



Proposed Rules on Disclosure of Security-Based Swap Positions

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On December 15, 2021, the Securities and Exchange Commission (“SEC”) proposed for comment new rules that would require any person or group of persons who owns security-based swap positions that exceed a specified reporting threshold amount to publicly report on a new Schedule 10B the positions and certain related information within one business day following execution of the security-based swap transaction that triggers the reporting requirement. The proposed rules would prevent investors from building significant economic positions in companies (as measured by the proposed rules) through cash-settled swaps without triggering an SEC filing. The deadline for submitting comments to the SEC is 45 days after publication of the proposed rules in the Federal Register.

High-Level Summary for Shareholder Activists

Proposed Section 10B of the Securities Exchange Act of 1934, as amended, is structured as a large trader position reporting rule that would be broadly applicable to security-based swap positions, including positions in equity-based swaps, debt-based swaps, security index-based swaps and various combinations thereof. The proposed rules would create a new reporting regime outside the current Schedule 13D reporting system that would require prompt reporting of security-based swap positions, including cash-settled swap positions, that exceed an applicable threshold amount. The applicable threshold amount that would trigger a filing would be different for positions in equity-based swaps, debt-based swaps and credit default swaps (“CDSs”).

For an equity-based swap position, the predominant form of swap position taken by shareholder activists in connection with their campaigns, a filing obligation would be triggered upon exceeding the lesser of the following two thresholds:

Notional Threshold—Upon equaling or exceeding \$300 million in notional value calculated on a gross basis; provided, however, that once the position exceeds a gross notional amount of \$150 million, the calculation would also need to include the value of all underlying securities owned by the holder and the delta-adjusted notional amount of any options, futures or other derivatives based on the same class of equity securities held by it.

Percentage Threshold—Upon the “number of shares attributable” to the position representing more than 5% of a class of equity securities; provided, however, that once this number represents

more than 2.5% of the class of equity securities, the calculation would also need to include in the numerator all underlying equity securities owned by the holder and any options, futures or other derivatives based on the same class of equity securities held by it.

After triggering the applicable threshold amount, the reporting person would be required to file, within one business day following execution of the security-based swap transaction that results in the reporting person exceeding the threshold amount, a Schedule 10B containing information regarding the reporting person, the swap position, any underlying equity securities or related securities of the company held by it and other related information.

While the Schedule 10B would provide an early warning to the company of the position, unlike the Schedule 13D, it would not specifically inform the public of the filer's investment purpose or other plans or proposals the filer may have with respect to the company.

Purpose of Proposed Rules

The proposed rules are intended to alert market participants and regulators when a person or group of persons is building a large security-based swap position, which could be "indicative of potentially fraudulent or manipulative purposes." They are also intended to alert market participants and regulators to the existence of concentrated exposures to a limited number of counterparties, thereby informing the market participants and regulators of the related risks posed by these positions. With respect to "manufactured or other opportunistic strategies" in the CDS market, the proposed rules are intended to allow counterparties to manage their risk, and provide market participants and regulators with advance notice that a person or group of persons is building a large CDS position, which could create an incentive to vote against their interests as a debt holder potentially to ensure that a credit event occurs (known as "net-short debt activism").

While the proposed rules are broadly designed to enhance transparency in the marketplace in order to improve risk management with respect to large security-based swap positions and concentrated positions of counterparties and to ultimately avoid contagion market risk resulting from a default, the rules are highly relevant to shareholder activists who are accustomed to building significant positions in companies utilizing security-based swaps, including cash-settled swaps. The proposed rules also address rumblings by companies and their advisors that shareholder activists take significant economic positions in companies in the form of cash-settled swaps in order to delay disclosure of their positions under the Schedule 13D rules.

Mechanics of Proposed Rules

General Framework

The proposed rules would require:

- any person (and any entity controlling, controlled by or under common control with such person) or group of persons,
- who through any contract, arrangement, understanding or relationship, after acquiring or selling directly or indirectly, any security-based swap,

- is directly or indirectly the owner or seller of a “Security-Based Swap Position” that exceeds the applicable “Reporting Threshold Amount,”
- to publicly file with the SEC a Schedule 10B (no later than the end of the first business day following the day of execution of the swap transaction that resulted in the swap position exceeding the threshold) containing information regarding the reporting persons, the swap position and other related information.

Similar to the Schedule 13D rules, group members would be permitted to satisfy their filing obligations with a single joint filing or by each group member making its own individual filing. The proposed rules also contain provisions intended to prevent evasion of the reporting requirements with respect to a Security-Based Swap Position through the use of a trust, proxy, power of attorney or other contract, arrangement or device.

Reportable “Security-Based Swap Positions”

The term “**Security-Based Swap Position**” means all security-based swaps based on:

1. a single security or loan, or a narrow-based security index, or any interest therein or based on the value thereof;
2. any securities issued by the same issuer of the securities, loans, or securities included in the narrow-based index (including any interest therein or based on the value thereof) described in clause (a); or
3. any narrow-based security index that includes any of those issuing entities or their securities (including any interest therein or based on the value thereof), in each case as applicable.

The layered definition of “Security-Based Swap Position” would potentially result in various combinations of equity-based swaps, debt-based swaps and security index-based swaps that would need to be reported, assuming an applicable Reporting Threshold Amount (discussed below) is met. Below is additional guidance and examples extrapolated from the SEC’s proposing release:

- If a Security-Based Swap Position is based on a single security or loan that is included in a narrow-based security index, the calculation of the Security-Based Swap Position with respect to a particular component of the index would be based on the weighting of the reference company or securities as a component of the index.

For example, assume a person holds a swap position based on a narrow-based index that includes XYZ Corp. The holder’s calculation of its Security-Based Swap Position with respect to XYZ Corp. would be based on the weighting of XYZ Corp. on the index relative to the other names comprising the index.

- With respect to security-based swaps based on equity securities, a Security-Based Swap Position would include all security-based swaps based on a single class of equity securities.

For example, assume a person holds both a physically-settled swap and a cash-settled swap that are each based on the common stock of XYZ Corp. The holder’s calculation of

its Security-Based Swap Position with respect to XYZ Corp. common stock would include both swap positions.

- A security-based swap that is based on a narrow-based security index could create two separate filing obligations. *First*, reporting would be required if the Security-Based Swap Position comprises swaps that are based on a narrow-based index that itself exceeded the applicable reporting threshold amount.

For example, if a person holds a security-based swap on a narrow-based security index comprising equity securities referencing a notional amount of \$300 million (this exceeds the applicable threshold—see discussion of thresholds below), the Security-Based Swap Position on the index itself would be \$300 million for purposes of the rules and would need to be reported.

Second, if a person holds a Security-Based Swap Position comprising security-based swaps based on a single security or loan, that calculation of the applicable reporting threshold would need to include all security-based swaps based on the single security or loan represented by the narrow-based index in an amount proportionate to the weighting of the security or loan in the index.

For example, in the example above, if one security represents 10% of the narrow-based security index, the holder would not just have a reportable Security-Based Swap Position on the index itself (of \$300 million) but would also have a Security-Based Swap Position of \$30 million attributable to the single security and this position would need to be aggregated with any other security-based swaps that are based on the same single security in calculating the entire Security-Based Swap Position with respect to the single security.¹

- The reporting requirements would apply to a person's gross position in a security-based swap (meaning the sum of the absolute values of the notional amounts outstanding of all the swaps included in the position) even when the position comprises multiple positions with different counterparties.

For example, a holder of a \$75 million notional long equity swap position with one counterparty and a corresponding \$75 million notional short position on the same reference security with another counterparty would have a Security-Based Swap Position of \$150 million—the offsetting positions would not net each other out for purposes of calculating the reporting threshold.

- Security-based swaps based on a single class of equity securities issued by a company and security-based swaps based on debt securities of the same company would constitute separate Security-Based Swap Positions. A Security-Based Swap Position based on a CDS would also constitute a separate Security-Based Swap Position.

¹ However, for Security-Based Swap Positions based on equity, such as the swap position in this example, for purposes of determining whether the applicable reporting threshold has been triggered, both a notional threshold and a threshold based on the number of shares attributable to the swap position would need to be calculated. In the example, the notional amount of \$30 million attributable to the single security would need to be converted into a share amount using the methodologies discussed in the ownership thresholds discussion below.

For example, a Security-Based Swap Position would include all security-based swaps on common stock of XYZ Corp. If the same person also held a CDS position based on debt securities of XYZ Corp., the CDS position would constitute a separate Security-Based Swap Position. If the same person also held security-based swaps based on debt securities of XYZ Corp. that were not CDSs, this position would also constitute a separate Security-Based Swap Position.

- A Schedule 10B reporting a Security-Based Swap Position would also need to disclose other securities (including other security-based swaps) held by the reporting person that are “related” to the reportable Security-Based Swap Position.

For example, if a reporting person has a Security-Based Swap Position comprising security-based swaps on debt securities (non-CDS) of XYZ Corp. that exceeds the applicable reporting threshold, as well as a Security-Based Swap Position comprising security-based swaps on equity securities of XYZ Corp. that does not exceed the applicable reporting threshold, the reporting person would need to report on the Schedule 10B the debt-based Security-Based Swap Position that triggered the filing but the statement would also need to report the equity-based swaps as “related securities.” However, if each of the debt-based Security-Based Swap Position and equity-based Security-Based Swap Position exceeded the applicable threshold, separate Schedules 10B would need to be filed for each position and each such filing would need to cross-reference the other filing for purposes of disclosing the “related securities” positions.

Bifurcated “Reporting Threshold Amounts”

A Schedule 10B would need to be filed to disclose a Security-Based Swap Position after exceeding the applicable “**Reporting Threshold Amount**.” The definition of Reporting Threshold Amount would be different for positions in equity-based swaps, debt-based swaps² and CDSs.³ **As all three thresholds are complex, we only discuss the threshold applicable to equity-based swaps as these are the most common swap positions taken by shareholder activists with respect to their activist campaigns.**

Reporting Threshold Amount for Equity-Based Swaps

The Reporting Threshold Amount with respect to equity-based swaps would be further bifurcated such that it would mean the lesser of: (i) a threshold based on the notional amount of the Security-Based Swap Position and (ii) a threshold based on the total “number of shares attributable” to the Security-Based Swap Position as a percentage of the number of shares outstanding of the reference equity security.

² **Debt-Based Swap (Non-CDS) Threshold**—gross notional amount of \$300 million.

³ **CDS Threshold**—the lesser of: (i) a long notional amount of \$150 million, calculated by subtracting the notional amount of any long positions in a deliverable debt security underlying a security-based swap included in the Security-Based Swap Position from the long notional amount of the Security-Based Swap Position; (ii) a short notional amount of \$150 million; or (iii) a gross notional amount of \$300 million.

Notional Threshold

A Schedule 10B filing obligation would be triggered once a Security-Based Swap Position equals or exceeds \$300 million in notional value, calculated on a gross basis (including both long and short positions). Recognizing that the reporting requirements could be evaded by keeping the position below \$300 million in gross notional value while acquiring the underlying equity securities and/or non-security-based swap derivatives referencing the underlying securities, the rule would also provide that once a Security-Based Swap Position exceeds a gross notional amount of \$150 million, the calculation of the position would also need to include the value of all underlying equity securities owned by the holder (based on the most recent closing price of the securities) and the delta-adjusted notional amount of any options, futures or other derivatives based on the same class of equity securities held by it.

Percentage Threshold

The SEC is proposing a second test based on the number of shares represented by the Security-Based Swap Position. The main purpose of this separate test is to address positions in companies with smaller market capitalizations where the notional amount test may not be triggered by the \$300 million / \$150 million gross notional thresholds but may represent a significant percentage of the company's outstanding equity securities and therefore "carry the potential to impact the issuer."

Under this test, a Schedule 10B filing obligation would be triggered once a **"Security-Based Swap Equivalent Position"** represents more than 5% of a class of equity securities. As with the Notional Test, recognizing that the reporting requirements could be evaded by keeping the position below the threshold while acquiring the underlying equity securities and/or non-security-based swap derivatives referencing the underlying securities, the rule would also provide that once a Security-Based Swap Equivalent Position represents more than 2.5% of a class of equity securities, the calculation of the position would also need to include in the numerator all underlying equity securities owned by the holder and the "number of shares attributable" to any options, futures or other derivatives based on the same class of equity securities held by it.

Under the Percentage Test, a **"Security-Based Swap Equivalent Position"** would mean the **"number of shares attributable"** to all security-based swaps comprising the Security-Based Swap Position. The **"number of shares attributable"** to a security-based swap as well as any options, futures or other derivatives based on the same class of equity securities would mean the larger of:

- The number of shares of the reference equity security that may be delivered upon on the exercise of the rights under the derivative instrument, as determined in accordance with the terms of the applicable documentation;
 - *Intended to apply* to physically-settled instruments—if the instrument refers to a specific number of shares of the reference security or a formula to compute the number of shares that will be delivered, that number would be used.
- The number of shares of the reference equity security determined by multiplying (x) the number of shares by reference to which the amount payable under the derivative instrument is determined by (y) the delta of the applicable derivative instrument;

- *Intended to apply* to cash-settled instruments that provide for a way to compute the number of shares of the reference security based on the amount payable with an adjustment feature to account for instruments with a delta that is not equal to one.

and

- The number of shares of the reference equity security determined by (x) dividing the notional amount of such derivative instrument by the most recent closing price of shares of the reference equity security, and then (y) multiplying such quotient by the delta of the applicable derivative instrument.
 - *Intended to apply* to cash-settled instruments where no such computation methodology exists.

Calculation of the Notional Threshold and Percentage Threshold would apply not only to all security-based swaps referencing a single equity security but also to security-based swaps referencing a narrow-based security index that contains the single security.

- *For example*, if a person has a Security-Based Swap Position consisting of single-name security-based swaps referencing the common stock of XYZ Corp. as well as security-based swaps referencing a narrow-based security index that contains the common stock of XYZ Corp., the “number of shares attributable” to the index-based swaps would need to be added to the “number of shares attributable” to the single-name security-based swaps in order to calculate the total number of those shares as a percentage of the outstanding shares of XYZ Corp. With respect to the index-based swaps, the “number of shares attributable” to such index-based swaps would be calculated in accordance with one of the above three prongs depending on the nature of each index-based swap (physically-settled vs. cash-settled, contains computational methodology vs. no such methodology, etc.).

Schedule 10B Information and Amendments

In the event a filing obligation is triggered, the reporting person would need to file a Schedule 10B disclosing, among other things, the following information:

- Name of reporting person, whether the reporting person is a member of a group and the names of the members of the group.
- Residency or place of organization of the reporting person and type of reporting person (by code).
- Event date that triggered the filing of the Schedule 10B.
- Notional amount of the Security-Based Swap Position and information regarding “the composition of the position as it relates to the direction (i.e., long or short) and the tenor/expiration of the underlying security-based swap transactions.”
- For a Security-Based Swap Position based on equity securities, ownership of (i) all equity securities underlying a security-based swap included in the position and (ii) all security-based swaps based on debt securities (including CDSs) issued by the same company.
- For a Security-Based Swap Position based on debt securities (including CDSs), ownership of (i) all debt securities underlying a security-based swap included in the

position and (ii) all security-based swaps based on equity securities issued by the same company.

- Ownership of any other instrument relating to the Security-Based Swap Position and/or underlying security or loan or group or index of securities or loans, or any security or group or index of securities, “the price, yield, value, or volatility of which, or of which any interest therein, is the basis for a material term of a security-based swap included in the Security-Based Swap Position.”
- If the Reporting Threshold Amount is based on the number of shares corresponding to a Security-Based Swap Position based on equity securities, the number of shares attributable to the position and the closing price used in the calculation.
- A brief description of any contracts, arrangements, understandings or relationships relating to any security-based swaps included in the Security-Based Swap Position or any underlying or related securities or loans.

Notably, Schedule 10B would not require disclosure of the identity of the counterparty to any security-based swap or any related derivatives.

In addition, unlike Schedule 13D, the Schedule 10B would not require:

- Disclosure of the source and amount of funds used for entering into the position or acquiring the underlying or related securities (Schedule 13D—Item 3);
- Disclosure of the purpose of entering into the position or plans or proposals with respect to the company (Schedule 13D—Item 4);
- Disclosure of individual transactions relating to the position or the underlying or related securities during the prior 60 days (Schedule 13D—Item 5(c)); or
- Filing as exhibits any agreements relating to the position or the underlying or related securities (Schedule 13D—Item 7).

A reporting person would be required to amend its Schedule 10B upon any “material change” in the facts set forth in the prior filing, including any material increase in the Security-Based Swap Position or if the position falls back below the applicable reporting threshold. A 10% or more change in the previously disclosed position would be deemed “material” for purposes of the amendment requirements. The amendment would need to be filed no later than the end of the first business day following the material change.

Machine-Readable Data Submission on Schedule 10B

The proposed rules would require filers to submit the Schedule 10B using a specific structured, machine-readable language known as Financial Information eXchange Markup Language (“FIXML”). Filers would have the ability to either submit the Schedule 10B directly in FIXML or use a fillable web form to generate the Schedule 10B in FIXML. Electronic style sheets would process the FIXML data and represent the data in a “human-readable form” that could be publicly viewed on the SEC’s EDGAR webpage.

Implications for Shareholder Activists

The proposed rules would create a new reporting regime outside the current Schedule 13D reporting system that would require one-business-day reporting of significant equity swap positions, including cash-settled swap positions, sometimes built by shareholder activists. While the Schedule 10B disclosing the equity swap position and any underlying equity securities or related securities of the company held by the filer would provide an early warning to the company of the position, unlike the Schedule 13D, it would not specifically inform the public of the filer's investment purpose or other plans or proposals the filer may have with respect to the company.

Under the current SEC disclosure rules, shareholders who "beneficially own" in excess of 5% of the outstanding equity securities of a company who do not have a passive investment intent are required to file a Schedule 13D disclosing the securities position, investment intent, plans and proposals and other information within 10 calendar days of crossing the 5% ownership threshold.

With respect to security-based swaps where the holder of the swaps may be deemed to beneficially own the underlying securities because the swaps may be settled in the underlying securities or there exist other indicia of beneficial ownership (such as the ability to instruct the counterparty how to vote any securities it holds to hedge its position), the securities underlying the swap position are generally deemed to be beneficially owned and count towards calculation of the 5% ownership threshold. Accordingly, once a Schedule 13D filing is triggered as a result of crossing the 5% ownership threshold resulting from beneficial ownership of securities underlying such swaps or a combination of the amount of such underlying securities and direct securities holdings of the company, a Schedule 13D publicly disclosing the swap position would need to be filed within 10 calendar days.

Under the proposed rules, such security-based swap positions would be required to be reported on a Schedule 10B no later than just one business day of the swap transaction that resulted in the swap position exceeding the applicable Section 10B threshold. As a result, the proposed rules would significantly accelerate the timeframe during which a holder of such security-based swaps is required to publicly disclose a significant swap position (as measured by the proposed rules).

With respect to cash-settled swaps, practitioners generally take the position that the notional securities referenced by such cash-settled swaps are not "beneficially owned" by the holder of the swaps for purposes of Schedule 13D reporting as long as the swaps may not be settled in the underlying securities and the holder does not have the power to vote or dispose of, or the ability to influence voting or investment decisions over, any underlying securities that the counterparty may hold as a hedge. As a result, shareholder activists holding such cash-settled swaps generally do not count the notional amount of securities referenced by such swaps for purposes of calculating the 5% ownership threshold and therefore do not file Schedules 13D to report these positions (assuming they do not otherwise beneficially own other securities of the company that exceed the 5% ownership trigger).

Under the proposed rules, these cash-settled swaps would need to be reported on a Schedule 10B no later than one business day following the swap transaction that resulted in the swap position exceeding the applicable Section 10B threshold. As a result, the proposed rules would require rapid public disclosure by shareholder activists when building significant economic positions in companies through cash-settled swaps.