# A TWO-PART DISCLOSURE MANDATE AS A COMPROMISE SOLUTION TO THE DEBATE ON SECTION 13(D)'S DISCLOSURE WINDOW

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Abstract

*For several decades, Section 13(d) of the Securities Exchange Act of 1934 has required that investors acquiring more than 5% of the outstanding equity securities in a publicly traded company disclose to the Securities and Exchange Commission (SEC) their stake in that company within ten days of exceeding the 5% threshold—thus acting as a de facto deterrence mechanism against potential surreptitious takeovers of such companies. With the passage of the Dodd-Frank Act in 2010, the SEC was able to shorten this disclosure window, which sparked an intense debate over the proper scope and strictness of Section 13(d). The pro-transparency faction urges the SEC to reduce the disclosure window to one day, while its opponents urge that the status quo remain and raise concerns about the deterrent effect a shortened window would have on beneficial activist investor scrutiny on corporate management. The decline of shareholder rights plans and the simultaneous rise of activist investing in the U.S. increases the urgency of finding the ideal resolution to this seemingly intractable issue.*

*A compromise solution could help bridge the gap between these two factions. Under the proposed solution, investors would be required to notify the board of a public company within one day of acquiring more than 5% of the company's shares, while still having ten days to publicly notify the Commission. On its face, the compromise solution creates the potential to satisfy both sides of the debate. On one hand, a board could disclose to their shareholders any significant investor acquisitions in their company within a day of the Section 13(d) threshold being reached, and, on the other, the investor could negotiate with the board to keep the information confidential for a longer period of time so that the investor could acquire more shares while simultaneously advancing ideas for enhancing the value of the company without the glare of the public spotlight. Although legal and strategic challenges exist in implementing this solution, neither poses a risk of undermining its utility.*



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## Introduction

Created in 1968 with the passage of the Williams Act, Section 13(d) of the Securities Exchange Act of 1934 (Exchange Act) was originally aimed at forcing investors who accumulated more than a certain percentage of stock in a publicly traded company to disclose their holdings shortly after exceeding a pre-defined threshold.[1] Specifically, this section has mandated for decades that investors who acquired more than 5% in a publicly traded company disclose to the SEC their stake in that company within ten days of exceeding the 5% threshold.[2]

But over the past two years, a debate has intensified over the proper scope and strictness of Section 13(d). With the passage of the Dodd-Frank Act (DFA) in July of 2010, the SEC was given authority to review and modify Section 13(d),[3] and this opportunity has stirred controversy between two competing sides. On one side, pro-transparency advocates seek a shorter window—one or two days instead of ten—in which investors must disclose their holdings in a public company once exceeding the 5% threshold.[4] They argue that this shortened window is necessary to ensure corporate boards are quickly made aware of surreptitious large-scale share acquisitions by activist investors who are looking to exert influence on corporate decision making.[5] They also wish to see that the stock gains of any such acquisition be shared among more investors—not just the activists.[6] The other faction seeks to maintain the status quo, arguing that any shortening of the disclosure window would deter activist investors from establishing large positions in public companies and reduce their capacity to improve company performance.[7]

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[1] *See* Jonathan Macey & Jeffrey Netter, *Regulation 13D and the Regulatory Process*, 65 Wash. Univ. L. Quart. 131, 133–34 (1987), *available at* http://digitalcommons.law.yale.edu/fss_papers/1776.

[2] *See* Securities Exchange Act of 1934 § 13, 15 U.S.C. § 78 (2006).

[3] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929R, 124 Stat. 1376, 1866 (2010).

[4] *See, e.g.*, Petition from Wachtell, Lipton, Rosen & Katz to the Securities & Exchange Commission (March 7, 2011) [hereinafter Wachtell Petition], *available at* www.sec.gov/rules/petitions/2011/petn4-624.pdf.

[5] *See id.* at 7.

[6] *See id.*

[7] *See, e.g.*, Lucian A. Bebchuk & Robert J. Jackson, Jr., *The Law and Economics of Blockholder Disclosure*, 2 Harv. Bus. L. Rev. 39 (2012).

Although each side raises legitimate points, little has been said about a middle-ground solution that could help ensure that the benefits of both viewpoints are achieved. Such a compromise has been proposed by one prominent corporate governance scholar and will be the focus of this Note.[8] Instead of shortening the disclosure window to one or two days, the window would remain at ten days; however, the corporate board of the public company in which the activist investor has taken at least a 5% stake will be notified of this holding within one day of the threshold-exceeding acquisition. Ultimately, it will be up to the target company's board to decide on how soon their shareholders will know of the activist investor's stake in the company.

This compromise solution serves two goals. First, it ensures that corporate boards are more quickly made aware of potential acquisitions that could threaten the current leadership of the company and thus partly satisfies the pro-transparency advocates. Second, it ensures that activist investors who take such stakes in public companies will still be able to adequately reap the benefits of the work necessary to research the company and play a role in improving the company's fortunes—thus maintaining the arguably positive influence that activist investors have on corporate decision making.

Of course, not everyone will agree with such a compromise, and potential consequences—both legal and strategic—may arise from its implementation that need to be analyzed before declaring it an ideal solution. For example, as part of their fiduciary duty, boards may decide to disclose the activist investor's acquisition to stockholders before the ten-day window elapses. They may try to extort concessions from these investors in exchange for keeping quiet. Other investors, meanwhile, may be unaware of the investor's large stake and miss out on the share price appreciation during the disclosure window—a main concern for the pro-transparency faction. Other boards may simply decide to uphold a policy of always disclosing on the first day to better deter activist investors, who may otherwise have purchased more shares so as to influence corporate decision-making in a way that maximizes the value of the company. Giving the board the power to decide how long the disclosure window should actually be would not sit well with the supporters of the status quo, but would ultimately create a scenario in which both factions' concerns are at least partly addressed. All of these implications need to be considered before declaring this compromise solution a success.

This Note proceeds as follows. Part I discusses the background of Section 13(d), explaining its historical and practical purposes, and emphasizing its renewed importance in light of the decline of the poison pill and the emergence of more aggressive investors seeking to exert influence over pub-

[8] This Note's proposed solution arose in discussions with Professor Guhan Subramanian of Harvard Business School and Harvard Law School, who devised the general two-part disclosure mandate structure.

lic companies. Part II review the competing positions of the two most influential factions in the current Section 13(d) debate, particularly focusing on a pro-transparency petition by the prominent law firm, Wachtell, Lipton, Rosen & Katz (Wachtell) and on an academic paper by corporate governance scholars Lucian A. Bebchuk and Robert J. Jackson, Jr. arguing to maintain the status quo, and a compromise will then be proposed. Part III analyzes this solution, highlighting some of its legal and strategic implications and detailing potential challenges. Finally, the paper concludes with a few suggestions for future research.

## I. Background

Of the many provisions in the DFA, one in particular has permitted the SEC to review and shorten Section 13(d)'s disclosure window.[9] Specifically, Congress modified Section 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."[10] By providing the SEC authority to shorten the disclosure window, Congress acknowledged the simmering controversy that had begun to flare up in recent years. Before addressing this debate, however, this paper will first analyze the original purpose of Section 13(d).

### A. *The Historical and Practical Purposes of Section 13(d)*

In 1968 Congress passed the Williams Act, which added Section 13(d) to the Exchange Act.[11] The Williams Act was passed at a time when there was a worryingly high number of takeovers, particularly in the form of cash tender offers.[12] Senator Williams and others in Congress were concerned that investors did not have enough information about these takeover bids to make appropriate investment decisions and saw required disclosure by would-be acquirers as a way of mitigating this problem.[13]

Additionally, Williams thought it made sense to extend this disclosure requirement to investors who intend to acquire a public company via a proxy battle (that is, through acquiring shares and voting out the board members, replacing them with hand-picked successors).[14] A key component of this disclosure filing was to include any plans or proposals to make major changes to the "business or corporate structure" of the target firm if the purpose of the stock acquisition was to acquire control.[15] Williams argued that this com-

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[9] *See* 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.

[10] Dodd-Frank Act § 929R, at 1866.

[11] *See* Macey & Netter, *supra* note 1, at 133.

[12] *See id.*

[13] *See id.*

[14] *See id.*

[15] 15 U.S.C. § 78m(d)(1)(C) (2006).

ponent, along with other extensive Section 13(d) disclosures, was necessary to provide the public "with adequate information on which to base intelligent investment decisions, thereby enhancing public confidence in the Nation's securities markets and encouraging healthy growth and development of those markets."[16] These remarks indicate that Section 13(d)'s primary purpose was to inform investors of another investor's accumulation of a large amount of shares in that company—ostensibly because investors would like to know about it. Yet this broad interpretation could be narrowed by acknowledging the context in which the Williams Act was passed and acknowledging the motivating force behind the drafting of Section 13(d)—to inform investors of a potential change in control of a company. This can be considered the historical purpose of Section 13(d) and underpins the pro-transparency faction's argument.

Based on the aforementioned discussion, one could therefore conclude that a shortened disclosure window would better serve the purpose of Section 13(d). Yet one could also draw from Williams's statement that disclosing more information to investors is but a means to an end—that of encouraging the healthy growth and development of U.S. capital markets. Activist investors, through researching underperforming companies and intervening in their management and strategy to increase their share price, help improve the efficiency of such companies. Over the years, however, as investor activism has grown and hedge funds have multiplied, a case could be made that the purpose of Section 13(d)'s disclosure window has morphed. One may argue that the disclosure window has turned into a way for activist hedge funds to reap rightfully earned profits by purchasing what they perceive as undervalued shares for ten days in excess of the 5% threshold before disclosure becomes mandatory. The disclosure window could be considered a way to incentivize investors to engage in costly research of companies, take influential stakes in those companies, reap an initial profit, and then work to improve the operations of that company to earn additional gains. This could be considered the practical purpose of Section 13(d)'s ten-day disclosure window and is the primary argument by the pro-activist faction.

Much of the following discussion will focus on these two competing purposes of Section 13(d), but first I turn to a relatively recent trend in corporate governance that will serve to underscore the importance of Section 13(d) as an anti-takeover mechanism: the decline of the poison pill among public U.S. companies and the sharp rise in activist investing among large public companies.

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[16] S. Rep. No. 550, at 1 (1967).

### *B. The Decline of the Poison Pill and the Renewed Importance of Section 13(d)*

Williams was certainly right that Section 13(d) could serve as an anti-takeover mechanism for public companies. Although securities regulations limit acquirers' ability to take over public companies, little stops them from acquiring companies through open-market purchases—except for the inability to find enough sellers willing to sell at a certain price. But if sellers do not know that a would-be acquirer is seeking to buy a controlling or influential share in a company, they will not know to charge a premium on their shares. With increased disclosure, sellers will more quickly charge a premium on their shares to the would-be acquirer and therefore make acquiring a large enough stake more costly. This mechanism, if implemented appropriately, can therefore serve as a useful takeover defense.

Over the last several decades, the advent and rise of the shareholder rights plan—more commonly known as the poison pill—by U.S. public companies has mitigated Section 13(d)'s role as a takeover defense. For a company that has a poison pill in place, if more than a certain percentage of the company's shares are purchased by a would-be acquirer, the shareholder rights plan will kick in, allowing the company's other shareholders to purchase additional shares from the company at a steep discount—thereby diluting the voting power of the would-be acquirer and making an acquisition infeasible or, at the very least, much too costly.[17] The poison pill has long served as a strong deterrent to the open-market purchase of shares for the purpose of acquiring or significantly influencing a company without the consent of the current board.

Yet over the last decade, a decline in the adoption of shareholder rights plans across U.S. public companies has cast more attention on Section 13(d) as an alternative takeover defense. From 2000 to 2010, the number of poison pills in force for public companies has dropped from 2,218 to 999.[18]

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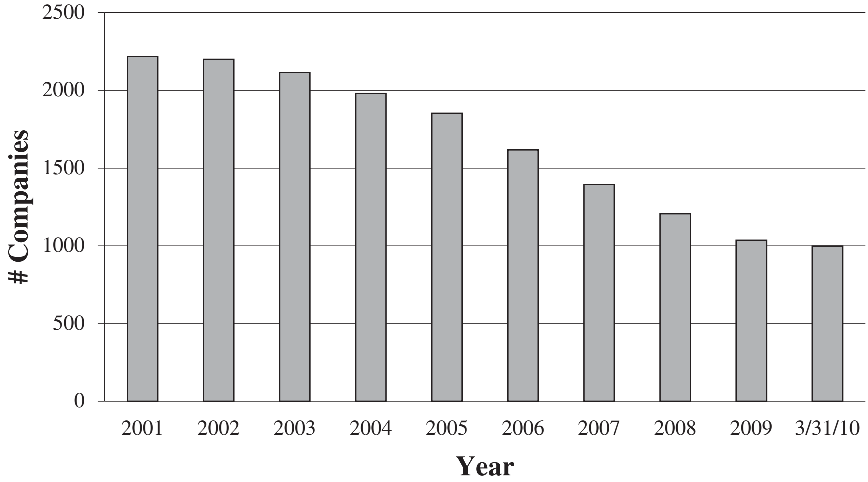
[17] William T. Allen, Reinier Kraakman & Guhan Subramanian, Commentaries and Cases on the Law of Business Organization 523 (4th ed. 2012).

[18] *Research Spotlight*, SharkRepellent.net (April 1, 2010), https://www.sharkrepellent.net/request?an=dt.getPage&st=1&pg=/pub/rs_20100401.html&Specific_Purpose_Poison_Pills&rnd=730863.

CHART 1: THE DECLINE OF POISON PILLS AMONG U.S. PUBLIC COMPANIES[19]




With fewer poison pills in force, companies have fewer defenses against surreptitious large-scale acquisitions of stock on the open market, and so boards could increasingly rely on 13(d) disclosure as a means of ensuring that sellers charge enough of a premium for would-be acquirers to think twice before purchasing a controlling or influential stake in the company. From this viewpoint, 13(d) disclosure serves both to distribute more evenly any perceived value-enhancing effect that an activist investor's attention may have on the company and also to protect the board. However, the current disclosure regime may not be effective at achieving either goal.

### *C. Case Studies: J.C. Penny and Fortune Brands*

Two stark examples best illustrate just how influential one activist hedge fund can be in guiding the strategic direction of some of America's largest public companies despite the Section 13(d) indirect protection mechanism. Such intervention can have mixed results for the long-term value of the target company.

Pershing Square, a New York-based hedge fund, knows very well how easy it is to acquire a large stake in public companies within the ten-day disclosure window. Pershing, along with Vornado Realty Trust, acquired approximately 27% ownership of J.C. Penney through open market purchases and derivative purchases within ten days of crossing the 5% threshold in late September 2010 before finally disclosing their influential stake via a Sched-

[19] *Id.*

ule 13D filing.[20] Although they did not acquire a controlling stake, representatives from both companies were appointed to J.C. Penney's board of directors,[21] which presumably provided these activist investors with significant leverage in future strategic decisions of the company. Their surreptitious stock acquisition also netted them significant paper gains: J.C. Penney's stock closed at $33.12 on the day the 13D filing was released compared to an average of $28.31 over the prior ten days during which Pershing and Vornado were accumulating shares.[22] Those gains did not last, however, as the stock price took a nosedive over the next two years while Pershing Square's manager, William Ackman, failed to push through what he saw as value-enhancing changes.[23] The result was a weakened customer base, a company unable to adapt to a changing retail market, and a directionless management team and board of directors.[24] In 2013, Ackman finally realized that he failed to turn the company around and ultimately sold out of J.C. Penney at a loss of approximately $700 million.[25]

Although Pershing ultimately suffered a significant loss on its investment in J.C. Penney, its other investment in Fortune Brands around the same time netted the fund a sizable gain over a similar period.[26] The hedge fund first acquired slightly less than 5% of the company's stock and then aggressively accumulated more stock until it reached 10.9% on the day of its 13D filing.[27] During the accumulation period, Fortune Brands stock was trading at an average of $49.55, whereas it shot up to $55.50 on the day Pershing announced its stake.[28] A 10.9% stake may not provide influence, let alone control, but the company announced that it would split up two months after Pershing acquired its stake—a value-enhancing move favored by the hedge fund.[29] Two years later, in 2012, Pershing Square sold its stake for an estimated $458 million profit.[30]

These illustrative examples show how one fund can accumulate sizable positions in notable public companies and negotiate directly with the board to push through significant changes to the business, leading to diametrically

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[20] *See* Wachtell Petition, *supra* note 4, at 6.

[21] *See id.*

[22] *See id.*

[23] *See* Jason Hall, *Ackman Selling Out of J.C. Penney Changes Little*, The Motley Fool (Aug. 30, 2013), http://www.fool.com/investing/general/2013/08/30/what-ackman-selling-out-of-jc-penney-doesnt-mean.aspx.

[24] *See id.*

[25] *See* Sapna Maheshwari, *Billionaire Investor Ackman To Dump J.C. Penney Shares After Losing Estimated $700 Million*, BuzzFeed (Aug. 26, 2013), http://www.buzzfeed.com/sapna/billionaire-investor-ackman-to-dump-jc-penney-shares-after-1?bftw=.

[26] *See* Will Ashworth, *Fortune Brands: A Great-But-Not-Perfect Moment for Ackman*, Investor Place (May 9, 2013), http://investorplace.com/2013/05/fortune-brands-a-great-but-not-perfect-moment-for-ackman/.

[27] *See* Wachtell Petition, *supra* note 4, at 6.

[28] *See id.*

[29] *Id.*

[30] *See Ashworth, supra* note 26.

different outcomes. Coincidence or not, these two examples at the very least suggest the ease with which activist investors can acquire large stakes in companies despite the disclosure rules intended to mitigate such activities.

### *D. More Recent Investor Activism*

At the time, Pershing Square's activist investing was considered somewhat extraordinary, but today such activist investing is commonplace. A few hedge fund managers, acquiring modest shareholder influence, have been pushing for major changes at some of the world's largest companies with mixed success. Several notable examples include:

- In April 2013, $12 billion hedge fund ValueAct bought a $2 billion stake in Microsoft—less than 1% of the company's outstanding shares—yet was allowed to meet regularly with some of its directors and even place the fund's manager onto the board.[31]
- In May 2013, $12.9 billion hedge fund Third Point bought a 6.5% stake in Sony and immediately called for a partial spinoff of Sony's entertainment arm in hopes of increasing the company's share price by up to 60%.[32] Sony ultimately rebuffed Third Point's proposal, and now the hedge fund is pushing for a shake up of management.[33]
- In 2011, Third Point acquired 45 million shares of Yahoo at an average price of $13.02, and, after waging a successful campaign to transform the company's management in 2011 and 2012, the fund sold 40 million of its shares in July 2013 for $29.11 each—a five-year high.[34]
- In 2012, Greenlight Capital, a $5.3 billion[35] fund, helped push Apple's management into implementing a $100 billion share repurchase and dividend program that coincided with a 20% increase in the company's short-term share price.[36]

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[31] *See* Michael J. De Le Merced & Julie Creswell, *With Huge War Chests, Activist Investors Tackle Big Companies*, DealBook (Aug. 30, 2013), http://dealbook.nytimes.com/2013/08/30/with-huge-war-chests-activist-investors-tackle-big-companies/?_r=0.

[32] *See* Louis Bedigian, *Third Point's Dan Loeb Wants to Break Up Sony*, MSN Money (May 14, 2013), http://money.msn.com/top-stocks/post.aspx?post=9d476f0a-a650-44f0-8da7-34b85758fa24.

[33] *See Third Point to Put Sony Shares Under Own Name*, Reuters (Sept. 20, 2013), http://www.reuters.com/article/2013/09/20/us-sony-thirdpoint-idUSBRE98J0S120130920.

[34] *See Third Point to Sell Most of Yahoo Stake, Loeb to Quit Board*, Reuters (Jul. 22, 2013), http://www.reuters.com/article/2013/07/23/us-yahoo-thirdpoint-idUSBRE96L0H120130723.

[35] *David Einhorn's Latest Dividend Stock Moves Greenlight Capital*, Trefis (Aug. 15, 2013), http://www.trefis.com/stock/oak/articles/201400/david-einhorns-latest-dividend-stock-moves-greenlight-capital/2013-08-15.

[36] *See* Neil Hughes, *Apple's $100B Capital Reinvestment Prompts Greenlight Hedge Fund to Increase Stake*, AppleInsider (May 7, 2013), http://appleinsider.com/articles/13/05/07/apples-100b-capital-reinvestment-prompts-greenlight-hedge-fund-to-increase-stake.

- In 2013, billionaire activist investor Carl Icahn attempted to thwart a takeover of Dell by its eponymous founder Michael Dell and the private equity firm Silver Lake Partners for approximately $24.8 billion.[37] Icahn partnered with Southeastern Asset Management to create a rival bid in hopes of forcing Silver Lake and Dell to pay more for the company, but their opposing bid ultimately floundered amid changes in board voting rules and a failed lawsuit.[38]

Two competing viewpoints emerged about whether such investor activism is a boon to improving corporate productivity that should be encouraged or an unhelpful phenomenon that must be mitigated with stricter disclosure rules.

## II. The Current Debate and a Proposed Solution

Two of the loudest voices in the current debate on Section 13(d) are those of prominent partners at Wachtell, who favor a shortened disclosure window,[39] and that of the corporate governance scholar Lucian A. Bebchuk, who favors maintaining the status quo.[40] Both sides raise convincing points that help flesh out the tensions pulling the disclosure window in different directions. I begin with these competing viewpoints before working toward a compromise solution that resolves some of these tensions and that leads to a net economic benefit to society.

### A. *The Wachtell Petition*

On March 7, 2011, Wachtell filed a petition with the SEC arguing, among other things, that Section 13(d)'s ten-day disclosure window should be shortened to one business day.[41] The firm raises several points, starting with how the current disclosure window facilitates "market manipulation and abusive tactics" that are to the "detriment of market transparency and investor confidence."[42] Wachtell then fleshes out these points by examining the historical purpose of Section 13(d) as well as its current inability to stymie aggressive accumulation of stock within a short period of time and the negative consequences that has on other investors' wealth and information.[43]

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[37] *See* Henry Mance & Richard Waters, *Carl Icahn Abandons Dell Pursuit with Parting Shot,* Fin. Times (Sept. 9, 2013), *available at* http://www.ft.com/cms/s/0/cb703916-1953-11e3-83b9-00144feab7de.html.

[38] *See id.*

[39] *See* Wachtell Petition, *supra* note 4, at 6.

[40] *See* Bebchuk & Jackson, *supra* note 7.

[41] *See* Wachtell Petition, *supra* note 4, at 5.

[42] *See id.* at 1, 2.

[43] *See id.*

Wachtell repeats much of the discussion above about the historical purpose of Section 13(d), pointing to its original purpose of "alert[ing] 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."[44] The firm reasons that the ten-day reporting lag leaves other investors in the dark for far too long, during which time the activist investor can accumulate stock at an effective discount and aim to achieve influence or control over the company—a result in direct contradiction with the stated purpose of Section 13(d).[45]

Wachtell then notes that the ten-day reporting window was designed in a time when communications technology was relatively rudimentary, such that investors accumulating a 5% stake had enough time to report their holdings without the requirement being unduly burdensome.[46] But with rapid advances in technology, this ten-day window may now be considered an "eternity" in a world in which investors demand, and may reasonably expect, near-instantaneous updates on the company stock they hold.[47] Investors now have the ability to file disclosure reports almost immediately, requiring little work, so Wachtell argues that the ten-day window is a merely an artifact of an antiquated age—one that should be updated to keep up with the times.[48] In their opinion, one business day is sufficient time for sophisticated investors, those most likely to acquire a 5% stake in a public company, to file such reports and would better accord with the stated historical purpose of Section 13(d).[49]

Wachtell also advances a fairness argument. The firm points out that activist investors ultimately reap a benefit in being able to acquire shares at a relative discount—the average price of the stock during the ten-day report window and the price immediately after—which should instead be spread out to other investors.[50]

Throughout Wachtell's petition, the firm appeals to the historical purpose of Section 13(d) and argue that a shortened disclosure window naturally makes sense as advances in technology have made one-day reporting periods relatively easy to follow. Wachtell advances a picture of abusive activist investors who surreptitiously acquire shares on the cheap and then exert negative influences on the boards of these companies for further gain in both power and wealth.[51] The position below, however, paints a different story—one in which activist investors are agents of positive change in

[44] *See id.* at 3 (citing Wellman v. Dickinson, 682 F.2d 355, 365–66 (2d Cir. 1982).
[45] *See* Wachtell Petition, *supra* note 4, at 2.
[46] *See id.* at 3.
[47] *See id.*
[48] *See id.*
[49] *See id.* at 5.
[50] *See id.* at 6–7.
[51] *See id.* at 3.

poorly run companies that need to be properly compensated for their research and productive work.

### *B. The Bebchuk and Jackson Position*

Bebchuk and Jackson respond directly to the Wachtell Petition with their Article, *The Law and Economics of Blockholder Disclosure*.[52] They do so by first rebutting the presumption that market transparency by itself should sufficiently justify certain investors disclosing their purchases of shares in public companies.[53] Instead, they argue that the legislative history of the Williams Act suggests that Congress carefully balanced the benefits of more market transparency against the corporate governance benefits that activist investors effect when purchasing large blocks of shares in public companies.[54] Much of their position hinges on advocating that the ten-day reporting window is a necessary result of this balancing test.

Starting with the legislative history, Bebchuk and Jackson argue that Section 13(d)'s reporting requirements arose from a careful compromise between providing investors with enough market information for them to make appropriate investing decisions and the necessity of ensuring that activist investors are adequately compensated for their time and effort in acquiring shares of a company and improving its performance.[55] Bebchuk and Jackson point to the give-and-take process that occurred throughout the legislative history of the Williams Act—first requiring immediate disclosure of a 5% stake in a company, then requiring a seven-day reporting deadline for a 10% stake, and then finally proposing the current ten-day reporting window—as an indication of the importance Williams and others placed on balancing the interests of the general investing public and activist investors.[56] Indeed, Williams argued that his final bill "'carefully weighed both the advantages and disadvantages to the public' of the disclosure requirement and took 'extreme care to avoid tipping the scales either in favor of management or in favor of' large investors."[57] Based on this reasoning, Bebchuk and Jackson argue that although market transparency was important to Williams, it must ultimately be balanced against the risk of dissuading activist investors from providing a positive corporate governance benefit for poorly run companies.

Establishing that the aforementioned balancing test is core to Section 13(d), Bebchuk and Jackson then describe the benefits that activist investors confer on the corporate governance of poorly run firms. They reference a large variety of legal and finance literature establishing how, among other things, activist shareholders are associated with large, positive, abnormal re-

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52 *See* Bebchuk & Jackson, *supra* note 7.
53 *See id.* at 44.
54 *See id.*
55 *See id.*
56 *See id.* at 44–45.
57 *Id.* at 45 (citing 113 Cong. Rec. 24,664 (1967)).

turns on average in the companies in which they invest, improved links between compensation and performance, and an increased likelihood of transactions that discipline management.[58] They then demonstrate that tightening the ten-day reporting window might reduce the incidence or size of activist positions in public companies, thereby reducing the positive benefits that they confer on these companies.[59]

Finally, Bebchuk and Jackson argue that although activist investors may be able to buy shares at a discount during the ten-day reporting lag, this does not lead to such investors stealing a control premium from any other investors.[60] Most of the time, these activist investors do not accumulate nearly enough shares to acquire control in their target companies. Instead, the potential rise in stock price reflects the market's perception that the activist investor's stake in the company will lead to value-enhancing actions by the company—the activist investor must still convince other investors to go along with the plan.[61]

In effect, Bebchuk and Jackson advance a straightforward property rights argument: activist investors will only incur research and improvement costs if they are at least guaranteed the right to reap the monetary benefits of their research and improvements. Otherwise, they simply will not expend the resources. The ten days during which the activist investor can buy shares at a relative discount serves as this compensation and incentivizes continued research and improvement activities by these activist investors. The Wachtell Petition, in contrast, seeks to more widely distribute the benefits of the activist investor's research and improvement activities to other investors by shortening the time in which the activist can acquire shares at a bargain.

Ultimately, the conflict between these two positions boils down to three fundamental tensions: (1) the importance of market transparency for shareholders to make appropriate investing decisions; (2) the benefit of activist investors improving the corporate governance of poorly run firms and the potential reduction in activist activity corresponding to a shortened reporting window (that is, more market transparency); and (3) the importance of redistributing gains reaped by activist investors during the reporting window to other investors. Nonetheless, within these tensions, there is room for a compromise solution that helps protect investors from making inappropriate investing decisions while promoting economically efficient investing behavior by activist investors.

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58 *See id.* at 48.
59 *See id.* at 49–51.
60 *See id.* at 51–53.
61 *See id.* at 52.

### C. A Two-Part Disclosure Mandate as a Compromise Solution

Among the dissonance regarding the Section 13(d) disclosure window, one middle-ground solution involves a two-part disclosure mandate. Instead of shortening the disclosure window requiring activist investors to disclose their stake publicly, the SEC should implement a rule requiring that investors disclose their acquisition within one day to only the board of the company in which they acquire a 5% interest. The regular SEC filing window would remain at ten days. At first glance, this solution may not seem like a compromise at all. Activist investors continue to reap benefits at the expense of other investors and market transparency does not increase—it seems that the pro-activist investor faction wins and the pro-transparency faction loses—but the final result creates a more nuanced rule that helps achieve fundamentally competing goals.

It is true that activist investors continue to reap many of the benefits of their research under this solution. They may potentially continue to buy shares at a discount during some part of the ten-day public reporting lag since the board would be in negotiations with the activist investor on how to improve the company without an acrimonious public back-and-forth. Although this benefit conflicts with Wachtell's position of dispersing gains brought upon by an activist investor's stake, there is good reason for letting activist investors reap the benefits of their time and effort in researching and taking an active role in a poorly run company. As mentioned by Bebchuk and Jackson, corporate finance and governance literature points to a beneficial corporate governance role for these investors.[62] Reducing their gains could, and perhaps would, dissuade them from taking on this function. The two-part mandate strikes a balance between the competing interests mentioned above by enabling the board to make the ultimate disclosure decision in the context of what is best for its shareholders.

First, without activist investors taking large stakes in public companies and influencing their strategic decisions, there would arguably be no increase in wealth to disperse in the first place, so it is actually fair to allocate most of the resultant capital gains—the initial bump in stock price after disclosure—to the activist investors. Additionally, other investors continue to gain from the work of the activist investor, both during the pre-disclosure acquisition window and after, via a rising stock price. Thus, retaining this feature of the status quo should not necessarily be considered a disadvantage from the viewpoint of ensuring well-run equity markets as long as activist investors can make appropriate investing decisions. It is possible that boards will simply make it a policy to always disclose the activist investor's acquisition to their constituent shareholders early, thus leading to improved overall market transparency and providing the pro-transparency faction with their desired goal. However, it may in fact be in the best interest of the company,

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[62] *See id.* at 48.

and thus the board, to hold back on publicly disclosing such information for at least part of the reporting period to incentivize the occurrence of value-enhancing investments by activist firms.

Second, although the two-part disclosure mandate does not improve market transparency as much as its supporters would like, the actual effect of more transparency is marginal in the context of the historical purpose of Section 13(d). As mentioned above, the legislative history of Section 13(d) demonstrates that it aimed to improve market transparency by requiring that large shareholders publicly disclose if they acquire more than a 5% stake in a public company. But the rationale behind the creation of this threshold was Williams's desire to ensure that investors know when a change of business control may arise, as noted in the legislative history[63] and as a central element of Section 13(d) itself.[64] Investors want to know, and should know, if the company in which they hold an interest is about to undergo a change of control. Yet activist investors can rarely acquire a controlling stake in a public company within ten days of acquiring a 5% stake. Thus, improving market transparency by shortening the disclosure window would simply allow investors to know more quickly who has been acquiring large stakes in public companies, but not quite at the level of control. The historical purpose of Section 13(d) would not necessarily be better served by a reduction in the disclosure window.

Third, investors want to know when activist investors typically take on positions in companies they feel will appreciate in value because then they can sell their shares at a higher price, but activist investors only do so if they know they can reap a benefit commensurate with the cost of undertaking the investment by buying those same shares at a lower price. By making the markets more transparent in this regard, fewer activist investors would likely engage in such activity, thus reducing their beneficial corporate governance role and reducing economic efficiency.[65] The legislative history of the Williams Act also acknowledged this point, framing the choice of a ten-day disclosure window as a balancing act between more market transparency and encouraging beneficial activist investor conduct.[66] Although the investing public is not made aware of the activist investor's stake in a more timely manner per se, the target company's board is, which leads to the possibility that the company's shareholders will learn of the acquisition sooner.

By putting the timing of the disclosure in the hands of the directors who have a fiduciary duty to maximize shareholder wealth, the two-part mandate better balances the competing interests between redistributing the gains of activist intervention and incentivizing more beneficial activist investing. Be-

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[63] *See* Macey & Netter, *supra* note 1, at 133.

[64] As noted in Section 13(d)(1)(C) of the Exchange Act. *See Section 13(d) of the Securities Exchange Act of 1934*, HEDGE FUND LAW BLOG (last visited Nov. 21, 2012), http://www.hedgefundlawblog.com/section-13d-of-the-securities-exchange-act-of-1934.html.

[65] *See* Bebchuk & Jackson, *supra* note 7, at 50.

[66] *See* Bebchuk & Jackson, *supra* note 7, at 45.

cause the directors have a compelling legal responsibility to resolve these tensions in a socially optimal way (that is, by maximizing shareholder wealth) they are in the best position to time the disclosure to strike the best balance for their particular company rather than rely on an inflexible disclosure regime—whether that be ten days or one—which may produce a worse result for that company and, in aggregate, for society.

Overall, the compromise solution has the potential to protect general investors better by forcing activist investors to disclose their large stakes to public company boards sooner while simultaneously continuing to promote economically beneficial shareholder activism. Although public market transparency may not drastically increase under this solution (although it could), we should instead focus on why improved market transparency has historically been important under Section 13(d)—to protect investors by allowing them to make appropriate investment decisions regarding potential changes in corporate control.[67] If instead this protection function can be achieved through a more informed board working on behalf of general investors, then these investors do not necessarily need to be informed earlier of activist investor acquisitions. Earlier mandatory disclosure to corporate boards improves the odds that directors can negotiate positive outcomes with activist investors outside of the glare of the public spotlight, thus benefitting general shareholders and maintaining the necessary incentives for activist investors to put in costly effort to continue their economically beneficial corporate governance role.

Although conceptually simple, the proposed solution must overcome legal and strategic challenges before it can be implemented in practice. Only after these hurdles can be met is it possible to discuss whether the solution will lead to better outcomes for public company shareholders.

## III. Legal and Strategic Challenges to the Compromise Solution

In implementing the proposed solution, both legal and strategic challenges need to be addressed. On the legal side, boards must not be mandated by corporate case law to immediately disclose to all of the company's shareholders what would certainly be a material fact: an activist investor taking an influential stake in the company. Boards must also have some protections from insider trading allegations given the material information they possess from the time they are aware of the activist investor's stake to the time they disclose such information to the market. Each of these concerns can be resolved.

From a strategic perspective, corporate boards must have some incentive to keep confidential their awareness of the activist investor's stake in the board's company during the nine-day public reporting lag. If no such incentive exists, then they would naturally establish a preemptive policy of imme-

[67] *See* Wachtell Petition, *supra* note 4, at 3.

diate disclosure, thus raising an apparently strong deterrent against activist investors and potentially diminishing these investors' suggested value-enhancing scrutiny. If, however, an incentive exists for corporate boards to negotiate with activist investors before the public disclosure of the activist's stake in the company, then activist investors could reap additional benefits through continued purchases or a better position to push for company changes. One could envision a scenario where both the board and activist investors have reason to come to the negotiating table. Indeed, such a situation could play out, thus making this compromise solution less of a de facto shortening of the disclosure window and more of an opportunity to facilitate value-enhancing behavior by both activists and corporate boards.

### *A. Legal Challenges to Overcome*

To ensure the viability of the compromise solution, boards must not necessarily be mandated to immediately disclose the activist investor's stake in the company upon receiving such information. Generally speaking, corporate boards have a duty of candor to their shareholders, which arises from their well-established duties of care and loyalty.[68] Indeed, a board would be deemed in breach of their fiduciary duty of care if they were to make an omission of a material fact to the company's shareholders due to the board's erroneous judgment—despite the omission being made in good faith.[69] Conversely, if the board lacks good faith in approving a disclosure, they may be deemed in breach of their duty of loyalty.[70] So long as directors do not breach their duties of loyalty and care in the course of their performances, they are given broad judicial protections under the business judgment rule.[71] When this rule applies, courts will generally defer to the business decisions of the board and not hold them liable for any resulting damages.[72] When a breach of a fiduciary duty occurs, however, the director or board in question is subject to a much stricter "entire fairness" standard of review, which requires that the directors and officers prove they acted fairly and competently.[73] If the director or officer is unable to meet this stricter review standard, then he can be personally liable to the corporation and its shareholders.[74] Thus, whenever possible, a board will try to steer away from any possibility of breaching their fiduciary duties, which suggests that they would more likely than not quickly disclose any investor's significant stake in the company in fear of breaching their fiduciary duty of care.

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[68] *See, e.g.*, Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998).
[69] *See id.*
[70] *See* In re Tyson Foods, Inc. Consol. S'holders Litig., 919 A.2d 563, 597–98 (Del. Ch. 2007).
[71] *See* Gantler v. Stephens, 965 A.2d 695, 708–9 (Del. Sup. 2009).
[72] *See id.*
[73] *See* Weinberger v. UOP, 457 A2.d 701, 710 (Del. 1983).
[74] *See id.*

There are, however, many situations in which directors are privy to material information that they do not need to immediately disclose to their shareholders in accord with their duty of care. Internal financial documents showing preliminary sales and operating performance are not disclosed prior to the relevant 10Q or 10K filing despite the likely relevance of the information to shareholder investing decisions. Internal deliberations on future strategic plans for the company are likewise not released prior to the relevant public filing, despite being germane to shareholders' investment decisions. It therefore stands to reason that, despite the relevance to shareholders of an investor taking a significant stake in the company, the board need not immediately disclose such a fact unless the omission rises to the level of gross negligence, reckless indifference to shareholder concerns, or complete irrationality with respect to their decision-making process.[75] Given the prior examples, the board would likely not breach their duty of care for choosing to strategically delay disclosure.

Although boards would likely not be required to disclose an investor's significant stake under corporate case law prior to the public disclosure date, they may nonetheless seek an amendment to the corporate bylaws to ensure that a lack of immediate disclosure would not trigger a breach of the board's fiduciary duty of care. This course of action has the benefit of potentially providing complete assurance to the board that they are free to delay disclosure as they deem necessary, but it may be rejected by shareholders. The board is then in a more precarious position if they choose not to immediately disclose since shareholders may become disgruntled at the board's apparent defiance if disclosure was not made promptly.

A smaller legal problem remains in dealing with insider trading allegations during the time in which the board is aware of the investor's stake in the company, but the investing public is not. Like any other confidential material information, however, this problem can be overcome through a share repurchase program authorized by the SEC, along the lines of Rule 10b-18.[76]

Most importantly, however, is that regardless of how the board chooses to approach disclosing an investor's significant stake in their company, legally speaking, they are likely not required to immediately disclose this information to their shareholders, thus removing the key legal hurdle to implementing the compromise solution.

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[75] *See* Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985).

[76] *See* U.S. Sec. and Exch. Comm'n, *Division of Market Regulation: Answers to Frequently Asked Questions Concerning Rule 10b-18* (retrieved Aug. 18, 2013), *available at* http://www.sec.gov/divisions/marketreg/r10b18faq0504.htm.

### *B. Many Strategic Possibilities, But One Optimal Outcome—a Negotiated Solution*

Aside from the legal hurdles facing the compromise solution, strategic issues also exist. First, a board could *threaten* to always disclose the investor's stake immediately after learning of it, thus acting as a deterrent against such activism. Although activists may believe their intervention in a company could be beneficial to raising its value and therefore its share price—thus rewarding the activist with a profit for his effort and benefitting other shareholders in the process—the board of the company may have a different opinion and believe that such intervention would create more harm than good and attempt to block it. The current disclosure regime leans toward providing activist investors with more time to acquire large stakes in publicly traded companies while simultaneously limiting boards' abilities to prevent such interventions. With the modified disclosure regime mentioned above, boards will have more opportunity to potentially limit activist intervention by establishing disclosure policies that could reduce the profits the activist investor would earn by intervening in the company and thus influence the activist investor's net benefit (or cost) arising from intervening in the company. Boards may establish early disclosure policies in the hopes of altering the cost-benefit analysis of activist investors so significantly that activist investors would be much more likely not to intervene in such companies and thus not threaten the boards' power.

Threats are only credible, however, if the threatened party *perceives* that the net effect of performing the threatened action makes the threat maker better off than if the threat is not carried out; otherwise, the threatened party will call the threat maker's bluff, and the rational threat maker will not perform the threatened action. Furthermore, the threatened party's perception of the net costs of the threat must match up with what the threat maker believes; otherwise, if the threat maker honestly believes he or she will made better off if performing the threat, then he or she will perform the threat if challenged regardless of what the threatened party believes. One can apply these principles in analyzing the result of strategic gamesmanship between activist investors and their target companies' boards.

First, assume that the activist investor perceives that the net negative effect of a particular public company board's immediate disclosure is greater (or net beneficial effect is smaller) to the board than if they did not immediately disclose and instead chose to privately negotiate with the activist investor. If the board also believed this, then the activist investor would invest in the board's company and they would both engage in private negotiations. If the board did not believe that private negotiations would yield better results than immediate disclosure, then they would immediately disclose regardless of whether the activist investor believed the threat to be credible or not.

In either case, the threat of early disclosure would likely not deter the activist investor from investing in the public company. Whether or not boards immediately disclose, activist investors still stand to benefit through their interventions because of share price appreciation on their pre-disclosure acquisition stake. Although the benefits flowing to activist investors will diminish if boards immediately disclose, the likely negative effect could be mitigated if activist investors acquire most of their post-disclosure stake within a day instead of over ten days. In such cases, only marginal investment candidates would be discarded. Thus, if we assume that activist investing will continue largely unabated (as the pro-transparency faction argues) under a modified disclosure regime, then the opportunity for private negotiations rests solely with the target company boards. If they believe immediate disclosure is in their shareholders' best interests then they will disclose immediately, but if they believe that private negotiations could foster a better environment for both the activist investor and the public company board to hash out their potentially conflicting ideas for how to raise the value of the company then they will not immediately disclose. Instead of an activist investor waging a vociferous and distracting campaign to influence changes in the company's direction under the status quo (as mentioned above in selected examples), the threat of early disclosure could lead to private negotiations between the activist investor and the corresponding company's board.

Although an activist investor may stand to lose some profit under a company's policy of immediate disclosure, the activist investor could gain in the long run by increasing the odds of a board being receptive to changes in the period immediately following disclosure to the board but before the public is made aware of the activist investor's stake. The mere chance that an activist investor can push through changes faster could shift the investor's benefit calculations in favor of continued investing in most candidate companies—thus partly ameliorating the concerns of the Bebchuk faction that quicker disclosure would deter beneficial activist investing activity. Although exact cost-benefit analyses from the perspective of activist investors cannot be calculated with precision, the changes to the disclosure regime should not undermine the primary benefits of activist investing and could, in fact, indirectly offset more obvious losses from a high risk of boards immediately disclosing activist investors' stakes in their companies.

A second scenario that may arise is if a board instead *commits* to always disclosing the investor's stake upon learning of it by voting to establish such a policy. Unlike a threat that the activist investor could see through and dare to challenge—sometimes successfully, depending on the costs and benefits to each party—a commitment would be useful to better deter the activist investor since now the activist investor cannot assume any possibility that the threatened action will not be performed, which ultimately reduces the activist investor's expected value of intervening in that particular company. Even under such a policy, however, activist investors would likely still not be deterred from investing in such companies because of the long-term gains to be had from post-disclosure share price appreciation on the investors' accumulated shares during the pre-disclosure period. Indeed, as mentioned above, investors can mitigate such a policy's harmful effects on their cost-benefit calculations by better accumulating shares during the first day after crossing the 5% threshold.

More importantly, observing the number of public company boards that commit to always immediately disclosing investors' significant stakes in their companies (versus the number that publicize a general policy or none at all) could put a spotlight on what private participants believe is the ideal approach to dealing with activist investors. Instead of abstractly debating whether activist investors will be substantially deterred from investing in public companies because of more immediate disclosure rules, or whether boards will always opt to more quickly disclose significant stakes in their respective companies to better keep investors informed about significant changes in influence within the company, the modified disclosure rule will give boards leeway to evaluate the costs and benefits of disclosing sooner or later on a company-by-company basis. The results of this bottom-up approach could better inform top-down policy on what the appropriate disclosure regime should be going forward.

Most importantly, if we assume that activist investors see a net benefit to investing in public companies outside of the share price appreciation during the remaining nine days after disclosing their stake to the target companies' boards and that the boards have not committed to always disclosing such stakes, then it is possible that activist investors will negotiate with public company boards during the nine-day reporting lag. This outcome will lead to a better result for the pro-transparency faction because boards can better safeguard other shareholder interests and potentially disclose the investors' stakes earlier than what is currently mandated by Section 13(d). On the other hand, the compromise solution addresses the main concern of the Bebchuk faction by continuing to encourage activist investors to engage in the costly process of investing and intervening in public companies because they will continue to earn rewards for their efforts through a more efficient negotiation process with the target company boards—potentially leading to faster managerial and strategic changes in the company.

## Conclusion

Two years have passed since the signing of the DFA, and the debate over Section 13(d) has shown no sign of waning. With both competing factions digging in to their respective positions, one in favor of shortening the disclosure window and the other in favor of maintaining its current form, little has been said about a compromise solution that takes into account the interests of both positions. A two-part disclosure mandate, maintaining the public disclosure window while requiring a shorter one-day disclosure to the board of the company in which the activist takes a 5% stake, serves the concerns of both sides.

On the one hand, the concerns raised by Bebchuk and Jackson are partly addressed, with the public disclosure window staying at ten days to ensure activist investors are still adequately incentivized to take beneficial corporate governance actions against poorly run companies. On the other hand, the concerns raised by the Wachtell Petition are largely addressed by having an activist investor disclose to a public company board his 5% or larger stake in the target company within one day of acquiring such a stake—thus leading to a potentially shorter period in which the activist investor can purchase discounted shares of the company—and a quicker public disclosure of a significant stake in the public company in case of either a collapse or successful resolution of negotiations between the board and the activist investor. Since the negotiations would occur outside of the media and public spotlight, the likelihood of posturing and stonewalling is reduced, while the nine-day gap between private and public disclosure motivates both the board and activist investor to come to an agreement since the activist investor knows that the board could disclose the activist's stake to the company's shareholders at an earlier time than mandated by public disclosure rules. Given the board's fiduciary duty to shareholders and best understanding of the activist's value proposition to the company, they are likely in the best position to make the right choice on disclosure timing to shareholders.

Ultimately, more work needs to be done to determine how activist investors will change their investing behavior—both in frequency and in size of stakes taken in public companies—in response to changes in the disclosure window. Without such research, it is much more difficult to determine whether the potential harm of a decrease in beneficial corporate governance monitoring by activist investors that arises from a shortened reporting period would outweigh the potential good of greater market transparency. In the meantime, however, a compromise solution along the lines of the one proposed could help reduce the conflict between the two most vociferous factions in the Section 13(d) debate.