



Current Thoughts About Activism

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Friday August 9, 2013

Editor's Note: [Martin Lipton](#) is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy. This post is based on a Wachtell Lipton memorandum by Mr. Lipton, [Steven A. Rosenblum](#), and [Sabastian V. Niles](#). Work from the Program on Corporate Governance about hedge fund activism includes [The Long-Term Effects of Hedge Fund Activism](#) by Lucian Bebchuk, Alon P. Brav, and Wei Jiang.

A long-term oriented, well-functioning and responsible private sector is the country's core engine for economic growth, national competitiveness, real innovation and sustained employment. Prudent reinvestment of corporate profits into research and development, capital projects and value-creating initiatives furthers these goals. Yet U.S. companies, including well-run, high-performing companies, increasingly face:

- pressure to deliver short-term results at the expense of long-term value, whether through excessive risk-taking, avoiding investments that require long-term horizons or taking on substantial leverage to fund special payouts to shareholders;
- challenges in trying to balance competing interests due to excessively empowered special interest and activist shareholders; and
- significant strain from the misallocation of corporate resources and energy into mandated activist or governance initiatives that provide no meaningful benefit to investors or other critical stakeholders.

These challenges are exacerbated by the ease with which activist hedge funds can, without consequence, advance their own goals and agendas by exploiting the current regulatory and institutional environment and credibly threatening to disrupt corporate functioning if their demands are not met. Activist hedge funds typically focus on immediate steps, such as a leveraged recapitalization, a split-up of the company or sales or spinoffs of assets or businesses that may create an increase in the company's near term stock price, allowing the activist to sell out at a profit, but leave the company to cope with the increased risk and decreased flexibility that these steps may produce.

The power of the activist hedge funds is enhanced by their frequent success in proxy fights and election contests when companies resist the short-term steps the hedge fund is advocating. These proxy contest successes, in turn, are enabled by the outsized power of proxy advisory firms and governance reforms that weaken the ability of corporate boards to resist short-term pressures. The proxy advisory firms are essentially unregulated and often demonstrate a bias in favor of activist shareholders. They also tend to take a one-size-fits-all approach to policy and voting recommendations without regard for or consideration of a company's unique circumstances. This approach includes the potential for across-the-board "withhold votes" from directors if the directors fail to implement any shareholder proposal receiving a majority vote, even if directors believe that the proposal would be inconsistent with their fiduciary duties and the best interests of the company and its shareholders. Further complicating the situation is the fact that an increasing number of institutional investors now invest money with the activist hedge funds or have portfolio managers whose own compensation is based on short-term metrics, and increasingly align themselves with the proposals advanced by hedge fund activists. In this environment, companies can face significant difficulty in effectively managing for the long-term, considering the interests of employees and other constituencies, and recruiting top director and executive talent.

Although there is no single solution to these problems, the following perspectives and actions may help to restore a more reasonable balance:

- Recognize that the proper goal of good governance is creating sustainable value for the benefit of all stakeholders, rather than reflexively placing more power in the hands of activist hedge funds or often-transient institutional shareholders who are themselves measured by short-term, quarterly portfolio performance;
- Resist the push to enact legislation, regulations or agency staff interpretations that place more power in the hands of activist hedge funds and other investors with short-term perspectives, and that thereby weaken the ability of corporate boards to resist such short-term pressures; and
- In any new legislation or regulation that is enacted, provide appropriate protections to companies, as opposed to focusing only on new rights for shareholders who already have significant leverage to pressure companies.

Some specific examples of possible steps to implement these general principles may include the following:

- SEC Commissioner Daniel Gallagher recently questioned whether "investment advisors are indeed truly fulfilling their fiduciary duties when they rely on and follow

recommendations from proxy advisory firms” and expressed “grave concerns” about institutional investors engaging in “rote reliance” on proxy advisory firms’ advice. He attributed this in part to the unintended consequences of two SEC staff no-action letters from 2004, which he noted were not approved by the Commission and did not necessarily represent the views of the Commission or the Commissioners, that had “unduly increased the role of proxy advisory firms in corporate governance” by “essentially mandating the use of third party opinions.” *New Commission-level guidance could replace these staff interpretations and, instead, encourage proxy voting based on individual evaluation of each company and its long-term best interests. Other agencies may also wish to keep in mind this illustration of unintended and undesired outcomes as appropriate.*

- Activist shareholders take advantage of Securities Exchange Act Rule 14a-8 to force the inclusion, year-after-year and notwithstanding prior failures, of corporate governance and business-related shareholder proposals in public company proxy statements that have little connection to effective governance or the creation of long term shareholder value. These proposals can be misused to exert leverage over companies, and dealing with the deluge distracts from the business and requires significant time and resources. *Rule 14a-8 should be revisited to raise the bar on inclusion of shareholder proposals. This could include more substantial and longer-term ownership requirements to be eligible under Rule 14a-8, and exclusion of proposals in subsequent years that did not obtain a truly meaningful level of support (current rules prohibit a company from excluding a repeat proposal the following year unless 97% of the shares reject it the first time or 90% of the shares reject it at least three times, standards that are far too low).*
- Proxy advisory firms, such as Institutional Shareholder Services (ISS) and Glass, Lewis & Co., have disproportionate influence over voting decisions made by every public company’s institutional shareholder base and regularly support activist shareholders and hedge funds. Their recommendations and analyses may also contain material inaccuracies, and companies have little visibility into the preparation of these reports and the proxy advisory firms’ methodologies. *We believe that the proxy advisory firms should be held to reasonable standards to ensure transparency, accuracy and the absence of conflicts and that the special regulatory treatment given to these firms should end.*
- Activist hedge funds have recently exploited loopholes in existing SEC rules under Section 13(d) of the Securities Exchange Act to accumulate significant, control-influencing stakes in public companies rapidly without timely notice to the market. These techniques are facilitated by the widespread use of derivatives, advanced electronic trading technology and increased trading volumes. Many non-U.S. securities markets have already taken action to address the risks of such rapid, undisclosed accumulations.

A rulemaking petition, pending before the SEC since March 2011, would close the derivatives loophole and require acquirers of 5% stakes to disclose such positions to the public within one day, instead of the current ten-day window established forty years ago. *We believe approval of this rulemaking petition will help curb abuses and bring the rules current with con-temporary practices and technologies.*

- Companies face significant difficulty engaging with their institutional shareholder base because the current reporting regime does not provide timely information to companies as to who their shareholders are. A second rulemaking petition pending before the SEC, submitted in February 2013, requests that the SEC shorten the deadline for institutional investors to report their positions on Forms 13F from 45 days to two business days after quarter-end and increase the frequency with which shareholders report their position. The petition also supports reform of the Section 13(d) stock accumulation rules. *We believe approval of this rulemaking petition will promote market transparency and facilitate engagement between companies and shareholders.*
- Harvard Law School Professor Lucian Bebchuk has established the Harvard Law School Shareholder Rights Project (previously discussed [here](#)) to promote corporate governance that facilitates activist hedge fund attacks on companies. He has also published several articles and editorials arguing that activist attacks are beneficial to the targeted companies and should be encouraged. His articles and editorials are widely used by activist hedge funds and institutional share-holders to justify their actions. *We believe that the statistics Professor Bebchuk uses do not establish the validity of his claims that activist attacks are beneficial nor justify his uncritical embrace of activists. We believe that attacks, and the threat of attacks, by activist hedge funds and pervasive activism have significant implications for the broader economy and our nation's competitiveness and are major contributors to unemployment and slow growth of GDP. We believe that the recent studies by:*
 - Professor Pavlos E. Masouros, *Corporate Law and Economic Stagnation: How Shareholder Value and Short-Termism Contribute to the Decline of the Western Economies*
 - Professor Lynn Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public*
 - Professor Colin Mayer, *Firm Commitment: Why the corporation is failing us and how to restore trust in it*
 - Professor David Larcker and Brian Tavan, *A Real Look at Real World Corporate Governance*

reflect the true effects of activism and that it is in the national interest to reverse the legislation and regulation that promotes activism.