



April 11, 2022

Ms. Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington D.C. 20549

Re: Proposed Rule: Modernization of Beneficial Ownership Reporting (Release Nos. 33-11030 and 34-94211)

Dear Ms. Countryman,

On behalf of Pershing Square Capital Management, L.P. (“Pershing Square”), we are writing to provide our comments regarding the proposed amendments to beneficial ownership disclosure requirements on Schedule 13D (the “Proposing Release,” and the revisions proposed therein, the “Proposed Rule”). Specifically, we are commenting on the proposed changes to the concept of “group” beneficial ownership in Rule 13d-5. Capitalized terms used but not otherwise defined herein have the meaning ascribed to them in the Proposing Release.

Overview

Section 13(d) of the Exchange Act is intended to provide market participants with notice of rapid accumulations of ownership positions, that are made for the purpose of influencing control of an issuer. The concept of a “group” is intended to prevent circumvention of the reporting requirements.

The Proposed Rule appears to be targeted at so-called “wolf packs,” in which multiple active investors act together to influence the management of an issuer.¹

The Proposing Release acknowledges that “wolf-packs” rarely exist, estimating that the Proposed Rule would increase Schedule 13D filings by only 5%. The Proposing Release even asserts that this subset of circumstances *should* be deemed a group under the existing rules and law, and that the failure to do so is the result of a “misimpression” regarding the concept of group ownership. We note that this “misimpression” has held through four decades of court interpretation of the rules and underlying statute. And yet, for this relatively rare problem, the Proposed Rule

¹ See John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance* 28-39 (Columbia Law & Econ., Working Paper No. 521, 2015).



offers not a clarification of the existing rules, but instead a massive expansion of the concept of group ownership. Not only is this proposed solution wholly disproportionate to the problem it purports to address, it is also well beyond the purpose and scope of the underlying statute, costly if not impossible to administer, and would be significantly disruptive and deleterious to the health of financial markets.

The Proposed Rule would do away with widely accepted and well-established precedent in determining group status, which looks to the existence of an agreement, formal or informal, to establish that two or more persons were acting in concert and in furtherance of a common purpose. Under the Proposed Rule, group status could arise as a result of acquiring securities after having received information from another investor. The result is that an active investor would have no idea of how to avoid being deemed a group member—effectively, there would be a tremendous chilling effect on both their communications and their acquisitions. The circumstances in which reporting obligations and liability could potentially arise would be manifestly and substantively unfair, and such disclosures would provide no useful information to the investing public. We urge that any misimpression could be dealt with if the Commission issues a release that makes clear that an “agreement” need not be in writing, that it could be oral and informal. Moreover, the rule as proposed would incite and would result in a proliferation of litigation.

Rather than looking for an agreement or common purpose, under the Proposed Rule, each instance of coincident acquisitions could give rise to claims of group status, centered on triable issues of fact with respect to when and what information was shared, and for what purpose a purchase was made.

By increasing the probability that any given investor’s ownership would be aggregated with that of another investor, this expanded concept of group membership would effectively lower the triggering ownership level. Uncertainty regarding the number, identities, and ownership levels of other potential group members would effectively lower this level further. Coupled with the proposed changes to the treatment of derivative positions and the shortened reporting deadlines under the Proposed Rule, investors would be less able to obtain significant ownership positions at attractive prices, reducing the incentive and ability of activist investors to positively influence issuers and create value for public investors.

Moreover, the Proposed Rule would have disruptive consequences far beyond the immediate ramifications of beneficial ownership reporting. Ownership reporting under the Hart-Scott Rodino Antitrust Improvements Act of 1976, as amended (“HSR”) would also be implicated, as it is uncertain whether being deemed a member of a group would deprive an investor of relying on the “passive investor” exemption from HSR notification. A wide array of regulations and corporate contracts incorporate the Rule 13d-3 concept of group ownership. The increased grouping of investors would result in more 10% owners for purposes of Section 16 of the Exchange Act, requiring ongoing reporting obligations within two business days of any transaction. Poison pills would be more easily triggered, without any proportionate increase in the potential “threat”

posed to an issuer by an activist's ownership, resulting in immediate and significant financial costs, and outcomes at odds with jurisprudence regarding the reasonableness of such extreme defensive measures. Similarly, the "change in control" provisions of equity compensation agreements could be more easily triggered, resulting in accelerated payouts in circumstances where no actual shift in control exists. In addition, it is uncertain how the concept of group ownership under the Proposed Rule will interact with interpretations of tax law, which may be particularly relevant to equity compensation, net operating losses, and REIT status.

In short, the Proposed Rule presents a rare occurrence as a serious problem, and proposes a sweeping and thoroughly disruptive solution that would harm market participants and issuers alike.

Statutory Basis of the Proposed Rule

The Proposing Release contends that there are cases in which the existing rules require disclosure of beneficial ownership but, due to a near-universal "misimpression" of the group concept, such disclosures are not being made. The Proposed Rule does not offer a clarifying revision, however. Instead, it offers as a remedy entirely new categories and situations in which group membership could arise. We believe that the proposed approach is not only disproportionate to the purported problem, but also beyond the bounds of Section 13(d).

For over 40 years, market participants and courts have looked to the existence of an agreement, broadly defined, formal or informal, written or oral, to establish that action in concert or combination in furtherance of a common objective has occurred. The leading case in this area, *CSX Corporation v. Children's Inv. Fund Mgmt. (UK) LLP*, refers to the "requisite agreement" when offering an analytical framework to be applied in assessing whether or not a group had been formed.² The existing body of case law in this area provides market participants with greater clarity and certainty with respect to the circumstances in which market participants may be deemed to be part of a "group" for purposes of Section 13(d) of the Exchange Act.

Reference to "Agreements" does not Conflict with the Statute

The Proposed Rule would remove the reference to agreements in Rule 13d-5(b)(1), requiring only that two or more persons "act as" a group in order to be deemed a group.³ In doing so, it would create uncertainty as to the definition of "group," without furthering the purposes of Section 13(d). The Proposing Release takes the position that the prevailing view, that an agreement is a necessary condition or indicator of group status, "directly conflicts" with Section 13 of the

² *CSX Corporation v. Children's Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511 (S.D.N.Y. 2008).

³ "When two or more persons act as a group under section 13(d)(3) of the Act, the group shall be deemed to have acquired beneficial ownership, for purposes of section 13(d) of the Act, of all equity securities of an issuer beneficially owned by any such persons as of the date of the group's formation." Modernization of Beneficial Ownership Reporting, SEC Release Nos. 33-11030 and 34-94211 (Feb. 10, 2022) (the "Proposing Release") at 82.

Exchange Act,⁴ and that the language of Rule 13d-5(b)(1) has been misinterpreted to improperly restrict the scope of Section 13(d).

We do not believe that any such conflict with the underlying statute exists. From a textual standpoint, the absence of the term “agreement” in the text of Section 13 and its presence in Rule 13d-5 does not present an inherent conflict. As with any rulemaking, Rule 13d-5 necessarily includes language that is not present in the statute, in order to enable the application of statutory intent. The words “act as” in Section 13(d) can provide, for example, that formal organization as a legal partnership is not necessary to establish group status where several persons are otherwise acting as a legal partnership would. But this would not prohibit rulemaking that required other indicia of coordination, such as an informal agreement, to be present for a group to exist. This absence of conflict is particularly true given the broad meaning courts have ascribed to the term “agreement,” as described below.

The Proposing Release takes the position that Section 13 requires the concept of a group to extend beyond agreements in the “classic contractual ‘offer’ and ‘acceptance’ sense of the term,” but that it should reach broader to include formal and informal, written or unwritten agreements.⁵ The Proposing Release also notes the terms “understanding,” “arrangement” and “relationship” in Rule 13d-3(a) as pointing to “a recognition that concerted action need not be formalized or otherwise expressed.”⁶ but this does not conflict with lending importance to the existence of an agreement. These are well-accepted and uncontroversial positions, and we agree. If the Commission wants to clear up any misimpression, we urge that it issue a release to correct market participants’ interpretation.

The Proposing Release then states that, if an agreement were a necessary condition for establishing group status, these informal arrangements would not be reached, limiting the application of Section 13 to “only a subset of persons who otherwise ‘act as a group,’”⁷ and increasing the evidentiary burden on the Commission and plaintiffs for establishing that a group exists. The implication is that “agreement,” as used in Rule 13d-5(b)(i), only refers to formal agreements.⁸ Here, we disagree. The text of Rule 13d-5(b)(1) does not require such a narrow interpretation, and the record of Section 13 litigation does not reflect such an interpretation. The “conflict” between the rules and the statute simply doesn’t exist.⁹

⁴ “For example, if the Commission were to construe Rule 13d-5(b)(1) as the exclusive definition of the term “group,” and thus make an “agreement” a necessary element, that would directly conflict with the statutory language and narrow the circumstances in which Sections 13(d) and 13(g) could apply.” *Id.* at 78, n. 126.

⁵ *Id.* at 79-80.

⁶ *Id.* at 79.

⁷ *Id.* at 80.

⁸ Even if one accepts the premise of the Proposing Release, that “agreement” in Rule 13d-5(b)(i) was intended only to supplement the definition of “acquisition” so that the formation of a group would be a triggering event under Rule 13d-1, it does not follow that the term must only refer to formal agreements. *See Id.* at 75.

⁹ The Proposing Release also takes the position that the prevailing understanding of the term “agreement” in Rule 13d-5(b)(i) would give rise to an unintended exemption from reporting for groups that form prior to reaching the ownership

Courts, whether looking to the existence of an agreement out of an interpretation that Rule 13d-5(b) requires it, or as an administrable evidentiary standard for establishing action in concert, have interpreted the term “agreement” broadly to include informal and unwritten arrangements, and have relied on circumstantial evidence in order to establish that some manner of agreement existed. The facts and circumstances for establishing action in concert, and the evidentiary burden for doing so, would seem similar to those for establishing the existence of an “agreement.”¹⁰

The Proposing Release also states that Section 13(d)(3) is intended to include, in addition to agreements in the classic contractual sense, “pooling arrangements, whether formal or informal, written or unwritten.”¹¹ The meaning of “pooling arrangements,” is unclear. For example, in a pooled investment vehicle with investments in multiple issuers, one of which is reportable on SC 13D, would all investors in the vehicle be deemed group members with the investment manager of the vehicle? In a special purpose vehicle with an investment adviser, would investors (who have no dispositive or voting power) be deemed group members? Further, the Proposing Release also does not address how this provision relates to, or serves a purpose in addition to, the catch-all provision of Rule 13d-3(b).

Without any description of what these circumstances would be and how they would fall within the scope of Section 13, the Proposed Rule would create significant uncertainty for market participants as to whether group status exists and when such status would come into existence.

The Proposed Rule is Disproportionate to its Purpose

The Proposing Release does not identify or provide any examples of this subset of persons acting in concert that the existing rules and case law fails to reach. Indeed, it would be difficult to imagine a set of circumstances in which parties acted in concert, but did so without at least some kind of implied agreement. In the Proposed Rule, the Commission appears to be targeting a subset of a subset: those active investors who are acting in concert, but not to the degree or in a manner that would give rise to group status under the existing law.

threshold and subsequently acquire securities in excess of the threshold, as Rule 13b-5(i) is only operative after the ownership threshold is surpassed. We cannot find support in the text of Rule 13b-5(i) for this proposition. Rule 13b-5(i) can be interpreted to provide that a group is formed upon an agreement, regardless of ownership level. Upon making an acquisition that surpasses the ownership threshold, that group is a person that would be required by Rule 13d-1 to file a Schedule 13D.

¹⁰ See *SEC v. Levy*, 706 F. Supp. 61 (D.D.C. 1989) (“*Levy*”), which the Proposing Release cites as standing for the proposition that no agreement is necessary (see *Proposing Release*, fn. 131). In *Levy*, the court (citing *Securities and Exchange Commission v. Savoy Industries*, 587 F.2d 1149 (D.C. Cir. 1978) (“*Savoy*”)) states that a “sufficient ‘combination’ for the purposes of imposing liability under Section 13(d)(3) and Rules 13d-5(b)(1) and 13d-3” requires a “meeting of the minds, understanding or arrangement that ... need not be written” (quoting *Savoy*). These cases confirm the understanding that groups may be formed informally, while using terms synonymous with a broad sense of the term “agreement.” *Levy* and *Savoy* do not support the position that an agreement is not required, let alone that such a requirement would be contrary to the purposes of Section 13(d)(3).

¹¹ *Id.* at 79-80.

The Proposing Release does, however, seem to acknowledge that these circumstances are not common. The Proposing Release states that the Commission lacks data on how many groups “may not be reporting beneficial ownership because of the misimpression that an agreement is required,” and estimates that the proposed revisions to Rule 13d-5 would increase filings by approximately 5%, which “may overestimate the potential increase...because such adoption may incentivize persons to take steps to avoid triggered a requirement to report beneficial ownership.”¹² The Commission does not provide any basis for this estimate, and we question whether such an important issue should be dealt with absent a formal estimate.

In the case of “wolf packs” not being deemed to be groups under the existing rules, this may be less an interpretive failure of the existing rules, and more a result of the fact that the existence of “wolf packs” is an unsubstantiated myth of coordination among the parties. While active investors may stand to benefit from aligning with each other in their mutual interest, particularly in the case of a possible proxy contest, it is more likely that active investors are competing over a limited pool of potential profits. Not only are their investment purposes different, but so are their direct financial interests.

In short, the proposed revisions offer a solution, but without identifying a problem, let alone quantify the significance of that problem. The benefits of correcting this “misimpression” are minimal, while the costs to market participants are extremely significant, as described further below.

The Proposed Rule: Communication as a Basis for Group Status

The Proposed Rule Expands Group Status beyond the Congressional Intent of Section 13(d)(3)

By eliminating the concept of an agreement, the Proposed Rule would broaden the application of Rule 13d far beyond the intended purposes of Section 13(d)(3). An agreement, however informal, requires some set of affirmative actions to be taken. The importance of the reference to an agreement is that it reflects that group membership should not include those without any intention to act in concert or in furtherance of a common purpose. The Proposing Release takes the position that the intent of putative group members is irrelevant, citing the absence of a state of mind element in the text of Section 13.¹³ Yet, intent is at the center of the Rule 13d regulatory framework. The filing obligation under Rule 13d-1 arises where a party has the *intent* to influence or change control of a company. Section 13(d)(3) of the Exchange Act was included in order to prevent “coordinated circumvention”¹⁴ of having reached the triggering ownership level. Rule 13d-3(b) addresses deliberate “plans or schemes” to evade the reporting requirements by any other

¹² *Id.* at 169, n. 275.

¹³ *Id.* at 80.

¹⁴ *Id.* at 72.

device. While it is well-established that scienter is not an element of Rule 13d-1 violations, such that liability arises regardless of whether a person was aware of their failure to comply with reporting obligations, we are not aware of any support for the proposition that intent is irrelevant to determining group status or any other aspect of Section 13.

Proposed Rule 13d-5(b)(1)(ii) would do exactly this, expanding the concept of a group to include those who have no intention to act in concert with another person, who do not share a common purpose with another person, or both. The Proposed Rule would provide that, with limited exceptions, if a person, in advance of filing a Schedule 13D, discloses to any other person that such filing will be made (to the extent such information is shared with the purpose of causing such other person to acquire securities in the same covered class) and such other person acquires, based on that information, securities in the same covered class for which the Schedule 13D will be filed, then those persons are deemed to have formed a group within the meaning of Section 13(d)(3).

The Proposed Rule imports a concept from insider trading law, of tippers and tippees benefiting from non-public information, but in the absence of the fiduciary duty violations or misappropriation of information that underpin insider trading liability. Here, the information consists solely of the intended actions of an entity other than the issuer, originates from and is freely communicated by that entity, and is not subject to any other duty or obligation to make public disclosure. The Proposed Rule presents a significant risk that, as is the case with insider trading law, that mere possession of information is sufficient to establish having acted on the basis thereof.

The Proposing Release provides two principal justifications for Proposed Rule 13d-5(b)(1)(ii). First, that the sharing of such information could improve the likelihood of an investor (a “blockholder,” as referred to in the Proposing Release) succeeding in accomplishing its goal, through (a) “engender[ing] support” for future proposed changes to the issuer or (b) by incentivizing the recipient to purchase shares to benefit from an expected price increase upon the filing of the Schedule 13D. But a blockholder may share information with other market participants for reasons not directly related to the proposed changes that are the subject of its pending Schedule 13D filing. The blockholder may do so without any expectation that the recipient act upon that information in a way that benefits the blockholder. Under the Proposed Rule, the blockholder would have to take the risk that, if the recipient subsequently purchased securities, the blockholder would be presumed to have shared that information “for the purpose of causing” the recipient to do so, which would cause a group to be formed among the blockholder and the recipient.

From the perspective of the recipient, it may have been planning to acquire those securities before receiving the information, or may act upon the information, but with a different purpose. For example, the recipient could seek to benefit from a short-term price increase, but have no intention to hold the securities for a longer period or to vote in favor of the changes proposed by the blockholder. Or, the information received from the blockholder could lead the recipient to form

its own investment thesis, and make wholly distinct proposals regarding the issuer.¹⁵ Those who receive information from a blockholder are at risk of inadvertently becoming subject to group reporting obligations in circumstances that were never intended to be covered by Section 13.

Moreover, this risk is amplified because the investment criteria used by blockholders to select underperforming companies are similar and it is not uncommon for blockholders to target a company based on similar criteria, such as ineffective executive leadership and an undervalued stock price. Blockholders thus often focus on the same issuer based on their own independent research and imputing group reporting obligations more broadly than permitted by Section 13 will frequently impose group reporting obligations on blockholders who are targeting the same issuer based on their own independent research.

Second, the Proposing Release states that the Proposed Rule serves an investor protective purpose, as “any near-term gains made by these other investors attributable to this asymmetric information may come at the expense of uninformed shareholders who sell at prices reflective of the status quo,” and that this “informational imbalance may result in opportunistic purchases benefiting a favored few.” Market participants do not have a general entitlement to protection from all market asymmetries, including, for example, independent research by blockholders that was obtained lawfully.¹⁶ Section 13 was enacted to provide market participants and issuers with notice of “rapid accumulations of its equity securities by persons who would then have the potential to change or influence control of the issuer.”¹⁷ Proposed Rule 13d-5(b)(1)(ii) would not only effectively lower the reporting threshold, but would also require disclosure by those who did not share any control intent, or even own sufficient securities to exert any influence. In addition, Section 13 was enacted in the context of hostile cash takeovers. Modern activist investing, as the Proposing Release acknowledges, is characterized by minority ownership positions seeking changes to corporate governance. The impact such efforts would have on share prices is more speculative than a buyout, and the consequences (an issuer retaining many of its incumbent directors and remaining a publicly traded company) are much less final. It is not clear that this level of additional disclosure would address the degree or type of information asymmetry that Section 13 was enacted to address. Finally, it is clear that if a party is planning an acquisition approach, both the proposed acquiror and the person it tells about the proposal are free to trade so long as no tender offer is involved.

The Proposed Rule would restrict parties from making certain communications (or result in burdensome disclosure obligations) in situations where such communications did not occur for the purpose of, or increase the likelihood of succeeding in, influencing or changing control of the

¹⁵ See, e.g., Carmen X. W. Lu, *Unpacking Wolf Packs*, 125 YALE L.J. 773, (2016), cited in n. 266 of the Proposing Release, which provides an example of three hedge funds engaged with the same issuer did so with different agendas, and exited their campaigns at different times.

¹⁶ The Proposing Release states in footnote 138 that the Commission expresses no opinion as to whether a blockholder owes a fiduciary duty to the other holders of the covered class of security.

¹⁷ *Id.* at 18, n. 24.

issuer. The Proposed Rule would create a group where there is no action to be taken in concert, and no common purpose to be furthered. Absent a common purpose, it is difficult to characterize the 3% beneficial ownership of one person and the 4% beneficial ownership of another as an effort to evade the 5% beneficial ownership trigger. However, the Proposed Rule would apply Section 13(d)(3) to situations in which no attempt is being made to circumvent the beneficial ownership reporting threshold, and subject market participants to reporting obligations in circumstances that are effectively beyond their control.

The Limited Exemptions in Proposed Rule 13d-6(c) and Rule 13d-6(d) are too Narrowly Defined to Accomplish Their Intended Purpose

While helpful to alleviate some of these issues, the limited exemptions in Proposed Rule 13d-6(c) and (d) do not adequately address these concerns. These rules would exempt communications between parties, and derivative contracts between parties, that are not undertaken with the purpose or effect of changing control of the issuer, and are not made in connection with such a transaction. Neither provision contains an exemption for actions taken without a common purpose.

The Proposed Rule is also unclear as to whether all parties must lack a control purpose, or whether the control purpose of any one party would deprive all other parties to a communication or contract of the exemption. The Proposing Release states that Proposed Rule 13d-6(c) would permit communication among shareholders seeking to align their voting with respect to proposals to be put forth at a meeting of an issuer's stockholders, but the text of the Proposed Rule is compatible with deeming such communications as being for the purpose of affecting control of an issuer. The Proposing Release states that the proposed Rule 13d-6(d) would provide that two or more persons will not be deemed to have formed a group under Section 13(d)(3) or 13(g)(3) solely by virtue of their entrance into an agreement governing the terms of a derivative security.¹⁸ This exemption is aimed at allowing financial institutions to conduct ordinary course business, but the conditions of the rule are too restrictive to accomplish this purpose. Specifically, Rule 13d-6(d) can only be relied upon if the parties did not enter into the agreement with the purpose or effect of changing or influencing control of the issuer or in connection with or as a participant in any transaction having such purpose or effect.

If an activist investor (or an investor with a reputation for activism) enters into a derivative security in connection with its efforts to influence or change control of an issuer, it is unclear whether the activist and its counterparty could qualify for this exemption since the parties may not meet the no influence or control test. Nearly always, the financial institution will have some general awareness of the activist's intentions and thus will have to risk being considered as part of a "group" due to its ordinary course trading activity. Such a counterparty, despite having a "short" position with respect to the issuer in that derivative contract, could be deemed a group member if

¹⁸ Proposing Release at 98.



it purchases securities of the issuer to hedge its position, or purchases such securities for an unrelated purpose. Moreover, this same risk could apply to basic stock purchases by an activist investor from a financial institutions. As described further below, it would also create obstacles for acquisition transactions and interfere with the antitrust regulatory framework.

It is predictable that, faced with the litigation risk of being found to be part of a group, financial institutions would not just be apprehensive about, or marginally disincentivized from, entering into transactions with an activist counterparty. Rather, financial institutions would avoid the risk altogether, and wholly refrain from engaging in these transactions that are economically useful and unrelated to the purposes of Section 13.

These circumstances are beyond the intent of Congress in passing Section 13 and impose liability and reporting obligations on ordinary course market activity.

Negative Impacts of the Proposed Rule

The Proposed Rule would be Administratively Impracticable

Proposed Rule 13d-5(b)(iii) also would be administratively unworkable. A blockholder would only be aware of the formation of a group if and when the recipient notified the blockholder that it had acquired securities. Similarly, though a recipient may be aware that a blockholder expects to file a Schedule 13D in the near future, it would not know when the blockholder's (and the recipient's) reporting obligation arose until the blockholder informed the recipient, or when the blockholder filed its Schedule 13D report, at which time the reporting deadline for the recipient may have passed. Each party would be subject to ongoing requirements to amend their filings based on transactions entered into by the other party and, upon entry into certain contracts, communications with the issuer or the public, and other material events. In order to avoid violations of Rule 13d-1 and 13d-2, these parties would have to share a substantial amount of information on a frequent basis, requiring them to provide each other with insight into their strategy and activities at a level of detail that could be harmful to their own interests. This is particularly true in light of the accelerated reporting deadlines and the treatment of cash-settled derivatives contained in the Proposed Rule. Market participants could become liable for transactions of which they were unaware, entered into by unrelated third parties.

Proposed Rule 13d-5(b)(1)(iii) identifies circumstances in which the Commission believes that the potential for a change in corporate control is significant enough to merit public disclosure, but where the beneficial ownership of, and relationships between, the relevant parties do not trigger reporting obligations. It may, in fact, be the case that the concerns underlying Section 13 are equally implicated when there are several below-threshold owners seeking to influence or change corporate control, regardless of the commonality of their purpose. It may also be the case that sharing information can amplify the power that an investor has beyond that implied by their

ownership alone. But Section 13(d) does not provide a basis for requiring disclosure in these circumstances, and the rulemaking process cannot provide it.

The Proposed Rule Would Inhibit Value-Creating Market Activity

The Proposed Rule would have substantial negative effects on potential reporting persons, the investing public, and on markets as a whole. These negative effects would significantly outweigh any potential benefits. The Proposed Rule would have a direct chilling impact on beneficial market activity, hinder communication among market participants, and produce serious administrative burdens. The impacts would extend beyond the immediate context of Schedule 13D reporting to Section 16 beneficial ownership and other areas of corporate law, including poison pills, employee benefit plans, and other contracts or arrangements that reference the Rule 13D concept of group and beneficial ownership.

The Proposing Release acknowledges that the principal factor to be weighed against any potential benefits of Proposed Rule 13d-5(b) is the impact it would have on corporate activism. The Proposing Release cites studies finding that companies targeted by activist hedge funds “tend to improve productivity,” “relocate underused assets to more productive uses,” resulting in price increases that at the time of Schedule 13D reporting “do not reverse in the long term,” and that even the threat of potential shareholder activism can provide these benefits.¹⁹

The Proposing Release also acknowledges that the financial incentive for activist investors to engage issuers can be substantially reduced by reporting obligations, as disclosure can increase the price of acquiring the issuer’s securities, enable the issuer to take defensive actions at an earlier stage, and create substantial compliance and legal costs. These factors impact both the potential increase in value that an investor might obtain and the likelihood that the investor will succeed at doing so.

However, we believe that the chilling effects of the Proposed Rule are greater in magnitude and reach than the Proposing Release acknowledges. By expanding the definition of a “group,” the Proposed Rule effectively lowers the ownership threshold. Reporting obligations would be triggered at lower levels of ownership for a given amount of voting power. This is exacerbated by the uncertainty created by the Proposed Rule. An investor would not be in the position of limiting its acquisitions to 4% because it would be grouped with a 1% owner in a broad number of circumstances described above. The investor would have to assess both the risk and uncertainty around the number of persons with whom it could be grouped, the possible ownership of such persons, and the likelihood of being deemed a group. The difficulty of determining group status increases compliance and legal costs around the time of filing, and increases the likelihood of potentially costly litigation that could prevent the activist from continuing its campaign, or greatly reduce any of the profits it earns from doing so. These factors weigh in favor of much lower

¹⁹ *Id.* at 135-37.

ownership stakes, earlier disclosure, some combination thereof or, alternately, not making the investment at all. However contested the concept of an “agreement” may be, it serves as a sufficiently bright line for market participants trying to determine their reporting obligations, particularly given the case history available to aid in such a determination.

Activist investors typically hold far less voting power than would be required to obtain shareholder approval. Even with beneficial ownership of 8% to 9%,²⁰ an activist must garner a substantial amount of support from other investors. To the extent this beneficial ownership is comprised of securities that do not confer voting power, support from other investors is even more necessary. Under Proposed Rule 13d-5(b)(1)(iii), the expense and risk of communications with other investors would increase greatly. Each instance of outreach before filing an initial Schedule 13D would carry a risk of disclosure being triggered at an earlier date, and all instances of outreach would carry a risk of inadvertently forming a group and subsequently failing to make timely or accurate disclosure of the group’s beneficial ownership. Potential recipients of information would also be less receptive to discussions, as they would risk becoming subject to Rule 13d-1, or become unable to acquire securities of the issuer.

The use of derivatives will depend on an activist investor’s strategy, desired economic exposure, risk tolerance, and the liquidity of the target company’s securities, among other factors. Reticence by financial institutions to serve as counterparties could significantly raise the cost and risk of investment and, by reducing the economic exposure an investor could obtain, would further reduce the potential return on investment for activist investors.

Proposed Rule 13d-5(b)(1)(iii) poses a particularly significant litigation risk. Group members, whether known at the time of filing, or alleged to be group members after the fact, will likely have engaged in transactions of which the investor was unaware or did not timely report. The rule requires determinations as to the materiality of the information shared and the purposes of sharing that information that are easily contested, and the latter of which could be difficult to defeat in summary judgment.

The cost to public investors of this reduction in shareholder activism will consist not only of the value-enhancing campaigns that do not occur, but also of value-destructive actions by issuers or entrenched management that is no longer subject to the disciplining effect of a potential activist campaign.

The Proposed Rule Would Cause Poison Pills to be Triggered

²⁰ See Brav, Alon and Dasgupta, Amil and Mathews, Richmond D., Wolf Pack Activism (May 10, 2021). Management Science, forthcoming, European Corporate Governance Institute (ECGI) - Finance Working Paper No. 501/2017, Robert H. Smith School Research Paper No. RHS 2529230, Available at SSRN: <https://ssrn.com/abstract=2529230> or <http://dx.doi.org/10.2139/ssrn.2529230>.

Poison pills originated as a defensive measure against unsolicited acquisition attempts. Upon the potential acquiror reaching a certain ownership threshold, typically 10% or 15%, its economic interest would be substantially diluted.²¹ Courts assess the appropriateness of the threshold at which the pill is triggered in relation to the perceived threat faced by the issuer, particularly the threat of a control transaction occurring without shareholders receiving a “control premium” from the acquiror.

Poison pills have evolved to provide a defensive weapon not only against takeovers, but also activist investors. Issuers have adopted “two-pronged” poison pills, that have one threshold for passive investors, and a separate, lower threshold for active investors. Issuers have also sought to expand the calculation of ownership beyond Rule 13d-3, including measures that are intended to target so-called “wolf packs” of activist investors that are not a group under Rule 13d, but that the issuer deems to be acting in concert.

Poison pills typically define ownership with reference to Rule 13d-3. Accordingly, the Proposed Rule would impact the operation of every poison pill that is outstanding at the time of its adoption (and likely a larger set that are “on the shelf,” ready to be rapidly deployed). If adopted, the Proposed Rule would instantly increase the reported beneficial ownership of a potentially large number of market participants as a result of (i) the inclusion of certain derivatives as being beneficially owned and (ii) potential filing persons finding themselves newly in a group with other market participants. Proposed Rule 13d-5(b)(1)(iii) would effectively build into these poison pills the same, overly broad concept of cross-attributing beneficial ownership that courts have viewed with extreme skepticism.

The Proposed Rule Would Interfere with Antitrust Regulation

The Proposed Rule would have a presumably unintended but significant consequence for the acquisition of voting securities under the HSR Act. Under HSR, a person making an acquisition of voting securities valued at or above \$50 million (as adjusted)²² must first file a notification report with the Federal Trade Commission (“FTC”) and the Antitrust Division of the U.S. Department of Justice (“DOJ”) and observe a 30-day waiting period (which may be extended by either Agency) before the person may consummate the acquisition.²³ Because the HSR regulatory scheme is intended to be neutral with respect to contests for corporate control, the Premerger Notification Office of the FTC has long advised investors that they may accumulate an unlimited nonpublic economic stake in a target issuer without filing the required notification by

²¹ *In re Williams Cos. Stockholder Litig.*, 2021 Del. Ch. LEXIS 34, 2021 WL 754593.

²² For 2022, the adjusted HSR threshold is \$101 million. *See Revised Jurisdictional Thresholds for Section 7A of the Clayton Act*, 87 Fed. Reg. 3,541 (January 24, 2022).

²³ HSR Rule 802.9 exempts acquisitions of voting securities of up to 10% of the outstanding voting securities of the issuer regardless of the dollar value of the securities if made “solely for the purpose of investment.” 16 C.F.R. § 802.9.

acquiring non-voting derivative instruments instead of voting securities.²⁴ A person later wishing to convert that economic stake into voting securities would first have to make an HSR filing and observe the waiting period.²⁵

The Proposed Rule would effectively overturn this longstanding FTC procedure and upset the carefully balanced Congressional schemes regulating securities markets and competition. Specifically, as stated above, the Proposed Rule would expose financial institutions to significant liability for serving, in the ordinary course, as the derivative counterparty to an investor with the reputation of being an activist, or who has filed a Schedule 13D. By eliminating the ability of an activist investor to accumulate a nonpublic economic stake in an issuer, the SEC would, by fiat, eliminate a longstanding FTC-approved strategy available in a control contest. As a consequence, activist investors would be limited to the initial HSR filing threshold as the upper boundary of a nonpublic stake in the issuer. Such a drastic change in the balance between SEC-administered and FTC-administered regulatory regimes should not be implemented without express direction from Congress.

The Proposed Rule Would Significantly Increase Section 16 Reporting Burdens

Section 16 of the Exchange Act imposes reporting obligations on directors, officers, and 10% beneficial owners of an issuer. Section 16 imports the calculation of beneficial ownership provided in Rule 13d-3 and is, in some ways, more onerous than Section 13, as it requires the disclosure of all transactions in an issuer's equity securities (without any materiality threshold), requires disclosure to be made within two business days of the transaction, and imposes a strict liability penalty of disgorgement for any opposite-way trades within a six-month period that resulted in a profit.

Section 16 includes 10% beneficial owners as “insiders” not just because they can “influence or control the issuer as a result of their equity ownership,”²⁶ as the Proposing Release states, but because they “can be presumed to have access to inside information” as a result of the influence or control they may have.²⁷ Activist investors, who are viewed antagonistically by issuers, are unlikely to have inside information as a result of their equity ownership. The Proposed

²⁴ See HSR Informal Interpretation Letters, #0511010 (Nov. 14, 2005) (Swap agreement did not confer beneficial ownership under HSR.), available at <https://www.ftc.gov/legal-library/browse/hsr-informal-interpretations/0511010>; ABA Section of Antitrust Law, Premerger Notification Practice Manual, 5th Edition (2015), Interpretation No. 31.

²⁵ See 16 C.F.R. § 801.32.

²⁶ *Id.* at 110. “Given that Rule 16a-1(a)(1) has the same purpose as Regulation 13D-G—*i.e.*, to identify persons who can influence or control the issuer as a result of equity ownership—it appears appropriate to continue to apply the standards of Regulation 13D-G, as proposed to be amended, to identify 10% holders subject to Section 16.”

²⁷ *Id.* at 108, n. 168. “Ownership Reports and Trading By Officers, Directors and Principal Security Holders, Release No. 34-28869 (Feb. 21, 1991) [56 FR 7242 (Feb. 21, 1991)] (stating that as applied to 10% holders, Section 16 “is intended to reach those persons who can be presumed to have access to inside information because they can influence or control the issuer as a result of their equity ownership” and noting that Section 13(d) of the Exchange Act “specifically addresses such relationships”).



Rule, by treating cash-settled derivatives as beneficially owned, and by expanding the application of group ownership, would significantly increase the number of 10% owners. Additionally, expanding the definition of group overly broadly as described in the Proposing Release would prematurely trigger Section 16 filing obligations and impose short swing liability on many parties who were not previously subject to Section 16 liability.

Disclosure requirements under Section 16 would create a significant administrative burden for all market participants that become 10% owners, not just activist investors. Corporate directors and officers trade infrequently, partly due to restrictions on their ability to trade under internal insider trading policies, and partly in order to avoid triggering Section 16 filings and creating the risk of short-swing liability. All other market participants who do not have access to material non-public information are free to trade in response to their perception of changing market conditions. Becoming subject to Section 16 would increase their cost of transacting and risk of liability for doing so, inhibiting the formation of larger ownership blocks that can effectively monitor management, and harming liquidity and price discovery in an issuer's securities. This additional disclosure would be duplicative of that required by Rule 13d-1, and would not provide any public benefit.

The unique enforcement mechanism of Section 16, in which the issuer can sue to recover profits, or private actors can bring suit on behalf of the issuer, would also increase the burden on issuers. There is an active plaintiff's bar that regularly sends issuers demand letters requesting that the issuer take action to recover short-swing profits. Regarded as nuisance lawsuits that would be more expensive to litigate, Section 16 demands are usually resolved by a settlement payment by issuers. The Proposing Release estimates that the Proposed Rule would increase Section 16 filings by approximately 10%. While issuers may gain from the ability to sue activist investors for alleged Section 16 violations, they would also be subject to a much greater volume of nuisance lawsuits.

The Proposed Rule Could Trigger Change in Control Provisions in Compensatory Agreements

It is a common feature of many compensatory agreements between an employer and its directors or employees that the timing and amount of payments under those agreements are affected by the occurrence of a "change in control", and it likewise is a common feature of such agreements that the definition of a change in control hinges in part on the actions of persons "acting as a group" within the meaning of Section 13(d) of the Exchange Act. For example, a change in control might be triggered whenever any person or more than one person acting as a "group" (as defined in Section 13(d) of the Exchange Act) becomes the "beneficial owner" (as such term is defined in Rule 13d-3 under the Exchange Act), directly or indirectly, of securities of the employer representing more than a specified percentage of the employer's stock.

As a result, the Proposed Rule could work unintended and unwanted consequences on the myriad arrangements with such a change in control definition and, at a minimum, adoption of the Proposed Rule would require countless employers to examine their change in control definitions



and consider whether and how to amend them—if indeed they even have the contractual latitude to implement an amendment.

Moreover, the “acting as group” concept is a feature of change in control definitions in various Internal Revenue Code provisions whose provisions are triggered or otherwise affected by the occurrence of a change in control. For example, Internal Revenue Code Section 280G (relating to “golden parachute” provisions) and Section 409A (relating to the taxation of nonqualified deferred compensation) both incorporate the “acting as a group” concept in their respective change in control definitions. Accordingly, adoption of the Proposed Rule could upset settled expectations about how such tax code provisions would operate in respect of existing compensatory arrangements.

Conclusion

Given the arguments presented above, we urge the Commission to not adopt the proposed amendments to beneficial ownership disclosure requirements unless significant changes are made to the rules to address the concerns above. Adoption of such rules would lead to a chilling effect on beneficial market activities, and provide limited, if any, protection to investors. Additionally, if the Commission believes there is a misimpression in the market on the meaning of group, we urge that the Commission issue a release that makes clear that oral and informal agreements or understandings can result in group formations.

Sincerely,

A handwritten signature in blue ink, appearing to read 'Halit Coussin'.

Halit Coussin
Chief Legal Officer & Chief Compliance Officer
Pershing Square Capital Management, L.P.