CIRCA
COUNCIL FOR INVESTOR RIGHTS AND CORPORATE ACCOUNTABILITY

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

March 21, 2022

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

Re: Prohibition Against Fraud, Manipulation, or Deception in Connection with Security-Based Swaps; Prohibition against Undue Influence over Chief Compliance Officers; Position Reporting of Large Security-Based Swap Positions - File No. S7-32-10

Dear Ms. Countryman:

We are a consortium of investors known as the Council for Investor Rights and Corporate Accountability ("**CIRCA**") who believe that a well-functioning system of checks and balances among management teams and boards of directors, on the one hand, and shareholders, on the other hand, is fundamental to the long-term competitiveness, economic growth and prosperity of the U.S. capital markets and the U.S. economy generally. A core principle underlying the U.S. system is that shareholders who invest the time and resources necessary to hold managers or directors accountable for underperformance, and succeed in enhancing value for all shareholders, should be allowed to profit from their activities. These incentives are consistent with basic principles of capitalism and free enterprise, on which our markets depend.

The proposed adoption by the Securities and Exchange Commission (the "**SEC**") of rule 10B-1 (the "**Proposed Rule**"),[1] under the Securities Exchange Act of 1934, as amended (the "**Exchange Act**"), would significantly reduce the incentives for an investor to expend the necessary resources to engage in a campaign to effect corporate change. The harmful effects of the Proposed Rule on shareholder activism are magnified by the unlevel playing field already faced by shareholders; shareholders are disadvantaged in their efforts to bring about change because management and directors of public companies can use the corporation's own resources to resist shareholder actions, while shareholders, who are the owners of the companies, are forced to pay proxy or other expenses out of their own pockets. The only economically rational basis for a shareholder to seek to influence corporate management and boards (given the unlevel playing field they face) is the opportunity to benefit from the increase in the corporation's value if a campaign is successful (an outcome that is by no means assured). The Proposed Rule would alter the risk/reward equation

[1] *See* Prohibition Against Fraud, Manipulation, or Deception in Connection with Security-Based Swaps; Prohibition against Undue Influence over Chief Compliance Officers; Position Reporting of Large Security-Based Swap Positions, SEC Rel. No. 34-93784 (Dec. 15, 2021) [87 FR 6652 (Feb. 4, 2022)] (the "**Proposing Rule Release**"). The Proposing Rule Release proposed three rules, in total, including proposed rule 10B-1. We are not commenting on re-proposed Exchange Act rule 9j-1 or Exchange Act rule 15Fh-4.

for shareholders seeking to influence the management and policies of operating companies ("**activist investors**") by requiring premature disclosure of an investor's strategy, thereby causing a run up in the stock price of a target company at a much earlier stage, thus, reducing the investor's ability to profit from its own ideas and capital outlay. In so doing, the Proposed Rule will reduce shareholder engagement and diminish or destroy market-based accountability mechanisms that act as a check on underperforming, non-responsive or unscrupulous management and boards of directors.

The Proposed Rule introduces inconsistent reporting requirements into an area that is already subject to extensive regulation, including reporting requirements under Sections 13(d), (g) and (f) of the Exchange Act and related rules (the "**Section 13 Rules**") and the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (the "**HSR Act**"). The basic triggers and thresholds for reporting and the time periods within which disclosures must be made under the Proposed Rule are substantially different from (and more draconian than) those referenced under the Section 13 Rules (which are themselves subject to proposed rulemaking).[2] The Proposed Rule also fails to take into account the interplay between public reporting required by that rule and the HSR Act. Given the relatively low reporting threshold of the HSR Act, activist investors have routinely relied on the ability to acquire security-based swaps ("**SBS**") to accumulate their target positions prior to having to make an HSR Act filing and provide the related disclosure to the target company.

This change in approach is likely to lead to confusion in the marketplace, thereby driving up costs for investors. The early disclosure also tips the hand of investors, providing management and boards of directors with strategic advantages to insulate themselves from an activist campaign. Taken together, these changes will negatively impact the current incentives for activist investors to allocate the time and resources necessary to pursue a campaign seeking to cause management and directors to focus on the best interests of shareholders.

The Proposing Rule Release sets forth three core reasons for the adoption of the Proposed Rule, none of which provides a compelling basis for adoption. First, the Proposed Rule is intended to address a perceived concern regarding "net-short debt activism." Second, the Proposed Rule indicates a regulatory desire to provide additional transparency around SBS to protect multiple SBS dealers from unknowingly having exposure to the same counterparty and to provide information about market holdings in SBS to allow the SEC to oversee the market more efficiently. Third, the Proposed Rule indicates that there is an inherent unfairness, referred to as "information

[2] We note that recent proposed changes to certain rules of the SEC promulgated pursuant to Section 13 of the Exchange Act (the "**Proposed 13D/G Amendments**"), on which we intend to comment separately, would exacerbate the impact of the Proposed Rule. *See* Modernization of Beneficial Ownership Reporting, SEC Rel. Nos. 33-11030, 34-94211 (Feb. 10, 2022). Among the proposed changes, we believe that the proposal under the Proposed 13D/G Amendments to treat activist counterparties to cash-settled derivatives as beneficial owners of the referenced securities when they have a "control" intent, to broaden the situations under which some investors could be deemed to be acting as part of a "group" and to shorten the reporting period for an initial Schedule 13D filing would be damaging to activist shareholders and disincentives activism generally.

asymmetry," in not allowing retail investors to be able to see the investment strategies of other investors when structuring their investments through SBS. The SEC indicates that knowledge about the existence of SBS positions is necessary for market participants to price their investment positions appropriately relating to the referenced securities.[3]

We respectfully submit that the basic justifications for the adoption of Rule 10B-1 as it relates to activist equity investing, which often relies to a significant extent on SBS, are misplaced. "Net-short debt activism" has no application in traditional activist equity investing, which is focused on active engagement with management teams and boards of directors to *increase* the long-term value of the enterprise on behalf of all shareholders. With respect to the need for additional transparency by swap dealers and regulators, such transparency can readily be accomplished by requiring SBS counterparties to disclose their outstanding SBS positions to their dealers and, if ultimately determined to be necessary, to report their SBS positions confidentially to the SEC, as the Commodity Futures Trading Commission (the "**CFTC**") requires for swaps.[4] In addition, the SBS market is already subject to transaction reporting under Regulation SBSR. Finally, contrary to the SEC's assertions, information asymmetries are not inherently unfair or inefficient; we respectfully submit the exact opposite is true – asymmetries exist because investors are rewarded for their research, capital outlays and efforts, which in the case of shareholder activism, ultimately benefits all shareholders and the marketplace more generally.

Contrary to its obligations under the Administrative Procedures Act, the SEC's economic analysis for the Proposed Rule fails to consider the impact of public reporting on activist investors and the ultimate costs to our capital markets in disincentivizing activism. It also fails to evaluate whether there are less damaging approaches available to the SEC to address the concerns underlying the Proposed Rule, which we believe there are.

For the reasons outlined above and further described below, we respectfully submit that the Proposed Rule should not be adopted.

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[3] *See, e.g.*, Proposing Rule Release at 117 [87 FR at 6681] (". . . CDS sellers would likely prefer not to transact with such CDS buyers or could have trouble pricing this risk, to the extent they are unaware of which counterparty is such an empty creditor. Additional information for market participants in the form of reporting, however, may also alleviate part of this information asymmetry by making it easier for CDS sellers to identify such counterparties, thus mitigating the potential for moral hazard." (footnote omitted)). Although most of the discussion in the Proposing Rule Release regarding information asymmetry relates to CDS, the section discussing equity total return swaps, of the type used by activist investors, also references information asymmetry as a "problem" and suggests that the reason it should be rectified is to improve liquidity and pricing. *Id.* at 140 n.234 [87 FR 6688] and 150 [87 FR 6691].

[4] *See* CFTC Regulation 20.4 (the "**CFTC Large Trader Reporting Rule**").

The Proposed Rule would damage the U.S. corporate governance system and, ultimately, harm the investing public by:

- **Reducing key incentives to investors to engage in shareholder activism, thereby removing checks and balances in the corporate governance system to the disadvantage of all shareholders;**

- **Reducing the value of the intellectual property of activist investors by limiting or eliminating the profits to be generated from their own ideas and capital outlays, which will inevitably lead to diminished management accountability to act in the best interest of shareholders**

- **Providing strategic advantages to corporate managers and directors to help insulate themselves from shareholder challenges; and**

- **Creating an inconsistent, disclosure regime relative to the Section 13 Rules, which may result in confusion among market participants thereby leading to inefficiencies and increased costs.**

The Proposed Rule establishes a precedent that is contrary to the SEC's stated public policy goals by:

- **Undermining the SEC's efforts to encourage private industry to lead efforts to improve society and the world, which includes an emphasis on good corporate governance;**

- **Taking a dramatically different approach to position reporting than the CFTC has for swaps, contrary to the direction of Congress, and prior to considering whether the SBS transaction reporting regime, which is already in place, is sufficient to address apparent regulatory concerns;** [5]

- **Failing to take into account the interplay between the reporting required by the Proposed Rule and other regulatory regimes, such as the HSR Act, and the practical issues this will create for investors;**

- **Contradicting the SEC's own rules relating to protection of trade secrets; and**

- **Requiring SBS counterparties to disclose proprietary financial and investment information to the public, which is contrary to Schedule 13F's requirements and established credit-related disclosure.**

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[5] *See* CFTC Large Trader Reporting Rule.

The cost benefit analysis underlying the Proposed Rule fails to:

- **Evaluate the chilling effect that the Proposed Rule will have on activist investors and the harmful collateral effects that a reduction of such corporate activism will have on retail investors and other stakeholders, and explain why, on balance, curing the alleged information asymmetries is more beneficial to shareholders than allowing activist investors to hold underperforming management and directors accountable; and**

- **Evaluate less costly alternative measures than those in the Proposed Rule.**

<u>Discussion</u>

A. The Proposed Rule would damage the U.S. corporate governance system and, ultimately, harm the investing public.

1. The Proposed Rule reduces key incentives to investors to engage in shareholder activism, thereby removing checks and balances in the corporate governance system to the disadvantage of all shareholders.

Activist investors play a critical role in overseeing and scrutinizing corporate conduct. Their activities take many forms, ranging from campaigning for corporate commitment to issues that are significant to shareholders, such as mitigating climate change, to identifying undervalued businesses, to preventing waste of corporate assets by managers seeking to "empire-build" or otherwise act in their self-interest rather than to benefit corporate shareholders.[6] Although boards of directors of public companies are responsible for overseeing corporate managers and removing them when they engage in activities that are not in the best interest of shareholders, academic studies have found that the oversight functions performed by directors are enhanced by the presence of activist investors who are willing to undertake public campaigns and proxy contests to ensure director and management accountability.[7]

Mutual funds, other traditional managers, and other institutional investors that own a significant portion of the equity of many public companies have typically been unable, as a result of regulatory

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[6] Yaron Nill, *Missing the Forest for the Trees: A New Approach to Shareholder Activism*, 4 HARV. BUS. L. REV. 157, 162 (2014) ("**New Approach to Shareholder Activism**").

[7] *See e.g.*, Alon Bray, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1730 (2008) ("**Hedge Fund Activism**") (finding that hedge funds are effective activist investors by exerting pressure on the management of public firms to make shareholder value a priority and generate value for shareholders).

restrictions,[8] or unwilling, as a result of relationship or conflict concerns[9] or economic incentives,[10] to engage in activist campaigns, which are typically expensive to run. One of the few types of institutional investors willing and able to make the substantial outlay of capital and resources necessary to conduct such activist investor campaigns has been private funds and, in particular, hedge funds.[11] Hedge funds are generally not as constrained in the amount of equity they can purchase in a single issuer, and the funds use incentive-based fee structures that reward them when their engagement results in share price appreciation.[12]

The presence of private fund activist investors has enabled activism to grow and encouraged traditional managers to support such efforts when aligned with the interests of their clients.[13] In addition, these activist investors have generated substantial value for target firm shareholders, who benefit when the activist investor is successful in improving corporate performance.[14] As noted by a group of academics, "[h]edge funds with a track record of successful corporate activism generate higher returns . . . ."[15] For example, based on analyses by academics of hedge fund activism, shareholder payouts increased following corporate activist campaigns by 0.3 to 0.5

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8 New Approach to Shareholder Activism at 162. *See also* Hedge Fund Activism at 2 ("Unlike mutual funds and pension funds, hedge funds are able to influence corporate boards and managements due to key differences arising from their different organizational form and the incentives they face. Hedge funds employ highly incentivized managers who manage large unregulated pools of capital. Because they are not subject to regulation that governs mutual funds and pension funds, they can hold highly concentrated positions in small numbers of companies, and use leverage and derivatives to extend their reach."); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1048 (2007) ("**Hedge Funds in Corporate Governance**") (discussing that mutual funds suffer from multiple disadvantages that impede their ability to act as effective monitors of corporate governance, including regulatory constraints, inadequate incentives, and conflicts of interest).

9 Hedge Funds in Corporate Governance at 1054-62 (2007) (discussing that mutual funds suffer from conflicts of interest between fund managers and fund beneficiaries and are affiliated with other financial institutions (such as investment banks) and as such may be reluctant to antagonize present or future clients of their parent company with activist activities, and public pension funds are subject to political constraints and conflicts of interest potentially due to, among other reasons, a board of trustees consisting of gubernatorial appointees, elected politicians who serve *ex officio*, and officials elected by fund beneficiaries).

10 The large number of index funds have little incentive to improve the performance of the index; rather their incentive is to replicate the performance of the index at the lowest cost possible. Resources spent on shareholder activism only make an index fund less competitive with its more passive peers.

11 New Approach to Shareholder Activism at 167.

12 *Id.*

13 *Id.* ("The presence of these [private fund] players has enabled activism to transform from a limited occurrence to a reality that dominates both corporate governance scholarly debates and the business arena. The increasing involvement of these new institutions and the emergence of proxy advisory firms have also stimulated the activism conducted by traditional institutions, leading to an increase in the number of shareholders willing to take an active role in the governance of the corporation.").

14 Hedge Fund Activism at 5.

15 *Id.* at 3.

percentage points (measured as a percentage of the market value of equity) and book value leverage also increased. The studies also found improvement in return on assets and operating profit margins following corporate activist campaigns.[16] Other benefits resulting from the campaigns include: rationalization of executive compensation,[17] preservation of jobs, increases in pay to employees, strengthening of creditworthiness[18] and increased focus by corporations on important long-term planning issues, including significant environmental, social and governance ("**ESG**") issues such as how companies will address climate change.[19] Anecdotally, recognition of the presence of activist investors has also promoted corporate management to engage more frequently with their shareholder base, promoted salutary behavior and provided a check on management.

Empirical research shows that activist investor campaigns do not lead to many of the downsides predicted by critics of shareholder activism. In particular, there is no evidence that corporate activist interventions generate short-term gains that come at the expense of subsequent long-term declines in operating performance of target companies. It is well documented that the market's initial reaction to the announcement of an activist investor's intervention is viewed as "good news" that results in short-term gains in the stock price in light of the market's general view that activism provides benefits to, rather than imposes costs on, the target companies.[20] These short-term gains do not unravel overtime; corporate activist campaigns tend to lead to both short-term gains *and* sustained, long-term improvements in the operating performance of target companies.[21]

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16 *Id.*

17 Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 713 (2013) ("**Bebchuk UVA Article**") (noting evidence that executives who are insulated from removal consume higher amounts of corporate benefits, including compensation).

18 Hedge Fund Activism at 4 ("Since shareholders are by no means the only party affected by hedge fund activism we also ask whether other stakeholders are impacted. In particular, we consider the possibility that the positive stock market reaction to activism might reflect wealth redistribution from creditors and executives. We find that hedge fund activism does not shift value from creditors to shareholders.").

19 *See* Chris Ruggeri, *Investor Engagement and Activist Shareholder Strategies* (Feb. 19, 2019), HARV. L. SCH. F. ON CORP. GOVERNANCE, https://corpgov.law harvard.edu/2019/02/19/investor-engagement-and-activist-shareholder-strategies/ (discussing that shareholder activism may sharpen the focus on corporate issues and result in strong shareholder engagement that enables corporate management to, among other things, understand shareholders and their goals and communicate short- and long-term strategies effectively); James E. Langston, *Shareholder Activism in 2020: New Risks and Opportunities for Boards* (January 24, 2020), HARV. L. SCH. F. ON CORP. GOVERNANCE, https://corpgov.law.harvard.edu/2020/01/24/shareholder-activism-in-2020-new-risks-and-opportunities-for-boards/ (discussing that shareholders are "borrowing tactics from the shareholder activist playbook" to advance ESG reforms).

20 Lucian A. Bebchuk, Alon Bray & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L.J. 1085, 1122 (2015) (noting that this has been determined by looking at returns of target companies both before and after the announcement of an activist campaign, showing that the average abnormal returns observed during the 20-day period before and after an investor files a Schedule 13D are approximately 6%).

21 *Id.*

The Proposed Rule would require an activist investor to disclose its strategy and ownership position publicly, potentially at a very early stage of its investment program, *i.e.*, when SBS positions reach notional levels of $300 million or even lower when the investor also holds other instruments. These disclosure thresholds have no correlation to the size of the SBS position relative to the outstanding shares of capital stock of the issuer, and the Proposed Rule may therefore mandate public disclosure of an activist investor's confidential investment information when such disclosure would not be required under the Section 13 Rules or otherwise serve to further the interest of the market. For example, in the case of a large capitalization company, such as Apple, the $300 million threshold represents 0.01% or one-one hundredth of one percent of Apple's total market capitalization. Even if a smaller market capitalization large cap issuer were a target – such as General Mills, which has a market capitalization of approximately $38 billion – a $300 million threshold would represent only 0.8%, or less than 1% of the issuer's total capitalization. The same would be the case for substantially every issuer with a market capitalization of more than $6 billion.

The impact of the Proposed Rule is not limited to large capitalization issuers. The Proposed Rule further requires disclosure of all SBS positions, including SBS that are solely cash settled, where the SBS references stock equal to more than 5% of a class of equity securities or potentially as little as 2.5% of a class of equity securities if the investor's other interests in the issuer, when aggregated with the SBS position, represents more than 5% of a class of equity securities. Activist investors have long relied on the ability to accumulate a solely economic position in a target company through the use of cash-settled SBS without the requirement to make public disclosure, let alone immediate public disclosure. This solely economic stake does not provide the activist investor with any voting or investment power with respect to the underlying securities. The disclosure of cash-settled derivatives is also the subject of the Proposed 13D/G Amendments, and will receive significant comment and response from market participants, including from CIRCA. However, the adoption of the Proposed Rule as to cash-settled SBS will make the debate regarding the definition of beneficial ownership moot for purposes of activists investors, because it would compel public disclosure by activist investors of their investments far earlier than disclosure would otherwise be required by the Section 13 Rules. This compelled premature disclosure is likely to come at a point in time when the activist investor has not yet been able to accumulate a meaningful enough position in the target company to make the expenditure of its time and resources for an activist campaign worthwhile.

The Proposed Rule does not factor in the interplay between the public reporting requirements under the Rule and the HSR Act, which is often crucial in the context of an activist campaign. Under the HSR Act, an activist investor cannot purchase "voting securities" of a target company, such as common stock, with a value of more than $101 million without filing for and receiving approval under the HSR Act. Upon making an HSR Act filing, the activist investor is required to inform the target company thereof, which may lead to broader public disclosure. Activist investors have long used SBS to solve this potentially crippling problem; SBS are not deemed "voting securities" for purposes of the HSR Act, and therefore their acquisition may be completed without the need for an HSR Act filing or the related premature disclosure to target companies. The

Proposed Rule would change all of this by compelling next business day public disclosure, thereby resulting in the activist investor being unable to accumulate the desired stake prior to the likely run up in the stock price of the target company when the disclosure is made, while also providing the target company with a significant tactical advantage to defend against the campaign. The net effect of the foregoing may result in the activist investor not pursuing an opportunity that could have delivered significant tangible benefits to investors and other stakeholders.

We respectfully submit that public reporting of SBS positions that are not significant relative to the market capitalization of a target company or that represent solely economic transactions between counterparties does not provide meaningful information about concentrated holdings of investors. Because the filings would be required to identify the counterparty – which would be recognizable as an activist investor – publication of this information simply serves to provide entrenched management of a target an opportunity to begin planning its defense to a proxy campaign and to run up the price of the target's stock. Together, these collateral effects reduce the likelihood that an ensuing campaign to pressure the company board will succeed, or even take place in the first instance.

2. **The Proposed Rule reduces the value of the intellectual property of activist investors by limiting or eliminating the profits to be generated from their own ideas and capital outlays, which will inevitably lead to diminished management accountability to act in the best interest of shareholders.**

Activist hedge funds and other activist investors invest substantial time and resources to identify companies that would be attractive targets for strategic engagement. As fiduciaries, fund managers are required to invest capital taking into account the anticipated costs, risks, and return on investments.

As discussed above, premature public disclosure of an activist investor's investment idea, while the corporate activist is in the process of building out that investment idea, increases the risks associated with the investment – namely, that management will engage in tactics designed to defeat the activist investor and the market participants will seek to profit off the activist investor's research by acquiring stock of the target company.

Notwithstanding the foundational role that shareholder activism plays in corporate governance in the United States and the fact that the success of shareholder activism depends heavily on the intellectual know-how of the activist investors, the Proposed Rule would require activist investors to provide a comprehensive road map to all of their positions in a target company's securities to the general public and to the entrenched managers of the target on a near real time basis. Moreover, the Proposed Ruled requires public disclosure potentially at significantly lower ownership levels than have applied under the Section 13 Rules. By doing so, the Proposed Rule misappropriates the activist investor's ideas and makes it likely that the activist investor (and its own shareholders) will see decreased profits from their own intellectual property as other market participants would capture of the value of activist's intellectual property by copying the long positions reflected in

the SBS, profiting from those trades while driving up the price of the target company's stock. Effectively, if the Proposed Rule were adopted as proposed, the SEC would be requiring a portfolio manager to disclose its investment strategy publicly, even though such disclosure is not required by the Section 13 Rules, so that the general public can profit from the strategy and front-run the architect of the strategy. Such misappropriation directly contradicts the bedrock principal in the U.S. Constitution that inventors should have exclusive rights for specified lengths of time over their own inventions in order to promote innovation and allow them to profit from their own efforts.[22]

The SEC has long recognized the material and adverse impact that disclosure of an ongoing investment strategy may have on institutional investors. For example, in the context of quarterly Schedule 13F filings and excepted redactions, the SEC has indicated that it "believes that generally it is in the public interest to grant confidential treatment to an ongoing investment strategy of an investment manager. Disclosure of such strategy would impede competition and could cause increased volatility in the market place." In light of the acknowledged adverse impact that public reporting of confidential investment positions may have on investors, we respectfully request that the SEC take a similar approach to SBS position reporting and limit reporting to the present requirements of the Section 13 Rules rather than seeking to implement an alternative regime having substantially different reporting requirements.

3. The Proposed Rule provides strategic advantages to corporate managers to defeat activist investors and directors to help insulate themselves from shareholder challenges.

Premature disclosure of an activist investor campaign affords the target company significant practical and strategic advantages. Because managers have access to corporate assets to defend against activist investor campaigns, they typically have superior resources to those available to activist investors.[23] As a result, activist investors depend heavily on strategy to exert the pressure they seek to bring on directors to police unscrupulous, entrenched and/or underperforming managers.

By requiring an activist investor to disclose all of its portfolio holdings in or referencing a target company's securities – both cash-settled and physical – the Proposed Rule provides a significant advantage to corporate managers in defeating activist investors, fundamentally disrupting the balance between shareholders and company management.

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22 Article I, Section 8, Clause 8 of the United States Constitution grants Congress powers to "promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries." This is known as the "Patent and Copyright Clause."

23 *See* Bebchuk UVA Article at 690-91 (discussing impediments to electoral challenges, including incumbents' "easy access to the company's coffers," which serves to further increase costs to activists to counter incumbents' campaigning); Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 850 (2005) (discussing the disadvantage to shareholders to affect corporate decision-making relative to company management due to, among other reasons, management's ability to divert corporate resources and reject beneficial acquisition offers to maintain management independence and private benefits of control).

As described above, the Proposed Rule is substantially more draconian than the current requirements of the Section 13 Rules. First, the threshold levels for disclosure for the Proposed Rule may be significantly lower than those for Schedule 13D, as discussed above. Even the highest threshold level of $300 million, which only applies if the reporting person does not also own any voting securities, represents substantially less than the value of 5% of the voting securities of a public company in many cases. Lower threshold levels under the Proposed Rule could trigger reporting if an activist investor entered into SBS with a notional value of more than $150 million and also held voting securities of the target, options and/or other cash-settled derivatives the total value of which exceeded $300 million. The Proposed Rule would also require the reporting of cash-settled SBS that exceed 5% of the class of equity securities of the target company, irrespective of the fact that this position may not be reportable under the Section 13 Rules and that the dollar value of the position may not be significant in the absolute sense or sufficient to warrant an activist investor's pursuit of value enhancing initiatives given the negative impact that the premature disclosure will have on its ability to build its stake or implement its strategy as to the target company.

We also note that, under current law, the HSR Act generally prohibits an activist investor from acquiring voting securities with a value in excess of $101 million without making a filing with the appropriate governmental agency, notifying the target company of the making of such filing, and waiting a period of at least 30 days before it can continue to acquire additional voting securities of the issuer. In many cases, this notification threshold is well below the minimum position size that an activist investor needs to acquire to make the investment of its time, resources and capital worthwhile. The HSR Act, however, is focused solely on the acquisition of voting securities and therefore activist investors have long used SBS, typically cash-settled SBS, to accumulate their desired sufficient economic position without the need to make an HSR Act filing. The Proposed Rule would make this long-standing approach irrelevant, as it would compel public disclosure of the SBS position thereby tipping management and the board of directors of the target company to the investment and allowing them to take measures (including possible public disclosure to run up the stock price) to the detriment of the activist investor.

4. **The Proposed Rule creates an inconsistent, disclosure regime relative to the Section 13 Rules, which may result in confusion among market participants thereby leading to inefficiencies and increased costs.**

The Proposed Rule is seeking to regulate an area that is already subject to extensive regulation under the Section 13 Rules, and is also subject to additional proposed rule-making of the SEC pursuant to the Proposed 13D/G Amendments. We are concerned that the Proposed Rule is seeking to implement a reporting regime that is inconsistent with the Section 13 Rules, including the Proposed 13D/G Amendments.

The Section 13 Rules only require disclosure once an investor has acquired beneficial ownership of equity securities representing more than 5% of the outstanding class of equity securities. However, as described above, one of the reporting thresholds of the Proposed Rule has no

correlation to the size of the SBS position relative to the outstanding shares of capital stock of the issuer and may, therefore, mandate public disclosure of an investor's confidential investment information in circumstances when such disclosure would not be required under the Section 13 Rules.

Under the Section 13 Rules, once an investor acquires beneficial ownership representing more than 5% of the outstanding class of equity securities, it has a period of 10 days (or 5 days if the Proposed 13D/G Amendments are adopted) to make its initial Schedule 13D filing (assuming the investor is not eligible to report on Schedule 13G under specified exemptions). The Proposed Rule would not only compel disclosure in many situations where such disclosure is not required under the Section 13 Rules (*i.e.*, because disclosure is mandated at ownership levels that may be far less than 5% of the outstanding shares of a class of equity securities), but also requires that disclosure be made on a next- business day basis, thereby depriving investors of the current 10-day reporting regime under the Section 13 Rules and the even shorter 5-day reporting period contemplated by the Proposed 13D/G Amendments. While we strongly believe that the current 10-day timing requirements provided for in the Section 13 Rules strikes the appropriate balance between disclosure to the marketplace and provides ample time for the filing person to complete its investment program prior to it becoming public, we appreciate that this issue will be subject to significant comment in connection with the Proposed 13D/G Amendments. For present purposes, however, we believe that the adoption of the Proposed Rule, which would significantly alter the timing for public disclosure of an investor's ownership interest in a public company relative to the requirements of the Section 13 Rules, is not appropriate.

We believe that the Section 13 Rules are the appropriate avenue through which these public disclosure obligations should be embodied and have significant concerns regarding the creation of competing and inconsistent disclosure regimes. The Proposed Rule, if adopted in its current form, would lead to unintended and anomalous results. For example, if an investor chooses to purchase $350 million of common stock of a public company with a market capitalization of $7.1 billion, the investor would own less than 5% of the outstanding shares of the class of equity securities and therefore would not be required to disclose its ownership position under the Section 13 Rules (other than on a quarterly 13F filing for which the SEC has a long-standing policy permitting exclusion of the name of a target company if there is an active investment program). However, if this investor elected to acquire the same economic position through a cash-settled SBS, the Proposed Rule would mandate disclosure of the investor's position upon crossing the $300 million gross notional amount level or, potentially earlier, if the investor purchases in excess of $150 million in gross notional amount of SBS and otherwise owns underlying securities with a value that, when taken together with the delta-adjusted notional amount of any options, security futures, or any other derivative instruments based on the same class of equity securities, would exceed the $300 million level. We respectfully submit that this result – which disadvantages an investor that for strategic, economic, structural, tax or any one of a myriad of reasons, has elected to acquire its ownership position through SBS rather than shares of common stock – is neither intended nor appropriate.

Stock settled SBS are already subject to reporting under the Section 13 Rules, which provide that the holder thereof has beneficial ownership of the underlying security to the extent such holder can acquire the underlying security within 60 days or (as is the case in many activist situations) if such holder has acquired the SBS with the purpose or effect of changing or influencing the control of the issuer, or in connection with or as a participant in any transaction having such purpose or effect. To the extent that an activist investor's stock settled SBS position, when taken together with other relevant holdings of an issuer that is beneficially owned thereby within the meaning of the Section 13 Rules, exceeds the 5% beneficial ownership reporting threshold, public disclosure is mandated within 10 days. We respectfully submit that a new reporting regime that requires disclosure at levels far lower than the existing 5% beneficial ownership threshold and on a significantly expedited basis for timing of filing is neither required nor in the best interests of shareholders or other market participants.

The Proposed Rule contemplates regulating SBS in a manner that is inconsistent both with current law and the treatment of cash-settled derivatives (other than SBS) in the Proposed 13D/G Amendments. While we strongly believe that customary cash-settled derivatives (including SBS) do not connote beneficial ownership on the holder thereof and therefore should not be subject to reporting under the Section 13 Rules,[24] we appreciate that this issue will be subject to significant comment in connection with the Proposed 13D/G Amendments and we intend to set forth our position in more detail in responding to that proposed rule-making. We believe, however, that the creation of separate reporting regimes for SBS relative to derivative positions that are not SBS will create significant confusion in the marketplace. For example, the Proposed 13D/G Amendments contemplate deeming the holder of certain cash settled derivatives as the beneficial owner of the underlying securities if such holder holds the cash settled derivatives (other than SBS) with the purpose or effect of changing or influencing the control of the issuer, or in connection with or as a participant in any transaction having such purpose or effect. The Proposed Rule creates an independent reporting obligation for the holder of an SBS irrespective of the control intentions and silent regarding beneficial ownership by the SBS counterparty of the dealer's hedge. These types of inconsistent regulatory and reporting obligations are unprincipled and arbitrary. They will almost certainly lead to regulatory arbitrage and, instead of informing the market, are likely to confuse investors and markets in general.

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[24] In that regard, we note that the SEC considered this issue in 2011, pursuant to adoption of Section 13(o) under the Dodd-Frank Act, which provided that a person shall be deemed a beneficial owner of an equity security based on the purchase or sale of a security-based swap only to the extent that the SEC adopts rules after making certain determinations with respect to security-based swaps and consulting with the prudential regulators and the Secretary of the Treasury. *See* Beneficial Ownership Reporting Requirements and Security-Based Swaps, SEC Rel. 34-64628 (June 8, 2011) At that time, the SEC expressly determined not to change beneficial ownership rules for SBS, re-adopted Rules 13d-3 and 16a-1 following consultation with the prudential regulators and the Secretary of Treasury to assure that these provisions continue to apply, and stated: "The purpose of this rulemaking is solely to preserve the regulatory status quo and provide the certainty and protection that market participants have come to expect with the existing disclosures required by the rules promulgated under Sections 13(d), 13(g) and 16(a)."

B. The Proposed Rule establishes a precedent that is contrary to the SEC's stated public policy goals.

1. **The Proposed Rule undermines the SEC's efforts to encourage private industry to lead efforts to improve society and the world, which includes an emphasis on good corporate governance.**

Over the past two years, the SEC has increasingly focused on the role of private industry in regard to environmental issues (*i.e.*, climate change) and social issues in response to an outcry from investors regarding their interest in those issues and their desire for companies they invest in to play a role in effecting positive change. The shareholder interest in those elements has, in turn, created a focus on corporate governance, which is the "G" in the acronym for this movement, *i.e.*, ESG. Commissioner Lee, for example, noted that "environmental and social issues, once perhaps treated as more peripheral, are now central business considerations. So boards are stepping up their engagement on climate and ESG related-risks and opportunities."[25]

In this case, the Proposed Rule will drive ESG initiatives by companies in the opposite direction from that pushed for by shareholders. The Proposed Rule will help to entrench corporate managers and their preferred slate of (non-diverse) directors and reduce the ability or the incentive of institutions to fight for the type of social awareness, diversity and leadership that shareholders seek but are not able to achieve on their own without the resources and tenacity of activist investors. The ability to bring about effective engagement on environmental and social issues relates directly to the strides in corporate governance resulting from activist investors.

Over the last two decades, economic activist and representatives of the ESG community, including pension funds (public, union and private), have been successful partners in setting norms for governance across a myriad of issues including majority voting for directors, increasing transparency of executive pay, and limiting the use of poison pills. The Proposed Rule makes it substantially harder for activist investors to continue to partner with the ESG community in bringing about these critical reforms for the benefit of all investors by multiplying the hurdles that activist investors must jump through and removing the ability of investors to profit from their own ideas and capital outlays.

2. **The Proposed Rule takes a dramatically different approach to position reporting than the CFTC has for swaps, contrary to the direction of Congress, and prior to considering**

[25] Commissioner Allison Herren Lee, *Climate, ESG, and the Board of Directors: "You Cannot Direct the Wind But You Can Adjust Your Sails"* (June 28, 2021).

whether the SBS transaction reporting regime, which is already in place, is sufficient to address apparent regulatory concerns.[26]

Following enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**"), the CFTC adopted the CFTC Large Trader Reporting Rule. Like the Proposed Rule,[27] the purpose of the CFTC Large Trader Reporting Rule was to provide transparency and facilitate market integrity.[28] To achieve that purpose, the CFTC, under the leadership of now-SEC Chair Gensler, developed a tailored reporting regime that requires reporting only by market intermediaries, such as clearing houses and futures commission merchants with respect to limited types of swaps, and provides a sunset provision for the reporting after transaction reporting becomes effective.[29] Most significantly, the CFTC Large Trader Reporting Rule requires reporting only to the CFTC itself, on a confidential basis. In commenting on the non-public nature of the reporting requirements, the CFTC noted that the CFTC would treat the disclosed information confidentially, consistent with Section 8(a)(1) of the Commodity Exchange Act that prohibits the CFTC from making public "data and information that would separately disclose the business transactions or market positions of any person and trade secrets . . . ."[30]

We do not see any basis for the SEC to take a different approach with respect to collection of SBS information from the approach taken by the CFTC in the CFTC Large Trader Reporting Rule. The provisions were adopted pursuant to the same provision of the Dodd-Frank Act.[31] Moreover, the Dodd-Frank Act expressly directed the SEC to consult with the CFTC prior to commencing rulemaking relating to SBS and to "coordinate to the extent possible with the [CFTC] and the

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26 Treating the position reportable information as filed on a non-public basis and applicable only to SBS Entities (as such term is defined in the Proposing Rule Release) would be consistent with Regulation 20.4, the parallel position-reporting rule adopted by the CFTC in 2011 for swaps (the "**CFTC Large Trader Reporting Rule**"). Conforming the Proposed Rule to the CFTC Large Trader Reporting Rule would also be consistent with Congress's direction to the SEC under the Dodd-Frank Act to consult with the CFTC prior to commencing rulemaking relating to SBS and to "coordinate to the extent possible with the [CFTC] and the prudential regulators for the purposes of assuring regulatory consistency and comparability, to the extent possible." Dodd-Frank Act § 712(a)(2), 15 U.S.C. § 8302.

27 Proposing Rule Release at 22 [87 FR at 6656].

28 Large Trader Reporting for Physical Commodity Swaps, 76 FR 43851, 43859 (July 22, 2011) ("**CFTC Rule Adopting Release**") ("In addition to providing increased market transparency . . . the extension of the Commission's surveillance activities to these . . . markets will enhance the deterrence and detection of problematic activities and, thus, help ensure the integrity of these markets and protect market participants and the public from disruptive trading, price manipulation, and the effects of market congestion.").

29 Although swap transaction reporting did become effective after adoption of the CFTC Large Trader Reporting Rule, the CFTC did not in fact rescind the position reporting requirements.

30 *Id.* at 43862 (quoting 7 U.S.C. § 12(a)(1)).

31 Title VII of the Dodd-Frank Act directed both the CFTC, in respect to swaps, and the SEC, in respect to SBS, to establish position limit requirements which the CFTC did in 2011 though adoption of the CFTC Large Trader Reporting Rule.

prudential regulators for the purposes of assuring regulatory consistency and comparability, to the extent possible."[32] Development of a rule, like the Proposed Rule, that differs materially from the comparable CFTC Large Trader Reporting Rule, could lead to development of different markets for SBS and swaps, which could make hedging difficult and pricing less efficient not only for SBS but also for other instruments used to hedge exposure to SBS or swaps.

Moreover, the value of additional disclosure is unclear at this time in light of the fact that SBS transaction reporting only commenced last November (*i.e.*, 2021) and public dissemination of such information began only last month. A measured approach to adopting any new SBS disclosure requirements would first analyze the transaction-reporting regime and consider whether the information only recently made available to the SEC and the public already addresses concerns raised by the agency in the Proposing Rule Release. To the extent that the SEC believes that SBS dealers are not collecting sufficient financial, credit, concentration and other risk information from their counterparties to adequately risk-manage their positions, the SEC, as the designated regulator of those entities, may direct them to collect necessary information on a confidential basis.

3. The Proposed Rule contradicts the SEC's own rules relating to protection of trade secrets.

Rule 200.80(b)(4) under the SEC's FOIA rules[33] provides that the SEC generally will not publish or make available to any person matters that "[d]isclose trade secrets and commercial or financial information obtained from a person and privileged or confidential." Rule 200.80(b)(4) addresses situations in which information is filed with the SEC on a non-public basis and third parties seek to obtain access. Although Rule 200.80(b)(4) is not directly on point in respect to the disclosure requirements of the Proposed Rule, it suggests a deference to the trade secrets held by a third-party filer. The requirements in the Proposed Rule that portfolio managers publicly disclose their trade secrets is contrary to the SEC's recognition of people's rights to trade secrets and to not having those trade secrets disclosed to others, expressed in the FOIA rule.

4. The Proposed Rule would require SBS counterparties to disclose proprietary financial and investment information to the public, which is contrary to Schedule 13F's requirements and established credit-related disclosures.

One of the stated reasons for requiring public disclosure under the Proposed Rule is to "alert market participants, including counterparties . . . to the risk posed by the concentrated exposure of a counterparty [and to] . . . enhance risk management by security-based swap counterparties and inform pricing of the security-based swaps."[34] Managing counterparty credit and market risk by

[32] Dodd-Frank Act § 712(a)(2), 15 U.S.C. § 8302.

[33] "FOIA" refers to the Freedom of Information Act, 5 U.S.C. § 552.

[34] Proposing Rule Release at 21 [87 FR at 6656] (noting, by way of example, "if a single counterparty has a $5 billion security based swap position distributed equally among five different dealers on the same underlying equity security, public reporting of that security-based swap position would alert each dealer to the total exposure of the reporting counterparty").

requiring an arm's-length trading counterparty to disclose its financial position, trading strategy and collateral to the public is wholly counter to established credit and "know-your-customer" practices for lenders and other financial services providers.

When a consumer applies to a bank to finance the purchase of a new home through entry into a mortgage loan, the consumer's personal information and information about the house are not published publicly. Instead, the lender carries out a customized credit check on the borrower and independently evaluates the collateral on a private basis. The bank is required to treat the borrower's information confidentially and not publicly disclose the information.

The paradigm followed for consumer lending (which is the same paradigm that applies to trading in swaps and to securities brokerage) should also apply to SBS. There is no reason why the investing public or issuers of referenced securities have any legitimate need to know the investment strategies pursued by an activist investor. It is reasonable and appropriate to require SBS counterparties to provide credit and market concentration and other entity-specific risk information to an SBS dealer with which the counterparty is trading. It is not reasonable, however, to require SBS counterparties to divulge that information to the general public, particularly given the significant and adverse costs of public disclosure.

5. The other principal justifications for the adoption of the Proposed Rule do not appear to have application to equity investments made by activist investors.

In addition to providing more transparency to protect security based swap dealers as described above, the Proposing Rule Release sets forth two other principal reasons for the adoption of the Proposed Rule: (1) a concern regarding "net-short debt activism"; and (2) a desire for additional transparency of the SEC and other regulators as it relates to a person (or a group of persons) building up a large security-based swap position.

The Proposing Rule Release describes "net-short debt activism" as a situation in which a market participant with a large credit default swap position and a controlling voting interest in the debt of a reference entity votes against its interest as a debt holder to ensure that a credit event occurs. This concern has no application to traditional activist equity investing, which is focused on active engagement with management teams and boards of directors to *increase* the long-term value of the enterprise on behalf of all shareholders.

With respect to the need for additional transparency among regulators, we respectfully submit that the current reporting regime, including disclosures made pursuant to the Section 13 Rules and the information made available to the CFTC under its Large Trader Reporting Rule, is sufficient. However, if it is ultimately deemed necessary to provide incremental disclosure to regulatory bodies, we believe that such disclosure should be made to such regulatory bodies on a private and confidential basis, and that real time public disclosure thereof does not further the stated purpose set forth in the Proposing Rule Release or serve the best interests of investors.

C. *The cost-benefit analysis underlying the Proposed Rule fails to evaluate the chilling effect that the Proposed Rule will have on activist investors and the harmful collateral effects that a reduction of such corporate activism will have on retail investors and other stakeholders, and explain why, on balance, curing the alleged information asymmetries is more beneficial to shareholders than allowing activist investors to hold underperforming management and directors accountable and to evaluate less costly alternative measures than those in the Proposed Rule.*

The cost-benefit analysis published by the SEC in the Proposing Rule Release focuses on information asymmetry in the SBS market, which the SEC argues leads to possible mispricing of SBS in the total return market and to arbitrage advantages for some market participants over others in the credit default swap market,[35] and on the time and resources needed by a counterparty to make filings on proposed Form 10B on a timely basis. That is the wrong focus and fundamentally misstates the real economic costs of the Proposed Rule. The costs imposed by the Proposed Rule are substantially greater and result in significantly more party specific and public harm than acknowledged by the SEC. As we have discussed above, the Proposed Rule will likely significantly curtail activist investors from engaging in economically beneficial activities as a result premature disclosure of their investment program and thesis, which, in turn, will undermine their ability to successfully and profitably execute on the investment idea. Secondly, the Proposed Rule establishes a precedent for misappropriation of investors' trade strategies and trade secrets, which undermines a bedrock principle of capitalism and will discourage investors from spending the necessary time and resources to improve the operations and value of publicly traded companies and root out self-dealing or other nefarious conduct of corporate managers. Finally, the public disclosure approach adopted by the Proposed Rule directly contradicts (i) the confidential filing approach adopted by the CFTC (adopted when SEC Chair Gary Gensler was CFTC Chair), notwithstanding Congress's express directive to the SEC and the CFTC to make parallel rules for SBS and swaps consistent, (ii) the SEC's long standing views regarding the ability to protect the confidentiality of active investment programs in the Schedule 13F context, and (iii) standard credit due diligence practices used by banks, broker-dealers and other financial intermediaries to collect necessary financial, credit and risk information from borrowers and counterparties.

In light of the inadequate cost-benefit analysis, the public has not had an adequate opportunity to review and comment on the Proposed Rule and the SEC has not given appropriate consideration to alternative proposals that would have fewer economic costs. However, because it seems clear that revision of the cost-benefit analysis by the SEC would only serve to highlight how extraordinarily damaging adoption of such a rule would be, we believe that there is no point in revising the analysis and recommend instead that the Proposed Rule be abandoned.

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[35] *See* Proposing Rule Release at 114 [87 FR at 6680] (noting that public disclosure would be important to eliminate bad practices by arbitrageurs in the CDS market: "[t]his data is important because some market participants in the past have engaged in tactics that academics and media have described as 'opportunistic strategies.'").

Our Recommendations

We recommend that the SEC end its efforts to adopt a public reporting regime for SBS through the Proposed Rule. To the extent that the SEC believes that it needs additional information about SBS or other derivatives positions to better monitor and regulate the SBS and derivatives market, we think that it would be appropriate for the SEC to adopt a tailored disclosure regime under which counterparties provide position information to the SEC on a confidential basis, exempt from disclosure to the public under FOIA. As directed by Congress and as necessary to allow for efficient arbitrage across asset classes, any such rule should be consistent with the CFTC Large Trade Reporting Rule for swaps. In addition, in light of the fact that SBS transaction reporting and public dissemination of such information began only recently, prior to adopting any new SBS disclosure requirements, the SEC should wait to analyze whether the information being disclosed as part of the new reporting regime already addresses the agency's stated concerns. To the extent that the SEC believes that SBS dealers are not collecting sufficient information from their counterparties in order to adequately risk-manage their positions, as the designated regulator of those entities, the SEC should direct them to collect necessary information on a confidential basis.

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

Respectfully submitted,

Rob Collins

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