COMMENTERS BATTLE OVER SEC 13D PROPOSAL; STRONG PUSHBACK FROM MARKET PARTICIPANTS

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Following the April 11 expiration of the comment period for the SEC's dramatic proposal to amend the 13D/13G rules, we reviewed submissions to the SEC from some of the notable commenters. While a number of corporations and business groups supported the proposals, others, including certain institutional investors, activists and market participants, as well as some academics, strongly opposed key elements of the proposals.

As discussed in our February 16 client alert, the SEC proposed significant changes, including:

- Significantly accelerating filing deadlines
- Extending the filing cut-off from 5:30 pm ET to 10 pm ET
- Expanding beneficial ownership concepts to include certain cash-settled derivative securities
- Expanding and clarifying the meaning of groups
- Exempting certain communications and consultation from regulation as a group
- Requiring 13Ds and 13Gs be filed using an XML machine-readable data language

Not surprisingly, public companies and their trade groups and advisors generally supported the proposals, including Business Roundtable, National Investor Relations Institute (NIRI), Society for Corporate Governance, Wachtell Lipton and companies such as FedEx and Freeport-McMoRan. Some proposed more aggressive modifications, such as:

- reducing the deadline for initial 13Ds from five days to two business days (NIRI and SCG) or one business day (Wachtell)
- requiring moratorium on further acquisitions until two business days after filing the 13D (Wachtell)

- further broadening the definition of beneficial ownership to include any derivative that includes the opportunity, directly or indirectly, to profit or share in any profit of the subject security, subject to certain exceptions (Wachtell)

By contrast, key elements of the proposal received strong pushback and criticism from other groups, particularly with respect to the expanded definition of the group concept, the inclusion of cash-settled derivatives in beneficial ownership and accelerated filing deadlines.

Elimination of requirement for "agreement" to form a group

Numerous commenters objected to the elimination of the requirement for an agreement in the concept of a group, including advisors and market participants such as the Securities Industry and Financial Markets Association (SIFMA), Investment Company Institute, Investment Adviser Association, Simpson Thacher & Bartlett, T Rowe Price, Dodge & Cox ,and State Street Corporation and activists such as Elliott Investment Management and Pershing Square. For example:

- In a deeply researched and analyzed submission, Elliott Investment Management objected to the "radical redefinition" of a group as conflicting with Section 13(d)(3), which requires a meeting of the minds among group members, and the legislative history which tied group membership with an agreement to act in concert.

- SIFMA, Elliott, Pershing Square and Simpson all assert that appellate courts have uniformly interpreted Section 13(d) as requiring an agreement among parties.

- Perhaps foreshadowing potential litigation claims, Elliott discussed its reasoning for concluding the proposal would be subject to invalidation on several grounds, including (i) the *Brand X* doctrine, which is that an appellate court's construction of a statute is binding and not subject to revision – even through agency rulemaking – when the court holds the statute has a clear and unambiguous meaning, (ii) the absence of "reasoned decision-making" under the Administrative Procedure Act (APA), (iii) the departure from past agency practice without adequate explanation and (iv) the absence of awareness that the SEC is changing its position rather than, as the SEC maintains, clarifying its position.

- Elliot also asserts that this aspect of the proposal violates the First Amendment, because it would impinge upon protected commercial speech and would also violate the Fifth Amendment's due process clause due to the vagueness of the standard as to what conduct would create a group.

Most of the commenters expressed strong concern that the proposal could have a chilling effect on a variety of market transactions and, as noted by Professors Edwards (UNLV), Haan (Washington & Lee), Min (Michigan State) and Steelman (NY Law), beneficial communications among shareholders seeking ESG change. Some, including 65 Law and Finance Professors, expressed

concern with the “dearth of data and academic research” regarding the costs and benefits of the proposed redefinition of “group”.

Several also noted that the definition of beneficial ownership is incorporated into a number of other rules, including Section 16, as well as widespread definitions of change of control, including for purposes of M&A, credit, compensation and derivative agreements – which potential carryover effects were not addressed by the SEC’s analysis in its proposal.

Inclusion of cash-settled derivatives in beneficial ownership

Many of the same institutional investors and market participants objected to the SEC’s proposal to include cash-settled derivatives in the definition of beneficial ownership.

- Several commenters noted that the SEC failed to provide evidence of derivatives providing incidents of ownership, such as control over voting or investment power, or any examples of specific cash-settled derivative products giving rise to concern , including commenters such as SIFMA, Council for Investor Rights and Corporate Accountability (CIRCA), Elliott and Simpson Thacher, with SIFMA noting that one of the examples did not even involve a cash-settled derivative.
- Elliott criticized the SEC for asserting ” an unsubstantiated belief” that such derivatives “may be used” to improperly pressure counterparties to make decisions regarding voting or disposition of referenced securities – but without providing any evidence of actual instances in the marketplace or any empirical data.
- They view existing law as sufficient to address the SEC’s concerns and view the proposal as being inconsistent with the existing beneficial ownership regime.

Several commenters expressed concern that such an expansion could have significant unintended consequences under other federal and state laws, as well as many contracts, including commenters such as the Investment Company Institute, Investment Adviser Association and TIAA

Accelerated filing deadlines

The proposed acceleration of filing deadlines received criticism from institutional investors and activists, as well as from academics.

- *Information asymmetry.* Professors Schwartz (Yale) and Shavell (Harvard), two leading academics on financial markets, asserted that the proposal for accelerating filing deadlines is based on a fundamental flaw, because the SEC fails to consider whether a buyer would be willing to invest in the analysis of an investment opportunity if required to disclose the information it acquired prior to purchasing shares; in other words, requiring disclosure before trading deters buyers from effecting trades

Investment Adviser Association, T Rowe Price and Dodge & Cox voiced strong concern that the shorter deadlines would provide greater opportunities for front running and other predatory trading by free riders, reducing fund returns and harming fund shareholders. D&C believes the SEC should not "try to level the playing field by forcing certain market participants to share their intellectual capital and work product with other market participants unless [it] can identify specific harm to markets and/or investors, which it has not done."

CIRCA expressed concern that shorter deadlines would significantly reduce incentives for investors to effect corporate change.

- *Insufficient time.* Many of the commenters urged that more time is needed to complete filings, noting that the advances in technology cited by the SEC do not actually streamline the processes needed to prepare and verify filings, particularly given corporate structures and different time zones.
- *Qualified Institutional Investors.* The Investment Company Institute, Investment Advisers Association, SIFMA and a number of institutional investors objected to accelerating filing deadlines for qualified institutional investors, noting that they are required to certify the absence of potential to change or influence control and due to the front-running and free riding concerns noted above. Further, institutional investors often have large volumes of 13G filings to make, and shifting to monthly filing would strain resources and present system challenges for collecting data from multiple entities.

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MEET THE TEAM

R. Randall Wang

St. Louis

randy.wang@bclplaw.com
+1 314 259 2149

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