PROFESSORS LUCIAN A. BEBCHUK & ROBERT J. JACKSON, JR.

July 11, 2011

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, Northeast
Washington, D.C. 20549

Re: Commission Examination of Section 13(d) Rules and Rulemaking Petition Submitted by Wachtell, Lipton, Rosen & Katz

Dear Ms. Murphy:

We understand that the Commission is considering making changes to its rules under Section 13(d) of the Securities Exchange Act of 1934, which apply to holders of significant blocks of public-company stock.[1] In connection with the Commission's consideration of these changes, the law firm of Wachtell, Lipton, Rosen & Katz has submitted a rulemaking petition (the "Petition") urging the Commission to tighten the disclosure rules applicable to blockholders.[2] We respectfully request that the Secretary transmit this letter to the Commission for consideration in the course of its examination of its rules under Section 13(d).

Both of us are academics who research and teach in the corporate law field. Lucian Bebchuk is the William J. Friedman and Alicia Townshend Friedman Professor of Law, Economics, and Finance, and the Director of the Program on Corporate Governance, at Harvard Law School; Robert J. Jackson, Jr. is Associate Professor of Law at Columbia Law School.[3] We

[1] Beneficial Ownership Reporting Requirements and Security-Based Swaps, Release No. 34-64628, 76 Fed. Reg. 34,579, 34,581 (June 14, 2011) ("[O]ur staff is engaged in a separate project to develop proposals to modernize reporting under Exchange Act Section[] 13(d)"); *see also* CBS MARKETWATCH, *SEC Eyes Faster Disclosure for Activist Funds* (Feb. 25, 2011) ("[T]he chief of the SEC's Office of Mergers & Acquisitions told [the press] that [the Staff] will recommend to the Commission that they should shorten the number of days [blockholders] have before they must publicly disclose [their] stake in the company.").

[2] WACHTELL, LIPTON, ROSEN & KATZ, *Petition for Rulemaking Under Section 13 of the Securities Exchange Act of 1934* (March 7, 2011) [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.

[3] We write solely in our individual capacities; our institutional affiliations are given here for identification purposes only. We are grateful to Chapmann Wong for exceptional research assistance.

are engaged in a joint research project on the rules governing blockholders, and our comments in this submission build upon this academic work.

We write to urge the Commission not to proceed with changes to these rules before undertaking a comprehensive examination of their economic implications for investors and efficiency, and to identify the questions such an examination should consider. In the meantime, the existing research and available empirical evidence provide no basis for concluding that tightening the rules governing blockholders would satisfy the requirement that Commission rulemaking protect investors and promote efficiency,[4] and indeed raise concerns that such tightening could harm investors and undermine efficiency.

It might be argued that the tightening of rules governing blockholders proposed by the Petition would merely represent "technical" changes needed to modernize the Section 13(d) rules in light of changes in the marketplace.[5] In our view, however, the proposed changes should not be viewed as technical adjustments. Instead, the desirable design of the Commission's rules under Section 13(d) must be examined in the larger context of the beneficial role that blockholders not affiliated with incumbent directors or managers ("outside blockholders") play in American corporate governance and the broad set of rules governing such outside blockholders.

Our comments proceed as follows:

- First, we describe the significant empirical evidence indicating that the accumulation and holding of outside blocks in public companies benefits shareholders and promotes efficiency, making incumbent directors and managers more accountable and thereby reducing agency costs and managerial slack.

- Second, we explain that tightening the rules applicable to outside blockholders can be expected to reduce the returns to blockholders and thereby reduce the incidence and size of outside blocks—and, thus, blockholders' investments in monitoring and engagement, which in turn could result in increased agency costs and managerial slack.

- Third, we explain that there is currently no empirical evidence to support the Petition's assertion that changes in trading technologies and practices have recently led to significant increase in pre-disclosure accumulations of ownership stakes by outside blockholders.

- Fourth, we explain that, since the passage of Section 13, changes in state law—including the introduction of poison pills with low-ownership triggers that impede outside

[4] *See* 15 U.S.C. § 78c(f).
[5] *See generally* Petition, *supra* note 2.

blockholders that are not seeking the acquisition of control—have tilted the playing field against such blockholders.

- Finally, we explain that the tightening of the rules requested by the Petition is not justified on the grounds that such tightening is needed to protect investors from the risk that outside blockholders will capture a control premium at shareholders' expense.[6]

We conclude by urging the Commission to pursue a comprehensive examination of the rules in this area—as well as the empirical questions discussed below. In the meantime, however, for the reasons given below, existing research and empirical evidence offer no basis for adopting new rules that tighten restrictions on outside blockholders.

Empirical Evidence on the Value of 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.[7] 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.

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 abnormal returns.[8] 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,

[6] We would like to stress that our analysis is based on existing research and empirical work. Future work on the issues we identify, which we hope will be conducted, may warrant reconsidering conclusions we reach below.

[7] 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).

[8] *See* Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1730-31 (2008).

positive average abornal returns.[9] This evidence is consistent with the view that market participants expect the presence of blockholders to be beneficial for firm value.[10]

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. For example:

- A study by Marianne Bertrand and Sendhil Mullainathan, found that CEO pay is less likely to reward "luck" rather than performance when a blockholder is represented on the company's board.[11]

- A study by Yaniv Grinstein, Urs Peyer, and one of us shows that the presence of representatives of blockholders on a board's compensation committee is associated with reduced incidence of stock option backdating.[12]

- 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.[13]

- 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.[14]

- Finally, a study by Anil Shivdasani[15] shows that the presence of outside blockholders is associated with an increased likelihood of transactions that discipline management.[16]

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[9] *See* April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187, 188-89 (2009).

[10] This conclusion was also reached in an early empirical study by Clifford Holderness and Dennis Sheehan. *See* Clifford G. Holderness & Dennis P. Sheehan, *Raiders or Saviors? The Evidence on Six Controversial Investors*, 14 J. FIN. ECON. 555, 557 (1985) (concluding that the filing of a Schedule 13D by six investors known to actively engage with management was associated with positive abnormal returns).

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

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

[13] *See* Anup Agrawal & Tareque Nasser, *Blockholders on Boards and CEO Compensation, Turnover and Firm Valuation* (January 2011), *available at* http://bama.ua.edu/~aagrawal/IDB-CEO.pdf.

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

[15] *See* Anil Shivdasani, *Board Composition, Ownership Structure, and Hostile Takeovers*, 16 J. ACCT. & ECON. 167 (1993).

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,[17] 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.[18] Indeed, there is evidence that the shareholders mounting these challenges are likely to have a significant stake in the firm.[19] 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.

The Commission should recognize 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 any Commission examination of the rules governing outside blockholders.

The Effect of Tightening the Rules on Outside Blockholders

Having discussed the benefits of outside blockholders for investors—taking their presence as given—we now turn to the factors that determine whether such blockholders are

[16] The literature described here focuses on the effects associated 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.

[17] *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 (1992); David Ikenberry & Josef Lakonishok, *Corporate Governance Through the Proxy Contest: Evidence and Implications*, 66 J. BUS. 405, 432-33 (1993).

[18] *See* Lucian A. Bebchuk & Oliver Hart, *Takeover Bids vs. Proxy Fights in Contests for Corporate Control* (2001), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=290584.

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

likely to emerge. It is well understood in the academic literature that the incidence and size of outside blocks, and the investments in value-enhancing activities made by outside blockholders, depends on the ability of outside blockholders to obtain returns that cover their costs. Outside blockholders 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 in the literature 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.[20] 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 of the blockholder's monitoring and engagement activities—benefits that otherwise might not be produced.

Tightening the disclosure rules governing blockholders 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. In some cases, those considering becoming a significant blockholder might be deterred from doing so altogether. In other cases, those becoming a significant blockholder 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, and 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 will not impose any meaningful costs.[21] But the main cost of disclosure obligations in this context is not the transaction costs, such as legal fees, imposed by securities filings. Rather, as the literature widely recognizes, the principal cost of tightened disclosure obligations for potential outside blockholders is that such tightening 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. This cost to potential outside blockholders might, in turn, produce costs for investors by reducing the incidence and size of outside blocks.

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[20] For early works 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 7.

[21] *See* Petition, *supra* note 2, at 5 (because blockholders are "sophisticated, experienced investor[s]," tightened rules will not impose a substantial burden on them).

The Petition seems to take the view that the purpose of the Williams Act was to place an absolute 5% limit on the pre-disclosure accumulations of outside blockholders. Thus, the Petition seems to argue, the Commission should focus on the "technical" question of how best to achieve this result.[22] However, while Senator Williams initially proposed legislation that would have made it unlawful for an outside blockholder to cross the 5% threshold without prior disclosure,[23] Congress expressly chose not to follow an approach that imposes a firm 5% constraint on pre-disclosure accumulations. Instead, Congress decided only to require disclosure ten days after the 5% threshold is crossed.

To be sure, the recently enacted Dodd-Frank legislation made clear that the Commission has the power to shorten the ten-day period if it so chooses.[24] 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.

The Commission should thus not be guided by an assumed goal of preventing any pre-disclosure accumulations exceeding 5%. Instead, the Commission's rules should be guided by the general objectives its rules are required to serve. Whether the Commission should tighten the disclosure rules that apply to outside blockholders is thus not a technical question of how best to prevent accumulations beyond 5%, but rather a policy question of whether such tightening would protect investors and promote efficiency by producing gains that exceed the costs of tightened rules. In examining this question, the Commission should take into account the considerable empirical evidence that blockholders convey substantial benefits to investors. The Commission should also take into account the adverse effects that tightening these rules can be expected to have on the incidence and size of outside blocks; the resulting increases in agency problems; and the additional issues that we identify below.

The Lack of Evidence that Changes in Trading Practices Have Led to Increased Pre-Disclosure Accumulations by Blockholders

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

[22] *Id.* at 7 (contending that the drafters of the Williams Act thought "5% ownership conferred significant control rights and should require public disclosure").

[23] *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).

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

previously.[25] According to the Petition, "recent events have highlighted the potential extremes to which these acquisition tactics may be taken, and make clear the urgent need for . . . reform."[26] The Petition, however, does not provide any empirical evidence to support its 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 systematically examine these data—for example by comparing evidence from recent years to data from earlier periods—or rely on 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.[27] 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 the four cases described in the Petition but does not identify any other U.S. cases.[28]

Noting 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 those relied upon by the Petition is itself far from a new market development. A study by Clifford Holderness 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.[29]

Thus, in assessing the Petition's 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.

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[25] *See* Petition, *supra* note 2, 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").

[26] *Id.*at 2.

[27] *See id*. at 5-6; 8; 10.

[28] *Id.* at 3 & n.9 (citing Andrew Ross Sorkin, Dealbook, *Big Investors Appear Out of Thin Air*, N.Y. TIMES (Nov. 1, 2010) (noting the cases of J.C. Penney, CSX, and CNET)).

[29] *See* Holderness & Sheehan, *supra* note 10, at 563.

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.

Changes in the Legal Landscape since the Passage of the Williams Act

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* 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 to[30]—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.[31] Because of the substantial legal impediments to hostile takeover bids, the incidence of such bids is low.[32] 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.

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

[30] *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).

[31] 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).

[32] *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).

displaying tolerance toward such pills.[33] 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, with 15% having pills triggered by a threshold of 10% or less.[34] 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 blockholder disfavored by the incumbents emerges—an important feature of the current landscape that market participants 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.[35] Companies have also been adopting poison pills with "continuing directors" 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.

We note that, overall, these state-law rules are uniquely unfavorable to outside blockholders in comparison to other common law countries such as the United Kingdom, Canada, and Australia. The Petition claims that the disclosure rules applicable to blockholders in other countries, including the United Kingdom, "compel[] the Commission to enact related reforms."[36] The Petition does not acknowledge, however, how the United States compares with such 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. Any comparative analysis of rules in this area would do well to consider the broad set of rules governing outside blockholders—and to 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.

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[33] 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.

[34] Based on a July 11, 2011 search on the SHARKREPELLENT DATASET OF FACTSET RESEARCH SYSTEMS INC., *available at* http://sharkrepellent.net.

[35] *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).

[36] Petition, *supra* note 2, at 9.

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. That is: In determining whether changes to the Commission's rules would protect investors and promote efficiency, the Commission should focus on the effect of such changes in the context of the bigger picture, including *all* of the legal rules that govern blockholders. Given the value of outside blockholders to investors, the Commission should be especially 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.

Is a Tightening of the Rules Necessary to Protect Control Premia?

The Petition seems to argue that disclosure requirements for blockholders must be tightened to protect investors from losing the premium associated with corporate control. To illustrate, consider a situation in which an outside blockholder identifies an under-performing 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 x 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.

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 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.[37] 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

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

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.

The Petition describes 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.[38] 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.[39] CalPERS, which commonly holds far less than a 5% stake in most public companies, has had influence on companies it targeted using its "focus list."[40] 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.

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 under-performing companies. Under-performing incumbents have much to gain from increased insulation from outside blockholders' monitoring

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[38] Petition, *supra* note 2, at 6. Notably, in both cases the outside blockholder did not obtain control of a majority of the board of directors. *See id.*

[39] Steve James, *Massey Faces Shareholder Anger Over Mine Disaster*, REUTERS (April 13, 2010), *available at* http://www.reuters.com/article/2010/04/13/us-massey-idUSTRE63C2Q920100413.

[40] *See* California Public Employees' Retirement System, Reform Focus List Companies, *available at* http://www.calpers-governance.org/focuslist/reform-companies.

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.

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We have provided a brief review of the received academic understanding and available empirical evidence on the role of outside blockholders in American corporate governance. As we have explained, any changes in the disclosure obligations of outside blockholders should be considered within this broader context. The Commission's examination of its rules in this area should thus take into account the evidence that outside blockholders' presence and activities benefit investors and promote efficiency; that disincentives to blockholders' activities can be expected to increase agency costs and managerial slack; and that state law rules have evolved in ways that discourage and impede these blockholders. Furthermore, the Commission's consideration of the rules governing blockholders should be based on a careful empirical assessment of several important issues related to the regulation of outside blockholders. In particular, the Commission's considerations should include the following:

- 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;

- An assessment of the effects of existing disclosure requirements, and of the expected effect 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 Schedule 13D filings, 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 size of the stakes held by outside blockholders and the monitoring and engagement investments made by such blockholders.

We encourage the Commission to undertake a systematic study of the role of outside blockholders, and the rules governing their activities, along the lines described above. In the meantime, however, the Commission should not pursue a piecemeal tightening of these rules.

Based on the received academic understanding and the available empirical evidence in this area, such changes would not satisfy the requirement that the Commission's rules protect investors and promote efficiency—and there is a basis for concern that such changes could adversely affect investors and the performance of publicly traded companies.

If discussion of these comments would be helpful to the Commission or its Staff in its consideration of the rules regulating blockholders, we would be pleased to be of assistance. Please do not hesitate to contact us at your convenience. Lucian Bebchuk may be reached at (617) 495-3138 or via electronic mail at bebchuk@law.harvard.edu, and Robert Jackson may be reached at (212) 854-0409 or via electronic mail at robert.jackson@law.columbia.edu.

Sincerely,

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