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Comment Letter on SEC Proposals to change the disclosures for activist ownership in SEC Form 13D, by Edward P. Swanson, Glen M. Young, and Christopher G. Yust.

We are writing to direct attention to a newly published study of shareholder activism that is relevant to ongoing SEC policy making. We provide references to selected figures and tables in our paper as a guide to the results that are most useful to policy making. The study considers active ownership positions and does not consider 13G filings. Our only incentive is to draw attention to the findings of our study (and related academic research); we have no economic ties to the industry. This letter provides an overview of our study, the key (general) implication of the results for policy making, and the implications for specific SEC initiatives. In discussing policy implications, we discuss some potential unintended consequences.

Overview of the Study

Using a larger, more comprehensive sample of activist interventions than used in prior research -- a sample which includes activism by both hedge funds and other entities (e.g., private equity firms, venture capital firms, mutual funds, insurance companies, and financial service firms), we find strong evidence that activist interventions increase both short- and long-term shareholder value. The returns are economically and statistically significant for a wide range of activist demands, although the highest returns arise from demands to sell all, or part, of the business. The long-term returns -- over two, three and five years -- are considerably greater than the short-term returns, especially for demands that do not involve a sale. The study's finding of an increase in long-term returns conflicts with the criticism that activists are motivated primarily by short-termism. We describe the returns in more detail below.

In addition to returns, the study includes a series of figures and corresponding tables that show that an activist announcement serves as a turning point for informed market participants and the target firm itself. Activist announcements are followed by more positive analyst recommendations (Figure 4, Table 4), an increase in holdings by institutions classified as long-term investors (Figure 5, Table 5), an increase in accounting return-on-assets for the target (Figure 6, Table 6), and a higher Tobin's Q for the target (Figure 7, Table 7). Each of these changes occur around the announcement date. Prior to the announcement, recommendations, return-on-investment, and Tobins' Q were decreasing.

While prior research also provides evidence of positive benefits to long-term shareholders, the overall evidence becomes overwhelming when our study included.[1] This statement is supported by consistent results across a range of evidence and a considerably larger sample of activist events, consisting of 4,312 campaigns at 2,652 target firms. A key distinction from prior research is the inclusion of more than 2,000 campaigns by non-hedge fund activists. These activists, who we collectively refer to as "other private activists," are largely unstudied, even though they constitute nearly half of activist interventions. Our study, "Are all activists created equal? The effect of interventions by hedge funds and other private activists on long-term shareholder value," is coauthored by Edward P. Swanson, Glen M. Young, and Christopher G. Yust. A copy is available in the February 2022 issue of the *Journal of Corporate Finance* or from SSRN at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3984520

[1] Notable prior research providing evidence of benefits to long-term shareholders includes Brav, Jiang, Thomas, and Partnoy (2008) and Bebchuk, Brav and Jiang (2015). The beneficial outcomes are myriad, including increased target firm innovation (Brav et al. 2018), decreased emissions (Akey and Appel 2019), and increased gender diversity on the board (Marquardt and Wiedman 2016).

Broad Implications for Policy:

As discussed above, the average returns to shareholders following an activist intervention are positive and both economically and statistically significant. Importantly, the returns are larger for long-term shareholders than for those who sell quickly after an intervention is announced. It is unlikely these positive returns would have occurred without an informed activist intervention. The key implication for policy is that caution should be exercised in passing regulations that reduce the incentives for interventions by activist investors.

The recent SEC trend toward shortening the time periods for disclosure could reduce the frequency of activist events because buying shares over a short time is likely to increase the stock price and, thereby, increase the cost of an ownership position. While we generally favor more transparent reporting, shareholder activists need to have time to establish a sufficient ownership position to make an intervention profitable. Informed activism is costly because it involves the cost of identifying targets and the types of changes, both operating and governance, likely to benefit long-term shareholders. Thus, absent the ability to significantly benefit from target stock price appreciation, the incentive to engage in activism campaigns may diminish.

An addition to the number of interventions, a short disclosure window could also affect the type of changes demanded by activists. The returns when an activist demands a sale of all, or part, of the targeted company are considerably higher than the returns for other types of demands. The average abnormal return (risk and market adjusted) during the 10-day pre-announcement period for sale demands is 4.12%, which increases to 17.36% when including six days after the announcement (see Table 2, Panel A, col. 2). Over 12, 24, and 36 months, the average abnormal returns are 18.31%, 25.04%, and 25.41%, respectively (see Table 3, Panel A, col. 2). Most of the returns to sale demands are therefore realized in the six days after the announcement. These abnormal returns would presumably remain largely available to activists demanding a sale even with a shorter disclosure window than the current 10 days, assuming the activist has been able to establish the desired ownership position. In contrast, the abnormal returns for non-sale demands are more modest and require an investment is held over a longer post-announcement period to be economically significant. The average abnormal return for non-sales demands during the 10-day pre-announcement period is 1.23%, which increases to 3.91% when including six days after the announcement (see Table 2, Panel A, col. 3). The average abnormal returns increase to 7.49%, 11.59%, and 13.54% over 12, 24, and 36 months, respectively (see Table 3, Panel A, col. 3). We are concerned that reducing the relatively modest returns to non-sale demands would make many of them unprofitable, resulting in fewer activist interventions that do not demand a sale. By their nature, non-sale demands are desirable in that they are less confrontational, often requiring manager cooperation over an extended period.

A short disclosure deadline could also have other unintended consequences. Activists could rely more on derivatives, such as total return swaps and call options. Derivative positions can be established quickly and are less likely to move the short-term stock price. This possibility is reduced, however, if the 5% ownership calculation includes cash-settled derivatives, as the SEC proposes.

Additionally, policy makers are concerned about the potentially adverse effects of passive investors and algorithmic trading on price discovery, a critical requirement for efficient markets. In short, for stock prices to reflect information, informed traders need to buy (sell) underpriced (overpriced) stocks. The growth in algorithmic trading may reduce price discovery by making it less profitable for informed traders to identify mispricings (Baldauf and Mollner 2020; Lee and Watts 2021). Given these concerns, it should be noted that hedge funds and other activists improve stock price formation (Cao et al. 2018). Thus, disclosure requirements that reduce their ability to profit from price discovery may also harm market efficiency.

To summarize, a shorter disclosure period could decrease the frequency of activist interventions, affect the type of operating changes demanded (sale or non-sale), and affect the way an ownership position is established (beneficial ownership or derivatives). Additionally, it could harm the overall efficiency of the stock market. The likelihood that new regulations result in these changes has been increased in recent years by new capital flowing to multi-strategy firms (Kumar 2022; Levine 2022). A firm focusing on shareholder activism (a single strategy) is likely to continue to search for intervention opportunities, irrespective of the reporting requirements. In multi-strategy firms, shareholder activism must compete for capital with other strategies, such as convertible arbitrage, merger arb, or relative-value structured-credit trades. Informed activism is expensive, and within multi-strategy firms, a reduction in profitability could cause a shift away from activism to other strategies.

Of course, the present disclosure regulations for activist interventions may not be optimal. Our evidence, like most research, examines average behavior. In aggregate, however, research shows the benefits of activist interventions to long-term shareholders more than offset the adverse effects. While we view greater transparency as generally desirable, and a laudable goal for policy makers, it may be appropriate to allow a relatively long disclosure period when shareholder activism is involved. At a minimum, we encourage extensive consideration of both the benefits and potential costs of any new reporting requirements.

Implications for Specific SEC Initiatives:

Among current initiatives, the evidence in our study is most directly related to the SEC proposal to shorten the time for disclosure in Form 13D that an activist investor has acquired a 5% beneficial ownership of a public company's stock (SEC 2022a). The SEC proposal would change the filing deadline from 10 days to five days. SEC Chair Gary Gensler had previously indicated a shorter period was under consideration during a virtual Q&A at the Exchequer Club in Washington, D.C. (Li and Javers 2022). Chair Gensler expressed concern about information asymmetry and this concern is explicitly mentioned in the SEC proposal. He provided the following example in the virtual Q&A: "Right now, if you've crossed the 5% threshold on day one, and you have 10 days to file, that activist might in that period of time, just go up from five to 6% or they might go from five to 15%, but there's nine days that the selling shareholders in the public don't know that information."

Investors who sell during the period after the 5% threshold is reached but prior to the Form 13-D announcement still generally benefit from the intervention, as an increase in the average stock price occurs prior to the announcement. As discussed previously, the average abnormal return (risk and market adjusted) during the 10-day, pre-announcement period is 1.23% for non-sale and 4.12% for sale events. During the five days after the 5% threshold is reached, our study shows the respective returns average 0.73% and 1.90%. Accelerating the filing date from 10 to 5 days would, therefore, reduce the returns during the period when the SEC is concerned about information asymmetry by 0.5% (1.23% - 0.73%) for non-sale demands and by 2.22% (4.12% - 1.90%) for sale demands. Evidence shows the asymmetric returns that the SEC is concerned about are quite modest. They are much less than those realized after the Form 13-D announcement. These forgone returns seem too small in of themselves to justify a change in the disclosure period for 13-D filings.

As discussed, longer-term investors realize most of the increase in returns from activist interventions, while investors who sell during the pre-announcement period realize lower but positive returns. This strikes us as fair, a point also made by Matt Levine (2022) who discusses the example developed by Chair Gensler. His column, which is prior to the specific 5-day SEC proposal, concludes by observing: "to be clear the people who really want this rule change are corporate executives, who do not like to be surprised by activists and want to make life as hard for them as possible. The longtime advocates for this rule change have been Wachtell, Lipton, Rosen & Katz, the law firm where I once worked, which does a lot of activism defense and has petitioned the SEC to shorten the reporting period for years." While we commend the SEC for proposing a 5-day disclosure period, rather than the one-day period in some recent initiatives, we question whether any change in the disclosure period is needed. If the 5% ownership threshold includes cash-settled derivatives, as the SEC has recently proposed, the disclosure period will be effectively shortened when derivatives are used.

The SEC (2022b) is also considering a one-day disclosure deadline for swap positions that meet certain materiality thresholds. The SEC has expressed concern that swaps can place a stock or debt holder in a position, where they benefit more from actions that have an adverse effect on the company than those with a positive effect. The SEC is especially concerned this could affect their voting behavior. An activist is likely to enter the long side of a total return swap that is based on the stock price of the targeted company. In this case, the incentives of the activist coincide with those of the stockholders since they benefit from an increase in the stock price. The counterparty to the swap would lose money if the stock price increases, so they could have incentives that would differ from the stockholders. In practice, however, counterparties (often banks) generally buy the underlying stock, so they are neutral about price changes. While the swap investor may be able to influence the vote of the counterparty, the swap investor's incentives are aligned with those of investors. As we understand it, swaps entered into as part of an activist intervention therefore do not have the risk characteristics that the SEC cites to support a one-day disclosure of swap positions.

We are not aware of data on how often activists use total return swaps. However, total return swaps can provide a way for activists to leverage an ownership position. The current disclosure rule for an activist position is currently based on 5% of the beneficial ownership, so it does not generally include derivative positions in calculating ownership. The current SEC proposal would seem to include cash settled swaps. Specifically, the proposed new Rule 13d-3(e) would provide that a holder of a cash-settled derivative security, other than a security-based swap, will be deemed the beneficial owner of the reference equity securities if the derivative is held with the purpose or effect of changing or influencing the control of the issuer of the reference securities, or in connection with or as a participant in any transaction having such purpose or effect.

We propose that swaps meeting the criteria to be included in the 5% beneficial ownership be disclosed when the Form 13D is filed, even if the swap meets the criteria for the proposed one-day disclosure. This seems like a reasonable compromise that allows the activist to establish their position without signaling other informed investors. It recognizes that a reasonable case can be made for including the ownership equivalent of such derivative positions in the existing 5% beneficial ownership threshold for Form 13D disclosure. There is logic in allowing the economic substance, rather than the legal form, to determine 5% beneficial ownership.

We thank you for your consideration and the opportunity to participate in the policy-making process.

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