

David Kwon
December 20, 2022

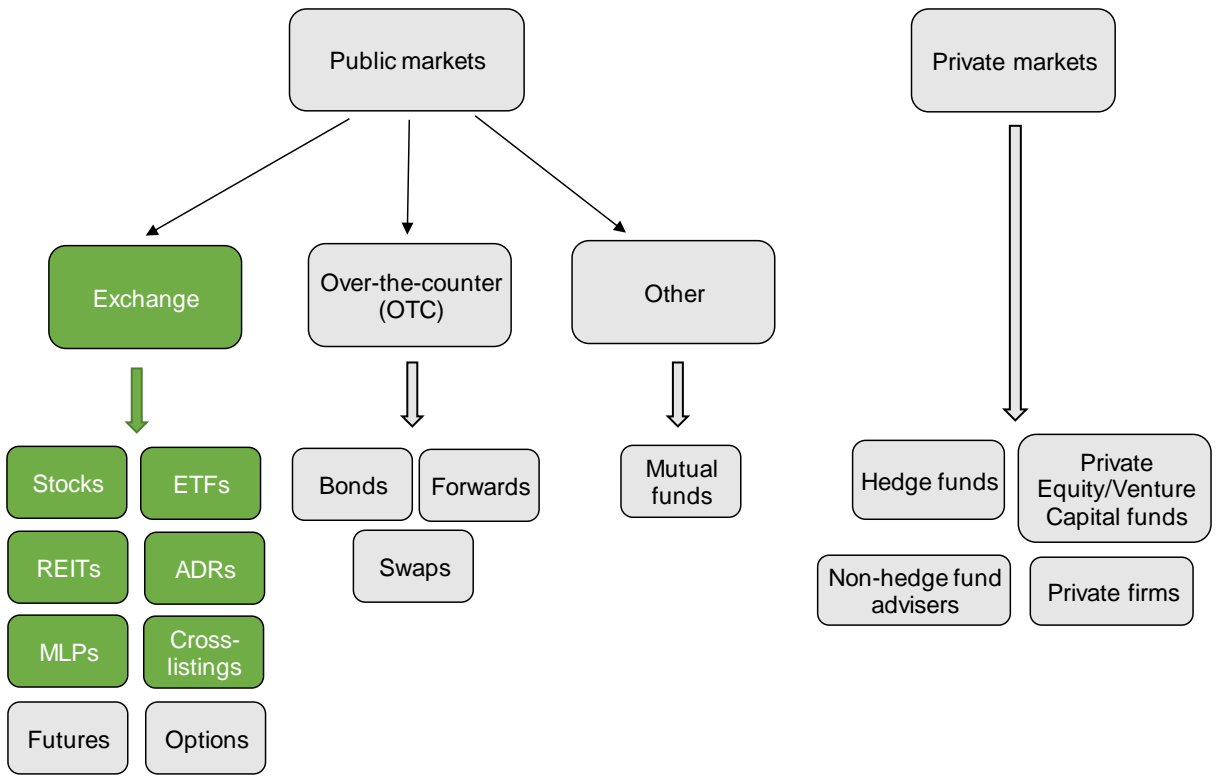
Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. S7-08-20, Reporting Threshold for Institutional Investment Managers

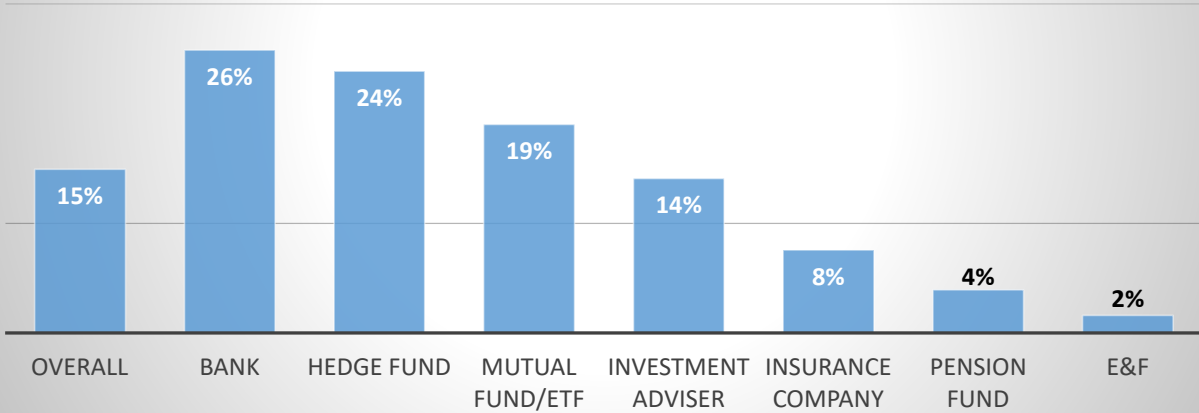
Dear Ms. Countryman,

I am writing to you regarding the U.S. Securities and Exchange Commission (SEC)'s proposal to update the 13(f) rule which was announced in 2020. This proposal sparked a lot of debate and discussion about the benefits and costs of the 13(f) rule and about investment disclosure more generally. For example, while the SEC's proposal suggested the existence of disclosure costs in the form of copycatting (and frontrunning) activities, a recent bill proposed by Congresswoman Maxine Waters to expand investment disclosure suggests that copycatting is minimal. My recent dissertation on the 13(f) rule (completed while I was in an accounting PhD program at Yale University) addresses this debate and has relevant findings for this proposal.

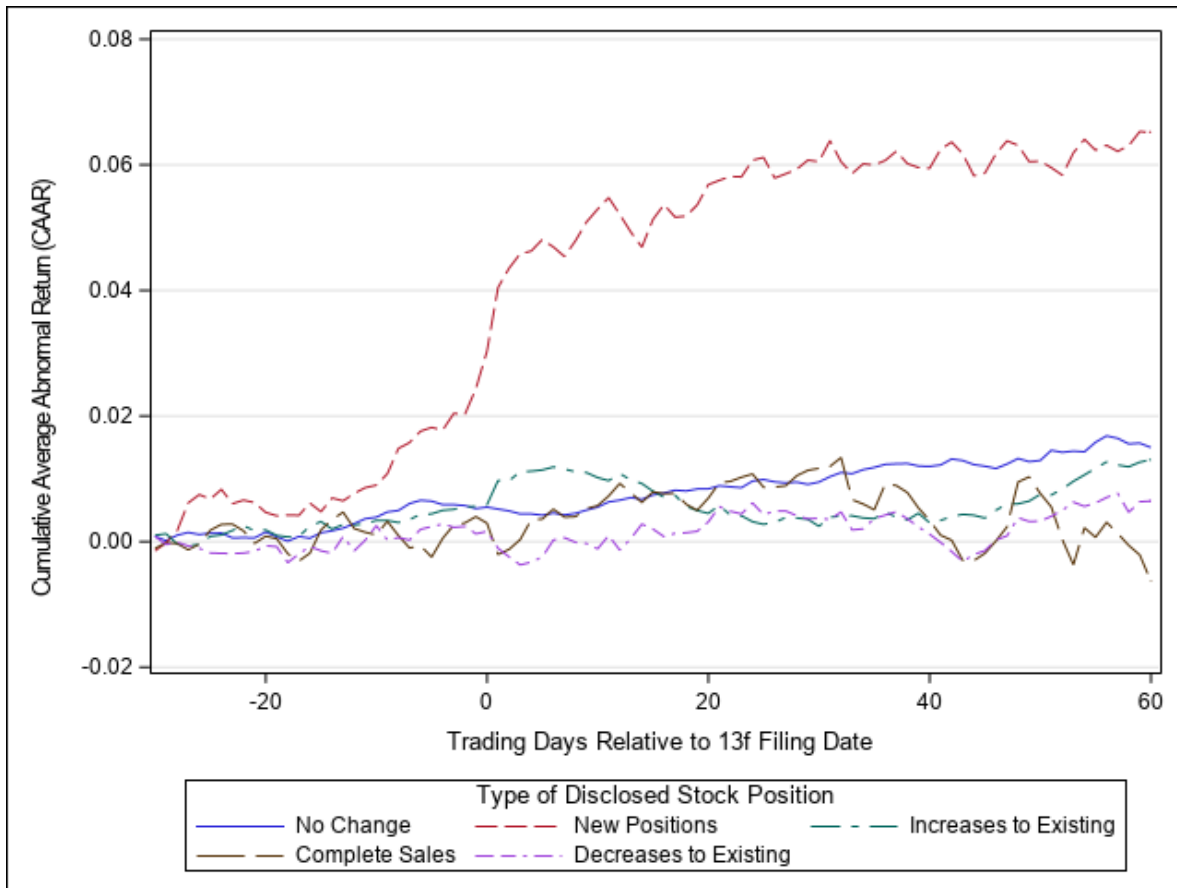
My dissertation found many issues with the 13(f) rule, which requires institutional investors to disclose stock holdings. First of all, despite the US government's desire under the 13(f) rule to monitor institutional trading activity and monitor the impact of institutions on market stability especially in times of stress, the government curiously decided to only require stocks to be disclosed, resulting in only about 15% of institutional assets being disclosed on 13(f) forms today. A full 85% of institutional investments is not being monitored by the government. The chart below shows in green the instruments that must be disclosed, and the instruments in grey that are not, and the following chart shows the percentage of institutional portfolios that is disclosed across institutional categories. The 13(f) rule thus creates a discriminatory disclosure environment among institutional investors simply based on the instruments they use; a small-cap value manager has to disclose all of its portfolio (assuming it meets the 13(f) threshold), while a global macro hedge fund that uses only derivatives can keep its portfolio secret. The stock-specific nature of the 13(f) disclosure rule also means that institutions of similar size, similar type, or facing similar economic exposures can face different disclosure treatment under the rule.



13f securities as a percentage of total AUM, by institution type



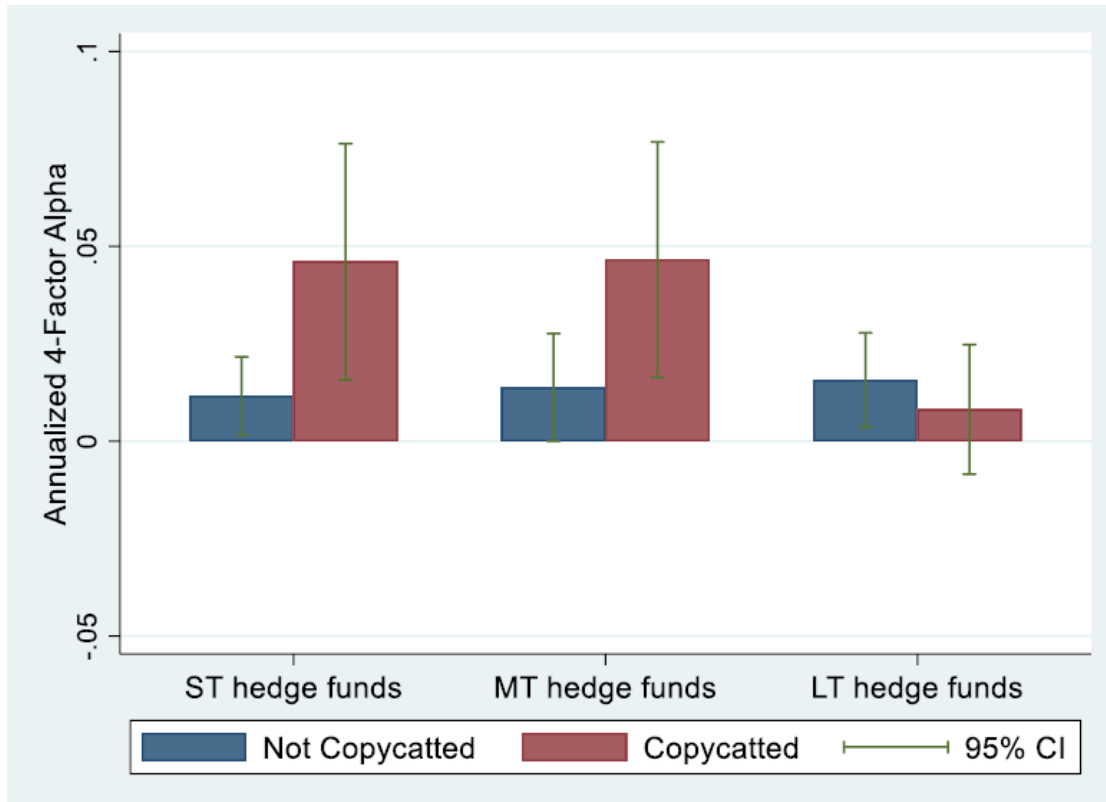
Second, I find evidence that copycats do exist. I find that a subset of institutional stock investors – long-term stock investors (that are top-performing) – are the primary target of copycats due to lower replication risk. Copycats face lower risk when trying to copy long-term investors like Warren Buffett than when copying short-term investors because copycats are better able to successfully match the portfolio of long-term investors. For example, a simple strategy copying Buffett’s 13(f) holdings would have generated 95% of Buffett’s annualized return performance over 40 years. In fact, top-performing long-term stock investors, including long-term hedge funds and pension funds, face significant positive market reactions to their disclosures of newly purchased stock, while top-performing short-term stock investors do not see positive market reactions. In the two charts below, I first show market reactions to Warren Buffett’s stock disclosures and we can see that only his new stock purchases receive substantial market reactions upon disclosure, suggesting evidence of copycats, and in the next chart I show that among pension funds, only top-performing long-term pension funds experience a significant market reaction upon disclosure of newly purchased stock (shown by the blue line).





Lastly, I show in portfolio simulations that while short-term investors, to the extent that they face any copycatting, likely benefit from the positive market reactions caused by outside copycats, long-term investors do not benefit and can even be harmed. The reason for this is that the positive market reactions due to copycatting merely frontload returns, rather than increase returns permanently. Take Warren Buffett for example, who may have some special insight into a specific stock. A long-term investor like Buffett may not expect to benefit over the long-run from the positive market reactions caused by outside copycats, if he expects his special insight on the stock to be incorporated into the stock price over time anyways, regardless of copycatting. In other words, assuming that market reactions from copycatting merely correct an undervaluation, a long-term investor is likely to not benefit from such market reactions over the long run. I test and confirm these predictions in a sample of hedge funds and pension funds. Since copycats cause long-term stock investors to experience excess volatility in their returns without higher returns, my study finds that long-term stock investors' risk-adjusted returns are being harmed under the 13(f) rule. The chart below shows that copycatted stocks (those with high market reactions) do not outperform non-copycatted stocks for long-term hedge funds. However, high market reaction stocks do outperform for short-term and medium-term hedge funds. The following table below shows in portfolio simulations that copycatting activity negatively impacts targeted (i.e., copied) long-term investors' Sharpe ratios. The next chart shows that in my sample of long-term hedge funds, their Sharpe ratios are

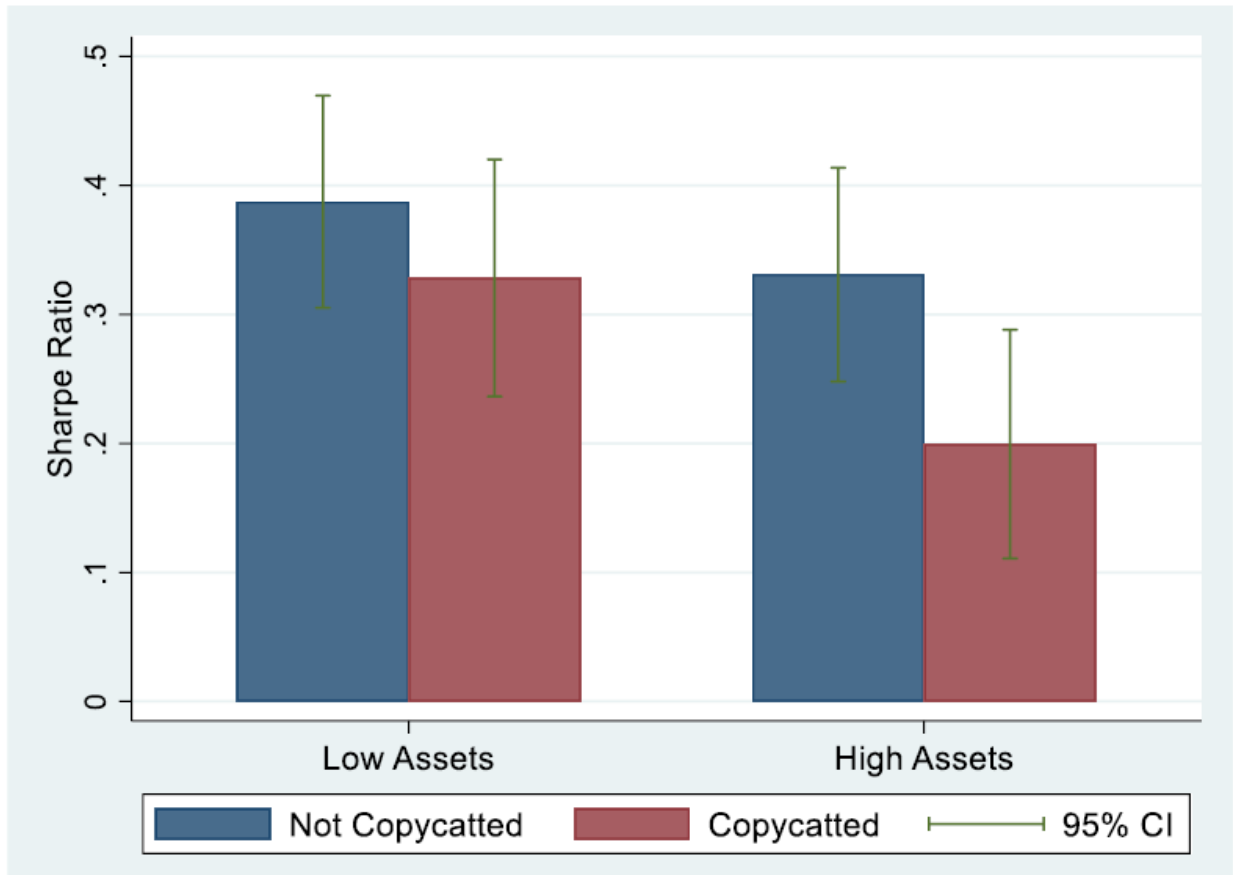
especially harmed when they have larger assets (when they are building up positions more often and therefore more likely to be harmed by copycatting).



Market Reaction Assumption	Scenario: No Copycatting			Scenario: Copycatting			Absolute Decline in Sharpe Ratio	Percentage Decline in Sharpe Ratio
	Annualized Return	Annualized Volatility	Sharpe Ratio	Annualized Return	Annualized Volatility	Sharpe Ratio		
5%	14.2%	13.9%	1.02	13.6%	14.2%	0.96	(0.06)	-6%
10%	14.3%	13.9%	1.03	13.2%	14.6%	0.91	(0.12)	-12%
20%	14.4%	13.9%	1.04	12.5%	15.5%	0.81	(0.23)	-22%
20%: 25% Build	14.6%	13.7%	1.06	11.3%	14.7%	0.77	(0.29)	-27%
10%: 100% Build	14.3%	14.0%	1.02	14.3%	15.1%	0.95	(0.07)	-7%
20%: 100% Build	14.5%	14.0%	1.04	14.5%	16.6%	0.87	(0.17)	-16%

Notes: In my portfolio simulations, I assume that this investor has a 4-year horizon replacing 10 of its 40 stocks each year. I assume that each new purchase is copycatted generating a market reaction, and that the stock price in the scenario of copycatting converges to the stock price in the scenario of no copycatting within one year. Sharpe ratio is defined as annualized returns / annualized volatility.

Source: Author's calculations using data from CRSP



My study helps inform the government on the costs of investment disclosure as it contemplates whether to “fill in the gaps” of disclosure. I show that when investment disclosure is required, this results in excess volatility in the stock holdings of top-performing long-term stock investors without benefitting their portfolio returns over time, and even sometimes harming portfolio returns over time as they grow larger in assets. So, my dissertation suggests that long-term stock investment (and therefore innovation, which requires a long-term investing horizon) in the economy is being disincentivized in favor of short-term trading under the 13(f) rule.

Due to these significant public disclosure costs, while at the same time considering the government’s desire to monitor institutional activity in financial markets, I recommend that the government eliminate the 13(f) rule and create a new rule that requires large investors like institutions (and even individuals with significant assets) to disclose *complete* portfolio holdings *privately* to regulators. This would have the benefit of removing public disclosure costs while at the same time allowing those in the government with confidential access to monitor investment activity across asset classes and financial instruments and to look for excessive trading especially in time of stress, which after all was the original vision of the 13(f) rule.

[Here is the link](#) to my dissertation if you would like to read further. Thank you!

Sincerely,
David Kwon