March 22, 2022

By Electronic Mail
rule-comments@sec.gov

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

RE: File No. S7-06-22: Modernization of Beneficial Ownership Reporting

Submitted By: Bernard S. Sharfman*

Dear Secretary Countryman,

This comment letter respectfully identifies two fatal flaws in the SEC's proposed rule, Modernization of Beneficial Ownership Reporting ("proposed rule"),[1] that would not allow it to survive a legal challenge. First, by ignoring the "sole purpose" of the Williams Act,[2] the protection of investors who are confronted with a *cash tender offer*, the proposed rule is an *abuse of discretion*, if not *arbitrary and capricious*, under the Administrative Procedures Act ("APA").[3] Second, by ignoring the requirements of an adequate "cost-benefit analysis" as required by the court in *SEC v. Business Roundtable*,[4] the proposed rule is an agency action that is *arbitrary and capricious* under the APA.[5]

Standard of Review

This letter assumes that the proposed rule, as is, will be challenged in court. The standard of review is provided by the APA. The APA calls upon courts reviewing agency rulemaking to "decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action"—as well as to review all "findings" and "conclusions" and rejecting those deemed to be "arbitrary," "capricious," "an abuse of discretion" or "otherwise not in accordance with the law."[6] In addition, the U.S. Supreme Court has long determined to give agency

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[1] 87 FR 13846 (Mar. 10, 2022).
[2] Act of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 454, amending Securities Exchange Act § 13.
[3] 5 U.S.C. § 706(2)(A).
[4] 647 F.3d 1144 (2011).
[5] 5 U.S.C. § 706(2)(A).
[6] Administrative Procedure Act, Pub. L. 79–404, 60 Stat. 237 (1946), § 706, *codified at* 5 U.S.C. § 706.

rulemaking a "hard look," under *State Farm*,[7] though it has traditionally deferred to agency interpretations of ambiguous statutory language under *Chevron*. [8]

Abuse of Discretion

As correctly stated in the proposed rule, the SEC has the statutory authority, under Section 13(d)(1) of the Securities Exchange Act of 1934 ("Exchange Act"), to shorten the filing time of an acquisition of more than 5% of a cover class of equity securities from the current requirement of within 10 days to within 5 days.[9] However, this does not mean that the SEC has unlimited discretion to do so. This discretion is restrained by what the U.S. Supreme Court has determined to be the "sole purpose" of the Williams Act, the Act that created Section 13D of the Exchange Act.

Very simply, the U.S. Supreme Court has repeatedly and unambiguously stated that the "sole purpose" of the Williams Act was for the protection of investors who are confronted with a *cash tender offer*.[10] For example, the Court in *Piper et. al. v. Chris-Craft Industries, Inc.* stated that:

> The legislative history thus shows that the sole purpose of the Williams Act was the protection of investors who are confronted with a tender offer. As we stated in *Rondeau v. Mosinee Paper Corp.*, 422 U. S. at 58: "The purpose of the Williams Act is to insure that public shareholders who are confronted by a *cash tender offer* for their stock will not be required to respond without adequate information. . . ."[11]

Unfortunately, the proposed rule does not make the connection between a reduction in filing time and the "sole purpose" of the Williams Act. While the Act is mentioned eight times in the proposed rule, it omits any reference to the Supreme Court cases where the "sole purpose" of the Williams Act is discussed, does not make an attempt to demonstrate a connection between a reduction in filing time and how it will impact the ability of investors to be adequately informed in a *cash tender offer*, and only mentions the term *cash tender offer* once, in footnote 35. Moreover, the proposed rule makes very clear it is not targeted to the plight of shareholders being confronted with a *cash tender offer*, but to shareholders who have sold their shares prior to a hedge fund activist, who is not making a cash tender offer or seeking control, announcing it has acquired a 5% or more position in the company.

In sum, since the proposed rule does not connect the proposed reduction in filing time with the purpose, the "sole purpose" of the Williams Act, the SEC's implementation of this proposed rule would necessarily be considered to be beyond its statutory authority and an "abuse of discretion," if not "arbitrary and capricious," under the APA.

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[7] Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983).
[8] Chevron U.S.A., Inc. v. NRDC, 467 U.S. 837, 844-845 (1984).
[9] 87 FR 13849.
[10] A tender offer is where the offeror goes directly to the company's shareholders with an offer to buy their shares. See U.S. Sec. & Exch. Comm.. FINANCIAL REPORTING MANUAL, Topic 14 – Tender Offers, 14100 Regulatory Schemes, Section 14110.1, https://www.sec.gov/corpfin/cf-manual/topic-14. A cash tender offer is "a tender offer by either the issuer of the subject securities or by a third party where the offer consideration is cash only." *Id.* at 14110.3.
[11] 430 U.S. 1, 35 (1977). *See also*, Rondeau v. Mosinee Paper Corp., 422 U. S. 49, 58 (1975); Edgar v. Mite Corp., 457 US 624, 632 (1982); United States v. O'hagan, 521 US 642, 667 (1997).

Business Roundtable

The extremely influential case of *Business Roundtable* stands for the proposition that '"the Commission has a unique obligation to consider the effect of a new rule upon "efficiency, competition, and capital formation," 15 U.S.C. §§ 78c(f), 78w(a)(2), 80a-2(c), and its failure to "apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation" makes promulgation of the rule arbitrary and capricious and not in accordance with law."'[12] That is, the Commission has a "statutory responsibility to determine the *likely* economic consequences of" a proposed rule "and to connect those consequences to efficiency, competition, and capital formation."[13] Unfortunately, the proposed rule cannot do this and, to the Commission's credit, the proposed rule admits to this. As stated in the proposed rule:

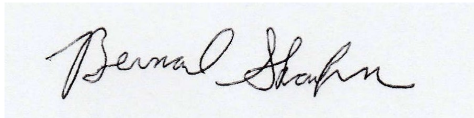
> [W]here possible, we have attempted to quantify the benefits, costs and effects on efficiency, competition and capital formation expected to result from the proposed amendments. However, we are unable to quantify all potential economic effects because we lack information necessary to provide reasonable estimates for those effects. For example, the Commission is unable to reasonably quantify the potential harm to investors as a result of mispricing under the current rules, or the reduction in trading costs due to improvements to liquidity or capital formation that may arise from more efficient pricing under the proposed amendments. We also are unable to quantify, with precision, the increased costs for blockholders to initiate *corporate change* as a result of the shortened Schedule 13D filing deadlines and, therefore, the reduction of the costs and benefits the presence of such blockholders bring. To estimate such costs, we would need to know, for example, how many potential blockholders would reduce their share accumulation prior to disclosure after the proposed rule change, and the amount of any such reduction. The ability for blockholders to achieve their target accumulation level prior to disclosure depends on such target level, the liquidity of the targeted covered class, their acquisition plans and their ability to adapt the plans.[14]

This acknowledged lack of information leads to a striking admission—"Because we do not have all the inputs for these variables, we cannot provide a reasonable estimate of the effects of the proposed amendments."[15] This admission is even more striking because the examples given, the potential benefits of a shortened filing deadline to shareholders who are contemplating a sale of their shares versus the harm caused to non-selling shareholders from the potential cooling effect on the efforts of blockholders to influence a company's decision-making without taking control (hedge fund activists), go to the heart of any required cost-benefit analysis. Moreover, this intended or unintended attack on traditional hedge fund

[12] 647 F.3d 1144, 1148 (2011).
[13] *Id.*
[14] 87 FR 13877-78.
[15] *Id.*

activism,[16] an empirically proven way to correct managerial inefficiencies[17] at a public company,[18] without rigorous analysis to back up this attack, is baffling. In sum, under *Business Roundtable*, until the SEC can provide "a reasonable estimate of the effects of the proposed amendments," the proposed rule, if implemented by the Commission, would be found by a reviewing court to be "arbitrary and capricious," requiring the court to vacate the rule.

Very truly yours,



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[16] Traditional hedge fund activism "is characterized by taking a large but not controlling position in a target company's stock, 5% to 10% of the stock outstanding, presenting value enhancing recommendations that are expected to correct managerial inefficiencies, spending the time and resources communicating their recommendations to other target company shareholders, and being provided a market confirmation of the value of this activism with a positive and significant impact on the value of the company's stock at the time of or near announcement of the activism." Bernard S. Sharfman, *Opportunism in the Shareholder Voting and Engagement of the 'Big Three' Investment Advisers to Index Funds*, forthcoming, J. CORP. L. (2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3995714.

[17] The huge amount of empirical research that demonstrates the value of hedge fund activism to shareholders (*see* n.18), strongly supports the theory that "In the context of public companies, hedge fund activism may constitute a valuable asset in and of itself if the goal of such activism is to enhance managerial efficiency." *See* Bernard S. Sharfman, *A Theory of Shareholder Activism and Its Place in Corporate Law*, 82 TENN. L. REV. 791, 804 (2015).

[18] Alon Brav, Wei Jiang and Rongchen Li, *Governance by Persuasion: Hedge Fund Activism and Market-based Shareholder Influence* (Jan. 10, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3955116. Based on a thorough survey of empirical studies hedge fund activism, they were able to conclude:

> Opponents of hedge fund activism argue that activists focus narrowly on short-term financial performance, and such "short-termism" may be detrimental to the long-run value of target companies. The empirical evidence, however, supports the conclusion that interventions by activist hedge funds lead to improvements in target firms, on average, in terms of both short-term metrics, such as stock value appreciation, and long-term performance, including productivity, innovation, and governance. Overall, the evidence from the full body of the literature generally supports the view that hedge fund activism constitutes an important venue of corporate governance that is both influence-based and market-driven, placing activist hedge funds in a unique position to reduce the agency costs associated with the separation of ownership and control.

Id. at 1-2.