

**MEMORANDUM**

July 20, 2011

To: File No. 4-624

From: Scott H. Kimpel  
Office of Commissioner Troy A. Paredes

Re: Request for rulemaking regarding the beneficial ownership reporting rules under Section 13 of the Securities Exchange Act of 1934

On July 15, 2011, Commissioner Troy A. Paredes and Scott H. Kimpel, Counsel to the Commissioner, met with Roy J. Katzovicz, Pershing Square Capital Management L.P.; Donna Anderson, T. Rowe Price; Stephen L. Brown, TIAA-CREF; and Stuart J. Kaswell, Managed Funds Association. The participants discussed the above-referenced petition for rulemaking. Mr. Katzovicz also distributed the attached discussion materials.

Attachment.

# ***Section 13(d) Discussion Materials***

*July 15<sup>th</sup> 2011*

*Prepared by members of the Managed Funds Association for a discussion with  
the staff of the Securities and Exchange Commission and representatives of  
other interested market participants*

## **Discussion Agenda**

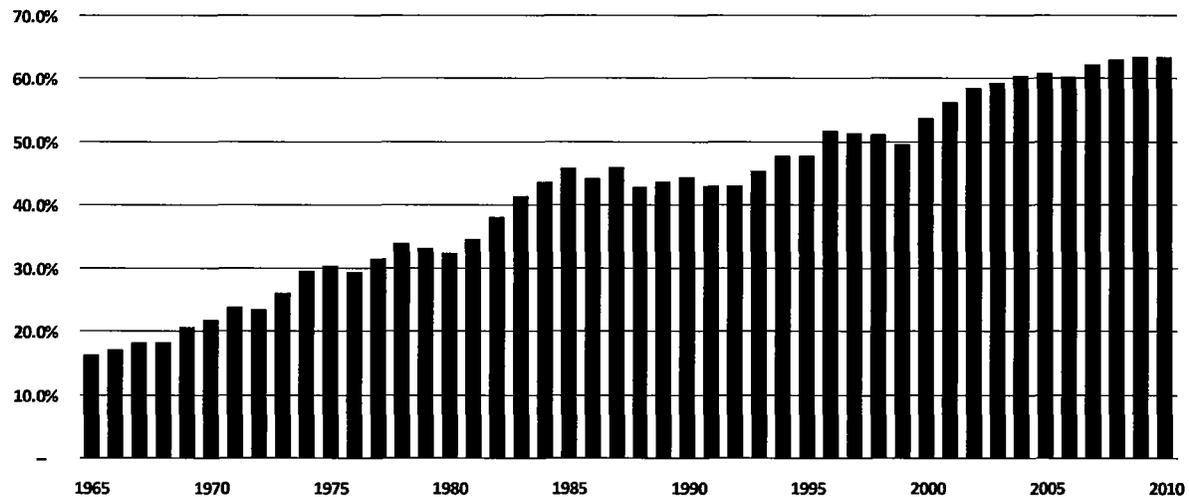
- **Context of 13(d) Rulemaking Requests**
- **Potential Impact of Proposed Changes on Shareholders**
- **Background of the Williams Act**
- **The Modern Corporate Governance Landscape**
- **Putting Proposals for Changes to 13(d) in Context**
- **Proposed Considerations for Broader Rulemaking Review**

## **Considering 13(d) Rulemaking Requests**

- **Recent proposal for narrow changes to Section 13(d) rules focuses on “modernization,” but in truth goes to heart of the debate regarding active shareholder engagement, which impacts all market participants**
  - “The small reporting change being proposed could significantly chill hedge fund activism and further entrench management ... Amending the reporting requirements and pitching it as a shareholder-friendly maneuver has the virtue of having the government impose a solution that the private market may not desire.” – *Steven Davidoff, The New York Times, March 15, 2011*
  - “Shareholders often benefit from activism ... But letting such riches accrue to the market instead of the activists might chill their effect by, for example, confining their targets to only the biggest companies, where chances of success may be slimmer. That could lead to fewer activists who, on balance, serve as valuable watchdogs against lazy management.” – *Jeffrey Goldfarb, Reuters Breakingviews, March 31, 2011*
- **In addition to opinions of management advocates and actively engaged shareholders, we believe hearing the thoughts of a broader spectrum of market participants, including typically passive shareholders (whom management advocates claim will benefit from piecemeal changes to disclosure regime), will be valuable to the Commission**

## Exhibit A: Current Shareholder Landscape

Percentage of Corporate Equities Held by Institutional Investors



Source: *Flow of Funds Accounts of the United States, The Federal Reserve.*

Includes the corporate equity holdings of state and local governments, federal government, holdings of U.S. issues by foreign residents, monetary authority, commercial banking, savings institutions, property-casualty insurance companies, life insurance companies, private pension funds, state and local government retirement funds, mutual funds, closed-end funds, exchange-traded funds, brokers and dealers, and funding corporations.

## **Potential Impact of Proposed Changes on Shareholders**

- **Evidence suggests that proposed rulemaking would significantly impact market-driven incentives to address company underperformance, to the likely detriment of *all* shareholders**

- “[R]eturns to stocks of companies targeted by activist hedge funds show significant positive returns in the one-year, two-year, and three-year periods following the fund’s acquisition of the stock.” – *George W. Dent Jr., Delaware Journal of Corporate Law, 2010*

- “From the beginning of the contest period for a board seat through the first year of a hybrid board’s existence, companies’ total returns were 19.1 percent, or 16.6 percentage points better than peers’. And total share price performance through the three-year anniversary of the hybrid boards averaged 21.5 percent, almost 18 percentage points more than their peers. ... One element that seems to affect results was the size of the stake held by the dissident shareholder. The greater the stake, the bigger the gains.” – *Gretchen Morgenson, The New York Times, May 23, 2009 (emphasis added), summarizing an Investor Responsibility Research Center Institute and Proxy Governance study on boards where shareholders won one or more board seats*

- **Could chill activity which helps give life to shareholder democracy and addresses classic principal-agent issues**

- “[A]ctivism generates value on average ... because [activists] credibly commit upfront to intervene in target firms on behalf of shareholders and then follow through on their commitments ... The benefit from hedge fund activism goes beyond the improved performance and stock prices at the actual target companies. The presence of these hedge funds and their potential for intervention exert a disciplinary pressure on the management of public firms to make shareholder value a priority.” – *Brav et al, Journal of Finance, Aug. 2008*

- “Activists take on the trouble and expense of behaving like hands-on, if sometimes antagonistic, owners. Most shareholders don’t do that, because ownership is fragmented and intermediated by brokerage houses or fund managers who tend to vote either with management, not at all, or – at best – in line with the recommendations of shareholder advisory firms ...” – *Richard Beales, The Wall Street Journal, June 16, 2008*

## **Background of the Williams Act (1968) - Focus**

- **Given such potential impacts, before narrow changes impacting such activity are considered it is useful to step back and look at the Williams Act and how its goal of benefitting shareholders is best served in the modern corporate governance landscape**
- **Response to wave of hostile takeovers ... Which unlike proxy contests were unregulated**
  - “In recent years, acquiring control of publicly held corporations through cash tender offers and purchases of blocks of securities, as opposed to proxy contests has gained favor. When control is sought through the proxy contest, the Exchange Act and its proxy rules require disclosure to be made to shareholders concerning the identity of the participants in the contest, their associates, the shareholdings of these persons, and other relevant information.” – *SEC 34<sup>th</sup> Annual Report (1968) (emphasis added)*
- **Sought appropriate balance between transparency and encouraging beneficial activity (which even hostile tender offers were considered) ... Earlier proposals for filings 20 days in advance and later 7 days after crossing threshold were rejected as too onerous and tipping scales too far in favor of management**
  - “We have taken extreme care to avoid tipping the scales either in favor of management or in favor of the person making the takeover bids.” – *113 Cong. Rec. 24664 (1967)*
  - “[C]loser analysis shows that Congress’ ‘equal footing’ observations were in response to strong criticisms that the proposed legislation would unduly inhibit tender offers.” – *Piper v. Chris-Craft, 430 U.S. 1, 30 (1977)*
  - In reviewing Williams Act thresholds, the SEC has taken into consideration “the benefits to investors and to the public” and “any bona fide interests of individuals in the privacy of their financial affairs.” – *Report of the SEC on Beneficial Ownership Reporting Requirements (1980)*
- **Such balance of transparency and promoting beneficial activity common in securities law**

## **Background of the Williams Act (1968) – Control Assumptions**

- **Ultimately required disclosure at 10% (lowered to 5% in 1970) after 10 days**
- **Focused on control**
  - “The touchstone of the national disclosure policy in this area is the concept of control or potential control.” – *Final report of the SEC on the Practice of Recording the Ownership of Securities in the Records of the Issuer in Other Than the Name of the Beneficial Owner of Such Securities, 94<sup>th</sup> Cong., 2<sup>nd</sup> Sess. (Committee print 1976), at 50 n. 13.*
- **Disclosure thresholds grounded in realities of the time regarding control**
  - In proposing lowering the 13(d) disclosure threshold from 10% to 5%, Congressman Springer suggested that “it [was] possible with only 10 percent to determine what will happen to a corporation that [an investor] buys into because 10 percent in some corporations gives you almost control.” – *116 Cong. Rec. 40188 (1970)*
- **Highly disaggregated shareholder bases and lack of access to and motivation to seek out information permitted some minority investors to wield control**
  - In the mid-1960s, after one corporate raider acquired “approximately 9.7% of the common stock of Wheeling Steel Corporation,” which had approximately 12, 000 shareholders, the result was “a management upheaval, a recognition of [the raider’s] control, and the election of officers satisfactory to him.” – *A.A. Sommer, Jr., Who’s “In Control”?*—*S.E.C., 21 Bus. Law. 559, 569 (1966)*

## The Modern Corporate Governance Landscape

### **Pre-Williams Act 1968**

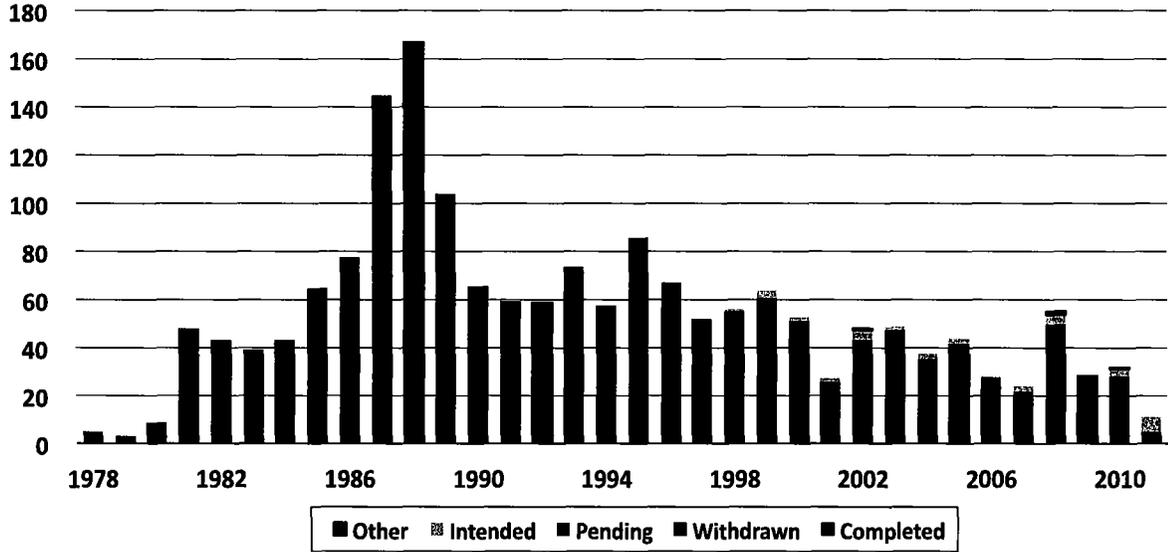
- No information requirements for tender offers
- Few if any statutory or legal defenses against hostile takeovers
- Led to wave of hostile takeovers in 1960's (and again in 1970's and 1980's)
  
- Hostile corporate raiders sought to purchase controlling stakes in companies
- Majority of value realization accrued to hostile acquirer
  
- More than 80% of shareholders were individuals
- Widely disaggregated shareholder bases with limited access to information and little incentive to become informed permitted effective control to be passed with 5-10%

### **2011**

- Nearly every state has adopted an anti-takeover statute deterring hostile takeovers
- Often supplemented by poison pills, advance notice by-laws and other defenses
- As a result, "hostile takeovers" very rare
  
- Actively engaged shareholders take minority positions in companies
- Majority of value realization accrues to other shareholders who hold onto their stock
  
- Approximately 2/3 of investors are institutional
- Highly concentrated, institutional-focused shareholder bases require anyone seeking to replace board members to win their support

# Exhibit B

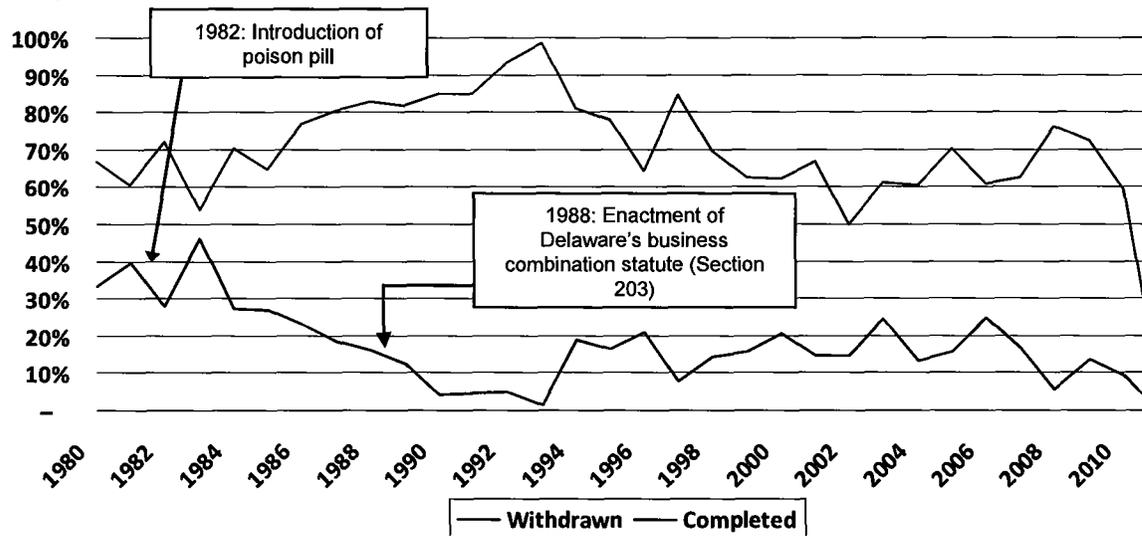
## Hostile / Unsolicited Deals



Source: *Thomsen SDC*. Excludes multiple listings for select deals. Hostile deals include potential transactions where the target Board of Directors officially rejects an offer but the offeror persists with its takeover attempt. Unsolicited deals include potential transactions where the offer is made not at the request of the target's board and where the target's board has not recommended the transaction.

# Exhibit C

Percentage of Hostile / Unsolicited Deals Withdrawn and Completed



Source: Thomson SDC. Excludes multiple listings for select deals.

## **Putting Proposals for Changes to 13(d) in Context**

- **Advocates of narrow changes to Section 13(d) have adopted the language of the hostile takeover to describe today's actively engaged shareholders ... In reality quite different**
- **Seek operational, strategic, financial or other change to create value for all shareholders**
- **Actively engaged shareholders typically take minority stakes ... While even a small shareholder can prevail in a proxy contest or other vote, this does not amount to "control"**
  - Before and after election, shareholders own the company ... Have chosen new representatives
  - All directors subject to fiduciary duties to all shareholders ... Even in *Airgas* hostile takeover context, directors nominated by bidder were bound by fiduciary duties and rejected takeover bid as too low
  - "In our opinion, a change in the majority of the board is not necessarily the same thing as a change in control. If the dissident nominees are independent of each other, then control is not in play – there may simply be a turnover of the board." – *RiskMetrics Group Inc., M&A Edge Note, March 31, 2009*
- **Shareholders are well-informed and management has had ample opportunity to make case for the status quo by the time of a vote by virtue of the proxy rules**
- **Far different value considerations, given that benefits of active engagement shared by all shareholders who retain their holdings**
- **Unclear why policies should favor selling shareholders over shareholders proposing change and the majority of other shareholders who retain their stakes**

## **Proposed Considerations for Broader Rulemaking Review**

- **Although originally a response to hostile takeovers, the current 13(d) disclosure regime sets the balance between providing incentives for engaged investors to propose change and allowing passive shareholders to benefit from those investments**
- **Piecemeal changes proposed by management advocates would alter that balance in ways that could be detrimental for shareholders**
- **We are grateful for the Commission's time and hope to be helpful as it considers these issues, including by:**
  - **Giving our perspectives on policy objectives and how they may or may not benefit shareholders**
  - **Helping to provide empirical evidence including assisting with a review of the costs and benefits of any proposed changes and the impact upon shareholders**
  - **Facilitating a broad discussion with a variety of market participants**
- **Such a discussion could likely lead to changes to encourage greater shareholder involvement**
- **We are available at the Commission's convenience to discuss any of these issues further**

## Appendix

## **Jurisdictional Comparison**

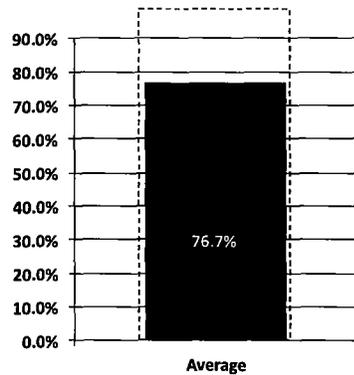
<b>Country</b>	<b>Filing Threshold</b>	<b>Timing of Filing</b>	<b>Significant Disclosure</b>	<b>Corporate Governance Landscape</b>
<b>USA</b>	5%	10 days	% owned. 13D/13G distinction. 13D discloses purpose of acquisition, future intentions, related contracts, arrangements, understandings or relationships	Poison pills, advance notice bylaws often requiring lengthy notice, state anti-takeover provisions, over 50% of companies do not permit shareholders to call special meetings* & thresholds to call meetings typically 15% and higher
<b>United Kingdom</b>	3%	2 trading days	% owned	No poison pills, set notice period for shareholders proposals, 5% to call special meeting
<b>The Netherlands</b>	5%	2 days	% owned	Limited-duration protective foundation rights, set notice period for shareholders proposals, 10% to call special meeting
<b>Germany</b>	3% / 10%	4 trading days	% owned at 3 % / Future intentions at 10%	No poison pills, set notice period for shareholders proposals, 5% to call special meeting
<b>Australia</b>	5%	2 trading days	% owned; agreements, arrangements, understandings	No poison pills, set notice period for shareholders proposals, 5% to call special meeting
<b>Hong Kong</b>	5%	3 business days	% owned; agreements to acquire shares	No poison pills, set notice period for shareholders proposals, 5% to call special meeting

\* Sharkrepellent.net, out of 3,806 companies in Sharkrepellent universe, as of July 13<sup>th</sup> 2011.

# Median Quorums

## MEDIAN PROXY CONTEST QUORUMS

68 Meetings from 2008-2011<sup>1</sup>

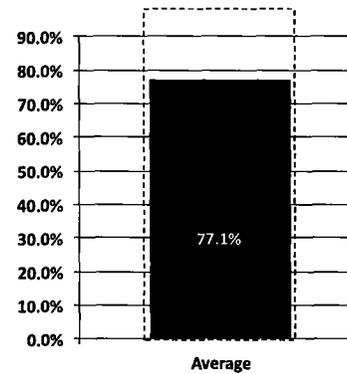


Source: Company Filings

<sup>1</sup>Modern median quorums in contested proxy elections suggest holders would need to control 38.4% in order to dictate outcomes for elections of directors. Mean quorums for the sample universe were 74.0%.

## MEDIAN CONTESTED MERGER QUORUMS

147 Contested Mergers from 2003-2011<sup>2</sup>



Source: Company Filings

<sup>2</sup>Modern median merger quorums in contested mergers suggest that holders would need to control in excess of 27.1% to block management-supported transactions. Mean quorums for the sample universe were 76.0%.