Columbia Business School
AT THE VERY CENTER OF BUSINESS™

Columbia University
Graduate School of Business
Uris Hall, 3022 Broadway, Room 610
New York, NY 10027-6902
Ph: 206 724 6056
Fax: 212 316 9219

Shivaram Rajgopal
Roy Bernard Kester and T.W. Byrnes
Professor of Accounting and Auditing

Via Electronic Mail March 31, 2022

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

Re: 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; Release No. 34-93784 and Beneficial Ownership Reporting (13D-G) proposal, file no. S7-06-22.

Dear Secretary Countryman:

Robert Eccles and Shiva Rajgopal jointly submit this letter in response to proposed Rule 10B-1 relating to position reporting of "large" security-based swap positions, which was published in the Federal Register as part of the Commission's Release No. 34-93784 and the Beneficial Ownership Reporting (13D-G) proposal, file no. S7-06-22.

Shareholder activism – the practice of buying small stakes in public companies and pushing for change – is one of the best tools we have for holding companies accountable. The efforts of shareholder activists can benefit not just long-term investors (including the beneficiaries of pension funds, i.e., people like you and me), but also anyone who thinks that investors should be doing more to discover value relevant information about a firm and, if you are a socially conscious investor, to recognize the risk of climate change.

Around 20 percent of an S&P 500 firm is owned by the three passive indexers (BlackRock, Vanguard, and State Street) whose business model is the provision of low-cost index funds. Their business model is not designed to generate fundamental information that would suggest whether the company is under- or over- valued. As an example, consider the case of one prominent S&P 500 firm. That firm has under-performed the S&P 500 index by around 250 percent in the decade spanning 2010-2021. Will an asset management firm stay solvent if it underperformed the market by 250 percent? Yet, the big three passive indexers continue investing in that firm because the company is in the index. Who, if anyone, has the power to get that firm's management to confront its problems? Undervalued firms usually attract the attention of activist shareholders. Overvalued firms usually attract short sellers.

If we make life difficult for both types of activists, we stifle whatever little incentive we provide to hold management's feet to the fire.   For an ESG example, take activist firm Engine No. 1's successful campaign last year to add three independent directors to ExxonMobil's board, with the aim of getting the oil giant to finally start treating climate change as a fundamental threat to long-term shareholder value. While there is still much work to be done at ExxonMobil, the Engine No. 1 campaign at least got the industry's attention, indicating that activists in the future may be able to bring about even more dramatic change.

They will, that is, unless the Securities and Exchange Commission (SEC) ties their hands. And ironically, despite the SEC's stated goal of making environmental, social, and governance issues (ESG) a top priority, a flurry of newly announced SEC proposals threatens to do just that.

Before getting to the new rules, a bit of background. The rules as they currently exist already require activist investors to make substantial disclosures. If an activist firm buys more than five percent of the voting shares of a company, then it has to disclose ¬to the SEC and the public, within 10 days, not only the size of its stake, but also the recommendations it plans to make.

When one looks at the history of the law that established these rules, one finds that both the five percent threshold and the 10-day window were carefully designed to create a balance of power between companies and their shareholders. The law's drafters, working in the 1960s to address the issue of "corporate raiders," wanted to create sensible protections against "hostile takeovers." But they also wanted to preserve the ability of shareholders ¬¬to hold underperforming boards and managements accountable.

The balance of power that they established works, and there is no evidence that anything about it is broken. The overwhelming majority of academic research on this topic has shown, in the words of one recent study, that "activist interventions create long-term shareholder value." One of us has argued that activism is one of four effective strategies for investors to engage with companies. It is typically used when an entrenched management team refuses to engage with its shareholders to hear their concerns.

The use of derivatives by activists to build their stakes has improved this balance, in part because it has helped activists and companies avoid public disputes. Derivatives – which are instruments that track the underlying performance of a stock but lack the stock's voting power – allow activist investors to build a position without implying a threat to take over the company. Policy makers have generally not required disclosure of these instruments because they do not involve voting power and thus carry no implications for corporate control.

This dynamic allows for friendlier approaches, more productive conversations, and ultimately more settlements in which companies agree to make improvements that will benefit all shareholders. Sure enough, in recent years, the rising use of derivatives has coincided with a rise in the number of activist situations that have ended in amicable settlements.

Unfortunately, one of the SEC's newly proposed rules,"10B-1, Position Reporting of Large Security-Based Swap Positions," would require activists to publicly disclose even the non-voting portion of their positions, including derivatives. Such disclosures could make settlements more difficult because, once public, the reputations of both the activist and the company are on the line, and entrenchment becomes more likely.

And just this past month, the SEC took even more direct aim at activists with a new proposed rule revising 13-D that would reduce the 10-day window to five days. Shortening the window could actually discourage activists from building positions in the first place, because stock prices tend to rise when a successful activist discloses a position, reducing the activist's incentive to further build its stake.

If an activist firm concludes that it will not be able to build a meaningful stake in the newly shortened five-day window, then it will forgo the investment altogether – and all shareholders will lose out on the value that the activist could have created. This rule is directly contrary to one of the three elements of the SEC's mission: "to protect investors."

Taken together, these new rules would reduce the number of engagements that activist firms conduct and make the engagements that do happen more contentious, leading to less value creation, worse governance, and more acrimony at public corporations. One of us has argued that despite our admiration for the ESG records of European companies, focus on their "E&S" record might actually detract from the emphasis on "G." Dutch, French, and German firms, by and large, have far poorer "G" relative to their American counterparts. More damaging, the poorer "G" is associated with lower market valuations of these firms relative to a control sample of U.S. firms. Why? Because these firms are chock-a-block full of anti-takeover devices that make life very difficult for activists to intervene and confront management to improve shareholder value. And, remarkably, U.K. firms do not suffer from such a valuation discount relative to the U.S. because Britain has worked hard to make stock ownership more diffuse relative to its Continental cousins. It has also forbidden anti-takeover devices such as poison pills or classified boards. The point being: barriers to mechanisms that make managers accountable to investors are bad for information discovery and for forcing accountability on CEOs.

For those of us who care about ESG goals, the timing of the SEC's regulatory push couldn't be worse, because an increasing number of activist interventions are aimed at companies that are underperforming on ESG metrics.

Giving the CEOs and boards of companies like ExxonMobil more power to thwart activists like Engine No. 1 could halt this trend and undermine the SEC's efforts to get companies to take ESG more seriously. After all, what good is forcing more public-company ESG disclosures if you are simultaneously curtailing the ability of ESG-focused activists to hold these companies accountable? And, if you are looking for a non-ESG example, the new SEC rules will make it even more unattractive for activist investors to accumulate positions to force a reckoning on the stated underperforming S&P 500 firm's C-suite and its board.

The theoretical ideas underlying our objections were popularized by Grossman and Stiglitz in their classic 1980 paper in the American Economic Review. The argue that investors will not rationally incur the expenses of gathering information unless they expect to be rewarded by higher returns compared with the free alternative of accepting the current market price. Furthermore, modern theorists recognize that when intrinsic value for a firm is difficult to determine and when trading costs exist, even further room exists for price to diverge from value.

One alternative to the SEC's stated rules is to make activists report their derivative and other positions within five days to the SEC but not publicly. We can think of at least two precedents for such an arrangement. First, banks regulated by the Federal Reserve regularly disclose significant information privately to the Fed without public filings. Second, Warren Buffett's Berkshire Hathaway has reportedly struck deals with the SEC in the past asking for an exception to the 10-day

reporting rule. Buffett's logic is that he has the right to stymie funds that blindly mimic his purchases as "good investment ideas are rare, valuable and subject to appropriation (if not protected) just as are good product or business acquisition ideas." This same logic applies to activist investors. Why should Berkshire Hathaway be able to play by a different set of rules than activist investors.

Not all initiatives designed to increase transparency are worth the costs they incur. Nor do they always achieve the results they intend. If the SEC truly believes what it says about the importance of ESG and holding managers accountable to investors, then it should abandon these rule changes or at least modify them.

Sincerely,

Robert Eccles and Shiva Rajgopal