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May 18, 2015

United States Securities and Exchange Commission
100 F Street, Northeast
Washington, D.C. 20549-1090
Attention: Mr. Brent J. Fields, Secretary
Re: Rulemaking Petition No. 4-624

Dear Mr. Fields:

We write to comment on the petition for rulemaking urging the Commission to tighten the disclosure rules that apply under the Williams Act to holders of large blocks of public-company stock.¹ The Petition asks that the Commission reduce the number of days within which these shareholders must disclose their position from ten days to one. The Petition has been before the Commission for more than four years, and the Commission has not taken any action on the proposal. Nevertheless, in light of recent calls for tightening the disclosure obligations governing the purchase of blocks of public-company shares,² and the pending status of the Petition, we write to submit the attached research so that it might inform the Commission's analysis should the SEC decide to consider the tightening proposed by the Petition.³

In our attached Article *The Law and Economics of Blockholder Disclosure*,⁴ which we are today submitting for the Commission's consideration, we explain why the Commission should not view the Petition's proposed tightening of the rules in this area as a merely "technical" change needed to provide market transparency or "modernize" the SEC's rules. Instead, the Petition's proposed changes should be examined in the larger context of the optimal balance of power between corporate insiders and these blockholders.

The Article discusses the beneficial and documented role that outside holders of large blocks of public-company stock play in corporate governance—and the adverse effect that any tightening of the Williams Act's disclosure thresholds can be expected to have on such blockholders. We explain that there is currently no evidence that trading patterns and technologies have changed in ways that would make it desirable to tighten these thresholds. Furthermore, since the passage of the Williams Act, the corporate-law rules governing the balance of power between incumbents and outside blockholders have already moved considerably in favor of the former—both in absolute terms and in comparison to other jurisdictions—rather than the latter.

¹ See Letter from Wachtell, Lipton, Rosen & Katz to Elizabeth M. Murphy, Secretary, U.S. Sec. & Exch. Comm'n (Mar. 7, 2011), available at www.sec.gov/rules/petitions/2011/petn4-624.pdf [hereinafter Petition].

² See Letter from Citizens for Responsibility and Ethics in Washington et al. to Hon. Richard Shelby, Chairman, U.S. Sen. Comm. on Banking, Housing, and Urban Affairs et al. (April 15, 2015) (in light of the SEC's inaction on the Petition, "urg[ing] Congress to step in with a legislative solution").

³ We write solely in our individual capacities; the institutional affiliations listed here are provided for identification purposes only.

⁴ 2 HARV. BUS. L. REV. 40 (2012).

Our analysis provides a framework for the comprehensive examination of the rules governing outside blockholders that the Commission should pursue. In the meantime, we argue, the Commission should not adopt rules that would tighten the disclosure thresholds that apply to blockholders. Existing research and available empirical evidence provide no basis for concluding that such tightening would protect investors and promote efficiency. Indeed, there is good basis for concern that such tightening would harm investors and undermine efficiency.

* * * *

The Article proceeds in five Parts. In Part I, we explain why policy analysis weighing the benefits and costs of tightening these rules is needed before the Commission proceeds with rulemaking in this area. It might be argued that faster disclosure of information is unambiguously desirable under principles of market transparency and was the principal objective of the Williams Act, which first established these rules in 1968. Thus, at first glance one might conclude that the Commission should tighten these rules without weighing the advantages and disadvantages of doing so. Unlike ordinary rules that require insiders to provide information to investors, however, the Williams Act imposed an exception to the general rule that outside investors in public-company stock are entitled to remain anonymous. The drafters of the Williams Act made a clear, explicit choice not to impose a hard 5% limit on pre-disclosure accumulations of shares, choosing instead to strike a balance between the costs and benefits of blockholders' activities. Thus, in deciding whether to tighten its rules in this area, the SEC should be guided by the general requirement that any costs associated with changes to its rules should be outweighed by benefits for investors.

We therefore turn to developing a framework for the policy analysis that the Commission should conduct. In Part II of the Article, we begin by examining the costs of tightening the rules on blockholders. We first explain the benefits of these blockholders for corporate governance. We review the considerable empirical evidence indicating that the accumulation and maintenance of outside blocks makes incumbent directors and managers more accountable, thereby reducing agency costs and managerial slack. Thus, we argue, tightening disclosure requirements can be expected to reduce the returns to blockholders and thereby reduce the incidence and size of outside blocks as well as blockholders' investments in monitoring and engagement—which, in turn, could result in increased agency costs and managerial slack.

In Part III, we assess the asserted benefits of tightening the rules that are described in the Petition. We show that there is no empirical evidence to support the Petition's contention that tightening these rules is needed to protect investors from the risk that outside blockholders will capture a control premium at other shareholders' expense.

Part IV considers whether the Petition's proposed tightening is justified by changes in trading practices, legal rules in the United States, or legal rules in other jurisdictions that have occurred since the passage of the Williams Act. We first explain that there is no systematic empirical evidence suggesting the Petition's suggestion that investors can now acquire large blocks of public-company shares more quickly than they could when the Williams Act first became law. We then show that changes in the legal landscape since that time have tilted the balance of power between corporate insiders and blockholders against the latter—and therefore counsel against tightening the rules in a way that would further disadvantage blockholders.

We also explain why comparative analysis of the regulation of blockholders in other jurisdictions does not justify tightening the rules governing blockholders in the United States. Overall, we argue, the Commission should recognize that the rules governing the balance of power between management and outside blockholders are already tilted in favor of insiders—both in absolute terms and in comparison to other jurisdictions—rather than blockholders.

Part V concludes by recommending that the Commission pursue a comprehensive examination of the rules in this area along the lines described in the Article. Such an examination should include an investigation of several empirical questions we identify, including:

- An assessment, building on existing empirical work, of the magnitude of the benefits conferred on shareholders by the presence of outside blockholders and the factors that determine the size of these benefits in particular cases;
- An assessment of the effects of tightening disclosure requirements, and of the expected effects of tightening or relaxing them, on both the incidence and size of the stakes held by outside blockholders and the investments in monitoring and engagement activities made by such blockholders;
- An assessment, based on an empirical study of filings under the Williams Act, of how pre-disclosure accumulations by outside blockholders have changed, if at all, since the passage of the Williams Act; and
- An assessment of the extent to which the evolution of rules impeding the activities of outside blockholders—including rules allowing companies to use poison pills against outside blockholders not seeking to acquire control—adversely affect both the incidence and magnitude of stakes held by outside blockholders, as well as the monitoring and engagement investments that such blockholders make.

Such empirical research, we explain, will provide the Commission with the information necessary for a comprehensive analysis of the costs and benefits of the Petition’s proposal. (In a subsequent study with Alon Brav and Wei Jiang,⁵ which we will submit for the Commission’s consideration in a separate comment letter, we contribute to the necessary empirical examination of the subject.) In the meantime, however, we conclude that existing research and empirical evidence provide no basis for tightening the disclosure obligations of outside blockholders.

* * * *

We appreciate the opportunity to provide comments in connection with the Commission’s consideration of the Petition. If further discussion of these comments would be helpful to the Commission or the Staff, we would of course be pleased to be of assistance. Please do not hesitate to contact us at your convenience. Professor Bebchuk can be reached at (617) 495-31398 or via electronic mail at Bebchuk@law.harvard.edu, and Professor Jackson can be reached at (212) 854-0409 or via electronic mail at robert.jackson@law.columbia.edu.

⁵ Lucian Bebchuk, Alon Brav, Robert J. Jackson, Jr., and Wei Jiang, *Pre Disclosure Accumulations by Activist Investors: Evidence and Policy*, 39 J. CORP. L. 1 (2013).

Very truly yours,

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THE LAW AND ECONOMICS OF BLOCKHOLDER DISCLOSURE

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The Securities and Exchange Commission is currently considering a rulemaking petition that advocates tightening the rules under the Williams Act, which regulates the disclosure of large blocks of stock in public companies. In this Article, we explain why the Commission should not view the proposed tightening as a merely “technical” change needed to meet the objectives of the Williams Act, provide market transparency, or modernize its regulations. The drafters of the Williams Act made a conscious choice not to impose an inflexible 5% cap on pre-disclosure accumulations of shares to avoid deterring investors from accumulating large blocks of shares. We argue that the proposed changes to the SEC’s rules should similarly be examined in the larger context of the optimal balance of power between incumbent directors and these blockholders.

We discuss the beneficial and documented role that outside blockholders play in corporate governance and the adverse effect that any tightening of the Williams Act’s disclosure thresholds can be expected to have on such blockholders. We explain that there is currently no evidence that trading patterns and technologies have changed in ways that would make it desirable to tighten these disclosure thresholds. Furthermore, since the passage of the Williams Act, the rules governing the balance of power between incumbents and outside blockholders have already moved significantly in favor of the former—both in absolute terms and in comparison to other jurisdictions—rather than the latter.

Our analysis provides a framework for the comprehensive examination of the rules governing outside blockholders that the Commission should pursue. In the meantime, we argue, the Commission should not adopt new rules that would tighten the disclosure thresholds that apply to blockholders. Existing research and available empirical evidence provide no basis for concluding that such tightening would protect investors and promote efficiency. Indeed, there is a good basis for concern that such tightening would harm investors and undermine efficiency.

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** Associate Professor of Law, Columbia Law School. This Article draws upon a comment letter (available at <http://sec.gov/comments/4-624/4624-3.pdf>) that we filed with the Securities and Exchange Commission in July 2011. We benefited from the valuable comments of Ronald Gilson, Jeffrey Gordon, Richard Squire, and participants at the Conference on Markets and Owners hosted by the Columbia Project on Investment, Ownership, and Control in the Modern Firm. We would like to thank Andrew Joyce and Chapman Wong for exceptional research assistance. We are also grateful to the Harvard Law School and the Columbia Law School for financial support.

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INTRODUCTION

A rulemaking petition recently submitted to the Securities and Exchange Commission by the senior partners of a prominent law firm advocates tightening the rules that have long governed the disclosure of blocks of stock in public companies.¹ The Commission has subsequently announced a rulemaking project to develop proposals for tightening these rules, and members of the Commission's staff have signaled that the staff is prepared to recommend that the Commission adopt such proposals.² Chairman Mary Schapiro, acknowledging the "controversy" surrounding these important rules, has indicated that the Commission is actively considering whether to adopt the changes proposed in the Petition.³

In this Article, we provide a detailed framework for the Commission's examination of these rules. We argue that the Commission should not proceed with changes to these rules before undertaking a comprehensive examination of their economic implications for investors. In the meantime, the

¹ Letter from Wachtell, Lipton, Rosen & Katz to Elizabeth M. Murphy, Secretary, U.S. Sec. & Exch. Comm'n (Mar. 7, 2011), available at <http://www.sec.gov/rules/petitions/2011/petn4-624.pdf> [hereinafter Petition]. Because the Petition provides a comprehensive statement of the arguments that might be raised in support of tightening these rules, we use the Petition as a basis for discussing those arguments—and the questions that the Commission should examine in evaluating them.

² See Beneficial Ownership Reporting Requirements and Security-Based Swaps, Exchange Act Release No. 34-64628, 76 Fed. Reg. 34,579, 34,581 (June 14, 2011) (to be codified at 17 C.F.R. § 240) ("[O]ur staff is engaged in a separate project to develop proposals to modernize reporting under Exchange Act Section[] 13(d)"); Ronald D. Oral, *SEC Eyes Faster Disclosure for Activist Funds*, CBS MARKETWATCH (Feb. 25, 2011), http://articles.marketwatch.com/2011-02-25/markets/30783592_1_activist-investors-damien-park-fund-managers ("[T]he chief of the SEC's Office of Mergers & Acquisitions, Michele Anderson, said that she plans to recommend to the [C]ommission that they should shorten the number of days activist investors have before they must publicly disclose they have a 5% stake in the company.").

³ See Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, Remarks at the Transatlantic Corporate Governance Dialogue (Dec. 15, 2011), available at <http://www.sec.gov/news/speech/2011/spch121511mls.htm>.

existing research and available empirical evidence provide no basis for concluding that the tightening of disclosure thresholds advocated by the Petition would protect investors and promote efficiency, as the Commission's rules must;⁴ indeed, the existing research and empirical evidence raise concerns that such tightening could harm investors and undermine efficiency.

Our analysis proceeds as follows. In Part I, we explain why policy analysis weighing the advantages and disadvantages of tightening these rules is needed before the Commission proceeds with the proposed tightening. It might be argued that more prompt disclosure of information is unambiguously desirable under principles of market transparency and was the clear objective of the Williams Act, which first established these rules by adding Section 13(d) to the Securities Exchange Act in 1968. Thus, at first glance one might conclude that the Commission should tighten the rules without consideration of the costs and benefits of doing so. Unlike ordinary disclosure rules that require insiders to provide information to investors, however, the Williams Act imposed an exception to the general rule that outside investors in public-company stock are entitled to remain anonymous. The drafters of the Williams Act made a conscious choice not to impose a hard 5% limit on pre-disclosure accumulations of shares, instead striking a balance between the costs and benefits of disclosure of blockholders' activities to avoid excessive deterrence of the accumulation of these outside blocks. Thus, in deciding whether to tighten the rules in this area, the Commission should be guided by the general requirement that any costs associated with changes to its rules should be outweighed by benefits for investors.

We therefore proceed to provide a framework for the policy analysis that the Commission should conduct. In Part II, we begin by considering the costs of tightening the rules on blockholders. We first explain the benefits of these blockholders for corporate governance. We review the significant empirical evidence indicating that the accumulation and holding of outside blocks makes incumbent directors and managers more accountable, thereby reducing agency costs and managerial slack. Thus, we argue, tightening disclosure requirements can be expected to reduce the returns to blockholders and thereby reduce the incidence and size of outside blocks as well as blockholders' investments in monitoring and engagement—which, in turn, could well result in increased agency costs and managerial slack.

In Part III, we consider the asserted benefits of tightening the rules described in the Petition. We explain that there is no empirical evidence to support the Petition's contention that tightening these rules is needed to protect investors from the risk that outside blockholders will capture a control premium at shareholders' expense.⁵

⁴ See 15 U.S.C. § 78c(f).

⁵ We emphasize that our analysis is based on existing research and empirical work. Future work on the issues we identify may well warrant reconsideration of the conclusions we reach below.

Part IV considers whether the proposed tightening is justified by changes in trading practices, legal rules in the United States, or legal rules in other jurisdictions that have occurred since the passage of Section 13(d). We first explain that there is no systematic empirical evidence supporting the suggestion that investors can now acquire large blocks of stock more quickly than they could when Section 13(d) was first enacted. We then show that changes in the legal landscape since that time have tilted the balance of power between incumbents and blockholders against the latter—and therefore counsel against tightening the rules in a way that would further disadvantage blockholders. We also explain why comparative analysis of the regulation of blockholders in other jurisdictions does not justify tightening the rules governing blockholders in the United States. Overall, we argue, lawmakers should recognize that the rules governing the balance of power between management and outside blockholders are already tilted in favor of insiders—both in absolute terms and in comparison to other jurisdictions—rather than outside blockholders.

We conclude by recommending that the Commission pursue a comprehensive examination of the rules in this area along the lines we put forward. Such an examination should include an investigation of the empirical questions we identify. In the meantime, however, as we explain below, existing research and empirical evidence offer no basis for tightening the disclosure obligations of outside blockholders.

Before proceeding, we note that we focus on the timing of disclosure by blockholders and, in particular, the Petition's assertion that the Commission should shorten the 10-day period in which blockholders must disclose their presence after they have reached 5% ownership. Other questions, such as whether derivatives and similar securities should count toward the 5% threshold, are beyond the scope of this Article.⁶ We do, however, offer a framework for analyzing these questions that should be considered in future work on any rules that affect the balance of power between incumbents and blockholders. As we explain below, any analysis of such rules should give adequate weight to the beneficial role played by blockholders described in this Article.

I. THE NEED FOR POLICY ANALYSIS OF TIGHTENING THE RULES ON BLOCKHOLDERS

Before turning to an assessment of the advantages and disadvantages of tightening the rules governing blockholder disclosure, this Part first explains why careful policy analysis of the proposed tightening is needed. It might be argued that the Commission need not conduct policy analysis of this kind before tightening its rules in this area. In particular, it might be argued that

⁶ Petition, *supra* note 1, at 8 (arguing that the Commission's 13(d) rules should be amended to include ownership through these securities toward the threshold).

accelerating the disclosure of information is unambiguously beneficial for two reasons: first, more prompt disclosure is justified by basic principles of market transparency; and second, more prompt disclosure is necessary to achieve the objectives of the Williams Act. We examine each of these claims in turn in Sections A and B below. We conclude that neither argument provides a sound basis for the Commission to proceed with the proposed tightening without first conducting a careful policy analysis of the costs and benefits of doing so.

A. *The Unique Disclosures Required by the Williams Act*

At first glance, it may seem that requiring immediate disclosure of the accumulation of outside blocks of public-company stock will improve market transparency and, thus, is obviously desirable. On this view, principles of transparency compel such disclosure and make it unnecessary for the Commission to conduct a policy analysis before proceeding with the changes proposed by the Petition.

In considering this view, however, it is important to note that the disclosure rules we focus on here apply not to information that insiders must provide to investors, but rather to information that outsiders must disclose about their purchases of public-company stock. For such purchases, the general principle is that, outside the specific exception established by the Williams Act, buyers of shares are not required to disclose their purchases to the market—even when that information would be of interest to others.

Suppose, for example, that Warren Buffett chose to purchase 2% of the stock of a publicly traded company. Certainly this information would be the subject of a great deal of interest to other investors. But as a general rule the law does not require Buffett, or any other outside investor in similar circumstances, to disclose purchases of this kind.⁷ And for good reason: such a requirement might enable other investors to free-ride on Buffett's investments in information acquisition about under-valued companies and thus could have an adverse effect on such investments. For this reason, the appeal

⁷ To be sure, outsiders can learn about the investment activities of some institutional investors from filings under Rule 13f, which requires quarterly disclosure of the holdings of institutional managers who exercise investment discretion over accounts with an aggregate value of \$100 million or more. *See* 17 C.F.R. § 240.13f-1 (2011). Unlike disclosure under Section 13(d), however, these disclosures are made only quarterly; thus, investments made at the end of each quarter need not be disclosed for a substantial time after they are made. Moreover, unlike disclosure under Section 13(d), investors are free to request, and frequently receive, confidential treatment of their filings under Rule 13f. *See, e.g.*, George O. Aragon et al., *Why do Hedge Funds Avoid Disclosure? Evidence from Confidential 13F Filings* 10 (finding, in a sample of hedge funds, that 17.6% funds requested confidential treatment of their filings) (unpublished manuscript, on file with authors). *See also* Andrew Ross Sorkin, *One Secret Buffett Gets to Keep*, DEALBOOK (Nov. 11, 2011), <http://dealbook.nytimes.com/2011/11/14/one-secret-buffett-gets-to-keep/> (describing the confidential treatment Warren Buffett has received of his Rule 13f filings).

of market transparency is not by itself a sufficient justification for requiring outside investors to disclose their purchases of public-company stock.

To be sure, the Williams Act did establish an exception to the general principle that outside investors may remain anonymous. Rather than imposing a general requirement of transparency, however, the Williams Act delineated a limited exception requiring disclosure in certain prescribed circumstances. In the next section we consider whether tightening the rules is necessary to meet the objectives of the drafters of the Williams Act.

B. Is Tightening Necessary to Achieve the Williams Act's Objectives?

It might be argued that tightening the disclosure rules that apply to outside blockholders is necessary to achieve the purposes Congress sought to address in 1968 when it adopted the Williams Act's exception to the general rule that investors in public companies may remain anonymous. Indeed, the Petition contends that Congress hoped to "compel the release of information to the investing public" about outside blocks of 5% or more, and that today "this purpose is no longer being properly served," because "the ten-day reporting lag leaves a substantial gap" when blockholders can continue to accumulate shares in secret.⁸

This argument proceeds on the mistaken assumption that the drafters of the Williams Act intended to place an absolute 5% limit on pre-disclosure accumulations of outside blockholders but failed to design the rules to achieve this objective. As explained below, however, this account of the objectives of the Williams Act is incorrect. In fact, Congress expressly considered—and declined to adopt—that approach.

The history of the Williams Act makes clear that the ten-day period between the acquisition of a 5% stake and disclosure is not a "gap" left open by incompetent drafters.⁹ Instead, it reflects a careful balance that Congress struck, after extensive debate, between the need to provide information to investors and the importance of preserving the governance benefits associated with outside blockholders.

Senator Williams' initial proposal in this area, which he introduced in October 1965, would have made it unlawful for an outside blockholder to cross the 5% threshold without prior disclosure.¹⁰ The Senator abandoned that proposal, however, after its advance-notice provision was met with significant opposition from the Commission and others.¹¹

⁸ Petition, *supra* note 1, at 2–3.

⁹ For a detailed account of the legislative history of the Williams Act, see WILMER CUTLER PICKERING HALE AND DORR LLP, THE WILLIAMS ACT: A TRULY "MODERN" ASSESSMENT (Aug. 5, 2011), available at <http://www.sec.gov/comments/4-624/4624-5.pdf> (unpublished manuscript).

¹⁰ See A Bill Providing for Fuller Disclosure of Corporate Equity Ownership of Securities Under the Securities Exchange Act of 1934, S. 2731, 89th Cong. § 2 (Oct. 22, 1965).

¹¹ See 112 Cong. Rec. 19,004 (1966).

Instead, following discussions with the Commission, members of the New York Stock Exchange, and private industry, Senator Williams introduced a new bill in January 1967 that would have required that an investor acquiring 10% of the equity of a public company disclose that stake within seven days.¹² When he introduced his new proposal, Senator Williams described his conscious effort to balance the effect of the new law on management and blockholders. He noted that he had “taken extreme care” “to balance the scales equally to protect the legitimate interests of the corporation, management, and shareholders”; “every effort ha[d] been made to avoid tipping the balance of [the] regulatory burden in favor of management or in favor of” those subject to the new disclosure requirement.¹³

Even this new proposal, however, drew criticism from corporate-law commentators of the time. During hearings on Senator Williams’ second proposal, one observer expressed concern that the proposed disclosure would undermine the benefits of outside blockholders, arguing that blockholders make “corporate management . . . recognize . . . that it will be subject to replacement if its performance” is substandard, and that these benefits were “imperative” for effective corporate governance.¹⁴

Senator Williams later concluded that outside investors who acquire large blocks of public company stock “should not be discouraged, since they often serve a useful purpose by providing a check on entrenched but inefficient management.”¹⁵ Thus, Senator Williams proposed a third bill. This proposal was the first to introduce a ten-day window between the acquisition of the investor’s stake and disclosure, requiring any person acquiring beneficial ownership of 10% of a public company’s stock to disclose that ownership within 10 days.¹⁶ When introducing the proposal, Senator Williams argued that the new bill “carefully weighed both the advantages and disadvantages to the public” of the disclosure requirement and took “extreme care to avoid tipping the scales either in favor of management or in favor of” large investors.¹⁷ This proposal later became law. Two years later, when Congress lowered the disclosure threshold from 10% to 5%, it chose to keep the ten-day disclosure window in place.¹⁸

This legislative history suggests that the ten-day window between the acquisition of a 5% stake and required disclosure is not a technical “gap” left open by incompetent congressional drafters. Instead, the window reflects the balance that Senator Williams and his colleagues struck between the ben-

¹² See S. 510, § 1, 90th Cong. (introduced January 18, 1967).

¹³ 113 Cong. Rec. 854 (1967).

¹⁴ *Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids: Hearing Before the Senate Sub. Comm. on Securities of the Senate Comm. on Banking and Currency*, 90th Cong. 134 (1967) (statement of Stanley Kaplan, Professor, University of Chicago).

¹⁵ 113 Cong. Rec. 24,664 (1967).

¹⁶ S. 510, § 2, 90th Cong. (amended Aug. 31, 1967).

¹⁷ 113 Cong. Rec. 24,664 (1967).

¹⁸ See Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968); Act of December 22, 1970, Pub. L. No. 91-567, 84 Stat. 1497 (1970).

efits that the holders of large blocks of stock convey upon public investors and the need for disclosure of these blocks.¹⁹ The fact that blockholders have the ability to acquire additional stock during this ten-day period would not be surprising to the legislators who approved the Williams Act in 1968. Instead, this outcome is a product of Congress's careful consideration of the benefits that blockholders provide to public investors.

In a recent article, a partner in the law firm that submitted the Petition responded to a comment letter that we provided to the Commission regarding the Petition.²⁰ The article contends that our arguments "do not address . . . the undeniable point that the current § 13(d) rules no longer effectively serve their stated purpose."²¹ We think that this argument assumes, incorrectly, that the "stated purpose" of these rules is to absolutely bar outside blockholders from pre-disclosure accumulations exceeding 5% of the company's stock. As we have explained, however, the legislative history of the Williams Act makes clear that Congress intentionally left open the ten-day window during which such accumulations may be made. What the article describes as a "loophole," then, instead reflects the longstanding legislative compromise that Congress adopted when it enacted the Williams Act in 1968.²²

To be sure, although Congress chose in 1968 to allow blockholders to acquire stock during the ten days before they are required to disclose, in 2010 Congress made clear in the Dodd-Frank Act that the SEC has the power to shorten the ten-day period if it so chooses.²³ The grant of this authority should not, however, be understood as a Congressional mandate that the Commission take whatever steps are necessary to ensure a firm 5% constraint on pre-disclosure accumulations. Had Congress wanted that outcome, it could have prohibited pre-disclosure accumulations exceeding 5%, instructing the Commission to adopt rules implementing this objective. Instead, by granting the Commission this authority, Congress has simply posed a question that deserves the Commission's attention: Does it make sense to strike the balance between outside blockholders and management differently than Congress did in 1968?

¹⁹ Interpreting this legislative history, the Supreme Court has repeatedly concluded that the Williams Act is the product of Congress's balancing of these considerations. *See, e.g.*, *Edgar v. MITE Corp.*, 457 U.S. 624, 633 (1982) ("There is no question that in imposing the [Section 13(d) disclosure] requirements, Congress intended to protect investors. But it is also crystal clear that a major aspect of the effort to protect the investor was to avoid favoring either management or the takeover bidder.").

²⁰ David Katz & Laura A. McIntosh, *Corporate Governance Update: Section 13(d) Reporting Requirements Need Updating*, N.Y. L.J., Mar. 22, 2012 (responding, in part, to Letter from Lucian A. Bebchuk, Professor, Harvard Law School & Robert J. Jackson, Jr., Associate Professor, Columbia Law School, to Elizabeth M. Murphy, Secretary, U.S. Sec. & Exch. Comm'n (Jul. 11, 2011), available at <http://www.sec.gov/comments/4-624/4624-3.pdf>).

²¹ Katz & McIntosh, *supra* note 20, at 6.

²² *Id.*

²³ *See* Dodd-Frank Wall Street Reform Consumer and Protection Act, Pub. L. No. 111-203, § 929R(a), 124 Stat. 1376 (2010).

In making that decision, the Commission should not be guided by general intuitions about transparency or mistaken assumptions about the Williams Act's objectives, but instead by the principle that its rules must protect investors and promote efficiency. We therefore turn below to an analysis of the costs and benefits of the proposed tightening of the rules governing the disclosure of outside blockholders.

II. THE COSTS OF TIGHTENING THE RULES ON BLOCKHOLDERS

The literature in law, economics, and finance has long recognized that the presence of outside blockholders—and particularly blockholders willing to invest in monitoring and disciplining management—is beneficial for investors.²⁴ Shareholders who make these investments in monitoring must bear their full costs but share the benefits with fellow shareholders, capturing only the shareholder's *pro rata* fraction of these benefits. For this reason, shareholders that hold only a small fraction of the firm's shares have little incentive to make such investments—even when those investments could produce a significant increase in value. By contrast, outside blockholders with a significant stake have stronger incentives to invest in monitoring and engagement. These investments can be expected to make incumbents more accountable and to reduce agency costs and managerial slack.

These investments, however, are costly, and it is well understood that the incidence and size of outside blocks depend on blockholders' ability to obtain returns that cover these costs. As we explain below, tightening the rules that apply to blockholders can be expected to reduce the incidence of outside blocks as well as blockholders' investments in monitoring and disciplining management.

A. *Empirical Evidence on the Value of Blockholders*

There is a substantial body of empirical evidence that is consistent with the view that outside blockholders improve corporate governance and benefit public investors. To begin, two recent studies examine situations in which outside blockholders announced their presence to the markets by making Section 13(d) filings. In one study, Alon Brav, Wei Jiang, Frank Partnoy, and Randall Thomas found that the filing of a Schedule 13D revealing an activist shareholder's position is associated with large, positive average ab-

²⁴ For an early article recognizing the importance of outside blockholders, see Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461 (1986); see also, e.g., Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729 (2008); April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187 (2009); Clifford G. Holderness & Dennis P. Sheehan, *Raiders or Saviors? The Evidence on Six Controversial Investors*, 14 J. FIN. ECON. 555 (1985).

normal returns.²⁵ In another study, April Klein and Emanuel Zur concluded that the filing of a Schedule 13D in which an outside blockholder indicates that it aims to redirect management's efforts is also associated with large, positive average abnormal returns.²⁶ This evidence is consistent with the view that market participants expect the presence of blockholders to be beneficial for firm value.²⁷

Furthermore, consistent with the findings of positive market reactions to the presence of an outside blockholder discussed above, there is substantial empirical evidence indicating that the presence of outside blockholders is associated with improved outcomes for shareholders on various dimensions. This body of work includes the following studies:

(i) A study by Marianne Bertrand and Sendhil Mullainathan finds that CEO pay is less likely to reward "luck" instead of performance when a blockholder is represented on the company's board;²⁸

(ii) A study by Lucian Bebchuk, Yaniv Grinstein, and Urs Peyer shows that the presence of representatives of blockholders on a board's compensation committee is associated with reduced incidence of stock option backdating;²⁹

(iii) A study by Anup Agrawal and Tareque Nasser shows that the presence on a company's compensation committee of an independent director associated with a significant shareholder is correlated with a stronger relationship between CEO pay and performance, a stronger relationship between CEO turnover and performance, and lower levels of CEO pay;³⁰

(iv) A study by James Brickley, Ronald Lease, and Clifford Smith shows that the presence of institutional blockholders is associated with increased shareholder opposition when management proposes entrenching anti-takeover amendments to the company's charter;³¹ and

(v) A study by Anil Shivdasani shows that the presence of outside blockholders is associated with an increased likelihood of transactions that discipline management.³²

²⁵ See Brav et al., *supra* note 24, at 1730–31.

²⁶ See Klein & Zur, *supra* note 24, at 188–89.

²⁷ This conclusion was also reached in an early empirical study by Clifford Holderness and Dennis Sheehan. See Holderness & Sheehan, *supra* note 24, at 557 (concluding that the filing of a Schedule 13D by six investors known to actively engage with management was associated with positive abnormal returns).

²⁸ See Marianne Bertrand & Sendhil Mullainathan, *Are CEOs Rewarded for Luck? The Ones Without Principals Are*, 116 Q. J. ECON. 901, 903 (2001).

²⁹ See Lucian A. Bebchuk et al., *Lucky CEOs and Lucky Directors*, 65 J. FIN. 2363, 2365 (2010).

³⁰ See Anup Agrawal & Tareque Nasser, *Blockholders on Boards and CEO Compensation, Turnover and Firm Valuation* (Nov. 27, 2011), available at <http://bama.ua.edu/~aagraval/IDB-CEO.pdf> (unpublished manuscript).

³¹ See James A. Brickley et al., *Ownership Structure and Voting on Antitakeover Amendments*, 20 J. FIN. ECON. 267 (1988).

³² See Anil Shivdasani, *Board Composition, Ownership Structure, and Hostile Takeovers*, 16 J. ACCT. & ECON. 167 (1993). The literature described here focuses on the effects associ-

Finally, the presence of an outside blockholder benefits shareholders by making the possibility of a proxy fight more viable. The possibility of a proxy fight is generally understood to be a disciplinary mechanism that plays an important role in making directors accountable for corporate performance and constraining agency costs. There is significant evidence that the announcement of a proxy fight is associated with positive abnormal returns,³³ and the disciplinary force of the prospect of a proxy fight could well produce additional benefits for shareholders in many cases in which a proxy fight does not actually take place. Without an outside blockholder, however, a proxy fight is unlikely even in a case of substantial underperformance because there may not be a shareholder with sufficient “skin in the game” to bear the costs involved in a proxy challenge.

In contrast, the presence of an outside blockholder with a significant stake makes a proxy fight more viable. When a proxy fight might lead to an increase in shareholder value, the prospect of having its block appreciate in value might provide such an outside blockholder with sufficient incentive to bear the costs of mounting a proxy fight.³⁴ Indeed, there is evidence that the shareholders mounting these challenges are likely to have a significant stake in the firm.³⁵ Thus, at companies without an outside blockholder (or the prospect of a blockholder emerging), incumbent directors and executives face a substantially reduced threat of a proxy fight in case of underperformance, and this insulation from the possibility of a proxy fight will be likely to have an adverse effect on shareholder interests, increasing agency costs, and managerial slack.

B. *The Effect of Tightening the Rules*

Having discussed the benefits of outside blockholders for investors—taking their presence as given—we turn now to the factors that determine whether such blockholders are likely to emerge. It is well understood that the incidence and size of outside blocks, and the investments in value-enhancing activities made by outside blockholders, depend on the ability of outside blockholders to obtain returns that cover their costs. Outside blockholders

ated with *outside* blockholders—that is, blocks held by shareholders not affiliated with management. By contrast, large blocks held by insiders may render insiders less rather than more accountable to shareholders.

³³ See Lisa F. Borstadt & Thomas J. Zwirlein, *The Efficient Monitoring Role of Proxy Contests: An Empirical Analysis of Post-Contest Control Changes and Firm Performance*, 21 FIN. MGMT. 22, 23 (1992); cf. David Ikenberry & Josef Lakonishok, *Corporate Governance Through the Proxy Contest: Evidence and Implications*, 66 J. BUS. 405, 432–33 (1993) (finding that the targets of proxy contests exhibit negative abnormal returns, and worsening operating performance, immediately prior to the initiation of a proxy contest).

³⁴ See Lucian A. Bebchuk & Oliver Hart, *Takeover Bids vs. Proxy Fights in Contests for Corporate Control* (Eur. Corporate Governance Inst. Working Paper Series in Fin., Paper No. 04/2002, 2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=290584.

³⁵ See John Pound, *Proxy Contests and the Efficiency of Shareholder Oversight*, 20 J. FIN. ECON. 237, 253 tbl.3 (1988).

make costly investments in monitoring and engagement and, in addition, may be forced to bear the costs of non-diversification associated with their large stake.

It has long been recognized that an important source of incentives to become an outside blockholder is the blockholder's ability to purchase shares at prices that do not yet fully reflect the expected value of the blockholder's future monitoring and engagement activities.³⁶ Once the presence of an outside blockholder is publicly disclosed, prices rise to a level reflecting these expected benefits. If an outside blockholder could not purchase an initial block at prices below this level, the returns to becoming an active outside blockholder would fall, and shareholders would lose the benefits of blockholders' presence. The ability to buy an initial block at prices below the post-disclosure level enables blockholders to capture a fraction—albeit a fairly limited fraction—of the expected benefits from their expected future activities. Other shareholders benefit from giving blockholders this ability, because other investors capture the lion's share of the benefits generated by the blockholder's monitoring and engagement activities—benefits that otherwise might not be produced.

Tightening the rules that govern the amount of time blockholders have to acquire shares before disclosing their stake can thus be expected to reduce the returns to outside shareholders considering acquiring a block and, in turn, to result in a reduction in the incidence and size of outside blocks.³⁷ In some cases, those considering becoming significant blockholders might be deterred from doing so altogether. In other cases, those becoming significant blockholders might elect to purchase a smaller block. Given the importance and beneficial role of outside blocks, disincentives to the creation of such blocks can be expected to impose costs on investors, increasing agency costs and managerial slack. Rules creating such disincentives should be adopted only if they can be expected to produce benefits that exceed these costs.

The Petition suggests that for sophisticated players with ample access to legal counsel—as most outside blockholders are—tighter disclosure rules would not impose any meaningful costs.³⁸ But the main cost of disclosure obligations in this context is not the transaction costs, such as legal fees, imposed by securities filings. Rather, the principal cost of tightened disclosure obligations for potential outside blockholders is that such tightening

³⁶ For early work recognizing this point, see S.J. Grossman & O.D. Hart, *Disclosure Laws and Takeover Bids*, 35 J. FIN. 323 (1980); Shleifer and Vishny, *supra* note 24.

³⁷ We focus here only on the rules that govern the timing of disclosure that blockholders are required to provide after they have reached the 5% ownership disclosure threshold. We put to one side other questions, such as whether derivatives and similar securities should count toward the 5% threshold. *See supra* text accompanying note and note 6.

³⁸ *See* Petition, *supra* note 1, at 5 (because blockholders are “sophisticated, experienced investor[s],” tightened rules will not impose a substantial burden on them); *see also* Katz & McIntosh, *supra* note 20, at 3–4 (arguing that the “sophistication of the investors” who trigger Section 13(d)'s disclosure requirements make tighter disclosure requirements “feasible” for these investors).

reduces the fraction of the benefits produced by their monitoring and engagement that the potential outside blockholders can expect to capture if they choose to acquire a block.³⁹ This cost to potential outside blockholders might, in turn, produce costs for investors by reducing the incidence and size of outside blocks.

Before tightening the rules governing the outside investors who hold large blocks of public company stock, regulators should carefully consider the valuable role that these outside blockholders play in corporate governance, the increased agency costs and managerial slack that would arise if outside blockholders are discouraged or suppressed, and the significant empirical evidence on the benefits produced by outside blockholders. These considerations should play a role in the Commission's examination of the rules governing outside blockholders.

III. THE ASSERTED BENEFITS OF TIGHTENING THE RULES ON BLOCKHOLDERS

As we have noted, tightening the rules on blockholders may impose substantial costs on investors—including the increase in agency costs and managerial slack that might accompany a diminished role for blockholders in corporate governance. These costs, of course, must be weighed against any benefits that would arise from tightening these rules. The Petition argues that the key benefit of tightening these rules would be to protect public company investors from losing the premium associated with corporate control.

To illustrate, consider a situation in which an outside blockholder identifies an underperforming company with 100 million shares and a market capitalization of \$1 billion. Suppose that the blockholder purchases 5% of the company's shares for \$10.00 each on June 1, and an additional 2% for \$10.10 each between June 1 and June 9. Suppose, too, that the outside blockholder files a Schedule 13D on June 10—and that, upon the filing of the Schedule 13D, the price per share rises by 5%, to \$10.60. According to the Petition, the blockholder's ability to pay \$10.10 per share, rather than \$10.60 per share, for the additional 2% deprives the selling shareholders of a control premium of \$1 million ($\0.50×2 million shares), enabling the blockholders to capture control benefits of \$1 million. Tightening Section 13(d)'s disclosure rules, the Petition claims, is necessary to protect investors from losing control premia in such situations.⁴⁰

This claim, however, is unwarranted. In cases like these, the blockholder purchasing an additional 2% has not obtained control benefits, and shareholders have not lost a control premium. A buyer obtains a control

³⁹ Cf. Brav et al., *supra* note 24, at 1730 (finding that the filing of a Schedule 13D by hedge funds is associated with positive abnormal stock returns).

⁴⁰ See, e.g., Katz & McIntosh, *supra* note 20, at 3 (arguing that, under current rules, one blockholder was able to acquire shares of J.C. Penney "at a substantially lower price from unwitting shareholders than would have been possible" under a tighter set of disclosure rules).

block only when the block is large enough for the buyer to have the practical ability to determine corporate outcomes, which in turn permits the buyer to obtain substantial “private benefits of control” not shared by other, non-controlling shareholders. Blocks that are large enough to convey control usually trade at a premium to the prevailing market price.⁴¹ By contrast, the buyer of the outside block in cases like the example above does not obtain control and its private benefits.

A shareholder with a 7% block will be able to move the company in the direction the blockholder views as value-increasing only if the blockholder can convince other shareholders that doing so would be desirable (or if the incumbent directors and executives anticipate that the blockholder will be able to convince shareholders). If an outside blockholder *is* able to facilitate such a change, the blockholder would not be capturing a private benefit, but rather a gain that would be shared, on a *pro rata* basis, with fellow shareholders. Indeed, should the non-controlling outside blockholder decide to sell its 7% block, it would likely be unable to get a control premium over the market price for its block. While blocks that carry a control premium with them are generally sold as a block, outside blockholders that decide to exit after filing a Schedule 13D usually do not sell their block as a whole but rather, consistent with the view that they have not captured a control premium, sell shares in the market.⁴²

The Petition relies heavily upon two recent anecdotes in which an outside blockholder influenced public companies—noting that in one case the company decided to pursue the strategy advocated by the blockholder, and in the other the company appointed a representative of the blockholder to its board—and suggests that these cases “demonstrat[e] the influence and control” that blockholders enjoy.⁴³ But this sort of “influence” should hardly be equated with the blockholder obtaining control and capturing a control premium at the expense of other shareholders. Indeed, there are many cases in which shareholders holding far less than a 5% stake were able to exert influence over a public company. Recently, for example, shareholders owning less than 1 percent of the stock of Massey Energy successfully urged that CEO Don Blankenship be removed.⁴⁴ CalPERS, which commonly holds far less than a 5% stake in public companies, has had influence on

⁴¹ For an empirical analysis of control premia, see Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537 (2004).

⁴² See, e.g., Brav et al., *supra* note 24, at 1747–48 (describing the exit behavior of blockholders such as activist hedge fund investors and concluding that “hedge fund activism does not generally involve control blocks of stock”).

⁴³ See Petition, *supra* note 1, at 6. Notably, in both cases the outside blockholder did not succeed in electing its nominees to a majority of the seats on the company’s board of directors. See *id.*

⁴⁴ Steve James, *Massey Faces Shareholder Anger Over Mine Disaster*, REUTERS (Apr. 13, 2010), available at <http://www.reuters.com/article/2010/04/13/us-massey-idUSTRE63C2Q920100413>.

companies it targeted using its “focus list.”⁴⁵ This type of influence, or the appointment of a single blockholder representative to the board, is by itself not evidence that the shareholder has obtained “control.”

Of course, outside blockholders can derive benefits—even though these are not “control” benefits—from the ability to buy additional shares at lower prices before their presence is made public. This ability allows the outside blockholder to capture an increased fraction of the benefits its activities are expected to produce, which in turn gives outside blockholders incentives to create value that will be shared with other investors. While tightening Section 13(d)’s disclosure requirements could give shareholders an increased fraction of the benefits from the blockholder activity that would still take place after the rules are tightened, these benefits would come at the cost of a reduction in the expected incidence and size of outside blocks—and, in turn, increased agency problems and managerial slack.

Thus, while it is far from clear that shareholders would obtain any net benefits from tightening these rules, what *is* clear is that such tightening would significantly benefit incumbent directors and executives—especially those at underperforming companies. Underperforming incumbents have much to gain from increased insulation from outside blockholders’ monitoring and engagement and therefore would benefit from changes in rules that would provide disincentives for the emergence of significant, active outside blockholders. For shareholders, however, such increased insulation would be detrimental, increasing agency costs and managerial slack. The Commission should carefully consider these potential costs before modifying the rules in this area.

IV. CHANGES SINCE THE PASSAGE OF THE WILLIAMS ACT

The Petition also argues that changes since the passage of the Williams Act—and, in particular, changes in trading technology—justify tightening these rules. In this Part we explain why changes in the decades since the passage of the Williams Act provide little support for the proposed tightening. Section A explains that there is currently no evidence that changes in trading practices provide a basis for tightening of disclosure rules. Indeed, as we argue in Section B, changes in the legal landscape since the passage of the Williams Act have imposed significant additional costs on blockholders over the past three decades—and therefore weigh against the Petition’s proposed tightening of the rules on blockholders. Finally, in Section C we explain why developments in jurisdictions outside the United States do not provide support for tightening the rules as the Petition suggests; to the contrary, U.S. law places outside blockholders at a much greater disadvantage than they face in any of the jurisdictions that the Petition relies upon when

⁴⁵ See *Reform Focus List Companies*, CALPERS (last visited April 8, 2012), <http://www.calpers-governance.org/focuslist/reform-companies>.

arguing in favor of tightening the rules governing blockholder disclosure in the United States.

A. Changes in Trading Practices

The Petition stresses that much has changed since the passage of the Williams Act. In particular the Petition argues that, due to changes in trading practices and technologies, outside blockholders now tend to amass larger positions before filing a Schedule 13D than they did previously.⁴⁶ Indeed, the Petition contends, “recent events have highlighted the potential extremes to which these acquisition tactics may be taken, and make clear the urgent need for . . . reform.”⁴⁷ But we are aware of no empirical evidence to support the Petition’s claim that outside blockholders have in recent years amassed larger pre-disclosure ownership stakes than they accumulated in earlier periods.

Data on pre-disclosure accumulations by blockholders are now, and long have been, publicly available from Schedule 13D filings. However, the Petition does not provide a systematic examination of these data—for example by comparing evidence from recent years to data from earlier periods—or refer to any empirical study doing so. Instead, the Petition refers to four anecdotes—two from 2010, involving J.C. Penney and Fortune Brands, and two from 2008, involving CSX and CNET.⁴⁸ In claiming that investors “frequently do” engage in large accumulations during the period between the crossing of the 5% threshold and the time of disclosure, the Petition also relies on a newspaper article that refers to three of these four cases described but does not identify any other U.S. cases.⁴⁹ And, as we have noted, a partner of the law firm that authored the Petition recently published an article supporting the Petition. Although that article was written nearly a year after the Petition was submitted, the article still mentions only one anecdote (drawn from the set of four anecdotes on which the Petition relied) and the same newspaper report, offering no systematic examination of the data that is publicly available from Schedule 13D filings.⁵⁰

Describing four cases occurring over the past four years, however, is not the type of systematic evidence that could provide a basis for concluding that Commission rulemaking is urgently needed to address changes in trading practices and technologies. Indeed, the existence of anecdotes like these is itself far from a new market development. A study by Clifford Holderness

⁴⁶ See Petition, *supra* note 1, at 3 (stating that “[t]he advent of computerized trading . . . allowing massive volumes of shares to trade in a matter of seconds” and “the increasing use of derivatives has accelerated the ability of investors to accumulate economic ownership of shares . . .”).

⁴⁷ *Id.* at 2.

⁴⁸ See *id.* at 5–6, 8, 10; see also Katz & McIntosh, *supra* note 20, at 3.

⁴⁹ *Id.* at 3, n.9 (citing Andrew Ross Sorkin, *Big Investors Appear Out of Thin Air*, DEALBOOK (Nov. 1, 2010) (noting the cases of J.C. Penney, CSX, and CNET)).

⁵⁰ See Katz & McIntosh, *supra* note 20, at 3.

and Dennis Sheehan examined Schedule 13D filings during the 1977–1982 period and reported the existence of a small minority of cases with significant accumulation between the crossing of the 5% threshold and the filing of the Schedule 13D.⁵¹

In addition, a recent study in this area suggests that the anecdotes described in the Petition are not representative of blockholders' accumulation practices today. In response to the Petition, Alon Brav, J.B. Heaton, and Wei Jiang submitted a letter to the Commission indicating that their study of certain blockholders' disclosures between 2001 and 2007 indicates that more than 50% of blockholders voluntarily disclose their stakes *before* the tenth day, when the disclosures are required. Indeed, the authors find that the relationship between the number of days that it takes the blockholder to report and the stake the blockholder reports is negative. Based on their assessment of blockholder activity during this period, the authors conclude that the anecdotes described in the Petition are "not typical."⁵²

In assessing the claim that accumulation practices by outside blockholders have markedly changed over time—creating an "urgent" need to adjust the rules to changed market circumstances—the Commission should not rely on a few anecdotes. An adequate assessment of this claim requires a systematic empirical examination of publicly available Schedule 13D filings to determine what changes in pre-disclosure accumulations by outside blockholders, if any, have taken place since the passage of the Williams Act. Such a study could, for example, examine substantial samples of Schedule 13D filings in each five-year period since the passage of the Williams Act and compare the ownership stakes held by outside blockholders at the time they made these filings.

Of course, the results of such a study would not be dispositive with respect to whether changes in the rules governing outside blockholders would benefit investors and promote efficiency. In making that decision, the Commission should take into account the evidence we have previously described as well as the additional considerations described below. However, such an inquiry would help the Commission obtain an adequate factual understanding of whether pre-disclosure accumulations in recent years are significantly different from earlier patterns. To our knowledge, no existing empirical evidence provides sufficient support for that claim.

B. Changes in the Legal Landscape

While it is not clear at this stage what changes, if any, have occurred in the accumulation practices of outside blockholders since the passage of the Williams Act, the Commission should carefully consider significant *legal*

⁵¹ See Holderness & Sheehan, *supra* note 24, at 563.

⁵² Letter from Alon Brav et al. to Elizabeth M. Murphy, Secretary, U.S. Sec. & Exch. Comm'n (July 5, 2011), at 2, available at <http://www.sec.gov/comments/4-624/4624-2.pdf>.

changes that have clearly taken place during that period. Over the past three decades, legal rules have evolved in ways that impede outside blockholders and disadvantage them vis-à-vis incumbents. Given how the legal landscape has changed since the passage of the Williams Act, the Commission should be especially cautious before further tightening the rules that apply to blockholders.

To begin, those who might consider buying an outside block as a “toehold” prior to acquiring a control block—the case that the drafters of the Williams Act devoted much attention to⁵³—now face formidable impediments that did not exist when the Williams Act was passed. In particular, state law now allows boards to use poison pills to block hostile tender offers.⁵⁴ Because of the substantial legal impediments to hostile takeover bids, the incidence of such bids is low.⁵⁵ Today, active outside blockholders filing a Schedule 13D are commonly not expected to seek to acquire control, but rather to monitor and engage with management and fellow shareholders.⁵⁶

More importantly, in addition to the limits on unsolicited offers for control, further legal changes since the passage of the Williams Act impede blockholders that seek merely to influence how their company is managed. To begin, companies have been adopting poison pills with low ownership thresholds—pills designed not to prevent an acquisition of control but to keep outside blockholders unfriendly to management from increasing their stake—and state law has been displaying tolerance toward such pills.⁵⁷ Among the 805 public companies in the Sharkrepellent dataset that currently have poison pills in place, 76% have pills triggered by an ownership threshold of 15% or less, while 15% have pills triggered by a threshold of 10% or less.⁵⁸ Furthermore, while most publicly traded companies do not currently have a pill in place, these companies always have an “off-the-shelf” low-trigger pill available to them and can install one immediately if an outside

⁵³ See, e.g., H.R. Rep. No. 91-1711, at 2 (1968) (describing the focus of the drafters of the Williams Act on the use of cash tender offers in connection with takeover bids).

⁵⁴ In Delaware, boards' virtually absolute power to block hostile offers has been established by the courts. See *Air Prods. & Chems., Inc. v. Airgas, Inc.*, 16 A.3d 48 (Del. Ch. 2011). In other states, this power is enshrined in pill-endorsement statutes. Michal Barzuza, *The State of State Antitakeover Law*, 95 VA. L. REV. 1973 (2009).

⁵⁵ See, e.g., George P. Baker & Guhan Subramanian, *The Global Market for Corporate Control* (unpublished manuscript, on file with authors) (reporting that hostile tender offers represented approximately 3.6% of all merger and acquisition volume in the United States in 2002).

⁵⁶ See, e.g., Brav et al., *supra* note 24, at 1732 (blockholders such as “activist hedge funds do not typically seek control in target companies”).

⁵⁷ In *Versata Enters., Inc. v. Selectica, Inc.*, 5 A.3d 586, 599–607 (Del. 2010), the Delaware Supreme Court upheld the use of a poison pill with a 5% ownership trigger where the company had certain net operating loss assets that could lose value if that ownership level was breached. The Delaware courts have not yet established the lowest level at which pill triggers may be set in the absence of such an asset, but current practices indicate that practitioners expect (or hope) that companies will be permitted to use triggers at a 15% or 10% ownership level.

⁵⁸ See Factset Research Systems, Inc., Dataset, SHARKREPELLANT, <http://sharkrepellent.net> (last visited Apr. 8, 2012).

blockholder disfavored by the incumbents emerges—an important feature of the current landscape that a market participant considering becoming an outside blockholder must consider.

In addition, state law now allows companies to use poison pills selectively to disfavor some outside blockholders and to prohibit some shareholders—but not others—from holding stakes exceeding a specified threshold.⁵⁹ Companies have also been adopting poison pills with “continuing director” provisions triggered when a majority of directors is replaced with new directors not approved by the incumbents, thereby discouraging outside blockholders from attempting to run a proxy fight for a majority of the seats on the board.⁶⁰

To be sure, the Commission does not have the power to make direct changes to the state law rules that have, since the passage of the Williams Act, evolved to disfavor outside blockholders. But in considering whether to make changes in rules it *does* have the power to amend, the Commission should take these state law rules into account in deciding what changes, if any, would be desirable. Given the value of outside blockholders to investors, the Commission should be wary of adopting rules that would further discourage these blockholders and their activities without a clear showing that the benefits of any such rules would outweigh their costs.

C. *Falling Behind the Rest of the World?*

Finally, the Petition argues that the rules governing the timing of blockholder disclosure in other countries, such as the United Kingdom, “compel[] the Commission to enact related reforms.”⁶¹ As we explain below, however, this claim is based on an unduly narrow comparison of the rules that apply to blockholders. In fact, when one considers the broad set of rules regulating the balance of power between incumbents and outside blockholders, it is clear that U.S. law puts blockholders at a greater disadvantage than they face in other relevant jurisdictions.

The Petition and its advocates argue that support for their position is provided by rules in several foreign jurisdictions—the United Kingdom,⁶²

⁵⁹ See, e.g., *Yucaipa Am. Alliance Fund II, L.P. v. Riggio*, 1 A.3d 310, 312–313 (Del. Ch. 2010) (upholding the use of a poison pill triggered by the acquisition of 20% ownership by shareholders other than Leonard Riggio, the founder of Barnes & Noble, Inc.), *aff’d*, 15 A.3d 218 (Del. 2011).

⁶⁰ See generally WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, *COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION* 606 § 13.9.1 (3d ed. 2009) (describing the use of “continuing director” pills); see also *Invacare Corp. v. Healthdyne Technologies, Inc.*, 968 F. SUPP. 1578 (N.D. Ga. 1997) (upholding the use of such pills under Georgia law).

⁶¹ See Petition, *supra* note 1, at 9.

⁶² See Katz & McIntosh, *supra* note 20, at 4 (citing Disclosure Rules and Transparency Rules, 2012, Fin. Servs. Auth. Handbook, ch. 5 (U.K.), available at <http://fsahandbook.info/FSA/html/handbook/DTR/5>).

Australia,⁶³ Canada,⁶⁴ and Hong Kong⁶⁵—that require blockholders to disclose lower stakes or to disclose stakes more quickly than current U.S. rules. Citing these jurisdictions, a partner in the firm that authored the Petition argues in recent work that, “[i]n the absence of updated requirements, the U.S. markets are more vulnerable than those in other jurisdictions to . . . exploitat[i]on] of the 10-day window.”⁶⁶

This view fails to acknowledge, however, how the United States compares with these countries in terms of the overall treatment of outside blockholders. In no common law country other than the United States can an outside blockholder disclosing its presence fear being immediately subject to a poison pill precluding it from exceeding an ownership level that falls substantially below a control block. Indeed, in our view, to the extent there is a risk that U.S. law puts our markets at a disadvantage, that risk is most acute with respect to state law rules that render the United States much more hostile to outside blockholders—which, as we have explained, play an important role in corporate governance.

To be sure, the Commission should consider developments in foreign jurisdictions and their effects on U.S. markets when examining its rules on outside blockholders. But a narrow assessment of the law in these jurisdictions, limited only to the disclosure rules that apply to blockholders, offers an incomplete picture of the overall effect of legal rules on the role of blockholders in corporate governance. Instead, any comparative assessment of the United States’ rules on blockholder disclosure should consider the broad set of rules governing outside blockholders—and recognize that the United States stands out among common law countries in the legal tools it gives incumbents seeking to impede outside blockholders who attempt to improve governance and increase firm value.

Indeed, lawmakers in the United States should be concerned that, overall, the rules governing the balance of power between management and outside blockholders have already moved some distance in favor of the former, particularly when compared to other jurisdictions. A partner in the firm that submitted the Petition has argued that the Commission’s failure to tighten these rules further has worked “to the detriment of the United States’ ability to compete effectively in the global economy,” and that tightening is needed to “level[] the playing field.”⁶⁷ To the contrary, as we have explained, current law in the United States already tilts the playing field

⁶³ See Katz & McIntosh, *supra* note 20, at 4 (citing Takeover Panels, Guidance Note 20: Equity Derivatives (Austl.), available at http://www.takeovers.gov.au/content/DisplayDoc.aspx?doc=guidance_notes/current/020.htm&pageID=&Year).

⁶⁴ See Katz & McIntosh, *supra* note 20, at 4 (citing Province of Ontario Securities Act, R.S.O 1990, c. S.5, § 102.1 (Can.)).

⁶⁵ See Katz & McIntosh, *supra* note 20, at 4 (citing Hong Kong Securities and Futures Ordinance, No. 571, (2003), pt. XV).

⁶⁶ See Katz & McIntosh, *supra* note 20, at 4.

⁶⁷ *Id.* at 6.

against blockholders further than the law in any other advanced economy. The United States is the only country in which incumbents can use shareholder rights plans to impose a ceiling on the size of the stakes that can be purchased by outside blockholders that incumbents do not favor. Combined with low-trigger rights plans, a further tightening of the rules requiring disclosure of outside blocks could give incumbents the power to keep outside blockholders at bay. This interaction between previously sanctioned defensive measures and disclosure rules is not present in any other advanced economy. Thus, lawmakers seeking to guard the United States' capital markets, and its ability to compete effectively, should be wary of any steps that would further tilt the legal playing field in favor of incumbents.

CONCLUSION

The Securities and Exchange Commission is currently considering tightening the rules that govern the timing of the disclosure of large blocks of stock in U.S. public companies. Such tightening cannot be justified by an appeal to general intuitions about market transparency or by the claim that tightening is required to achieve the objectives of the Williams Act. Instead, before proceeding with the proposed tightening, the Commission should conduct a policy analysis of its expected costs and benefits. In this Article, we have provided a framework for that analysis.

As we have explained, the Commission should consider the significant evidence that blockholders' presence and activities provide substantial benefits to public companies and their shareholders—and the adverse effect that tightening blockholders' disclosure obligations can be expected to have on these activities. Moreover, current evidence on changes in market practices since the passage of the Williams Act provides no basis for tightening these rules. Instead, changes in the legal landscape since that time make clear that blockholders face significant hurdles that are greater than those they face in other jurisdictions as well as those that were in place when Section 13(d) was first adopted in 1968.

We encourage the Commission to undertake a comprehensive examination of the rules governing blockholders. In our view, the Commission's examination should include a careful assessment of the empirical issues we have identified, including the following:

- (i) An assessment, building on existing empirical work, of the magnitude of the benefits conferred on shareholders by the presence of outside blockholders and the factors that determine the size of these benefits in given cases;
- (ii) An assessment of the effects of existing disclosure requirements, and of the expected effects of tightening or relaxing them, on both the incidence and size of the stakes held by outside blockholders and the investments in monitoring and engagement activities made by such blockholders;

(iii) An assessment, based on an empirical study of Schedule 13D filings, of how pre-disclosure accumulations by outside blockholders have changed, if at all, since the passage of the Williams Act; and

(iv) An assessment of the extent to which the evolution of rules impeding the activities of outside blockholders, including rules allowing companies to use poison pills against outside blockholders not seeking to acquire control, adversely affects both the incidence and size of the stakes held by outside blockholders and the monitoring and engagement investments made by such blockholders.

In the meantime, the Commission should not pursue a piecemeal tightening of the rules governing the timing of blockholder disclosure. The received academic understanding and the available empirical evidence provide no basis for concluding that such changes would protect investors and promote efficiency. Indeed, there is a strong basis for concern that such changes would adversely affect investors and the performance of publicly traded companies.