Via Email

July 29, 2019

Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: Amendments to Financial Disclosures About Acquired and Disposed Businesses

Dear Madam Secretary:

We are grateful for the opportunity to present our views on the proposed changes to the disclosure requirements under Rule 3-05.[1]

The Council of Institutional Investors (CII) is a nonprofit, nonpartisan association of public, corporate and union employee benefit funds, other employee benefit plans, state, and local entities charged with investing public assets, and foundations and endowments with combined assets under management of approximately $4 trillion. Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families. Our associate members include a range of asset managers with more than $35 trillion in assets under management.[2]

The Securities and Exchange Commission's (SEC's) proposed "Amendments to Financial Disclosures About Acquired and Disposed Businesses" purports to "improve the disclosure requirements for financial statements relating to acquisitions and dispositions of businesses."[3] The end goal of the proposal is to "improve for investors the financial information about acquired or disposed businesses, facilitate more timely access to capital, and reduce the complexity and costs to prepare the disclosure."[4] While we support the goal of the proposal, we cannot support its substance because we believe the proposal's supporting analysis is, at best, incomplete.

The proposal's analysis does not adequately consider the potential costs to long-term investors of value-destructive mergers and acquisitions (M&A). Nor does it adequately consider the potential costs to long-term investors of issuer reliance on Regulation A. The comments included in this

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[1] Amendments to Financial Disclosures about Acquired and Disposed Businesses, 84 Fed. Reg. 24600, (proposed May 28, 2019) (to be codified at 17 C.F.R. pts. 210, 230, 239, 240, 249, 270, and 274) [hereinafter *Proposal*].
[2] For more information about the Council of Institutional Investors ("CII"), including its board and members, please visit CII's website at http://www.cii.org.
[3] *Proposal*, *supra* note 1, at 24600.
[4] *Id*.

letter focus on certain aspects of the proposal that are of interest to institutional investors, including CII members.

Failure to Consider Costs of M&A Activity

CII's views on the proposal's failure to consider the costs of M&A activity is well summarized in SEC Commissioner Robert J. Jackson Jr.'s conclusions in his Public Statement on the proposal:

> Contrary to the ideological intuition evident in today's release, mergers come with both benefits and costs. Some acquisitions create important efficiencies; others allow managers to build empires and extract value from investors. Our disclosure rules should give investors the tools to tell the difference.[5]

Commissioner Jackson noted two reasons investors should be concerned by the proposal.[6] One reason is "the economic analysis in the release reflects . . . one-sided thinking in our rulemakings."[7] Commissioner Jackson explains that "the economic analysis goes on at length about the benefits of rolling back certain disclosures,"[8] but "says nothing about the foundational theory or evidence showing that mergers also come with substantial agency costs."[9]

A second reason is a proposed change to the "significance tests,"[10] which determine whether detailed disclosure on an acquisition is necessary.[11] More specifically, the proposal changes the investment significance test (one of several significance tests) from being based on assets, as has been done for decades, to being based on the market value of the acquirer's equity.[12]

Commissioner Jackson finds the "change . . . could result in less disclosure about acquisitions made by companies whose market value is significantly different from their book value."[13] The problem with these companies potentially having less disclosures, according to Commissioner Jackson, is "[t]hose are the mergers that are more likely to be bad deals—precisely the type of mergers for which we should require the most transparency."[14]

On both issues, we agree with Commissioner Jackson.

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[5] Robert Jackson, *Statement on Financial Disclosures about Acquired and Disposed Businesses*, SECURITIES AND EXCHANGE COMMISSION, May 3, 2019, https://www.sec.gov/news/public-statement/statement-jackson-050319.
[6] *See id*. (Stating "[i]n two ways, today's proposal ignores evidence on how corporate insiders use mergers to extract private benefits at investor expense").
[7] *Id*.
[8] *Id*.
[9] *See id*.
[10] *See Proposal*, *supra* note 1, at 24603 (explaining all of the significance tests fully).
[11] *See* Jackson, *supra* note 5.
[12] *See id*.
[13] *See id*.
[14] *See id*. (emphasis omitted).

The One-Sided Nature of the Analysis

We note the SEC's economic analysis guidelines require consideration of likely benefits and costs.[15] While the SEC contends mergers create benefits through efficiency,[16] evidence to the contrary is largely ignored in the proposal despite well-known evidence of management acquiring companies for their own self-interest.[17] The two key examples of the one-sided nature of the SEC's analysis are (1) omitting a discussion of recent studies and (2) highlighting the benefits accruing to shareholders of the acquired company, without discussion of the costs to the shareholders of the surviving organization.

On the first issue, recent studies generally indicate negative results from merger activity.[18] For example, one recent study found companies making acquisitions experienced an average share price decline of 4.3% over three years, with 61% of those companies underperforming industry competitors.[19] Other data indicates that in 2012 half of all deals actually destroyed value, an improvement over the 1980-90s where the rate was 60-70%.[20] Overall the recent studies generally demonstrate that acquisitions do not create growth on average, result in underperformance relative to competitors and are correlated with a falling stock price of the acquiring company.[21]

We note that the studies the SEC referenced in support of the proposal predate the relevant studies we found by decades in some cases.[22] Moreover, as discussed by Commissioner Jackson, the studies cited by the SEC have well-known methodological deficiencies.[23] As Commissioner

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[15] SECURITIES AND EXCHANGE COMMISSION, CURRENT GUIDANCE ON ECONOMIC ANALYSIS IN SEC RULEMAKINGS (Mar. 16, 2012), at 10–11, https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf.
[16] *Proposal*, *supra* note 1, at 24633 (stating: "[T]o the extent that the proposed amendments reduce the compliance burden, they may reduce the cost of merger and acquisition activity. Well-functioning markets for corporate control are, on average, beneficial to investors as they serve as a disciplinary mechanism in which less efficiently managed assets are transferred to more efficient management. Mergers and acquisitions may also generate synergies by combining two entities, and may result in firms with more efficient scale or scope.").
[17] *See* Jackson, *supra* note 5.
[18] *See* Richard Tortoriello et al., *Mergers & Acquisitions: The Good, the Bad, and the Ugly (and how to tell them apart)*, S&P GLOBAL, Aug., 2016, at 2–4, https://www.spglobal.com/marketintelligence/en/documents/mergers-and-acquisitions-the-good-the-bad-and-the-ugly-august-2016.pdf; *See M&A: How it can affect your investments*, FIDELITY (Sep. 27, 2018), https://www.fidelity.com/viewpoints/active-investor/mergers-and-acquisitions [hereinafter *Fidelity*]; *See generally* Fangjian Fu et al., *Acquisitions Driven by Stock Overvaluation: Are they Good Deals?*, SINGAPORE MANAGEMENT UNIVERSITY, July 2013, https://ink.library.smu.edu.sg/cgi/viewcontent.cgi?article=4249&context=lkcsb_research.
[19] *Fidelity*, *supra* note 18 (citing a CFA Institute study).
[20] Louise Lucas, *Spending on M&A often wasteful*, FINANCIAL TIMES, Apr. 13, 2012, https://www.ft.com/content/7fb2274e-7f14-11e1-a06e-00144feab49a (citing recent and past studies analyzing firm values).
[21] *See Fidelity*, *supra* note 18; See Tortoriello, *supra* note 18, at 2-4 (indicating that acquisitions are usually bad for shareholders); *See* Fu et al., *supra* note 18, at 1.
[22] *See generally* Mark Mitchell and Kenneth Lehn, *Do Bad Bidders Become Good Targets*, THE UNIVERSITY OF CHICAGO PRESS, Apr., 1990, https://www.jstor.org/stable/2937670?seq=1#page_scan_tab_contents; Anup Argawal and Jeffrey Jaffe, *Do Takeover Targets Underperform? Evidence from Operating and Stock Returns*, THE JOURNAL OF FINANCIAL AND QUANTITATIVE ANALYSIS, Dec., 2003, https://www.jstor.org/stable/4126741?seq=1#page_scan_tab_contents; Kenneth Lehn and Mengxin Zhao, *CEO Turnover after Acquisitions: Are Bad Bidders Fired?*, THE JOURNAL OF FINANCE, Aug., 2006, https://onlinelibrary.wiley.com/doi/abs/10.1111/j.1540-6261.2006.00889.x.
[23] *See* Jackson, *supra* note 5.

Jackson adds, "[t]hose studies also exclude evidence from the merger waves of the 1980s and 1990s—evidence that shows that many of those mergers harmed investors over the long run."[24]

On the second issue, the SEC analysis only highlights benefits to the acquired company shareholders. Commissioner Jackson discusses this issue in his statement:

> [T]he release describes the obvious fact that target companies receive a substantial premium when they're acquired. But the release ignores the other half of this well-known equation: that acquiring companies' stocks tend to take a hit upon the announcement of a merger. Looking at the performance of the combined company, which is more logically—and economically—sound, shows that many mergers are not in investors' long-term interests.[25]

We note that the benefits accruing to the shareholders of the acquired company may be very real; historically those shareholders receive a 30% premium over the pre-announcement price.[26] However, the long term investors of the acquiring company have historically seen their stock lose 1-3% of its value over the following three years.[27] The major implication is that even if a merger does create value, sometimes over 100% of the value created goes to the shareholders of the acquired company, leaving shareholders of the acquiring company worse off.[28]

<u>Change to Investment Significance Test</u>

The second reason that Commissioner Jackson offered as to why investors should be concerned by the proposal is the change to the investment significance test. He describes the change and its potential consequences in his public statement:

> For decades, we have determined the "significance" of the merger by reference to the audited value of the acquirer's assets according to its last-filed annual financial statements. Today's proposal would, among other things, determine a deal's significance based upon the market value of the acquirer's equity.
>
> The problem with this change is that it could result in less disclosure about acquisitions made by companies whose market value is significantly different from their book value. The evidence shows that those are the mergers that are more likely to be bad deals—precisely the type of mergers for which we should require the most transparency. That's especially true in light of evidence suggesting that managers prefer to hide information

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[24] *Id*.
[25] *Id*. (internal citations omitted).
[26] *See Fidelity*, *supra* note 18 (showing recent studies have shown gains for the acquired company's shareholders at around 30%); *See* Reza Yaghoubi et al., *Mergers and acquisitions: a review. Part 1*, EMERALD INSIGHT, Jun. 17, 2015, at 161, https://www.emerald.com/insight/content/doi/10.1108/SEF-03-2015-0078/full/html?skipTracking=true (highlighting that older studies have found that the target company generally has a very positive return).
[27] *See Fidelity*, *supra* note 18; See Tortoriello, *supra* note 18, at 2-4 (indicating that acquisitions are usually bad for shareholders); But see Yaghoubi, *supra* note 26, at 169 (indicating that the returns may simply be zero or even positive with some measures).
[28] *See M&A: How it can affect your investments*, THE ECONOMIST, Nov. 14, 2014, https://www.economist.com/business/2014/11/14/the-new-rules-of-attraction (stating: "The problem is that, all too often, over 100% of these gains has accrued to the shareholders of the firm being bought. Typically the acquirer overpays for the synergies on offer, exaggerates or overestimates them in its lust to justify a deal, or botches the subsequent integration of the organizations.").

> about underperforming mergers in order to avoid accountability to investors. So it's not clear to me why we should change our rules to give investors less information about these deals, since doing so risks giving executives more freedom to pursue mergers that harm the long-term health of the company. [29]

A 2016 S&P Global study examined how acquisitions tended to impact companies and what factors caused those impacts.[30] The study looked at Russell 3000 companies,[31] encompassing the largest 3,000 U.S. stocks representing 98% of incorporated equity securities.[32] This broad and representative study found evidence of long-term declines in profitability, return on capital and earnings growth for mergers generally.[33]

Of note, the study also found that the only two significant deal factors in predicting underperformance for the acquirer (and thus their shareholders) were (1) relative deal value (the larger the deal value relative to the acquirer, the greater the underperformance) and (2) the ratio of stock to cash consideration (the more stock consideration relative to cash consideration, the greater the underperformance).[34]

More deals involving both of these significant deal factors from the S&P study could be encouraged by the change to the investment test, because the threshold required to trigger disclosure requirements would increase for companies with a high market cap relative to assets (referred to as "high-cap companies"). On the first S&P study factor, deals of higher relative value could be encouraged because high-cap companies would have fewer disclosure requirements.

Encouraging more transactions from high-cap companies could be problematic for the second S&P study factor because companies with overvalued stock are more likely to use stock as consideration,[35] more likely to overpay for their target,[36] and generally underperform their competitors post-acquisition.[37] Most critical, the findings indicated shareholders would have been better off had the acquisition never taken place.[38]

Failure to Consider Implications of Regulation A Problems for this Proposal

While the proposal does not reduce the reporting requirements for Regulation A companies,[39] we are surprised and disappointed that no analysis appears to have been performed on the recent

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[29] *See* Jackson, *supra* note 5.
[30] *See* Tortoriello, *supra* note 18, at 1-2.
[31] *Id*. at 3.
[32] James Chen, *Russell 3000 Index*, INVESTOPEDIA, Nov. 13, 2017, https://www.investopedia.com/terms/r/russell_3000.asp.
[33] Tortoriello, *supra* note 18, at 2-4.
[34] *Id*. at 6.
[35] Fu et al., *supra* note 18, at 1.
[36] *See Id*. at 12-16 (highlighting other factors from companies do not explain this overpayment).
[37] *See Id*. at 16-21.
[38] *See Id*. at 21-24.
[39] *Proposal*, *supra* note 1, at 24612 (stating "smaller reporting companies would continue to be required to provide up to two years of acquired business historical financial statements and Regulation A issuers would continue to be permitted to present the periods applicable under Regulation A").

problems identified with Regulation A offerings and whether those problems should impact the proposed disclosures.[40]

Regulation A exempts certain offerings from the requirement to register as a public offering.[41] Recently a major issue of fraud occurred with a company using Regulation A (under a tier 2 offering commonly referred to as Regulation A+) causing more than $25 million in illegal trading proceeds.[42] This incident and others apparently led NASDAQ to state that it has "observed problems with certain Regulation A companies",[43] and both NASDAQ and the New York Stock Exchange have been more cautious about Regulation A listings.[44]

For example, NASDAQ recently proposed, and the SEC approved, more rigorous listing standards to help ensure Regulation A companies are capable of "satisfying the SEC and Exchange's reporting and corporate governance requirements."[45] In CII's May 2nd letter in response to NASDAQ's proposed improvements to Regulation A listing standards, we requested the Commission perform its own "detailed analysis of the costs to investors resulting from . . . the limited accounting and disclosure requirements of Regulation A" and "[t]hat analysis should then be explicitly discussed and carefully considered in any future SEC or exchange rulemaking that permits less burdensome accounting and disclosure standards for some, or all, SEC registrants."[46] We believe the proposal's supporting analysis is incomplete without an examination of the Regulation A problem.

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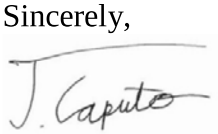
If you have any questions regarding this letter or need additional information, please do not hesitate to contact CII's General Counsel Jeff Mahoney at 202.822.0800 or jeff@cii.org.

Sincerely,



Joseph W. Caputo

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[40] *Id*. at 24637-38 (showing there is no consideration of the costs of Regulation A offerings).
[41] U.S. SECURITIES AND EXCHANGE COMMISSION, Regulation A, https://www.sec.gov/smallbusiness/exemptofferings/rega.
[42] U.S. SECURITIES AND EXCHANGE COMMISSION, SEC Adds Fraud Charges Against Purported Cryptocurrency Company Longfin, CEO, and Consultant (Jun. 5, 2019), https://www.sec.gov/news/press-release/2019-90.
[43] *See* Self-Regulatory Organizations; The Nasdaq Stock Market LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change To Adopt Additional Requirements for Listings in Connection with an Offering under Regulation A of the Securities Act, 84 Fed. Reg. 17,225 (Apr. 24, 2019), https://www.govinfo.gov/content/pkg/FR-2019-04-24/pdf/2019-08205.pdf (noting that the companies are generally less mature, have less developed business plans, and concerns of fraud have been raised) [hereinafter *Nasdaq Filing*].
[44] *See* Alexander Osipovich, *Exchanges Shy Away From Mini-IPOs After Fraud Concerns*, WALL STREET JOURNAL, Jun. 10, 2019, https://www.wsj.com/articles/exchanges-shy-away-from-mini-ipos-after-fraud-concerns-11560177205.
[45] *See Nasdaq Filing*, *supra* note 43, at 17,225.
[46] Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to Secretary, Securities and Exchange Commission (May 2, 2019), https://www.cii.org/files/issues_and_advocacy/correspondence/2019/May%202,%202019%20SEC%20Letter%20on%20Nasdaq%20Regulation%20A%20Listing%20Proposal%20(final).pdf.