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Corporate Governance Update: 13(d) Reporting Inadequacies in an Era of Speed and Innovation

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The Securities and Exchange Commission and other market regulators confront a challenging issue: How to effectively monitor and regulate activity in an environment that is both fast-moving and highly complex? The principles and architecture of the Securities Exchange Act of 1934 were created for a much simpler financial world—an analog world—and they struggle to describe and contain the digital world of today. The lightning speed of information flow and trading, the constant innovations in financial products, and the increasing sophistication of active market participants each pose enormous challenges for the SEC; together, even more so. The ongoing controversy over Section 13(d) reporting exemplifies the many challenges facing the SEC in this regard.

In 2011, then-SEC Chair Mary L. Schapiro announced a broad review of the beneficial ownership rules governing the ownership reporting requirements for equity securities.[1] The SEC had been formally petitioned that year to update the Schedule 13D reporting requirements to shorten the reporting window—specific authority for which had been provided by the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010—and broaden the definition of beneficial ownership.[2] Unfortunately, Section 13(d) reform was delayed by the overwhelming volume of rulemaking required under Dodd-Frank.[3] A recent letter to Congress signed by several ethics and watchdog groups renewed the call for intervention by lawmakers on this important issue.[4] Though the requirements of Section 13(d) related to the timing of required

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

[2] 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.

[3] *See* Michael Siconolfi & Susan Pulliam, "SEC Is Urged To Shorten Window for Investor Tip-Offs," Wall St. J., Mar. 27, 2014, available at http://www.wsj.com/articles/SB10001424052702304688104579465661917560346.

[4] Letter from Citizens for Responsibility and Ethics in Washington, Government Accountability Project, & New Rules for Global Finance to Hon. Richard Shelby, Chairman, & Hon. Sherrod Brown, Ranking Member, U.S. Senate Committee on Banking, Housing, & Urban Affairs; Hon. Jeb Hensarling, Chairman, & Hon. Maxine Waters, Ranking Member, U.S. House Committee on Financial Services, Apr. 15, 2015, available at www.citizensforethics.org/page/-/PDFs/Legal/Letters/4-15-15-10_Day_Rule_Banking_Letter.pdf?nocdn=1.

disclosure unfortunately appear unlikely to be revised in the near future,[5] the SEC appears to be keenly aware of the rules' regulatory shortcomings. The SEC announced eight settlements of Section 13(d) enforcement actions in March 2015, and it is reportedly investigating a number of situations in which activist funds appear to have informally coordinated their market activity. Section 13(d) is an essential tool for promoting transparency and market integrity. While judicious enforcement in the short term may be helpful, comprehensive reform should be accomplished as soon as practicable,

Reporting Is Not Timely or Thorough

The reporting regime under Section 13(d) of the Securities Exchange Act is, as it stands, woefully inadequate. Section 13(d) fails to require timely or thorough disclosure. In a world of instant information, the deadline for filing a Schedule 13D remains 10 calendar days *after* crossing the 5 percent ownership threshold.[6] This window is large enough for material developments to occur in secret, undermining the regulatory goals of investor protection and market efficiency. Exacerbating this issue is the fact that the investor can continue to make acquisitions during the 10-day period even after crossing the 5 percent ownership threshold. Hedge funds and other activists have, in recent years, used this gap to accumulate large positions and gather support among fellow investment funds. The target company, the other shareholders, and the market have been none the wiser until the activists had amassed positions and influence well in excess of 5 percent. Though the 5 percent threshold is recognized as an important trigger for market disclosure, the 10-day window permits accumulators to continue acquiring additional shares without the market price reflecting the impact of such accumulation.

Clearly, technological advances have made short filing deadlines practical and desirable. Moreover, since crossing the 5percent threshold is rarely a surprise to the beneficial owner of the securities, there is no reason that the Schedule 13D cannot be prepared in advance and filed almost immediately upon acquisition of the reportable interests. Currently, if there is a material change to a Schedule 13D, an update must be filed "promptly," which—at least when the material change involves 1 percent or more of the subject securities—is generally understood to mean within one or two business days, and in many circumstances, the SEC staff's view has been that disclosure should be made the same day as the triggering event. There is no reason that the initial report cannot be filed within one or two business days as well. Delaware Supreme Court Chief Justice Leo Strine Jr., speaking at a conference in March 2015, added his voice to those calling for reform of Section 13(d). Chief Justice Strine recommended requiring "real time" disclosures, possibly within 24 hours, as well as reducing the stock ownership threshold to 2 percent and including options and derivatives in the required disclosures.[7]

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[5] *See* Liz Hoffman, "SEC Unlikely to Touch 13(D) Stock-Buying Window," Wall St. J., Oct. 2, 2014, available at blogs.wsj.com/moneybeat/2014/10/02/sec-unlikely-to-touch-13d-stock-buying-window/.

[6] 17 CFR § 240.13d-1.

[7] *See* David Benoit & Liz Hoffman, "Taking Sides on Activist Investors," Wall St. J., Mar. 19, 2015, available at www.wsj.com/articles/strine-urges-closing-of-10-day-investment-disclosure-window-1426791548; *see also* Leo E. Strine Jr., Essay, "Can We Do Better By Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law," 114 Columbia L. Rev. 449, 493-96 (2014) available at

As Chief Justice Strine suggested, another significant shortcoming of Section 13(d) is that it does not currently require full disclosure of an investor's significant positions. A sophisticated investor can accumulate a variety of influential interests in a target stock and complex, dynamic combinations of economic and voting power without having to publicly report any of them. Disclosure of derivatives such as options, warrants, and convertible securities is required only in limited circumstances, while non-traditional, synthetic arrangements generally are not covered, and short positions, even very large ones, are not disclosable at all. This leaves a vast universe of securities beyond the reach of Section 13(d). Earlier this year, SEC Commissioner Luis Aguilar noted that the size of the global derivatives market is currently estimated at $630 trillion, with approximately $14 trillion representing transactions in securities-based swaps regulated by the SEC.[8]

Derivatives and synthetics—which are not a limited set of products but the subject of constant innovation and, moreover, easily customizable—can serve to "decouple" the traditional bundle of rights and obligations of stockholders and thereby separate voting from economic interest. The challenge for U.S. governance and regulatory mechanisms, which are largely predicated on disclosure requirements as a means of promoting market efficiency, is to capture the complexities of these arrangements.[9] As it now stands, financial innovation has undermined transparency. As Professor Henry T.C. Hu eloquently states:

> The [public disclosure] system is manifestly insufficient to capture the complex objective realities that are now being created by financial innovation…. This informational challenge undermines the panoply of transparency-dependent corporate governance mechanisms, including equity-based compensation systems to align management and shareholder interests, the market for corporate control, and the monitoring of management behavior and performance."[10]

Decoupling arrangements can lead to "empty voting," in which an investor holds voting rights in excess of their economic interest, and "morphable ownership," in which an investor holds economic interest in excess of formal voting rights but has the ability to transform the economic position into a traditional ownership position.[11] Both strategies severely disrupt the traditional one

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http://columbialawreview.org/can-we-do-better-by-ordinary-investors-a-pragmatic-reaction-to-the-dueling-ideological-mythologysts-of-corporate-law/.

[8] *See* SEC Commissioner Luis A. Aguilar, Public Statement, "Establishing a Registration Framework for Dealers and Major Participants in the Derivatives Market," Aug. 5, 2015 (citing data from Bank for International Settlements), available at http://www.sec.gov/news/statement/establishing-a-registration-framework-for-dealers.html.

[9] Wachtell, Lipton, Rosen & Katz highlighted this issue in the Section 13(d) context seven years ago. For a full discussion, see Theodore N. Mirvis et al., "Beneficial Ownership of Equity Derivatives and Short Positions — A Modest Proposal to Bring the 13D Reporting System into the 21st Century," Wachtell, Lipton, Rosen & Katz Client Memo, Mar. 3, 2015, available at www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.15395.08.pdf. This memorandum offers a proposal for an updated definition of beneficial ownership under Rule 13d-3.

[10] *See, e.g.*, Henry T.C. Hu, "Financial Innovation and Governance Mechanisms: The Evolution of Decoupling and Transparency," 70 Bus. Law. 347, 352 (Spring 2015), available at http://www.valuewalk.com/wp-content/uploads/2015/04/SSRN-id2588052.pdf.

[11] *See id.* at 355.

share/one vote model upon which corporate governance—including voting rules, takeover defenses, and disclosure requirements—is based. The SEC is well aware of issues relating to empty voting and decoupling generally, both of which were discussed at length in the "Proxy Plumbing" Concept Release on the U.S. Proxy System in 2010.[12] To the extent that the SEC does not act in the near future to regulate decoupled and morphable positions, public companies should seriously consider availing themselves of innovations on the takeover defense side to protect themselves from possible attacks. Corporate by-law provisions, change-of-control protections, and shareholder rights plans designed to protect against morphable ownership stakes are becoming more common in response to opportunistic and unscrupulous accumulation techniques.[13] Although these mechanisms tend to operate imperfectly, they are a private ordering attempt to overcome a recognized regulatory inadequacy.

Gray Areas in Trading, Transactions

Even more difficult for a disclosure regime to address are information networks among like-minded investors. A March 2014 *Wall Street Journal* article alleged that activist investors strategically and selectively disclose information to other investment firms about their planned campaigns.[14] The tipped investors use the information to buy or sell in advance of a major announcement by the tipping firm, thereby benefiting from the resulting change in stock price. The proceeds of these trades are a functional payoff among informal investment partners. The *Wall Street Journal* article included charts showing that stock prices moved significantly in the days before investor announcements, indicating pre-announcement trading that may have resulted from private tips. This information sharing may be legal so long as the investors do not form an undisclosed "group" collectively holding 5 percent or more of the target stock, though the SEC warned hedge funds in 2014 that collaborative sharing of investment ideas is "a risk to be mindful of" and may in certain instances "cross the line."[15] The *Journal* reported in June 2015 that the SEC is investigating instances of this activity.[16] The known practice is just a single example of a way that current regulations, intended to require disclosure when significant investors take material actions in a target company's stock, can fail to do exactly that.

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[12] Exchange Act Release No. 82495, "Concept Release on the U.S. Proxy System," July 14, 2010, available at www.sec.gov/rules/concept/2010/34-62495.pdf.

[13] Shareholder rights plans that defend against morphable ownership are generally understood to be valid in Delaware. *See* Hu, *supra note 10*, at 365 (citing *In re Atmel Corp. S'holders Litig*. (Del. Ch. May 22, 2009) (in which a shareholder rights plan designed to protect against the possibility of morphable ownership was described by the court as a "careful, reasoned, and incremental response of the law to the ever-changing business practices that affect Delaware corporations")).

[14] *See* Susan Pulliam et al., "Activist Investors Often Leak Their Plans to a Favored Few," Wall St. J., Mar. 26, 2014, available at http://www.wsj.com/articles/SB10001424052702304888404579381250791474792.

[15] *See* Perrie Michael Weiner & Patrick Hunnius, "Expect Greater SEC Scrutiny of Activist Hedge Funds That Share Information or Collaborate in Advance of Their Trades," Law360.com, Apr. 17, 2014 (quoting SEC Staff), available at www.law360.com/articles/529294/activist-investors-brace-yourselves-for-13d-changes.

[16] *See* Liz Hoffman et al., "SEC Probes Activist Funds Over Whether They Secretly Acted in Concert," Wall St. J., June 4, 2015, available at www.wsj.com/articles/sec-probes-activist-funds-over-whether-they-secretly-acted-in-concert.

In March 2015, the SEC announced eight settlement orders in enforcement actions against corporate insiders in connection with three going private transactions.[17] Each of the individuals was charged based on their failure to file timely amendments to their Schedule 13D filings as their plans for the transactions developed. The SEC staff in the Office of Mergers and Acquisitions discovered the violations in the course of their review of the proxy and Schedule 13E-3 transaction statements that were filed in furtherance of the transactions, months or even years later. These settlement orders (which resulted in cease-and-desist orders and payment of civil penalties, to which the individuals consented) indicate two things of note. First, the SEC is increasingly scrutinizing Section 13(d) disclosures. Though actual amendment may not be on the near horizon, the SEC appears to be tightening enforcement of the rules as they exist and indicating to market participants that disclosures will be carefully reviewed—where possible, with the benefit of hindsight. Schedule 13D filers should keep in mind that their disclosures may be evaluated in the context of additional disclosures that are made by other filers, for other purposes, and at a much later date.

The second takeaway from the March 2015 settlement orders is that the scope of disclosure required in an amendment to a Schedule 13D may be effectively broadening. It had previously been understood that 13D filers did not have to amend the generic disclosures in their initial filings until a definite plan had been formulated. Though the recent SEC orders do not provide a bright-line test, it seems that disclosure relating to the formulation of a plan may be required, and possibly disclosure of the steps taken toward determining whether or not to proceed with the formulation of a plan, particularly if they represent a change from the initial or prior disclosure. The orders indicate that although in some cases even discussions with other parties could trigger disclosure, the formation of a "group" for Section 13(d) purposes will still require actual agreement between the parties.[18] It is important to note, however, that under the rules, such an agreement need not be written; an oral or even tacit agreement would require disclosure.

The SEC's focus on Section 13(d) disclosures is a welcome development, with two important caveats. First, increased enforcement is not a substitute for meaningful reform; thoughtful and thorough revision of the requirements of Section 13(d) will be far more effective in promoting transparency and compliance. Second, the scope of securities regulation is meant to be expanded through the administrative rulemaking process, not through zealous enforcement. To the extent that the SEC's scrutiny and administrative proceedings begin to shift the line separating acceptable and impermissible conduct—which may be happening in the context of Schedule 13D amendments, as indicated by the SEC orders discussed above—newly vigorous en-

[17] Securities & Exchange Commission, Press Release, Mar. 13, 2015, "Corporate Insiders Charged for Failing To Update Disclosures Involving 'Going Private' Transactions," available at www.sec.gov/news/pressrelease/2015-47.html.

[18] For a more detailed discussion, see David A. Katz & Alison Z. Preiss, "SEC Charges Schedule 13D Filers for Failing To Timely Disclose Steps Taken To Pursue Going-Private Transactions," Wachtell, Lipton, Rosen & Katz Client Memo, Mar. 17, 2015, available at www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.23896.15.pdf.

forcement might arguably raise due process issues.[19] While efforts by the SEC to promote full and prompt compliance with the beneficial ownership disclosure requirements will help to enhance their value as a meaningful source of information, their relevance to the market will be necessarily limited until comprehensive reform can be accomplished and fully implemented.

Information and the Market

A powerful debate currently rages as to whether activism is—and whether more robust disclosure requirements as to large investors' plans and positions would be—beneficial or detrimental to other investors and the financial market in general. Activists such as Bill Ackman have publicly opposed reform of Section 13(d) reporting requirements on the basis that more effective rules would limit their ability to profit from the current deficiencies relating to timing and scope. Activists also oppose tightening the definition of "group" activity, as it would limit their ability to privately share profitable information regarding upcoming announcements and plans.

These activist investors argue that removing opportunities and incentives to profit in the marketplace would not be beneficial to the market or its participants generally. Yet this argument is fundamentally ill-conceived; taken to its extreme, it would paint nearly all securities regulation as undesirable. Taking a step back, consider who "wins" and who "loses" during the ten-day period in which Schedule3D disclosure is delayed. No one can reasonably argue that disclosure of a five percent or greater stake is not market-moving information. In fact, precisely because the market does not have this information, the accumulator can profit from this informational advantage during the disclosure window. The counterparties to the accumulators are the losers, as they are selling their shares to the accumulator at a lower price than would be the case if the information were fully disseminated to the market. In other contexts, such activities would be considered "insider trading."

America has for generations taken the view that investor protection and market integrity are values worth protecting through regulation. Moreover, the current governance regime, for better or worse, is built on a foundation of public disclosure. Unless or until the existing securities regulation framework is fundamentally reconceived, the SEC must work to ensure that its rules effectively produce timely and thorough disclosure of material information. Failure to do so will only further embolden activists and others to use their informational advantage to profit at the expense of an uninformed market:

> Transparency and disclosure are required for investor confidence in our financial markets. When activist hedge fund managers manipulate the laws and exploit gaps (with the well–paid assistance of former top regulators, no less) to hide their acquisitions, allowing them to reap outsize profits while ordinary investors are left

[19] SEC Commissioner Michael S. Piwowar addressed this subject in a 2014 speech. *See* SEC Commissioner Michael S. Piwowar, Remarks to the Securities Enforcement Forum, Oct. 14, 2014, available at http://www.sec.gov/News/Speech/Detail/Speech/1370543156675.

> in the cold, Americans legitimately believe the game is rigged. We urge you to take up legislation that would help level the playing field.[20]

Earlier this spring, at the Tulane Corporate Law Institute, SEC Chair Mary Jo White was quoted as saying that in "certain situations, activism seeks to bring about important changes at companies that can increase shareholder value."[21] Chair White emphasized that, in her view, engagement between activists and companies can be beneficial and that some types of activist activity can promote productive engagement.[22] That said, she observed that "all parties, including activists and management, are obligated under the federal securities laws to provide shareholders with timely, clear, complete, and accurate disclosures about the subject matter and their interests." Section 13(d) is currently a weak and largely ineffective means of achieving that goal. Reform is long overdue, and it is time for the SEC or Congress to take immediate corrective action.

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[20] Letter from Citizens for Responsibility and Ethics in Washington, Government Accountability Project, & New Rules for Global Finance to Hon. Richard Shelby, Chairman, & Hon. Sherrod Brown, Ranking Member, U.S. Senate Committee on Banking, Housing, & Urban Affairs; Hon. Jeb Hensarling, Chairman, & Hon. Maxine Waters, *supra note 4*.

[21] *See* Benoit & Hoffman, *supra note 7; see also* SEC Chair Mary Jo White, Remarks to Tulane University Law School 27th Annual Corporate Law Institute: A Few Observations on Shareholders in 2015 (March 19, 2015) available at www.sec.gov/news/speech/observations-on-shareholders-2015.html.

[22] *See id.*