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March 20, 2022

Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609
Via Electronic Mail to rule-comments@sec.gov

Re: Release No. 34-93784; File No. S7-32-10.
Proposed Prohibition Against Fraud, Manipulation, or Deception in Connection with Security-Based Swaps; Prohibition against Undue Influence over Chief Compliance Officers; Position Reporting of Large Security-Based Swap Positions;

Dear Ms. Countryman,

I am writing to comment on the proposed rules above put forward in Release No. 34-93784 (the "Proposed Rules"). In particular, I focus on one important element of the Proposed Rules – the mandated disclosure of "equity-based swaps" ("the Equity Swap Rule"). I do not discuss other aspects of the Proposed Rules such as those regarding the disclosure of "credit default swaps."

I serve as the James Barr Ames Professor of Law, Economics, and Finance, and the Director of the Program on Corporate Governance, at Harvard Law School.[1] I have done extensive research in corporate governance, including on issues that are directly relevant

[1] I write solely in my individual capacity; my institutional affiliation above is given here for identification purposes only. Additional institutional affiliations of mine can be found at my homepage http://www.law.harvard.edu/faculty/bebchuk.

to the proposed rule.[2]

Section A of this comment letter focuses on a serious cost that the Equity Swap Rule would impose – its detrimental effect on hedge fund activism – that the Commission might have overlooked and that is not considered in the Release. Section B discusses the problematic disparity between the treatment of equity swaps and equity securities that the Proposed Equity Swap Rule would introduce, and explains that the rationales put forward in the Release cannot justify introducing such a disparity.

Based on the discussion in the preceding Sections, Section C identifies a number of issues that the Commission should analyze before putting forward for public comment any proposed rule governing disclosure of equity swaps. Without analyzing these issues, and receiving public comment on the results of such an analysis, the Commission would not have an adequately informed basis for concluding that a rulemaking in this area would protect investors and promote efficiency, competition, and capital formation.

A. Overlooking Detrimental Consequences for Shareholder Activism

The Equity Swap Rule would require any buyer that acquires an equity swap position worth more than $300 million to disclose the acquisition within one day. The Release discusses at length the reporting costs that such buyers would have to bear.[3] However, the Release does not discuss or even acknowledge other and more substantial costs that the Rule would produce – the adverse effects that the Rule would have on hedge fund activism and in turn on the effectiveness of shareholder oversight and the accountability of corporate managers.

The lack of attention to the expected costs of the mandated disclosure is surprising due to the Commission's recognition that disclosure mandates might adversely affect hedge fund activism in its recent Releases Nos. 33-11030 and 34-94211 ("the 13d Release"). Buyers of stock are currently required under Rule 13d to disclose their obtaining a 5%+ position within a period of ten days, and the 13d Release proposes, among other things, reducing the length of this period from ten to five days. Stock prices commonly increase significantly when 13d filings are made by hedge fund activists, because the market expects

[2] For an article overviewing of my research in the field of corporate governance that was solicited for and published in a recent University of Chicago Law Review issue devoted to the most-cited legal scholars, s*ee* Kobi Kastiel, *Lucian Bebchuk and the Study of Corporate Governance*, 88 University of Chicago Law Review 1689 (2021).
[3] Release, at 143-148.

activist engagements to be on average value-enhancing. As a result, the ability to buy a certain stake at pre-disclosure prices provides hedge fund activists with incentives to identify companies that are under-performing and whose value could be enhanced. Accordingly, the 13d Release considers the possibility that the tightening of disclosure requirements would reduce activist payoffs and in turn decrease the level of activist activity.

The Equity Swap Rule would raise a related concern, because hedge fund activists use equity swaps in many cases to accumulate an economic position in an identified target. In such cases, the Proposed Equity Swap Rule would lead to considerable acceleration in revealing to the market and the company's management the activist's interest in the company, and the acceleration of mandating such disclosure would likely discourage and impede activism.

The considered acceleration of disclosure would occur because the proposed Equity Swap Rule would require immediate disclosure of the acquisition of any equity swaps position exceeding $300 million. This dollar amount represents a small percentage of market capitalization for many S&P 500 companies.

Thus, for hedge fund activists that accumulate economic positions in a target with significant market value through equity swaps, the Equity Swap Rule would lead to disclosure of the activist's potential interest in engaging with the company at a much earlier time and stage of accumulation than under current rules. Disclosure at such an early stage would curtail the ability of such activists to accumulate a position prior to their initial disclosure. Such early disclosure would also enable management to start engaging in defensive actions much earlier than under current rules. Altogether, for such activists, the Equity Swap Rule would substantially reduce their payoffs and considerably discourage their activities.

The Commission should systematically analyze this effect and pay close attention to it. Discouraging hedge fund activism, and impeding the ability of activists to engage with under-performing companies, would have significantly detrimental consequences for the efficiency of our capital markets and the protection of investors. Engagement by activist investors produces value-enhancing changes in under-performing companies, contributes to making corporate managers accountable, and provides such managers with beneficial incentives.

There is a significant body of empirical work that documents these benefits.[4] Professor Robert Jackson and I highlighted and analyzed these benefits in a comment letter to the Commission several years ago, and in subsequent academic work expanding on it.[5] I urge the Commission to devote to this issue the serious attention it deserves.

Notably, when discussing the information that a buyer of an equity swap would be required to disclose by the Equity Swap Rule, the Release states that "the Commission … understands [certain information] may be sensitive or proprietary information" and that the disclosure requirements are "intended [not to require] market participants to disclose sensitive or proprietary information."[6] The Release, however, fails to recognize that, in the case of activist hedge funds, the mere fact of an activist fund's taking an interest in a given company is a major piece of sensitive information (as is reflected in the stock price reactions to the disclosure of an activist's taking an initial position in a company). And the mandated disclosure of this sensitive information would have the effects discussed above.

B. Disparate Treatment of Equity Swaps and Equity Purchases

The Release recognizes and discusses the value of consistent treatment of economically equivalent situations.[7] However, the Commission does not pay adequate attention to the disparate treatment of the disclosure of equity swaps and equity purchases that the Proposed Equity Swap Rule would produce.

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[4] For a recent comprehensive survey of the empirical literature documenting the economic benefits of hedge fund activism, see Alon Brav, Wei Jiang, and Rongchen Li, *Governance by Persuasion: Hedge Fund Activism and the Market for Corporate Influence*, Finance Working Paper No. 797/2021, European Corporate Governance Institute, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3955116.

Studies I contributed to this literature include Lucian A. Bebchuk, Alon P. Brav and Wei Jiang, "The Long-Term Effects of Hedge Fund Activism," *Columbia Law Review*, Vol. 115, 2015, pp.1085-1156; Lucian A. Bebchuk, Alon P. Brav, Wei Jiang and Thomas Keusch, "Dancing with Activists," *Journal of Financial Economics,* Vol. 137, 2020, pp.1-41.

[5] See Letter from Lucian A. Bebchuk and Robert Jackson Jr. to Ms. Elizabeth M. Murphy, Secretary Securities and Exchange Commission, July 11, 2011, at https://www.sec.gov/comments/4-624/4624-3.pdf; See Lucian A. Bebchuk and Robert J. Jackson Jr., "The Law and Economics of Blockholder Disclosure," *Harvard Business Law Review*, Vol. 2, 2012, pp.40-60.

[6] Release, p. 86.

[7] See, e.g., Release at 77-78 (suggesting that market participants should not be able to change disclosure requirement by replacing some securities with economically equivalent securities).

Consider an S&P 500 company with a market value of $30 billion (which is on the order of the median market value of S&P 500 companies). An activist hedge fund accumulating an economic position via the buying of equity securities would be able to purchase a position worth up to $1.5 billion without revealing the fund's interest in the company to the market and to the company's management.

However, if the activist hedge fund were to accumulate an economic position via purchasing equity swaps, the Equity Swap Rule would require the fund to reveal its interest in the company immediately upon obtaining a position worth $300 million. This dollar amount would be just 20% of the value of equity securities that the fund would be able to acquire without disclosure being required under SEC rules.

What warrants such a disparate treatment? According to the Release, the "the intent … is to alert regulators and the market, including counterparties to security-based swap trades and the companies whose securities underlie security-based swaps, that one or more market participants are amassing a large position in security-based swaps."[8] A recent case that seems to have played a role in motivating the Commission was that of Archegos Capital Management, L.P.[9] In that case, an investor obtained exposure to the economics of more than 10% of multiple companies' shares by taking highly leveraged positions in equity swaps with several different broker-dealers, and the forced liquidation of the positions brought market disorder, significant declines in the stock prices of the relevant companies, and losses for the broker-dealers.[10]

The Commission could expect that the mandated disclosures would prevent or reduce the odds of an Archegos scenario in the future. However, the Release fails to recognize that the Equity Swap Rule (and the disparate treatment coming with it) would unnecessarily govern situations in which concerns for such a scenario are not relevant, and that the Rule's excessively broad coverage would produce significant costs.

To begin with, the Release fails to recognize that its goal of addressing situations in which buyers "amass… a large position" is inconsistent with its choice of a $300 million threshold. There are many public companies for which a $300 million position is *not a*

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[8] Release, at 86.

[9] *See* Commissioner Allison Herren Lee, Standing Up the Security-Based Swap Regime: Statement on Proposed Rules for Antifraud, Position Reporting and CCO Support, December 15, 2021 (noting the collapse of Archegos Capital Management as an example of the risks of concentrated exposure).

10 See Benoit, Alexander Osipovich and David, *"Archegos Blowup Puts Spotlight on Gaps in Swap Regulation," Wall Street Journal,* April 1, 2021.

large position, but rather a position that could be quickly liquidated without applying a material pressure on the stock price. In such companies, the "amassing" of a $300 million position simply does not produce concerns of the type that the Commission seemed to have in mind as warranting measures to alert regulators and market participants.[11]

Furthermore, the Commission's concerns seem to arise from its assumption that buyers of equity swaps are more highly leveraged than buyers of equity securities (for which there are legal limitations on the use of leverage). However, even if this is the case with *some* buyers of equity swaps, that would not warrant imposing the Equity Swap Rule on *all* buyers of equity swaps. In particular, for (i) buyers of equity swaps worth a given dollar amount that are leveraged to a lower extent than the leverage permitted and used by buyers of equity securities, there would be no reason to impose tighter disclosure requirements than for (ii) buyers of equity securities worth the same given dollar amount.[12]

C. Back to the Planning Table and the Drawing Board

Below I note and briefly discuss six issues that the Commission should analyze and consider carefully, and the evidence (quantitative and/or qualitative) that that Commission should obtain, in order to have an adequately informed basis for designing and putting forward for public comment new rulemaking in this area.

1. The Use of Equity Swaps: The Commission should obtain information about the users of equity swaps and the purposes for which they use such swaps. Such an examination would be necessary for assessing the extent to which equity swaps are used by hedge fund activists, and what other types of market participants make significant uses of equity swaps. Such assessment would in turn be necessary to consider what activities would likely be discouraged by the Equity Swap Rule and the extent to which they would be discouraged.

2. The Expected Acceleration of Activist Disclosures: The Commission should examine the frequency with which and the extent to which the Proposed Rule would have led to acceleration in the disclosure of activist interest in past activist engagements. Such

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[11] Notably, when the Release puts forward an example of how a large position could produce risks, it uses an example of "a single counterparty [having] a $5 billion security-based swap position distributed equally among five different deals on the same underlying equity security." See Release, at 21.

[12] It might be argued that, to the extent that problem arises from the external effects of leverage, the most effective remedy would be substantive limits on leverage as disclosure. I note, however, that requiring special disclosure of equity swaps only by buyers that use leverage above a certain threshold could well induce buyers to avoid using leverage exceeding this threshold,

examination would in turn enable an assessment of how the Equity Swap Rule would affect the ability of activists to cover their expenses and the level of activist engagements.

3. The Costs of a Discouraging Activist Activity: To the extent that the Equity Swap Rule would discourage and reduce engagements by activist hedge funds, the Commission should examine the resulting expected reduction in the benefits produced by such engagements. In such examination, the Commission should consider both benefits produced by value-enhancing changes brought about by engagements and benefits produced by the provision of incentives to managers to avoid under-performance.

4. The Effects of Discouraging the Use of Equity Swaps: Because the Equity Swap Rule would introduce disparate treatment of equity swaps and equity securities, which would in turn discourage the use of the former, the Commission should examine the costs that would result from discouraging such use. This examination should build on the information that the Commission would obtain regarding the types of market participants that use equity swaps and the extent to which they do so.

5. When a $300 million Position is not "Large" at all: The Commission should identify the large set of public companies for which the taking of a $300 million equity swap position would not represent an "amassing of a large position" that would be expected to produce disorderly market trading and material pressure on stock prices in the event of a forced liquidation.

6. Leverage of Equity Swaps: For the reasons discussed earlier, the Commission should obtain information about the extent to which high leverage is used in the purchase of equity swaps. If there is a substantial set of equity swap transactions that use or could use leverage that is not higher than the leverage used for the purchase of equity securities, some key concerns that seem to underlie the Equity Swap Rule would not be applicable to this set of transactions.

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I conclude by urging the Commission to pursue a systematic examination of the conceptual and empirical issues discussed above. In the meantime, the Commission should recognize that there is no good basis for adopting the Proposed Equity Swap Rule. Indeed, until the Commission undertakes the above examination, it would not have even an adequate basis for putting forward for public comment a proposal for rulemaking in this area.

If discussion of these comments or the issues that should be analyzed would be helpful to the Commission or its Staff, I would be pleased to be of assistance. Please do not hesitate to contact me at your convenience at [redacted] or via electronic mail at [redacted]

Sincerely,

Lucian Bebchuk