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SHAREHOLDER ENGAGEMENT BY INVESTORS MAY TRIGGER REQUIREMENT TO CONVERT FROM SCHEDULE 13G TO 13D

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WHAT HAPPENED

The SEC staff recently modified guidance indicating when “shareholder engagement” by an investor holding more than 5% of the stock of a public company constitutes “influencing control” that requires reporting on a long-form Schedule 13D instead of a short-form Schedule 13G.

According to the new guidance (CDI 103.12), an investor that only discusses how its views on a particular topic may inform its voting decisions would not be disqualified from using Schedule 13G. However, going beyond that and exerting pressure on management to implement specific measures or policy changes could constitute “influencing” control and require reporting on Schedule 13D.

TAKEAWAYS

Traditional (non-activist) institutional investors may shift away from explicit calls for policy changes or specific actions in discussions with public companies to avoid being viewed as exerting pressure. One prominent institutional investor now highlights its role as a “passive” investor at the start of each engagement. Some may curtail their willingness to communicate their voting plans or decline invitations to meet with management.

Companies should consider seeking opportunities to engage with investors outside the shareholder meeting calendar, when they may feel less risk of being viewed as exerting control. For example, an investor may be willing to share its views on potential governance proposals when responding to an inquiry from a company – so long as it does not signal that its vote would be conditioned on the company’s action. However, other investors may refrain from engagement absent further SEC guidance.

As a result, companies may need to look to additional sources of guidance on investor feedback. In the case of larger investors, companies may be able to discern voting preferences by tracking their public statements and published voting policies. Companies may also consider placing greater weight on other governance resources, such as proxy advisor voting policy guidelines as well as proxy solicitors or advisors.

In addition, companies should evaluate their communication strategies and consider whether to improve or expand disclosures in their proxy statements or supplemental materials on key topics of investor interest.

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ELIGIBILITY TO USE SCHEDULE 13G

Section 13 of the Securities Exchange Act of 1934, as amended, generally requires the filing of a detailed report on Schedule 13D within five business days by anyone who acquires more than 5% beneficial ownership, or from the date of losing eligibility to file on Schedule 13G.

Institutional investors generally rely on an exception allowing reporting on Schedule 13G instead of 13D, based on their eligibility as one of three types of investors:

- Qualified institutional investors: specified types of institutional investors who acquired or hold shares in the ordinary course of business without the purpose or effect of changing or influencing control of the company.
- Passive investors: persons who have only an investment interest in the company, have not acquired the shares to effect a possible change of control, and who are not a direct or indirect beneficial owner of 20% or more.
- Exempt investors: persons who beneficially owned more than 5% at the time the company became subject to SEC rules, such as with an IPO, or who acquired less than 2% during the preceding 12 months.

Each of the first two categories require that the investor have not acquired the shares with the purpose or effect of changing or influencing control of the company.

For more information, see our October 12, 2023 post entitled Major changes to 13D-13G reporting adopted by SEC.

UYEDA QUESTIONS 13G ELIGIBILITY OF ASSET MANAGERS TO ENGAGE AND VOTE AGAINST DIRECTORS ON ESG ISSUES

Acting Commissioner Uyeda foreshadowed the new guidance in his Remarks at the 2022 Cato Summit on Financial Regulation, where he questioned the eligibility of asset managers to engage with public companies and vote against directors on ESG matters while continuing to report on Schedule 13G. He stated:

"The second condition for Schedule 13G eligibility requires that the asset manager must not have control intent with respect to the company. With respect to stewardship, does an asset manager truly lack control intent? . . . If an asset manager (1) develops ESG policies, (2) meets with companies to discuss how they are not following such policies, and (3) then votes against directors because the company's ESG practices do not match the asset manager's policies, has that asset manager done more than simply engage?

* * *

"A company's ESG practices can include, among other things, its ESG strategy and goals, the timeline on which to execute, how much resources to dedicate to achieving its goals, and how much voluntary disclosure it provides with respect to the foregoing. All of these activities might be reasonably considered to be part of the "management and policies" of a company. A company's board, and particularly the members on a committee overseeing ESG matters, may have the power to direct or cause the direction of the company's ESG practices. So can an asset manager's stewardship and engagement activities – with the implicit threat of voting against a director standing for re-election – be described as having the purpose or effect of changing or influencing control of the company? In my view, that is an open question."

NEW SEC GUIDANCE ON "CHANGING OR INFLUENCING CONTROL"

According to CDI 103.12, the determination when communications with management would result in loss of eligibility to report on Schedule 13G is a facts-and-circumstances analysis. The focus is on whether the investor acquired or holds the shares with the purpose or effect of changing or influencing "control" of the company.

Considerations include:

- *Subject Matter of Engagement.* Examples of disqualifying topics include specifically calling for the sale of the company or a significant amount of assets, the restructuring of the company, or the election of director nominees other than the company's.
- *Permissible Discussions.* Discussions of particular topics with management and how the investor's views may inform its voting decisions, without more, would not be disqualifying.
- *Problematic Discussions.* Going further and exerting pressure on management to implement specific measures or policy changes may constitute "influencing" control. Examples include:
  - Recommending elimination of a staggered board, switching to a majority voting standard in uncontested director elections, eliminating a poison pill, changing executive compensation practices, or undertaking specific actions on an ESG or political policy and, as a means of

pressure, explicitly or implicitly conditioning support of director nominees on adoption of its recommendation.

- Discussing with management the investor's voting policy on a particular topic and how the company falls short and, to apply pressure on management, stating or implying that it will not support director nominees unless management makes changes to align with the investor's expectations.

RELATED PRACTICE AREAS

- Securities & Corporate Governance

MEET THE TEAM

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