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Corporate Governance Update: Section 13(d) Reporting Requirements Need Updating

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A year has passed since Wachtell, Lipton, Rosen & Katz submitted a petition to the U.S. Securities and Exchange Commission requesting that it update its Schedule 13D reporting requirements to "clos[e] the Schedule 13D ten-day window between crossing the 5 percent disclosure threshold and the initial filing deadline, and adopt[] a broadened definition of 'beneficial ownership' to fully encompass alternative ownership mechanisms." As the petition noted: "Recent maneuvers by activist investors both in the U.S. and abroad have demonstrated the extent to which current reporting gaps may be exploited, to the detriment of issuers, other investors, and the market as a whole."[1] The SEC is scheduled to issue a concept release later this spring addressing the concerns raised by the petition. Activist hedge funds have responded strongly—opposing changes to the current Schedule 13D rules—complaining that the suggested changes will significantly hurt their business. Regardless of whether the present reporting scheme allows activist investors to profit by keeping their accumulations secret, it is clear that the present reporting regime is outdated and needs to be reconsidered. At a time when the SEC is requiring greater transparency from public companies and their executives, the same policy concerns demand greater transparency with respect to the acquisition of equity securities of public companies by third parties.

Upcoming SEC Action

SEC Chairwoman Mary L. Schapiro announced in December 2011 that the SEC plans a broad review of the beneficial ownership reporting rules.[2] The review process will begin with a concept release and will address whether the 10-day initial filing requirement for Schedule 13D filings should be shortened; whether beneficial ownership reporting of cash-settled equity swaps and other types of derivative instruments should be clarified and strengthened; and how the presentation of information on Schedule 13D and Schedule 13G can be improved.[3]

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[1] Wachtell, Lipton, Rosen & Katz, Petition for Rulemaking Under Section 13 of the Securities Exchange Act of 1934, Mar. 7, 2011, *available at* www.sec.gov/rules/petitions/2011/petn4-624.pdf (Wachtell Lipton Petition).

[2] Chairwoman Mary L. Schapiro, Remarks at the Transatlantic Corporate Governance Dialogue, U.S. Securities and Exchange Commission, Washington, D.C., Dec. 15, 2011, *available at* www.sec.gov/news/speech/2011/spch121511mls.htm.

[3] *Id.*

Chairwoman Schapiro noted that under the Dodd-Frank Wall Street Reform and Consumer Protection Act, the SEC has new statutory authority to shorten the 10-day filing period for initial Schedule 13D filings, as well as to regulate beneficial ownership reporting of security-based swaps.[4] Specifically, Congress modified §13(d)(1) of the Exchange Act to read, "within ten days after such acquisition, *or within such shorter time as the Commission may establish by rule*."[5] With this modification, Congress acknowledged the issue and laid the legislative groundwork for needed reform in this area.

Current Rules Inadequate

Prior to the adoption of the Williams Act in 1968, prospective acquirers could and often did purchase large amounts of stock before initiating a public tender offer. Under the reporting regime established by the Williams Act, which has remained largely unchanged for over 40 years,[6] any person who acquires beneficial ownership of more than 5 percent of the outstanding shares of any class of voting equity securities registered under Securities Exchange Act §12 must file a disclosure on Schedule 13D within 10 days of the acquisition. The reporting requirements in the Williams Act were designed to give investors information about large share acquisitions before they turned into takeovers or proxy fights.

The §13(d) reporting requirements have been inadequate to serve their intended purpose for some time. The first reason is the timeline. The 10-day window for an initial filing on Schedule 13D may have been reasonable in 1968 but has, due to technological advances, become effectively so lengthy as to undermine one of the central purposes of the rule. Computerized trading, electronic filing, and the instant dissemination of material information among market participants have created an environment in which an enormous amount can happen in 10 days. Potential acquirers can (and do), under the current regime, acquire just under 5 percent of a company's shares, wait until all of their preparations are complete, and then aggressively cross the threshold and quickly acquire a large amount of additional shares before 10 days elapse and public disclosure is provided.

The second reason that the §13(d) reporting requirements have become inadequate is that they do not take into account new types of situations that my not fall squarely into the category of "beneficial ownership" as used throughout the rules but that nonetheless provide modern investors economic exposure to, or influence or control over the voting and

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[4] *Id.*

[5] Dodd-Frank Wall Street Reform and Consumer Protection Act § 929R (emphasis added).

[6] The Williams Act provided for a 10 percent initial reporting threshold when it was passed in 1968; the threshold was lowered to 5 percent in 1970 because of concerns that even 5 percent ownership conferred significant control rights and should require public disclosure. *See, e.g.*, Staff of S. Comm. on Banking and Currency, Subcomm. on Securities, Report on Additional Consumer Protection in Corporate Takeovers and Increasing the Securities Act Exemptions for Small Businessmen 1 (Comm. Print 1970) ("Ten percent of the stock of large corporations, indeed even 5 percent, can … have a significant impact on corporate control.")

disposition of, substantial blocks of securities. The current definition of "beneficial ownership" allows many sophisticated investors to avoid the reporting requirements as they currently exist, defeating the rules' purpose of informing investors of significant share acquisition activity.

Sophisticated market participants have not hesitated to exploit the inadequacy of the current beneficial ownership reporting requirements. In one highly-publicized situation from 2010, two hedge funds were able to acquire a total of approximately 27 percent ownership of J.C. Penney prior to filing their required Schedule 13D.[7] The use of open market purchases, forward purchases, call options and total return swaps, including during the 10-day window after crossing the 5 percent threshold, permitted the hedge funds to acquire the stock at a substantially lower price from unwitting shareholders than would have been possible with stricter disclosure rules.[8] Only a few months later, representatives of the hedge funds were appointed to the J.C. Penney board, demonstrating and solidifying the corporate control that they were able to acquire within the 10-day window provided by the §13(d) reporting rules as they currently stand.

Modernization Required

In other contexts, the SEC has explicitly recognized that its reporting regimes should take into account the advances in market and information technology, both by implementing new disclosure requirements and by shortening the timelines for filings. In 2004, the SEC reduced the deadline for filing a Current Report on Form 8-K, the required disclosure mechanism for material changes and events, to four business days following the triggering event.[9] Similarly, the SEC imposed an accelerated filing requirement on officers, directors, and 10 percent shareholders of corporate issuers with respect to reporting transactions in the issuer's securities, to the second business day following the triggering transaction.[10] The most extreme example is that of Regulation FD, which generally requires issuers to inform the market broadly of any material, non-public information *simultaneously* with its intentional disclosure to any outside party.[11]

There is no question that the ease of electronic filing and the sophistication of the investors who trigger the reporting requirements make similarly short deadlines under §13(d) as

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[7] *See, e.g.*, Maxwell Murphy, Deal Journal, "How Bill Ackman Stalked J.C. Penney," Wall St. J., Oct. 8, 2010; Joann S. Lublin & Karen Talley, "Big Shoppers Bag 26% of J.C. Penney," Wall St. J., Oct. 9, 2010.

[8] In the first full trading day after the hedge funds filed their Schedule 13D reports, J.C. Penney's stock closed at $33.12, compared to the average closing price of $28.31 over the prior 10 days during which the investors were accumulating shares.

[9] Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Release Nos. 33-8400, 34-49424; File No. S7-22-02 (March 16, 2004), *available at* www.sec.gov/rules/final/33-8400.htm.

[10] Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Release Nos. 34-46421, 35-27563, IC-25720; File No. S7-31-02 (Aug. 27, 2002), *available at* www.sec.gov/rules/final/34-46421.htm.

[11] Selective Disclosure and Insider Trading, Release Nos. 33-7881, 34-43154, IC-24599; File No. S7-31-99 (Aug. 15, 2000) (adopting Regulation FD).

feasible as the deadlines imposed by the rules mentioned above. Indeed, shorter timeframes for reporting beneficial ownership are currently the rule in a number of jurisdictions outside the United States. The United Kingdom, for example, imposes a two-trading-day deadline for disclosure of acquisitions in excess of 3 percent of an issuer's securities.[12] Germany requires a report "immediately," but in no event later than four days after crossing the acquisition threshold.[13] Canadian securities laws require not only a disclosure "promptly" through the issuance of a press release when the relevant threshold is reached, but also (until the acquiror's holdings exceed the 20 percent threshold for the Canadian take-over bid regime) limit additional acquisitions or offers to acquire until one business day after the required disclosure has been made in the market.[14] Hong Kong securities laws require a report within three business days of the acquisition of a "notifiable interest" under the law.[15] Australia requires disclosure of any position of 5 percent or more within two business days if any transaction affects or is likely to affect control or potential control of the issuer, or the acquisition or proposed acquisition of a substantial interest in the issuer.[16] The fact that these other jurisdictions require such short deadlines not only shows that it is workable, but also puts pressure on the United States to do the same. In the absence of updated requirements, the U.S. markets are more vulnerable than those in other jurisdictions to predatory and manipulative tactics designed to exploit the current 10-day window.

Wachtell Lipton jumpstarted the current SEC review of Schedule 13D reporting with the submission of its petition in March 2011.[17] The petition proposed that an initial Schedule 13D filing be required within one business day of crossing the 5 percent threshold, followed by a two-day standstill during which the acquirer would be prohibited from acquiring beneficial ownership (under the broadened definition) of any additional equity securities of the issuer. The Wachtell Lipton petition compared the proposed Schedule 13D standstill provision to the 10-day cooling-off period rules applicable to formerly passive investors switching from Schedule 13G filers to Schedule 13D filers, which prohibit such persons from voting, directing the voting of, or acquiring an additional beneficial ownership interest in, equity securities of the issuer from the time they develop a control intent until 10 days after the filing of the required Schedule 13D.[18]

The Wachtell Lipton petition also proposed changing the definition of beneficial ownership for §13 reporting purposes to include ownership of any derivative instrument that

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[12] Chapter 5 of the Financial Services Authority's Disclosure Rules and Transparency Rules.

[13] Part 4 of the German Securities Trading Act.

[14] Ontario Securities Act §102.1, Ontario Securities Commission Rule 62-504 – Take-over Bids and Issuer Bids §7.1.

[15] Part XV of the Securities and Futures Ordinance.

[16] Australian Takeover Panels Guidance Note 20.

[17] Wachtell Lipton Petition.

[18] *Id.* (citing 17 C.F.R. §240-13d-1(e)(2)).

includes the opportunity, directly or indirectly, to profit or share in any profit derived from any increase in the value of the subject security.[19] The definition of derivative instruments would in turn include, generally speaking, 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."[20] The expanded definition also would include ownership of short positions in a security, on the theory that they have the same potential as long positions to influence the trading of the security.[21]

Response to Suggestions

The changes proposed in the Wachtell Lipton petition have been met with vigorous opposition from hedge funds, who benefit greatly from the inadequacy of the current rules to provide timely disclosure to the market.[22] Wachtell Lipton's petition also prompted a lengthy response from two law professors, Lucian A. Bebchuk and Robert J. Jackson Jr.[23] In a public letter to the SEC, they urged the SEC not to proceed with any changes to the reporting requirements until a thorough examination of the potential economic implications could be undertaken. Their letter argued that existing research and empirical evidence provide no basis for concluding that reforms such as those proposed by Wachtell Lipton would protect investors and promote efficiency, and that indeed, they may well have the opposite effect.[24]

Professors Bebchuk and Jackson claim that an outside investor's accumulation of a sizeable block of target stock can increase share price and can be associated with outcomes such as "an increased likelihood of transactions that discipline management."[25] They argue that the presence of large and activist shareholders tends to promote efficiency and increase executive and director accountability. They posit that tightening the §13 rules would tend to decrease the number of such shareholders, which they accordingly see as an undesirable result. Along with

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[19] *Id.*

[20] *Id.* (citing Theodore N. Mirvis, Adam O. Emmerich & Adam M. Gogolak, *Beneficial Ownership of Equity Derivatives and Short Positions – A Modest Proposal to Bring the 13D Reporting System into the 21st Century*, on file with Wachtell, Lipton, Rosen & Katz (2008)).

[21] *Id.*

[22] *See, e.g.*, Memorandum from Scott H. Kimpel of the Office of Commissioner Troy A. Paredes of the Securities and Exchange Commission Regarding Request for Rulemaking Regarding the Beneficial Ownership Reporting Rules Under Section 13 of the Securities Exchange Act of 1934 (July 20, 2011), File No. 4-624, *available at* www.sec.gov/comments/4-624/4624-4.pdf.

[23] Lucian A. Bebchuk & Robert J. Jackson, Jr., Letter to the Securities and Exchange Commission Regarding Commission Examination of Section 13(d) Rules and Rulemaking Petition Submitted by Wachtell, Lipton, Rosen & Katz, July 11, 2011, *available at* www.sec.gov/comments/4-624/4624-3.pdf.

[24] *Id.*

[25] *Id.*

other commentators, professors Bebchuk and Jackson suggest that the SEC should review and undertake comprehensive empirical studies regarding significant developments in the corporate landscape since 1968—from takeover defenses such as the poison pill to the rise of the institutional shareholder—before attempting any revision to the §13(d) rules.[26]

What the professors and other opponents of the Wachtell Lipton petition do not address is the undeniable point that the current §13(d) rules no longer effectively serve their stated purpose. One could perhaps debate whether the profit-making activities of hedge funds are beneficial to society as a whole. But the purpose of the §13(d) reporting rules is, as the U.S. Court of Appeals for the Second Circuit put it 30 years ago, 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."[27] There can be little dispute that the current system no longer fulfills its original purpose of requiring the provision of material information about significant stock acquisitions in an efficient and timely fashion. And, where markets are concerned, if information is not timely, it is often useless.

Taken to its logical extreme, the professors' arguments might lead to the conclusion that the Williams Act reporting requirements should be eliminated altogether. While that result might allow activist hedge funds to make even bigger profits than they already do, Congress evidently has different priorities. The Williams Act is the law of the land, and the SEC has been authorized under the Dodd-Frank Act to modernize the rules and tighten them to ensure that they are serving their stated purpose. The proposals made in the Wachtell Lipton petition are designed to do just that. We strongly support rule changes that will close the loopholes that currently exist due to the overlong 10-day reporting window and the outdated definition of beneficial ownership, and we hope that the SEC's rulemaking process will proceed quickly and smoothly to that conclusion.

In fact, we believe that if the SEC fails to modernize the Schedule 13D rules, this will continue to permit investors (such as activist hedge funds) with short-term perspectives to gain an unfair advantage to the detriment of long-term investors and, ultimately, to the detriment of the United States' ability to continue to compete effectively in the global economy. Public companies need the ability to invest in the long term and deploy capital without facing undue pressure from short-term focused investors. Many of the recent changes to the proxy rules have provided additional tools to these investors; shortening the 10-day window and modernizing the definition of beneficial ownership would be a step towards leveling the playing field.

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[26] *Id.*; *see also* Andrew E. Nagel, Andrew N. Vollmer, & Paul R.Q. Wolfson, "The Williams Act: A Truly 'Modern' Assessment," *available at* blogs.law.harvard.edu/corpgov/files/2011/10/The-Williams-Act-A-Truly-Modern-Assessment.pdf.

[27] Wellman v. Dickinson, 682 F.2d 355, 365-66 (2d. Cir. 1982), citing GAF Corp. v. Milstein, 453 F.2d 709, 717 (2d Cir. 1971), cert. denied, 406 U.S. 910 (1972).