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Schedule 13G "Passive" Investor Status: When Being a Little Active Is Still Passive!

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In July, the Staff in the Division of Corporation Finance posted a new C&DI on Section 13(d) that provides stockholders (and issuers) with some helpful insights, and perhaps greater clarity, on when significant stockholders can engage in a dialogue with management and still remain on Schedule 13G. As many practitioners know, Schedule 13G (the "short form" for reporting beneficial ownership of equity positions of 5% or more) often requires an affirmative certification from the reporting person(s) that the securities were not acquired, and are not held, with the purpose or effect of changing or influencing control of the issuer. This is commonly referred to as the "passive" investor certification which is set forth at the end of Schedule 13G, directly above the signature line.

In short, to report beneficial ownership on Schedule 13G the reporting person(s) must be "passive" (i.e., not active) with respect to any intent or attempt to exercise control over the issuer. The only exception to this passive investor certification is for security holders who are either "grandfathered" or have acquired their securities gradually (i.e., those that acquired securities before the class of equity was registered with the SEC or have accumulated their stake slowly over time—less than 2% in any twelve-month period). See Rule 13d-1(d) and Section 13(d)(6)(B) of the Exchange Act.

Of course, the certification (when required in order to report on 13G) begs the question of whether certain activities, such as submitting a 14a-8 shareholder proposal to management, lobbying for improved corporate governance measures or even pushing for increased share buybacks or dividends would (by itself) trigger a 13G amendment obligation and thus cause the reporting person(s) to have to report their ownership on Schedule 13D (the longer, more onerous, disclosure form and reporting regime) going forward.

The new guidance makes clear that certain limited activities, such as engaging management or the board in discussions regarding specified corporate governance topics including removal of a staggered board, majority voting standards for the election of directors, and/or elimination of poison pill rights plans, alone, would not cause the loss of 13G eligibility, so long as the purpose of the discussions is to improve corporate governance generally.

In a similar vein, discussions regarding executive compensation or matters of social or public interest (i.e., environmental policies) would not, by itself, give rise to the loss of 13G eligibility. The Staff further clarified that the threshold test for determining when a notice is required under the Hart-Scott-Rodino Act would not, by itself, be determinative as to when a beneficial owner is no longer eligible to report on Schedule 13G.

In providing this helpful guidance, the Staff emphasized that the ability to continue reporting on Schedule 13G will be determined by "all relevant facts and circumstances." Noting that if the dialogue is really a precursor to facilitating a change of control transaction (e.g., pushing for a merger, removal of directors in an election contest, or sale of a significant amount of assets) then such activities would likely be deemed inconsistent with the passive investor certification required by Schedule 13G and the reporting person(s) would need to amend and report on Schedule 13D.

This guidance is a welcome ray of sunshine on the sorts of activities that will and will not preclude reporting on the short form Schedule 13G. While there may still be some room for debate on the issue, such as when a stockholder proposes the addition of an independent director, and recommends one individual in particular, we expect this guidance will result in greater uniformity among 13(d) reporting persons and more accurate and timely identification of those reporting persons who are seeking to effect control or influence over issuers.