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Don't Discourage Outside Shareholders

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The Securities and Exchange Commission is currently considering a rule-making petition that advocates tightening the rules governing how quickly shareholders must disclose when they hold 5 percent or more of a company's shares.

Such a change could unduly discourage the creation and activism of outside shareholders, who play an important role in corporate governance.

Under current S.E.C. rules established by the Williams Act of 1968, outside shareholders have 10 days to make a public disclosure when they obtain 5 percent of any company's stock. The petition seeks to eliminate the 10-day "window" and require shareholders to disclose their stakes as soon as they accumulate 5 percent or more of a company's stock.

As Robert Jackson and I show in a recent study, the proposal to tighten the rules raises significant policy issues. In contrast to the claims of the petition's authors, the proposal should not be viewed as a "technical" closing of a loophole intended to meet more effectively the objectives of the Williams Act.

The legislative history clearly indicates that the drafters of the Williams Act made a conscious choice not to impose an inflexible 5 percent cap. Senator Harrison Williams's initial proposal would have made it unlawful for an outside shareholder to cross the 5 percent threshold without prior disclosure. Ultimately, however, the 10-day window was adopted after extensive consideration.

This consideration, according to Senator Williams, "carefully weighed both the advantages and disadvantages to the public" and took "extreme care to avoid tipping the scales either in favor of management or in favor of" large shareholders. The choices made were informed by the belief that such shareholders "should not be discouraged, since they often serve a useful purpose by providing a check on entrenched but inefficient management."

Are there good policy reasons for the S.E.C. to revisit the balance struck by the existing rules? In examining this question, the S.E.C. should give considerable weight to the beneficial role outside shareholders play in corporate governance.

Much research documents that the presence and involvement of outside shareholders enhances a company's value and performance. Large shareholders have an incentive to monitor the performance of incumbent mangers and to engage with them, or even mount a proxy challenge, in the event of underperformance.

Consequently, the presence of large outside shareholders, or the prospect of their emergence, provides an important source of discipline for management. Often, a company's stock price is bolstered after S.E.C. records, known as 13D filings, disclose the emergence of a large outside shareholder. This is a reflection of investors' belief that such a presence can be expected to benefit their fellow shareholders.

The proposed 5 percent hard cap, however, would reduce the amount of stock that could be purchased before making a 13D filing. That would lower the potential returns to large outside shareholders produced by identifying an underperforming company and taking a significant stake in it. Consequently, the proposal would probably mean fewer shareholders would move to take large stakes in companies, which in turn could well result in more managerial slack at corporations.

The petition suggests that the proposed tightening is needed to protect shareholders who sell during the 10-day window from a buyer seeking to gain control without paying them for it. But while large shareholders often buy more than the 5 percent level during the 10-day window, they typically end up with blocks that fall substantially short of control. Because they typically do not obtain control, any influence large shareholders have on a company's future decisions is commonly not a result of their ownership stakes but rather their success in persuading fellow shareholders of their views.

The proposal also suggests that revising the rules is called for by changes in market practices and trading technologies, which have expanded opportunities for outside shareholders to accumulate large stakes quickly before being required to make a public disclosure.

Supporters of the petition do not base this claim on systematic evidence. Instead, they rely on four cases from the last five years in which substantial stakes were accumulated before a disclosure. Such cases, however, already occurred as early as the 1980s. What needs to be done — and was not done by the petition's authors — is a systematic analysis of publicly available filings by large outside shareholders. Until such an analysis is done, the S.E.C. should not assume that accumulations of large stakes have recently increased compared with historical levels.

What has clearly changed since the passage of the Williams Act is that state laws have developed in ways that strengthened the position of incumbent directors when compared with outside shareholders. For one, state law has evolved to allow incumbents to put in place poison pills preventing a large shareholder they disfavor from accumulating more than 10 to 15 percent of a company's shares. The rules governing the balance of power between incumbents and outside shareholders are now substantially tilted in favor of insiders — both relative to earlier times and to other countries — rather than outside shareholders. This tilt counsels against tightening S.E.C. rules in ways that would further disadvantage outsiders.

The Securities and Exchange Commission would do well to conduct a comprehensive examination of the rules governing the balance of power between incumbent directors and outside shareholders. In the meantime, however, the S.E.C. should not impose a hard 5 percent cap. Existing research and evidence raise significant concerns that such a tightening would hurt investors and the economy.