The New York Times
DealB%k
Edited by Andrew Ross Sorkin

February 07, 2013

Don't Make Poison Pills More Deadly

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Under a publicly announced agenda for 2013, the Securities and Exchange Commission is to examine the rules governing when shareholders must disclose the acquisition of a significant position in a public company. An unintended and harmful effect of such a change may be that it will help companies adopt so-called low-threshold poison pills – arrangements that cap the ownership of outside shareholders at levels like 10 or 15 percent. The S.E.C. should be careful to avoid such an outcome in any rules it may adopt.

Under current S.E.C. rules established under the Williams Act of 1968, outside shareholders who obtain stakes of 5 percent or more of a company's stock must publicly disclose their holdings within 10 days. The S.E.C., however, is planning to consider a rule-making petition, filed by a prominent corporate law firm, that proposes to reduce the 10-day period, as well as to count derivatives toward the 5 percent threshold.

Supporters of the petition argue that earlier disclosure would benefit public investors by enabling selling investors to obtain the somewhat higher market price that an earlier disclosure might bring. This, however, needs to be weighed against the costs to investors from discouraging activist outside shareholders. As I explained in an earlier column, there is much evidence showing how such shareholders confer significant benefits on their fellow investors.

Whatever view one takes on this tradeoff, the push for tightening disclosure rules is at least partly driven by the benefits that earlier disclosure would provide for corporate insiders. Supporters of the petition have made it clear that tightening disclosure requirements is intended to alert not only the market but also incumbent boards and executives in order to help them put defenses in place more quickly.

The drafters of the Williams Act envisioned a landscape that would allow outsiders who were not seeking to control a company to keep accumulating shares, provided that they made the required disclosures. But companies in the United States have been increasingly using poison pills with low thresholds to limit the stakes of outside shareholders they disfavor.

Poison pills were developed in the 1980s to enable insiders to block a hostile acquisition. Over time, however — and without sufficient attention by investors and public officials — companies have started to use poison pills to prevent acquisitions of stakes that fall substantially short of a controlling block.

Indeed, among the 637 companies with poison pills in the FactSet Systems database, 80 percent have plans with a threshold of 15 percent or less. No other developed economy grants corporate insiders the freedom to cap the ownership of blockholders they disfavor at such low levels.

The current ability of insiders to adopt low-threshold poison pills is a highly relevant factor for any assessment of the rules governing the relationship between incumbents and outside shareholders. In particular, the S.E.C. should recognize that tightening disclosure requirements could impose costs on public investors and the economy by facilitating the use of such pills.

Consider a situation in which an investor opposed by management makes a public announcement immediately upon accumulating a 5 percent stake. Then suppose the company quickly adopts a poison pill with a low threshold that prevents or drastically limits further accumulation of stock by the buyer. In this case, the company's response to the immediate disclosure would not enable public investors to capture higher prices for shares they sell to the large shareholders; to the contrary, it would prevent these investors from selling shares to the large shareholder at mutually beneficial prices.

Furthermore, by entrenching insiders and insulating them from engagement by large outside shareholders, low-threshold poison pills could well impose costs on public investors who do not wish to sell their shares.

If the S.E.C. does decide that tightening disclosure requirements is desirable, it should design the rules to avoid aiding the use of such poison pills. This could be done by limiting the application of tightened disclosure requirements to companies whose charters do not permit the use of low-threshold poison pills.

Proponents of the petition, which has thus far failed to attract any supportive comments from institutional investors, should endorse including such a limitation in any reform. Doing so is necessary to address concerns that tightened disclosure requirements might be aimed at protecting entrenched insiders rather than public investors.

Even if the petition's proponents keep pressing for rules that would facilitate low-threshold poison pills, the S.E.C should avoid serving this objective. As the investor's advocate, the S.E.C. should ensure it does not take any action that would harm investors by facilitating the pernicious use of such poison pills.

This column expands on a discussion that was part of a Conference Board debate with Martin Lipton.