April 7, 2014

Current Thoughts About Activism, Revisited

We published this note last August. Since then there have been several developments that prompt us to revisit it; adding the first three paragraphs below.

First, Delaware Supreme Court Chief Justice Leo E. Strine, Jr. published a brilliant article in the Columbia Law Review, *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law* in which he points out the serious defects in allowing short-term investors to override carefully considered judgments of the boards of directors of public corporations. Chief Justice Strine rejects the argument of the academic activists and activist hedge funds that shareholders should have the unfettered right to force corporations to maximize shareholder value in the short run. We embrace Chief Justice Strine's reasoning and conclusions.

Second, almost simultaneously with *Can We Do Better*, Laurence Fink, Chairman and CEO of BlackRock, one of the largest and most successful investment managers, expressing another policy position we embrace, wrote to the CEOs of the S&P 500:

> Many commentators lament the short-term demands of the capital markets. We share those concerns, and believe it is part of our collective role as actors in the global capital markets to challenge that trend. Corporate leaders can play their part by persuasively communicating their company's long-term strategy for growth. They must set the stage to attract the patient capital they seek: explaining to investors what drives real value, how and when far-sighted investments will deliver returns, and, perhaps most importantly, what metrics shareholders should use to assess their management team's success over time.
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> It concerns us that, in the wake of the financial crisis, many companies have shied away from investing in the future growth of their companies. Too many companies have cut capital expenditure and even increased debt to boost dividends and increase share buybacks. We certainly believe that returning cash to shareholders should be part of a balanced capital strategy; however, when done for the wrong reasons and at the expense of capital investment, it can jeopardize a company's ability to generate sustainable long-term returns.
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> We do recognize the balance that must be achieved to drive near-term performance while simultaneously making those investments—in innovation and product enhancements, capital and plant equipment, employee development, and internal controls and technology—that will sustain growth.
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> BlackRock's mission is to earn the trust of our clients by helping them meet their long-term investment goals. We see this mission as indistinguishable from also aiming to be a trusted, responsible shareholder with a longer term horizon. Much progress has been

made on company-shareholder engagement and we will continue to play our part as a provider of patient capital in ensuring robust dialogue. We ask that you help us, and other shareholders, to understand the investments you are making to deliver the sustainable, long-term returns on which our clients depend and in which we seek to support you.

Third, we have added three additional academic articles supporting the policy positions we embrace, and we have minor changes in the text.

We believe that 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 more 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 leaving 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 contests when companies resist the short-term actions 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 demonstrate a general 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 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 would help to restore a more reasonable balance:

- Recognize that the proper goal of good governance is creating both long-term and short-term 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.

Specific examples of possible steps to implement these general principles include the following:

- SEC Commissioner Daniel Gallagher, who has wide knowledge and deep understanding of the securities business and corporate governance, 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 firm 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 view 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 this illustration of unintended and undesired outcomes in mind as appropriate.*

- Commissioner Gallagher has also recently called attention to activist shareholders taking 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 them distracts from the business and requires significant time and resources. *We endorse Commissioner Gallagher's call to revisit Rule 14a-8 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 the special treatment.*

- Activist hedge funds have recently exploited loopholes in existing 13(d) regulatory requirements 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 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 contemporary 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 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, who believes that shareholders should have the right to control all of the material decisions of the companies they invest in, has established the Harvard Law School Shareholder Rights Project to promote corporate governance—based on his policy beliefs-- 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 shareholders 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. We believe that attacks, and the threat of attacks, by activist hedge funds and pervasive activism are major causes of un-*

derinvestment, unemployment and slow growth of GDP. We believe that the recent academic studies by:

> K.J. Martijn Cremers, Lubomir P. Litov and, Simone M. Sepe, *Staggered Boards and Firm Value, Revisted*
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> Jillian Popadak, *A Corporate Culture Channel: How Increased Shareholder Governance Reduces Firm Value*
>
> Jing Zhang, *Why Are Bad Loans Securitized, the Impact of Shareholder Rights in the Banking Industry*
>
> Pavlos E. Masouros, *Corporate Law and Economic Stagnation: How Shareholder Value and Short-Termism Contribute to the Decline of the Western Economies*
>
> Lynn Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public*
>
> Colin Mayer, *Firm Commitment: Why the corporation is failing us and how to restore trust in it*
>
> David Larcker and Brian Tavan, *A Real Look at Real World Corporate Governance*

directly and convincingly rebut the statistics relied on by Professor Bebchuk, reflect the true effects of activism and establish that it is in the national interest to reverse the legislation and regulation that promote activism and short-termism.

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