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April 15, 2011

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
One Station Place
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Comments on Release No. 34-64087; File No. S7-10-11

Dear Ms. Murphy:

We are pleased to submit the following comments with respect to the Securities and Exchange Commission's Release No. 34-64087; File No. S7-10-11 (the "Release"). Our Firm recently submitted a petition for rulemaking (the "Wachtell Lipton Petition") calling for changes to modernize certain aspects of the beneficial ownership reporting rules which are the subject of the Release.¹ In particular, the Wachtell Lipton Petition outlined our belief that the ten-day reporting window after crossing the 5% ownership threshold and the overly narrow definition of "beneficial ownership" used throughout Section 13(d) of the Securities Exchange Act of 1934 (as amended, the "Exchange Act") create dangerous gaps in the reporting regime which undermine their effectiveness and leave issuers and investors vulnerable to manipulation. Savvy activist investors are increasingly demonstrating their willingness and ability to exploit these gaps for their own gain, at the expense of other market participants. This failure of the beneficial ownership reporting rules to achieve their animating purpose of providing issuers,

¹ Petition for Rulemaking Under Section 13 of the Securities Exchange Act of 1934, submitted by Wachtell, Lipton, Rosen & Katz (Mar. 7, 2011), File No. 4-624, available at <http://www.sec.gov/rules/petitions/2011/petn4-624.pdf>.

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investors and the securities markets with full and timely disclosure of the accumulation of potential control stakes in U.S. public companies is a serious issue that we continue to urge the Commission to address by modernizing the beneficial ownership reporting rules.

As the Commission notes in the Release, Section 766 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) added additional language to the Exchange Act which would, upon its effective date of July 16, 2011, further exacerbate this problem by calling into question the current treatment of security-based swaps under the beneficial ownership reporting rules. In the Release, the Commission has proposed to re-adopt without change the relevant provisions of Rules 13d-3 and 16a-1 promulgated under the Exchange Act to clarify that the treatment of transactions in security-based swaps will not change due to the effectiveness of these new Exchange Act provisions. This action is both timely and necessary so as to avoid a further limitation on the already overly myopic beneficial ownership definition used throughout the rules, and we urge the Commission to adopt final rules prior to July 16, 2011. However, because the beneficial ownership reporting rules are badly broken in a number of respects, we encourage the Commission to look beyond maintaining the status quo and instead take much-needed action towards thorough reform of the reporting regime. The Commission states in the Release that it is considering additional actions to “modernize reporting under Exchange Act Sections 13(d) and 13(g).”² We applaud this intention, but urge the Commission to undertake as promptly as practicable comprehensive reform beyond the narrow step needed to preserve the status quo reflected in the Release.

For the reasons outlined below and in the Wachtell Lipton Petition, we recommend that the Commission:

- close the ten-day gap in the reporting window and require initial Schedule 13D filings to be made within one business day following the crossing of the five percent ownership threshold;
- institute a moratorium on the acquisition of beneficial ownership of additional equity securities of an issuer by any acquirer required to file a Schedule 13D for such issuer for two business days after such initial filing has been made;
- adopt a flexible definition of “beneficial ownership” for purposes of Section 13(d) that encompasses ownership of any derivative instrument which includes the opportunity, directly or indirectly, to profit or share in any profit derived from any increase in the value of the subject security; and
- undertake a study of enhanced remedies for violations of the beneficial ownership reporting rules.

As noted by the Commission in the Release, the “beneficial ownership disclosure requirements of Schedules 13D and 13G were designed to provide disclosures to security holders

² Release at 7 (citations omitted).

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regarding persons holding significant positions in public companies,”³ including “persons who have the potential to influence or gain control of the issuer.”⁴ As stated in the Release, the purpose of the rules is both to “help investors make fully informed investment decisions with respect to their securities”⁵ as well as to “provide management of the issuer with information to ‘appropriately protect the interests of its security holders.’”⁶ The Commission added:

In addition to providing information to issuers and security holders, Section 13(d) was adopted with a view toward alerting “the marketplace to every large, rapid aggregation or accumulation of securities, *regardless of technique employed*, which might represent a potential shift in corporate control.”⁷

In order to achieve these goals, the information required by the reporting rules must be complete, accurate, and timely disseminated. Unfortunately, developments in technology and trading norms have made clear that there are a host of loopholes in the reporting rules that permit hedge funds and activist investors to accumulate in total secrecy potential control stakes in, or acquire substantial economic exposure to, issuers with publicly traded securities. The example of security-based swaps highlights one major reason for this failing, which is that investors are increasingly able to acquire any or all of the characteristics of direct stock ownership without triggering disclosure requirements through the use of inventive derivative structures. The concept of beneficial ownership, as used throughout the reporting rules and in the calculation of when the minimum ownership threshold has been reached, encompasses only those securities over which an investor (or group of investors) holds either “voting power” or “investment power,” including the power to “dispose of, or to direct the disposition of,” a security.⁸ Other forms of ownership, including through derivatives, are currently explicitly counted for purposes of the Section 13(d) reporting rules only where they confer upon the holder the right to acquire beneficial ownership (*i.e.*, either voting power or investment power) over the underlying security within sixty days.⁹ The second primary gap in the reporting rules is the ten-day window between crossing the acquisition threshold and the initial reporting deadline. Investors can, and commonly do, rapidly acquire, through direct or derivative investments, far in excess of the 5% reporting threshold prior to the deadline for filing an initial Schedule 13D. This permits aggressive investors to proceed with “sneak attacks” and acquire substantial stakes in public companies without the opportunity contemplated by Section 13(d) for the market to value the shares accordingly with appropriate price discovery, without warning to the issuer or potential investors in the issuer’s securities, and at times without expending a significant economic investment by employing derivatives transactions or other devices that evade the federal reporting obligations and margin rules.

³ Release at 10.

⁴ Release at 9.

⁵ Release at 11.

⁶ *Id.* (citation omitted).

⁷ Release at 11-12 (emphasis added) (quoting *GAF Corp. v. Milstein*, 453 F. 2d. 709, 717 (2d. Cir. 1971), *cert. denied*, 406 U.S. 910 (1972)).

⁸ 17 C.F.R. § 240.13d-3(a).

⁹ 17 C.F.R. § 240-13d-3(d)(1).

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The reporting threshold was set at 10% at the time the Williams Act was originally adopted, but quickly scaled back to 5% as Congress determined that the lower ownership level still carried substantial weight and influence over an issuer's activities.¹⁰ However, activists are increasingly able to structure their investment strategies so as to render the 5% threshold virtually irrelevant, both by employing derivatives which fall outside of the reporting definition of "beneficial ownership" and by compressing their acquisitions of reportable positions into the ten-day window. This risk of a "dash" to acquire additional shares within the window period has long been recognized by policymakers,¹¹ but recent examples of extreme abuses highlight the need to immediately correct the problem. Alexander & Baldwin, J.C. Penney and Fortune Brands are only some of the recent high-profile examples where activists have made no public disclosure at all prior to the accumulation of an approximately 10% or greater stake in an issuer. Indeed, in the case of J.C. Penney, two shareholders were able to acquire aggregate beneficial ownership of more than 25% of the outstanding shares before any disclosure of their intentions. There is a direct cost to other investors where these activities are permitted. Investors who sold their shares of J.C. Penney common stock during the applicable 13D window period received approximately \$500 million less in proceeds than they would have received based on the closing price immediately following the filing of the Schedule 13D. The disclosure rules should not facilitate this wealth transfer mechanism by sanctioning secrecy in matters of this importance to the integrity of the public securities markets.

Rules that permit these types of ambush acquisitions to occur are no longer serving their purpose, and must be fixed. The "ten-day window" for filing the Schedule 13D disclosure form was established in 1968, decades *before* computerized trading, derivative accumulation programs, and electronic filing of SEC reports, and even before the founding of FedEx. It remains in place years *after* filing deadlines were substantially shortened under various securities laws, including for companies making Current Reports on Form 8-K, and officers and directors – *and 10% shareholders* – making Section 16 trading reports. The disclosure laws of numerous other countries, including the United Kingdom, Germany, Hong Kong and Australia, have significantly shorter disclosure windows.¹² It is past time for the Section 13(d) rules and regulations to evolve to close real and perceived loopholes which are currently being exploited, with a wink and a nod, for private gain. The beneficial ownership reporting rules will continue to leave investors and issuers vulnerable to abusive acquisition tactics until they require the immediate disclosure of 5% stakes in public companies, measured by a definition of beneficial ownership that recognizes the reality of the way acquisition programs are carried out in today's markets.

¹⁰ Pub. L. No. 91-567, 84 Stat. 1497 (1970); Staff of S. Comm. on Banking and Currency, 91st Cong., Additional Consumer Protection in Corporate Equity Ownership and in Corporate Takeover Bids 3 (Comm. Print 1970) ("Shareholders of [a] target company are entitled to full disclosure when over 5 percent of their company's stock is to be acquired...These acquisitions may lead to important changes in the management or business of the company.").

¹¹ Advisory Committee on Tender Offers, SEC, Report of Recommendations (July 8, 1983), reprinted in Fed. Sec. L. Rep. (CCH) No. 1028 (Extra Edition) 22 ("The 10-day window between the acquisition of more than a 5% interest and the required filing of a Schedule 13D was found to present a substantial opportunity for abuse, as the acquiror 'dashes' to buy as many shares as possible between the time it crosses the 5% threshold and the required filing date.").

¹² See Chapter 5 of the United Kingdom Financial Services Authority's Disclosure Rules and Transparency Rules; Part 4 of the German Securities Trading Act; Part XV of the Hong Kong Securities and Futures Ordinance; Australian Takeover Panels Guidance Note 20.

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In order to fix the beneficial ownership definition, the Commission must make clear that the use of a bare legal fiction vesting the technical characteristics of ownership and voting “control” in a third party should not permit investors to exempt themselves from the beneficial ownership reporting rules. As recognized in the Release, persons who “have the means to acquire significant amounts of equity securities wholly or partly based upon the purchase or sale of a security-based swap . . . may have the potential to effect a change of control transaction or preserve or influence control of an issuer.”¹³ Accordingly, the Commission needs to go beyond readopting the existing language of the beneficial ownership reporting rules as proposed in the Release and adopt a broad and flexible definition of beneficial ownership. Such a definition should recognize the varied ways in which an investor can acquire influence and control over an issuer and close the loopholes available to activist investors under the existing reporting regime. In addition to security-based swaps that provide voting or investment power, investors can and do acquire the characteristics of beneficial ownership through a broad universe of derivative securities, including those that are nominally “cash-settled.” The definition of beneficial ownership for Section 13 reporting purposes should encompass ownership of any derivative instrument which includes the opportunity, directly or indirectly, to profit or share in any profit derived from any increase in the value of the subject security.¹⁴ Derivative instruments should include, subject to certain exceptions, any instrument or right “with an exercise or conversion privilege or a settlement payment or mechanism at a price related to an equity security or similar instrument with a value derived in whole or in part from the value of an equity security, whether or not such instrument or right shall be subject to settlement in the underlying security or otherwise.”¹⁵ In addition, it should be made explicitly clear that the definition encompasses ownership of short positions in a security, as such positions have the same potential as long positions to influence the trading of the subject security.

Some have argued that the ten-day window should be maintained in order to incentivize activist investors to purchase large stakes in public companies and agitate for corporate change.¹⁶ Activists need this period, this argument posits, to accumulate shares at a lower price than they would need to pay if their intentions were known and a potential control premium was reflected in the market price of the subject stock. This argument breathtakingly turns on its head the purpose of the Williams Act as the Commission stated in the Release, whereby “on the basis of the information disclosed [in the Schedule 13D], the market would ‘value the shares accordingly’ due to increased prospects for price discovery.”¹⁷ The beneficial ownership reporting rules are not, and have never been, designed to permit hedge funds to

¹³ Release at 23-24.

¹⁴ See Theodore N. Mirvis, Adam O. Emmerich and Adam M. Gogolak, *Beneficial Ownership of Equity Derivatives and Short Positions – A Modest Proposal to Bring the 13D Reporting System into the 21st Century* (2008) (hereafter “A Modest Proposal”), <http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.15395.08.pdf>. We note that we do not currently believe that equivalent changes are required or advisable with respect to the determination of which persons or entities constitute 10% shareholders with respect to Section 16 of the Exchange Act and the rules promulgated thereunder, which we do not believe present the same risk of abuse as the Section 13 reporting rules.

¹⁵ See “A Modest Proposal” at 3.

¹⁶ Jonathan Macey, Opinion, *Uncle Sam and the Hostile Takeover*, Wall St. J., Mar. 21, 2011; Joshua Gallu, *Secret Corporate Raids to Get Harder Under SEC Rule Change*, Bloomberg, Feb. 22, 2011 (quoting William Ackman, CEO of Pershing Square Capital Management LP).

¹⁷ Release at 12 (citation omitted).

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secretly trade ahead of their required disclosures and take advantage of artificially depressed stock prices as a result of their secrecy.

There is no more reason to permit stealth and ambush accumulations of massive direct and derivative stakes in U.S. public companies without full, fair and prompt public disclosure than there would be to let corporate insiders or hedge funds trade on inside information. Claims that agitation by activists is *per se* beneficial, based on anecdotal citations of short-term stock price pops, ignore the harm to shareholders who sell in the absence of full disclosure and elevate the same type of chronic short-termism that contributed to the recent financial crisis. Market regulators should not be deterred from correcting loopholes in the disclosure rules resulting from the revolutions in trading practices and information sharing since the original passage of the Williams Act.

We appreciate this opportunity to submit, and the Commission's consideration of, our comments on the Release. We ask the Staff to contact any of Theodore N. Mirvis, Andrew R. Brownstein, Eric S. Robinson, Adam O. Emmerich or William Savitt at (212) 403-1000 should it have any questions.

Very truly yours,

Wachtell, Lipton, Rosen & Katz