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Invested in America

April 11, 2022

Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Notice of Proposed Rulemaking on Modernization of Beneficial Ownership Reporting (File No. S7-06-22)

Dear Ms. Countryman:

The Securities Industry and Financial Markets Association ("*SIFMA*")[1] appreciates the opportunity to comment on the Securities and Exchange Commission's (the "*Commission's*") Modernization of Beneficial Ownership Reporting proposal (the "*Proposed Rule*").[2]

We support transparency reforms that are properly calibrated to make markets more efficient and competitive and to give the Commission and other regulatory authorities the information necessary to monitor for risks to financial stability or market integrity. We understand that the Proposed Rule reflects the Commission's desire to "modernize" Schedule 13D/G reporting. We appreciate that it may be reasonable to consider, for example, whether changes in technology and market practices warrant accelerated filing deadlines in certain circumstances.

The Proposed Rule would go much further than this, however, making sweeping changes to a regulation that has historically functioned well to implement the relevant statutory provisions of Section 13 of the Securities Exchange Act of 1934 (the "*Exchange Act*"). These sweeping changes would be complicated and costly, yet the reasoning behind many of them involves highly speculative and thinly supported theories of market participants' behavior. The Proposing Release justifies some proposed changes by references to past acts of misconduct by persons who sought to evade reporting requirements, but it is far from clear that any of the new

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1 SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's one million employees, we advocate on legislation, regulation and business policy affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

2 Modernization of Beneficial Ownership, 87 Fed. Reg. 13846 (Feb. 10, 2022). We also refer to the preamble of the Proposed Rule (i.e., the material other than the proposed textual amendments to Regulation 13D-G) as the "*Proposing Release*."

rules would do more to address intentional evasion than Regulation 13D-G's existing anti-evasion rule already does. Overall, as we will explain further, many of the proposed changes should not be adopted or, at a minimum, should not be adopted without significant further consideration and revisions to key aspects of the Proposed Rule.

While our membership includes many types of market participants, dealing has long been a core business for many of our members. As essential market intermediaries, dealers—whether broker-dealers, banks or other institutions[3]—provide liquidity, promote capital formation, promote market efficiency through market-making operations and facilitate transactions for customers. We are therefore keenly attuned not only to the potential effects of the Proposed Rule on dealing activities *per se*, but also what the Proposed Rule, if adopted as proposed, would mean for our customers, who include end-users of all kinds across the U.S. and world economies.

It is from this perspective that we must respectfully express urgent concern about the Proposed Rule's dramatic expansion of the group concept. Although we have many deep concerns about the Proposed Rule, the expansion of the group concept—which is based on a flawed reading of the statutory language—is the greatest threat to ordinary-course dealing activities. As written, the Proposed Rule would create undue doubt as to whether, merely by transacting with a customer with respect to a security derivative, whether or not cash-settled, a dealer might be deemed to have inadvertently formed a group with the customer. While that result would have a number of negative consequences, at the top of the list is the risk of a dealer's unintentionally becoming subject to Section 16 of the Exchange Act as a member of a group that is a greater-than-10% beneficial owner (a "*10% Owner*"). As we discuss in detail in Part I, it is absolutely imperative that any final rule amending Regulation 13D-G remove this needless risk to dealers and, by extension, securities markets, which could do grave harm to liquidity and capital formation.

As we discuss in detail in Part II, the Proposed Rule's expansion of the definition of beneficial ownership to include certain cash-settled derivatives[4] also rests on a shaky foundation. The case that the existing definition is truly a problem, or that the proposed expansion of the definition is needed to solve it, is weak and conclusory. The Commission also does not consider

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[3] In this letter, we use the term "dealer" to mean a person specified in Rule 13d-1(b)(1)(ii), or "QII," that conducts a securities or derivatives dealing business in the relevant instrument or instruments. As contemplated at various points in the Proposed Release, when a QII acting as a dealer enters into a derivative with a customer as a counterparty, the QII may (or may not) hedge its exposure by taking other (cash or non-cash) positions in the referenced security (or in one or more of many other instruments). The QII may also be assumed to have a "public side" securities trading business in which trading desks may also transact in the reference security in the ordinary course of business.

We also use the terms "Passive Investor" and "Exempt Investor" with the same meanings given in the Proposing Release.

[4] In this letter, unless the context requires otherwise, we use "cash-settled derivative" to indicate a derivative with respect to a referenced Section 12–registered voting equity security that is required to be settled exclusively in cash and that is not a security-based swap.

meaningfully that the Proposed Rule would, among other consequences, require parties to cash-settled derivatives to daily re-calculate their beneficial ownership, defined in a newly variable way that would change based on factors outside of their control. Additionally, expanding the definition of beneficial ownership under Regulation 13D-G could dramatically expand the reach of Section 16, which imports that definition for purposes of determining 10% Owner status. The Proposing Release identifies this as a potential issue, but fails to consider it in any depth.

In Part III, we identify a number of fundamental concerns about the accelerated filing deadlines under the Proposed Rule, including statements in the Proposing Release about the costs of this proposed change that are based on superficial and incorrect assumptions.

Finally, in Part IV, we conclude with a discussion of the reconsideration process and timing necessary for any amendments to Regulation 13D-G that are ultimately adopted to both satisfy the Commission's obligations under Sections 3(f) and 23(a)(2) of the Exchange Act, and provide a reasonable and administrable timeline for implementation and transition. Following the roadmap that we lay out here is, we firmly believe, a prerequisite to a final Regulation 13D-G that is thoughtful, reasonable and legally sound.

I. Concerns Arising from the Commission's Expansive Interpretation of the "Group" Concept

The Commission's reading of the statute is fundamentally flawed. The Proposing Release's dramatic expansion of the group concept goes well beyond the bounds of the Exchange Act.

A discussion of the Proposed Rule's treatment of the group concept must start with the Proposing Release's reading of the statute. Section 13(d)(3) of the Exchange Act states:

> When two or more persons act as a partnership, limited partnership, syndicate, or other group for the purposes of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a "person" for purposes of this subsection.

The Commission appears to view this language as giving nearly free rein to broaden the group concept to an arbitrary extent. This view, in turn, appears to be the basis for some of the most pernicious suggestions in the Proposing Release—above all, the notion that one could ever unintentionally and unknowingly be part of a group.

The Proposing Release invokes the premise that "[u]nder a plain reading of Sections 13(d)(3) and 13(g)(3), an agreement is not a necessary element of group formation"[5] and repeatedly refers to the contrary view as a "misimpression."[6] But the Commission's "plain

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5 Proposing Release at 13867.

6 *Id*. at 13888-89, 13893 n. 275.

reading" is seriously flawed under conventional principles of statutory construction as well as the legislative history that the Proposing Release itself cites.

The phrase "partnership, limited partnership, syndicate, or other group" is a list of four terms. "Whether a statutory term is unambiguous," the U.S. Supreme Court has said, "does not turn solely on dictionary definitions of its component words. Rather, the plainness or ambiguity of statutory language is determined not only by reference to the language itself, but as well by the specific context in which that language is used, and the broader context of the statute as a whole."[7] Moreover, "[w]here general words follow specific words in a statutory enumeration, the general words are construed to embrace only objects similar in nature to those objects enumerated by the preceding specific words."[8]

Between partnerships, limited partnerships and syndicates, the common thread of "similar[ity] in nature" is, in fact, that each form of organization is based on an agreement: each involves two or more persons who have manifested a "mutual understanding . . . about their relative rights and duties regarding past or future performance."[9]

To consider the forms of organizations in turn: a partnership is usually defined as "the association of two or more persons to carry on as co-owners of a business for profit."[10] A partnership may exist without a written partnership agreement and does not require a "[s]ubjective intent to create the legal relationship of 'partnership'."[11] It does, however, require "the intent . . . to establish the business relationship that the law labels a 'partnership'."[12] In almost all cases, that business relationship must include an intention to share losses as well as profits.[13]

A partnership is, by default, a general partnership. A limited partnership is a narrower, more specialized concept. In the United States, a limited partnership is a statutorily created

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7 *Yates* v. *U.S.*, 574 U.S. 528, 537 (2015) (internal quotations and citations omitted).

8 *Circuit City Stores, Inc.* v. *Adams*, 532 U.S. 105, 114-15 (2001) (internal quotations and citations omitted).

9 BLACK'S LAW DICTIONARY (11th ed. 2019) (definition of "agreement").

10 Uniform Partnership Act § 202; New York Partnership Law § 10.1.

11 Uniform Law Commission, Comment to Uniform Partnership Act § 202 (2019).

12 *Id*. *See also* BROMBERG & RIBSTEIN ON PARTNERSHIP, 3rd ed. 2021, § 2.04[C] ("The courts have often said that the relevant intent is to do the acts that in law constitute partnership.").

13 BROMBERG & RIBSTEIN, *supra* note 12, §§ 2.04[B]-[C] (indicia of partnership can include a written partnership agreement, capital contributions, profit and loss sharing, a trade name and keeping partnership bank accounts or financial records), 2.06[B] ("because the profit share is so important, non-profit-sharing relationships typically are partnerships only if strong evidence exists of other indicia"), 2.06[D][2] (discussing question whether partnership can be found without agreement to share expenses and other losses).

entity[14] in which the relationships between the partners are determined primarily by a partnership agreement that forms a contract.[15] It is settled that, "[a] limited partnership being a voluntary association, a person cannot become a partner without manifesting consent to do so. That consent . . . is judged objectively."[16]

Similarly, in legal and financial contexts, "syndicate" means "a group organized for a common purpose,"[17] such as "[a] group of investment bankers who share the risk in underwriting a securities issue."[18] As with the other forms of organization, one cannot be part of a syndicate without intending and consenting to do so. Of course, the vast majority of syndicates, like general and limited partnerships, are based on an express written agreement.

Thus, Congress enacted a list of terms beginning with relatively more specific forms of organization, all based on agreement, and ending in "other group." Conventional canons of statutory construction, familiar to Congress, require that "other group" be construed to include only those forms of organization that are "similar in nature" to "partnership, limited partnership or syndicate." In this context, the Proposing Release's statement that "Sections 13(d)(3) and 13(g)(3) are devoid of any reference to the term 'agree' or 'agreement'"[19] is misleading. Those sections enumerate terms for organizations whose core definitions are based on the existence of an agreement.

To postulate a Section 13(d)/(g) group involving no agreement whatsoever is, equivalently, to postulate two or more persons who become regulated as a group despite having no "mutual understanding" about anything. Such a "group" is, at best, a descriptive category, like "persons whose birthdays are in April." Membership in such a category does not depend on the knowledge or intentions of the members. But it is entirely unsupportable to say that the Section 13(d)/(g) group concept could work this way, given that the statutory language "*act as* a partnership, limited partnership, syndicate, or other group" presupposes a manifestation of subjective intention by the members.

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14 *Id*. § 8.02[A] ("In the United States, the limited partnership has traditionally been regarded as a creature of legislation.").

15 New York Partnership Law § 110(b) ("A [New York] limited partnership shall have a written partnership agreement."); Delaware Revised Uniform Limited Partnership Act § 1101(c) ("It is the policy of [Delaware limited partnership law] to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements."); BROMBERG AND RIBSTEIN, *supra* note 12, § 8.01[F] (describing limited partnerships as having a "more clearly contractual nature" than corporations).

16 Uniform Law Commission, Comment to Uniform Limited Partnership Act § 401 (2019).

17 BLACK'S LAW DICTIONARY, *supra* note 9 (definition of "syndicate").

18 *Id*. The handful of other uses of "syndicate" in the Exchange Act are consistent with this meaning. Exchange Act §§ 3(a)(5)(C)(iii)(III) ("a syndicate of banks of which the bank is a member"), 11(d)(1) ("participated as a member of a selling syndicate or group within thirty days prior to such transaction").

19 Proposing Release at 13867-68.

Our reading of "other group" does not, by any means, render those words superfluous in the context of the statute.[20] The Proposing Release states:

> If the term "agreement" were read into Sections 13(d)(3) and 13(g)(3) as if it were an unintentionally omitted term, application of Section 13(d) or 13(g) also would be limited to only a subset of persons who otherwise "act as a group" within the meaning of Sections 13(d)(3) and 13(g)(3) instead of all persons who act as a group as expressly mandated.[21]

As phrased, this statement is tautological because it assumes, rather than proves, that a group does not require an agreement. One might, however, read this statement as asking what purpose the words "other group" would serve if they were not given the broad sense advanced by the Commission in the Proposing Release. Many answers are possible. As a few examples, a joint venture, certain types of trust, an employer–employee relationship or the voting provisions of a stockholders' agreement might involve an agreement as to a common purpose with respect to issuer securities, yet neither involve a single "person" nor constitute a partnership, limited partnership or syndicate. The laws of a non-U.S. jurisdiction might conceivably recognize a form of organization that is similar to a limited liability company, but is not considered a "person" with separate legal personality under the laws of that jurisdiction. The constituent members of such an organization might appropriately be deemed to be an "other group" depending on the facts and circumstances. These examples are hardly exhaustive, but they show that a straightforward, sensible interpretation of "other group" is fully consistent with the statutory scheme.

The Proposing Release's statement that "there is no indication that Congress intended for the analysis of whether or not a group had formed to be dependent upon the existence of an express or implied agreement among two or more persons"[22] is also fundamentally untrue. The legislative history cited by the Proposing Release provides little support for its expansive reading of "other group." A 1967 Senate report, for example, summarized the Section 13(d)(3) language as follows:

> This provision would 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 . . . . The group would be deemed to have become the beneficial owner . . . at the time they *agreed to act in concert* . . . . This provision is designed to obtain full disclosure of the identity of any person or group obtaining the benefits of

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20 *See* Antonin Scalia and Bryan A. Garner, READING LAW (2012), at 176 ("If a provision is susceptible of (1) a meaning that gives it an effect already achieved by another provision, or that deprives another provision of all independent effect, and (2) another meaning that leaves both provisions with some independent operation, the latter should be preferred.").

21 Proposing Release at 13868.

22 *Id*. at 13867.

> ownership *by reason of* any contract, understanding, relationship, agreement or other arrangement.[23]

This passage hardly supports the Proposing Release's view that the statutory language lacks a "state of mind element"[24] or that a group may arise "regardless of the absence of any contract or agreement."[25]

The Proposing Release suggests that the Commission will be "burden[ed]" if the existence of a group under Regulation 13D-G is "dependent upon evidence proving the existence of an agreement."[26] But it does not follow that the statute can reasonably be read to contemplate the existence of unintentional groups. As the discussion above shows, it cannot. Furthermore, the Commission—like any regulator, government actor or litigant—will necessarily have *some* evidentiary burden when it seeks to enforce claims against a private party. For decades, Section 13(d)/(g) case law has operated with a higher evidentiary burden to prove group status than the rock-bottom standard that the Proposing Release now calls for.[27] Before making such a sweeping change to settled law, the Commission would need to do much more analysis of why the change is justified and what effects it might have on markets and capital formation.

For Regulation 13D-G to have a legally sound, workable version of the group concept, the Proposed Rule's amendments to group-related provisions should not be adopted or, alternatively, must be better tailored in key respects, including to create an appropriate safe harbor for dealing activities.

Even if the Proposing Release's new, expanded concept of a group did not exceed the statutory language, the ways in which that concept is proposed to be woven into Regulation 13D-G are deeply problematic in and of themselves.

> *Proposed Rule 13d-5(b)(i) should not be adopted. It would accomplish nothing other than to create confusion and invite Section 16 litigation.*

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23 Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids, S. Rep. No. 90-550, 1st Session 8 (1967); Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids, H.R. Rep. No. 90-1711, 2d Session 9 (1968) (emphases added).

24 Proposing Release at 13868. The language in the passage highlights the subjective intent—the state of mind—of the persons described. *See* WEBSTER'S NEW INTERNATIONAL DICTIONARY (2d ed. 1934) (defining "seek" as "[t]o try to acquire or gain; to strive after as an aim"); GARNER'S MODERN ENGLISH USAGE, 4th ed. 2016 (defining "evasion" as "the deliberate avoidance of doing what one should").

25 Proposing Release at 13868 n. 129.

26 *Id*. at 13868.

27 *See, e.g.*, *Corenco Corp.* v. *Schiavone & Sons, Inc.*, 488 F.2d 207 (2d Cir. 1973); *Wellman* v. *Dickinson*, 682 F.2d 355 (2d Cir. 1979), *cert. denied sub. nom*. *Dickinson* v. *SEC*, 460 U.S. 1069 (1983); *Morales* v. *Quintel Ent., Inc.*, 249 F.3d 115 (2d Cir. 2001); *Hallwood Realty Partners, LP* v. *Gotham Partners, LP*, 286 F.3d 613 (2d Cir. 2002); *Roth* v. *Jennings*, 489 F.3d 499 (2d Cir. 2007); *CSX Corp.* v. *Children's Inv. Fund Mgmt.*, 2011 WL 2750913 (2d Cir. July 18, 2011).

Proposed Rule 13d-5(b)(i) would replace the phrase "When two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer" with the phrase "When two or more persons act as a group under Section 13(d)(3) of the [Exchange] Act." As the discussion above makes clear, these two phrases mean the same thing. In principle, the wording change should have no practical effect; the change would be unnecessary, but perhaps unobjectionable. The Proposing Release clearly invests the wording change with significance, however. When read together with the Proposing Release's discussion of the statutory language and the wording change, Proposed Rule 13d-5(b)(1)(i), if adopted as proposed, would appear to stand for several novel principles.

First, that group status would now be much broader than had been previously understood. Despite the Proposing Release's pretense of merely correcting "misimpressions," there would nonetheless, in this scenario, be a deliberate rule change resulting from a notice-and-comment rulemaking process (circumscribed though that process has been).

Second, that group status might now arise from an after-the-fact assessment of effects or outcomes—in other words, that one could unintentionally and unknowingly be part of a group.

Third, that the Commission has stated or implied that a large body of existing case law was decided incorrectly.

We must emphasize that, even if these principles did not stretch well beyond the Commission's authority under the Exchange Act, they would do nothing to improve the clarity or predictability of the rules of the road. Today, as the Commission and market participants well know, the "agreement" standard under current Rule 13d-5(b)(1) does not establish any bright lines or safe harbors. Rather, it requires an evaluation of the facts and circumstances of the relevant situation. Nonetheless, we believe—and courts have recognized—that the "agreement" standard has, on the whole, served as a workable compromise between the statute and its underlying policies, on the one hand, and the markets' need for clear rules, on the other hand. Above all, unlike the Commission's novel principles, the current "agreement" standard properly emphasizes the volition of each group member.[28]

It also seems highly likely that the Commission's novel principles would invite a new wave of litigation by the Section 16 plaintiffs' bar, who would undoubtedly feel empowered to allege the existence of 10% Owner groups based on fact patterns far more tenuous than would be considered plausible today.[29] Whether a 10% Owner group exists, and if so what liabilities its

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[28] To adapt a point from the discussion of partnerships above, the existence of a group surely does not depend on the intent of the members to create and wear the label of a "Section 13(d) group." It does, however, depend on an intent to take the coordinated actions that will create that relationship. The Proposing Release asserts that the "agreement" standard is under-inclusive, but there is no meaningful evidence for that assertion. In particular, if a person knowingly takes "concerted action" with others while denying the existence of any agreement to do so, then, first, the statement that there is no agreement may be incorrect and, second, the anti-evasion provisions of Regulation 13D-G may apply.

[29] *See* Peter Romeo & Alan Dye, SECTION 16 TREATISE AND REPORTING GUIDE § 9.02[3] (5th ed. 2019) ("The moving parties behind [most Section 16 claims] are . . .a small number of attorneys who specialize in the pursuit of Section 16(b) claims. These lawyers act as Section 16(b) watchdogs by closely examining the

members may therefore have under Section 16(b), is already the subject of much litigation.[30] The risk of such litigation, in our experience, is already something of which dealers and others are highly aware and that incentivizes them perhaps more than any other single factor to be careful and circumspect in communications about equity securities. The Commission's novel principles could increase this risk exponentially without there being any legitimate connection to the policies underlying Section 16. Thus, while the Commission should not adopt Proposed Rule 13d-5(b)(i) for the reasons stated above, if it does, it must, at a minimum, provide that that rule would not be taken into account in determining 10% Owner status for purposes of Section 16.

Any rule ultimately adopted should include a comprehensive safe harbor for dealing activities of QIIs.

Beyond Proposed Rule 13d-5(b)(1)(i), several other provisions of the Proposed Rule would operate together to expand the group concept yet further, then modestly limit the group concept via two safe-harbor provisions that, as described below, are not appropriately drafted to achieve their stated goals.

Conceptually, the group-related provisions of the Proposed Rule would do the following:

- First, via Proposed Rule 13d-5(b)(1)(i), expand the group concept through broad language and removal of the requirement for an agreement.

- Then, via Proposed Rule 13d-5(b)(1)(ii) (the "tipper-tippee provision"), expand the group concept yet further by providing that, as a rule of construction, "[a] person that is or will be required to report beneficial ownership on Schedule 13D who, in advance of making such filing, directly or indirectly discloses to any other market participant the non-public information that such filing will be made, acts as a group with such other person or persons within the meaning of section 13(d)(3) of the Act to the extent such information was shared with the purpose of causing such other person or persons to acquire equity securities of the same class for which the Schedule 13D will be filed . . . [and] such other person or persons acquired beneficial ownership based on such information."

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trading activities of insiders in the reports filed by them with the SEC under Sections 16(a) and 13(d) of the 1934 Act. Their efforts are intended to uncover potential Section 16(b) claims promptly and obtain sizable fees for their efforts in recovering for the issuer the short-swing profits allegedly realized by its insiders on the transactions at issue.") (internal citation omitted).

30 *Id*. § 2.03[5][d] ("[S]ome of the more nettlesome issues have involved the application of Section 16 to members of a Section 13(d) 'group' that owns more than ten percent of a registered class of equity security, even where no member of the group individually owns more than ten percent. . . . Rule 16a-l (a)(f)'s definition of beneficial owner has proven to be fertile ground for the plaintiffs Section 16(b) bar to furrow.").

- Finally, via Proposed Rule 13d-6(c) (the "communications safe harbor") and Proposed Rule 13d-6(d) (the "derivative safe harbor"), mitigate some of these expansions by providing two new safe harbors from group status in limited circumstances. As particularly relevant for this letter, the derivative safe harbor would provide that "[t]wo or more persons who, in the ordinary course of their business, enter into a bona fide purchase and sale agreement setting forth the terms of a derivative security . . . . shall not be deemed to have acquired beneficial ownership of . . . . any such equity securities of the issuer referenced in the agreement as a group . . . . provided, that such persons 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."

As we have explained, Proposed Rule 13d-5(b)(1)(i) should not be adopted. The Commission should also decline to adopt the tipper-tippee provision, which would not identify any forms of true group activity that would not already be properly characterized as such under the current rule, but would simply create additional doubt about whether group status would be determined based on ambiguous elements of a factual record regardless of whether two persons agreed to act in concert.

Viewed together, Proposed Rule 13d-5(b)(1)(i) and the tipper-tippee provision are especially inappropriate as applied to the dealing activities of QIIs. Given the types of information that a QII might sometimes learn in the course of transacting with a customer, and the related activities in which the QII might engage, these provisions, as proposed, threaten to create group status out of ordinary-course dealing activities by QIIs. The derivative safe harbor is, in turn, drafted too narrowly to correct this misapplication of the group concept.

Accordingly, any final amendments to Regulation 13D-G should replace the Proposed Rule's inappropriately narrow derivative safe harbor with a comprehensive dealer safe harbor providing that a QII (i) acting as a dealer with respect to a customer, with respect to a cash-settled derivative or otherwise, (ii) in the ordinary course of the QII's business and (iii) without any intention by the QII to change or influence control of an issuer, will not be part of a group with that customer, either when entering into the transaction with the customer or in connection with any hedging, termination or settlement of the transaction, or as a result of any other dealing activity relating to such issuer but unconnected to such customer, regardless of the customer's control intention with respect to that issuer or the QII's knowledge of any such control intentions (a "*dealer safe harbor*").[31]

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[31] A QII acting as dealer also should also not be deemed to have acquired any beneficial ownership of issuer securities solely by virtue of the dealer's interest in a cash-settled derivative agreement. We discuss below our concerns with the Proposed Rule's expansion of the definition of beneficial ownership to include such instruments. In the scenario with which the Proposing Release appears to be most concerned, the customer has a long position (e.g., holds a cash-settled call option), and the dealer has what would be considered to be a short position (e.g., has written the cash-settled call option); per the Proposed Rule's Note 1 to paragraph (e)(2), the QII acting as dealer would therefore acquire no beneficial ownership under the derivative instrument. On the other hand, there may be instances in

This comprehensive dealer safe harbor would address gaps in the proposed derivative safe harbor by clarifying that the safe harbor applies to: (i) a dealer providing liquidity in cash equity securities just like a dealer in derivative securities; (ii) a derivatives dealer not only when entering into a transaction but also in connection with any hedging, termination, or settlement of the transaction; and (iii) a dealer transacting with a customer even if that *customer* intends to change or influence control of the issuer, so long as the *dealer*, in contrast, does not have such an intent.

A sensible cost-benefit analysis clearly militates in favor of this dealer safe harbor. Such a safe harbor would be consistent with the Commission's previously expressed view that QIIs are generally intended to be "permitted greater flexibility" under Regulation 13D-G "in recognition of the fact that [QIIs] routinely buy and sell securities in the ordinary course of business and are less likely to abuse the process."[32] Furthermore, whatever the merits of adopting a rule to capture "an organizational structure that unites a number of funds into a loosely knit organization (i.e., the 'wolf pack')),"[33] that "structure" is manifestly absent from an ordinary-course dealing transaction in which a dealer and customer act as arm's-length counterparties to each other (for example, when a cash market dealer buys securities to replenish its inventory after selling some to its customer or a derivatives dealer buys securities to hedge a derivative with its customer). Capturing dealing activity in such a rule would also fail to advance the Proposing Release's stated goal of targeting "sharing . . . material information [among] investors positioned to act on the information."[34]

Furthermore, stipulating that dealers do not act as groups with their customers will not meaningfully change the mix of information to be made available to the public under the Proposed Rule. Where the customer has a control intention, current Rule 13d-3(d) does, and Proposed Rule 13d-3(e) would, already impute beneficial ownership to the customer of securities that may be acquired under derivatives and other rights. As we discuss below, we believe that, from the customer's perspective, the link between an equity derivative and control or influence of the issuer is generally too attenuated to make imputation of beneficial ownership appropriate for Section 13 purposes, let alone for purposes of making a person subject to Section 16 as a

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which the QII in the ordinary course of business with other customers has a long position under the derivative instrument. If the QII holds that position in the ordinary course of its business and without any intent to change or influence control of the issuer, however, there would still be no cause to attribute beneficial ownership to the QII under the long position. (In this case, the customer has the short position. That short position would not reduce the customer's reportable beneficial ownership, but could nonetheless be disclosed in Item 6 of the customer's Schedule 13D, if it files one, and entry into the short position could potentially constitute a material change in facts that requires the customer to amend a previously made Schedule 13D filing, if applicable.) Furthermore, we expect that the application of Rule 14e-4's definitions of "long position" and "short position" to cash-settled derivatives for purposes of Regulation 13D-G may not always be simple or clear.

[32] Amendments to Beneficial Ownership Reporting Requirements, 63 Fed. Reg. 2854, 2855 (Jan. 12, 1998).

[33] Proposing Release at 13870 n. 143.

[34] *Id*. at 13869.

10% Owner. Nonetheless, assuming for argument's sake that such imputation is appropriate on the grounds that it provides the public with necessary information (and is within the bounds of the statute), the customer's Schedule 13D disclosure will then provide the public with that information. No further purpose would be served by deeming the QII counterparty acting as dealer to be part of a group with the customer, thereby placing reporting obligations and potential short-swing-profit liability onto the QII notwithstanding that the QII has acted passively and the reported size of the customer's stake already effectively includes any hedge position held by the QII.[35]

A dealer safe harbor should encompass all aspects of a derivative or other security transaction, that is, not only entry into the transaction, but ongoing hedging, termination and settlement activities by the QII as well. The dealer safe harbor, unlike the derivative safe harbor as drafted, should also include any cash or other dealing transactions as well as derivatives transactions, to which all of the foregoing reasoning applies equally.

Without a dealer safe harbor, between the uncertainty and risk of the expanded group concept and the narrowness of the currently proposed safe harbors, QIIs would likely be much less willing to enter into equity derivatives transactions with customers and, furthermore, might be less willing to enter into security transactions of any kind without heightened scrutiny of the customer. Higher hedging costs for customers and reduced market liquidity are two foreseeable costs of that outcome, which the Proposing Release does not consider.

Furthermore, the need for an affirmative safe harbor is acute. While in some areas, one might be able to argue that despite falling outside one safe harbor (here, the derivative safe harbor), one is not necessarily caught up by the general rule (here, Proposed Rule 13d-5(b)(1)(i) or the tipper-tippee provision), the expansiveness of the Proposed Rule's group concept and its tipper-tippee provision would foster undue and potentially unworkable uncertainty on that point.

> *Any tipper-tippee provision, derivative safe harbor or other group-related rule, if ultimately adopted, must include critical drafting fixes to be fair and workable and accomplish the Commission's goals in promulgating the safe harbors.*

Although we urge that the Commission provide a comprehensive safe harbor for QIIs acting as dealers from being considered to act as part of a group, nonetheless, if any version of the proposed tipper-tippee provision, derivative safe harbor or other group-related rule is ultimately to be adopted—and whether or not that rule applies to QIIs acting as dealers—it must include critical drafting fixes. We believe that the most important of these are as follows:

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[35] Note that we are neither contesting that shared beneficial ownership of the same securities may exist in certain circumstances, nor arguing that the existence of a genuine group should be disregarded if one member were to report beneficial ownership of all securities beneficially owned by any member of the group. Given, however, that the dealer and the customer in this example do not in fact act as a group within an appropriately circumscribed understanding of the statutory basis for that standard, and that the goal of preventing "easy avoidance of . . . disclosure," Proposing Release at 13865 n. 115, has already been accomplished here, it would be especially inappropriate to impose group membership on the dealer.

These rules should provide for a "reasonable belief" standard as to the control intentions of other parties.

Several parts of the Proposed Rule's group-related provisions are drafted ambiguously using either passive voice or plural phrases, or both, which make them difficult to apply. For example, the tipper-tippee provision uses the passive voice phrase, "such information was shared with the purpose of causing . . .", the communication safe harbor similarly uses a passive voice phrase, "[c]ommunications among or between such persons are not undertaken . . . ," and the derivative safe harbor uses the plural phase, "such persons did not enter into the agreement with the purpose . . . ."

These phrases, though ambiguous, could be read to suggest that even if one person (the "first person") has no control intention, whether that person falls in or out of group status depends on the control intentions of one or more other persons (the "second person"). Again, such a rule is legally dubious insofar as it minimizes the primacy of the first person's intentions and suggests that the first person could be part of a group despite not having knowledge of the basis of its group membership (here, the control intentions of the second person). Beyond this, however, it is paradoxical to say that, in effect, for the first person to establish a defense against being deemed to act collectively with the second person depends on the first person's understanding of the second person's thoughts and actions. Such a reading would lead to the absurd result of instigating the sort of collective behavior that could, under the Proposed Rule, likely confer group status, just so a person could determine whether it was part of a group in the first place.

This is not a tenable approach for the Commission to take. As a practical matter, furthermore, the first person may often not reasonably be in a position to know the second person's control intentions with certainty, let alone to monitor those intentions on an ongoing basis. Indeed, this is relatively more likely to be the case as between persons who are not, in fact, sufficiently coordinating their actions with respect to an issuer's shares that they should properly be deemed to be a group. For the first person to be able to reliably avail itself of the communication safe harbor or derivative safe harbor (or to conclude that the second person is not a pending Schedule 13D filer and thus does not implicate the tipper-tippee provision for the first person), the first person must be able to determine, individually, that it qualifies for those safe harbors.

Specifically, the Commission should clarify the language of the Proposed Rule so that, if the first person establishes a reasonable belief that the second person is not sharing information to cause the first person to acquire the relevant equity securities (in the case of the tipper-tippee provision), is not communicating with the purpose or effect of changing or influencing control of the issuer (in the case of the communication safe harbor) or entering into a derivative security with such purpose or effect (in the case of the derivative safe harbor), this reasonable belief would allow the first person to be confident that the first person will not thereafter be deemed to act as a group with the second person, even if the second person has misled the first person about, or subsequently changed, its control intent.

This issue of a first person's knowledge of information about another person is familiar across the U.S. securities laws. The Commission's usual approach, and one that we believe would be appropriate here, is to provide that the first person must establish a reasonable belief about the information, but thereafter may rely on that reasonable belief notwithstanding whether it ultimately turned out to be correct, or was once correct but then ceased to be.[36] This approach is particularly appropriate in the context of derivatives transactions. The Commission could provide that, in the context of a derivative transaction, the reasonable belief need be established only at the outset of a transaction or series of related transactions with a customer about the securities of a particular issuer. The course of a derivative transaction could, for example, involve adjustments to the position with the counterparty or to the positions that a person may maintain from time to time as a hedge. It may in many cases be inconsistent with the utility of the ability to rely on a reasonable belief to require the belief to be re-established at every step of the relationship. This approach, too, has precedent in the Commission's guidance in other settings.[37]

Any safe harbor applicable to derivatives dealers should cover not only "ent[ry] into a bona fide purchase and sale agreement," but hedging, termination and settlement activities.

A derivative transaction frequently includes all of these steps in the ordinary course. Although the derivative safe harbor was presumably intended to cover all of these steps, given the Commission's stated intention to "avoid impediments to certain financial institutions' ability

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[36] *See, e.g.*, Rule 2a51-1 under the Investment Company Act of 1940 (the "*1940 Act*") ("The term 'qualified purchaser' as used in section 3(c)(7) of the [1940] Act means any person that meets the definition of qualified purchaser in section 2(a)(51)(A) of the Act and the rules thereunder, *or* that [an issuer] *reasonably believes* meets such definition.") (emphasis added), Rule 506(b) under the Securities Act of 1933 (the "*Securities Act*") (describing the condition that an issuer in a private placement "*reasonably believe*[s]" that limits on participation by non-accredited investors are satisfied), Rule 144A(d)(1) under the Securities Act (describing the condition that securities in certain transactions "[be] sold only to a qualified institutional buyer or to a purchaser that the seller and any person acting on behalf of the seller *reasonably believes* is a qualified institutional buyer").

[37] *See, e.g.*, American Bar Association, SEC No-Action Letter (available April 22, 1999) ("Question: Does [a] Section 3(c)(7) Fund need to make a new determination of qualified purchaser status for an investor each time the investor elects to reinvest its earnings of the Fund? Answer: No. Section 3(c)(7) [of the 1940 Act] excludes from the definition of investment company any issuer whose outstanding securities are owned by persons who, at the time of acquisition of the securities, are qualified purchasers, and which is not making or proposing to make a public offering of its securities. Consistent with prior staff interpretations of Section 3(c)(1) of the [1940 Act], the staff does not interpret Section 3(c)(7) as requiring the status of a person as a qualified purchaser to be reaffirmed in connection with the crediting of a Section 3(c)(7) Fund's earnings to an investor's account.") (internal citation omitted). *See also* Commodity Futures Trading Commission and Securities and Exchange Commission, Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping; Final Rule, 77 Fed Reg. 48208, 48262 (July 18, 2012) ("The determination of whether a Title VII instrument is either a swap or a security-based swap should be made based on the facts and circumstances relating to the Title VII instrument prior to execution, but no later than when the parties offer to enter into the Title VII instrument. If the Title VII instrument itself is not amended, modified, or otherwise adjusted during its term by the parties, its characterization as a swap or security-based swap will not change during its duration because of any changes that may occur to the factors affecting its character as a swap or security-based swap.") (internal citation omitted).

to conduct their business in the ordinary course,"[38] its language as drafted—which refers only to "ent[ry]" would not necessarily accomplish this goal even assuming that a person and its derivative counterparty both lack any intention to change or influence control of the relevant issuer. In its discussion of the derivative safe harbor, the Proposing Release itself notes that "[t]o offset any risk exposure to that derivative security, *including any obligations that may arise at settlement,* the financial institution may accumulate the reference equity security . . . ."[39] The implication appears to be that transactions in connection with such obligations should be covered by the safe harbor, but the rule text as drafted appears to be narrower than this. Accordingly, any final version of a derivative safe harbor should be expanded appropriately. We emphasize that this change does not obviate the need for a broader-based dealer safe harbor that covers all ordinary-course dealing activities of QIIs, regardless of customers' intent and whether the QIIs' activities are derivatives transactions per se. Nonetheless, for any eventual users of a derivative safe harbor of the type proposed to enjoy the protection that it is intended to confer, the language should be re-drafted as suggested above.

Any tipper-tippee rule should provide greater clarity about what it could mean to receive "indirect[]" disclosure of a pending Schedule 13D filing and about when a purchase would be deemed to be "based on such information" for purposes of the rule.

While, again, we urge that a dealer safe harbor be adopted that would supersede any tipper-tippee provision with respect to the ordinary-course dealing activities of a QII, if any version of a tipper-tippee provision is ultimately adopted, it should remove ambiguities from the proposed language as drafted and provide additional interpretive guidance.

For example, if a customer is typically an active investor and typically takes greater-than-5% positions, does a person transacting with that customer—even if the person has no information about the customer's stake in or relationship to the relevant issuer—worry that it now faces a difficult-to-rebut presumption of "knowing" that the customer intends to file a Schedule 13D? What if the customer has already filed a Schedule 13D? In either of these cases, has the person transacting with the customer received "indirect[] disclos[ure]" of a pending Schedule 13D filing? If so, and if a trading desk within that person—either the same one or a different one from the one that transacted with the customer—transacts in securities of the same issuer in the ordinary course of a market-making business, would that person trigger the tipper-tippee provision?

On the facts stipulated, the answer should be no. In the context of the Commission's expansive interpretation of the group concept, however—and given the Commission's expressed desire to lower the evidentiary bar for establishing group status—the tipper-tippee provision could lead to a presumption that an acquisition by that person was "based on such information" (in this example, the possibly imputed knowledge that the customer would file a Schedule 13D). For a QII acting as a dealer, such a presumption would be especially pernicious because customer-facing dealing and cash market-making activities may happen on one desk or on desks

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[38] Proposing Release at 13873.

[39] *Id*. at 13872 (emphasis added).

in close proximity, making it difficult or impossible to affirmatively prove absence of coordination with respect to purchase activities on an ongoing basis.

If any tipper-tippee provision is ultimately adopted, therefore, it should (i) remove the concept of "indirect disclosure," which is intrinsically ill-defined, (ii) confirm that a purchase of securities by a QII in the ordinary course of its business as a dealer (including any bona fide hedge purchases) will not be considered to be "based on [the] information" of a pending Schedule 13D filing and there will otherwise be no presumption that a particular purchase was based on such information in the absence of any affirmative evidence to that effect and (iii) provide illustrative examples that show an appropriately direct causal link between disclosure of a pending Schedule 13D filing and purchases by the person receiving the disclosure.

These rules should make clear that the safe harbors control over any contrary provisions.

Lastly, any final rule should state explicitly that any safe harbors adopted supersede and control over any other part of the rule that would otherwise deem a person to act as part of a group. Although this certainly appears to be the intention of the Proposed Rule, it is less clear than it could be, and market participants would benefit from confirmation.

II. The Proposed Rule's Expansive Definition of "Beneficial Ownership"

The arguments for deeming cash-settled derivatives to confer beneficial ownership are fundamentally misguided. Moreover, the concerns motivating these arguments are better addressed by the current provisions of Regulation 13D-G.

The Proposed Rule would dramatically expand the existing, well-understood and widely relied-upon definition of beneficial ownership under Section 13 by including certain cash-settled derivatives. This change, like many of those relating to groups discussed above, rests on faulty premises—many of which are particularly, though not exclusively, relevant to QIIs acting as dealers. There is no compelling need to, and the Commission should not, adopt this expansive definition of beneficial ownership. If it is to be adopted in some form, however, it is critical that key changes be made to the Proposed Rule to avoid a number of inappropriate results and unintended consequences.

The Proposed Rule's treatment of cash-settled derivatives is fundamentally misguided. As set forth in the Proposing Release, the arguments why such derivatives should confer "beneficial ownership" within the meaning of Section 13 consist of highly speculative theories of market effects that might conceivably occur and in which cash-settled derivatives might be said to have played a role.[40] On the basis of these bare hypotheticals, the Commission would require parties

[40] Proposing Release at 13860-61 ("An investor in a cash-settled derivative *may* be positioned . . . to acquire any reference securities that the counterparty *may* acquire to hedge the economic risk of that transaction, including any obligations that *may* arise in connection with settlement. Entry into the agreement governing the derivative *may*, therefore, result in a rapid accumulation of a covered class . . . . [I]f an arrangement or understanding exists outside of the term of a derivative instrument that enables

to cash-settled derivatives to: in many cases, daily re-calculate their beneficial ownership, which would change based on factors outside of their control; navigate a much more complicated test for becoming subject to Section 16; and potentially suffer ongoing uncertainty about whether or when beneficial ownership would be imputed or aggregated.

The Proposing Release states:

> We recognize that cash-settled derivative securities differ from the rights covered under Rule 13d-3(d)(1) in that they ordinarily do not entitle their holders to acquire the reference securities. To the extent such derivative security is held with the purpose or effect of changing or influencing the control of the issuer, however, we believe that the *potential* for a holder of a cash-settled derivative security to exert influence on a counterparty that *may* directly hold the reference securities implicates the same concerns that the Commission articulated in adopting Rule 13d-3(d)(1). Thus, we believe that deeming such holders to be beneficial owners of the reference securities would be consistent with the Commission's longstanding view of the right to acquire beneficial ownership as described in Rule 13d-3(d)(1).[41]

This premise is extremely attenuated, not consistent with market practice and is simply not supported by evidence of abuse.

First, some of the sources that the Proposing Release treats as supporting the inclusion of cash-settled derivatives in beneficial ownership are of questionable relevance. The Proposing Release cites a case in which "reference securities" were held to have been "impermissibly 'parked' with the counterparty on behalf of the derivative holder."[42] But the "derivative" in question was not a cash-settled derivative and the actions of the parties were hardly beyond the reach of Regulation 13D-G's anti-evasion provisions. In other words, the changes in the Proposed Rule are unnecessary for the Commission to be able to proscribe the conduct in question.

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the investor to acquire the reference securities from a counterparty, the reference securities *could* be viewed as having been impermissibly 'parked' . . . . The use of cash-settled derivative securities in the change of control context also *may* serve as a catalyst for related acquisitions of beneficial ownership by institutional counterparties that ultimately *could* contribute to a shift in corporate control . . . . Holders of cash-settled derivatives also *may* have incentives to influence or control outcomes at the issuer of the reference security . . . . such holders *may* possess economic power that *can* be used to produce desired outcomes through engagement with a counterparty or issuer of the reference security and *potentially could* impact the stock price. An unwinding of agreements governing cash-settled derivatives also *could* adversely impact the stock price of an issuer . . . . Consequently, counterparty dispositions of reference securities at [settlement] . . . . *may* impair the orderly operation and efficiency of our capital markets.") (emphases added).

41 *Id*. at 13862 (emphases added).

42 *Id*. at 13861 n. 91 (citing *SEC* v. *First City Financial Corp.*, 890 F.2d 1215 (D.C. Cir. 1989)).

Similarly, the Proposing Release cites to materials produced by persons who are, by virtue of longstanding opposition to shareholder activism, undoubtedly interested in the outcome of the Proposed Rule.[43] While such materials may be relevant and persuasive in certain cases, it is not clear whether the Commission has discharged its burden to "critically review" analysis provided by interested parties.[44]

Second, the premise of "exert[ing] influence on a counterparty" is inconsistent with standard representations, warranties and agreements contained in ISDA agreements governing derivative securities, which make clear that a party to a cash-settled derivative agreement has no control over the future disposition or use of the counterparty's hedge position once it is established.[45] Notably, dealers typically will manage their hedge positions on a portfolio-wide basis, not based on counterparty preference but in accordance with their own risk management practices. Moreover, any unwritten agreement relating to "parking" or similar conduct would raise not only evasion concerns, but also books and records issues for dealers.[46]

The Commission's concerns with the hedging activities of a dealer, including activities at settlement, are also unfounded. As noted above, any activity by the dealer is for its own account. In the event that a dealer's establishment or unwind of a hedge position independently raises market conduct concerns, the Commission has multiple means of addressing those concerns.[47]

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43 *E.g.*, *id*. at 13861 n. 94 (citing a memo by law firm Wachtell, Lipton, Rosen & Katz).

44 The SEC is obligated to "critically review" analysis provided by interested parties, or perform its own analysis to support factual claims. *See, e.g.*, *Susquehanna Int'l Grp.* v. *SEC*, 866 F.3d 442, 447 (D.C. Cir. 2017) (concluding that the SEC did not engage in "the reasoned analysis that the Exchange Act and the [Administrative Procedures Act] require" where it simply "took [the regulated entity's] word for it"); *Greene Cnty. Planning Bd.* v. *Fed. Power Comm'n*, 455 F.2d 412, 420–22 (2d Cir. 1972) (invalidating action where agency "substituted the statement of [the regulated entity] for its own" due to "potential, if not likelihood, that the [regulated entity's] statements will be based on self-serving assumptions").

45 *See*, *e.g.*, International Swaps and Derivatives Association ("*ISDA*") Master Agreement, § 3(g) ("No Agency: [Each party represents] [i]t is entering into this agreement, including each Transaction, as a principal and not as an agent of any person or entity") and 2002 ISDA Equity Derivatives Definitions, §13.2 (Agreements and Acknowledgements Regarding Hedging Activities) ("each party to a Transaction agrees and acknowledges that . . . any Hedge Positions established by either party or any of its Affiliates is a proprietary trading position and activity of such party or such affiliate[;] each party or such Affiliate is not holding the Hedge Positions or engaging in the Hedging Activities on behalf or for the account of or as agent or fiduciary for the other party, and the other party will not have any direct economic or other interest in, or beneficial ownership of, the Hedge Positions or Hedging Activities[;] and the decision to engage in Hedging Activities is in the sole discretion of each party, and each party and its Affiliates may commence or, once commenced, suspend or cease the Hedging Activities at any time as it may solely determine").

46 *See, e.g.*, Exchange Act Rule 17a-3(a)(7)(i) (required recordkeeping of terms and conditions of transactions with customers).

47 *See, e.g.*, Exchange Act § 9(a) (prohibiting manipulative transactions and market conduct by brokers).

We note also that most dealers have policies, procedures and practices in place designed to directly address the kind of adverse practices hypothesized by the Proposing Release. These include policies addressing how dealers vote shares, the dealer's disclosure of the contents of its voting policies to its derivatives counterparties and on the coordination of voting with those counterparties, as well as policies ensuring that dealers dispose of hedges in an appropriate and consistent fashion. Furthermore, the Proposing Release clearly reflects a presumption that when a customer (who may have control intent) is the long party under a cash-settled derivative with a dealer, the dealer will hedge its short position by acquiring and holding physical shares. Many dealers often hedge on a portfolio basis, however, rather than trade by trade, and through a variety of means; moreover, prudential regulations regarding leverage ratios and liquidity adopted after the global financial crisis provide dealers with incentives not to hedge derivative securities with physical shares.

For these reasons, the best and most judicious course of action would be not to treat cash-settled derivatives as conferring beneficial ownership for purposes of Regulation 13D-G.

The Rule 16a-1 definition of "derivative security" is over-inclusive (including by encompassing certain swaps that are not within the Commission's authority to regulate) and should not be imported wholesale into Regulation 13D-G.

The Rule 16a-1(c) definition of "derivative security" is intentionally broad. It was designed to be used within the framework of Section 16, which, as discussed below, has policy aims and practical considerations that are different from those of Section 13. The use of the Rule 16a-1 definition of "derivative security" is untenable in the context of Schedules 13D-G.

Issues relating to indexes or baskets of securities.

A derivative security under Rule 16a-1 includes, with certain exceptions, "any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege at a price related to an equity security, or similar securities with a value derived from the value of an equity security." Derivative securities do not include "[i]nterests in broad-based index options, broad-based index futures, and broad-based publicly traded market baskets of stocks approved for trading by the appropriate federal governmental authority."[48]

Proposed Rule 13d-3(e)(1) describes a test for beneficial ownership based on holding a derivative security other than a security-based swap. Derivative securities that reference a narrow-based security index may be security-based swaps and thus outside the scope of the Proposed Rule.[49] Some derivative securities, however, may reference an index or basket that is

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[48] Exchange Act Rule 16a-1(c)(4).

[49] Exchange Act §§ 3(a)(55)(B) (definition of "narrow-based security index"), 3(a)(68) (definition of "security-based swap").

broader than "narrow-based," but not so broad as to be "broad-based" under the Commission's traditional interpretive guidance on Rule 16a-1.[50]

Under Proposed Rule 13d-3(d)(1), a cash-settled intermediate-based interest could be deemed to confer on the holder beneficial ownership of one or more underlying reference securities in the intermediate basket. This result would be inappropriate for several reasons:

- There will be numerous reference securities in the intermediate basket, making it even less plausible that a person's cash-based indirect interest in any one reference security is relevant to the control or influence of the issuer.

- The notion of delta-adjusting an intermediate-based interest is not well defined; the discussion of "delta" in the Proposed Rule clearly assumed a single referenced security.

- The intermediate-based interest may be a swap (but not a security-based swap), meaning that it would fall within the regulatory jurisdiction of the CFTC, not the SEC; the SEC does not have regulatory or enforcement authority with respect to such swaps under Section 13, let alone to say that such swaps are equivalent to beneficial ownership of an equity security under Regulation 13D-G.[51]

Accordingly, any rule ultimately adopted should exclude from the coverage of Regulation 13D-G any derivative securities that are based on an index or basket of securities that is not a "narrow-based security index."

Issues relating to non-standardized deltas.

Further, Proposed Rule 13d-3(e)(2) would apply the "delta" concept for purposes of determining the number of securities that a holder of a cash-settled derivative will be deemed to beneficially own pursuant to Proposed Rule 13d-3(e)(1). The Proposing Release and the Proposed Rule treat the "delta" of a derivative instrument as a universally consistent calculation. That is not the case in practice. Each financial institution has models that calculate "delta" based on various factors such as volatility, and these factors may be weighted differently for different financial institutions, or different calculation periods may be used—for example, volatility for

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[50] *Goldman, Sachs & Co.*, SEC No-Action Letter (available June 7, 1996); *Goldman, Sachs & Co.*, SEC No-Action Letter (available Oct. 15, 1997). We refer to such derivative securities as "intermediate-based interests" on an "intermediate basket." An example of an intermediate basket might be a basket of 15 equity names, each of which is equally weighted. An intermediate-based interest on that basket may be neither a security-based swap nor, because each name constitutes more than 5% of the basket, considered "broad-based."

[51] *See* Exchange Act §§ 3A (limitations on Commission's authority to regulate "security-based swap agreements" subject to CFTC jurisdiction of which a material term is based on the price of a group or index of securities), 13(o) (Commission's authority under Section 13(o) of the Exchange Act extends only to security-based swaps, not to swaps subject to the exclusive jurisdiction of the CFTC).

two years or for three months. As a result, two different financial institutions could have two different beneficial ownership calculations with respect to the same underlying position. In the context of the need to make public filings and to potentially become a 10% Owner for Section 16 purposes, this is an untenable situation. Where regulatory filings must be made and organizations will become subject to Section 16 short-swing profit recovery, clarity and consistency is imperative.

Issues relating to instruments without a fixed exercise price.

Under Rule 16a-1, derivative securities exclude "[r]ights with an exercise or conversion privilege at a price that is not fixed."[52] Incorporation of this concept into Regulation 13D-G may create "springing" beneficial ownership, and thus shifting reporting requirements, despite having nothing at all to do with corporate influence or control. Again, this appears to us to be a concept that is not relevant to determining beneficial ownership for purposes of Regulation 13D-G. Such instruments without a fixed exercise price are just one more example of unpredictable consequences that could result from using the Rule 16a-1 definition, which supports the conclusion that the definition should not be imported into Regulation 13D-G or, at a minimum, requires much more rigorous analysis and tailoring by the Commission.

Even if the decision is made to include cash-settled derivatives in Section 13 beneficial ownership calculations, cash-settled derivatives should not be included in beneficial ownership for purposes of determining whether a person is a 10% Owner and thus subject to Section 16.

Section 16 treats a 10% Owner as a corporate insider. Like directors and officers of an issuer, a 10% Owner is presumed to be in a position to exploit material non-public information about the issuer. This presumption supplies the policy rationale for subjecting 10% Owners to the strict-liability profit-disgorgement regime of Section 16.

Section 16, in effect, asks two questions: first, who is an insider; and second, with respect to what sorts of interests tied to the issuer's share price should the insider be subject to disclosure and short-swing-profit rules? On the first question, for several decades, the Commission has defined 10% Owner status as greater than 10% beneficial ownership of voting securities as currently determined under existing Regulation 13D-G.[53] This standard, while of course raising interpretive questions over time, is logical. It uses voting and dispositive power over the issuer's securities as a proxy for access to and influence over the issuer, just as a director's or officer's role is used as a proxy for similar access and influence.

On the second question, the Section 16 definition of beneficial ownership—based not on voting or dispositive power, but on pecuniary interest—is intentionally broad. The purpose of

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[52] Exchange Act Rule 16a-1(c)(6).

[53] Ownership Reports and Trading By Officers, Directors and Principal Security Holders, 56 Fed. Reg. 7242, 7244 (Feb. 8, 1991).

that definition is to say: *if* a person has been determined to be in a position to exploit material non-public information about the issuer, and thus an insider, *then* with what instruments might that person plausibly do so for financial gain? In this latter context, it is reasonable to consider cash-settled instruments as within the scope of the inquiry.

Section 16's definition of "derivative security" is therefore used to define the scope of cognizable pecuniary interests held by persons who have already been determined to be subject to Section 16 by virtue of their roles as directors, officers or 10% Owners. The definition includes cash-settled instruments for this limited purpose; but that is far from saying—as the Proposed Rule implicitly would—that such cash-settled instruments create the type of influence or control to justify the application of Section 16 in the first place.

Instead, the Proposed Rule would short-circuit Section 16's two-stage analysis, by using the Section 16 definition of "derivative security" to determine whether a person is subject to Section 16 in the first place. This approach is conceptually flawed because it would use a definition of beneficial ownership, for purposes of determining who is an insider, that includes instruments with an extremely attenuated link, if any, to access to or influence over the issuer.

This approach is also highly impractical. Under the current definition of beneficial ownership in Regulation 13D-G, determining 10% Owner status is relatively straightforward. As a result, a person building a stake in an issuer faces a relatively clear choice about whether and when to become a 10% Owner subject to Section 16. It is extremely useful, and fair, for the person to have that choice. Under the Proposed Rule, the situation would become more tenuous. A person could need to daily re-calculate its beneficial ownership if the person's holdings included a delta-adjusted component, the delta could change based on factors outside of the person's control and unrelated to the person's relationship to the issuer and heightened monitoring would be costly and inefficient to manage. Moreover, the Section 16 definition of "beneficial ownership" does not always translate neatly into a single number of shares or a single ownership percentage of a given class (for example, an intermediate basket, with 20 securities where the Section 16 security represents 8% of the market value of the intermediate basket). In the Section 16(a) reporting framework, that is not intrinsically a problem. If part of the Section 16 definition of "beneficial ownership" were used to determine 10% Owner status under the Proposed Rule's amendments to Regulation 13D-G, however, it would be an acute problem.

Finally, a Section 13(d)/(g) group may become a 10% Owner, subjecting each person within the group to Section 16 reporting and liability with respect to that person's own transactions.[54] As discussed above, under the Proposed Rule's expanded definition of "group," if a person faces the possibility that it may be deemed to be a member of a group despite having no agreement with the other members of the group, the person may become subject to Section 16

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[54] Exchange Act Rule 16a-1(a). As noted above, in our experience, the risk of being deemed a 10% Owner group is one of the main practical deterrents to security holders' acting in a coordinated manner with respect to issuer shares.

inadvertently or, indeed, without even knowing that it has become subject to reporting of profit disgorgement under Section 16.

The Proposing Release has provided no cost-benefit analysis about the impact of an expanded Section 16, other than increased filings under Section 16(a); a much more rigorous and detailed analysis of costs and benefits, including market effects, would clearly be necessary before expanding Section 16 coverage in the manner in which the Proposed Rule would.

III. Acceleration of Filing Deadlines for Qualified Institutional Investors

QIIs should not be required to file or amend Schedule 13G on the accelerated timeframe of the Proposed Rule. Above all, QIIs and Passive Investors must not be made subject to daily monitoring requirements, the costs of which would be substantial but the benefits difficult to discern.

The Proposing Release states:

> Investors reporting pursuant to current Rules 13d-1(b) and 13d-1(d) may avoid beneficial ownership reporting by selling down their positions before the end of the calendar year, and, in the case of QIIs, selling down before the end of a month if ownership exceeds 10%. . . . The existing deadlines and manner of applicability not only could give rise to a gap in reporting for persons who *possess the potential to change control of an issuer*. . . . The proposed acceleration of these deadlines is expected to result in more timely disclosures while minimizing any additional burdens. We believe that these investors should already have well-established compliance systems in place to monitor Schedule 13G ownership levels to determine whether filing obligations have been triggered. For example, compliance operations at QIIs currently need to monitor beneficial ownership levels at least on a monthly basis in case their holdings exceed more than 10% at the end of the month and trigger an initial Schedule 13G filing pursuant to Rule 13d-1(b)(2).[55]

We cite this passage at length because the analysis is flawed in several important respects.

First, the assumption of "potential to change control" is inconsistent with the certifications that QIIs and Passive Investors are required to make. The Commission has previously expressed the view that QIIs, in particular, are intended to be "permitted greater flexibility" in making Schedule 13G and Schedule 13G/A filings "in recognition of the fact that [QIIs] routinely buy and sell securities in the ordinary course of business and are less likely to abuse the process."[56] If a QII or a (formerly) Passive Investor cannot make, or can no longer make, the required passivity certification to be a Schedule 13G filer, Regulation 13D-G already

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[55] Proposing Release at 13855-56 (emphasis added).

[56] Amendments to Beneficial Ownership Reporting Requirements, *supra* note 16.

provides a means by which the QII or (formerly) Passive Investor must file on Schedule 13D instead. On the other hand, the Proposing Release argues that the intended flexibility for certain categories of investors should be curtailed for *all* persons in those categories because *some* persons (formerly) in those categories *might* one day seek to exert a controlling influence—notwithstanding that there is already a specific rule that addresses this very situation.

The Proposing Release also cites, as a justification for accelerating the reporting deadlines for QIIs, the example of a person who "*improperly* relied upon Rule 13d-1(b) to defer reporting its beneficial ownership."[57] But that example is not meaningful in evaluating the appropriate framework for persons who *properly* report as QIIs. The Proposing Release goes on to note that "a QII may beneficially own in excess of 5% of a covered class for the entire year, sell down its position to 5% or below on the last day of the calendar year and bypass having to report at all under the current regulatory framework assuming that its beneficial ownership continues to be held in the ordinary course of business, without a disqualifying purpose or effect, and does not exceed 10% of a covered class."[58] This state of affairs is implied, without evidence, to be a problem,[59] which we do not believe that it is.

In other words, the Proposed Rule would impose more stringent requirements on those investors who *are* passive because of (hypothesized) behavior by investors who are *not* passive and because a very small number of investors may have mis-categorized themselves in the past. This would be an incredibly indiscriminate, disproportionate response to a problem that has historically been successfully dealt with under the current rules governing evasion of reporting of beneficial ownership.

Finally, the statement that QIIs "already have well-established compliance systems in place to monitor Schedule 13G ownership levels"[60] is, at best, misleading in context. As the Proposing Release goes on to note, "compliance operations at QIIs currently need to monitor beneficial ownership levels at least on a *monthly* basis."[61] But that is not what the Proposed Rule would require: it would require such monitoring on at least a *daily* basis. And that daily

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57 Proposing Release at 13856 n. 59.

58 *Id.*

59 By use of the phrases "avoid beneficial ownership reporting" and "bypass having to report," the Proposing Release—while carefully noting that the related conduct complies with current rules—may be read to imply that QIIs and Passive Investors may take steps to manage their beneficial ownership numbers so as to (permissibly) conceal information that would otherwise be made public. Regardless of whether that implication was intended, the possibility that QIIs and Passive Investors would act in this manner—again posed by the Proposing Release hypothetically without evidence—is, in our experience, extremely unlikely. Any such intentional conduct would appear to be inconsistent with the ordinary course of business certification made by QIIs and Passive Investors.

60 *Id*.

61 *Id*. at 13886.

monitoring would, for the first time, require daily calculations of deltas to produce delta-adjusted beneficial ownership numbers for certain instruments.

Some QIIs might be able to adapt to that change with relatively little disruption or incurrence of new costs. However, the creation, implementation and testing of a daily reporting system and delta-adjustment will be significant for at least some QIIs and Passive Investors. By effecting a significant change to a regulatory monitoring requirement that has been in place for many years—and making the requirement itself much more onerous—the Proposed Rule would undoubtedly impose meaningful costs on QIIs and Passive Investors. And these costs have not been adequately addressed by the Commission's costs and benefits analysis. (In particular, if the Commission ultimately determines to adopt some acceleration to the current Schedule 13G reporting deadlines, the Commission should give more serious thought to the merits of aligning the Schedule 13G filing dates for QIIs to the quarterly cycle for Form 13F filings by institutional investment managers, which the Proposing Release mentions as a possibility but dismisses without meaningful consideration.)[62]

IV. The Need for a Re-Proposal and a Significant Transition Period for Any Final Rule

The Proposed Rule should be revised and re-proposed for notice and comment together with a revised and re-proposed version of the Commission's proposal on reporting of security-based swap positions.

As this letter has outlined, the Proposed Rule would make numerous foundational changes to Regulation 13D-G. The Proposed Rule would, among other things, dramatically expand the existing, well-understood and widely relied-upon definition of "beneficial ownership" by including certain cash-settled derivatives and by broadening the concept of a "group"; require accelerated filings by persons who are, by definition, passive holders; and particularly for dealers and other institutions, require expansions and upgrades of reporting and monitoring systems without clear justification or a reasonable transition period.

We must respectfully note that, for the reasons described above, the stated rationales for these proposed changes are, on the whole, exceedingly speculative. The Proposing Release also ignores, minimizes or draws unwarranted conclusions with respect to existing provisions of current Regulation 13D-G that can be used to solve the purported problems that the Proposing Release identifies.

Yet the changes in the Proposed Rule would have a significant and, presumably, unintended adverse effect on markets by creating new risks and burdens for dealers and other intermediaries as well as for end-investors. The Proposing Release fails to take into account many of these important costs. The Proposing Release declares, without support, that "compliance costs to QIIs" in connection with shortened Schedule 13G deadlines—including newly required daily monitoring systems—"should be minor." Similarly, "compliance costs"

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62 *Id.* at 13890.

arising from the change in the definition of beneficial ownership are assumed to be "small." Apart from predicting a modest increase in the number of Schedule 13D/G and Form 3/4/5 filings, the Proposing Release simply says that the Commission is "unable to quantify" the costs of expanding the definition of beneficial ownership or expanding the group concept. Those costs that are identified—such as "loss in revenue" for derivatives dealers—are only first-order costs; there is little or no mention of market changes, such as potentially decreased liquidity, that could result from the Proposed Rule's creating such greatly magnified risks for ordinary-course securities transactions. Most crucially, for firms to be subject to greater risk of, but have less certainty about, potentially becoming subject to Section 16 is undoubtedly an enormous cost, yet one that the Proposing Release does not attempt to address in any thoughtful manner. We acknowledge that this cost is not simple or easy to estimate, but a proposal as sweeping as the Proposed Rule must make a more considered effort to do so.

Finally, the Section 13(d) definition of beneficial ownership currently used in Regulation 13D-G is used in many different instruments and contexts, some of which do not relate to direct participation in equities markets. That definition is used, for example, in anti-takeover measures such as shareholder rights plans ("poison pills") and fair price provisions. It is also used in shareholder-approved equity compensation plans, employment contracts, credit facilities and debt instruments (so-called "poison put" provisions). Many of the relevant provisions in these agreements simply to refer to the definition of beneficial ownership as defined by Section 13(d), either without an express reference to the definition as of a particular date, or with a note such as "as amended from time to time."

The Proposed Rule's changes to the definition of beneficial ownership could cause unintended changes in the meaning and operation of these agreements. Analyzing and evaluating those changes, negotiating revisions to contracts and other related activities will be costly and potentially disruptive. Notwithstanding that the users of these agreements collectively represent an important constituency on whom the Proposed Rule would impose significant costs, they are not identified as an "affected party" or "relevant market participants" in the Proposing Release.

By focusing on speculative harms; failing to engage seriously with the question whether new or different rules would be needed to combat them; and failing to consider costs, the Proposed Rule falls far short of providing a sound justification for the significant proposals being made. For these reasons, the Commission has not satisfied its obligations under Sections 3(f) and 23(a)(2) of the Exchange Act, and the Proposed Rule would require re-proposal even if it were the only outstanding rule proposal.

Of course, the Proposed Rule is far from the only outstanding proposal. Yet the Proposed Rule would make many interdependent changes to important areas of the law, at once, in a compressed timeframe—in terms of both the limited comment period and the absence of a contemplated transition period for any rule ultimately adopted—on the basis of little substantial analysis of costs and benefits, and at a time when critically related proposals are also

outstanding, with little clarity about their ultimate direction and resolution. These factors make the need for re-proposal only more acute.[63]

Most notably, the Commission's proposal on position reporting of security-based swaps (the "*10B Proposal*") has recently been outstanding for notice and comment.[64] The 10B Proposal is particularly relevant to consideration of this Proposed Rule, which makes it impossible to evaluate the proposals in isolation from each other. We support the Commission's determination not to treat security-based swaps as giving rise to beneficial ownership for purposes of Regulation 13D-G. Nonetheless, the adoption and implementation of these related regulations will clearly require care and coordination. As set forth in the 10B Proposal, new SEC Schedule 10B would have different filing triggers and thresholds and report a different set of information than Schedules 13D/G do. Proposed Schedule 10B and proposed Schedules 13D/G would, however, include some of the same information. To the extent that the mix of publicly available information is relevant to commenting on the Proposed Rule, that mix depends on the outcome of the 10B Proposal, and vice versa. Logically, the quality of the information made public would also benefit from ensuring that the two proposals are appropriately harmonized. Furthermore, within a firm, there will likely be substantial overlap in terms of personnel and resources dedicated to studying, commenting on and implementing the two proposals, including any required build-out of systems.

In consideration of all these factors, the sensible course for the Commission to follow, and one that we strongly recommend, is to consider comments on the Proposed Rule, including those set forth in this letter, and on the 10B Proposal, then re-propose both rules together, and with more robust cost analyses, for further notice and comment.

Given the potential need to implement new systems and take other steps to comply with a final rule, any amendments to Regulation 13D-G should take effect no earlier than 24 months following adoption.

If, following the re-proposal notice and comment process described above, the Commission determines to proceed with amendments to Regulation 13D-G, the amendments must also be accompanied by a reasonable phase-in period. Our members agree that if the Proposed Rule were adopted as proposed, the time and costs for developing appropriate policies, procedures, monitoring systems, documentation and other compliance elements would be substantial, much more so than the Proposing Release assumes. Because of these costs and

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63 We and 24 other trade associations have previously expressed to the Commission our concern regarding the problematic duration of short comment periods for these types of important rule changes; *See* SIFMA, *Importance of Appropriate Length of Comment Periods*, https://www.sifma.org/resources/submissions/importance-of-appropriate-length-of-comment-periods/.

64 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, 87 Fed. Reg. 6652 (Dec. 15, 2021).

operational challenges, any amendments to Regulation 13D-G that are ultimately adopted should not take effect for at least 24 months following their adoption.

Furthermore, as noted above, the Section 13(d) beneficial ownership definition is ubiquitous. As a result, issuers and others will need to perform an inventory of all instruments and agreements that refer to Section 13(d) to determine whether changes should be made and, if so, to get the necessary approvals, which could include, among others, shareholder approval, lender approval and consent solicitations with respect to outstanding debt or other instruments. This will take time—in the case of any shareholder approval, at least one full proxy season, and possibly more.

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We appreciate the opportunity to comment on the Proposed Rule. If you have any questions or comments, please contact Robert W. Reeder (212-558-3755), Joseph A. Hearn (212-558-4457) or Colin D. Lloyd (212-558-3040) in Sullivan & Cromwell's New York office, or Rita-Anne O'Neill (310-712-6698) in Sullivan & Cromwell's Los Angeles office.

Sincerely,

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CEO and President
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cc: The Hon. Gary Gensler, SEC Chair
The Hon. Hester M. Peirce, SEC Commissioner
The Hon. Allison Herren Lee, SEC Commissioner
The Hon. Caroline A. Crenshaw, SEC Commissioner