The Law and Economics of Blockholder Disclosure

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Overview

- We focus on whether the SEC's Section 13(d) rules should be tightened to prevent pre-disclosure accumulations of more than 5%.

- Our paper provides a framework for the SEC's examination of the advocated tightening.

- Based on currently available evidence, we conclude that the SEC should not proceed with the petition's proposed tightening.

- We support a reexamination of the Commission's rules in this area, and identify the empirical questions that such an examination should investigate before any changes to current rules are made.

The Need for a Policy Analysis

- It might be argued that acceleration of blockholder disclosure is clearly called for by a basic belief in transparency and by a desire to effectively achieve the goals of the Williams Act.

However:

- Outsiders using outside information are typically not required to disclose their purchases for the sake of transparency; the Williams Act created a limited exception to this principle.
- Furthermore, the drafters of the Williams Act chose not to prohibit pre-disclosure accumulations above the 5% threshold: Although Senator Williams's initial proposal did make it unlawful for blockholders to cross the 5% limit without prior disclosure, after extensive debate Congress intentionally and consciously chose not to impose such a limit.
- Thus, current disclosure requirements should be tightened only if the SEC reaches a policy conclusion, after weighting relevant costs and benefits, that doing so would benefit investors.

Costs of the Proposed Tightening (1)

- Monitoring and engagement by outside blockholders is widely recognized to be beneficial for shareholders (e.g., Shleifer & Vishny (1986)).

- Given existing impediments to the market for corporate control, outside blockholder activities are especially important for reducing agency costs and managerial slack in public companies.

- The drafters of the Williams Act recognized that outside blockholders "should not be discouraged, since they often serve a useful purpose by providing a check on entrenched but inefficient management."

- Tightening the rules would reduce payoffs from block accumulation, thereby discouraging block formation, reducing outside blocks' size, and lowering the incidence and intensity of blockholder monitoring and engagement activities.

Costs of the Proposed Tightening (2)

The existing empirical evidence suggests that concerns about reducing blockholder activities should be given substantial weight. Among other things, findings consistent with a beneficial role for outside blockholders include:

- The filing of a Schedule 13D indicating the presence of a blockholder is associated with positive average abnormal returns (Brav, Jiang, Partnoy and Thomas, 2008).
- The filing of a 13D in which a blockholder indicates that it aims to redirect management's efforts is also associated with large, positive abnormal returns (Klein and Zur, 2009).
- The presence of a blockholder is associated with increased shareholder opposition to entrenching anti-takeover amendments to corporate charters (Brickley, Lease and Smith, 1988).
- When a blockholder is represented on a company's board, CEO pay is less likely to reward "luck" rather than performance (Bertrand and Mullainathan, 2001).
- Having blockholders on a company's board is associated with reduced incidence of option backdating (Bebchuk, Grinstein and Peyer, 2010).
- Having a blockholder representative on the compensation committee is correlated with a stronger CEO pay-performance link, stronger link between performance and CEO turnover, and lower CEO pay (Agrawal and Nasser, 2011).

Asserted Benefits of the Proposed Tightening

The petition asserts that tightening the rules is necessary to prevent outside blockholders from capturing the private benefits of control without paying for them.

However:

- Pre-disclosure accumulations of outside blocks, including those going beyond 5%, generally does not provide investors with control and the associated private benefits—outside blockholders are typically able to move the company in the direction the blockholder prefers only by convincing other shareholders that doing so would be desirable, not by exercising control power.

- The petition relies on anecdotes in which companies chose to pursue a strategy advocated by outside investors—but that hardly indicates that outside blockholders had control—indeed, sometimes investors holding significantly less than 5% are able to influence companies to move in the direction they advocate.

- To be sure, outside blockholders planning to be active obtain benefits from pre-disclosure accumulations—as do outside blockholders that identify an undervalued company and plan to be passive—but these are not control benefits taken from the shareholders who remain in the company and who lose the prospect of a control premium.

Changes Over Time (1)

A tightening of the rules is argued to be needed because changes in trading patterns and technologies have increased the frequency of pre-disclosure accumulations going beyond 5%.

- However, we are aware of no systematic empirical evidence suggesting that an increase in the speed or frequency of pre-disclosure accumulations has occurred over time.

- The petition and its supporters refer repeatedly to four anecdotes over the last five years. Although the data on 13(d) accumulations is publicly available, they have not conducted any systematic comparison of how these accumulations have changed over time.

- The empirical evidence suggests that pre-disclosure accumulations over the 5% threshold occurred frequently in the 1980s (Holderness and Sheehan, 1985).

- Until further empirical work can be done on these questions, the SEC should not assume that pre-disclosure accumulations of more than 5% have become more common in recent years.

Changes Over Time (2)

Indeed, the changes to state law in the decades since the passage of the Williams Act strongly counsel against tightening the rules.

- State-law rules have shifted in a way that significantly tilts the playing field in favor of incumbents and against outside blockholders.

- Among other things, state-law rules now permit the adoption of low-trigger poison pills that prevent blockholders from acquiring even blocks that are widely recognized not to convey control.

- These pills are now common at large public companies: among the 805 public companies in the Sharkrepellent dataset with pills now in place, 76% have pills with triggers of 15% or less, and 15% have pills triggered by the acquisition of 10% or less of the company's stock.

Changes Over Time (3)

Finally, the petition suggests that the adoption of blockholder-disclosure rules in other countries requires a change in SEC rules so that the United States does not fall behind.

However:

- When considering the rules governing the balance of power between outside blockholders and incumbents as a whole, it is clear that U.S. rules put blockholders at a far greater disadvantage than they face in other jurisdictions. (For example, no foreign jurisdiction described by the petition or its supporters authorizes the use of low-trigger poison pills that are increasingly common at U.S. public companies.)

- If anything, the rules in other jurisdictions should lead the SEC to be concerned that the United States is, overall, too tough—not too lax—with respect to the regulation of outside blockholders.

Conclusion

- On the basis of current evidence, the SEC should not proceed with the proposed tightening of the rules that govern the timing of Schedule 13D disclosures.

- We welcome a comprehensive examination of the SEC's rules in this area. Such an examination should include an empirical study of questions including the following:

  - Study of the magnitude of the benefits conferred on shareholders by blockholders and the factors that determine those benefits;
  - An assessment of the effects of the existing disclosure requirements, and the expected effects of tightening or relaxing those requirements;
  - Study of how pre-disclosure blockholder accumulations have changed—if at all—since the passage of the Williams Act; and
  - Analysis of the how the evolution of state-law rules impeding blockholders, such as the authorization of low-level poison pills, affects the incidence and size of blocks—and blockholders' activities.

We welcome your comments.