policies underlying Section 13(d) of the Exchange Act. This change would apply only to those Beneficial Owners who may have an intent to control and thus does not apply to Beneficial Owners that qualify to file Schedule 13Gs.

Paragraph (e), as proposed, provides two detailed calculations (the larger of which would apply) for determining the number of equity securities that a holder of a cash-settled derivative will be deemed to beneficially own. In addition, the proposed Amendment includes edits to Item 6 of Schedule 13D to clarify that Beneficial Owners would be required to disclose all derivative instruments (including cash-settled, security-based swaps and other derivatives settled exclusively in cash) which use the issuer's securities as a reference security.

Definition of Group: The proposed Amendment adjusts the definition of a “group” under Section 13 of the Exchange Act.

Currently under Regulation 13D-G when investors form a “group,” the group is considered the Beneficial Owner of all the securities owned by the group's members. In effect, the full group's percentage ownership is counted toward each individual group member's Beneficial Ownership. The existing rule states “[w]hen two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer, the group formed thereby shall be deemed to have acquired beneficial ownership, for purposes of sections 13(d) and (g) of the Act, as of the date of such agreement, of all equity securities of that issuer beneficially owned by any such persons.”

Precedent has codified that in order for there to be a group, by definition under the rule, there must be an agreement between the parties to act together. However, the Amendment seeks to eliminate the need for an explicit agreement for a group to be formed. The Amendment instead states that a “group” need **not** have an explicit agreement to act together but may qualify as a group if they in effect have acted together. The proposed Amendment describes as an example of a group, a “wolf-pack” (or “tipper – tippee”) behavior in which one equity holder unilaterally decides to share information, in advance, that it will soon be filing in a Schedule 13D, hoping to provoke or inspire specific other persons to purchase the securities based on that information. In such an instance, under the proposed Amendment, the two parties would be treated as a group, despite there being no specific or articulated agreement.

The Amendments also provides new exemptions to the definition of a group. The exemptions permit investors to communicate and consult with each other, engage with issuers, and execute certain transactions without being treated as a “group.” One proposed exemption addresses instances (i) where the communication will not lead to a change or influence of control over the issuer and (ii) where the parties are not obligated (directly or indirectly) to take the action. A second proposed exemption addresses financial institutions acting as derivatives counterparties, and provides that two or more persons will not be deemed to have formed a group solely by virtue of their entrance into an agreement governing the terms of a derivative security. This exemption would only be available if part of the ordinary course of business and again not intended or resulting in a changing or influencing control over the issuer.

As a whole, the Amendment's new proposed definition of group and the new proposed exemptions reflect the SEC's interest in notifying the public of investors poised to make changes of control and

carves out exemptions for those not participating in such investor activism.

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