Notice and Comment Battle Royale – Blockholder Disclosure Rules and the S.E.C.

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Introduction

The Securities and Exchange Commission has publically announced that its 2013 agenda includes examining the rules which govern when shareholders must disclose acquisition of a significant position in a public company.¹ Current S.E.C. rules established under the Williams Act of 1968 provide that outside shareholders who obtain stakes of 5% or more of a company’s stock must publically disclose their holdings within 10 days. In 2011, the S.E.C. received a rule-making petition from the well-known law firm Wachtell, Lipton, Rosen & Katz advocating the tightening of rules which govern the disclosure of blocks of stock in public companies.² (The “Petition”) Anecdotally, the name “Lipton” refers to Martin Lipton, the individual credited with the creation of the Shareholders Rights Plan, a.k.a. the poison pill.

Following the submission of the Petition, the record was filled with a number of comments from both sides. One comment of particular importance disfavoring the Petition was submitted by two prominent professors, Lucian Bebchuck and Robert J. Jackson, Jr.³ (The “Comment”) Bebchuck is a professor of law, economics and finance at Harvard Law School and Jackson is professor of law at Columbia Law School. Their Comment urged the S.E.C. to undertake a comprehensive examination of the proposed rule’s economic implications for investors and efficiency, but that in the meantime, the existing research and available empirical evidence provides no basis warranting the tightening of disclosure rules for blockholders. They argue that the available empirical evidence actually raises concerns that such tightening could harm investors and undermine efficiency.

Following the Comment’s submission and over the past two years, a public battle of words and egos has been waged between the two sides and their famous mascots, including public appearances, town hall debates and further written reports and analysis. With the S.E.C. set to formally examine the disclosure rules in 2013, the debate has grown to a climax. But the question for the S.E.C. is still twofold: (1) what is the underlying purpose of the Williams Act disclosure standards; and (2) what disclosure rules best serve that purpose? There is not a clear answer to either, but in this paper I aim to provide an unbiased review of each side’s documented argument with a conclusion explaining my hypothetical opinion and advice to the S.E.C.

Purpose of 13(d) and the Williams Act

The first step in determining what new disclosure rules should be promulgated, if any, turns significantly on what one believes the purpose of the Williams Act disclosure rules are. The initial Petition was submitted under the premise that the drafters believed beneficial ownership reporting rules [section 13(d)] no longer effectively serve their stated purpose. The Petitioners took the stance that the purpose of 13(d) is to “alert the marketplace to every large, rapid

¹ http://dealbook.nytimes.com/2013/02/07/dont-make-poison-pills-more-deadly/
³ http://www.sec.gov/comments/4-624/4624-3.pdf
aggregation or accumulation of securities.” This interpretation was adopted from court in *GAF Corp. v. Milstein* (2d. Cir. 1971). The Petition argued that the disclosure rules reflect the nation’s general commitment to transparency in our security markets and more specifically regulatory judgment that stealth accumulations of large blocks can be unfair to market participants.

In juxtaposition, the Comment articulated their belief that public notification of accumulations and transparency are not the defaults under the Williams Act. Rather, public disclosure is an exception to the general principle that outside investors may remain anonymous. The Comment therefore argued that the purpose of 13(d) and its ten-day window between the acquisition of 5% stake and disclosure reflects a careful balance that Congress struck, after extensive debate, between the need to provide information to investors and the importance of preserving the governance benefits associated with outside blockholders.

The Comment relied on the congressional record of the adoption of section 13(d) which focused on three different proposals brought by Senator Williams. The excerpts used arguably exemplified that the Senate’s discussion turned on how to adjust the triggering blockholder percent and reporting window in order to balance the competing interests of the corporation, management and shareholders. The Senate concluded that outside investors who acquire large blocks of public company stock should not be discouraged since they often serve a useful purpose by providing a check on entrenched but inefficient management. Ultimately the Senate decided that a 10% trigger and 10 day reporting window was appropriate to avoid tipping the scale in favor of management or large investors. (Two years later Congress lowered the disclosure trigger to 5%). In addition, the Comment relied on the U.S. Supreme Court’s interpretation under *Edgar v. MITE Corp.*, which stated that the Congress’ intent in establishing 13(d) was not only to protect investors but to avoid favoring management or the takeover bid. Therefore, the Comment posited that the purpose of 13(d) was not just to alert the marketplace to every large accumulation of securities; rather it was a balance between the benefits that large blockholders convey upon public investors and the need for disclosure.

In a public response to the Comment, the drafters of the Petition claim that any reliance on the Congressional record to justify intent to protect blockholder’s interest is unfounded. The Petition drafters claim that changes to the length in reporting window had nothing to do with facilitating pre-filing accumulations, but reflected only Congress’ recognition of the administrative burden that would have been imposed by shorter deadline, mostly stemming from the need to use snail mail in 1968.

The argument regarding the purpose of 13(d) is clearly complex and could be (and has been) argued for many more pages. But the importance going forward in regards to evaluating each side’s recommendations to the S.E.C. comes from understanding that each side’s suggestions are based on and influenced by on each side’s belief of the purpose of 13(d). It makes sense then, why each side has spent so much time and energy arguing about the purpose of 13(d). If the purpose is like the Petitioners suggest, then their arguments which focus on increasing transparency would tightly fit the proposition for which they’re being offered. But if the Comment drafters are correct then their argument to keep the current regime is more likely to be accepted.

*Petition Specifics and Recommendations*
The next step then is to diagnose each side’s specific recommendations regarding what disclosure rules best serve the “purpose” of 13(d). The 2011 Petition to Initiate Rulemaking by Wachtell, Lipton Rosen & Katz called for three specific changes to the beneficial ownership reporting rules under Section 13 of the Securities Exchange Act of 1934. First, amend the Act to shorten the reporting deadline to 1 business day. Second, add a prohibition against the acquisition of any beneficial interest for 2 business days following a report filing. Third, expand the definition of “beneficial ownership” to encompass the ownership of any derivative instrument which includes the opportunity, directly or indirectly, to profit or share in any profit derived from the value of the security (including short positions).

Because the Petitioners believe that the purpose of Section 13(d) disclosure rules is to alert investors in securities markets to potential changes in corporate control and to provide them with an opportunity to evaluate the effect of these potential changes, this purpose is no longer served due to the ten-day reporting gap. They argue that the ten-day reporting window deprives the market of material information which creates incentives for abusive tactics by aggressive investors. In addition, the Petitioners argue that the pragmatic reason for ten-day reporting window is obsolete. The original reason for ten-days was due to the mechanics in filing old school reports, but with new technology, sophisticated investors have the resources to create and submit filing reports easily in much shorter windows.

The Petition provides a number of examples of shortened reporting windows in the United States and abroad in support of their argument of rationale and feasibility. In the United States, Form 8-K (ongoing disclosures) was recently shortened from 15 days to 4 days because 15 days no longer encompassed its goal of filings which were “rapid” and “current.” Additionally, Regulation FD now requires simultaneous disclosure when any material non-public information is intentionally disclosed to any outside party. Abroad, Australia requires notice 2 days following the acquisition of 5% of shares likely to affect control or substantial interest to issuer and the U.K. requires 2 days notice following 3% acquisition. Germany requires 4 days following the “acquisition threshold” and Hong Kong requires 3 days following “notifiable interest.”

The Petition also suggested the implementation of a “cool-off” period for triggered investors. The suggested prohibition against the acquisition of any beneficial interest for 2 business days following a report filing would arguably curtail incentive toward abusive tactics inherent in the lag between crossing the ownership threshold and the reporting deadline. The cooling-off period would prevent further acquisitions or the voting of the subject securities until the market and investors have been given time to react to the information in the Schedule 13(d) filing, which is arguably an implied purpose of 13(d).

Last, the Petition urged the S.E.C. to expand the definition of “beneficial interest.” Under Section 13, “beneficial interest” currently only encompasses those securities over which an investor (or group of investors) holds either “voting power” or “investment power,” including the power to “dispose of” a security. But other forms of ownership including derivatives (non-traditional or cash-settled) and other synthetic instruments and ownership strategies are excluded
The Petition argued that the current definition fails to recognize circumstances in which an investor may amass influence or control over both the voting and disposition of substantial blocks of securities, while maintaining a bare legal fiction that a third party holds such rights. They argue that each of these unregulated securities permits an acquirer to exercise the type of market control in the relevant security and potential to exert the type of influence over the issuer that Section 13(d) reporting obligations were arguably designed to address. The argument was again concluded with domestic and international examples of similar regulated securities in the countries like the UK, Germany and Switzerland.

One of the Petition’s most striking arguments was based on an actual case where Pershing Square and Vornada Realty acquired beneficial ownership of 25% J.C. Penny Stock before any public disclosure was made. Pershing first acquired 4.9% and then acquired the remaining percentage during the ten-day window via open market purchases, forward purchases, call options, and total return swaps. The day after reporting, J.C. Penny’s stock rose from $28.31 to $33.12. Over the following months, one representative from each Pershing and Vornada were then appointed to J.C. Penny’s board. The Petition argued that this case exemplified how parties could and do abuse the ten-day reporting window and non-regulated securities to gain undeserved control to the detriment of the public shareholders.

The Petition concluded by emphasizing that Section 13(d) is designed to create transparency in the acquisition of potential control positions in public companies, the accuracy of which investor confidence depends. Closing the ten-day window and adapting the definition of beneficial ownership to fully address the reality of the way securities are currently trades is feasible and integral to the functioning of the U.S. Securities markets.

The Comment by Lucian Bebchuck and Robert Jackson ultimately argued that existing research and available empirical evidence provide no basis for concluding that tightening rules governing blockholders would satisfy the requirement that Commission rulemaking protect investors and promote efficiency, and actually raises concerns that such tightening could harm investors. The Comment recommends that the S.E.C. not promulgate any new rules until they’ve done a comprehensive examination of the economic implications for investors. The Comment lays out an examination framework it suggests the S.E.C.’s should utilize, including: (1) blockholders make directors and managers more accountable which reduces agency costs and managerial slack thereby benefiting shareholders and promoting efficiency; (2) tightening rules will reduce returns to blockholders thereby reducing the incentive and size of outside blocks, which will result in increased agency costs and managerial slack; (3) no empirical evidence to support a claim that changes in trading technology have led to significant pre-disclosure accumulations of ownership stakes by blockholders; (4) since the passage of Section 13, changes in state law have tilted the playing field against blockholders; and (5) tightening rules is not justified on the grounds that it is needed to protect investors from blockholders capturing a control premium at their expense. The Comment believes that the S.E.C. is required to conduct extensive analysis before it promulgates a rule and it believes that providing a huge database of data in favor of their position will aid them in prohibiting new rulemaking.

The first and most extensive argument that the Comment makes in response to the Petition is regarding the empirical evidence on the value of blockholders. The Comment argues
that blockholders with a significant stake have strong incentives to invest in monitoring and engagement. These investments can be expected to make directors more accountable and reduce agency costs and managerial slack which is beneficial to shareholders. Shareholders that hold only a small fraction of the firm’s shares have little incentive to make such investments because they must bear the full cost but only capture a pro rata fraction of the benefits. The Comment provided evidence that market participants actually expect the presence of blockholders to be beneficial for firm value as evidenced by the filing of a Schedule 13D either (a) revealing an activist shareholders position or (b) an outside blockholder indicates that it aims to redirect management efforts, are associated with large positive average abnormal returns.

In addition, the Comment provided evidence of the benefit of large blockholders through improved outcomes for shareholders on various dimensions. This included evidence that (a) CEO pay is less likely to reward “luck” rather than performance when a blockholder is represented on the company’s board, (b) presence of blockholders on a board’s compensation committee is associated with reduced incidence of stock option backdating, (c) presence of institutional blockholders is associated with increased shareholder opposition when management proposes entrenching anti-takeover amendments to the company’s charter, and (d) presence of outside blockholders is associated with an increased likelihood of transaction that discipline management.

The Comment also found that the presence of outside blockholders benefits shareholders by making the possibility of a proxy fight more viable. At companies without an outside blockholder (or blockholder prospect), incumbent directors and executives face a substantially reduced threat of proxy fight. In a case of underperformance, this insulation from the possibility of a proxy fight will likely have an adverse effect on shareholder interests, increasing agency costs and managerial slack. If no shareholder has sufficient “skin in the game,” a proxy fight unlikely because they are not willing to bear the costs involved. Ultimately, they argued that the announcement of a proxy fight is associated with positive abnormal returns.

The Comment continues by explaining the effect of tightening rules has on outside blockholders. It argues that value-enhancing activities made by outside blockholders depend on the ability of outside blockholders to obtain returns to cover their costs. An important source of incentive to become an outside blockholder is the blockholder’s ability to purchase shares at prices that do not yet fully reflect the expected value of the blockholders future monitoring and engagement activities. If an outside blockholder could not purchase an initial block at process below this level, the returns to becoming an active outside blockholder would fall. Shareholders benefit from giving blockholders this ability, because investors capture the lion’s share of the benefits of the blockholders monitoring and engagement activities – benefits that might not otherwise be produced. Tightening the disclosure rules governing blockholders can thus be expected to reduce the returns to outside shareholders considering acquiring a block and, in turn, to result in a reduction in the incentive and size of outside blocks.

Bebchuck and Jackson also emphasize that purchases made during the ten-day reporting window do not takes value away from the public shareholders. They are that just because a blockholder engages in purchases during the 10 day reporting window does not mean the blockholder has taken a control premium away from investors. A buyer obtains a control block
when the block is large enough for the buyer to have a practical ability to determine outcomes, which in turn permits the buyer to obtain substantial “private benefits of control” and trade at a premium over non-controlling blocks.

An important argument against the Petition centers on the implications of new technology. This is important because a substantial portion of the Petition’s argument is based on the implicit assumption that technology has encouraged abuse against public shareholders during the reporting window. But the Comment denies this assumption claiming that the Petition does not provide any empirical evidence to support its claim that outside blockholders have in recent years amassed more large pre-disclosure ownership stakes than they accumulated in earlier periods. It argues that the four cases cited by the Petition which occur over the past four years is not the type of systematic evidence that can provide a basis for concluding that Commission rulemaking is urgently needed to address changes in trading practice and technologies.

Finally, the Comment posited that the change in the legal landscape regarding since the passage of the Williams Act has provided the security for public shareholders that the Petitioners seek. They argued that issues which the drafters of the Williams Act devoted much attention to preventing now face formidable impediments that did not exist when the Act was passed. This includes the fact that (a) state law now allows boards to use poison pills to block hostile tender offers, (b) outside blockholders filing Schedule 13D are commonly not expected to seek to acquire control, but rather to monitor and engage with management and fellow shareholders, and (c) companies have been utilizing state laws and implementing poison pills with low ownership thresholds. Out of the 805 public companies in “Sharkrepellent” database, 76% have pills triggered by an ownership level of 15% or less; and 15% have pills triggered by 10% or less. Additionally, the unique state based common law also arguably renders many of the Petition’s international examples inapplicable. In the United States, state law is uniquely unfavorable to outside blockholders in comparison to common law countries such as the UK, Australia, and Canada. Also, in no common law country other than the United States can an outside blockholder disclosing its presence fear being immediately subject to a poison pill precluding it from exceeding an ownership level that falls substantially below a control block. Therefore, the Comment argues that the protection the Petition seeks already exists in other legal checks and balances which have been created since the Williams Act was passed.

Advice to the S.E.C.

Under the countering punches diagnosed above, my statement to the S.E.C. is clear – not enough empirical evidence exists or has been presented publically to justify the promulgation of a shortened disclosure windows or expanded definition of “beneficial interest.” Based on the hundreds of pages presented by the opposing parties, my opinion regarding the purpose of 13(d) stands more in line with the Comment. It provided strong textual evidence taken in context from the legislative record which left little to be questioned. In contrast, the Petitioner’s response merely makes claims regarding the background of the legislative history, without providing any textual support. The Comment’s argument is bolstered by support by language from Supreme Court cases. The Petition merely relies on a single circuit case as the basis of purpose. Additionally, just from a practical perspective, it seems contradictory to think that the S.E.C.
would choose to engage in rulemaking to the detriment of shareholders, blockholders and the public markets (as evidenced by the Comment’s empirical evidence).

With this statement of purpose for 13(d) in mind, the overwhelming weight of evidence presented to the S.E.C. under notice and comment rulemaking favors not promulgating. Wachtell, Lipton, Rosen & Katz’s lack of evidence regarding empirical implications of the promulgation of a new rule stands in stark contrast to their reputation around the world. Instead of taking Bebchuck and Jackson’s arguments head on, the Firm attempts to dance around the evidence by arguing that no statute requires the S.E.C. to engage in the sort of analysis or economic studies the Comment demands. Although it might be true that the S.E.C. is not required to engage in the sort of analysis the Comment urges, Petition’s inability to go blow-for-blow with the Comment for empirical evidence on either the current rule or new rule begs the question as to what Petition’s motive for initiating rulemaking exactly is.

In conclusion, under my reasoned belief that the purpose of 13(d) is not solely to alert the marketplace to every large, rapid aggregation or accumulation of securities, I recommend that the S.E.C. not promulgate any new rule. I believe that substantial evidence exists which shows that blockholders are valuable to shareholders, public companies and the market in general. The S.E.C. should not engage in any rulemaking which could harm the value blockholders bring to the market with sufficient empirical otherwise. Because this evidence has not been presented under notice and comment rulemaking, it is up the S.E.C. to continue its research.

Selected Bibliography


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