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[redacted]

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Via SEC Internet Comment Form

Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

Re: File No. S7-06-22
Release Nos. 33-11020; 34-94211
Modernization of Beneficial Ownership Reporting ("the Proposal")

To the Commission:

This letter is submitted by me personally in connection with the Commission's consideration of its Modernization of Beneficial Ownership Reporting Proposals of February 10, 2022. I am the Richard Paul Richman Professor at Columbia Law School and co-director of the Millstein Center for Global Markets and Corporate Ownership. I have been a law professor at Columbia for thirty five years and regularly teach courses in corporate law and governance and mergers and acquisitions. My research and scholarship is concentrated in these fields, as reflected in an article cited by the Commission in its release (co-authored with Ronald Gilson).[1] In drafting this letter I have not been retained by any party with a potential interest in these proposals; nor have I previously represented or given expert testimony on behalf of any party in connection with an activism contest.

[1] Ronald Gilson and Jeffrey Gordon, The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights, 113 COLUM. L. REV. 863 (2013). For discussion directly relevant to 13D, see Ronald Gilson & Jeffrey Gordon, Agency Capitalism: Further Implications of Equity Intermediation), in RESEARCH HANDBOOK ON SHAREHOLDER POWER (Jennifer Hill & Randall Thomas, eds. (2015), available at SSRN: https://ssrn.com/abstract=2359690 .

After reading some of the submitted comments, talking with other professors and practitioners, and speaking at a conference addressing these rules, I would like to offer some ideas and regulatory suggestions that might be of value to the Commission in this stage of its deliberations. I focus on the following four points:

- ***First,*** the Proposal risks suppressing proxy contests, which are the principal, if not the sole, method for holding corporate managers accountable to shareholders.
- ***Second,*** to the degree the Commission is concerned about improper tipping of information related to activist engagements, that concern can and should be addressed by developing new rules specific to such tipping and trading, rather than the Proposal's ambiguous new definition of a "group";
- ***Third***, in light of the Commission's concerns about the use of swaps to disguise potential control positions, I propose a "safe harbor" for parties entering into certain swaps that clearly do not implicate those concerns; and
- ***Fourth***, I explain why the Commission's proposed definition of "group" is theoretically untenable and practically unworkable, and should be abandoned until the Commission can more carefully consider its implications.

First, a framing point. The Williams Act was enacted in 1968 to deal with a surge of a new form of control transaction, the hostile tender offer, which could result in a transfer of control via the accumulation of shares in a very short period of time. The Act had two moments: first, the creation of an "early warning system" under section 13(d) to alert the target and investors of an accumulation of stock that could precede a control transaction, and second, the regulation of the tender offer itself under section 14(d). Hostile tender offers, however, are essentially a thing of the past, suppressed by a private ordering creation licensed by state corporate law, the poison pill. It would be perverse to the turn section 13(d) of the Williams Act against what was the preferred form of governance challenge prior to the hostile tender offer – the proxy contest. But this is what the "Modernization Proposal" risks. This point must be emphasized: without a credible threat of maintaining a proxy contest an "activist" is simply a gadfly, noisy perhaps, but just a gadfly. And if we suppress proxy contests, which is likely to result from the Commission's proposal, we close down the most important channel for managerial accountability and corporate legitimacy.

The Proposal does this in at least three ways. First, the Proposal shortens the "10-day window" following a party's acquisition of five percent an issuer's securities to 5 calendar days. Since purchases subsequent to a 13D filing will impound the expected gains from shareholder engagement, shortening the window will in many cases significantly reduce the activist's potential economic return and thus in expectation will reduce the number of engagements. Second, the Proposal would classify the "underlying" shares of a cash-settled derivative to be beneficially owned by the long party on the swap. Particularly in interaction with the shortened disclosure window, this will in in many cases significantly reduce the activist's potential economic return and similarly in expectation reduce the number of engagements. Third, the

Proposal would create a nebulous definition of a "group" that would chill the kind of persuasive interactions that are core to a successful proxy contest in light of the heavily institutional share ownership of many corporations.

Let me add some detail. For activist challenges for large capitalization companies, the 10- day window may be of little importance because the activist stake does not exceed five percent. But for medium-cap and small-cap companies the 10-day window is important because of the impact on the activist's economic returns. How so? Given the current pattern of institutional ownership, the costs of an activist contest are relatively fixed. A detailed analysis of company's business plan is does not significantly increase with its size; these days, a credible threat of a proxy battle depends on reaching a relatively small number of asset managers and institutional investors, not the willingness to mail out proxy materials to millions of shareholders. For an activist engagement with a large-cap firm, earning a 7 percent return on a small (in percentage terms) position will cover those fixed costs. But for a mid-cap or small-cap firm, a larger percent ownership position is required to cover those costs as part of the activist's economic return. For all but the largest firms, liquidity for significant stock purchases is somewhat limited. This means a party that seeks to accumulate a meaningful block without significantly affecting the market price needs a longer trading period.[2] This where the 10-day window becomes important: it provides a sufficient number of trading days for the activist to acquire an economically sufficient position in a company's stock.

To be clear: the positions typically acquired by activists over the 10-day period do not amount to a control block, which was a concern of the Williams Act. Since the 1968 legislation, private ordering as permitted under state law has engendered the "poison pill," possessed in shadow form by all companies even if not formally adopted. This generally has limited activist accumulations (except in the rare case) to less than 10 percent. In an institutionally dominated market, 10 percent or even 15 percent hardly amounts to a position large enough to assure success in a proxy contest, much less immediate control.[3]

The objection to a 10-day window is two-fold: first that it enhances the extent of "information asymmetry" between the activist and uninformed market participants and that it

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[2] See Pierre Collin-Dufresne and Vyacheslav Fos, Do Prices Reveal the Presence of Informed Trading?, 70 J. FIN. 1555 (2015). This consideration dominates the argument about technological advances in registering trading activity.

[3] It should also be noted that originally the Williams Act (1968) made 10 percent the triggering ownership threshold, intending thereby to add additional disclosure to the notice provision of section 16(a) of the 1934 Act. Although the legislative history is sparse, the change in 1970 to 5 percent was apparently triggered by the practice of prospective tender offerors of acquiring 9+ percent before then launching their bid. See Note, Section 13(d) and Disclosure of Corporate Equity Ownership, 119 U. PENN. L. REV. 853, 862-64, 865 n. 56 (1971). This suggests that the framers of the Williams Act did not regard typical stakes of activists today as, in themselves, a sufficient indicator of a prospective control or influence shift. Indeed, a less-than 10 percent holder in a firm today, in an equity market dominated by institutional stockholders, would have *less* influence than such a holder in the late 1960s, a time of diffuse share ownership.

facilitates the formation of so-called "wolf packs." These parties may be thought of as risk arbitrageurs who simply want the activist initiative to succeed so they can realize a short term gain. Some believe that, after the activist has acquired its desired block, the activist facilitates the shift of stock into the hands of such outcome-motivated parties through strategic tipping.

The Commission seems very concerned about these "wolf packs" because it would include tippees into the "group" whose stock ownership must be aggregated for other purposes under the proposed rule.

This is my analysis of the situation: The activist is entitled to full economic return on the information that it has generated, and insofar as the information asymmetry arises from transactions with the activist, this ought not be targeted by the Commission any more than the information asymmetry in transactions by a skilled and highly reputed investor whose 13F reports produce a market reaction. This "information asymmetry" is bound up with an economic reward to activism, without which activism will cease. Tippees are different. I've argued that activists serve useful role of "potentiating institutional voice"; teeing up questions about the company's current strategy and operational skill for resolution by the longterm institutional holders whose business model makes them "rationally reticent."[4] Parties who are trying to capture the information asymmetry from an activist's tip will have a different motivation from the longterm holders in this model. They will be biased in favor of the activist's proposal, to realize the immediate gain and to gain a reputation as a reliable supporter, to keep the flow of tips coming.

I have serious doubts about the frequency of "wolf packs" and the purported practice of tipping such investors to gain supporters of the activist intervention. But here is a substitute proposal that both preserves the activist's ability to profit from information that it generates while reducing the risk that obviously troubles the Commission: Leave the present 10-day window but impose a prohibition on tipping by an activist as soon as it reaches the 5 percent disclosure threshold until it files a 13D. Such a rule would leverage the incentives of the activist in appropriate ways. Until it has finished it own acquisitions the activist is highly unlikely to tip any other party, because another's substantial buying activity and the related information leakage will raise the activist's own acquisition costs and thus reduce its rewards. After it has finished its own acquisitions, until it has filed at 13D, the proposed rule would bar the activist from tipping others.[5]

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[4] See Ronald Gilson and Jeffrey Gordon, The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights, 113 COLUM. L. REV. 863 (2013).

[5] This appears to be the intended result of proposed Rule 13d-5(b)(ii) et seq. that would make such a tippee a member of the activism "group" while imposing an unworkable burden on the tipper of monitoring the transactions in target securities of a party with which it has no agreement.

Rule 14e-3 captures the spirit but imposes the obligation on the tippee not to trade rather than on the activism proponent to refrain from divulging information about the intended activist engagement to parties who it should reasonably believe will use that information to purchase target stock before the

Turning now to Proposed Rule 13d-3(e), which would deem the long party on a Total Return Swap to be the beneficial owner of the underlying equity securities: The argument *against* finding "beneficial ownership" here is that this cash-settled arrangement gives the activist more "skin in the game," which adds to the activist's incentives "to get it right" in its activism campaign, without increasing the activist's direct influence to affect the outcome through additional voting power. Some contend that that a Total Return Swap works differently in practice: the securities industry counterparty will acquire target securities to hedge its swap obligation, will vote such securities in accord with its customer's wishes, and moreover stands ready to unwind the swap at its customer's request. This functionally gives the activist additional voting power and an option on the securities and thus the potential to assert voting rights directly. Industry participants have vociferously challenged these contentions as a factual matter.

One way out of these conflicting factual claims is a "safe harbor" that would exempt from beneficial ownership swaps and cash-settled derivatives that cannot obtain voting rights. For example, consider securities that are subject to a "qualifying swap agreement" pursuant to which (1) the securities industry counterparty agrees to vote shares acquired as a hedge in proportion to votes cast by other shareholders ("mirrored voting") and (2) the parties agree that the swap may not be unwound until after the record date of the proxy contest linked to the activist campaign. As to shares associated with such a "qualifying" Total Return Swap, there can be no doubt that the activist has neither voting control nor a right to acquire that have been traditionally associated with "beneficial ownership." Such an arrangement isolates the economic upside of successful activism without reducing the decision-making power of the longterm holders.

As to the "group" concepts in the Proposed Rule, frankly there is little good to say. If the Commission has a legitimate concern, it is with parties that have been drawn into the activism campaign by the lure of tip before the filing of the 13D, the so-called wolf pack. I have attempted to deal with that issue previously with an anti-tipping rule. The Commission seems to think that "group" formation should extend beyond an explicit or implicit agreement, to all parties "that act as a group." I think the most natural reading of §13(d)(3) includes an explicit or implicit agreement. The statute reads: "When two or more persons act as a partnership, limited partnership, syndicate, or *other group*…." (emphasis added). So far as I am aware, "partnerships, limited partnerships, and syndicates" are founded on agreement, express or implied, so in embracing "or *other* group," I think the statute embraces that essential feature. Any "group" concept that goes beyond "agreement," explicit or implicit, sets up a trap for the unwary and could chill legitimate activity. The effort to provide additional guidance is likely to involve the Commission in either unsatisfying no-action practice or multiple enforcement actions

filing of a 13D. Any rule should have a carve out for swap dealers who are purchasing securities to hedge a long swap position entered into by the activism proponent.

that will take the definition outside of the Commission's purview into the courts. This cannot be the best use of scarce Commission resources.

The Commission's rules (and its background explanations) would result in the term "act as" having two different meanings. One meaning of "act as," in the statute, is limited to actions that involve partnerships, limited partnership, syndicate, and other groups. But the rules (and explanatory gloss) seemingly use the same phrase, "act as," to indicate something much broader, sweeping up other activities that involve actions and communications based on the vague notion of "influencing control" coupled with an ex post assessment of whether communications or actions were undertaken with this purpose or effect. Frankly this second reading really means to reach parties who act "as [*if they were*] a group," an impermissible extension of the statutory language to reach parties who have not created or joined a group.

The deep mischief of the Commission's "group" definition is shown by the effort to create an "acting as a group" carve-out in Proposed Rule 13d-6(c) that would permit shareholders to communicate with one another, unless such communications "are undertaken with the purpose or the effect of changing or influencing control of the issuer and are not made in connection with … any transaction having such purpose or effect." This rule would chill the kind of shareholder communications that are central to a proxy contest. Proxy contests, unlike tender offers, are about *persuasion.* A shareholder facing a tender offer needs to decide only the offer is above the shareholder's reservation price for the security. If the tender offeror's business plan is unsound, that's of little concern to an exiting shareholder. A proxy contest is altogether different: the shareholder stays aboard for the ride. Consultation among fellow shareholders and discussion with the activist are an essential part of the story. I do not think the Commission has been sufficiently careful in its "group" definition to avoid harm to the US system of corporate governance.

With the rise of ESG activism, the next period is likely to see many proxy contests that put at issue the "purpose" of US public companies and that may seek "change" through director election contests. I think it unwise for the Commission to put in place rules that destabilize the existing and reasonably well-understood rules of behavior by shareholders, including institutional investors and asset managers.

My apologies for the late submission of this comment. I hope they will be of some value to the Commission in its consideration further action, whether re-proposals or of final rules.

Sincerely,

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