ALERT MEMORANDUM

New SEC Staff Guidance on "Passive Investor" Status for Schedule 13G

February 18, 2025

Key Takeaways

- Investors, particularly large institutional investors, may take a more measured approach to shareholder engagement to avoid being characterized as a 13D filer.
- Companies may receive less pressure from large institutional investors to implement changes in response to shareholder feedback.
- Shareholder feedback may be less informative as a result of the new guidance, which may impact voting outcomes at shareholder meetings.
- Proxy advisors, smaller institutional investors, and retail investors may play a more critical role in securing a company-favorable vote with respect to critical voting matters.

Background of the Updates

On February 11, 2025, the SEC staff issued two updates to the Schedule 13D/G Compliance and Disclosure Interpretations (C&DIs).[i] The guidance revises the staff's views on activities that preclude a shareholder's eligibility to report on short-form Schedule 13G in certain circumstances.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

NEW YORK

Adam Fleisher
+1 212 225 2286
afleisher@cgsh.com

Moliang Jiang
+1 212 225 2812
mjiang@cgsh.com

Jeffrey D. Karpf
+1 212 225 2864
jkarpf@cgsh.com

Francesca L. Odell
+1 212 225 2530
flodell@cgsh.com

Johnathan Povilonis
+1 212 225 2648
jpovilonis@cgsh.com

Paul J. Shim
+1 212 225 2930
pshim@cgsh.com

Clayton I. Simmons
+1 212 225 2183
csimmons@cgsh.com

SAN FRANCISCO

J.T. Ho
+1 415 796 4495
jtho@cgsh.com

Investors that beneficially own more than five percent of an issuer's outstanding publicly traded voting equity are required to report that ownership on the long-form Schedule 13D and consequently are subject to more onerous reporting requirements, unless they are eligible for an exemption to file on Schedule 13G instead. Rule 13d-1(b) and (c) provide two exemptions, but both require that an investor must be passive – *i.e.,* not have acquired the securities with the purpose or effect of changing or influencing the control of the issuer.[ii]

The C&DIs revise Question 103.11 and create a new Question 103.12, which sets forth the SEC staff's guidance on what it means to be a passive investor.[iii] The guidance is informed by the definition of "control" under Exchange Act Rule 12b-2. "Control" here means "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." This standard, although somewhat vague, is used throughout the securities laws.[iv]

In this context, Question 103.12 reaffirms that a finding of control is a facts-and-circumstances determination, and reiterates two key factors cited in the prior guidance: (i) the subject matter of the shareholder's engagement with the issuer's management and (ii) the context in which the engagement occurs.

The prior guidance indicated that, without more, the following generally would not preclude a finding of passivity:

- engagement with an issuer's management on executive compensation or social issues or public interest issues (such as environmental policies); or
- engagement on corporate governance topics, such as removal of a staggered board, majority voting standards in director elections, and elimination of poison pill plans, if undertaken as part of a broad effort to promote the shareholder's view of good corporate governance practices for all of its portfolio companies, rather than to facilitate a specific change in control in a particular company.

The prior guidance also indicated that Schedule 13G would be unavailable if a shareholder engaged with an issuer's management on matters that specifically call for the sale of the issuer to another company, the sale of a significant amount of assets, the restructuring of the issuer, or a contested director election.

New Question 103.12 changes this terrain. The new guidance indicates that passivity may be inconsistent with a shareholder that goes beyond discussing with management its views on a particular topic and how its views may inform its voting decisions, and instead exerts pressure on management to implement specific measures or changes to a policy, such as a shareholder that:

- recommends that the issuer remove its staggered board, switch to a majority voting standard in uncontested director elections, eliminate its poison pill plan, change its executive compensation practices, or undertake specific actions on a social, environmental, or political policy and, as a means of pressuring the issuer to adopt the recommendation, explicitly or implicitly conditions its support of one or more of the issuer's director nominees at the next director election on the issuer's adoption of its recommendation; or
- discusses with management its voting policy on a particular topic and how the issuer fails to meet the shareholder's expectations on the topic, and, to apply pressure on management, states or implies during any such discussions that it will not support one or more of the issuer's director nominees at the next director election unless management makes changes to align with the shareholder's expectations.

This guidance reflects concerns expressed by now-Acting Chairman Mark T. Uyeda in a speech in 2022:

> "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?
>
> …
>
> With respect to whether an asset manager's engagement has the purpose or effect of changing or influencing "control" of the company, the SEC has provided a definition of "control" under the Securities Exchange Act, which means the power to direct or cause the direction of the management and policies of a company. 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."[v]

What this means for investors

- In light of the staff's new guidance, investors that file Schedule 13Gs may need to reconsider their interactions with issuers or risk having to complying with the more onerous reporting requirements associated with Schedule 13D filers.
- Generally, an investor that only shares its views on a particular topic and how its views may inform its voting decisions, would not be viewed as attempting to exert control.
- However, if the investor goes beyond that and asks for the implementation of specific measures or changes, that could qualify as attempting to exert control.

What this means for companies

- We may see large institutional investors substantially curtail the feedback they provide companies about their voting intentions in connection with shareholder meetings.
- We may also see some large institutional investors decline to engage with companies or provide any recommendations for improvement, which could result in negative voting outcomes for companies.
- To achieve desired voting outcomes for critical voting matters, companies may need to provide more deference to proxy advisor recommendations and guidelines and/or engage proxy advisor consulting services. Proxy advisory firms may seek more comprehensive feedback from larger institutional investors in the offseason to ensure that their guidelines accurately reflect the viewpoints of such investors. However, given existing concerns regarding proxy advisor recommendations being construed as "solicitations," and that many expect the SEC to impose more restrictions on proxy advisors, proxy advisory firms are unlikely to solicit company-specific feedback and recommendations from institutional shareholders to inform their voting recommendations.
- In critical voting situations, companies may also need to increase or enhance engagement

and solicitation efforts with respect to smaller institutional investors and retail investors.

APPENDIX

Question 103.11

Question: The Hart-Scott-Rodino ("HSR") Act provides an exemption from the HSR Act's notification and waiting period provisions if, among other things, the acquisition of securities was made "solely for the purpose of investment," with the acquiror having "no intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer." 15 U.S.C. 18a(c)(9); 16 C.F.R. 801.1(i)(1). Does the fact that a shareholder is disqualified from relying on this HSR Act exemption due to its efforts to influence management of the issuer on a particular topic, by itself, disqualify the shareholder from initially reporting, or continuing to report, beneficial ownership on Schedule 13G?

Answer: No. The inability to rely on the HSR Act exemption alone would not preclude a shareholder from filing on Schedule 13G in lieu of the Schedule 13D otherwise required. Instead, eligibility to report on Schedule 13G in reliance on Rule 13d-1(b) or Rule 13d-1(c) will depend, among other things, on whether the shareholder acquired or is holding the subject securities with the purpose or effect of changing or influencing control of the issuer. This determination is based upon all the relevant facts and circumstances and will be informed by the meaning of "control" as defined in Exchange Act Rule 12b-2. [Feb. 11, 2025] [Comparison to prior version]

Question 103.12

Question: Shareholders filing a Schedule 13G in reliance on Rule 13d-1(b) or Rule 13d-1(c) must certify that the subject securities were not acquired and are not held "for the purpose of or with the effect of changing or influencing the control of the issuer." Under what circumstances would a shareholder's engagement with an issuer's management on a particular topic cause the shareholder to hold the subject securities with a disqualifying "purpose or effect of changing or influencing control of the issuer" and, pursuant to Rule 13d-1(e), lose its eligibility to report on Schedule 13G?

Answer: The determination of whether a shareholder acquired or is holding the subject securities with a purpose or effect of "changing or influencing" control of the issuer is based on all the relevant facts and circumstances and will be informed by the meaning of "control" as defined in Exchange Act Rule 12b-2.

The subject matter of the shareholder's engagement with the issuer's management may be dispositive in making this determination. For example, Schedule 13G would be unavailable if a shareholder engages with the issuer's management to specifically call for the sale of the issuer or a significant amount of the issuer's assets, the restructuring of the issuer, or the election of director nominees other than the issuer's nominees.

In addition to the subject matter of the engagement, the context in which the engagement occurs is also highly relevant in determining whether the shareholder is holding the subject securities with a disqualifying purpose or effect of "influencing" control of the issuer. Generally, a shareholder who discusses with management its views on a particular topic and how its views may inform its voting decisions, without more, would not be disqualified from reporting on a Schedule 13G. A shareholder who goes beyond such a discussion, however, and exerts pressure on management to implement specific measures or changes to a policy may be "influencing" control over the issuer. For example, Schedule 13G may be unavailable to a shareholder who:

- recommends that the issuer remove its staggered board, switch to a majority voting standard in uncontested director elections, eliminate its poison pill plan, change its executive compensation practices, or undertake specific actions on a social, environmental, or political policy and, as a means of pressuring the issuer to adopt the recommendation, explicitly or implicitly conditions its support of one or more of the issuer's director nominees at

the next director election on the issuer's adoption of its recommendation; or

- discusses with management its voting policy on a particular topic and how the issuer fails to meet the shareholder's expectations on such topic, and, to apply pressure on management, states or implies during any such discussions that it will not support one or more of the issuer's director nominees at the next director election unless management makes changes to align with the shareholder's expectations. [Feb. 11, 2025]

…

CLEARY GOTTLIEB

[i] SEC, Compliance and Disclosure Interpretations, Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting, Question 103.11 and Question 103.12 (February 11, 2025), available here. *See* the Appendix for the full text of the C&DIs, including a link to a redline showing the changes to Question 103.11. The next day, the SEC staff issued a new Staff Legal Bulletin No. 14M, available here, which addresses an issuer's ability to exclude shareholder proposals under Exchange Act Rule 14a-8, a heavily politicized topic.

This guidance follows other recent developments in the space. In October 2023, the SEC adopted amendments to Regulation 13D-G to shorten the deadlines for Schedule 13D and 13G filings, clarify the Schedule 13D disclosure requirements with respect to derivative securities, and provide guidance on when group status exists, among other things. See SEC Release 33-11253 (Oct. 10, 2023). In September 2024, the SEC announced settled charges against 23 entities and individuals for failures to timely report information about their holdings and transactions in public company stock. See SEC Release 2024-148 SEC Release 2024-148 (Sept. 25, 2024).

[ii] A third exemption from the requirement to file on Schedule 13D, Rule 13d-1(d), allows "pre-IPO" holders (or other investors that acquired the relevant securities prior to their registration under Exchange Act Section 12) to file on Schedule 13G as long as they continue to meet certain requirements. It does not require passivity.

[iii] This guidance has been moved from Question 103.11 to new Question 103.12.

[iv] In the context of Securities Act Rule 144, for example, affiliate status, which turns on an identical definition of control, often is presumed for directors, officers and 10% shareholders. Similarly, the SEC staff has indicated that being an officer or director generally is inconsistent with passivity status for Schedule 13D purposes: "The role of officers or directors will most likely eliminate their eligibility to file on Schedule 13G pursuant to Rule 13d-1(c). Notwithstanding any specific control intent, the fact that officers and directors have the ability to directly or indirectly influence the management and policies of an issuer will generally render officers and directors unable to certify to the requirements of Rule 13d-1(c)(1)." (Question 103.04)

[v] Remarks at the 2022 Cato Summit on Financial Regulation Mark T. Uyeda Washington D.C. Nov. 17, 2022 (https://www.sec.gov/newsroom/speeches-statements/uyeda-remarks-cato-summit-financial-regulation-111722#_ftnref28) (*citations omitted*).