May 18, 2022

Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

Re: File No. S7-06-22; Modernization of Beneficial Ownership Reporting; Release Nos. 33-11030; 34-94211

Dear Ms. Countryman:

Alan Schwartz is the Sterling Professor of Law at Yale Law School and Professor of Management at the Yale School of Management. He writes extensively about transactions, many of which involve asymmetric information. See, for example, "Unenforceable Securitization Contracts" (with Tracy Lewis), 37 *Yale Journal on Regulation* 164 (2020) and "Pay to Play: A Theory of Hybrid Relationships" (with Tracy Lewis), 17 *American Law and Economics Review* 462 (2016).

Steven Shavell is the Samuel R. Rosenthal Professor of Law and Economics at Harvard Law School, holds a Ph.D. in economics, and is the director of the John M. Olin Center for Law, Economics, and Business at Harvard University. He is the author of an article directly related to Release Nos. 33-11030; 34-94211 (the "Proposal" or "Proposed Rules" or "Release"), concerning the modernization of beneficial ownership reporting. The article is entitled "Acquisition and Disclosure of Information Prior to Sale," 25 *RAND Journal of Economics* 20 (1994). Another article of clear relevance to the Release is A. T. Kronman, "Mistake, Disclosure, Information, and the Law of Contracts," 7 *Journal of Legal Studies* 1 (1978).

We wrote a prior Comment Letter on April 12, 2022, in response to the SEC Proposal to shorten the period an investor has to file a Schedule 13D after the investor has accumulated a 5% (or more) stake in a public company. We write again now (1) to amplify the logic of our earlier Comment in various respects; (2) to observe that none of the Comments supporting the SEC Proposal that we have read addresses the issue of chief concern to us concerning the incentive of buyers to acquire information relating to mismanagement of corporations; and (3) to point out that the SEC Proposal is out of step with contract law in the United States because our contract law generally refrains from imposing disclosure obligations on *buyers* of property (in contrast to the obligations that our contract law imposes on sellers).

An investor must file a Schedule13D when the investor has accumulated a stake of 5% in a company. Today, the investor has ten days after accumulating its 5% stake in which to file—the accumulation period for the investor to make purchases without the market's awareness. The Proposal would shorten the post-5% accumulation period to five days.

The SEC offers two related justifications for this change.[1] Regarding the first, the proposed filing will inform the public five days earlier that the investor has taken a material stake in a target company. The market will then incorporate this information into the company's share price five days earlier. As the SEC puts it, earlier public disclosure would incorporate potential "market moving information" into share prices more rapidly, thereby improving the ability of investors to make decisions. Regarding the second justification, during the accumulation period activist investors know their plans for target companies but the market does not. Thus, asymmetric information exists between an activist and any seller of the target company's shares. This often implies that a seller would not trade at the present price of the shares but rather would trade only at a higher price if the seller were aware of what the activist knew and its plans. Hence, under the SEC view, the more shares the activist can purchase at the uninformed market price of the target's shares, the greater the unfairness to sellers of the target's shares.

Notwithstanding the foregoing considerations favoring the SEC Proposal, the SEC recognizes that shortening the accumulation period would reduce the gains to activist investors and so reduce activism itself. This the SEC agrees is a cost, because activism can produce beneficial change. However, the SEC believes that the gain from its Proposal in inducing earlier changes in the price of target companies' shares and in reducing unfairness to certain sellers of the companies' shares outweighs the cost. Accordingly, the SEC comes to the conclusion that reducing the accumulation period to five days is desirable on balance.

This Comment rests on three basic principles: (1) the market cannot impound new information into a price if that information has not been developed; (2) it is costly to acquire new information; and (3) in a securities market, a party that invests in the acquisition of information often relies on recovering its costs by trading on discovered favorable information *when that information has not been disclosed to the market*. These three principles have a clear implication: requiring an agent to disclose its information *before the agent trades* will decrease the agent's return from acquiring information. As a result, the agent's incentive to acquire information in the first place will be reduced. The basic flaw in the SEC's reasoning thus is that although the SEC requires an activist buyer to disclose information that the buyer *has acquired*, the SEC fails to ask whether the buyer *would acquire* the information initially. In reality, the buyer would often be unlikely to make the original investment in information.

Consider an example. Suppose potential buyer B contemplates spending $5 million to determine whether target company T is worth acquiring because T *might* be inefficiently managed. B would lay out the $5 million to investigate T only if B can be reasonably confident that it could make a decent profit from acquiring T's securities if T is in fact mismanaged. Note that B's spending $5 million on research about T is a risky investment, for B might be disappointed to learn that T is *not* inefficiently managed; and even if T *is* inefficiently managed, B might not succeed in purchasing sufficient shares of T to control or exert influence on its management (or persuade others to do so). In either case, B's $5 million would be wasted. So B would want a real payoff coming its way if its investigation uncovered mismanagement of T. But if the SEC now imposes a five-day requirement that speeds B's disclosure of its plans to the market, B will have to pay more to purchase T's shares and B's profits will be reduced. That is,

[1] The Appendix to this Letter quotes the relevant sections of the SEC's report.

other buyers will learn what is transpiring five days earlier and buy T's shares before B has a chance to acquire more of it at its present price.

Hence, under the SEC Proposal, the world could change in a way that the SEC apparently does not contemplate. Buyers like B would not be as willing to spend $5 million in the hope of profiting from acquiring shares of T. The result could be that B would not investigate T in the first place. That would mean that if T isn't well managed, the economic inefficiency in T's present performance would never be corrected by B.

We add the following observations. Suppose that the current SEC ten-day requirement is maintained and suppose that B's disclosure after ten days elevates the price of T shares. This upward change in the price of T would indicate that the market believes T's performance would improve under B's influence. Moreover, *the non-selling T shareholders—typically a large majority—would benefit from the increase in the price of T.* In addition, *the SEC's concern for the selling shareholders is misconceived*. If the SEC shortens the accumulation period by five days, these shareholders might not benefit from an increase in the price of T —because B might not have investigated T and sought to acquire its shares. To paraphrase this point, the SEC five-day disclosure proposal might kill (or wound) the golden goose that can induce information acquisition and thus shareholder benefits.

We now turn to the SEC's second justification for shortening the accumulation period—namely, that this shortening would reduce information asymmetry between buyers and present shareholders. Under the SEC's view, the reduction in asymmetry of information would facilitate investor decision making, help to allocate capital to its most efficient uses, and prevent unfairness to investors who might have sold shares to a buyer with superior favorable information about a firm.

Although as a *general* matter reducing information asymmetry will have various salutary consequences, that conclusion hardly follows in a context in which potential buyers invest resources in identifying target companies for possible acquisition. In such a setting our point, as we have explained, is in a sense the opposite of the view that asymmetry of information between a buyer and a seller is undesirable. Our view is that *permitting buyers to make a profit from their asymmetric information is often needed to induce them to invest effort to discover firms that are mismanaged.* The development of such information is clearly *socially good* because it can correct mismanagement. Furthermore, the asymmetry of information frequently *benefits most shareholders and does not harm others* as we suggested two paragraphs above.

We have read a number of Comments submitted by others on the SEC proposal at issue here, including the following: April 11, 2022, Daniel Austin, Director, U.S. Policy and Regulation, Alternative Investment Management Association; April 11, 2022, Maria Ghazal, Senior Vice President and Counsel, Business Roundtable; April 11, 2022, National Venture Capital Association; April 11, 2022, State Street Corporation; April 11, 2022, 65 Law and Finance Professors; April 11, 2022, TIAA; April 11, 2022, Wachtell, Lipton, Rosen & Katz; April 12, 2022, Jeffrey S. Davis, Senior Vice President and Senior Deputy General Counsel, Nasdaq, Inc.; April 13, 2022, Society for Corporate Governance; and April 15, National Investor Relations Institute. Six of these Comments support the SEC Proposal to reduce the length of the

accumulation period,[2] but none of them mention the consideration that we have emphasized in our Comment. The other four of the Comments do not support the SEC Proposal and pay essentially no attention to the issue that we stress.[3]

We also note that the SEC refers to the following article in support of its view that asymmetric information is undesirable: Lawrence Glosten and Paul Milgrom, "Bid, Ask, and Transaction Prices in a Specialist Market with Heterogeneously Informed Investors," 14 *Journal of Financial Economics* 71 (1985). This article too does not address the issue of central concern to us in our Comment: ensuring that potential buyers who invest in information about possible targets for acquisition profit enough to engage in their activity. Instead, the interest of Glosten and Milgrom was different—it was with specialist middlemen traders on organized markets who help to determine bid-ask spreads. Asymmetric information exists in their model because *insiders* might purchase shares of a firm. Insiders do not need to invest to obtain information about a firm—because they are privy to it. In all, therefore, the results of the Glosten and Milgrom article bear on a different set of issues from those on which we focus.

We conclude this Comment with the observation that the SEC Proposal is in conflict with the general stance of our courts vis a vis disclosure obligations of buyers of property. It has been the law in the United States for over two hundred years that an informed buyer who seeks to purchase a parcel of land, an antique, a small business, or whatever, is under no duty to disclose what makes that party want to make a purchase. See *Laidlaw v. Organ*, 15 U.S. (2 Wheat.) 178 (1817). For a more modern application of the legal rule, see *L & N Grove, Inc. v. Chapman,* 291So.2d 217 (Fla. Dist. App. 1974).

To illustrate the economic purpose underlying the reluctance of courts to impose a duty on buyers to disclose their knowledge about property they wish to acquire, consider this example based on *Hudson v. Texas Gulf Sulphur*, 72 F.2d 251 (2nd Cir. 1938). A mining company hires geologists to explore whether certain rock formations that indicate the presence of cobalt are present in a farming area. The geologists discover promising formations, and a company representative approaches a landowner with an offer to purchase his farm at a nice premium over the going price of similar farms. The owner asks why the company wants to buy and the representative responds: "Because you have a really valuable cobalt deposit on your land, that's why." In response, the landowner obviously would demand the "cobalt price" rather than the going price for his farm. And anticipating that response, the company representative would not tell the landowner; paying the cobalt price would wipe out its gain. Hence, for the mining company to be able to profit from investigating where cobalt deposits might lie, it must not face an obligation to disclose favorable information about the location of valuable deposits.

Indeed, not only is there no general duty imposed on buyers to disclose their information to sellers for the reasons we have offered, our courts permit buyers to actively *conceal* their interests in making purchases by hiring real estate agents or other proxies to purchase property without revealing the true identity of buyers. On this point, see Daniel Kelly, "The 'Public Use'

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[2] Those of Maria Ghazal; TIAA (vis a vis 13D filing); Wachtell, Lipton, Rosen & Katz; Jeffrey S. Davis; Society for Corporate Governance; and National Investor Relations Institute.

[3] The Comment of Daniel Austin mentions the issue of acquisition of information in passing at p. 8.

Requirement in Eminent Domain Law: A Rationale Based On Secret Purchases and Private Influence," 92 *Cornell Law Review* 1, 20-24 (2006).

In sum, the long-standing rule of our law that *buyers* of property do not face obligations to disclose their purposes is consistent with the rationale that such obligations would dilute their incentives to learn about the value of property they seek to purchase. The SEC proposal to shorten the period before an investor must file a Schedule 13D is thus in tension with our law and in our view with socially rational policy.

We thank the Commission for considering our additional Comment on its Proposed Rules.

Respectfully,

Alan Schwartz

Steven Shavell

Appendix: The SEC's Justifications in the Release for Shortening the Accumulation Period

"Overall, we believe the proposed amendments would benefit investors and market participants by providing more timely information relating to significant stockholders as well as potential changes in corporate control, facilitating investor decision-making and reducing information asymmetry in the market. We also recognize that these amendments could increase costs for investors and issuers. For example, the amendments could increase costs for blockholders seeking to influence or control an issuer, and therefore potentially inhibit shareholder activism and the improvement of corporate efficiency." Release at 109.

"Overall, we believe the proposed amendments to Regulation 13D-G would benefit investors and market participants by providing more timely information relating to significant stockholders as well as potential changes in corporate control, facilitating investor decision-making, reducing information asymmetry and improving price discovery in the market." Release at 118.

"More timely disclosure of such market-moving information could improve transparency, reduce information asymmetry and mispricing in the market, and allow investors to make more informed investment decisions." Release at 119.

"Thus, by shortening the deadline for initial Schedule 13D filings, the proposed amendment could improve the timeliness of beneficial ownership reporting, benefiting investors and other market participants through improved transparency and reduced information asymmetry in the market." Release at 121

"Therefore, during any delay between a market-moving event and the Schedule 13D filing, securities are likely to be mispriced relative to a full-information benchmark, and information asymmetry between Schedule 13D filers and those with whom they share the information, and the rest of the market, is greater than otherwise. The prolonged delay could, therefore, harm the investors who happen to sell their shares during the ten-day window. As discussed in Section III.A, we are not able to quantify the potential harm to investors due to data limitations." Release at 122.

"Additionally, academic studies have shown that information asymmetry has a first-order effect on liquidity. Thus, the proposed amendment, by reducing information asymmetry, would provide incremental benefits to investors in general through the increased liquidity of the shares of the companies subject to Schedule 13D filings." Release at 123 (citing Lawrence Glosten and Paul Milgrom, "Bid, Ask, and Transaction Prices in a Specialist Market with Heterogeneously Informed Investors," 14 *Journal of Financial Economics* 71 (1985)).

"More timely reporting would facilitate price discovery in the market, reduce information asymmetry and mispricing, and therefore allow investors to make more informed investment decisions." Release at 123.

"Therefore, timely reporting of value-relevant information would facilitate price discovery and reduce information asymmetry and mispricing in the market, benefiting investors and other

market participants similar to our proposed shortening of the initial Schedule 13D filing deadline." Release at 125

"As discussed above, information related to a potential change in corporate control is material to the market, and withholding the information could lead to information asymmetry and mispricing in the market". Release at 142

"By shortening Schedule 13D and 13G filing deadlines, expanding the scope of beneficial ownership to include holders of certain cash-settled derivative securities, and, clarifying and affirming that an actual agreement is not needed for the formation of a group, the proposed amendments could help ensure that large shareholders, including groups, comply with the reporting threshold, and therefore improve disclosure regarding material information related to potential changes of corporate control. More timely and enhanced disclosure would reduce information asymmetry and mispricing in the market, thereby improving liquidity and market efficiency. More efficient prices and more liquid markets help allocate capital to its most efficient uses. By making material information available to the public sooner, and reducing the differential access to information, the proposed amendments could increase public trust in markets, thereby aiding in capital formation. Finally, we believe that the proposed amendments could promote competition in that those who delay reporting would not have an advantage over similarly situated shareholders who report earlier. Furthermore, lowering information asymmetry could also increase competition among market participants. For example, if blockholders selectively reveal information, this gives some market participants advantages over others. On the other hand, we recognize that some aspect of the proposed amendments could increase the costs of accumulating large blocks of shares. If some investors choose not to trade when they otherwise might have, capital formation, and therefore market efficiency, could be harmed. However, this cost would be offset by increased liquidity that arises from reducing information asymmetry." Release at 150.