COUNCIL FOR INVESTOR RIGHTS AND CORPORATE ACCOUNTABILITY

Via electronic mail (rule-comment@sec.gov)

April 11, 2022

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

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

Dear Ms. Countryman:

We are a consortium of investors known as the Council for Investor Rights and Corporate Accountability ("**CIRCA**") who believe that a well-functioning system of checks and balances among management teams and boards of directors, on the one hand, and shareholders, on the other hand, is fundamental to the long-term competitiveness, economic growth and prosperity of the U.S. capital markets and the U.S. economy generally.

We are writing to express our strong disagreement with the amendments proposed by the Securities and Exchange Commission (the "**SEC**") to certain of its rules (the "**Section 13 Rules**") implementing Sections 13(d) and (g) under the Securities Exchange Act of 1934, as amended (the "**Exchange Act**").[1] As we noted in our comment letter of March 21, 2022,[2] if adopted, these proposed amendments (the "**Proposed Amendments**"), when taken together with proposed Rule 10B-1 under the Exchange Act,[3] will, in one fell swoop, reverse 20+ years of advances in shareholder engagement and corporate governance by reducing the economic incentives of investors to engage in shareholder activism, stifling the ability of shareholders to communicate on critical issues effecting their investments, and further tilting an already uneven playing field in favor of entrenched boards and management teams.

Activist investors play a critical role in overseeing and scrutinizing corporate conduct. Their activities take many forms, ranging from campaigning for corporate commitment to issues that are significant to shareholders, such as mitigating climate change, to identifying undervalued businesses, to preventing waste of corporate assets by managers seeking to "empire-build" or otherwise act in their self-interest

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1 Modernization of Beneficial Ownership Reporting, SEC Rel. No. 34-94211 (Feb. 10, 2022), [87 FR 13846 (Mar. 10, 2022)] ("**Proposing Release**").

2 *See* Letter from Rob Collins, Council for Investor Rights and Corporate Accountability, re: 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 – File No. S7-32-10 (Mar. 21, 2022), https://www.sec.gov/comments/s7-32-10/s73210-20120747-272911.pdf.

3 *See* 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, SEC Rel. No. 34-93784 (Dec. 15, 2021) [87 FR 6652 (Feb. 4, 2022)].

rather than to benefit corporate shareholders. The ultimate beneficiary of the effort and risk undertaken by activist investors is the investing public, with noted academics observing that "[h]edge funds with a track record of successful corporate activism generate higher returns . . . ."[4] The rules the SEC is seeking to adopt will upend this positive dynamic in our capital markets to the detriment of the investing public.

The Proposed Amendments will significantly reduce the incentives for an investor to expend the necessary resources to engage in a campaign to effect corporate change. Reduced economic incentives resulting from the premature disclosure of the proprietary investment thesis developed by activist investors, when coupled with the risk that is inherent in any concentrated investment that seeks to challenge the status quo at publicly traded companies, will inevitably lead to a substantial reduction in the number of activist campaigns. This will all result in a reversion to the corporate governance and shareholder engagement regime of 20 years ago that we can all acknowledge was substandard.

Moreover, the introduction of a new amorphous concept of "group"—untethered to the substantial body of case law, existing SEC rules, and practice that has developed over the last several decades, all of which looked to some form of agreement, formal or informal, as a basis for the formation of a "group"—will result in an immediate and dramatic halt on communications with activists. Make no mistake about it—this will not just be a chilling effect. It will be a freeze on the ability of all shareholders who could be deemed to have a "control intent" to work together to push boards and management teams of public companies to improve profitability and focus attention on matters of importance to shareholders, including environmental, social and governance ("**ESG**") initiatives.[5] Activist investors commonly "feel out" other investors regarding their views on specific companies before launching a risky—and costly—activist campaign. Is there any institutional shareholder on the planet that will risk being tagged as being part of a "group"—judged with the benefit of hindsight—just by dint of communicating with a known activist about a commonly-held position? If the SEC wants to enact a rule to stop active engagement by all shareholders—which we hope is not the case—then this is the rule to adopt.

The Proposed Amendments ignore the careful balance reflected in the provisions of the Williams Act and substantially increase the risk that the very investors whom Congress was seeking to protect will now be disadvantaged as a result of the effects of the Proposed Amendments on activist investors. The Williams Act was adopted to regulate hostile cash tender offers that forced shareholders to tender their shares on a compressed timetable and without adequate disclosure.[6] In connection with adoption of the Act, Congress "recognized that takeovers of underperforming companies could benefit shareholders and the economy as a whole."[7] Senator Williams, who sponsored the legislation, indicated that, in designing

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[4] Alon Bray, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1731 (2008) ("**Hedge Fund Activism**").

[5] Our comments are focused on shareholder activism addressed towards operating companies, which we believe raise important policy considerations, and not towards registered investment companies.

[6] Andrew E. Nagel et al., *The Williams Act: A Truly "Modern" Assessment*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Oct. 22, 2011) ("**Williams Act Assessment**"), https://corpgov.law.harvard.edu/wp-content/uploads/2011/10/The-Williams-Act -A-Truly-Modern-Assessment.pdf.

[7] *Id.*

the bill, Congress had "taken extreme care to avoid tipping the scales either in favor of management or in favor of the person making the takeover bids."[8] The Williams Act sought to balance the interests of all of the relevant constituencies, namely, managers, directors, potential acquirers and shareholders. This balance has evolved into a well-understood "ecosystem" of myriad rules and laws, including state corporate codes, antitrust regulations and SEC rules. With its proposals to adopt Rule 10B-1 and the Proposed Amendments, the SEC is unequivocally seeking to alter this ecosystem and tip the scales in favor of corporate management and boards of directors. This initiative is contrary to the direction of Congress, which expressly elected not to pick a side between management and shareholders.

The SEC has suggested that change to the Section 13 Rules pertaining to cash-settled derivatives is necessary because activist counterparties to these instruments may exert undue influence on dealer counterparties and/or enter into arrangements to "park" holdings of Covered Securities (as defined below) with a derivatives dealer.[9] While the SEC has asserted that these issues exist, the Proposing Release simply states these conclusions without any empirical support or justification as to why existing regulation is not sufficient to address this purported concern. Investors engaging in the conduct cited by the SEC are, under current law, already deemed to be the beneficial owner of the reference security underlying the cash-settled derivative, either pursuant to the anti-evasion provisions of Rule 13d-3(b) or the deemed beneficial ownership provisions of Rule 13d-3(d)(1)(i). Where existing law addresses the very concern that the SEC seeks to remedy with the Proposed Amendments, the SEC is required to provide concrete and empirical data supporting the need for change. None has been cited.

Simply put, the SEC has failed to meet the cost-benefit analysis burden that it is required to satisfy in connection with adopting new regulation. The SEC's basic rationale for the Proposed Amendments appears to be that the changes will provide more "transparency" and therefore be more "fair" to the average investor. This analysis is flawed and lacking. First, empirical data actually supports the opposite conclusion from that reached by the SEC—academic research has found that shareholder payouts meaningfully increased and that target companies realized a material improvement in return on assets and operating profit margins following corporate activist campaigns.[10] The data supports that shareholder activism is quite beneficial to the "average" investor not to mention the investors in the activist funds, which include pension plans, endowments and many other investors that advance the common good.[11] Second, the SEC's flawed thesis fails to account for the substantial chilling effect the Proposed Amendments will have on the existence of activist campaigns about which there would be this incremental "transparency." The failure to account for these effects will create significant harm to shareholders and the market by removing investors that have long provided an invaluable service by overseeing and holding accountable underperforming or self-dealing boards and management teams.

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[8] Louis Loss, Joel Seligman & Troy Paredes, V SECURITIES REGULATION 6.D.2 (6th ed. 2021) ("**Securities Regulation**") (quoting Piper v. Chris-Craft Indus. Inc., 430 U.S. 1, 22, 26-31, 35 (1977), itself quoting 113 Cong. Rec. 24664 (1967)).

[9] *Id.* at 52 [87 FR at 13861].

[10] Hedge Fund Activism, *supra* note 4, at 1731.

[11] *See id.* at 1731-32 (finding that "the market reacts favorably to activism, consistent with the view that it creates value" and that "[a]ctivists also appear to generate substantial value for target firm shareholders").

By failing to account for the impact on shareholder activism, the SEC's Economic Analysis is fatally flawed and the Proposed Amendments cannot, as a matter of law, be adopted.

Much of the rationale for the Proposed Amendments is predicated on a need to ensure symmetry of information between shareholders that will become required to file a Schedule 13D, on the one hand, and the marketplace in general, on the other hand. As noted above, the Williams Act was adopted to regulate hostile cash tender offers that forced shareholders to tender their shares on a compressed timetable and without adequate disclosure. However, there is no suggestion in the Proposing Release that this is the conduct that the SEC is now trying to address with the Proposed Amendments. Rather the Proposed Amendments are squarely focused on activist investors. The problem with the SEC's approach is that the very conduct that the Williams Act was adopted to regulate—and that the SEC seeks to modify through rule-making—is not what activist investors do. Activist investors play a critical role in holding underperforming management accountable and bringing about changes ***that benefit all shareholders***. The information "asymmetry" that the SEC seems concerned with in the context of the Proposed Amendments is no different from the general asymmetry that exists in the market when any investor—activist or otherwise—determines to invest the time and resources to develop and then implement an investment thesis. This information "asymmetry" has long been recognized and blessed by the SEC, and it continues to do so in the Proposed Amendments for "QIIs," "Exempt Investors," and "passive investors," which undermines the basic premise and rationale for the proposed changes.

Finally, we respectfully submit that the SEC should consolidate all filing requirements relating to concentrated positions in a class of voting equity securities registered under Section 12 of the Exchange Act ("**Covered Securities**") under the Section 13 Rules. As noted in our letter of March 21, 2022, the SEC should abandon proposed Rule 10B-1 and rely instead on the filing requirements and the timetable for filings and amendments set forth in the Section 13 Rules. Any position-reporting requirement relating to cash-settled derivatives should be non-public only.

Discussion

I. Proposed Changes to the Definition of "Group."

A. The Proposed Standard Is Overly Broad and Unclear.

Notwithstanding extensive judicial precedent and SEC rules to the contrary,[12] the SEC takes the position that an "agreement" between shareholders, formal or informal, should not be relevant for there to be a "group" under the Section 13 Rules. As an alternative, the SEC indicates that "concerted actions by two or more persons for the purpose of acquiring, holding or disposing of securities of an issuer are sufficient to constitute the formation of a group" (the "**concerted action standard**").[13] The SEC also indicates that if two or more persons "act as" a group they will be deemed to be a group,[14] which may be

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[12] *See* Williams Act Assessment, *supra* note 6.

[13] Proposing Release, *supra* note 1, at 80 [87 FR at 13868-69].

[14] *Id.* at 80 [87 FR at 13868].

demonstrated through "pooling arrangements, whether formal or informal, written or unwritten."[15] The SEC refers to this latter definition as the "act as standard" (the "**act as standard**").

The "concerted action standard" and the "act as standard" are overly broad and will fundamentally change investor behavior. Based on a plain reading of the Proposed Amendments, the standards are so broad that they would pick up ordinary investment advisory and brokerage arrangements, but more importantly would also appear to subsume customary active dialogue among shareholders, whether in connection with an active shareholder engagement campaign or otherwise. The SEC fails to provide any meaningful parameters or definition around either standard, and also fails to provide any reasonable argument for why changes from the long-standing judicial and market-based understanding of the existing regulatory framework is justified.

With respect to the "concerted action" standard, the SEC attempts to explain what the term means through negative inference and specific exceptions, but ultimately provides no concrete guidance or goal posts for investors to determine whether normal course dialogue may result in the formation of a "group" and the related regulatory consequences. The Proposing Release simply notes that "concerted action" would include "actions by two or more persons for the purpose of acquiring, holding or disposing of securities of an issuer" and "informal associations."[16] It is commonplace for shareholders of public companies to have an active dialogue with each other regarding company performance, management and board governance practices and strategy, company ESG initiatives (or the lack thereof), and a myriad of other issues and topics. These conversations often take place in the context of shareholders—sometimes activist shareholders—seeking to gain a better of understanding from their fellow owners of the business as to what they deem to be of utmost importance. If, based on this feedback or otherwise, a shareholder determines to undertake an active engagement campaign at a public company, the essence of that campaign is to convince like-minded shareholders that its ideas and strategies are beneficial to the company and will ultimately result in the creation of significant shareholder value. However, the rule proposed by the SEC would appear to treat these types of preliminary conversations as potentially conferring "group" status on the participants. Given the potentially draconian consequences of being found to have been part of a "group," we believe that these types of salutary conversations will no longer happen if the Proposed Amendments are adopted. The risk-reward to the "passive" investor is too skewed to make the conversation worthwhile.

In addition to the "concerted action" trigger for group status, the Proposing Release mentions the "act as standard" as a test for determining group status for purposes of the Section 13 Rules. The Proposing Release provides no detail around what conduct would trigger the "act as standard." Instead, the SEC notes that the "act as standard" includes activity by two or more persons based on an agreement as well as activity by such persons based on a "pooling arrangement." The SEC fails to provide what is meant by the term "pooling arrangement" or how it should be applied in the context of the Section 13 Rules. Given the seeming importance of the term "pooling arrangement" to the "act as standard" and the lack of definition around the term, it is difficult to analyze the term or even understand what would be

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[15] *Id.*

[16] *Id.* at 74-75 [87 FR at 13868-69 & n.129].

included. While we can guess at the meaning, that is a constitutionally defective standard for regulation and violates the public notice requirements of the Administrative Procedure Act.[17]

In our view, neither the "concerted action standard" nor the "act as standard" is sufficiently clear to form the basis for an SEC rule amendment.[18] The language is so broad that it would be virtually impossible for a shareholder to know if and when he/she/it has become a member of a group for purposes of the Section 13 Rules (and, potentially, the short-swing profit rules under Section 16 of the Exchange Act). The practical impact of this lack of clarity and certainty is to significantly diminish engagement among shareholders, particularly engagement between activist shareholders, on the one hand, and institutional investors, on the other hand. This active engagement is critical to the success of any activist campaign, and the inability to safely engage in this dialogue will lead to a significant reduction in activism, which will adversely impact the capital markets.

Finally, given the importance of the definitions to the Proposed Amendments, we believe that, if notwithstanding our appeal to abandon these proposed rule changes, the SEC determines to provide further definition and clarity around these concepts, it must distribute a revised proposal for further notice and public comment. The absence of critical definitions and detail means that any subsequent effort to address those defects in the release adopting the Proposed Amendments necessarily would constitute a substantive change, and not a mere clarification. As a result, until those definitions are published for public comment, we and other interested parties will be deprived of a reasonable opportunity to participate in the rule-making process in contravention of the Administrative Procedure Act.[19]

B. The Proposed Standard Would Have a Chilling Effect on the Ability of Shareholders to Communicate and Push for Corporate Change.

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[17] 5 U.S.C. § 553.

[18] The lack of clarity created by, and overly broad potential application of, the Proposed Amendments has been invalidated in other contexts. For example, in February 2021, the Delaware Court of Chancery invalidated a "poison pill" that was adopted by the board of directors of The Williams Companies, Inc. *See* The Williams Cos. Stockholder Litig., C.A. 2020-0707-KSJM (Del. Ch. Feb. 26, 2021). Much like the rule proposed by the SEC, the poison pill in the *Williams* case did not require an agreement between two parties in order for a board to conclude that the parties were "acting in concert" for purposes of calculating the poison pill's ownership trigger through "parallel-conduct" intended to change or influence control of the company. In striking down this poison pill, the court reasoned that the "acting in concert" standard—that did not even have a requirement to establish an "agreement" between investors—granted the board too much discretion to determine whether an exchange of information rises to a level that the parties are in fact "acting in concert" in a manner to trigger the significant consequences of the poison pill. In striking down the poison pill, the court was troubled by the "stifling impact the Plan has on stockholder communications, a chilling effect that exists whether the Board triggers the Plan or not." *Id.* at 87 n.401. Not dissimilar to the *Williams* case, the Proposed Amendments creates significant uncertainty as to whether ordinary course conversations between institutional investors regarding public securities will confer "group" status on the participants, thereby subjecting them to the filing obligations under, and significant consequences of, the Section 13 Rules (and, potentially, the short-swing profit rules under Section 16 of the Exchange Act).

[19] 5 U.S.C. § 553.

Institutional shareholders rely on the ability to share with each other ideas and information about issuers and their Covered Securities. The Proposed Amendments will significantly raise the risk of group status by doing so. Although the Proposed Amendments include exceptions permitting shareholders to communicate amongst themselves and with the issuer as well as to execute cash-settled derivative transactions without being subject to regulation as a group, the exceptions would not be available if even one of the shareholders involved in the communications had a "control intent". Moreover, given the breadth of the SEC's language regarding group status, the new "group" definition would create considerable uncertainty and, contrary to the SEC's stated intent, "have a chilling effect on shareholder communications or engagement . . . ."[20]

Institutional investors increasingly seek to push for corporate change, with a focus on a myriad of issues, including corporate governance, company performance, and ESG initiatives. A recent study published by the Harvard Business Review noted that "ESG was almost universally top of mind" among the world's largest asset managers and these firms are increasingly engaged in conversations about the most effective way to bring about corporate change.[21] The article also notes that shareholders are seeking deeper involvement with issuers on these topics.[22] To further their objectives, non-activist institutional investors frequently interact and exchange ideas with other investors, including activist investors, to bring about changes at issuers. For example, it is well documented that BlackRock and Vanguard played key roles in effecting corporate change in the proxy contest initiated by Engine No. 1 at Exxon that alleged that Exxon's response to the global climate crisis was far too weak to help achieve net zero emissions by 2050, putting shareholder value at risk. Engine No. 1 put forth a slate of four nominees, all with experience in the oil and gas or renewable energy industry, and BlackRock and Vanguard each voted for at least two of these nominees. Well prior to the initiation of the shareholder engagement campaign by Engine No. 1, each of BlackRock and Vanguard had stated that climate change was a key issue for their investments.[23] The stated and more general objectives of BlackRock and Vanguard to

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[20] Proposing Release, *supra* note 1, at 12 [87 FR at 13849] ("These two exemptions are designed to provide greater certainty regarding the application of Section 13(d)(3) and (g)(3), while ensuring that the proposed amendments to Rules 13d-3 and 13d-5 will not have a chilling effect on share shareholder communications or engagement or impair certain financial institutions' capacity to execute strictly commercial transactions in the ordinary course of their business.").

[21] Robert G. Eccles & Svetlana Klimenko, *The Investor Revolution*, HARV. BUS. REV. (May-June 2019), https://hbr.org/2019/05/the-investor-revolution.

[22] *Id.* ("Investors . . . are seeking deeper levels of engagement with their portfolio companies. As 'sustainable investing' becomes synonymous with 'investing,' shareholders will want to be able to engage with the C-Suite, including the CFO, and directly with the board.").

[23] In its Investment Stewardship Vote Bulletin, BlackRock has stated that "more needs to be done in Exxon's long-term strategy and short-term action in relation to the energy transition in order to mitigate the impact of climate risk on long-term shareholder value." Vanguard, in its Investment Stewardship Insights website, noted that "pressing need for Exxon to better align its climate strategy with (1) target setting in line with global peers and (2) its public policy efforts related to climate risks." BlackRock, *Investment Stewardship Vote Bulletin: ExxonMobil Corporation* (May 2021), https://www.blackrock.com/corporate/literature/press-release/blk-vote-bulletin-exxon-may-2021.pdf; Vanguard, *Investment Stewardship Insights, Voting Insights: A Proxy Contest and Shareholder Proposals Related to Material Risk Oversight at ExxonMobil* (May 2021), https://corporate.vanguard.com/content/dam/corp/advocate/investment-stewardship/pdf/perspectives-and-commentary/Exxon_1663547_052021.pdf.

address climate change, when taken together with their actions and statements with respect to Exxon, illustrates a situation in which one could argue that these investors were acting in concert with Engine No. 1—meaning that they all shared and presumably discussed a common perspective and desire to push for corporate change around the same subject matter. Of course, based on current law, this was shareholder interaction at its best, and not the formation of a "group" for regulatory purposes. These shareholders, while having no agreement or understanding regarding the voting or disposition of their securities, wanted to push a large corporation for change that was important both from a societal and investment perspective. The question therefore is whether the engagement between BlackRock and Vanguard, on the one hand, and Engine No. 1, on the other hand, could take place under the Proposed Amendments without rightful concern that their statements, policies and actions could result in them being a "group" as the SEC has proposed to define it. We submit that had the Proposed Amendments been in effect the level of shareholder interaction would have been significantly diminished or perhaps eliminated altogether. That is simply not a result that the SEC can intend and is certainly not in the best interests of our capital markets or society.

The manner in which investors engage with issuers and corporate management has fundamentally changed over the past 20 years, which the SEC does not consider. Whereas in the past, communications between buy side investors and management usually were facilitated by research analysts, that has changed.[24] Today, investors engage directly with management, which has resulted in critical dialogue among shareholders and between shareholders and management.[25]

In summary, the Proposed Amendments run a serious risk of thwarting efforts by shareholders to cause the companies they own to make important changes—changes that impact their investments, the markets more broadly and society as a whole. The proposal also imposes a dangerous speed bump on the trend of direct engagement between shareholders and management and among shareholders. The proposal does so by creating uncertainty as to "group" status when institutional investors communicate with each other. For example, although proposed new Rule 13d-6(c) allows two or more institutional investors to communicate and consult amongst themselves and to engage with an issuer without being deemed to be a "group," the exception would not apply if "undertaken with the purpose or the effect of changing or influencing control of the issuer" or "in connection with . . . any transaction having such purpose or effect." As described above, applying this exception to the Exxon example, we believe that there is significant risk that the institutional shareholders would have had significant reluctance to engage in the debate and make their viewpoint known had the Proposed Amendments been in effect—

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[24] *Id.*; *see also* Fleischer, Weinstein & Luftglass, TAKEOVER DEFENSE: MERGERS AND ACQUISITIONS § 10.01 (9th ed. 2021) ("An enormous increase in ownership of U.S. company equities by institutional investors and an increasing aggressiveness on their part, as well as the advent of hedge funds with stunning resources dedicated to targeting companies in campaigns of 'shareholder activism,' have led to a transformation, since the early 21st century, from a board-centric to a shareholder-centric model of corporate governance. This corporate governance model has dramatically increased the emphasis on rights of and engagement with shareholders, significantly weakened corporate antitakeover defensive protections and led to increased pressures on boards and management teams to move rapidly to address issues of underperformance and deliver improved results.").

[25] G. Serafeim, *Social-Impact Efforts that Create Real Value,* HARV. BUS. REV. (Sept.-Oct. 2020), https://hbr.org/2020/09/social-impact-efforts-that-create-real-value.

they would simply not want to run the risk that they were alleged to be "acting in concert" with Engine No. 1 given its "control intent." Recharacterization risk is particularly high if one of the participants in the campaign has a reputation as an activist. As a result, the end result of a successful campaign by an institutional investor to push an issuer to effect needed change might be expected to be an SEC enforcement action against the investor for failing to file a "group" Schedule 13D. The practical effect will be to significantly reduce the likelihood that investors will engage in the type of activity that proposed Rule 13d-6(c) specifically was intended to facilitate.

C. The Overly-Broad Group Definition of "Group" Would Unfairly Expose Shareholders to Liability Under Section 16(b).

A person deemed to be a "group" for purposes of the Section 13 Rules would also be deemed to be a group member for purposes of Section 16(a) reporting and the short swing profit rules under Section 16(b). This characterization—particularly when imposed on a shareholder who is unaware that it is deemed to be part of a "group" (*e.g.*, because it did not understand that the "purpose" another shareholder had for disclosing its Schedule 13D filing was to cause the recipient to purchase the Covered Securities or because it "acted in concert" with a group of investors that included an activist)—would subject the shareholder to draconian consequences under the short swing profit rules, which are closely policed by the plaintiff's bar. For example, if three institutional investors, each owning 4% of the same class of Covered Securities were to discuss ways to lobby the issuer of the Covered Securities to incorporate more environmentally friendly practices into the issuer's business, and one of the investors indicated it intended to buy an additional 1% of the issuers securities and file a Schedule 13D, all of the investors could be required to file not only a Schedule 13D but also a Form 3 and, in connection with dispositions, a Form 4.

In the foregoing scenario, an investor could be subject to disgorgement of short swing profits as a result of subsequent acquisitions or dispositions as it may be deemed to beneficially own more than 10% of the class of stock, thereby subjecting it to Section 16. Given the strict liability regime of Section 16 and the related limitations it has on liquidity of those subject to it, there is a significant chance that institutional investors will not engage with activist investors to discuss their respective perspectives on an issuer out of fear that they could become subject not only to the Section 13 Rules but also could be subject to substantial risk of liability and litigation based on an alleged Section 16 matchable transaction.

D. The Proposed Standard Is Inconsistent with the Williams Act.

The scope of the newly proposed exemptions from the definition of "group" create a sort of presumption of group status unless specific conditions underlying the exception are met. For example, SEC statements in the Proposing Release indicate that two shareholders of the same Covered Security that *coordinate in any manner regarding the holding* would be deemed to be a group unless specified

conditions are met.[26] This is not consistent with the legislative history underlying the Williams Act, which was enacted in 1968 and included, among other provisions, Section 13(d) of the Exchange Act. As noted in the legislative history, the purpose of the provisions relating to group activity was to prevent "a group of persons who seek to pool their voting or other interests in the securities of an issuer from evading the provisions of the statute because no one individual owns more than [5] percent of the securities."[27] Expansion of the definition to include *any coordinated activity* regarding a Covered Security is not the same thing as an agreement among shareholders to pool voting and other interests in order to avoid reporting.

Moreover, the Williams Act and Section 13 Rules are not designed to require disclosure of concerted shareholder activity in the abstract. Instead, as noted by the courts and evidenced by the legislative history, "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 . . . ."[28] However, there is no suggestion in the Proposing Release that this is the conduct that the SEC is now trying to address with the Proposed Amendments. Rather the Proposed Amendments are squarely focused on activist investors. As noted above, the problem with the SEC's approach is that the very conduct that the Williams Act was adopted to regulate—and that the SEC seeks to modify through rule-making—is not what activist investors do. Activist investors play a critical role in holding underperforming management accountable and bringing about changes ***that benefit all shareholders***. As a result, the Proposed Amendments are outside the intention of the statute.

II. Proposed Expansion of Beneficial Ownership to Include Cash-Settled Derivatives Is Misplaced Given Nature of the Instrument, Unfairly Interferes with the Ability to Build Adequate Position Size and Discriminates Against Activist Shareholders.

The law for over 50+ years has been that "beneficial ownership" is created when an investor has either voting power or investment power over the underlying public securities. A cash-settled derivative is solely an economic position that provides neither voting nor investment power over the underlying securities and therefore should not result in beneficial ownership. And for good reason—when an investor determines to build a position through cash-settled derivatives, it is making a trade-off. On the one hand, acquiring this solely economic position affords the activist investor the ability to accumulate a position of sufficient size to make the potential profit profile compelling enough to justify the allocation of time and resources, and the taking of risk, that is inherent in concentrated investments. On

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[26] Proposing Release, *supra* note 1, at 92 [87 FR at 13873] ("Rule 13d-6(c) would provide that two or more persons will not be deemed to have acquired beneficial ownership of, or otherwise beneficially own, an issuer's equity securities as a group solely because of their concerted actions related to an issuer or its equity securities, including engagement with one another or the issuer, provided they meet certain conditions. Such interactions, depending upon the level of coordination and degree to which the persons advocate in furtherance of a common purpose or goal, could be found to satisfy the 'act as' a group standard under Section 13(d)(3) or 13(g)(3) for the purpose of 'holding' a covered class.").

[27] V Securities Regulation 6.D.2, *supra* note 8, at n.137 (quoting S. Rep. No. 550, 90th Cong., 1st Sess. 8 (1967); H.R. Rep. No. 1711, 90th Cong., 2d Sess. 8-9 (1968)) (alteration in original).

[28] *Id.* (quoting Rondeau v. Mosinee Paper Corp., 422 U.S. 49, 58 (1975)).

the other hand, the activist investor needs to weigh that benefit against the fact that it does not own the underlying stock and therefore has no voting rights, which are critical in an activist campaign. Activist investors sometimes conclude that, on balance, they are willing to forgo significant rights associated with owning the underlying stock so they can accumulate their target position size because if they are unable to do so, the risk/reward profile of the investment is lacking. The trade-off and substantive difference when an investor holds the underlying securities as opposed to a solely economic investment in an issuer is not addressed in the Proposing Release, which assumes (without specific support or data) that the activist investor can nonetheless influence the voting of the underlying securities.

For example, an activist investor may identify an issuer with a market capitalization of $2 billion that is significantly underperforming, and may determine that an investment size of at least $150 million is required to make the investment worthwhile. Under the law that has been in effect for over 50+ years, the activist can accumulate its desired stake size, in part through the use of cash-settled derivatives, without the need to make public disclosure. If the activist investor is compelled to make disclosure of a position that crosses the 5% threshold solely due to an economic arrangement with a counterparty, given the likely run-up in the stock price and potential defensive measures adopted by the target company, it may be unable to acquire its target position size and therefore forego the investment, resulting in target company shareholders losing out on the benefits of the corporate change that the activist intended to initiate.

The Proposed Amendments also do not factor in the interplay between the public reporting requirements under the Proposed Amendments and the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (the "**HSR Act**"), which is often crucial in the context of an activist campaign. Under the HSR Act, an activist investor cannot purchase "voting securities" of a target company, such as common stock, with a value of more than $101 million without filing for and receiving approval under the HSR Act. Upon making an HSR Act filing, the activist investor is required to inform the target company thereof, which may lead to broader public disclosure. Activist investors have long used cash-settled derivatives to solve this potentially crippling problem; cash-settled derivatives are not deemed "voting securities" for purposes of the HSR Act, and therefore their acquisition may be completed without the need for an HSR Act filing and the related premature disclosure to target companies. The Proposed Amendments would change all of this by compelling public disclosure due to crossing the 5% threshold when counting the cash-settled derivatives, thereby resulting in the activist investor being unable to accumulate the desired stake prior to the likely run up in the stock price of the target company when the disclosure is made, while also providing the target company with a significant tactical advantage to defend against the campaign. The net effect of the foregoing may result in the activist investor not pursuing an opportunity that could have delivered significant tangible benefits to investors and other stakeholders.

The Proposed Amendments would amend Rule 13d-3 to require a counterparty to a cash-settled derivative (other than a security-based swap) to be deemed to be the beneficial owner of the Covered Securities referenced by the derivative if the derivative "is held with the purpose or effect of changing or influencing the control of the issuer of such class of equity securities, or in connection with or as a

participant in any transaction having such purpose or effect."[29] The SEC suggests that the change is necessary based on comments received by the SEC indicating that investors in cash-settled derivatives "may influence or control an issuer by pressuring a counterparty to make certain decisions regarding the voting and disposition of substantial blocks of securities."[30] The SEC expressed concern as well that activist counterparties to cash-settled derivatives may enter into arrangements to "park" holdings of Covered Securities with a derivatives dealer in connection with an unstated agreement by the dealer to cross the position back to the activist upon termination of the transaction.[31] The SEC suggested that the Proposed Amendments were designed to prevent such conduct.

We do not agree that changing the beneficial ownership rules is an appropriate remedy for the behavior that the SEC believes is improper. Existing Rule 13d-3 is sufficient to allow the SEC to bring an enforcement action against an investor or security-based swap counterparty that fails to report beneficial ownership of positions held by its derivatives counterparty when such investor holds a right to vote or acquire the stock held by the counterparty. In addition, the anti-fraud rules are available to penalize such behavior. The SEC also appears to ignore the significant measures that dealers already have in place with regard to cash-settled derivatives. For example, dealers almost universally have policies and procedures in place that require them to abstain from voting any hedge shares they have acquired in connection with a cash-settled derivative transaction. Alternatively, in many instances, dealers have separate internal functions that make voting decisions with respect to hedge shares. The individuals charged with overseeing voting decisions with respect to any hedge shares are separate and apart from the individuals that interact with a cash-settled derivative client, which the SEC does not consider or recognize in the Proposing Release. If the SEC seeks to prohibit derivative counterparties from entering into agreements with activists to "park" Covered Securities or to control voting or disposition of the hedge, the SEC should provide direct guidance under the existing rules to that effect. However, any such rule-making should only be pursued once the SEC has established that the existing regulatory framework is insufficient. We respectfully submit the SEC has failed to meet this burden—the Proposing Release does not contain any empirical evidence or data that supports the conclusory statement as to cash-settled derivatives that forms the basis for the Proposed Amendments.

Finally, we respectfully submit that the "control intent" cited by the SEC in the Proposed Amendments is misplaced. As noted above, the Williams Act was predicated on changes of corporate control, and ensuring that potential acquirers were not accumulating large stakes in public companies, without requisite disclosure, that would facilitate coercive tactics that would permit an acquisition of the balance of the outstanding stock for less than fair value. This is simply not what activist investors do—rather, activist investors typically acquire an ownership position of less than 15% of the outstanding stock (often less than 10%), and seek to effect change for the benefit of all shareholders. The use of cash-settled derivatives allows activist shareholders to accumulate their target position sizing without premature disclosure that may undermine their investment thesis and/or tip off incumbent management, thereby

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[29] *See* proposed Rule 13d-3(e)(1)(i).

[30] Proposing Release, *supra* note 1, at 58 [87 FR at 13862].

[31] *Id.* at 52 [87 FR at 13861].

providing them a strategic advantage. If the SEC wishes to adopt a rule that deems an investor the beneficial owner of a reference security in the context of cash-settled derivative where that investor intends to acquire a controlling interest in the target with a view towards acquiring the balance of the target, it should propose a specific rule to address that situation. However, a broad rule that undermines the ability of an activist investor to accumulate a position of sufficient size for it to undertake actions that benefit all shareholders does a disservice to the investing public.

III. Proposed Contraction of Filing Deadlines.

The Proposed Amendments would compress the filing deadline for Schedule 13D from 10 days to 5 days after acquiring beneficial ownership of more than 5% of a Covered Security. We believe that a 5-day deadline is too short of a time period within which to require reporting and will result in a diminished opportunity for an activist investor to accumulate its target position size and will provide an unnecessary advantage to entrenched management and boards to defend against a pending shareholder campaign. The accumulation of the target position size is of critical importance for a variety of reasons—it ensures the risk/reward profile is sufficient to allow the activist to proceed, it enhances the likelihood that the target will undertake meaningful engagement and therefore increases the likelihood of corporate reform that benefits all shareholders, and it ensures that the significant hard costs of engaging in activism—legal fees, advisory fees, proxy solicitation expenses, *etc.*—are proportional to the investment size. In our view, the current 10-day period established by Congress for initial reporting on Schedule 13D continues to be the appropriate filing period.

Activist investing requires the significant deployment of time and resources and the taking of concentrated positions in a limited number of companies, with the associated risks of that strategy. It is therefore imperative that activist investors be able to accumulate a sufficient position size to make its efforts worthwhile. The disclosure of an activist's position often sends the stock price of the target up significantly, reflecting the market's recognition of the value activist investors add to our capital markets. In addition to disclosure driving price appreciation, activist investors need to accumulate their stakes in a measured manner, or the position may directly or indirectly (through market speculation due to peculiar volume patterns) leak, thereby taking away all or a significant portion of the profit opportunity for the activist. It is for this reason that many activist investors limit their trading in target company stock to a relatively modest percentage of the daily average trading volume and/or use cash-settled derivatives to establish a portion of their position. Many target companies, in particular those with medium to smaller market capitalizations, have more limited volume in their stock. In these situations, cutting the reporting timeline in half, in particular with the proposed limitation on the use of cash-settled derivatives, would have a significant and adverse impact on an investor's ability to build its desired stake size without premature disclosure. The SEC appears to have recognized this issue as it expressly solicited feedback on whether the reporting period should be modified for smaller capitalization companies and/or companies with relatively insignificant daily trading volume.

Much of the rationale for the Proposed Amendments, in particular the shortening of the reporting period, is predicated on a need to ensure symmetry of information between shareholders that will become required to file a Schedule 13D, on the one hand, and the marketplace in general, on the other hand. It

is true that as activist investors accumulate their stake, there is a seller from whom the stock is purchased. However, this information "asymmetry" is no different from the general asymmetry that exists in the market when any investor—activist or otherwise—determines to invest the time and resources to develop and then implement an investment thesis. The SEC has long recognized the legitimacy of this "asymmetry" of information in allowing confidential treatment in Schedule 13F filings, and continues to do so through certain terms of the Proposed Amendments.

For example, under the terms of the Proposed Amendments, "passive investors" can accumulate a cash-settled derivative position with no corresponding beneficial ownership or disclosure if the investor crosses the 5% threshold, yet there clearly exists a similar "asymmetry" of information. Similarly, the Proposed Amendments allow QIIs and Exempt Investors a period of five business days after month-end in which beneficial ownership exceeds 5% to file a Schedule 13G, and allow "passive investors" 10 days following month-end to amend their Schedule 13G filings. These provisions allow certain types of investors the ability to accumulate significant positions with a disclosure timeline that is wildly different from those that apply to activist investors, yet appear to suffer from the same "asymmetry" issue that the Proposed Amendments are purportedly seeking to address.

A perfect example of this issue is what occurred last week with respect to Berkshire Hathaway's investment in Hewlett-Packard Company ("**HP**"). Berkshire Hathaway accumulated a position in HP representing more than 11.4% of the outstanding stock worth more than $4.2 billion, yet was not required to file a Schedule 13G.[32] Moreover, the Proposed Amendments would not require Berkshire Hathaway to make this filing until five business days after the end of the month in which it crossed the 5% threshold, allowing Berkshire Hathaway up to 35 days to continue to accumulate its position prior to public disclosure. We do not have an issue with the reporting requirements for investors like Berkshire Hathaway but rather use this as clear and tangible evidence that the "asymmetry" issue the SEC appears to want to address through the Proposed Amendments is not an issue at all—rather, it is a quintessential element of our capital markets where investors are (and should be) entitled to profit from their analysis, hard work and risk taking.

We respectfully submit that, like "QIIs," "Exempt Investors" and "passive investors," or investors that have been afforded relief from the Schedule 13F disclosure obligations when engaged in active investment program, there is no "asymmetry" of information in the activist investor context that requires correcting. Rather, activist investors should be encouraged to build positions that they in turn seek to leverage to effect corporate change ***for the benefit—not detriment—of investors more generally***.

The 10-day period before public disclosure also allows investors to make overtures to an issuer's management prior to public disclosure and to consult with other shareholders to ensure that the voices of significant shareholders are heard and shareholder proposals considered when approaching management. The 10-day period prior to a public disclosure of a substantial holding by an activist

[32] *See, e.g.*, Jonathan Stempel, *HP Soars 14.8%, Sets Record After Buffett Reveals $4.2 Billion Stake*, REUTERS (Apr. 7, 2022), https://www.reuters.com/technology/hp-soars-record-after-buffetts-berkshire-reveals-42-billion-stake-2022-04-07/.

allows the activist investor sufficient time to exchange views with management and with other investors prior to the public filing. After a Schedule 13D has been filed, those conversations become significantly more difficult. As a practical matter, a Schedule 13D filing has the effect of "throwing down the gauntlet" and impeding productive conversations between a significant shareholder and corporate management. To the extent that an investor can speak openly with management, the more likely it is that proposed changes can be implemented by the issuer in a constructive manner.

IV. Consolidation of Reporting Requirements for Covered Securities Under the Section 13 Rules.

As we noted in our letter of March 21, 2022, we urge the SEC to consolidate all rules related to beneficial ownership and reporting of Covered Securities under the Section 13 Rules in order to provide clarity to the market. Consolidation in this manner should minimize confusion regarding requirements and lead to consistency over time when amending the rules. In particular, we urge the SEC to abandon proposed Rule 10B-1 and, to the extent reporting of cash-settled derivatives is deemed necessary, to create a new rule, using the Section 13(d) referenced threshold of more than 5% of a class of Covered Securities to provide for confidential, non-public filing requirements for cash-settled derivatives referencing Covered Securities of more than 5% of an applicable class. Such a rule should not deem investment in cash-settled derivatives contracts to give rise to beneficial ownership in the referenced securities (for either the Section 13 Rules or Exchange Act Section 16 purposes) absent an investor having a right to dispose of or vote specified securities held as a hedge by the counterparty or a right to receive such securities through settlement of the derivative within 60 days or with a control intent, as contemplated by current Rule 13d-3. Current Rule 13d-3 is clear and comprehensive. By changing the definitions under the Section 13 Rules and spreading out disclosure obligations in respect to derivatives across different rules and requirements, the proposals will create confusion and adversely affect the ability of institutional investors to utilize cash-settled derivatives, which can offer important operational, tax, and other benefits.

V. The Proposed Amendments Will Have a Destructive Impact on Value Creation and Corporate Democracy.

The Proposed Amendments ignore the careful balance reflected in the provisions of the Williams Act and substantially increase the risk that the very investors whom Congress was seeking to protect will now be disadvantaged as a result of the effects of the Proposed Amendments on activist investors, who act as a check on management and boards for the benefit of all shareholders (and not just themselves). The Williams Act was adopted to regulate coercive cash tender offers that forced shareholders to tender their shares on a compressed timetable and without adequate disclosure.[33] In connection with adoption of the Williams Act, Congress "recognized that takeovers of underperforming companies could benefit shareholders and the economy as a whole."[34]

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[33] Williams Act Assessment, *supra* note 6.

[34] *Id.*

By effectively tagging as a Schedule 13D "group" any collection of shareholders engaged in discussions or concerted activities regarding Covered Securities, the SEC undoes the careful balance that Congress put in place. It is also noteworthy that, overwhelmingly, activist campaigns are not seeking control of the board or company—rather, most campaigns seek minority representation on the board, which is not even the context in which Congress originally adopted the William Act. Even more striking, the SEC seems intent on increasing the defenses for entrenched management and boards, notwithstanding that those defenses have increased substantially over the past 50 years. Public companies already have a myriad of advantages relative to activist investors, ranging from the use of corporate cash to entrench their positions to advance notice deadlines, control of constituent documents that may not permit the calling of a special meeting or action by writing consent, the ability to adopt a poison pill and/or benefit from state antitakeover statutes, such that experts typically find that "incumbent management . . . has the upper hand in corporate governance contests."[35]

The proposal to adopt Rule 10B-1 and the Proposed Amendments (particularly proposed Rule 13d-3(e)(1)(i) which creates a separate beneficial ownership standard for activist investors), would unequivocally change the balance achieved by Congress and further tip the scales in favor of corporate management and boards of directors. This initiative is contrary to the direction of Congress, which expressly elected not to pick a side in the battle for corporate control. It is also contrary to the SEC's mandate to protect investors. Activist investors play a critical role in holding underperforming management and boards accountable and bringing about changes that benefit all shareholders. As noted by one legal expert, "[w]ithout [activism], no one would obtain the benefits of the value creation that currently results from engaged investing, and corporate democracy would be weakened by narrowing in many cases the choices available to shareholders."[36]

VI. Focus on Asymmetric Information During Stake Building Is Misguided

A fundamental structural aspect of highly regulated U.S. capital markets is that uncoerced, willing sellers and willing buyers are permitted to trade at the time and price of their own choosing and without revealing their identity, actions, plans, proposals or transactions to their counterparties in advance. While significantly bounded by disclosure and prudential regulations, this remains an animating feature and a significant part of the basic structure of free markets. Willing sellers and willing buyers develop their own, independent views on value and when their views diverge, the fact of this divergence creates the conditions for trading to begin and for all market participants to receive the benefits of liquidity and efficient pricing over time. There are, of course, limits to this baseline. As described more fully elsewhere in this letter, the question posed by the current proposals is where to set those limits. Whether the issue be the triggering threshold, the time period for filing or any other element of potential change, the answer to where to set the limit should be a function of the underlying animating public policy.

In the adoption release, the SEC Chairman Gensler suggested that reducing the impact of information asymmetry was one of the primary policies underlying the proposals. We do not believe that the fact

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[35] *Id.*

[36] *Id.*

that activist buyers develop and keep private plans or proposals for a target issuer is an asymmetry that in any way exploits any information to which a selling shareholder should have any reasonable commercial expectation of knowing prior to an activist amassing a stake that ultimately requires such disclosure. Moreover, given the evidence that activist investors lift price and deepen liquidity during their stake building phase, selling shareholders actually receive a benefit in the form of higher prices and greater liquidity over longer periods. The activist lifting price in the market should be seen as an act of sharing in real dollar terms by the activist at the time of the trade of a portion of the activist's future expectations of future value with selling shareholders in order to induce them to sell. This can only be viewed as an unmitigated positive to unaware, short-term, selling shareholders and in no way as some sort of "tax" imposed on the system by activists. Finally, while those selling shareholders may not reap all of the ultimate benefits of the activist's engagement, we believe that fact to be unpersuasive support for any policy change. Most importantly, any conclusion to the contrary ignores the fact that a successful activist intervention confers typically at least 90-95% of the value to the other shareholders. We do not think it sound policy to deprive 90-95% of longer-term investors of market-based management accountability benefits that activists confer in order to avoid the incorrect perception that short-term, selling shareholders are being unfairly dispossessed of any opportunity or element of value.

VII. The SEC Fails to Provide a Cost-Benefit Analysis Sufficient to Support the Proposed Amendments.

The Administrative Procedure Act requires that any changes made by the SEC to existing regulation be supported by clear evidence that the changes will benefit investors and the market and that the changes are driven by sound policy decisions. The SEC has failed to satisfy this standard. Although the SEC provided over 50 pages of text describing its analysis, the essence of the argument for why the changes are justified is provided early on in the Economic Analysis. The argument for why the SEC believes that the Proposed Amendments would benefit investors and the market boils down to: the SEC believes that the Proposed Amendments would provide "more timely information relating to significant stockholders as well as potential changes in corporate control, facilitating investor decision-making and reducing information asymmetry in the market."[37] Said another way, the SEC's argument is that if an activist investor has a good investment idea, that investor should be required to share its idea with other investors so that they too can make money on the idea. This thesis is flawed and is anathema to the principles of capitalism that underpin our capital markets. This thesis, and the Economic Analysis in general, also fails to account for the substantial chilling effect the Proposed Amendments will have on activism and the ensuing harm to shareholders and markets by removing the guardians of corporate accountability and key participants in the efforts to cause companies to take up needed change, such as ESG initiatives. The Economic Analysis fails to take account for any of these costs, and thus is fatally flawed.

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[37] Proposing Release, *supra* note 1, at 115 [87 FR at 13877].

Our Recommendation

The Proposed Amendments Should Not Be Adopted.

We recommend that the SEC end its efforts to disincentivize activism and the important role that activist shareholders play to create value for the benefit of all shareholders. The SEC has provided no sufficient justifications for the Proposed Amendments, which would require premature disclosure of holdings, penalize shareholders with the threat of "group" status when they work together for corporate change, and treat as beneficial owners of voting securities for purposes of both reporting and short-swing profits cash-settled derivatives owned by a shareholder having a control intent or acting in concert with such a person.

We urge the SEC not to adopt the Proposed Amendments and, in particular, the proposed changes to the definition of group, the addition of new proposed Rule 13d-3(e)(1)(i) regarding beneficial ownership, and the 5-day reporting period for an initial Schedule 13D filing included in the Proposed Amendments. We also urge the SEC not to adopt proposed Rule 10B-1 and, if disclosure of security-based swap positions is deemed necessary by the SEC and can be appropriately supported by a reasonable cost-benefit analysis, to provide for a confidential filing regime under the Section 13 Rules.

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We appreciate the opportunity to comment on this SEC initiative and will be reaching out to the Commissioners and the SEC staff to set up meetings. Meanwhile, should you have any questions on our comments or would like to schedule a call, please feel free to reach out to me, at 202-819-5036, or our Counsel, Willkie Farr & Gallagher LLP, Georgia Bullitt, at 212-728-8250, Russell Leaf, at 212-728-8593 or Tariq Mundiya, at 212-728-8565.

Respectfully submitted,

Rob Collins

cc: Chairman Gary Gensler
Commissioner Hester M. Peirce
Commissioner Allison Herren Lee
Commissioner Caroline A. Crenshaw