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CORPORATE GOVERNANCE

Holding Activists and Proxy Advisory Firms Accountable?

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The nation's capital is center stage for the latest round of debates as to the impact of shareholder activism on American business. With the introduction of the Brokaw Act by four Democratic senators in March, followed by the announcement in May of a new D.C.-based lobbying organization formed by a bipartisan group of prominent activists, the long-running controversy over the unprecedented influence of shareholder activism has officially reached Washington. The activist agenda now includes public policy, and it appears that the influence of these powerful investors is to be wielded on K Street as it has been on Wall Street. By raising their own profile via a Washington-based lobbying entity, activists will place themselves and their business practices squarely in the spotlight. Perhaps a more significant public presence will engender a more favorable reputation for activists, or perhaps it will increase activist accountability to lawmakers and public shareholders; or, perhaps, it will do both.

At the same time, lawmakers are taking significant steps toward much-needed regulation of proxy advisory firms. With a bipartisan bill introduced this week, Congress outlined a comprehensive oversight framework for increasing the transparency and accountability of proxy advisory firms.

Rising Activism Concern

The immense financial power of activist investors and their aggressive attacks on corporations have caused concern on Capitol Hill. Last month, Pershing Square's William Ackman was called to testify before a Senate committee regarding his investments in Valeant Pharmaceuticals International, as well as his involvement in Fannie Mae, Freddie Mac, and Herbalife. Valeant's notorious strategy of drug acquisitions and massive price increases had yielded higher shareholder value (for a time) but inflicted extortionate costs on hospitals and patients. During the high-profile hearings, both Democratic and Republican senators expressed outrage at the practices, which were disavowed by Ackman and outgoing Valeant CEO Mike Pearson.¹

The Valeant hearings took place just one month after the Brokaw Act was introduced in the Senate to curb abuses of outdated disclosure laws by activist investors. Co-sponsoring Senator Tammy Baldwin (D-Wis.) had strong words directed at activists: "We cannot allow our economy to be hijacked by a small group of investors who seek only to enrich themselves at the expense of workers, taxpayers and communities."² Named after a small town in Wisconsin that was bankrupted by the closing of a plant after activists targeted the company, the Brokaw Act is intended to expedite and broaden required disclosures of activity in target company stock.³

The Brokaw Act would direct the U.S. Securities and Exchange Commission to amend the §13(d) reporting rules in several key ways. First, the Brokaw Act would reduce the 10-day filing window for an initial Schedule 13D filing to two business days. Second, it would require the disclosure of short positions over 5 percent on Schedule 13D. Third, it would expand the definition of beneficial ownership to include a direct or indirect pecuniary interest, in addition to voting or dispositive power. Investors would therefore have to include shares held in swaps and other cash-settled derivatives, not merely equity securities or securities convertible into equity securities. Fourth, the Brokaw Act would specifically require the disclosure of activity by hedge funds and groups of hedge funds under §13(d). The explicit inclusion of hedge funds in the definition of "persons" is a signal that the SEC is directed to pay close attention to activists and to "wolf pack" activity intended to evade the disclosure requirements. These four amendments would significantly increase the transparency and fairness of the disclosure rules, closing loopholes that are routinely exploited by activists and other sophisticated investors. The proposed revisions would result in higher quality information released in a timelier fashion, to the benefit of the public equity markets.⁴ Although the Brokaw Act does not go far enough to close all of the loopholes available to activists, it would be a significant step forward.

The Brokaw Act was introduced by Sen. Baldwin along with Sen. Jeff Merkley (D-Ore.) and co-sponsored by fellow Senators Elizabeth Warren (D-Mass.) and Bernie Sanders (D-Vt.). As election-year legislation sponsored by Democrats in the Republican-controlled Senate, the Brokaw Act is unlikely to be enacted in the foreseeable future. Yet the benefits of the proposed reforms would be wide-ranging and nonpartisan. Just as senators on both sides of the aisle joined

to condemn Valeant's business practices in the April hearings, Republicans and Democrats should unite to support this modernizing legislation.

Activists Respond

Earlier this month, a new lobbying effort was announced by a group of activist investors. The Council for Investor Rights and Corporate Accountability (CIRCA) is "committed to promoting the actions of shareholder activists, and their positive impact on corporate governance and business policies at publicly traded companies."⁵ In other words, the organization will advocate for activists' interests in Washington and generally seek to further the activist agenda, including by making the case that shareholder activism benefits publicly traded companies, their shareholders, and by extension, the economy in general. CIRCA reportedly is a coordinated effort by Ackman, Carl Icahn, Daniel Loeb of Third Point, Paul Singer of Elliott Associates, and Barry Rosenstein of Jana Partners.⁶ These investors manage roughly \$90 billion of assets and have publicly targeted a wide range of well-known companies, with varying results.

CIRCA clearly is intended to counter the anti-activist momentum that has been gathering among lawmakers and market participants alike. This is not the first such effort; in 2008, Carl Icahn established the United Shareholders of America group, which was intended to be "a voice for large and small shareholders ... in Washington to combat pro-management forces."⁷ The "U.S.A." as it was known, seems to have been a relatively short-lived effort that has been subsumed into Icahn's personal endeavors. CIRCA, by contrast, appears to be a higher-profile and more ambitious effort.

In Washington, the Valeant hearings, the proposed Brokaw Act, and the presidential campaign rhetoric in this election cycle no doubt have left activists feeling increasingly vulnerable to the possibility of legislation unfavorable to their interests. On Wall Street, criticism from prominent institutional investors of activists' "short-termism" and collusive tactics have put activists on the defensive. Last year, BlackRock chairman and chief executive Larry Fink pointed to "the proliferation of activist shareholders seeking immediate returns" as a significant concern for companies trying to build long-term value.⁸ The activists behind CIRCA had been discussing for several years the possibility of forming an organization, reportedly prompted by the formal petition for amendments to the §13(d) disclosure requirements submitted to the SEC by Wachtell, Lipton, Rosen & Katz in 2011, and with CIRCA they have now formalized their efforts.⁹ According to news reports, the organization intends to eschew political action and focus on convincing policy makers and the public that their activities create value for shareholders generally.

Activists and Accountability

Shareholder activists often claim to be a countervailing force against the power of entrenched boards of directors. According to a CIRCA representative, "CIRCA was founded on the widely accepted idea that a well-functioning system of checks and balances between boards of directors and shareholders is fundamental to long term economic growth and U.S. prosperity."¹⁰ Activists assert that their demands for change in corporate strategy, management, board composition, and

other elements of corporate governance serve to hold boards accountable for their decisions and performance. CIRCA's mission appears to be to convince lawmakers and the public that activists serve the public good.

The activist lobby is likely to have something of an uphill battle. In the populist, anti-financial-industry mood of the moment, exacerbated by the rhetoric of presidential candidates, sophisticated investors are viewed as predators rather than protectors of the investing public. Moreover, thoughtful and influential leaders continue to point to activists as inimical to worthwhile corporate goals. Larry Fink's February 2016 letter to S&P 500 chief executives encouraged companies to clearly articulate long-term plans for value creation as a defense against the superficially attractive but typically short-term visions of activists.¹¹ In the same vein, Leo E. Strine, chief justice of the Delaware Supreme Court, observed in March 2016 that, all too frequently, companies faced with activist attacks suddenly change their corporate strategy rather than staying with a pre-existing business plan that has been regularly and deeply reviewed by the board and senior management.¹² Chief Justice Strine has written in recent years about the dangers of short-term investors' dominating corporate decisionmaking and has advocated for the creation of a system that will employ shareholders' rights in a way "that is more beneficial to the creation of durable wealth for them and for society as a whole."¹³

Taking an optimistic look ahead, it is just possible that activist lobbying may end up creating a situation in which activists are compelled to change their practices for the better. Making the public case for activism runs the risk of drawing more negative attention to activists' enormous financial power, unscrupulous tactics, and mixed records of successes and failures. In trying to demonstrate that they hold boards accountable and benefit the American economy, activists may find that they themselves are held more accountable than ever before. And, just as Ackman found himself repudiating the controversial business practices of Valeant under the glare of the Senate hearings, activists engaged in public dialogue with lawmakers and other leaders may find themselves renouncing some of their more egregious, short-termist tactics. To the extent that activists attempt to style themselves the champions of Main Street investors, they will feel pressure to defend, mitigate, or abandon their obviously self-serving activities.

The dynamics of a meaningful activist lobbying effort will be interesting to observe. It certainly could be a welcome development if it leads somehow to a greater focus by activists, other investors, and corporations alike on strategic planning and meaningful long-term value creation. Perhaps unlikely, nonetheless such an outcome would indeed represent a "positive impact" of activist efforts on Wall Street, Main Street, and the American economy.

Proxy Advisory Firm Reform Act

Another bill, introduced in the House of Representatives on May 24, 2016, aims to create an oversight framework for proxy advisory firms such as ISS and Glass Lewis.¹⁴ The Proxy Advisor Firm Reform Act of 2016, introduced by Rep. Sean Duffy (R-Wis.) and Rep. John Carney (D-Del.), would require proxy advisory firms to register with the SEC. As part of the registration process, a firm would have to provide information regarding its procedures and methodologies, its organizational structure and whether it has a code of ethics. In addition, addressing a widespread concern, a proxy advisory firm would have to disclose any potential or actual

conflicts of interest created by its ownership structure and the services it provides to clients, including whether it engages in consulting services for companies, its largest clients (which can be disclosed confidentially to the SEC), and the policies and procedures in place to manage conflicts that may arise in this context.

Under the proposed legislation, registered proxy advisory firms would have to file an annual report with the SEC containing information on the number of shareholder proposals reviewed in the past year, the number of recommendations that were made, how many employees reviewed the proposals, and how many of the proposals were sponsored by clients of the proxy advisory firm. Proxy advisory firms also would be required to file and make publicly available their policies regarding the formulation of their proxy voting policies and voting recommendations. The bill would give corporations the right to review and comment on a proposed recommendation by a proxy advisory firm before the recommendation is provided to investors. Corporations would have a private right of action against a proxy advisory firm that did not provide this opportunity. Finally, registered proxy advisory firms would be required to appoint an internal compliance officer.

This bill would represent a significant step toward much-needed oversight of unduly influential proxy advisory firms. It would dramatically increase transparency and improve accountability, going well beyond the scope of the SEC's 2014 Staff Legal Bulletin No. 20. The issuance of SLB 20 followed a concept release and roundtable by the SEC and addressed several important issues relating to proxy advisory firms. SLB 20 clarified the duties and obligations of proxy advisors and of investment advisors that rely on proxy advisors' services. Still, more is needed, and as former SEC Commissioner Daniel Gallagher noted in his testimony before the House Financial Services Committee on May 17, the proposed legislation "would pick up where SLB 20 left off by providing a comprehensive regulatory regime to address many of the fundamental concerns that still remain regarding the activities of proxy advisers."¹⁵

Increased accountability for activists and for proxy advisory firms would be highly beneficial to corporate America. It is to be hoped that Congress will give the Brokaw Act and the Proxy Advisory Firm Reform Act full and fair hearings and that, ultimately, bipartisan support for both bills will result in a significantly improved regulatory environment for both investors and public companies.

Endnotes:

1. See Cynthia Koons & Anna Edney, "Ackman, Valeant Offer Apologies, Concessions at Drug Hearing," Bloomberg.com, April 27, 2016, available at <http://www.bloomberg.com/news/articles/2016-04-27/valeant-s-regrets-may-not-appease-senators-at-drug-price-hearing>.
2. See Donna Borak & David Benoit, "Democrats Take Aim at Activist Investors," WSJ.com, March 17, 2016, available at <http://www.wsj.com/articles/democrats-take-aim-at-activist-investors-1458251491>.

3. The text of the proposed legislation is available at <https://www.baldwin.senate.gov/imo/media/doc/3.17.16 - Brokaw Act Final.pdf>.
4. Wachtell, Lipton, Rosen & Katz has consistently advocated for modernization of the reporting regime. See Theodore N. Mirvis, et al., "Legislation Calls for Important Revisions to 13(d) Beneficial Ownership Reporting Rules," WLR&K Memorandum, March 18, 2016, and citations linked therein. The memorandum is available at http://www.deallawyers.com/member/docs/firms/Wachtell/03_16_reform.pdf.
5. See Reuters, "Activist Investor Heavyweights Form New Lobbying Arm," May 18, 2016, available at <http://www.reuters.com/article/us-usa-activist-lobbying-idUSKCN0Y92YV>.
6. See David Benoit, "Activist Investors Have a New Target: Washington," WSJ.com, May 18, 2016, available at <http://www.wsj.com/articles/activist-investors-ally-to-form-lobby-group-1463604738>.
7. See Peter Galuszka, "Icahn Launches the United Shareholders of America," CBS.com, Oct. 13, 2008, available at <http://www.cbsnews.com/news/icahn-launches-the-united-shareholders-of-america/>.
8. Larry Fink's 2015 letter is available at <http://www.businessinsider.com/larry-fink-letter-to-ceos-2015-4>.
9. See Benoit, supra. Wachtell, Lipton, Rosen & Katz's 2011 petition to the SEC is available at <https://www.sec.gov/rules/petitions/2011/petn4-624.pdf>.
10. See Reuters, supra.
11. Larry Fink's 2016 letter is available at <http://www.businessinsider.com/blackrock-ceo-larry-fink-letter-to-sp-500-ceos-2016-2>.
12. See Michael J. de la Merced, "Delaware's Chief Justice Speaks out on Big Mergers and Investors," NY Times Dealbook, March 17, 2016, available at <http://www.nytimes.com/2016/03/18/business/dealbook/delawares-chief-justice-speaks-out-on-big-mergers-and-investors.html>.
13. Leo E. Strine Jr., "Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law," Essay, 114 Columbia L.R. 449, 476, Jan. 31, 2011, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2421480##.
14. The text of the bill, H.R. 5311, can be found at <http://financialservices.house.gov/uploadedfiles/bills-114-pafra-pih.pdf>.
15. Testimony of Daniel M. Gallagher before the U.S. House of Representatives Committee on Financial Services, "Legislative Proposals To Enhance Capital Formation, Transparency, and Regulatory Accountability," May 17, 2016, at 11.