The Honorable Michael D. Crapo
Chairman
Committee on Banking, Housing & Urban Affairs
United State Senate
Washington, D.C. 20510

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing & Urban Affairs
United State Senate
Washington, D.C. 20510

April 18, 2017

Re: March 20 Request for Proposals to Increase Economic Growth

Dear Mr. Chairman and Ranking Member Brown:

On behalf of the Society for Corporate Governance (the Society"), we are pleased to respond to the Committee's March 20 request for proposals to increase economic growth.

Founded in 1946, the Society is a professional membership association of more than 3,200 corporate secretaries, in-house counsel and other governance professionals who serve approximately 1,600 entities, including about 1000 public companies of almost every size and industry. Society members are responsible for supporting the work of corporate boards of directors and their committees and the executive managements of their companies regarding corporate governance and disclosure. Our members generally are responsible for their companies' compliance with the securities laws and regulations, corporate law, and stock exchange listing requirements.

Constructing an environment that supports the creation and growth of publicly-owned companies is critical to generating jobs, accelerating economic growth and providing widely available investment opportunities to everyday Americans. Unfortunately, current trends among publicly-issued companies tell us that the existing regulatory framework is discouraging firms from becoming or remaining public. Indeed, according to the U.S. Chamber of Commerce, the United States is "now home to roughly half the number of public companies as twenty years ago, and we have only slightly more public companies than existed in 1982."[1]

[1] U.S. Chamber, Statement of the U.S Chamber of Commerce, March 22, 2107, House Financial Services Committee

Reversing this trend requires sustained focus from policy makers, so the Society thanks Chairman Crapo and Ranking Member Brown for their request for proposals to increase economic growth. Below, we outline two proposals to reduce the disincentives for companies to seek and maintain public ownership.

I. Make Quarterly Reporting Optional

- Congress should provide that publicly-owned companies are no longer required to report quarterly financial results. Companies would, of course, remain free to report quarterly results if they so choose. However, eliminating the obligation to report will materially reduce the pressure on managers to prioritize the short term over long term investment and job creation.

Background on Proposal

Section 13 of the 1934 Securities Exchange Act requires issuers to "file with the Commission . . . such quarterly reports . . . as the Commission may prescribe.[2]"

In the abstract, providing investors with more financial information seems quite compelling. In practice, however, the requirement that issuers file quarterly earnings puts meaningful pressure on managers to meet or exceed the expectations of certain investors, particularly short-term investors. Quarterly reporting is a key factor in the growth of "short-termism" among management and companies; a phenomenon that executives and commentators across the ideological spectrum recognize as negative.[3]

The net effect is to require managers to pit the meeting of short-term targets against long-term investment and strategy. As Larry Fink, CEO of BlackRock has noted, "the constant pressure to produce quarterly results. . .makes it difficult for companies to focus on long-term strategy."[4] Survey results of financial executives bear this out. According to a Duke University study, 80% of surveyed CFOs reported that "they would decrease discretionary spending on R&D, advertising and maintenance to meet an earnings target."[5] The study also observed "that the majority of managers would avoid initiating a positive NPV project if it meant falling short of the current quarter's consensus earnings."[6]

Yet long-term strategy and investment leads to superior performance and, by extension, higher profits, greater investment, and more jobs. A February 2017 McKinsey study noted "companies that operate with a true long-term mindset have consistently outperformed their industry peers since 2001 across almost every financial measure that matters."[7] The study observed that companies managed for the long-term "added nearly 12,000 more jobs on average than

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[2] 15 U.S. Code § 78m

[3] https://assets.aspeninstitute.org/content/uploads/2017/01/American-Prosperity-Project_Policy-Framework_FINAL-1.3.17.pdf

[4] http://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/our-gambling-culture

[5] https://faculty.fuqua.duke.edu/~charvey/Research/Working_Papers/W73_The_economic_implications.pdf

[6] https://faculty.fuqua.duke.edu/~charvey/Research/Working_Papers/W73_The_economic_implications.pdf

[7] https://hbr.org/2017/02/finally-proof-that-managing-for-the-long-term-pays-off

their peers from 2001 to 2015" and that U.S. GDP would likely "have grown by an additional $1 trillion . . . and generated more than five million jobs" if the whole economy had performed as well as long term managed companies.[8]

By making quarterly financial reporting optional, Congress can eliminate one of the key disincentives to going public. We urge the Committee to give this proposal consideration.

Legislative Language

- *Specifically, Congress should amend Section 13-(a)-2 of the 1934 Securities Exchange Act to eliminate the requirement that issuers file quarterly financial reports; and*
- *Congress should direct the SEC to amend 17 CFR 240.13a-13 accordingly.*

II. Increase Transparency in Equity Markets to Level the Playing Field Between Short Term Investors and Issuers

- Congress should require hedge funds and other investors to disclose the acquisition of at least five percent of an issuer's equity or economic value within 2 days of any such acquisition; in addition Congress should ensure that common derivative structures which confer an economic interest in (and influence over) an issuer are required to be disclosed.

Background on Proposal

The current 13(d) framework is out of date and allows certain--largely short term—investors to "facilitate market manipulation and abusive tactics"[9] to the "detriment of market transparency and investor confidence."[10] The purpose of the 13(d) disclosure rules simply put is transparency, i.e., to "alert investors in securities markets to potential changes in corporate control and to provide them with an opportunity to evaluate the effect of these potential changes."[11] However, the current beneficial owner disclosure regime, which was originally created in 1968, has been outpaced by technology and changes in the instruments investors employ to gain economic exposure to a security; notably through the purchase of cash-settled derivatives or swaps.

When the ten-day reporting deadline was adopted in the late 1960s, such a lag between purchasing a stake in an issuer and disclosure to the market may have been justified. By contrast, electronic trading now makes possible the acquisition of large blocs of shares in a matter of seconds or minutes. In addition, the advent of vibrant derivatives markets allows

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[8] https://hbr.org/2017/02/finally-proof-that-managing-for-the-long-term-pays-off

[9] Petition for Rulemaking Under Section 13 of the Securities Exchange Act of 1934, Wachtell, Lipton, Rosen & Katz, March 7, 2011

[10] Id.

[11] *Wellman v Dickinson*, F.2d 355, 365-366 (2nd Cir. 1982), citing *GAF Corp. v. Milstein,* 453 F.2d 709, 717 (2d Cir. 1971), *cert denied,* 406 U.S. 910 (1972).

investors to quickly accumulate large economic ownership of shares to augment their equity holdings which can provide investors with substantial influence.

As Delaware Supreme Court Chief Justice Strine has written:

> It is long overdue for this debate to be resolved. Five percent is not a magic number, but certainly the marketplace should know before a stockholder emerges with over 20% of the voting power. Pick a number between 5% and 12.5% and make public disclosures happen within 24 hours of hitting that threshold and require that there be no further purchases until that happens. Then, like all other modern markets, require that position to be updated in real time if it moves by a percent or more.
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> Even less understandable is the debate over what must be reported. Reforming § 13(d) in one critical respect is essential, which is to require that filers have to disclose completely their ownership interests in instruments of any kind tied to the value of the company's stock. If there is no reason to fear that hedge funds or other activist investors can threaten long-term value because longer-term investors will hold the balance of voting power, it logically follows that the voting electorate should have up-to-date complete information about the economic interests of a large bloc-holding hedge fund proposing that a corporation make business strategy changes it is suggesting.[12]

Activist investors can—and do—play a legitimate and productive role in corporate governance and strategy. However, no rational policy objective is served by allowing purchasers of large ownership stakes in publicly-owned companies to conceal their positions from the market, or the issuer. As we've said, investor activism can bring benefits to companies and shareholders but, equally, all other shareholders and management should be informed in a timely manner of activity that could affect the value of their equity holdings.

Managing the demands of shareholders is fundamental to the decision to become a public company. There is no doubt, however, that the reality of investor activism is seen by some executives as a disincentive to going public. We believe this is evidenced by recent companies who choose to go public with dual class, or non-voting, shares; they seek to limit their exposure to the demands of activists. For tech companies, and particularly biotech companies that need longer lead times to get their product to market, it is an important point of contention. By modernizing the beneficial ownership reporting rules, Congress will improve the ability of company management to more effectively discharge their fiduciary obligations to their shareholders and allow those same shareholders to best safeguard their investments.

[12] Securing Our Nation's Economic Future: A Sensible, Nonpartisan Agenda to Increase Long-Term Investment and Job Creation in The United States, p. 35-36, Leo E. Strine, Jr., RESEARCH PAPER NO. 15-41, INSTITUTE FOR LAW AND ECONOMICS, University of Pennsylvania Law School

Legislative Language

- *Specifically, Congress should amend Section 13(d)(1) of the Securities Exchange Act of 1934 to require that an investor must disclose to the SEC and the public that it owns at least five percent of a public company within two days of acquiring such five percent stake;*
- *In addition, Congress should amend Section 13(o) of the Securities Exchange Act of 1934 to require that a person shall be deemed to acquire beneficial ownership of an equity security based on the purchase or sale of a security-based swap if the swap confers economic exposure to that same equity security. In other words, the law should be changed to ensure certain derivative structures used by investors to obtain economic exposure to and influence over an issuer are included in calculating an investor's beneficial ownership of a particular company's equity security; and*
- *Congress should require the SEC to amend 17 CFR 240.13d et seq. accordingly.*

Thank you for your consideration. If you have any questions, please contact me at 212-681-2004 or at dstuckey@societycorpgov.org.

Very truly yours,

Darla C. Stuckey

Darla C. Stuckey
President and CEO
Society for Corporate Governance