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New Age of Shareholder Activism

Description, Analysis and Prescriptive Recommendations for Executives and Directors

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Executive Summary

Since the 2008 financial crisis, shareholder activism has played an increasingly prominent role both in the capital markets and the public dialogue. The Darden Restaurants' proxy battle in 2014 marked a new milestone: the full replacement of a board of directors by a determined activist hedge fund. This case brought the topic of shareholder activism to the forefront of every executive and director's attention. How has activism evolved? Do activists add value or are they simply analysts running screens? What, if anything, should executives and directors do?

To answer these questions, we conducted an extensive review of the existing academic literature and interviewed a panel of thirty experts, executives and activists. Based on our research we have arrived at the following preliminary conclusions:

- Boards of Directors ("BODs") and Executive Leadership Teams ("ELTs") should engage in deeper conversations about corporate performance and the appropriate metrics with which to evaluate it. They should also closely examine capital allocations and returns on capital at a more rigorous level; this might involve making additional resources available to boards.
- BODs should enact deeper structural capabilities to create a protocol for direct shareholder communications, which includes ensuring that the right performance parameters are communicated to the market.
- ELTs and, in particular, CEOs, should push for a culture of broader shareholder engagement within the corporation.
- ELTs should strengthen investor relations ("IR") and overhaul standard financial reporting by introducing complementary measures that drive the company's "story" into the capital markets.

Furthermore, we believe that activism is likely to continue playing an increasingly prominent role in global capital markets in the future. In particular, we believe the following:

- Activism will continue to gain traction in the capital markets. As it does, it will contribute to increasing payout ratios and leverage levels in public companies. In the long-run, this will increase earnings volatility, and make publicly traded companies more vulnerable to external shocks in the economy; and
- The regulatory landscape is likely to shift as proxy advisory firms draw increased scrutiny from political actors and the SEC explores strengthening fiduciary requirements on asset managers.

SECTION I: INTRODUCTION

Introduction

Background for the Research

This research project on shareholder activism has two primary goals: (1) Learn more about the history, current status and likely evolution of the shareholder movement; and (2) Develop tangible insights and prescriptive advice for executives and directors in public companies to help them shape a thoughtful response to the financially-motivated shareholder activist movement. This paper does not address socially-motivated shareholder activism, which involves investors that use similar tactics but push for non-financial outcomes.

As described in greater detail in the following methodology section, we conducted in depth interviews with thirty "key opinion leaders" ("KOLs") categorized into four stakeholder subgroups, studied the details of twenty-one contemporary corporate situations involved in activist activities **(Appendix B – Contemporary Situations)**, and examined published academic research **(Appendix A – Bibliography)** to develop our viewpoints and conclusions. The intent of this paper is to provide a comprehensive view of what we learned and how we think our findings should be interpreted.

Whatever the overall effects of activism on society and on corporate performance, nearly all stakeholders that we interviewed agreed that activism and its lessons should be viewed as a potential opportunity for a company that needs to be much better understood by executives and directors.

We started our research by defining the stakeholders in the "ecosystem" of shareholder activism, the secondary groups of interest, and the measures of success that are used by activists. These definitions are summarized in the next section of this paper in order to provide a common definitional foundation.

Defining Key Terms Used in the Research

The Executive Leadership Team ("ELT", defined as the CEO and his or her direct reports) and the Board of Directors ("BOD" or "Board") are the primary subset of corporate stakeholders for which we intend to provide insights. References to activist investors, or activists, indicate hedge funds or other

actors that take levered minority positions in public companies, and seek to compel changes to strategy or transactions in order to achieve increases in shareholder returns through proxies, conversations or publicity. These activists and their interactions with the companies provide the central story behind our research, but in many cases, supporting entities such as law firms, bankers, advisers, the media, and regulators play prominent roles. Moreover, we sought advice and thought leadership from active members of the academic community on this topic.

Throughout this paper, corporate performance refers to Relative Total Shareholder Return ("RTSR"). RTSR was selected because it is the primary metric used by activists and other actors in the broader investment community to evaluate company performance. RTSR is defined as the arithmetic difference between the Total Shareholder Return ("TSR") of the company and that of an appropriate peer group over a defined period of time.

The layout of the paper is as follows:

- The remaining portion of **Section I** of the paper will cover research methodology and the history of activists leading up to the current era.

- **Section II** of the paper will focus on the driving forces behind why activism is both on the rise and working, based upon the selected performance metric defined in this paper. Moreover, the levers that activism alters, such as information asymmetry, are explored while making note of both the alternatives to activism and the accelerators in the current environment.

- **Section III** profiles current shareholder activist investors and explains the different classifications of activists based on the research and interviews conducted for this paper.

- **Section IV** explores the mindset of activists and how they do their work.

- **Section V** provides a prescriptive set of internal and external recommendations for ELTs and BODs.

- **Section VI**, the final section, is as an exploration of topics that need further investigation and broad predictions about the future state of activism.

Methodology

Research Design

We conducted this research project on shareholder activism during the four-month period from January through April 2015. The research design had two components:

- A review of the academic literature and current business articles on activism;
- Unstructured interviews with KOLs about shareholder activism and associated issues, including corporate governance, policy considerations, and managerial performance.

This integrative approach enabled a richer investigation of the complexity around shareholder activism by merging empirical interview data with the research of professionals and academic experts in the field.

Review of Academic Literature and Published Articles in Business Press

We searched multiple databases to identify relevant academic literature, reviewing both quantitative and qualitative studies. We analyzed historical patterns of shareholder activism, in the 1980s and 1990s, to help provide important insights into today's shareholder activism.

Much of the existing academic literature provides a narrow view on specific issues in great depth. We provide a wider historical view with our report, with an emphasis on today's ecosystem, and identify areas for further study.

Contemporary articles from the past decade published by the business press were used to bridge the gap between academic papers and interviews, as well as provide valuable insights into the depiction and events during an activist engagement.

Interviews with Key Opinion Leaders

Our interview sample includes a total of thirty KOLs. The KOL's we selected were experts in their particular subject area, serving in top senior positions within their respective organizations. These individuals with practical and real time experience added novel and credible insights to our final recommendations.

Our sample includes: activists (6), CEOs (4), other C-level executives (3), independent corporate directors (4), legal, banking and corporate advisors (9), academics (3) and institutional investors (1). A summary of these sources is attached **(Appendix C – Interview Summary)**.

Interview Approach

We designed unstructured interview protocols to establish the direction of each interview. Interviews ran from thirty minutes to two hours. Half of the interviews were conducted in person and half via telephone. Two "lead" interviewers from our group were assigned to conduct each interview, with remaining group members taking extensive notes. This triangulation process ensured that data from each interview was validated by multiple observers.

We decided that interviews without attribution would yield more open and honest data and opinions, considering the potentially sensitive nature of our conversations with interviewees. Therefore, none of the findings from our interviews will be attributed to a specific person in our research paper, and the names of interviewees will be kept confidential.

Research Sponsorship

The research was conducted with the support of the Strategy and Entrepreneurial Studies Departments at the Ross School of Business at the University of Michigan under the guidance of Adjunct Professor William K. Hall.

History of Activist Investing

Origins of Shareholder Activism

The roots of shareholder activism begin in the early 20th century. Following the end of the Great Depression, Congress passed the Securities Exchange Act of 1934, which created the independent U.S. Government agency the Securities and Exchange Commission ("SEC"). This marked the first set of regulations to govern public markets and was intended to protect the interest of shareholders in public corporations (The Securities Exchange Act of 1934, P.L. 112-158).

As the U.S. stock markets regained momentum in the 1950's, a proliferation of mutual funds and index funds emerged as investors increasingly valued liquidity, diversification and the privacy of their holdings. This shift in ownership structure amplified the Fundamental Agency Problem in public corporations between the owners and control function of the company, as the shareholders became further removed from managers.

Until the emergence of index funds, the primary manner in which shareholders voiced their displeasure was via the "Wall Street Walk." This is a notion that suggests if the shareholders of a particular company do not agree with its strategy, governance practices, executive compensation or other matter, they could simply exit their position in the stock by selling shares. However, given the growing value of passively-held funds with long-term and permanent positions (i.e., those with mandates to permanently hold an entire index) this solution became increasingly futile. There was little recourse for shareholders who had a fundamental disagreement with the way the company in which they held an ownership stake was being operated.

Era of the "Corporate Raiders"

Modern shareholder activism entered a second phase in the 1970's with the Era of Corporate Raiders. This era was defined by renowned individual investors such as Carl Icahn, Nelson Peltz, Victor Posner and T. Boone Pickens, among others. Their form of retribution against a company, which they believed was underperforming, was to acquire a majority interest in the firm and use that position to replace management or force the company to implement their strategic proposals.

The transactions of these investors tended to be hostile; which is to say, management of the target company opposed the takeover and the investor would employ various tactics to unilaterally pursue an agreement with existing shareholders and bypass management – most frequently through a hostile tender offer directly to shareholders.

Once in power, the new majority investor would enact dramatic changes in order to extract value for the owners often at the expense of the firm itself. The parts of the company were worth more than the whole, sometimes due to outsized liabilities or a favorable secondary market for the company's assets. Often these plans involved liquidating the company's assets or drastically downsizing operations, immediately or gradually dissolving the firm while generating a handsome profit for the majority owner.

Given the nature of this type of transaction – generally hostile in nature and frequently inflicting negative consequences on the company and its many stakeholders – the pioneers of the practice became known as "Corporate Raiders." As activity rose through the next decade, management teams sought to defend the company against these Corporate Raiders. This led to the establishment of Poison Pills, Golden Parachutes, classified boards and other tactics which effectively constructed a legal moat around the company. Such structural defense practices, along with improved overall stock market performance and changes in U.S. laws that strengthened minority shareholder rights, led to a dramatic decline of corporate raids during the 1990's.

Rise of the "White Knights"

Amidst the rapid rise and success of the Corporate Raiders, a new class of investors rose to approach the modern phase of activism in a different way. In contrast to the Corporate Raider, the 1980's saw the rise of the leveraged buyout ("LBO") firm who often chose to side with management to take a troubled company private, make necessary operational changes, and then reemerge as a leaner, more profitable firm. When a company was under attack by a Corporate Raider or hostile buyer, these "White Knights" could be called in to provide an alternate option and perhaps a higher price for shareholders. In most White Knight scenarios, the existing management team would remain in place and there was a lower likelihood of the company abruptly breaking up as it would have been under the hostile Corporate Raider scenario.

While it can be argued that these White Knights held very similar motives as the Corporate Raiders, their different tactics led to very different reactions in the corporate world. Fueled by the junk bond market of Michael Milken and Drexel Burnham, the LBO boom of the 1980's pitted Corporate Raiders and management-friendly buyout firms against each other on many deals, bidding up the prices of firms to the delight of public shareholders. Peaking with KKR's dramatic buyout of RJR Nabisco, the LBO boom eventually receded as the deal economics turned for the worse (i.e. rising interest rates) and the excesses of the market became evident when several major buyout targets were forced to declare bankruptcy. In more recent decades, the buyout market has undergone additional ebbs and flows but the LBO continues to be a major tool used by private equity companies to take companies private and generate above market returns for their limited partners.

The Emergence of Contemporary Activism ("Activism 2.0")

The turn of the century gave way to a new era of shareholder activism. While some of the individual players remained constant from the Corporate Raider crusade of the 1970's and 1980's, the strategies employed by contemporary activists is altogether different. Rather than acquiring a majority stake in a company and forcing change, today's activist tends to quietly acquire a small stake in a firm, most often in the range 3-10%, before attempting to influence management to adopt their proposals.

The confluence of several factors has yielded a landscape ripe for this form of shareholder activism. Firstly, several of the structural defense tactics management and boards had employed in previous decades fell out of favor amongst institutional investors, limiting the barriers to entry for activist interventions.

Perhaps of equal significance, several major economic events occurred that have caused a shift in public perception of the corporation and in the mindset of corporate executives. From the early 2000's through 2010, the U.S. economy experienced the end of the Dot-com Bubble, a host of high profile corporate scandals (e.g., Enron, WorldCom, Adelphia) and finally, the 2008 Financial Crisis and its prolonged recovery. Underscoring these events was rising income inequality, including the multiple of average CEO compensation versus average worker reaching an inflation-adjusted all-time high. The sum of these consequential circumstances has resulted in a societal shift in the public perception of capitalism. Corporate America has been increasingly vilified by the public, culminating in the "Occupy Wall Street" Movement in 2011.

This shift in public perception paired with a comparatively less hostile approach has changed the perception of today's shareholder activists, which helps provides a more favorable landscape. Contrary to the Corporate Raiders of the previous generation who were overwhelmingly reviled as a self-interested, destructive force, today's activists have been labeled catalysts for change, disruptors of the status quo, and even "Capitalism's Unlikely Heroes." (Economist Magazine, February 2015).

SECTION II: DRIVING FORCES BEHIND ACTIVISM

Why is Shareholder Activism on the Rise?

Because It Works

The most common rationale cited by activist fund managers explaining the rise of activism was simply, "because it works."[1] While their methods differ and they tend to have slightly different theories about firm performance, all activists interviewed for this report agreed that activism is enormously lucrative for the activists themselves, their limited partners and the other shareholders of the firms with which they engage.

In order to generalize beyond this limited sample, an analysis was conducted on performance data for the largest activist hedge funds as aggregated by Hedge Fund Research, Inc. ("HFR"). This analysis revealed that activists have generated higher returns for investors than the S&P 500 or hedge funds as an asset class, returning nearly 18.7% CAGR since 2009 (vs. 15.0% and 6.9% respectively).[2]

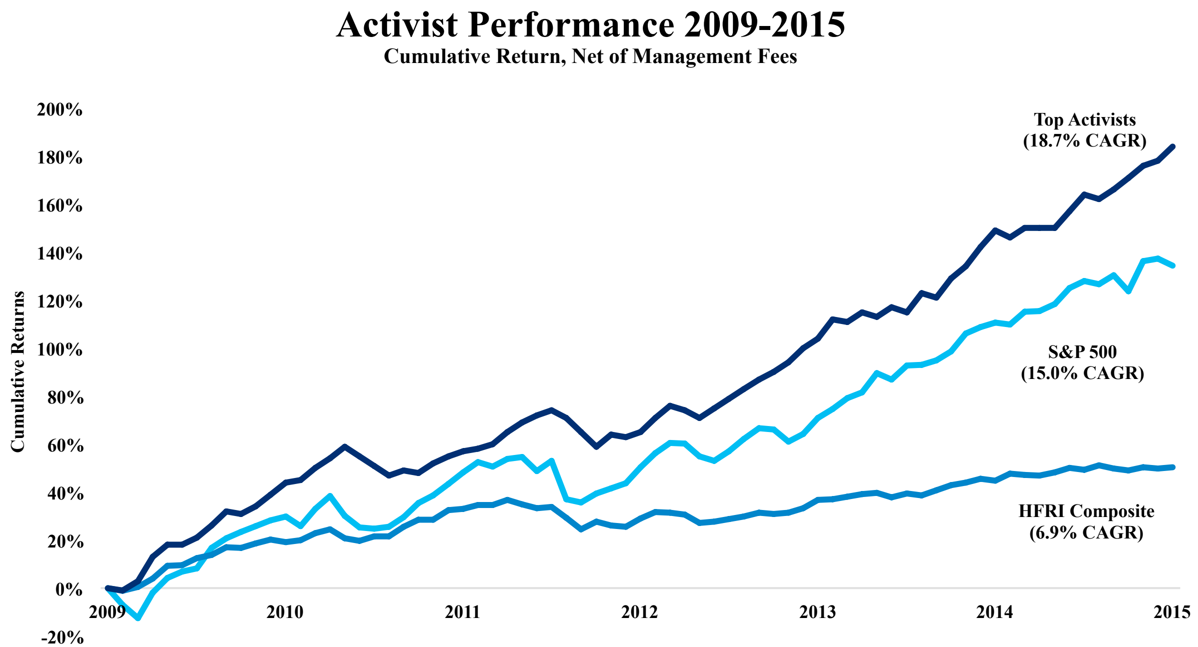

Figure 1 - Activist Hedge Fund Performance 2009-2015

[1] *Based on three interviews with top-tier event-driven hedge fund activists (more than $1B in AUM).*
[2] *Data came from Hedge Fund Research, Inc.'s 2014 annual report on hedge funds, FactSet data and an update by our team of index data through March of 2015.*

Persistently high returns at the largest activist hedge funds have stimulated large inflows of money into the activist sector over the past five years. Larger bases of Assets Under Management ("AUM") have allowed activists to successfully expand out of the middle market and pursue larger corporate targets.

Finally, academic studies also support the theory that activism is growing because of strong performance. A team of academics at Columbia (Brav et al. 2008) analyzed excess TSR, i.e. relative to value-weighted NYSE and NASDAQ per the Center for Research in Security Prices, after a 13D filing by an activist hedge fund, and found conclusive evidence that a successful activist intervention generated nearly 6.38% in excess TSR over two years. Furthermore, when the 13D filing suggested strategic review or the sale of the targeted company, the excess TSR is even larger, increasing by up to 8.54% (Brav et al. 2008).

The existence of large excess TSR, implies that activist hedge funds are able to generate and capture significant alpha, i.e., excess returns uncorrelated with market performance, this in turn makes them very attractive to investors.

It should be noted, however, that there is a contingent of spokespeople in the academic and business community that claim that activism does not, in fact, have a positive impact in aggregate. Martin Lipton (2013) of the legal firm, Wachtell, Lipton, Rosen & Katz, often considered the most prominent critic of shareholder activism, calls into question the empirical evidence presented by Bebchuk, Brav, and Jiang (2014) illustrating the positive impact of activism:

> *No empirical study, with imperfect proxies for value creation and flawed attempts to isolate the effects of activism over a long-term horizon influenced by varying economic, market and firm-specific conditions, is capable of measuring the damage done to American companies and the American economy by the short-term focus that dominates both investment strategy and business-management strategy today. There is no way to study the parallel universe that would exist, and the value that could be created for shareholders and other constituents, if these pressures and constraints were lifted and companies and their boards and managements were free to invest for the long term. The individuals who are directly responsible for the stewardship and management of our major public companies—while committed to serious engagement with their responsible, long-term shareholders—are nearly uniform in their desire to get out from under the short-term constraints imposed*

> *by hedge-fund activists and agree, as do many of their long-term shareholders, that doing so would improve the long-term performance of their companies and, ultimately, the country's economy.*

While the authors of this research paper accept the data demonstrating a positive impact of activism on TSR, in order to justify the rise in occurrences, it is sufficient to note that a large number of investors hold the belief that activism has a positive impact. The perception that shareholder activism is able to repeatedly produce positive alpha yields an increased entry of activist funds supported by growing capital inflow into those funds, further fueling the rise.

Why Does Shareholder Activism Work?

Fundamental Agency Problem Creates an Opportunity

The Fundamental Agency Problem describes issues that may arise as a result of the separation of ownership from control. In the modern corporation, this manifests itself as the separation of shareholders, i.e., principals, from management, i.e., agents. The primary mechanisms for failure are related to:

(1) **The divergence of interests between shareholders and managers.** While modern corporate governance structures were established with the intent to align the incentives of managers to those of shareholders through equity-based compensation, gaps remain. For example, managers may pursue projects or acquisitions that interest or benefit them personally but do not necessarily maximize shareholder value.

(2) **The difference in risk appetite between shareholders and managers.** There exists a fundamental contrast between the degrees of concentration an executive manager has in his firm relative to that of the average shareholder. While most shareholders have the ability to treat their investment in a firm as one of a diverse range of holdings, the typical manager's livelihood is more concentrated in the firm they are managing; both financially and in terms of their reputation. This contrast results in a difference in risk tolerance between owners and decision makers of the firm.

(3) **The asymmetry of information between shareholders and managers.** While managers are responsible to their shareholders, the asymmetry in access to critical information about the company's operations often results in inefficient or ineffective monitoring of management performance. The notion that management can filter the information shareholders have access to and employ as a means to evaluate performance represents a conflict of interest between principal and agent.

Given the degree of difficulty and costs associated with monitoring the decision-making and performance of management, traditional agency theory defines independent boards of directors as an appropriate proxy for owners. Boards have a greater degree of visibility and involvement in the operation of the firm. Further, as articulated by Fama and Jensen (1980), "Boards always have the power to hire, fire, and compensate the top-level decision managers and to ratify and monitor important decisions."

While some variation exists in practice, Figure 2 illustrates the relationship amongst shareholders, boards of directors and executive leadership at most publicly traded firms:

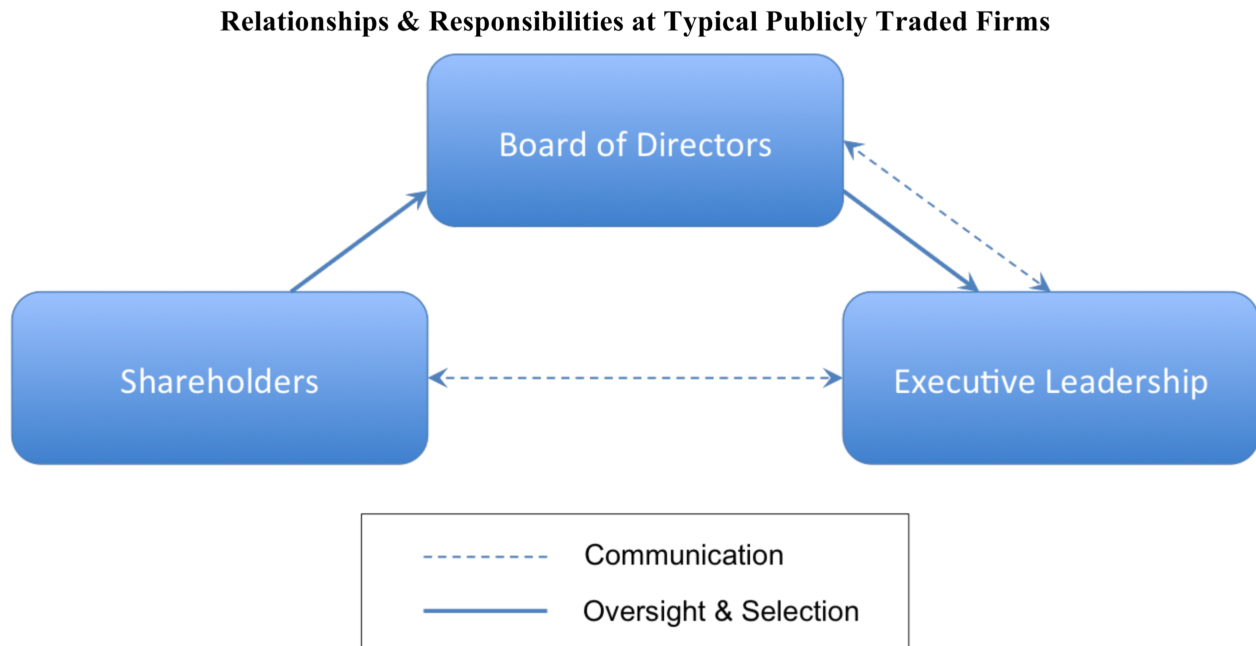

Figure 2 - Relationship among Shareholders, Boards and Executive Leadership

Despite the ability of diligent boards to add value to a firm and its various stakeholders, both academic research and anecdotal evidence point to the variety of inefficiencies that arise, limiting the contribution of boards of directors. The potential failings tend to fall into three categories:

(1) Financial. While most directors receive equity-based compensation, aligning their interests with shareholders, often their stake in the firm for whom they act as director represents a minimal fraction of their net investments; this results in a lower incentive to focus on this firm relative to other areas of personal or professional investment.

(2) Resource-Based. Many directors act as members of multiple boards and may even have full-time professional engagements; this leaves limited time for them to commit to their role on the board of a third party company; further, even if they have the time to commit, some directors may not have the necessary knowledge or experience to perform the role to optimum efficacy.

(3) **Relational.** While the NYSE requires a majority of board members to be independent, relationship dynamics between board members and executive leadership can be detrimental to board function; often directors are hesitant to risk upsetting the status quo by opposing management or taking a generally controversial position.

The current structure of relationships governing the delegation of decision-making authority from shareholders to boards of directors to managers is the best system yet conceived to close the gap created by the Fundamental Agency Problem. However, as noted above, deficiencies persist; thus creating opportunities for activist investors to add value, and to capture a portion of that value in the process.

Evolving Approach to Addressing the Fundamental Agency Problem

The behavior of minority shareholders of previous generations was aptly described by Eugene Fama (1980) as follows:

> *"Minority shareholders almost never have a say in the selection of top managers, or even in who ends up on the board. Indeed, by some accounts inattention is the only sensible course of action for dispersed shareholders ('rational ignorance'), as the cost of being well informed about governance of the firm is not outweighed by the marginal benefit of improved corporate performance that might result from informed voting or activism."*

Clearly a segment of today's generation of investors is working in opposition of Fama's assertion. The rise in occurrences of activism over the past decade illustrates the notion that more and more investors believe that returns can be achieved from strategic activism. Rather than looking at an existing portfolio of holdings and trying to influence them where possible, many of today's activists select their investments based on identified opportunities to impart influence in order to unlock existing value. This selective approach, identifying the so-called "low-hanging fruit", minimizes the relative cost of being well-informed and advocating for change.

Factors Accelerating Shareholder Activism

In the next several sections, the mechanisms that have incentivized and facilitated the recent growth of modern activist investing are described.

The role of hedge fund investment managers is to produce positive alpha. As will be described in detail below, activist investors are, at their core, value investors. As quoted by the head of a top activist fund, "As a value investor, it's very hard to produce consistent returns above the market simply based on being smarter than everyone else." Which is to say, it is nearly impossible to consistently forecast the future more accurately than the aggregate of the market. Therefore, activism is pursued as a way to generate an advantage.

Most of the market participants value a firm based on the stated strategy and intentions of current management and the market's perception of their ability to implement that strategy effectively. This results in a corresponding demand curve for this valuation. Meanwhile, the activist is able to enter the stock with a different demand curve in mind. They intend to promote an alternative action or strategy that they expect to shift the demand curve, either in the near term via a "bump" if the market agrees that their proposal is superior to the current state, or over a longer term timeframe, i.e., three to five years, as the new strategy is implemented.

As the benefits of this "activist advantage" have been demonstrated over the past five to ten years, activist funds have attracted even more capital, giving them a greater arsenal and therefore amplifying both the advantage and the incentive to exercise it. Most activists interviewed for this study stated that management's interests are rarely purely aligned with those of shareholders, and that activism capitalizes on the opportunity to realign those interests.

This Fundamental Agency Problem and fund managers' search for an advantage are not new phenomena. In order to explain why activism has been on the rise in recent years, it is essential to understand three fundamental factors that have facilitated and accelerated its emergence: (1) the increasing prominence of the business press media coverage, (2) the reduction in corporate governance practices that traditionally served as barriers to activism, and (3) the increasing role of institutional investors as intermediaries and owners of capital.

The Role of the Media

Much has been said about the influence the 24-hour news media cycle has imparted on the political landscape. The impact, popularized as the *CNN Effect*, has been divided into constituent categories: The media as Accelerator, Impediment, and Agenda Setting Agent (Livingston, 1997). The two that have significant relevance to the business landscape are:

(1) **Media as Accelerator.** Today's media landscape is based on an instantaneous and continuous coverage of topics of high intrigue. The resulting effect is increased public pressure on the stakeholders involved in the coverage to take action and end the coverage.

(2) **Media as Agenda-Setting Agent.** The degree of reach and constant access enables the media to focus the public's attention on issues that generate the greatest amount of buzz. Such topics tend to involve compelling emotional elements, crisis or conflict. This turns every news story, whether in the business or style sections, into a protagonist against antagonist story arch.

Over the past decade, the above effects have been exacerbated by the emergence of online social media platforms as legitimate sources of news coverage. Rumors and hints of a story can be as impactful on a company as much as a well vetted news article. The rates of media propagation and public influence have grown tremendously as a result.

These evolutions in the media have created a powerful tactic for activists to spread their message. Further, the disparity in expectations of communication between investors and company representatives yields a significant advantage for the activists. That is to say, shareholders have much more flexibility in how they portray their positions as they are not held to the same professional standards of conduct as the respective executives with whom they communicate.

Activists have recognized media outlets as powerful amplifiers of their message and have invested in strategic relationships accordingly. The degree of public interest in observing a public battle between an iconic investor and the CEO of Fortune 500 company drives significant coverage. Shareholder activism has become such a mainstream topic in the business media that many content

publishers have dedicated beat writers assigned to cover it. Activists are intentional about cultivating relationships with these reporters, yielding potential dividends in the case of a battle for public perception.

The media, therefore, has been a critical accelerator to activism, allowing minority shareholders to wield a degree of influence disproportionately greater than their ownership stake in the firm would dictate.

Corporate Governance Reforms

The rise of the Corporate Raider and hostile takeover era of the 1970's and 1980's gave birth to a host of corporate governance and legal defense tactics designed to defend corporations against unwanted attempts to gain control of a company. Such reforms include Poison Pills, classified boards, and limitations on the ability of shareholders to call special meetings, among others. These takeover defense tactics are commonly referred to as a "shareholder rights plan" (Davis, 1991).

In recent years, however, such defense tactics have become increasingly unpopular as they are perceived to reduce the efficiency of the market for corporate control. Corporate takeovers have the potential to offer great value to shareholders and by implementing plans to resist takeovers, companies are limiting the opportunity for such value to be captured by shareholders. The academic world is generally in agreement that the adoption of shareholder rights plans result in decreased firm value (Bebchuk and Cohen, 2005). Moreover, Institutional Shareholder Services ("ISS") and Glass, Lewis & Company ("Glass Lewis"), the two leading proxy advisory services list both poison pills and classified boards as problematic takeover defenses, generally recommending a "vote against or withhold" until such features are eliminated (ISS Voting Guidelines, 2015; and Glass Lewis Voting Guidelines, 2015).

These observations have resulted in a trend toward declassification of boards and gradual elimination of Poison Pills. A study by FactSet SharkRepellent shows the number of S&P 500 companies with classified boards dropped from 302 in 2002 to 126 in 2012 with an increasing trend toward declassification (Solomon, March 20, 2015).

This unequivocal shift in governance practices toward reduced protectionism is intended to maximize management and director accountability and reduce the Fundamental Agency Problem. As a result, it facilitates activist intervention by eliminating barriers to their engagement with a larger selection of target firms.

Growth of Passive Institutional Ownership

With the explosion of mutual funds and index funds since the early 1980s, an increasing percentage of shares are owned, not by individual investors, but by institutional investors. In fact, today, Blackrock is the largest single shareholder in most publicly traded corporations and enough to represent a beneficial ownership stake. This has had several effects contributing to the growth of activism.

Many index funds buy every stock in the S&P 500, which decreases, on the margin, the ability of investors to sell individual shares if they disagree with the company's strategy. This further amplifies the Fundamental Agency Problems. Due to the benefits of diversification, activists have been happy to take advantage of this.

Institutional investors are frequently shareholders in thousands of companies. It is impossible for them to do full due diligence for each proxy vote on every investment. However, the SEC decided that under the Advisors Act: "The duty of care requires an adviser with voting authority to monitor corporate actions and vote client proxies."[3] This duty has been further strengthened over the following decade, compelling many financial advisors to outsource their proxy voting decisions, or at least a substantial part of the analysis, to proxy advisors. The rise of proxy advisors, e.g., Glass Lewis and ISS, has facilitated the task of gathering investor support for a proxy because an activist need only convince the advisors to get buy-in from a large number of institutional shareholders.

Role of Advisory Services

Advisory services, such as ISS and Glass Lewis, provide independent research to institutional investors and proxy vote recommendations. Institutionals used to either support management or abstain from proxy votes. Because of structural changes in funds and increased concentration of ownership, Institutionals now feel obliged to vote their shares. Additionally, David Larcker, a governance expert at Stanford Graduate School of Business, recently wrote that "in 2003, SEC rules and related actions allowed institutional investors to rely on advice from third-party advisory firms to fulfill their fiduciary obligations when they voted their shares." Most institutional investors do not have the resources to research every proxy vote. As a result, ISS and Glass Lewis filled that void by providing proxy recommendations and consulting services to institutional investors and companies.

[3] *Decision was included in SEC Rule 206(4)-6, June 2003.*

Critics point out that the advisory services are still overwhelmed by the number of proxy votes. Larcker adds “few proper rules of corporate governance can be properly evaluated without deep knowledge of a company and its management. Rule-based approaches, such as those developed by proxy advisory firms, tend to be based on "best practices" – better termed "one-size-fits-all best guesses" – that have little or no relation to the specific strategic, competitive or management situations facing individual companies.”

The most highly contested votes receive specialized attention but Institutional investors often make up their own minds in the most contentious cases. Though they continue to seek the support of advisory services, many will ultimately make their own decision. Some of the largest funds, such as Blackrock and Fidelity have developed in house resources to guide their decision making in contentious situations.

Still, there is a tremendous amount of curiosity in the market about advisory services because of their tremendous influence. A partner at a prominent activist hedge fund acknowledged the activist movement has been buoyed by the support of the advisory services stating that “without their support, many of the changes we’ve sought would not have happened.” The advisory services also have consulting businesses that create the potential for conflicts of interest. As a result, regulators have begun to scrutinize advisory services much more closely.

SECTION III: PROFILE OF THE ACTIVIST INVESTOR IN 2015

Profile of the Activist Investor in 2015

Activists are investors just like any individual or organization who takes an ownership stake in a company. Two dimensions in which one can profile types of investors are the preferred level of diversification of their investments and the passivity of their investment. As shown in Figure 3, an investment in a passive index fund or ETF can be identified at one extreme of this spectrum, while an owner-operator of a business can be identified at the other extreme. In between these two extremes are other classes of investors who provide some degree of overlap based on the specific type of investment. We profile the activist investor as somewhere between actively managed mutual funds and pension funds, which invest in a variety of companies but may choose to identify with a particular industry or investment thesis, and private equity funds which generally invest in fewer firms and seek to exert a much greater degree of control over their investments.

Within activist investing there are a number of investment theses that an activist may pursue. These similarly form a spectrum from what we have identified as 'stock picking' actions, which may align more with those actions taken by an active fund manager, to a strategic review or turnaround situation, which is more closely aligned with the actions taken by a private equity firm.

Control and Asset Classification Continuum

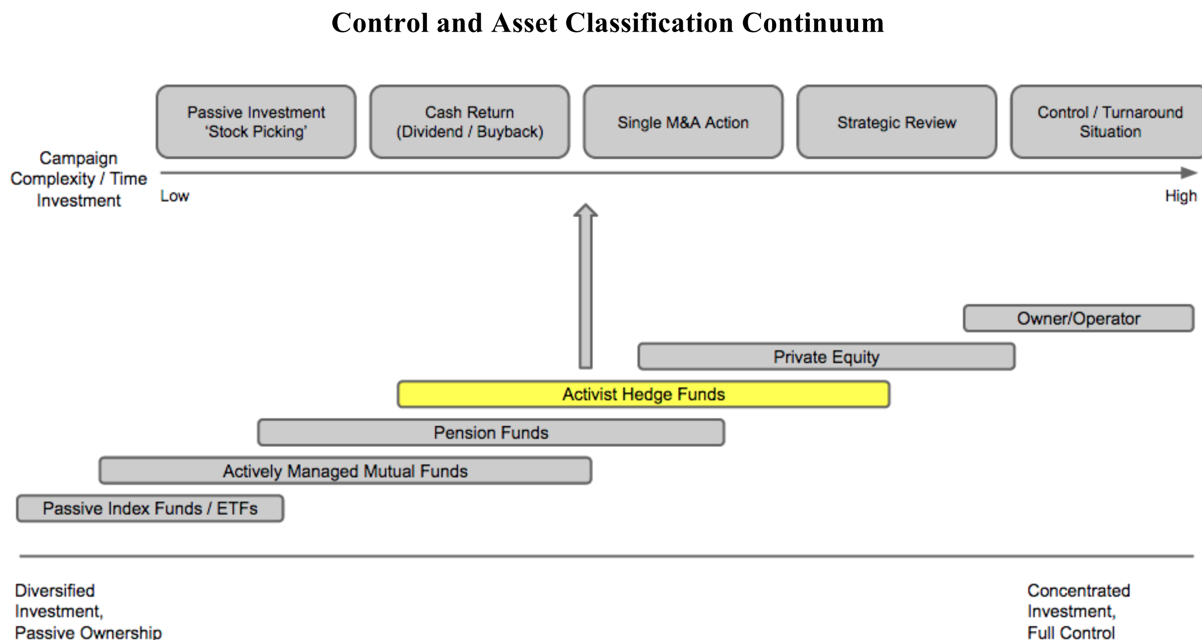

Figure 3 - The Control Continuum (Representing the Types of Capital and Campaigns Activist Hedge Funds Undertake)

Who are the Activists?

Who are the activists? It depends on who you ask. Some of the biggest names in the latest wave of shareholder activism, such as Carl Icahn and Nelson Peltz, were known as "Corporate Raiders" in the 1980s. Joining them are a new generation of investors who have built a reputation for advocating bold ideas and generating impressive financial results. For the purposes of this study, we focused on 'financial' corporate activists and set aside other corporate activists, such as social or environmental-focused activists. Like any class of investors, no two activists are exactly alike.

Most activists today operate by investing through one or more hedge funds. Ultimately, this means the activist must answer to and provide an adequate return for the investors in these hedge funds. Given the high-profile success of some of these activist hedge funds in recent years, they have found success in raising money. According to the Alternative Investment Management Association, activist hedge fund assets under management have increased 269% over the last five years to approximately $120B (AIMA, 2015). Each fund must appeal to its prospective investors with a unique value proposition. Many of these funds use terms such as "catalyst driven investing" or "event driven investing" and highlight their past track record of identifying value investing opportunities.

Activists are Value Investors

Several CEOs in our sample mentioned that there are certain names they would truly hate to see show up in their stockholders list. Other names would cause them to take notice but seemed to have a 'nicer' reputation and would not evoke as much of a visceral reaction but would still put them on the defensive. Though activists may use different tactics, at their core all activists are value investors. The targets of activists must be aware of the thought process and strategy of the activist campaign. Even some of the most outspoken activist personalities have been known to quietly partner with firms on occasion as tactics shift over time. Ultimately, an activist's success depends on providing that catalyst or event that will produce a positive return on their investment and produce returns for their firms and limited partners. Whatever their methods, activists will do whatever is necessary to win the support they need to implement their ideas and the changes they seek.

In some of our interviews, activists sought to provide additional clarity about how they view themselves versus the traditional value investor. One of the biggest differentiators discussed is the idea

that while a traditional value investor seeks an investment whose long term value will be realized over time given current markets and company performance, the activist seeks to find investment opportunities where they are able to serve as the catalyst that produces that value creation. Another activist in our sample provided the analogy of a 'value curve' over time based on the market's perception of a given company and its current-day performance. His goal in an activist campaign is to identify the action or actions that can change that narrative, shift the curve positively and generate positive returns for his investment and all shareholders. The timeframe of ownership for an activist tends to be shorter than that of many traditional value investors though there are many exceptions. Some activists may choose to stay in an investment for many years if there are multiple actions that can be taken to unlock value in the company. Activists who become insiders by becoming a part of the board are also much more likely to consider a longer time horizon.

Characterization of Activist Investors

As will be discussed below, most of the investments by an activist hedge fund do not automatically lead to the costly public campaigns sensationalized by the media. In fact, most investments by activist hedge funds largely take place without much public notice. The media coverage of activist investors has sensationalized the biggest public battles and like most news coverage, the most adversarial and contested battles drive media views and consequently receive an outsized share of the attention. While some activists may relish the notoriety that comes from engaging and ultimately succeeding in a public battle, many choose to take a different path. Others act as a quiet but vocal advocate behind the scenes. The content of their ideas may be similar but the tactics they choose to take and the response it engenders from the target company can sometimes lead to dramatically different results.

Another characterization of activists can thus be made along these lines. Though an individual or a firm may not always fit into a specific categorization, the reputation of a firm and an investor often precedes itself and the tendency shifts towards one category or the other. Simply put, an activist could either be described as a "partner" or as an "agitator". Understanding the motivations and styles of both groups of activists and the different tactics these groups may take in a campaign can be very informative.

The Partner

The partner activist is much less likely to see his name in the headlines and he would actually prefer it that way. The partner chooses to avoid the messy public battles of the agitator while still often pushing for the same kinds of dramatic change within a company. The partner works behind the scenes to change the minds of his target by carefully explaining the thought and analysis that drove him to reach these conclusions and persuading others to follow his path. The costs and distractions of a large public media battle are both not necessary and possibly detrimental to the goals of the partner activist. The partner is determined to push for change but seeks to do so by winning the hearts and minds of his target. The partner does this by negotiating with the target, developing trust within the board and/or executive leadership team in an effort to convince them that his ideas are worth pursuing.

Many partner activists tend to have a somewhat longer term investment horizon, especially with companies where they anticipate that multiple changes can and should be made. Taking a company in a different strategic direction is not a decision to be made lightly. As such, the partner must be willing to negotiate and work with the company to refine and improve his ideas in partnership with company leadership. He must consider whether or not to tie the success of his personal investments to the company's success by joining the board and becoming an insider, thus limiting his ability to quickly move in and out of the holding. Recognizing the limitations of his knowledge as an outsider, the partner is less likely to remain rigid in demanding that a company follows his worldview but will insist on sharing it with others to help broaden their worldview. For example, the information asymmetries between activists and board members often make it difficult to understand the necessary nuances and complexity to execute the large transactions proposed by an activist. After Starboard pushed Yahoo! on a number of points including a suggestion of spinning off the investments in both Alibaba and Yahoo! Japan into a separate entity, insiders were able to more closely analyze those ideas and spin-off its Alibaba stake alone in a tax efficient manner.

Highlights of Different Approaches Between Partner and Agitator Activists

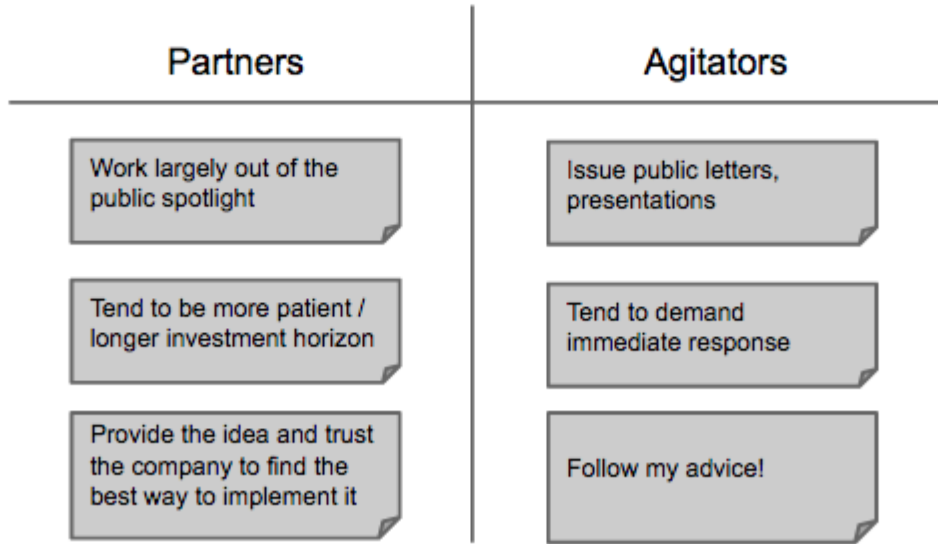

Figure 4 - Comparative Approaches of Partners and Agitators

The partner benefits from a positive reputation and past successes to attract new funds and attention when it makes a sizable investment in a target company. However, the partner's presence may only bring speculation from the general public as to what changes may be in store. The partner generally does not seek to publicly call out the firm or its current board or management, but certainly seeks to insert his ideas into the conversation. The partner generally appears to be more patient than the agitator though both are incentivized to act quickly.

The Agitator

It is doubtful that even the most outspoken activist would consider himself to be an agitator, but nonetheless there are a class of activist investors who primarily generate positive returns for himself and his partners by publicly agitating for change. Conversely, even the most mild-mannered partner activist could be pushed to become an agitator in a given campaign depending on the feedback and reception he receives in response to his overtures. Agitators push companies to see the world through their point of view and quickly pull various value-creating levers. Agitators seek to make a straightforward point and push the market conversation in their direction. For example, public comments by the likes of Carl Icahn or Harry Wilson pushing for higher dividends and stock buybacks from Apple and GM respectively led to

a magnifying glass being placed on the companies' history of cash distribution. The ensuing tactics can sometimes be relentless: public letters, websites, tweets, point by point presentations. These activists feed on the growing media coverage of the campaign and tend to amplify their rhetoric to attract even more attention to their cause. Agitators derive a benefit from their outsized media attention and personalities. Very public successes help them attract new capital to their funds. Conversely, the reputational costs of losing a public battle can be very high and so agitators are usually willing to fight to the bitter end if their projected outcomes still hold. If the opportunity appears to be worth the risks and the costs, an agitator may be willing to push for one or multiple proxy fights and stretch the battle for months or perhaps even years.

The Virtuous Cycle of the Agitator Activist

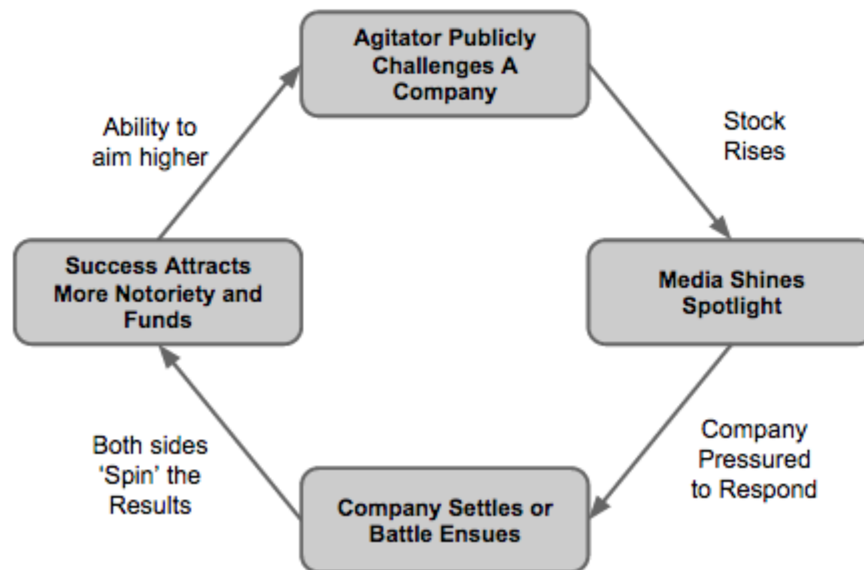

Figure 5 – The Cycle Repeats for an Agitator Activist

An agitator is likely to present a comprehensive argument and worldview that is vastly different than what the company communicates to the public market at the time. By taking the megaphone and reinforcing his worldview, the agitator begins to change the narrative of a company's story. Often the initial announcement of an agitator's presence in a company's stock will lead to a positive bump in the stock price. The market prices in the potential for improved performance brought about by the changes proposed by the activist investor and the stock rises. Of course, the ultimate success of the agitator requires him to get his way and to actually harvest the promised value creation opportunities that he claims exist. Without sufficient levels of success in public campaigns, that immediate increase in stock price will go away and it will be harder to attract support from other shareholders.

To the agitator, perception is reality. The public's perception of his superior ideas, superior execution and outsized returns only further reinforces his ability to drive changes at companies, generate alpha and attract more capital to his fund with which to do the same at a bigger scale. Success begets more success as retail investors and professional money managers will be more likely to listen to and seriously consider the ideas of the agitator in his next campaign. Some activities such as capital return actions generate very clear benefits to shareholders while other more strategic actions may present more risk to the company. By taking more risk, the potential returns for the activist increase as well.

SECTION IV: HOW ACTIVISTS ENGAGE

How Shareholder Activists Engage With Companies

This section explores the phases of an activist campaign from the perspective of the shareholder activist. Based upon our readings, interviews and our analysis, the stages of a campaign can be categorized into five phases. Furthermore, since the general view in the public is that the ELT and BOD go to "battle" with shareholder activists, this section uses a military characterization as a framework. Shareholder activism follows a continuous loop made up of five phases: 1) Peacetime Activities, 2) Diplomacy, 3) Battle Begins, 4) Aftermath of Battle, and 5) Next Campaign.

Phases of Battle with a Shareholder Activist

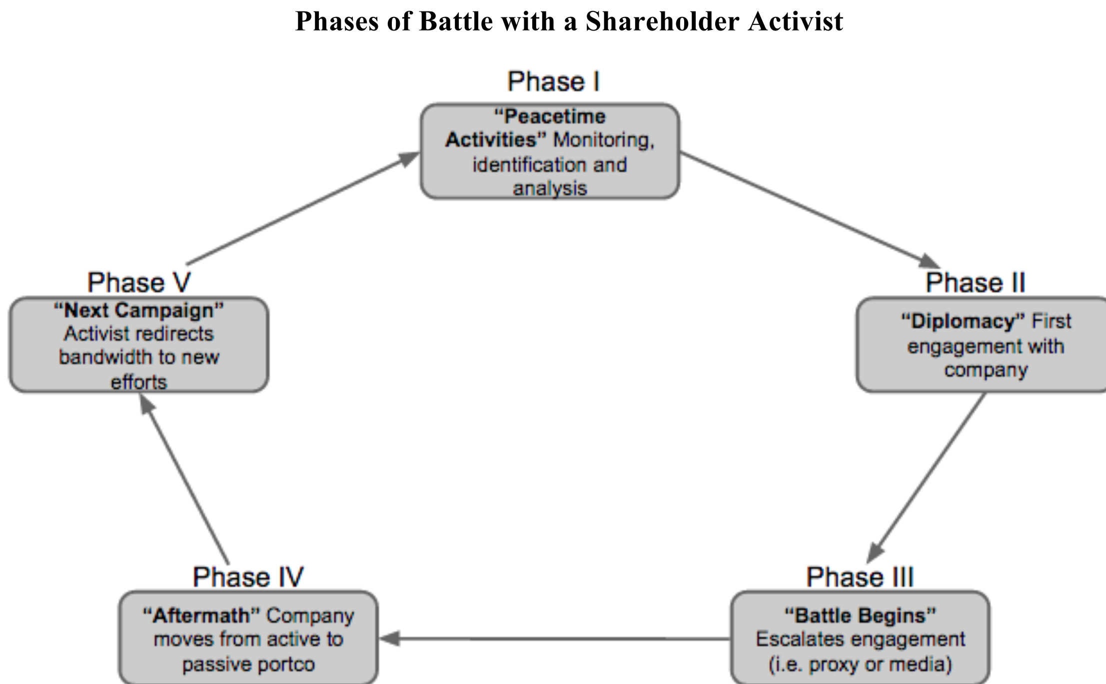

Figure 6 - Stages of Shareholder Activism

Phase One – Peacetime Activities

The first phase involves "peacetime activities", or preparations for battle. Overall, the majority of an activist's time is spent in this phase. Preparation means screening companies and responding to tips from other investors to identify opportunities that fit with the overall strategy employed by the activist. Like any other investment fund, activist hedge funds look for opportunities that balance out risks, timeframes and returns to optimize profits for the general and limited partners.

Screening: Opportunity Identification

Most hedge fund activists employ a fairly algorithmic approach to screening. The following screening criteria and basic identification strategies are not exhaustive. One of the basic identification strategies is to look for companies that have a conglomerate discount, i.e., operating in multiple, distinctly different industry codes, such as non-adjacent SIC or NAIC codes. Activists see this as an initial indication that the company may be trading at a discount relative to its value if some subsidiaries or divisions are spun-out.

The second basic identification strategy is to look for companies with sluggish performance compared to the "correct" peer group. Choice of the "correct" peer group is a definitional issue. Companies define their peer groups once a year in their 10Ks, but this definition can be manipulated to mask a company's underperformance relative to the "correct" peers. For instance, executive leadership may bias the peer group to show the company's relative performance in the best light. Managers can also ignore the decisions that have been made by the "correct" peers to divest underperforming assets or to make strategic shifts to enhance RTSR.

Because of this peer group selection, activism typically comes in waves through a particular industry. Recent highly publicized activist actions in the restaurant industry are a clear example of this – activism and 13D filings have occurred in numerous large companies from Darden Restaurants International to McDonalds to Bob Evans to Cracker Barrel.

The third basic identification strategy is to identify companies with less than stellar corporate governance practices or structures. As mentioned earlier in the paper, the rise of activism over the past decade has partially been due to the dramatic changes to standard practices in corporate governance, including the push to declassify board elections, removal of barriers to shareholder engagement, and anti-shark repellent sentiment held by many investors. The identification of less than stellar corporate governance practices allows the activist to employ additional tactics that will increase leverage against a company.

Tips from Other Investors

Due to the growth of passive investors over the past quarter century, the relationship between activists and passive investors has become more important. In 2009, the SEC decided to require passive investment funds to vote in proxy contests. As a result, passive investment funds are required to pay greater attention to the companies in their portfolio. However, they do not have enough "bandwidth" to examine companies in their portfolio with the same thoroughness that an activist can. Additionally, sell side investment analysts and business news reporters publish reports calling for activists to intervene in particular companies.

A tip comes in the form of an explicit or implicit indication from another investor about a company that is seemingly ripe for a third-party to right the course of the company. A "ripe" company might have entrenched management, a history of rebuffing investors at events or in response to an inquiry, a long-tenured board or investors that are concerned about decisions hampering long-term prospects. There may be a credibility issue between the activist and tipper. Activists need a heuristic to determine how good the tip is, before following it, by judging the tipper's intentions and incentives. The best way to judge the credibility of this two-way relationship is reflecting on prior overlapping histories in past activist engagements. Did the activist make other investors money? Did they do this on a long-term basis? It is possible to speculate that investors may tip off activists more in the future if targeted companies continue to outperform their peer groups.

In our research, activist interviewees told us two conflicting stories about "investor tipping". One story involved using tip reporting as a major sourcing of potential targets. The second story suggested that tip reporting is only supplementary to the screens that the activist already runs, and it rarely pays off. The difference in these two views may stem from the strategies the two activist firms employ. The second view reflects a deeper reliance on long-term relationships with the passive investors on the part of the activist.

In-Depth Analysis of an Opportunity

The analysis that hedge fund activists conduct is sophisticated and reflective of what an investment bank would do leading up to a multi-billion dollar M&A transaction. The major difference is that a hedge fund does this on an ongoing basis, with only public information and with reliance on deep industry expertise.

Hedge fund activists search for as much information as possible to provide assurance that the risk they undertake in an activist engagement is commensurate with the return. Many of our interviewees, boards of directors and company executives, said that that hedge fund activists are merely "time-shifting" decisions or publicizing decisions that were dismissed based on internal analysis. However, based upon our research, it appears that in many cases the company has not run the same level of analysis and is not prepared to make the same decision that the activist would employ. An activist has a direct incentive to manipulate the assets of a promising target based upon capital allocation trends in the "peer" group, identifying possible conglomerate discounts, and assessing "idle" cash reserves and a "lazy" balance sheet.

One activist in our research thoughtfully described the activist role in doing this type of analysis. He told us that generally an activist has a strong long-term view on a company, but that he believes the "curvature" of the performance arc peaks too late in time. The activist seeks ways to bring the peak of the performance arc forward in time and thereby increases internal rate of return to investors. Sometimes the mere presence of an activist is all that is needed to move this arc forward in time, speeding up the decision-making of a board or management team. The activist knows this is one possible outcome when it engages with a targeted company.

The materials put together for an activist campaign greatly depend on the particular engagement and are comprehensive, reflecting an incentive to recut financial performance data in every way possible. These materials are not constrained by SEC-required financial reporting standards, giving activists an upper hand. The data often display an analysis of the balance sheet alternatives versus the status quo, and they provide a forward-looking analysis from a third-party perspective. The debate should not be centered on the validity of the recommendations that activists make, but are merely laying out the incentives and the time investment made before activists begin to reach out to companies. In sum, activists have an advantage in being able to message more, with new sources of data to back up their point of view.

Phase Two – Diplomacy

During this second phase, activists will increase or begin to take a stake in a target company. Activists need to file a 13D with the SEC to declare an ownership stake above 5%. The filing is subject to a ten-day window after the 5% threshold is hit. Prior to the end of these ten days, activists typically decide

the full ownership position they intend to take and the initial strategic approach to the company, i.e., level of aggression or partnership.

Based on our research, many activists reach out to companies much sooner than the 10-day 13D filing deadline. The element of surprise is a cajoling and influential tactic. When activists pick up the phone to call a CEO, they often know more about how that call is going to go than the CEO. However, companies may forget, or ignore, that launching an aggressive campaign is also expensive for activists and a collaborative resolution is often in the activist's interest as well. That being said, almost all activists are prepared to do battle and have run the cost-benefit analysis of the campaign and the expected returns. The commitment to see a strategy through is one of the strongest leverage points that an activist has against a company's management and board of directors.

Activists are very knowledgeable about the relationships between investors and bet billions of dollars on the reliability of these relationships. As a permitted go-between under the law, activists are largely allowed to shop around and converse with other parties. These diplomatic relationships with some of the large passively and actively managed funds allow activists to have a "mental vote count" prior to investing in and engaging with a company. Most passive and active investment funds will not disclose their vote position, but they remain predictable. Activists often have a fair amount of certainty about their position amongst a company's investor constituency.

As mentioned earlier in the paper, the compliance departments of many passively and actively managed funds are directly tied to proxy advisory firms. Only dissenting views from the shareholder proxy advisory firms need to be catalogued. This creates more work for the funds to not vote in favor of the recommendation by the shareholder proxy advisory firms. This also allows many activists to use the information gained about corporate governance practices at a company to shore up its estimated vote count. One interviewee in our study estimated that this comprises 25-30% of every proxy vote.

During our interviews, a trend emerged for some passively and actively managed funds to conduct their own analysis on a proxy vote, i.e., bringing the shareholder proxy advisory services campaign in house. There is growing concern about the guidelines that third parties like ISS and Glass Lewis develop. Despite this growing concern, ISS and Glass Lewis are unlikely to be fully replaced in the near future which allows activists to enjoy this advantage for at least the intermediate future.

Phase Three – Engaging in Battle

"Battle" is a very strong characterization of the engagement process that activists have with target companies. However, many of our interviewees in executive leadership and director roles used this characterization to describe their feelings about an initial engagement with activist. At the extreme, the leadership and board of directors seem to feel like they are under attack by a guerrilla outsider.

Escalation of Commitment

Activists generally prepare for diplomatic talks to go sour and have contingency plans to escalate the "battle" to achieve their objectives. At the point of a 13D filing and declaration, even in quiet verbal conversations, activists have every incentive to continue pursuing their objectives until the end. The leveraged structure used for the investment places further pressure on the activist, defining tactical options and timeframes within which the complex engagement strategy must fit.

A 2014 report written by McKinsey estimated that three-quarters of all activist engagements begin collaboratively, but that less than a third end collaboratively. This means that the conversation typically sours somewhere between the earliest phases of engagement to the completion of the campaign[4].

Proxy Season

The proxy-filing season for public companies that file year-end financials is between April 15th and the end of June. Tens of thousands of proxy votes and director elections take place during this 10-week period. As mentioned above, this short period creates a significant constraint on the resources that passive and actively managed funds have to evaluate each activist intervention.

This time constraint gives activists an advantage in controlling the outcome of the battle, the loudest advocate with the most "homework" and information will automatically have an advantage. If companies are not as prepared, which is often the case, the activist can exploit time pressures during this short ten weeks to win the messaging war and the associated proxy votes.

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[4] *A collaborative engagement is one in which an activist has taken a position and reaches out to the company to call for a meeting or to share strategic or financial recommendations.*

Strategies Employed

The first step of a battle is determining the theater, whether it should be a series of one-on-one talks, letters, proxy votes or a full out media storm. Obviously, there is a natural progression of costs associated with each of these theaters. The majority of activists, without a well-established track record like Icahn, Ackman, etc., will start with a low-cost strategy and escalate from there.

Our research suggests that each activist hedge fund will develop a dominant strategy, but that each is not limited to the use of that particular strategy. The success of particular hedge fund activists inspires others to take additional risks or develop new methods. Prior to the Starboard engagement with Darden Restaurants, no activist had ever successfully replaced an entire board of directors. While there are specific events that led to the replacement of the board at Darden, other activists realized that there is potential for this strategy to work for them and are now adding this strategy to their "toolkit".

According to Brav et al. (2010), the most common activist objectives are listed in the table below. This list is largely consistent with our research.

Brav et al (2010) Estimates of Objectives (1,172 events, 2001-07)

					Hostile Events		Non-Hostile Events	
Objective	Events	Success	Partial Success	Number of Hostile Events	Success	Partial Success	Success	Partial Success
Gen. undervaluation & max shareholder value	561	47.9%	-	-	-	-	-	-
Capital structure	204	17.4%	26.5%	102	18.6%	43.1%	34.3%	7.8%
Business strategy	270	23.0%	30.7%	136	23.5%	39.0%	38.1%	5.2%
Sale of target company	235	20.1%	29.8%	142	27.5%	27.5%	33.3%	9.7%
Governance	284	24.2%	29.2%	187	26.7%	37.4%	34.0%	12.4%

Table 1 - Success Rate of Activism by Campaign Objective

Furthermore, Brav et al. (2010) summarized the tactics used by activists during this period in the table below. The table illustrates that the majority of the tactics employed by activists rely on direct communication with executive leadership and the board of directors. The second most prevalent is the formal demand for shareholder proposals or public criticism of the company. This seems to indicate that activists are talking to companies while simultaneously preparing formal shareholder proposals and/or strategies to criticize the company publicly.

Brav et al. (2010) Summary of Hedge Fund Activists' Tactics (1,172 events, 2001-07)

No.	*Tactic**	*% of Sample*
1	The hedge fund intends to communicate with the board/management on a regular basis with the goal of enhancing shareholder value	51.2%
2	The hedge fund seeks board representation without a proxy contest or confrontation with the existing management/board	11.9%
3	The hedge fund makes formal shareholder proposals, or publicly criticizes the company and demands change	35.1%
4	The hedge fund threatens to wage a proxy fight in order to gain board representation, or to sue the company for breach of fiduciary duty, etc.	7.3%
5	The hedge fund launches a proxy contest in order to replace the board	13.1%
6	The hedge fund sues the company	4.7%
7	The hedge fund intends to take control of the company, for example, with a takeover bid	4.6%
**Events can fall into more than one tactic category.*		

Table 2 - Prevalence of Activist Tactics in 13D Filings

Figure 7 (below) describes when an activist would use particular tactics.

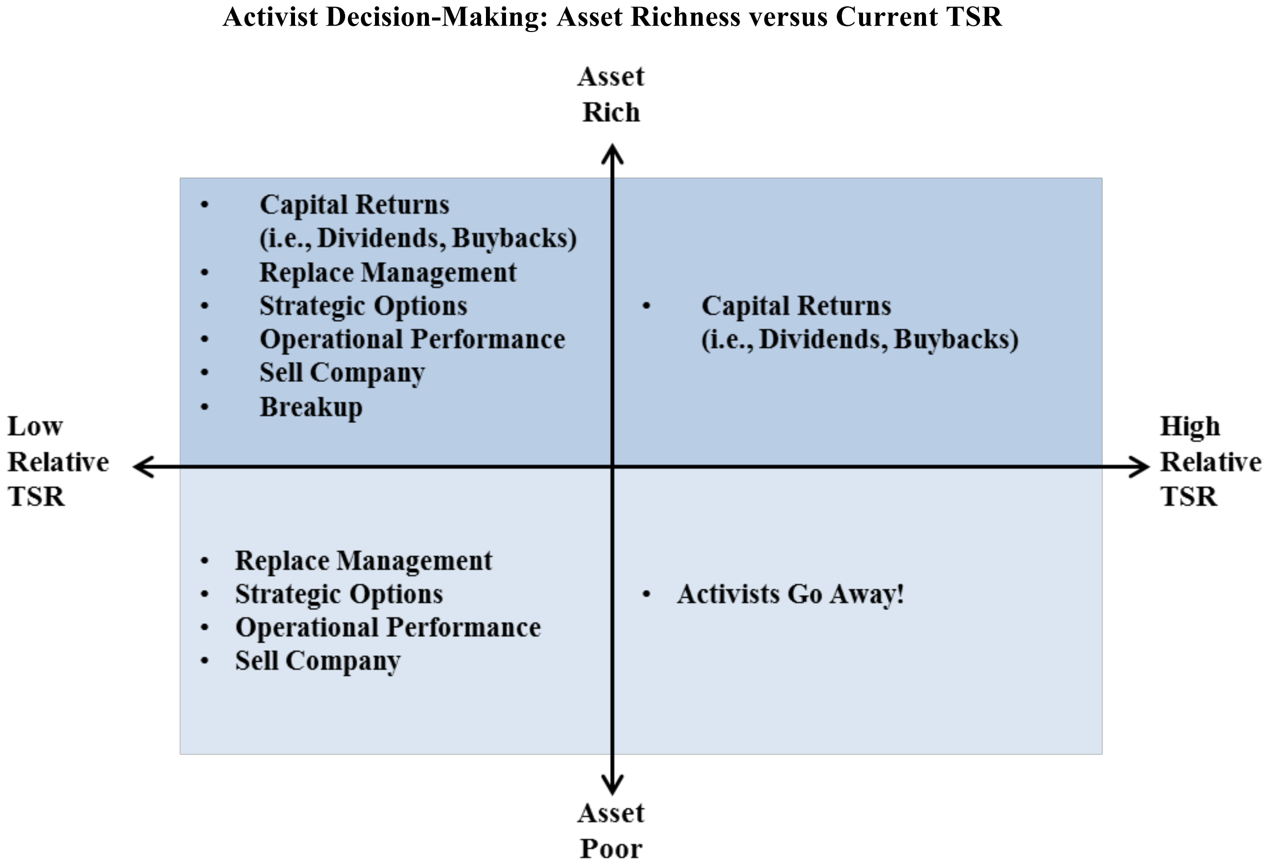

Figure 7 - Classification of Potential Activist Targets

With regards to tactics, the list above is neither comprehensive nor static. Since it was a historical snapshot, it does not provide a forward-looking view. Based on our interviews, we believe that the strategies and tactics employed by activists are greatly dependent on the actions of peer activist funds and historical precedence. Activists, by their very nature, have an incentive to seek an edge over peers, which results in an overall push for new methods to obtain control over a company at an even lower cost. The business press is not the best and only source of new tactics, as the vast majority of tactics being developed do not make the headlines. One of our interviewees estimated that 80% of activist campaigns are silent and out of the media, which means that companies will have to have a deeper understanding of the correct peer group and other companies in different industries.

Larger Company Targets

One major trend in activism is the targeting of larger public companies. In the past, companies over $20B were immune from activists, which was due to the size of activist funds and the over concentration in one investment when an activist takes a 5% stake. This 5% stake represents $1B and would tie up capital from most funds for too long to generate an appropriate risk-adjusted return. However, as activism continues to evolve – partnering among activists, targeting certain industries and taking a smaller stake to use external tactics – many activist hedge funds are getting over this hurdle and targeting companies that have market caps in the $10B to $20B range.

Activist investor Carl Icahn's position in Apple is a clear example of taking a small stake in a very large company, yet still managing impart influence. Icahn only has a 1% stake in Apple, which is an estimated $6.8B out of the $783B market cap (as of April 2015). The 5% threshold does not seem to matter if the activist has a high degree of influence on the media. Icahn has used social media to push for strategic changes since August 2013 when he announced his position in Apple via Twitter. In October 2014 and February 2015, Icahn called for the market to revalue the share price upward as well as for Apple to revise its cash strategy via the media (La Roche, 2015)

It is arguable that that Icahn does not need a singular event to be influential as an activist engagement, but needs to be simply recognized by the company and market as a credible commentator. This recognition would encourage some of the other investors to price in his advice. It is unclear if Icahn has been influential in the case of Apple. By looking just at the media flurry, one would think so, but the share price results are less clear. Both in October and February the share price increased by the end of the next trading day, while volume was 1.5x the average daily trading volume[5].

Board Seats

Activists can and will ask for board seats to ensure that their objective is met. If there is a perception that a board of directors is entrenched or unwilling to take the same level of objectivity, activists are fully willing to nominate an entire slate of new board of director members. Often the mechanisms that exist for board nomination require the nomination of one director or a full slate. In a few interviews, activists indicated that they would prefer achieving their objective without escalating to this

[5] *Analysis of share price via Capital IQ.*

level. Sometimes trusted directors who had retired or resigned from the board are brought back by the activist.

Mentioned earlier in this paper, many public company boards are declassified. As of December 2013, only 10% of companies listed on the S&P 500 still had staggered boards (NYSE Corporate Governance Guide, 2014). Declassification allows the nomination of a full slate of directors in one proxy vote, without having to wait multiple meetings to obtain a position of majority control. Declassification allows the required holding period by activists to decrease. There is no need to wait for multiple years with capital tied up in one investment to achieve the activist's objective.

There are two major considerations for companies to keep in mind when talking with activists with respect to board seats:

1) Many activists do not want to take a board seat and become an insider. The insider restrictions further tie up positions and reduce the flexibility of the activist to exit its investment in the company. Flexibility and response-time are essential to hedge funds and their investment techniques. However, when the activist perceives an increased need for control to achieve a long-term return, they may be more willing to take an insider position. Most of the time, when the activist declares his or her intention to seek a board position they are serious, but would likely settle for much less. The commitment of a company to concede spots on the board to new outsiders is seen as a win for the activist, even if the activist never appoints someone to the board directly. There seems to be an implicit understanding by other investors that the company is listening to the activist and willing to bring in fresh ideas and perspectives once a concession is made.

2) When activists nominate board of director members, they typically seek out superb candidates that either fill or round out a needed skill-set, pull directly from the nominee's past experience and/or have an excellent reputation amongst corporate leaders and other investors. In the selection process, the activist invites the candidate to meet with analysts and see the logic behind their strategic and financial recommendations. This results in better-informed director nominees. Also, the activists know that the candidate has listened to their ideas and will be informed by perspectives beyond those from the company itself. The activist can confidently gauge the risk of the candidate based on reducing the information asymmetry prior to nomination, even if the director ignores the activist recommendations.

When appointed, the new directors who are truly “independent” can disavow themselves of any direct conflicts of interest with activists. Laws, such as Regulation Fair Disclosure (“Reg FD”), requires the dissolution of this relationship. Activist can often “trust” these nominees to operate independently, but still help the activist fulfill their objectives. Recently, there is a trend of some activists providing additional incentives for new directors to further incentivize them to generate positive returns for shareholders. There is a growing debate as to whether directors with these enhanced third-party compensation agreements are truly “independent.”

Aligning Incentives with Board Nominees

Some activists work to align the incentives of new nominees to the board of directors with that of the activist. In these cases, new boards of director members proposed by the activist receive rights to acquire common stock from the activist. This serves to provide additional compensation for their time and aligns their decisions with the interests of the activist. This type of compensation arrangement has been a hotly debated point of contention in the recent Dow Corporation activist engagement, where former CEO and current non-executive chairman of AIG, Steve Miller, received rights to receive the gains of some 400,000 Dow shares (Benoit and Lublin, 2014). Critics worry about misaligned incentives and increased friction compared to other board of director members without such compensation.

Other types of incentives, also known as share appreciation rights (“SARs”), work to align the director with the activist without calling for direct communication. The SARs are issued with a tie to the activist’s position. Economic rationality would call for a many of the same implicit motivations in terms of decision-making. It further locks up the interests of directors as well. The SARs are on a typical timeframe of three to five years.

One argument that has been used for SARs is that additional compensation is needed to get the caliber of people, e.g., former CEOs and directors with specialized skills, who will add value to a target company. However, these people are often not driven by the explicit monetary incentives, as monetary compensation is often offset by a greater reputational risk if the activist engagement goes awry.

Phase Four – The Aftermath of Battle

The aftermath phase starts at the time of completion a particular engagement, which is not necessarily when the activist sells its position in the company. If all of the options for maximizing a portfolio company's performance have been explored, the hedge fund activist has effectively two basic decisions: hold or sell.

The fluid nature of today's shareholder activism allows hedge funds great flexibility to exert effort where it is most needed. Activist hedge funds are prone to action, given the race to have an information edge over competitors, and will gear up for the next target well before they exit an activist investment. The hedge fund generally switches to a portfolio management mindset with the company and will exit the investment when the company is sold, the stock hits the activist's expected target return, or there is a greater opportunity for the invested capital.

Activist hedge funds totaled $120B in 2014, representing a small percentage of the overall hedge fund asset class, but they are the best performing sub-class within this class (AIMA, 2015). The overall share of activist hedge funds is growing and is a reflection of recent successes. However, this trend could reverse itself if limited partners in activist hedge funds began to conclude that their capital was not generating the expected returns.

It is also important to keep in mind that activists may be launching simultaneous engagements. Activists do not have an unlimited bandwidth or capital to invest in many companies. Staff limitations may inhibit the ability to handle the slew of meetings that come with an activist engagement, the media has a limited appetite for an activist story on one fund, i.e., all battles cannot be aggressive in the media at the same time, and reserve capital is needed to adjust a position accordingly to achieve its goals. The most that can be done is question the maximum bandwidth that activism has due to the very real constraints that come with any investment and strategy. Given these constraints, if the asset class continues to grow, it is very possible that activists will seek greater returns and larger targets as their modus operandi.

Phase Five – Repeat with the Next Company

As outlined in this section, activists use different strategies depending on the target company, the industry and a number of other variables. There is generally a dominant strategy used by an activist, but it is not the only strategy they will use. Strategies evolve as business trends; regulations, taxation strategies and other outside factors change the economics and valuation trends within an industry. There is an evolving list of common strategies as activists try and prove out new tactics. Successful strategies logically lead to an uptick in activist activity that focuses on applying the "new" strategy to similar firms. This is also true when identifying potential governance issues. Activists will closely monitor how the proxy advisory firm standards change with respect to certain governance issues and may incorporate these features into their next campaign.

SECTION V: RECOMMENDATIONS TO EXECUTIVE LEADERSHIP

Adapting to the Emergence of Shareholder Activism

As has been documented in this research report, activist investors fill the gap created by a fundamental agency problem in linking the interests of shareholders, boards of directors and executive leadership. While a case can be made that certain activist campaigns are simply opportunistic and value extracting, in aggregate, shareholder activism has had a positive impact on corporate performance (Brav et al., 2014). Passively waiting for a potential activist intervention, however, represents a missed opportunity on behalf of companies for the following three reasons:

1) **Pre-empting activism.** It is possible for a corporation to pre-empt external activist involvement and capture the value a would-be activist might generate while minimizing "defense" costs to the firm. Dealing with a typical activist campaign involves the direct cost of hiring external advisors, e.g., banks, consultancies, law firms, the opportunity costs of distracting high-value personnel, the transaction costs in communication, analysis and negotiation, and the potential intangible costs of negative public perception.

   Relative to activists, companies have the advantage of access to inside information. The strategies and tactics recommended below will allow companies to leverage this position to limit the cost of a potential activist intervention.

2) **If the company is right.** While companies can reduce the likelihood of activist intervention, an activist campaign can never be averted with absolute certainty. If the company has been proactive and made the best set of decisions for the long-term interests of the shareholders and an activist still chooses to engage the firm, the strategies and tactics outlined below will best position the firm to defend itself and maintain its course.

3) **If the activist is right.** Even if executive leadership and the board of directors has thoughtfully pursued diligent analyses and actions on behalf of the shareholders, it is always possible that more valuable options are available but have not been internally identified. If an activist presents a superior course of action for a firm to pursue, the strategies and tactics below will ensure the firm is well positioned to assimilate these inputs in a constructive manner.

Recommendations to Corporate Leadership

This section offers a set of prescriptive recommendations that boards of directors and executive leadership should consider in order to benefit from the positive aspects of shareholder activism, while minimizing costs of the detrimental effects. These recommendations are characterized by presenting both inward and outward-facing activities that can be employed by boards of directors and executive leadership as illustrated in Figure 8.

Classification of Recommendations for Companies

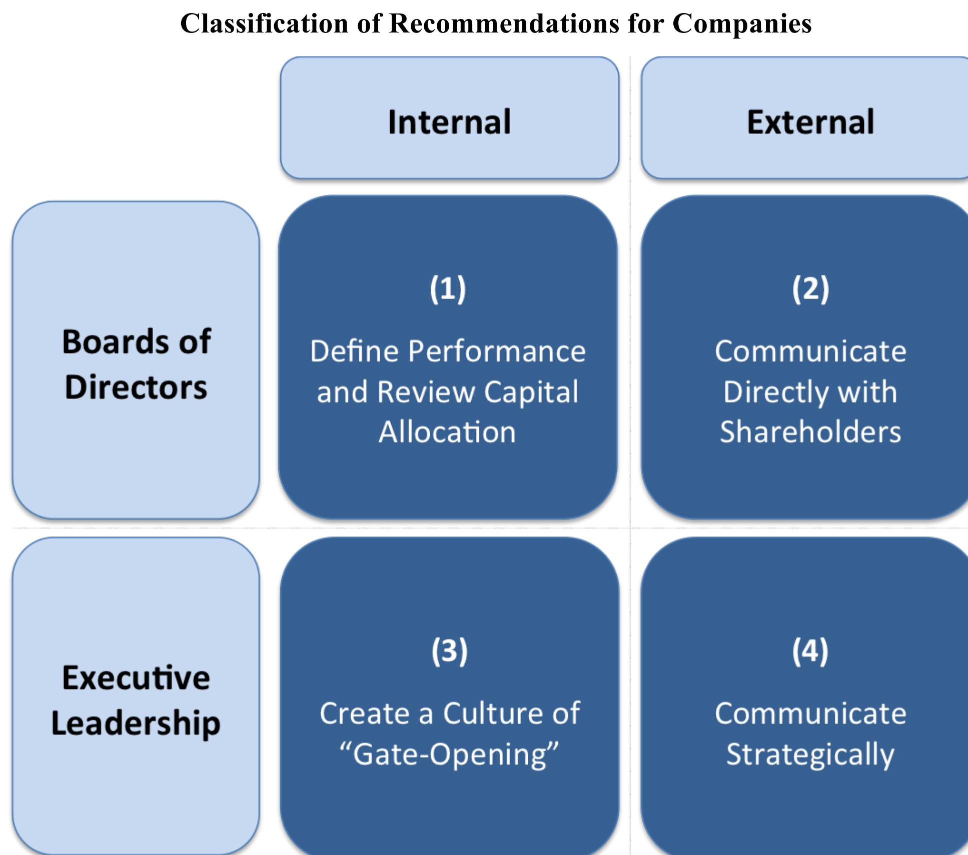

Figure 8 – Recommendations that Enable Companies to Benefit from Positive Aspects of Activist Intervention

[1] Boards of Directors – Internal – Define Performance

Activist attacks are costly, time consuming, and the agendas of activists may also adversely affect long-term returns to shareholders. Upwards of $10M can be spent by corporations to hire external advisors, bankers and lawyers to defend against attacks and they can drag on for months, diverting

management attention from potentially value creating activities.[6] As such, even though activist interventions often create value for shareholders, companies have an interest in reducing the cost of those interventions and, where possible, performing some activist activities to more proactively generate those returns and reduce costs. In an effort to preempt unnecessary activism, we conclude that many boards of directors can do a better job of defining corporate performance, developing better metrics to measure performance and analyzing business portfolios alternatives to achieve this performance.

There are three major components in defining performance: understanding the drivers of long term value creation, selecting the right metrics and benchmarks to measure this, and understanding the appropriate timeframes that investors utilize in assessing this performance. Activists often take advantage of situations when companies fail to choose appropriate benchmarks or have too narrow of definitions for performance. For example, Carl Icahn took Apple to task over its cash hoarding because even though Apple had strong shareholder returns, it could perform "better" by returning more cash to shareholders. By expanding the conversation about the definition of performance, Icahn was able to agitate the largest company in the world to act. One of the arguments Nelson Peltz used against DuPont was that the company was measuring its RTSR against an index of competitors who were not truly peer companies.

Boards have an opportunity to get ahead of activists by engaging in a deeper conversations about "performance". Our interviews with board members and their advisors revealed that there is often too little rigorous discussion among board members and executive leadership about what constitutes corporate success and which metrics should be used to guide firm strategy beyond hitting annual EPS targets. Some firms in our research are adding a more rigorous discussion of business success and corporate performance to the annual board agenda, and this is a good next step in preempting the activist movement.

Additionally, boards need to have rigorous conversations about how to balance demands from activists who allegedly push relatively short term agendas and exit soon after they achieve their objectives against the interests of long term shareholders. Shareholders are heterogeneous groups and have different time horizons in mind so getting the discussion about timing right can be particularly difficult for boards. For example, cutting R&D can contribute to short term profits but come at the expense of long term growth. What happens when activists have shorter time frames than boards? We believe that proxy fights serve their purpose as a channel for constructive conflict in these cases. If boards cannot convince

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[6] *Furthermore, Gantchev (2010) conducted a study from 2000-07 that estimated the cost of a proxy battle to a company is $10.5M.*

shareholders that their proposed time frame is the 'right' one, then shareholders have a right to override them and be heard, but also bear the risks and costs of being wrong. We discuss recommendations for these outcomes in more detail in our external board discussion.

Boards should also periodically review capital allocation to ensure that the firm's portfolio of businesses are adhering to these definitions of performance, making decisions to keep, fix or sell assets or manage liabilities more aggressively when performance can be improved. Several of the directors interviewed admitted that their boards do not do this and executives consistently stated that this task is their responsibility, and not the role of the board. We disagree and feel that as the buffer between shareholders and management, it is incumbent on the board to play a stronger role in reviewing capital allocation.

Boards need additional resources to effectively carry out their expanded agendas. Board members typically are pulled in many directions by competing demands. They are usually sitting executives at other companies or sit on multiple boards. The average public company board member spends only 20 days per year on board duties (Barton and Wiseman, 2015). In addition to these constraints, there are information asymmetries between boards and executives that are difficult to address.

Boards get most of their information from managers who may filter and frame information in ways that get boards to agree with their recommendations. We believe these issues warrant additional resources for boards to perform more analysis and reduce information asymmetries and temptations to filter information. This can be achieved through the addition of professional board members, full time board members dedicated to the company, or by boards utilizing independent valuation and strategy consultants to serve as corporate "red teams", teams formed with the explicit purpose of creating an urgent and immediate response to a threat, that provide supplemental information channels.

Independent advisory teams should be contracted by and be responsible to the board. In order to provide analysis that is rich enough to provide value for boards and managers alike those independent teams need to have access to insiders for information. Boards will need to strike a balance between independence and access, which can be difficult to manage, but the results will provide valuable independent opinions.

[2] Boards of Directors – External – Communicate Directly with Shareholders

The role of the Board of Directors is to represent the shareholders by serving as their "stewards" within a company. Our earlier recommendations attempt to remove some of the information asymmetry that exists between boards of directors and the executive leadership in a corporation. Our recommendations in this section suggest supplemental activities that BODs can undertake to structurally increase the level of information shared that is actionable or useful in investment decisions. Information other than this is merely spin and not sufficient to reduce the likelihood of an activist engagement. Boards of directors can take three proactive steps to reduce the likelihood of a shareholder activist engagement:

(1) BODs should create a structural capability to improve shareholder communication. We conclude that many BODs are not equipped to improve shareholder communications on an on-going basis. Instead, BOD-level conversations about shareholder communications arise on an as needed or, at best on an annual basis. We recommend that BODs create a committee, or some other formal structure, to champion the cause of communicating with shareholders.

(2) BOD members should be encouraged and allowed to serve as conduits for direct shareholder engagement. We also conclude that independent directors should be allowed and encouraged to hold listening sessions with key investors. The CEO and corporate IR should not be the only conduits to shareholders. Corporate officers may have a much shorter tenure than BOD members, which means that institutional knowledge is lost when these top managers move on. Our interviews revealed that executive corporate leadership teams are concerned about their independent directors revealing nonpublic information, thereby triggering Reg FD provisions or further disclosure. Based upon our research findings, many activist investors are asking for "active listening". There does not need to be a response from individual board members or the BOD to comments made by shareholders.[7]

(3) BODs should insure that the right corporate performance parameters are being communicated to shareholders. Our third recommendation is that BOD's need to

[7] *In 2003, the SEC published a rule that would allow directors to speak directly to shareholders. This followed passage of Reg FD and the Enron Crisis – providing clarity to many companies worried about new liabilities. The rule was finalized in 2004.*

> become more involved in the way corporate performance parameters and internal decisions are communicated externally. Two interviewees in our study told us that companies they were involved with had previously conducted all of the analyses requested by activist investors, and that these analyses had been debated by the boards. Subsequently, the boards concluded that the proposed actions were not in the interests of shareholders. However, the business press and the activists do not give any indication of that conclusion or that these analyses and discussions had been undertaken.
>
> Another interviewee discussed an engagement with an activist where the company conducted internal analysis, again concluding that the recommendation by the activist was ill founded. While this resulted in the shareholder activist backing down on the recommendation, this company and activist confrontation could have been averted in the first place by more thorough communication.
>
> The BOD should monitor shareholder communication to ensure a high level of transparency and accuracy with regards to the signals sent to investors. Simply put, investors don't know what they don't know.

Thinking strategically about the BOD's role in external communications should help ensure that companies realize and maintain their long-term potential. If thoughtful conversations with investors do not occur, companies will remain susceptible to activist engagement, even when it is not warranted.

Furthermore, companies should recognize that a number of their passive investors support more open communication. In April 2015, BlackRock CEO, Larry Fink, sent a letter to 500 CEOs that urged them to stop jeopardizing the long-term value of their companies and to evaluate more thoughtfully shareholder requested for increased share buybacks and dividends (Sorkin, April 2015). Other institutional investors expressed dismay that many companies have never reached out in the long period during which the stock was held.

Over a seven to ten year span, a BOD should be able to develop a comfortable, on-going "give and take" relationship with its institutional investors, just like the company does with its customers and suppliers.

Historically, institutional investors held small amounts of a company's stock, and if they disagreed with company performance, they would simply sell the stock. The long-term positions held by some institutional investors today means that investor satisfaction needs to be maintained by direct conversations on a regular basis. One interviewee in our sample stated that these conversations do not have to come every year, but that large shareholders need an "open door" to the company at least every couple of years.

In further reinforcing the point above, the Brav et al. (2010) study that covered the period from 2001-07 found that the most frequent tactic used by shareholder activists was to seek acknowledgement as a credible "advisor" to a company. A more direct dialogue with all shareholders would achieve this result.

[3] Executive Leadership Team – Internal – Create a Culture of Gate-Opening

Based upon our research, we recommend that executive leadership teams and, in particular, the CEO implement steps to align the internal culture of the firm to one of "gate-opening" allowing the voices of shareholders to be more thoughtfully listened to and acknowledged by corporate leadership. This "gate-opening" would facilitate better performance metrics and/or an improved activist defense, should either non-activist or activist investors become confrontational. It would also allow better evaluation of value-added strategic alternatives presented by shareholders. While such a shift could be led by any outstanding leader within the firm or among the BOD, we recommended that the change agent be the CEO.

This recommendation grew from our interview data. We uncovered two different approaches that leaders took toward activism and shareholder involvement. One group appeared to seek engagement with shareholders and view it as an important executive leadership responsibility that was both inevitable and benign. Views within this group differed as to tactics for such shareholder engagement, but all seemed to feel that it was a leadership responsibility that needed continuous improvement. Another group thought of shareholder engagement as an avoidable task. The latter group focused on using performance (relative TSR) to justify minimal information flow and minimal valuation of shareholder inputs.

"Gate-opening" is also linked to internal information sharing. Corporate cultures in which external perspectives were welcomed seemed to have extremely open internal channels of information.

This information flow appeared tied to culture and extended to communication of vital strategic and tactical information within the firm. Firms with the perspective of "gate-opening" appeared to limit information asymmetry internally between their boards and their executive leadership teams, which we see as a value-creating practice.

Additionally, our conversations with activist investors highlighted that executive leadership's best course of action is to prepare the organization for outside engagement. By accepting the inevitability of activist activity and by making the first response one of assumed "benevolence", executive leadership can take a power position within the relationship with activists. Activists want, in a majority of the cases, to engage non-confrontationally and with a clear role in the decision process, even if that position is merely one of an outside influencer. When without such a clear role, the activists in our sample felt that confrontation was in order.

This practice will also increase the perceived agreeability of the firm with its non-activists shareholders. Non-activist-shareholders in our interviews felt that firms with "gate-opening" perspectives are easier to support in times when there is disagreement in the strategic directions as put forth by the executive leadership and activists.

One suggestion to help forge a new culture of "gate-opening" for firms that seek to adopt it is for the key leader, the CEO, to take on the role of a change agent. The CEO will need to acknowledge and communicate the benefits of a "gate-opening" approach throughout the three following phases of explicit change management:

1. **Prepare the leadership by sharing pitfalls of minimalistic approaches to shareholder engagement.** One case study offered is Darden Restaurants' struggle with Jeff Smith and Starboard Value, which illustrates the problems inherent in harboring "contempt for shareholder interests" (Stevenson, October 2014).

2. **Lead the change process by utilizing the champion's cultural and resource capital.** For example, resource allocation, adding new, meaningful and related activities to the executive leadership or board agendas, and/or increasing awareness of commitments to shareholder engagement. An additional "gate-opening" activity is to include discussions within the executive leadership team on how to use proxy statements to acknowledge the role outsiders have in decision influence.

3. **Reinforce the change process with examples of success in the Phase 2 endeavors.**

   Sharing out and investing time to process what investor relations or other externally facing entities are learning from activist engagement is one method of reinforcement. Another is stimulating conversations and analysis of activist engagements not directly involving the firm. Use of case studies at this phase should be to balance conversation around dissecting both the positives, e.g., an engagement's ability to add value, as well as the potential negatives, e.g., the firm-specific concerns that these "gate-opening" practices may have on long-term performance. Regular, perhaps annual, recalibration of best-practice within the firm is in order at this stage, as well.

[4] Executive Leadership Team – External – Communicate Strategically

The executive leadership team in a public corporation should make a strategic effort to more thoughtfully and strategically engage with all of its shareholders. Activist campaigns often turn public and combative when the activist believes that the company either is not willing to listen to new ideas or the perception exists that the activist will be able to persuade other investors to support his ideas. Companies that simply meet minimum public disclosure requirements and view shareholder interaction as an unnecessary distraction often fail to attract the best ideas from the owners and are more likely to pursue strategies that deviate from the owners' interests, thus increasing the likelihood of activist success.

The IR function should be elevated to a more strategic position within the "C-Suite", with direct reporting to the CEO who should take more active oversight role of investor communication strategies. Someone with intimate knowledge of the company should hold the leading role within IR. To attract and develop this senior talent, the IR position could be included as part of a rotation intended to develop senior leaders within the company. This elevation of the position will be beneficial to the company and the investor base. The company benefits from having one of its most knowledgeable and experienced leaders speaking to investors and fielding their questions and those investors gain additional confidence in the answers they receive.

The IR function's goal should be to attract and develop an investor base that understands and 'buys into' the company's measure of performance and its strategic goals. It's too simple to say that a company should try to build a shareholder base of 'long only' shareholders. A mix of ownership "styles" is going to be the "new" reality, and the company must thoughtfully work with all parts of the shareholder base. The executive leadership team should work with the IR function to engage with owners in a variety of settings: conference calls, investor and industry conferences, company sponsored meetings, webinars etc. to not only communicate the company's perspective and latest news but to engage in dialogue and listen to what is on the mind of shareholders. The executive leadership team should be serious and genuine about attracting the best ideas from the shareholder base, comment on strategic trends in the industry and provide investors with the confidence that the leadership and board of the company are thoughtfully considering all possible options to enhance value.

Executive leadership must also seek to raise the quality of communications and its dialogue with investors. Simply reporting financial earnings in the 10-K and 10-Q is too little to fully educate shareholders on the strategic direction and decision processes that drive the company. This creates a vacuum in which the activist can insert its own theories and challenge the competence and efficacy of existing company leadership. The executive leadership team should provide more transparency into the key decisions made by the company. Details of the alternatives considered and rejected, and the reasons why they were not pursued can provide investors with a better understanding and confidence in the thought process and system of decision-making. There will always be sensitive information that should not be released to the general public, but a more detailed understanding of the process for evaluating that information will be sufficient to satisfy most investors.

In addition to more transparency, the investor community must understand the company's philosophy of performance and measures used to evaluate this performance. Communicating and reiterating philosophies and definitions of performance will provide additional justification for the decisions that are made. Reevaluating the logic of past decisions and providing transparency into their outcomes will also provide insights on ways in which the company will continue to evaluate and improve its performance over time.

All or Nothing? The Complementary Nature of These Recommendations

Readers of this report may ask if it is possible to benefit from the adoption of a subset of our recommendations. We understand that our recommendations require the coordination of several major groups of leaders within the firm and with so many other priorities and demands on leaders' time and attention, it can be daunting to approach many changes at once. For executives and board members in a company that finds that they are not currently engaged in any of the above areas, this is a valid concern. However, we found that the majority of companies in our sample are already "mindfully engaged" in at least one or more of these recommendations. Further research would be appropriate to measure the effect of engaging in each of these recommendations on company performance, and activist deterrence. For the purposes of this study, the following section provides our preliminary thinking based on the group's study of activist targets and our interviews with companies possessing a varied history with shareholder activism.

In order to fully realize the benefit of these recommended actions, we believe it is necessary for a company to engage in all four dimensions. Many media outlets and business publications have provided advice to companies and boards that proscribe pieces of this solution, but these often lack a holistic approach. Our recommendations are not simple fixes, but they create a system in which a company can build a mindset that attempts to address the agency problem that activist are attempting to correct. There are many ways to think about the efficacy of implementing a subset of these recommendations but perhaps the most straightforward method is to identify how the absence of one practice fundamentally undermines the effects of the other actions. The following demonstrates the importance of both a strong executive leadership team *and* board of directors and the ability for both parties to understand and effectively communicate with one another and with public investors:

- **Board of Directors Internal – Define Performance:** In the absence of a rigorous internal discussion on performance and performance metrics, it is very difficult for a company to internally evaluate itself or communicate its position to outside groups. Conflicting and inappropriate internal thoughts on performance will ultimately result in mixed messages that will be confusing to shareholders. Executive leadership teams may be put in a position where they are executing a strategy, and perhaps executing it well, but are achieving results that are not in line

with shareholder interests. This is perhaps the most fundamental of all of our recommendations, because the definition of performance is what ultimately drives company and investor actions. Failing to debate and define the concept of performance creates the largest information asymmetry between CEOs, Boards and outsiders and can lead to many of the agency problems that activism tries to correct.

- **Board of Directors External – Communicate Directly with Shareholders:** One of the activist's most common targets is the board of directors because they elected these members and because the board ultimately does have the ability to drive change in leadership and strategic direction. As such, it's important for the board of directors to be able to communicate directly with shareholders to hear their views and instill confidence in the shareholder base that their interests are ably represented. Difficult strategic decisions and the adoption of performance metrics that may differ from the peer group or from the views of some shareholders need to be communicated and explained to all investors. In the absence of this communication, activists will continue to question the direction of the company and challenge its actions. Though a strategic IR function does provide substantial benefit, the reinforcement of these ideas by the board will only provide greater credence to the ideas and strategies being communicated by the executive leadership team. It helps to show a united front and conviction in the strategies being executed by the company and the reasons for pursuing them.

- **Executive Leadership Internal – Culture of "Gate-Opening":** To effectively evaluate and communicate the performance metrics of the company to both insiders and outsiders, the executive leadership team must adopt a culture of increased transparency. A measure of performance that takes a balanced view of both short and long term measures will reward transparency and open information flow. Without clear information flow, the quality of information reported to investors will decrease, and it is more likely that investors will become skeptical of the story being told, allowing activists to enter the conversation with their alternate narrative. Transparency ultimately reduces the information asymmetry between leadership and the board that enables the board to represent the interest of all shareholders.

- **Executive Leadership External – Communicate Strategically:** The definition and communication of a company's performance against its peers and its own internal standards is a big step in reducing the information asymmetries and agency problems between company insiders and investors, but a company must also put itself in the best position to succeed by taking a

strategic view of investor relations. Cultivating relationships with the types of investors who understand and 'buy in' to the company's strategy and performance measures is the best way to ensure that the company will be given the time and sometimes the benefit of the doubt to pursue actions that sometimes have less certain or longer term outcomes. A company that fails to handle IR strategically opens itself up to having its message challenged by an activist who may push a different but equally compelling narrative and definition of a company's performance. Even great plans still must be carefully and strategically shared with the outside world in order for them to be accepted and fine-tuned by the best outside ideas that arise over time.

Our four recommendations outlined above complement each other in an attempt to address the agency problems that activism tries to correct. A careful balance among internal and external actions at both the board and executive leadership level is needed to reduce information asymmetries and to communicate and execute upon a strategy that achieves the level of performance that shareholders need and are willing to accept.

SECTION VI: FUTURE OF ACTIVIST INVESTING

Implications of Activism for the Economy and Financial Markets

As activist investors extend their reach, and as companies make decisions anticipating potential activist' demands and respond to others, we anticipate that:

- The degree of conglomeration in publicly traded companies will be reduced; and
- Both financial leverage and payout ratios will be increased.

Most of these changes will be good for investors in the short run. However, the increasing leverage will magnify earnings volatility and could lead to increasing corporate vulnerability to future adverse macroeconomic conditions.

Bebchuk et al., examined the question of corporate vulnerability to macroeconomic shocks by looking at the change in both ROA and the Q-statistic during the 2008-09 recession in firms that had been targeted by activists during 2004-2007. This analysis found that there was no evidence that firms that were targeted fared worse than their non-targeted peers. However, these results are not conclusive and have very low correlations, meaning much of the variation is accounted for by other variables. This is primarily due to the fact that they used a limited sample of activist campaigns, and conflict with the collective understanding of most bankers and corporate lawyers interviewed in our research.

Several bankers and corporate lawyers in our sample believed that over the long-run, the increasing focus on RTSR, and the associated increase in leverage and payouts will weaken corporate balance sheets and increase volatility. Similarly, an interviewee who is a head of IR at a Fortune 500 company claimed that investor's preference for leverage was cyclical, and that her company's conservative balance sheet had moved from being a strong asset during the 2008 financial crisis to one that could attract activists today.

Furthermore, another interviewee, a partner at a major consulting firm who worked with several targets of activism, shared the case of an industrial company where an activist forced increased leverage as well as the separation of its low-growth, low-volatility division from its highly-cyclical, capital intensive, high-growth division. According to this consultant, this made the new company's earnings

more volatile, and increased its reliance on capital markets for financing – especially during downturns, when financing is most scarce and most expensive.

This significantly increased the likelihood that attractive projects in the high-growth division could be delayed due to a financing shortfall. In spite of these possible problems, the separation of the company produced significant excess TSR relative to its peer group.

If we extrapolate from our research, we must conclude that there may be significant problems with activism that are being masked by the current positive economic cycle in the U.S., and that these may become evident when the next recession occurs.

Future for Activist Investors

Several of the advisors, particularly the investment bankers, who were interviewed for this paper believed that activism was riding the financial cycle, and that as soon as their returns flag or LPs face adverse effects, many of the activist funds will face a liquidity crisis. The bankers interviewed believed that this turn of events could inflict significant damage on activist funds, given a potentially limited base of permanent capital and highly levered business model.

However, many of the larger and more successful activists seem to have anticipated this by raising pools of permanent capital that will better prepare them to weather market turbulence. Some activists have set up reinsurance affiliates which allow them to use the premium float to finance investments. Others have set up special investment vehicles which they subsequently listed on publicly traded exchanges, gaining access to a pool of permanent capital. The trend is clearly toward more stable capital base for the major activists.

At the same time, the success of major activists in achieving above-market alpha will continue to attract investors into the asset class. The confluence of both trends suggests that activists will be increasingly able to take on the largest companies, and will successfully navigate the bottom of the next economic cycle. Activism is here to stay.

Shareholder Activism's Public Policy Landscape

The current political and public landscape needs to be considered before one can predict the likely future of shareholder activism. In the near term, Congress is unlikely to focus deeply on "Wall Street"-related issues, as Congress' attention is on the minutiae of implementation of prior financial regulation laws and on maintaining existing economic stimulus programs. The SEC is unlikely to get ahead of Congress, given the heightened level of scrutiny that stems from financial regulation implementation. However, Congress could focus on smaller subsets of issues that would impact shareholder activism, including labor implications, tax provisions, and investor transparency. Our best prediction is that political and public policy will remain "neutral" toward shareholder activism, until at least the 2016 elections.[8]

Given the political pressures that exist in the ecosystem of influencers, companies and political priorities surrounding Congress, there are three plausible public policy questions that Congress could address. These policy questions are:

(1) What is the acceptable role of shareholder proxy advisory services?

(2) Do activists' tactics extract too much of a company's value, which in turn hurts the public?

(3) Is further monitoring and registration of hedge fund activists warranted by the SEC?

This is not a comprehensive list of potential public policy responses, but one that best reflects today's political and public policy landscape.

Overview of Political and Public Policy Landscape

We examined the current stance of key public policy makers to determine sentiment toward activist investing. Current policy makers, particularly those serving in U.S. Congress, appear to have little interest in or understanding of shareholder activism or hedge funds in general. To test this contention, a

[8] *The difficulty of implementing a substantive policy change is augmented by divisive electoral politics entering into congressional debates. Additionally, the new Administration would hold responsibility over appointments to key enforcement agencies, which would mean there are many chances for provisions to get stripped in both legislative, rule-writing and implementation phases, making the policy change unenforceable.*

query of the Congressional Record was conducted for the 113th and 114th Congresses. The Congressional Record includes all public statements made by Members of Congress before both floors. In the Congressional Record for these sessions, there was only one mention of "shareholder activist" or "activist investor". This was made by Senator Dick Durbin (D-IL) on July 22, 2014 and in the context of international tax inversions which were said to be a cost-reduction tactic used by shareholder activists on target companies.[9]

Shareholder Proxy Advisory Services Firms

Some companies and political representatives representing companies have been questioning the perceived undue influence of the shareholder proxy advisory firms, such as ISS and Glass Lewis. Congress will follow the lead of the most powerful actors in the political system who are the companies that have direct ties to the policy makers through lobbying activities and prior relationships. The decision to hire representation, such as lobbyists, and set a political agenda is almost entirely driven by the corporate executive leadership. Individual shareholders as a group are not aggregated in a strategic and organized fashion to influence policy to the same degree a company can. Furthermore, institutional shareholders, which hold similar political sway, are unlikely to weigh in until there is significant movement on a policy proposal, as there is more to lose than gain by being proactive.

In the 113th Congress, the House Financial Services Committee held a hearing entitled "Examining the Market Power and Impact of Proxy Advisory Firms", which heard from representatives from the investor community and company representatives in the midst of the 2013 proxy season. During the June 5, 2013 hearing, the National Investor Relations Institute, Mr. Harvey Pitt, on behalf of the U.S. Chamber of Commerce, and the Shareholder Communications Coalition all testified about the perceived negative impact of shareholder proxy advisory services.

The U.S. Chamber of Commerce and the Shareholder Communications Coalition have stated strong oppositions to the market power that ISS and Glass Lewis control – approximately 97% of the proxy advisory industry. The U.S. Chamber's perspective is primarily concerned with how shareholder

[9] *During the 111th Congress, 15 separate bills of financial sector, targeted at hedge fund transparency, were introduced. The bills were evenly split between parties and expectedly weighted toward House origination. Interest decreased slightly in the 112th and 113th Congresses (2011-14), with the focus turning to Dodd-Frank implementation. The 24 bills introduced during the 112th and 113th Congresses with mentions of hedge funds were signaling legislation aimed at political interests around systemic risk and technical corrections to Dodd-Frank. Research was created by conducting a query of www.congress.gov on April 10, 2015.*

activism impacts member companies and increasing availability of tools to third-parties – hedge fund and pension fund activists – hold over companies. The U.S. Chamber has been a very public critic of the socially motivated agenda that many pension funds managed by unions promote through the proxy voting process. Mr. Pitt has been outspoken against shareholder activism dating back to his tenure at the SEC, and this viewpoint aligns well with the U.S. Chambers' perspective. The Shareholder Communications Coalition is an offshoot of the Business Roundtable, which has attempted to create a grassroots, pro-shareholder, organization that advocates for policy in the best interest of the managers who funded the efforts (House Financial Services Hearing, June 2013).

In response to the SEC's push to have institutional investors vote, rather than withhold votes, a need for third-party advice was created in 2009. ISS and Glass Lewis enabled institutional investors to meet this new obligation in a short amount of time – providing recommendations on one company for many institutional investors based on guidelines the firms developed. The business model requires significant economies of scale to provide these recommendations on a particular company's proxy vote to many institutional investors.

One of the pushes by companies is that regulators should oversee the development of ISS and Glass Lewis' guidelines. This would likely require additional regulation and would likely disrupt the market adjustment that is already underway – shareholder proxy advisory services firms are likely to be less influential in the future.

Market adjustments due to the fact that the larger institutional investors will be less reliant on advisory services in the future, as they are already bringing these activities in-house. Correction is already well underway and is recognized by ISS and Glass Lewis to the extent that both firms have begun to diversify their services. These firms may end up shifting their product mix more towards proactive consulting for companies to comply with generally accepted corporate governance practices. During one conversation with the head of proxy services for a large financial institutional investor, the interviewee told us that his institution was aware that proxy services alleviate a shortage of capacity during proxy season, but indicated this was a temporary problem.

We believe that policy makers should delay changes that would create another layer until it is unquestionably clear that the market correction is not enough to erode the 97% market share sufficiently

to provide less systematic vote recommendations. Full erosion is also not positive as it reduces the ability to monitor and offer advice on these companies.[10]

Focus on the Tactics Employed

Political and public policy attention is likely to increase regarding the tactics that shareholder activists employ. During the implementation of the Dodd-Frank Act, the SEC focused some of its attention on hedge funds, but not necessarily shareholder activists or other event-driven hedge funds. These conversations echo sentiments that have been made about LBOs in the 1990s and the corporate raider era in the 1980s that restraint of particular activities or tactics is needed without restricting capital. Policy makers are weary of condemning all activities that bring capital into markets, as this is a position that represents only the far left and right fringes in politics.

A number of tactics employed by hedge fund activists have been driven by favorable tax treatment. One example is the Reverse Morris Trust ("RMT"), a complex legal strategy allows for a tax-free spin-off of real estate holdings often into a REIT. RMT has long been on the short list of offsets in the Senate Finance Committee and scored as a revenue-generator countless times by the Joint Committee on Taxation ("JCT"). There has been an increased use of RMT since 2011, and as a tactic employed by shareholder activists, which has likely increased the JCT scoring of using the provision. This makes RMT a more attractive offset for spending or new programs in drafted legislation. The example of Senator Durbin's comments above are typical of the attack one would see if the tactics came under fire.

There are other broader tax provisions that have been touched in numerous hearings over the last decade – carried interest, dividend and capital gains taxes, and corporate income tax that could impact the activity level of shareholder activism. Carve-outs, the narrowing of acceptable activities under these tax provisions, are always possible, but the attempt at a narrower definition often opens up a larger debate on tax reform.

A number of bills that Congress has enacted or debated over the past three congresses have dealt with tactics making it easier for activists to exert influence on a company through the proxy process. One

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[10] *As previously mentioned, our primary concerns stem from the categorical nature of many of the shareholder proxy advisory service firms vote recommendations. This provides a tool for activists rather than promoting the best corporate governance practices. The case comparison should be made with the guidelines that the exchanges (in particular the NYSE) put forth that identify areas for concern but do not require that boards declassify or remove poison pills.*

example is the non-binding say on pay provision included in the Dodd-Frank Act. Another provision, that has languished, involves company disclosure on political contributions. It is possible for Congress to set limits on these efforts to democratize shareholder rights and power, which would remove a few of the tactics from the activist playbook. Given the populist appeal of these provisions, it seems unlikely that this outcome would occur.

Oversight on Hedge Funds: Registration

The third policy priority would be to make regulatory changes increasing the amount of information available to policy makers about hedge funds in general. In a sense, reducing the information asymmetry between hedge funds and regulators. Since activist investing is the most prominent in the current business press, it would be easy for prominent policy makers to use negative stories as talking points. Activist investing fits well into the "anti-Wall Street" rhetoric that followed the 2008 financial crisis. Once the information asymmetry is reduced, the question is left up to policy makers if further actions are justified. But with additional information on hedge fund activities, it will certainly be easier for policy makers to make their case and increase pressure if the politics call for an action against hedge funds.

Another reason that public policy makers may believe that information collection matters is that the companies being targeted by activist hedge funds may have importance to the overall economy. Often these companies are headquartered in states or districts that provide a personal and immediate relevance to policy makers. Public policy makers may hear from the employees that were laid off following a strategic change pushed by a shareholder activist. A couple stories of these displaced workers is enough to call attention to that engagement by a public policy maker.

Since 2008, there has been a drastic shift in the conversation around employment and unemployment. The conversation is one that public policy makers have used to shore up re-election campaigns or contests against incumbents. It is a particularly sensitive topic in the political landscape. Unions and organized workers have been able to focus intermittent attention on the decisions of large companies. While little beyond a rhetoric shift has stuck, public policy making is iterative and builds on prior years. If enough of these workers that have been displaced by companies that faced shareholder activists organized, there could a large public policy response. However, the practical limitations to

organizing these displaced workers makes it unlikely that they would prevail in offsetting the political power that companies hold in the congressional ecosystem.

However, one way to begin the process of developing and appropriate public policy response is by reducing the information asymmetry between activist hedge funds and policy makers. Registration of hedge funds, knowing the extent of the AUM and number of firms, would allow public policy makers to understand what and if new action is warranted. The following paragraphs treat all hedge funds as one asset class, despite the significant differences between event-driven hedge funds and neutral hedge funds, because policy makers are unlikely to make a differentiation between the hedge fund sub-asset classes.

Prior to the 2010 Dodd-Frank Act, hedge funds were not legally required to register with the SEC. Hedge funds had fallen under an exemption for private funds, along with private equity, due to the fact that they were categorized as investment advisers to accredited investors ($200,000 in annual income or $1 million in net assets). The accredited investor criteria has been the reason cited by policy makers that hedge funds should not be a target for increased regulation, based on the view that private investment decisions by high net worth individuals should not warrant public attention. Since the 1998 Long-Term Capital Management implosion and subsequent the New York Federal Reserve Bank bailout, views have begun to change due to concerns over the financial systemic importance of hedge funds. Efforts to register hedge funds hit a boiling point in 2004, when the SEC passed a rule on a 3-2 vote to require registration. The rule was ultimately reversed in 2006 when a federal court vacated the rule. Registration remained in limbo until passage of the Dodd-Frank Act.

The SEC implemented a rule from the Dodd-Frank Act that required hedge funds to register as of March 30, 2012. As a result of this new regulation and disclosure requirement, an additional 38% or 1,500 private fund managers registered with the SEC. However, plenty of opportunity remains for hedge funds to claim an exemption (funds under $100mm and those that do not use the postal system), so the basis for reporting on hedge funds is generally an aggregation of multiple proprietary databases that serve as a best guess (Cassar, 2015). For instance, a total of 7,372 private funds with $1.9 trillion in AUM (some private fund managers advised multiple funds) filed with the SEC that they were exempt. Thirty percent of the AUM were for hedge funds, which totaled $570 billion. (SEC Documents, January 2013).

The criticism for requiring hedge funds to register is that many of the smaller funds would face a larger impact of the registration requirement. Perhaps it was never profitable or feasible for these smaller funds in the first place to operate as hedge fund. With a smaller AUM, perhaps these hedge funds should

look at other asset classes that better balance risks at that investment level. The question remains open as to whether hedge funds should register with the SEC.

Other Considerations: SEC & Beyond

It is difficult to speculate on rule changes at the SEC level. The benefit of the SEC is that it oversees the practices of companies as well as those of financial institution disclosure. In December 2013, the current head of the SEC, Mary Jo White, publicly expressed her overall support for shareholder activists and shoring up poor corporate governance practices (Lynch, 2013). This signaling from the SEC indicates that there is not an agenda against activist hedge funds. With the recent caveat that Ms. White expressed some concern over what shareholder activists were saying in media at a conference in New Orleans in March 2015 (Gandel, March 2015). There have been a number of provisions aimed at shareholder activists that have been proposed in the context of the larger public and business press discussion of shareholder activism. These provisions include:

(1) Changing the 13D filing deadline to lessen the shock of an activist investor (some proposed down to a 1-day timeline after 5% of a company is purchased);

(2) Altering communication practices to restrict shareholder activists from reaching to institutional investors; and

(3) Removing the ability of shareholder activists to voice their theories in the business press.

It is too early to determine if any of these ideas will gain momentum, but it is important to consider them in the context of the future of shareholder activism. Currently, shareholder activism is not a big enough of a public policy concern to push the registration conversation further. Therefore, we believe that it is unlikely Congress will do anything unless shareholder activism triggers a large public failure or outcry. For both companies, activists, and advisors the issues highlighted above are worth considering as shareholder activism continues to grow.

Conclusions & Areas for Further Study

Our research leads to believe that shareholder activism is here to stay and likely to continue its rise, so long as the macroeconomic and policy conditions allow it. The corporate raiders of the 1980s evolved into what we see today's Shareholder Activism 2.0. Many of the pressures that led to the emergence of activism are likely to remain and even intensify. Thus, the relative rate of change, in both tactics and organization, will likely continue. Mark Twain is credited with saying that "history does not repeats itself, but it often rhymes;" activism has suffered a transformation with each U.S. economic cycle, and we expect this to continue being the case.

While we are unsure of exactly what shareholder activism will look like in the future, a few key considerations were identified during the course of our research:

- The emerging success of activists targeting larger companies
- The increasing ability of activists to take smaller stakes, without loosening control
- The increasing duration and stability of activist hedge funds' capital bases, which allows for longer holding periods
- The shift underway within many institutional investors to become more active shareholders

Given another semester, we would delve into details of corporate governance practices, in particular the emerging consensus among institutional investors for what sorts of practices best serve their interests, and demarcate the narrow lines between when an activist makes a go or no-go decision on a company. Both of these provide additional insights into the inner mechanics of shareholder activism. In sum, we observed an incredible amount of due diligence on the part of the activist, and at the core of all of our recommendations, we urge the same level from companies that plan to stave off an ill-founded activist attack, or to make such an attack unnecessary by remediating subpar performance. Companies can compete on an even playing field by doing their best (e.g. maximizing RTSR), which in turn reduces the alpha or premium that an activist gains from day one. Perhaps, in the end none of this matters: activism is a hot asset class, and like many such classes its moment may pass. If the activists lose market credibility, perhaps for perceived unfair and extractive practices that permanently erode firm value, perhaps for a few large bets gone wrong or for adverse interest rate scenarios – LP money would flow out of the asset class, and end the activist moment.

Such a realignment is possible, but unlikely. If history is a reliable guide, activism will abate only under the weight of its own success – when companies have been hounded into raising their game, the

activists will run out of targets, out of alpha, and out of capital. Or until the policy landscape changes. But until then, activism marches on.

APPENDICES

Appendix A - Review of Academic Literature & Published Articles in Business Press

Academic Research

Admati, A. R., & Pfleiderer, P. (2009). The "Wall Street Walk" and Shareholder Activism: Exit as a Form of Voice. *Review of Financial Studies.*

> This paper discusses the ability of a large shareholder to sell his/her stake and whether it can affect managerial decision making and/or agency issues. The paper lays out a series of scenarios involving different information asymmetries between managers, a large shareholder and other shareholders. The 'disciplining' effect of a large shareholder exists for some scenarios where the presence of the shareholder increases the likelihood that the manager will act in a way that is more beneficial to shareholders but in other scenarios, the presence of the large shareholder actually exacerbates the agency problem.

Armstrong, C. S., Balakrishnan, K., & Cohen, D. (2012). Corporate Governance and the Information Environment: Evidence from State Antitakeover Laws. *Journal of Accounting and Economics*, 53(1–2), 185-204. doi:http://dx.doi.org/10.1016/j.jacceco.2011.06.005

Brav, A., Jiang, W., Partnoy, F., & Thomas, R. (2008). Hedge Fund Activism, Corporate Governance, and Firm Performance. *The Journal of Finance*, 63(4), 1729-1775.

> Paper tries to measure effects of HF economic activism on TSR, as well as fundamentals, and to categorize it according to the type of activism attempted. Paper only considers cases in which 13Ds have been filed, since it uses 13D filings to identify activism. Authors reach the following conclusions: 1) HF Activism produces positive TSR over a 5 year period, with strongest returns at the start, 2) attempts to sell company, break it up or change business strategy produce the strongest returns, governance changes the weakest, 3) fundamentals (measured by ROS and ROA) increase after activism, 4) target firms are characterized by high CEO pay, which mean-reverts after activism.

Brav, A., Jiang, W. & Kim, H. (2010). Hedge Fund Activism: A Review. *Foundations and Trends in Finance.* Vol. 4, No. 3 (2009) 185–246.

Bebchuk, L. A., Brav, A., & Jiang, W. (2013). The Long-Term Effects of Hedge Fund Activism. *Columbia Law Review*, 114(June 2015), 1-87.

> The authors empirically test the claim that interventions by activist hedge funds have on average a value destroying effect on the long term interests of companies and their shareholders and find that the claim is not supported by the data (the myopic activist claim). They assert that the empirical rejection of the myopic activist claim should weigh against arguments for limiting the rights and involvement of shareholders in general of short-term shareholders in particular, by using staggered boards, avoiding reforms of corporate elections and tightening the disclosure rules governing stock accumulations by activist investors and suggest that corporate boards should not take a generally adversarial attitude towards activist interventions.

Bebchuk, L. A., & Robert J. Jackson Jr. (2014). Toward a Constitutional Review of the Poison Pill. *Columbia Law Review*, 114(6), 1549-1593.

Cassar, G., Gerakos, J., Green, J., Hand, J., & Neal, M. (2015). Hedge Fund Voluntary Disclosure. *Social Science Research Network.*

Chu, J. S., & Davis, G. F. (2013). Who Killed the Inner Circle? The Collapse of the American Corporate Interlock Network. [The Collapse of the American Corporate Interlock Network (September 11, 2013)] SSRN.

> This paper examines the factor by which different public corporations are interlocked. It concludes that the "inner circle" that has existed for most of the 20th century has largely collapsed. Recent actions, past couple decades, have further reduced the incentive and ability to have directors on multiple companies' boards.

Cohn, J. B., & Rajan, U. (2013). Optimal Corporate Governance in the Presence of an activist Investor. *Review of Financial Studies*.

> This paper examines the external and internal governance of a company. Says that the external governance (originated by activists) is a compliment to the internal governance. It contends that that there is almost an optimal point to ensure the right checks and balances for a company -- not quite a shareholder democracy or a large blockholder autocracy. It is somewhere in between that optimizes the company's response and treatment of the inherent agency problem between owner and manager.

Davis, G. F. (2008). A New Finance Capitalism? Mutual Funds and Ownership Re-Concentration in the United States. *European Management Review*, 5(1), 11-21.

Davis, G. F. (1991). Agents Without Principles? The Spread of the Poison Pill through the Intercorporate Network. *Administrative Science Quarterly*, 36(4), 583-613.

Davis, G. F., & Useem, M. (2002). Top Management, Company Directors, and Corporate Control. *Handbook of Strategy and Management*, 233-259.

Fama, E. (1980). *Agency problems and the theory of the firm*. Journal of Political Economy 88: 288-307

Gantchev, N. (2013). The Costs of Shareholder Activism: Evidence from a Sequential Decision Model. *Journal of Financial Economics*, 107(3), 610-631.

Gillan, S. L., & Starks, L. T. (2000). Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors. *Journal of Financial Economics*, 57(2), 275-305.

Gillan, S., & Starks, L. T. (2007). The Evolution of Shareholder Activism in the United States. Available at SSRN 959670.

Goranova, M., & Ryan, L. V. (2014). Shareholder Activism: A Multidisciplinary Review. J*ournal of Management*, 40(5).

Holderness, C. G. (2009). The Myth of Diffuse Ownership in the United States. *Review of Financial Studies*, 22(4), 1377-1408.

Johed, G., & Catasús, B. (2015). Institutional Contradictions at and around the Annual General Meeting: How Institutional Logics Influence Shareholder Activism. *Accounting, Auditing & Accountability Journal*, 28(1), 102-127. doi:10.1108/AAAJ-08-2012-01073

Karpoff, J. M. (2001). The Impact of Shareholder Activism on Target Companies: A Survey of Empirical Findings. Available at SSRN 885365.

> The author summarizes a variety of studies performed on shareholder activism prior to the time of writing. Basic conclusion is that there are many inconsistencies in previous studies (Ie. how a "successful" activist resolution is defined, the time frame considered, lack of control for public vs. private movements, etc). Despite inconsistencies across studies, there is general consensus that little evidence suggesting shareholder activism materially impacts firm value, CEO turnover or CEO compensation; there is, however, evidence of unusually high rates of company and governance restructurings and divestitures.

Livingston, D. (1997), Clarifying the CNN Effect: An Examination of Media Effects According to Type of Military Intervention, *Joan Shorenstein Center on Press, Politics and Public Policy, Harvard University, John F. Kennedy School of Government,* Research Paper R-18

Prevost, A. K., Rao, R. P., & Williams, M. A. (2012). Labor Unions as Shareholder Activists: Champions or Detractors? *Financial Review*, 47(2), 327-349. doi:10.1111/j.1540-6288.2012.00331.

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Harvard Business Review

Barton, D., & Wiseman, M. (2015). Where Boards Fall Short. *Harvard Business Review Online.*

Barton, D., & Wiseman, M. (2014). Focusing capital on the long term. *Harvard Business Review Online.*

George, B., Lorsch, J. W., & Schweppes, C. (2014). How to outsmart activist investors. *Harvard Business Review*, (May 2014).

Lorsch, J. W., & Clark, R. C. (2008). Leading from the boardroom. *Harvard Business Review*, April 2008.

Sonnenfeld, J. A. (2002). What makes great boards great. *Harvard Business Review*, September 2002.

Sonnenfeld, J., Kusin, M., & Walton, E. (2013). What CEOs really think of their boards. *Harvard Business Review*, 80, 9, 98-106.

Media & Online Publications Articles

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Chon, G. (2010, September 3). Wall Street's New, Unknown Power Broker. Retrieved April 13, 2015, from http://www.wsj.com/articles/SB10001424052748704855104575470024231652304

Chung, J., & Benoit, D. (2015, March 18). Jana Partners Sells 20% Stake in Firm. Retrieved April 12, 2015, from http://www.wsj.com/articles/jana-partners-sells-20-stake-in-firm-1426712659

Cunningham, L. (2015, January 25). The Secret Sauce of Corporate Leadership. Retrieved April 13, 2015, from http://online.wsj.com/articles/lawrence-a-cunningham-the-secret-sauce-of-corporate-leadership-1422231824

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Appendix B - Case Studies

Company	Sector	Date	Activist	Type	Proposal	Proxy?	Win?	Resolution	Board Seat	Buyback	Sale	Breakup	ost-Cutting	apex / R&D	Exec Comp	Comment
Heinz	Consumer Goods	May '06	Trian	Agitator	Board seats, boost buybacks, explore ways to increase SHV	Yes	Yes	Proxy fight, Peltz wins. Firm later sold to 3G and Buffett	✓	✓	×	×	×	×	×	
JC Penney	Retail	Oct '10	Pershing Square	Agitator	Board seats, replace CEO, rejuvena brand, cut costs, rebrand, pricing	No	No	New CEO brought in from AAPL, forced out. Ackman sells out of JCP at 50%+ loss in 2013	✓	×	×	×	✓	×	×	The classic example of an activist betting on management team and failing.
ITT	Industrials	Jan '11	Relational	Agitator	Breakup company	No	Yes	Company agrees to breakup, avoids proxy fight	×	×	×	✓	×	×	×	
Kraft	Consumer Goods	Jun '11	Trian	Partner	Pressed for CBY merger, and MDLZ divestiture	No	Yes	Mondelez snacks business spun out after CBY merger. Peltz appointed to MDLZ board	×	×	×	✓	×	×	×	
Illinois Tool Works	Industrials	Feb '13	Relational	Partner	Reduce divisions, abandon M&A driven growth, simplify business model	No	Yes	Divisions rationalized	×	×	×	✓	✓	×	×	
CommonWealth	Real Estate	Mar '13	Corvex	Agitator	Change company structure, bylaws	Yes	Yes	Proxy fight, board replaced, structure changed	✓	×	×	×	×	×	✓	
Pepsi	Consumer Goods	Jul '13	Trian	Agitator	Sell beverage division or merge with Mondelez	No	No	Trian agent added to board	×	×	×	✓	×	×	×	
DuPont	Chemicals	Nov '13	Trian	Agitator	Divestiture, cost-cutting, board seats	Yes	TBD		✓	×	×	✓	✓	✓	×	
Dow	Chemicals	Dec '13	Third Point	Agitator	Divestiture, board seat	No	No	Third Point nominees go on board	✓	×	×	✓	×	×	×	
Darden Restaurants	Restaurants	Dec '13	Starboard	Agitator	Replace all board, fire CEO	Yes	Yes	Board replaced	✓	×	×	✓	✓	×	×	A rare instance of a full board change occurring as a result of activism. Changed the game
Bob Evans Farms	Restaurants	Jan '14	Relational	Agitator	Replace board, spin-off RE, begin franchising	Yes	Yes	Most directors replaced	×	×	×	×	×	×	×	
Timken	Industrials	Jan '14	Tom Sandell	Agitator	Breakup company	Yes	Yes	Proxy fight, company splits	×	×	×	✓	×	×	×	
Yahoo	Technology	Sep '14	Starboard	Agitator	Spinoff, buybacks, merge with AOL	No	No	Ongoing	×	✓	×	✓	×	×	×	
Apple	Technology	Oct '14	Icahn	Agitator	Buyback	No	No	AAPL increases buybacks	×	✓	×	×	×	×	×	Icahn gets the world largest company to yield with ~1% of shares
General Motors	Auto	Feb '15	Harry Wilson	Agitator	Buyback, board seat	No	No		✓	✓	×	×	×	×	×	
Walgreens	Retail	Jul '14	Jana	Agitator	Cut costs, board seats	No	Yes	Jana won two seats	✓	×	×	×	✓	×	×	Jana won 2 board seats with a mere 1.2% of shares
eBay	Technology	Apr '14	Icahn	Agitator	Spinoff Paypal	No	Yes	Paypal spun off	×	×	×	✓	×	×	×	Icahn forced eBay to spinoff Paypal without strong takeover defenses
BNY Mellon	Financial Services	Jun '14	Trian	Agitator	Breakup custody and asset management businesses	No	No	Peltz wins a board seat	✓	×	×	✓	×	×	×	
Valeant	Pharma	Mar '14	Pershing Square	Agitator	Merge with Allergan	No	No	Actavis tops Valeant offer for Allergan	×	×	×	×	×	×	×	An unsual example of an activist promoting a hostile takeover by its target
Hertz	Services	Jan '14	Icahn	Agitator	Replace CEO, breakup, cut costs	No	TBD	Hertz splits off HERC division	×	×	×	✓	✓	×	×	
McDonalds	Restaurants	Nov '14	Ackman	Agitator	Split property into REIT	No	TBD	Ongoing	×	×	×	×	×	×	×	

Appendix C- Interviews

Interview	Industry	Role	Observations
A	University	Academic	● It's important to understand the full history of activism -- look at its evolution since beginning of 80s and takeover trend ● Management transparency doesn't do enough, the only real actions that exist to fix a company that is out of bounds is a takeover, or appoint someone to the board who will undertake the strategy you want
B	University	Academic (x2)	● "Cookie cutter" idea of shareholders does not make sense. Companies need to understand classes of shareholders, activists, institutionals, union pensions etc. ● Knowledge spill-overs -- without serving on other boards, there is no way to cross check strategic decisions. Sophisticated investors are supplanting this loss of knowledge.
C	Industrials	Executive (x3)	● Demonstrated a very pro-active and strategic IR function that both monitored market movements, and rotated operating executives into IR to better communicate strategy and finances, played simulations of activist attacks and kept a list of good and bad guys ● Activists agendas usually not new (issues), usually (an issue that has been) raised before ● Listen to activists and learn from them when they bring new perspectives to the table, ignoring activists is the worst possible course of action
D	Industrials	Executive	● Company already had things on its list for growth when the activist fund contacted them, and in fact had a bigger agenda. ● In order to buy credibility with activist, they agreed to give up a board seat
E	Automotive	Executive	● Categorize the activist correctly -- short term (bad) and long term (good). ● IR is a central function within the company. IR head reports directly to CEO. Company does a vulnerability assessment by accounting for all shares. Looking each investor up in the database (Thomson), watching movements and volumes.
F	Advisory Services	Advisor	● Activist investing is a real two edge sword, in one dimension it is a tremendous force for good. It brings a private equity mind set to public markets which is valuable because too many companies are burdened by their investors instead of people who should be communicated with effective IR. ● Too many companies with IR and treasury strategies about managing cash growth for company instead of balance between company and shareholders. ● Generally not good for long term sustainable performance for companies, but serves as a wakeup call to boards. Most activists are jerks that provide a valuable service. "Useful but painful to remind boards of the fiduciary duty" ● Instead of really understanding their shareholder base and treating the cash as shareholders instead of the companies they created a window for activists to take a position. (Could have given shareholders a special dividend or returned cash to shareholders to preempt activists, Relational had a point to make) Naiveté or neglect of shareholder base can lead to opportunities for activists. ● If you don't have arbitrageurs/activists in the market, there will be opportunities. You need these characters in the markets to keep the market efficient. You need someone agitating. If everyone were to put these things in place (not all of them will) and the role of activist investors disappeared, a company would get fat dumb and happy again and the role of activists would return.

G	Advisory Services	Advisor (x2)	● In a proxy contest you are always deciding between 2 strategic options. If you can't demonstrate that harm has been done or that the company has underperformed or underperformed its potential you will not win. If you look back at Sander Squire, there was anger about the sub-optimization and performance. ● Canadian Pacific in 2012 or Hess. Best run proxy contests. Had very large HFs running them. They could put enough money at work that they could tease out the aspects of their agenda and make a good economic case. Most shareholders are too conservative to vote for change when they don't have a recommended new board member with a case for why they can drive change. ● How compelling is the dissident's argument about what can be done differently. HP lost their cash on Autonomy, whole point of due diligence is to ask the tough questions. The question is not did they perform differently, but what would you do differently moving forward because you can't "un-ring that bell".
H	Advisory Services	Advisor	● The real change is that the fights have become about the boards and how activists will attack board members. If an activist has an idea, companies are meeting the activists pretty quickly. When they don't think the activist agenda is good, then the argument goes public and the activists question their reputation. ● There aren't many contests that go to votes, most have settlements. A couple have 'gone to the mat' where there are changes to the board and the specter of losing has driven more corporations to settle. Often times the shareholders want changes. Bigger question is are the activists always right in these situations. ● Activists are taking credit for everything that happens at the company that's good, and that anything that is bad is evidence that they need more of the activist. They even taken credit when the companies do the opposite of what the activists were fighting for.
I	Industrials	BOD	● The Starboard takeover at Darden was a high water mark for activism. ISS supported Starboard's majority slate (all 12 directors). They won and essentially took over a massive company. This changed everything. What activists want, more than anything else, is to be heard Activists trying to gain board representation is likely to be an increasing trend as activists tend to be highly confident, even egocentric, and they want control. They want to get on the board, get access to inside info and influence strategy and the direction of the company. This brings a highly-politically charged environment to the boardroom.
J	Banking	Advisor	● It's important to get in front of the client early. After an activist submits a 13-D, "Most banks will 'ambulance chase' that news with proposals communicating their capabilities and qualifications" ● To the extent that you believe an activist will approach with an 'ill informed' agenda, you have to do a good job of investor relations to let them know what you are doing. ● On activists and their styles: We have profiles that include their MO, their psychology, what firepower they have, have they made money for their shareholders. All of this gets put together for the client.
K	University	BOD / Academic	● The reason we've seen persistence in activism over decades is that there are companies and boards that underperform which become resistant to change and complacent. Just as in nature, predators ensure survival of the fittest over the long haul. ● It's been pretty clear that many activists have something valuable to offer. On how to react to activist campaign: The most important thing is for management and the board to keep eyes on the ball… where the ball is strategy, execution, people and succession. That's what they are paid for and that is the most important thing.

			Everything else is a distraction.
L	Hedge Fund	Activist (x2)	● If they could find pacifist investments and make good money they would do that, activism is a tool that they've used but not a strategy. ● In general what you find is there are 2 types of activism. I'm pushing on an open door and management has already decided to do these things. If management is already doing it and they don't want to give activists the credit for pushing. You get luck with timing of your arrival. ● Running activists campaigns is analogous to running a political campaign. We focus a lot on ISS and other proxy services. Generally in the current environment you don't have to work too hard to convince the long-onlys. Make sure that you are running a hearts and minds campaign, even more broadly than the shareholders. ● Activism is pro-cyclical, not much activism when markets are going down a lot. It's really hard in declining market, if someone feels like you're a trapped shareholder, they will be unlikely to buy more and maybe practical and sell. Other thing is that however high quality your capital is
M	Restaurants & Food	BOD	● There are good and bad activists. Took the battle from being public to being personal. The result of the engagement is that the board pays attention better. But believes that the long-term impact [of activism] is not totally understood. ● Hard to step in and question things as a new board member. Believes in the value of on boarding and agendas. However, when pressed admitted same analysis run by the activists had not been readily available for the board. She said that bankers were brought in annually to discuss related issues. ● Board gets better before management, not the other way around.
N	Hedge Fund	Activist	● Need to operate as an owner first. Owners have "staying power". Companies in the public market are orphans. Companies are too large to not have an owner. ● He was asked to join in efforts led by an activist to oust board of a company with egregious provisions in its bylaws. Stock was trading at 50% NAV -- discount due to practices. Needed 2/3 to approve proxy. 20mm shares were held up in a swap that counted as no. This made the vote margin much closer than it actually was. Received stock options. Came down to two meetings with Vanguard and Blackrock. Pointed to Vanguard's letter to every CEO of all portfolio companies. ● There's a lack of inertia at public companies. Activists are just investors. Believes that there is little incentive in the room. Activist is not in business to make friends. Most important thing that an activist brings is a different mindset.
O	Banking	Advisor	● Often asked by companies to educate new board members to review all the options. The full board has access to the information but do not necessarily use all of it. Biggest value they contribute is being valuation experts. ● Developed a risk metric system to assess companies. Not able to quantify everything. Some key risk identification characteristics are: average duration of board member -- measure of new blood on board, conglomerate discount, and one year of liquidity (in U.S. and in Europe 1.5 years due to credit concerns), etc. Multiples driving some of the activity. LBO involves too much equity to get the return required. ● Deal structure is 3x-4x leverage. Carrying cost of activist investments has never been lower. Activists extinguish themselves when they over proliferate. Icahn is unique because he has no need for fundraising and is market neutral. Timeliness of disclosure is a major issue. Thinks that SEC exemptions given for 13Ds is a major issue -- with Buffett championing it.

P	Insurance	Executive	● Called Ackman a stock picker type of activist. Said that there are two types of activists: quiet partner and stock pickers. Believes the rise of the media pundit, but the activist has always been here. Activists are masterful marketers. Activists prey on lack of trust. ● Three times a year, company speaks to about 30% of its shareholders just about corporate governance issues. Represents one of the strongest IR practices. Company rotates people from other departments through IR to given a fuller view of the company. ● CEO's job is to bring the outside in, such as bringing in new ideas, perceptions and unique application of strategy. Being an activist does not automatically mean bright. Perceives that only a small number of people are filing proxies. Called them robo-proposals and decide how series to take an attempt. Also, believes that spelling out key metrics for shareholders is a net positive and reduces shareholder risk. Thinks that smartest people do not necessarily work at index funds. The goal is to simply go long term.
Q	Legal	Advisor	● You have some [activists] who are focused on improving poorly performing companies for which you can't quarrel, and then you have others who target good performing companies trying to force them to make structural changes which could damage the company over the long run. ● Institutionals have outsourced governance responsibilities to ISS. If you are going to do that you should police it to make sure that you are getting accurate recommendations/evaluations. Some of the hedge funds have discovered that they can do the same thing as ISS.
R	Hedge Fund	Activist	● Legal architecture used for activism is legacy of 1960s reforms ● Activists balance the cost of additional information gained against restraints imposed by deals and/or becoming insiders. Everything is a negotiation, and every action is weighted against its potential to accelerate the value catalysts ● Activism is run like a political campaign
S	Restaurants & Food	Executive	● Large asset managers approach this through fundamental analysis. They are looking for the best representative to bring about performance. Concerned with the quality of management. ● ISS and Glass Lewis typically do not act out of context. Guidelines come from what clients want, they are not made up. This is often lost.
T	Asset Manager	Institutional Investor	● The quality of the directors, the right skills, do they have deep experience, are they getting enough new blood. At times it's apparent that there are sleepy directors on the board sometimes. Someone said directors are where executives go to die. ● I have worked on creating more robust guidelines, unfortunately we still have to rely a lot on Glass Lewis because of the volume. We meet quarterly and review the research that's out there to make sure we're voting in the best interests of shareholders. In terms of the activist situations we are reliant on Glass Lewis.
U	Advisory Services	Advisor	● In the 1980s, started working and there were barbarians at the gate, corporate raiders were the flavor of the day. Form of activism was focused on corporate control transactions. ● On the side of a company, two dimensions. First, during peacetime, before activist action, requires helping clients know given current state and how to be prepared. Second, management needs to have a comprehensive understanding how decisions are made around capital allocation. ● Capital allocation review process needs to be financially rigorous. Capital allocation has interdependencies, but rarely the alternatives are considered. We're at an interesting inflection point. Public companies are being run like private equity.

			Everyone is making money and we wouldn't had have these opportunities without activism. But there is a philosophical question -- what about disruption and the jobs that activism often causes? We need to have an economy.
V	Hedge Fund	Activist	● Yes, activists can come up with better plans. Doesn't necessarily mean the plans they propose are novel or better, just means that you can get changes. Often times they are asking for what bankers, analysts etc. have been asking for. None of what they are asking for from Yahoo was new. ● As an investment manager, we need to produce consistent results with positive alpha. If you go back historically and look at the different hedge fund strategies, the ones that produce the best results are the ones that possess an advantage. ● The problem is that when you get involved in a company that is not well functioning. Now you have a CEO, presenting in the same way, management is presenting a bunch of information. Board says okay. They think their job is to say okay. Not to cause major problems with management.
W	Legal	Advisor	● Activist pressures has never been greater since I've been working in the Delaware court system. Critical component of the activist program are efforts to open up shareholder elections, and restraining activist influence. Perspective of the courts is, with certain exceptions, is fairly agnostic. The courts view themselves as the promoters of an equal playing field, maintaining the balance of power between boards and stockholders. ● For the pro-activist standpoint, refusal by the court to prevent the manipulations of deadlines for voting and nominations, advance notice deadlines etc. The tactic that's being employed to restrict the activist is the adoption of the shareholder rights plan, with broad ownership requirements (time and stake).
X	Hedge Fund	Activist / Investor	● Important to define 'activism' – view each type of shareholder action differently. There are those who try to reform a company and those who try to make quick capital allocation decisions. ● Generally only discuss industries. If you talk specifics of a company, you can be considered a group and must file and report holdings together, other regulatory concerns. Comprehensive breakdown of the types of activism – more specific definitions.
Z	Professional Services	BOD (private company)	● Political considerations are often vital in activism and in turnarounds. ● Employees need to have a direct line to the board and officer within a company to quickly and accurately address issues. ● Key to shoring up company, that faced scrutiny, was to retain tight control over organization and remove corruption at every level, beginning with the management team.

Appendix D - About the Authors

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Gabriel Craft, MBA - Gabriel Craft is an MBA candidate at the University of Michigan focusing on Strategy and Human Capital. Before Ross, he worked for 2 years as an associate consultant for the Education Trust - West. In this role, Gabriel coordinated efforts between school governance boards and school district leadership to successfully implement large transformation projects in California's urban public schools. Before his consulting work experience Gabriel spent 5 years as a mathematics teacher, with time in the role split between positions in Los Angeles, CA and Santa Cruz, CA, his hometown. He will be joining PwC Advisory in San Jose, CA upon graduation. Contact Information: gacraft@umich.edu or (831) 428-2341.

Erick Goihman, MBA - Erick studied economics at the University of Pennsylvania. After graduation he spent four years with EY's Financial Services Office, where he focused on marketing and operations advisory. He is currently a second-year MBA concentrating in Strategy and Finance. Erick spent this summer with Treacy & Company, where he will return full-time upon graduation. Contact Information: goihman@umich.edu or (734) 548-2741.

Brandon Meloche, MBA - With an undergraduate degree in Mechanical Engineering, Brandon spent 6 years in the Automotive industry in Design Engineering, Product Management and Account Management. After a 3-year assignment based in several locations across Asia, Brandon enrolled at Ross with a focus on Strategy and Operations. He spent the summer of 2014 as an intern on the iPhone Operations team at Apple and will join Bain & Company in Chicago full-time upon graduation. Contact Information: bmeloche@umich.edu or (734) 353-8405.

Erica Sivertson, MBA, MPP - Erica is currently a MBA & MPP dual-degree student at the University of Michigan focusing on Strategy and Policy. Previously, Erica worked as a Director of Government Affairs at Quinn Gillespie & Associates and a legislative staffer (covered Dodd-Frank debate and economic issues) and Executive Assistant for U.S. Senator Amy Klobuchar in Washington, DC. Erica graduated from the University of Minnesota with bachelor in Finance and International Business. Erica will be joining Deloitte’s Strategy and Operations practice full-time in 2016 when she graduates. This summer she will be working in the executive office of Consumer Reports in New York. Contact Information: esiver@umich.edu or (612) 369-6115.

Tim Zepp, MBA - Tim studied electrical engineering at Duke University and spent 5 years after graduation working in SAP-based systems integration consulting for Accenture and Ernst & Young where he worked with the Defense and Financial Services industries. He enrolled at Ross with a focus on Finance and Strategy. He worked last summer as an investment banking associate with Jefferies in Charlotte, NC where he will return full-time after graduation. Contact Information: timzepp@umich.edu or (410) 245-0872.