Short-termism and Investor Engagement with Issuers

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THE ASPEN INSTITUTE

Long-Term Value Creation:

Guiding Principles for Corporations and Investors

LONG-TERM VALUE CREATION:

GUIDING PRINCIPLES FOR CORPORATIONS AND INVESTORS

The **Aspen Principles** represent an unprecedented consensus among companies, investors, and corporate governance professionals. In subscribing to these principles, and moving to implement them in their own organizations, subscribers are leading by example and taking a stand that a long-term focus is critical to long-term value creation.

As operating companies and institutional investors, we agree to:

- Work together and with others in the spirit of continuous improvement and ongoing communication, dedicating real resources to identifying and testing best practices for creating long-term value at our own firms;
- Support each other's efforts to promote metrics, communications, and executive compensation that create long-term value; and
- Support each other even in the face of internal and external pressures to compromise on these principles and default to short-term thinking.

We issue these principles as a call to action, and urge adoption of the Principles among other operating companies and investors. We believe the Aspen Principles, broadly adopted, can quite literally transform our capital markets – reinvigorating the ability of business to serve as the driver of long-term economic growth on a national scale, and to more fully serve the public good.

We particularly encourage boards of directors to consider the appropriate means to implement these principles.

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* *Co-convener of the Principles Drafting Committee*

The Aspen Institute's Corporate Values Strategy Group (CVSG) is dedicated to re-asserting long-term orientation in business decision-making and investing. Members of the CVSG share concern about excessive short-term pressures in today's capital markets that result from intense focus on quarterly earnings and incentive structures that encourage corporations and investors to pursue short-term gain with inadequate regard to long-term effects. Short-termism constrains the ability of business to do what it does best – create valuable goods and services, invest in innovation, take risks, and develop human capital. CVSG members believe that favoring a long-term perspective will result in better business outcomes and a greater business contribution to the public good.

The Aspen Principles offer guidelines for long-term value creation for both operating companies and institutional investors. The Principles were created in dialogue with CVSG members who—as leaders in both investment and business—sought to identify common ground from many sources, including the Business Roundtable, Council of Institutional Investors, CalPERS, CED, TIAA-CREF and others. To fully understand the spirit and nature of the Principles, it should be noted that:

1. The Principles are not intended to address every issue of contemporary corporate governance, but instead are designed to drive quickly to action in areas that *all parties* agree are critically important. CVSG members share a deep concern about the quality of corporate governance and favor effective communication between and among executives, boards, auditors, and investors. CVSG members will continue to engage in independent activities related to corporate governance issues not addressed here.
2. In drafting these Principles, members of the CVSG sought consensus and agreed that an overly-prescriptive approach would slow progress. The Principles are thus offered as guidelines, and are not detailed at a tactical level. Investors and companies, especially boards of directors, have the opportunity to innovate and adapt them to meet individual and evolving circumstances.

The Aspen Principles address three equally important factors in sustainable long-term value creation: metrics, communications, and compensation.[1]

1. Define Metrics of Long-Term Value Creation

Companies and investors oriented for the long-term use forward-looking incentives and measures of performance that are linked to a robust and credible business strategy. Long-term oriented firms are 'built to last,' and expect to create value over five years and beyond, although individual metrics may have shorter time horizons. The goal of such metrics is to maximize future value (even at the expense of lower near-term earnings) and to provide the investment community and other key stakeholders the information they need to make better decisions about long-term value.

In pursuit of long-term value creation, companies and investors should…

1.1 Understand the firm-specific issues that drive long-term value creation.

1.2 Recognize that firms have multiple constituencies and many types of investors, and seek to balance these interests for long-term success.

1.3 Use industry best practices to develop forward-looking strategic metrics of corporate health, with a focus on:

- enhancing and sustaining the value of corporate assets,
- recruiting, motivating, and retaining high-performing employees,
- developing innovative products,
- managing relationships with customers, regulators, employees, suppliers, and other constituents, and
- maintaining the highest standards of ethics and legal compliance.

1.4 De-emphasize short-term financial metrics such as quarterly EPS and emphasize specific forward-looking metrics that the board of directors determines are appropriate to the long-term, strategic goals of the firm and that are consistent with the core principles of long-term sustainable growth, and long-term value creation for investors.

2. Focus Corporate-Investor Communication Around Long-Term Metrics

Long-term oriented companies and investors are vigilant about aligning communications with long-term performance metrics. They find appropriate ways to support an amplified voice for long-term investors and make explicit efforts to communicate with long-term investors.[2]

In pursuit of long-term value creation, companies and investors should…

2.1 Communicate on a frequent and regular basis about business strategy, the outlook for sustainable growth and performance against metrics of long-term success.

2.2 Avoid both the provision of, and response to, estimates of quarterly earnings and other overly short-term financial targets.

2.3 Neither support nor collaborate with consensus earnings programs that encourage an overly short-term outlook.

3. Align Company and Investor Compensation Policies with Long-Term Metrics

Compensation at long-term oriented firms is based on long-term performance, is principled, and is understandable. *Operating companies* align senior executives' compensation and incentives with business strategy and long-term metrics. *Institutional investors* assure that performance measures and compensation policies for their executives and investment managers emphasize long-term value creation.

In pursuit of long-term value creation, companies and investors should implement compensation policies and plans, including all performance-based elements of compensation such as annual bonuses, long-term incentives, and retirement plans, in accordance with the following principles…

3.1 *How are Compensation Plans Determined and Approved?*
Executive compensation is properly overseen by a compensation committee of the board of directors. The board recognizes that…

a) The compensation committee is comprised solely of independent directors with relevant expertise and experience, and is supported by independent, conflict-free compensation consultants and negotiators.

b) The compensation committee calculates and fully understands total payout levels under various scenarios.

c) Boards and long-term oriented investors should communicate on significant corporate governance and executive compensation policies and procedures.

d) Careful strategic planning, including planning for executive succession, helps the board retain a strong negotiating position in structuring long-term compensation. The succession planning process is disclosed to investors.

3.2 *What are Executives Compensated For?*
Corporate and investor executives and portfolio managers are compensated largely for the results of actions and decisions within their control, and compensated based on metrics of long-term value creation [see Principle #1].

3.3 *What is the Appropriate Structure of Compensation?*
Compensation that supports long-term value creation…

a) Promotes the long-term, sustainable growth of the firm rather than exclusively short-term tax or accounting advantages to either the firm or employee.

b) Requires a meaningful proportion of executive compensation to be in an equity-based form.

c) Requires that senior executives hold a significant portion of their equity-based compensation for a period beyond their tenure.[3]

d) Prohibits executives from taking advantage of hedging techniques that offset the risk of stock options or other long-term oriented compensation.[4]

e) Provides for appropriate "clawbacks" in the event of a restatement of relevant metrics.

f) Requires equity awards to be made at preset times each year to avoid the appearance of market timing.

g) Ensures that all retirement benefits and deferred compensation conform to the general goals of the compensation plan.

3.4 *How Much Are Corporate and Investor Executives Compensated?*
Corporations and society both benefit when the public has a high degree of trust in the fairness and integrity of business. To maintain that trust, the board of directors…

a) Ensures that the total value of compensation, including severance payments, is fair, rational and effective given the pay scales within the organization, as well as the firm's size, strategic position, and industry.

b) Remains sensitive to the practical reality that compensation packages can create reputation risk and reduce trust among key constituencies and the investing public.

3.5 *How is Compensation Disclosed?*[5]
Public disclosure, fully in compliance with SEC rules, includes, in clear language…

a) Individual and aggregate dollar amount of all compensation afforded to senior executives, under various scenarios of executive tenure and firm performance.

b) The compensation philosophy of the board and the specific performance targets that promote the creation of sustainable value in the long-term.

June 2007

1. As this document is a reflection of existing sources, the greatest level of detail is offered on executive compensation. See the Appendix for a full list of organizations and sources of these principles.
2. In accordance with the SEC's Regulation Fair Disclosure
3. However, there may be circumstances in which boards should allow the sale or transfer of an executive's equity to accomplish purposes that do not alter the long-term incentive nature of the compensation.
4. In situations where senior executives are permitted to make personal equity trades that relate to their compensation, such trades should be fully disclosed ahead of time.
5. The new Compensation Discussion and Analysis requirements address disclosure requirements of the SEC.

Appendix

Sources of the Aspen Principles

1. Business Roundtable Institute for Corporate Ethics and CFA Centre, *Breaking the Short Term Cycle*
2. Business Roundtable, *Principles of Executive Compensation*
3. CalPERS, *Corporate Governance Core Principles and Guidelines*
4. Committee for Economic Development, *Built to Last: Focusing Corporations on Long-term Performance*
5. Council of Institutional Investors, *Corporate Governance Policies*
6. Financial Economists Roundtable, *Statement on Executive Compensation*
7. The Conference Board, *Report of the Commission on Public Trust and Private Enterprise*
8. TIAA-CREF, *Executive Compensation Policy*

Other Resources

9. Buffett, *2005 Letter to the Shareholders of Berkshire Hathaway, Inc*
10. Caux Roundtable, *Principles for Business*
11. Davis / McKinsey Quarterly, *How to Escape the Short-Term Trap*
12. EBR Consortium, *Enhanced Business Reporting Framework*
13. Gordon, *If There's a Problem, What's the Remedy?*
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18. Monks, *Corporate Governance in the Twenty-First Century*
19. Report of the NACD Blue Ribbon Commission on *Director Professionalism* (2005 Edition)
20. Report of the NACD Blue Ribbon Commission on *The Role of the Board in Corporate Strategy* (2006 Edition)
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22. Rappaport, *Ten Ways to Create Shareholder Value*
23. The Aspen Institute, *Corporate Values Strategy Group working groups*
24. The Conference Board, *Revisiting Stock Market Short-Termism*
25. United Nations, *Principles for Responsible Investment*
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27. Weil, Gotshal & Manges, *Seven Things Shareholders Want Directors to Understand in 2007*

The Corporate Values Strategy Group

The following individuals played an instrumental role in developing these Aspen Principles. While all contributed to discussions and/or document revisions, the listing of their name should not be construed as an endorsement of the final Principles on behalf of either themselves or their organization.

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The Harvard Law School Forum on Corporate Governance and Financial Regulation
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The Myth that Insulating Boards Serves Long-Term Value

Posted by Lucian Bebchuk, Harvard Law School, on Monday April 22, 2013

Editor's Note: Lucian Bebchuk is Professor of Law, Economics, and Finance at Harvard Law School. This post is based on his article, The Myth that Insulating Boards Serves Long-Term Value, forthcoming this fall in the *Columbia Law Review,* available here.

In a new study, The Myth that Insulating Boards Serves Long-Term Value (forthcoming, *Columbia Law Review*, October 2013), I comprehensively analyze – and debunk – the view that insulating corporate boards serves long-term value.

Advocates of board insulation claim that shareholder interventions, and the fear of such interventions, lead companies to take myopic actions that are costly in the long term – and that insulating boards from such pressure therefore serves the long-term interests of companies and their shareholders. This claim is regularly invoked to support limits on the rights and involvement of shareholders and has had considerable influence. I show, however, that this claim has a shaky conceptual foundation and is not supported by the data.

In contrast to what insulation advocates commonly assume, short investment horizons and imperfect market pricing do not imply that board insulation will be value-increasing in the long term. I show that, even assuming such short horizons and imperfect pricing, shareholder activism, and the fear of shareholder intervention, will produce not only long-term costs but also some significant countervailing long-term benefits.

Furthermore, there is a good basis for concluding that, on balance, the negative long-term costs of board insulation exceeds its long-term benefits. To begin, the behavior of informed market participants reflects their beliefs that shareholder activism, and the arrangements facilitating it, are overall beneficial for the long-term interest of companies and their shareholders. Moreover, a review of the available empirical evidence provides no support for the claim that board insulation is overall beneficial in the long term; to the contrary, the body of evidence favors the view that shareholder engagement, and arrangements that facilitate it, serve the long-term interests of companies and their shareholders.

I conclude that, going forward, policy makers and institutional investors should reject arguments for board insulation in the name of long-term value.

Here is a more detailed account of the analysis in the article:

According to the board insulation view, inefficient capital markets and short investor horizons couple to produce a problem of "short-termism." Short-termism refers to companies taking actions that are profitable for the short term but value-decreasing in the long term, such as increasing near-term earnings by cutting research that would pay off later on. Activist investors with short investment horizons, it is argued, seek such actions and often succeed in pressuring companies to take them. Furthermore, it is argued, when corporate arrangements facilitate shareholders' ability to replace or influence directors, fear of activist intervention in the absence of satisfactory short-term results produces pressure on management to focus excessively on these results to the detriment of long-term value.

Insulation advocates contend that the long-term costs of short-termism, produced by both shareholder interventions and fears of such interventions, make it desirable to shield boards from shareholders. The long-term interests of companies and their shareholders are best served, these advocates argue, by insulating boards from shareholder pressure and enabling them to focus on enhancing long-term value.

The stakes in this debate are large. Arguments supporting the long-term benefits of board insulation have played a central role in corporate law policy debates for at least three decades. These arguments have been advanced by prominent legal academics, significant economics and business school professors, management thought leaders, influential business columnists, important organizations, a recent report commissioned by the British government, and noted corporate lawyers. Indeed, invoking the alleged long-term benefits of board insulation has been a standard and key argument in a wide range of significant corporate law debates, including those in support of takeover defenses, impediments to shareholders' ability to replace directors, and limitations on the rights of shareholders with short holding periods.

Furthermore, insulation advocates have been successful in influencing important public officials and policy makers. Chancellor Leo Strine and Justice Jack Jacobs, prominent figures in the Delaware judiciary, have expressed strong support for this view. Congress held hearings on the subject. William Donaldson, when he was chair of the SEC, accepted that short-termism is "a critical issue," and short-termism arguments persuaded the SEC to limit use of the proxy rule adopted in 2010 to shareholders that have held their shares for more than three years. Even

institutional investors, which are otherwise reluctant to support limiting shareholder rights, have shown significant willingness to accept the validity and significance of short-termism concerns.

The substantial impact of the claims made by insulation advocates may be at least partly due to the asserted gravity of the concerns they have expressed. Insulation advocates have argued that short-termism has “substantial corporate and societal costs,” “has created a national problem that needs to be fixed,” represents “a disease that infects American business and distorts management and boardroom judgment,” and has “eroded faith in corporations continuing to be the foundation of the American free enterprise system.” Indeed, insulation advocates have even viewed shareholder pressure as causes for the Enron and WorldCom scandals, the crash of 1987, and the excessive risk taking by financial firms in the run-up to the financial crisis of 2008–2009.

While insulation advocates have used strong rhetoric in expressing their concerns, they have failed to provide an adequate basis for their claims. These claims rely on critical and unsubstantiated premises, overlook the significant long-term costs of board insulation, and are not backed by evidence. Indeed, I show in this paper that an analysis of the long-term effects of board insulation, informed by the relevant theoretical and empirical literature, does not support such insulation.

To begin, insulation advocates often fail to acknowledge that they are advancing empirically contestable propositions whose validity cannot be derived from theory or intuition. Contrary to what insulation advocates commonly presume, even assuming the existence of inefficient capital markets and short investor horizons, it does not follow from these assumptions that the long-term effects of board insulation are overall positive. Under these assumptions, board insulation might produce some long-term benefits – but these benefits might still be outweighed by significant countervailing costs.

In particular, with inefficient market pricing and short investor horizons, it is theoretically possible that activists might in some cases seek actions that are not value-maximizing in the long term. The question remains, however, how often such situations do arise and, furthermore, whether the expected costs of such situations exceed the expected benefits from activists’ clear interest in seeking actions that are positive for both the short term and the long term.

Similarly, with inefficient market pricing and short investor horizons, fears of activist intervention and the arrangements facilitating it might theoretically lead some management teams to make distorted decisions with respect to long-term investments. However, the expected costs of such decisions have to be weighed against the expected long-term benefits of activist stockholder

interventions and the accountability and discipline they produce. Such accountability and discipline provide incentives to avoid shirking, empire building, and other departures from shareholder interests that are costly for both the short term and the long term.

Turning to examine the balance of costs and benefits associated with board insulation, I point out patterns of behavior that reflect a widespread and consistent view among sophisticated and well-informed market participants that activist interventions, and arrangements facilitating them, do not overall decrease value in the long term. The lack of investment products and services based on the prediction that companies targeted by activists underperform in the long term suggests the absence of any significant group of long-term investors that are willing to bet money on the validity of this underperformance claim. Similarly, the overwhelming opposition to insulation-increasing arrangements reflected in the voting decisions of institutional investors, including investors with long investment horizons, indicates that these investors do not subscribe to the view that such arrangements serve long-term value.

These patterns should give insulation advocates some pause. They should be reluctant to maintain that they know the interests of investors better than investors themselves unless they have significant empirical evidence to back up their views. Insulation advocates, however, have thus far failed to provide such evidence. They often failed to acknowledge the need for evidence or offered their experience as evidence.

Fortunately, empirical evidence that can shed light on the long-term effects of board insulation has been accumulating over the past decade. I provide a full review and analysis of the relevant empirical work by researchers, including work in which I have participated. As to activist interventions, existing empirical evidence – including a recent study by Alon Brav, Wei Jiang and I that analyzes the long-term effects of a large universe of activist interventions – provides no support for the view that such interventions are followed in the long term either by losses to the shareholders of targeted companies or by declines in the companies' operating performance of these companies. As to the fear of activist interventions, the body of existing empirical work again does not provide support for the view that stronger board insulation serves the long-term interest of companies and their shareholders.

To the contrary, the existing body of evidence favors the view that shareholders' ability to intervene and engage with companies provides long-term benefits to companies, shareholders, and the economy. This evidence indicates that activists target companies whose operating performance has been declining, and that their interventions are followed by improvements in operating performance that do not come at the expense of performance later on. Anticipating such improvements, market capitalization of targeted companies appreciates upon the

announcement of activist campaigns to levels that are not reversed in the long term. Furthermore, arrangements that insulate boards from shareholders and shareholder pressure have been consistently associated with lower firm value as well as with worse operating performance.

Given that available theory and evidence do not support the claims of insulation advocates, public officials and institutional investors should not be receptive to claims based on the asserted long-term benefits of board insulation. They should reject the use of such claims as the basis for rules, arrangements, and policies that limit the rights and powers of shareholders.

The study is available here.

The Harvard Law School Forum on Corporate Governance and Financial Regulation
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The Long-Term Effects of Hedge Fund Activism

Posted by Lucian Bebchuk, Harvard Law School, Alon Brav, Duke University, and Wei Jiang, Columbia Business School, on Monday August 19, 2013

Editor's Note: Lucian Bebchuk is Professor of Law, Economics, and Finance at Harvard Law School. Alon Brav is Professor of Finance at Duke University. Wei Jiang, Professor of Finance at Columbia Business School. This post is based on their study, The Long-Term Effects of Hedge Fund Activism, available here. An op-ed about the article published in the *Wall Street Journal* summarizing the results of the study is available here.

We recently completed an empirical study, The Long-Term Effects of Hedge Fund Activism, that tests the empirical validity of a claim that has been playing a central role in debates on corporate governance – the claim that interventions by activist shareholders, and in particular activist hedge funds, have an adverse effect on the long-term interests of companies and their shareholders. While this "myopic activists" claim has been regularly invoked and has had considerable influence, its supporters have thus far failed to back it up with evidence. Our study presents a comprehensive empirical investigation of this claim. Our findings have important policy implications for ongoing policy debates on corporate governance and the rights and role of shareholders.

Below is a more detailed account of the analysis in our study:

Activist hedge funds have been playing an increasingly central role in the corporate governance landscape, and their activism has been strongly resisted by many issuers and their advisors. Opponents of such activism have been advancing the "myopic activists" claim — that activist hedge funds push for actions that are profitable in the short term but are detrimental to the long term interests of companies and their long-term shareholders.

The problem, it is claimed, results from the failure of short-term market prices to reflect the long term costs of actions sought by short-term activists. As a result, activists seeking a short term spike in a company's stock price have an incentive to seek actions that would increase short-term prices at the expense of long-term performance, such as cutting excessively investments in long-term projects or the reserve funds available for such investments.

The myopic activists claim has far been put forward by a wide range of prominent writers. Such concerns have been expressed by significant legal academics, noted economists and business school professors, prominent business columnists, important business organizations, and top corporate lawyers.

Furthermore, those claims have been successful in influencing important public officials and policy makers. For example, Chancellor Leo Strine and Justice Jack Jacobs, two prominent Delaware judges, have expressed strong concerns about short-sighted activism. And concerns about intervention by activists with short horizons persuaded the SEC to limit use of the proxy rule adopted in 2010 to shareholders that have held their shares for more than three years.

The policy stakes are high. Invoking the long-term costs of activism has become a standard move in arguments for limiting the role, rights, and involvement of shareholder activists. In particular, such arguments have been used to support, for example, takeover defenses, impediments to shareholders' ability to replace directors, limitations on the rights of shareholders with short holding periods.

The myopic activists claim is a factual proposition that can and should be empirically tested. However, those advancing the myopic activists claim have thus far failed to back their claims with any large sample empirical evidence. Some supporters of the claim seem to assume the validity of their claims, failing to acknowledge the empirically contestable nature of their claim and the need for evidence, while other supporters of the claim have offered their experience as evidence.

At the same time, financial economists have produced significant empirical work on hedge fund activism. There is evidence that Schedule 13D filings – public disclosures of the purchase of a significant stake by an activist – are accompanied by significant positive stock price reactions as well as subsequent improvements in operating performance. However, supporters of the myopic activist claims dismiss this evidence, taking the view that losses to shareholders and companies from activist interventions take place later on.

On their view, improved performance following activist interventions comes at the expense of sacrificing performance later on, and short-term positive stock reactions merely reflect inefficient market prices that are moved by the short-term changes and fail to reflect their long-term costs. Thus, one prominent supporter of the myopic activism claim claimed earlier this year that the important question is"[f]or companies that are the subject of hedge fund activism and remain independent, what is the impact on their operational performance and stock price performance relative to the benchmark, not just in the short period after announcement of the activist interest, but after a 24-month period."

Data about companies' operating performance and stock returns years following activist intervention is publicly available and easily accessible. Nonetheless, supporters of the myopic activists view have failed to back their view with empirical evidence or even to test empirically the validity of their view. In our study, we seek to fill this void by providing the first comprehensive empirical investigation of the myopic activists claim.

Our study uses a dataset consisting of the full universe of approximately 2,000 interventions by activist hedge funds during the period 1994–2007. We identify for each activist effort the month (the intervention month) in which the activist initiative was first publicly disclosed (usually through the filing of a Schedule 13D). Using the data on operating performance and stock returns of public companies during the period 1991-2012, we track the operating performance and stock returns for companies during a long period – five years – following the intervention month. We also examine the three-year period that precedes activist interventions and that follows activists' departure.

Starting with operating performance, we find that operating performance improves following activist interventions and there is no evidence that the improved performance comes at the expense of performance later on. During the third, fourth, and fifth year following the start of an activist intervention, operating performance tends to be better, not worse, than during the pre-intervention period. Thus, during the long, five-year time window that we examine, the declines in operating performance asserted by supporters of the myopic activism claim are not found in the data. We also find that activists tend to target companies that are underperforming relative to industry peers at the time of the intervention, not well-performing ones.

We then turn to stock returns following the initial stock price spike that is well-known to accompany activist interventions. We first find that, consistent with the results obtained with respect to pre-intervention operating performance, targets of activists have negative abnormal returns during the three years preceding the intervention. We then proceed to examine whether, as supporters of the myopic activism claim believe, the initial stock price reflects inefficient market pricing that fails to reflect the long-term costs of the activist intervention and is thus followed by stock return underperformance in the long term.

In investigating the presence of negative abnormal returns during this period, we employ three standard methods used by financial economists for detecting stock return underperformance. In particular, the study examines: first, whether the returns to targeted companies were systematically lower than what would be expected given standard asset pricing models; second, whether the returns to targeted companies were lower than those of "matched" firms that are similar in terms of size and book to market; and, third, whether a portfolio based on taking

positions in activism targets and holding them for five years underperforms relative to its risk characteristics. Using each of these methods, we find no evidence of the asserted reversal of fortune during the five-year period following the intervention. The long-term underperformance asserted by supporters of the myopic activism claim, and the resulting losses to long-term shareholders resulting from activist interventions, are not found in the data.

We also analyze whether activists cash out their stakes before negative stock returns occur and impose losses on remaining long-term shareholders. Because activist hedge funds have been documented to deliver adequate returns to their own investors, such a pattern is a necessary condition for long-term shareholders being made worse off by activist interventions. We therefore examine whether targets of activist hedge funds experience negative abnormal returns in the three years after an activist discloses that its holdings fell below the 5% threshold that subjects investors to significant disclosure requirements. Again using the three standard methods for detecting the existence of abnormal stock returns, we find no evidence that long-term shareholders experience negative stock returns during the three years following the partial or full cashing out of an activist's stake.

We next turn to examine the two subsets of activist interventions that are most resisted and criticized – first, interventions that lower or constrain long-term investments by enhancing leverage, beefing up shareholder payouts, or reducing investments and, second, adversarial interventions employing hostile tactics. In both cases, interventions are followed by improvements in operating performance during the five-year period following the intervention, and no evidence is found for the adverse long-term effects asserted by opponents.

Finally, we examine whether activist interventions render targeted companies more vulnerable to economic shocks. In particular, we examine whether companies targeted by activist interventions during the years preceding the financial crisis were hit more in the subsequent crisis. We find no evidence that pre-crisis interventions by activists were associated with greater declines in operating performance or higher incidence of financial distress during the crisis.

Our findings that the data does not support the claims and empirical predictions of those holding the myopic activism view have significant implications for ongoing policy debates. Going forward, policymakers and institutional investors should not accept the validity of assertions that interventions by hedge funds are followed by long-term adverse consequences for companies and their long-term shareholders. The use of such claims as a basis for limiting shareholder rights and involvement should be rejected.

Our study is available here.

Harvard Business Review

THE MAGAZINE
July-August 2012

What Good Are Shareholders?

by Justin Fox and Jay W. Lorsch

The path forward for corporate executives and shareholders appears blocked. Executives complain, with justification, that meddling and second-guessing from shareholders are making it ever harder for them to do their jobs effectively.

Shareholders complain, with justification, of executives who pocket staggering paychecks while delivering mediocre results. Boards are stuck in the middle—under increasing pressure to act as watchdogs and disciplinarians despite evidence that they're more effective as friendly advisers.

This deadlock has its roots in the 1970s, when power began to move in the direction of shareholders after a long period during which managers had called almost all the shots. The shift, although it had political and economic causes, was also enabled by the rise of a philosophy of shareholder dominance that grew out of academic research on the motivations and behavior of corporate managers. According to that philosophy, shareholders are the center of the corporate universe; managers and boards must orbit around them.

Corporate reality, though, has proved stubbornly uncooperative. In legal terms, shareholders don't own the corporation (they own securities that give them a less-than-well-defined claim on its earnings). In law and practice, they don't have final say over most big corporate decisions (boards of directors do). And although many top managers pledge fealty to shareholders, their actions and their pay packages often bespeak other loyalties. This gap between rhetoric and reality—coupled with waves of corporate scandal and implosion—has led to repeated calls to give outside investors even more say. If only corporations really did put shareholders first, the reasoning goes, capitalism would function much better.

This argument has great appeal, but it is hard to square with the facts. Our current muddle, remember, comes after many years during which shareholders gained power yet were repeatedly frustrated with the results. It's at least possible, then, that the problem lies with shareholders themselves. Perhaps they aren't really suited to being corporate bosses. Perhaps expecting them to govern and discipline corporations is doomed to disappointment. Or perhaps there are ways in

which shareholders can be effective and helpful—but we risk overlooking them if we concentrate on the need for shareholder primacy.

Our aim here is to focus on shareholders. Who are they? What are their incentives? What are they good at? What are they bad at? The body of research and discussion on these questions is growing. (For a summary, see "Are Institutional Investors Part of the Problem or Part of the Solution?," a working paper by Ben W. Heineman Jr. and Stephen Davis, published by Yale's Millstein Center for Corporate Governance and Performance.) Our contribution is to offer a framework for thinking about shareholders' role and to make some suggestions for changes. We've divided shareholders' contributions into three areas: money, information, and discipline.

1. Money

The most straightforward job of the shareholder is to provide funds. In practice, however, it isn't straightforward at all. Corporations do need capital to invest in growth, but they don't get it in aggregate from shareholders. Net issuance of corporate equity in the U.S. over the past decade has been negative $287 billion, according to the Federal Reserve. That negative number would be much bigger if we left out financial institutions and their desperate fundraising in 2008 and 2009. Factor in dividend payments, and we find a multi-trillion-dollar transfer of cash from U.S. corporations to their shareholders over the past 10 years. Established corporations tend to finance investments out of retained earnings or borrowed money. They don't need shareholders' cash.

Not all corporations have this luxury, of course. Many do need capital from equity investors. They are often the young, growing companies we all want to see more of. Without shareholders who are willing to take risks that a bank or a bondholder would not, these companies might remain stuck in low gear or never even get moving. The investors who provide this cash are usually granted clout commensurate with their contribution. Venture capitalists and angel investors get board seats and sometimes veto power over management decisions and appointments. Investors who step up in times of trouble are often favored over others and given a say in strategic decisions. Corporate governance disputes tend not to occur in such situations: Management effectively answers to the shareholders who provided much-needed capital—at least for a while.

But most shareholders and most corporations don't fit these descriptions. The funding role in a typical publicly traded corporation is filled less by shareholders than by the stock market as a whole. The market provides liquidity. Having shares that can easily be bought and sold, with prices that all can see, reassures lenders and business partners. It enables mergers. It allows early investors and employees to sell company shares and exercise options. It gives investors who come forward when cash is sorely needed a way to realize gains on their investments later. It greases the wheels of capitalism.

Those wheels have been getting ever greasier. In one study, Eugene Fama and Kenneth French found that from 1973 to 2002, a large and growing percentage of corporations issued shares each year. From 1973 to 1982, the percentage was 67%; from 1993 to 2002, it was 86%. What drove the increase? More stock-financed mergers and more employee stock options and other stock-based compensation. This isn't necessarily a healthy development. All-stock mergers tend

to destroy value. Many corporations have overused stock options as a means of paying employees—especially top executives (see the sidebar “More Say but Still Lots of Pay”). And more generally, market liquidity appears to have diminishing returns.

More Say but Still Lots of Pay

In the 1980s and 1990s, under pressure from governance activists, institutional shareholders, the financial media, finance scholars, and even the U.S. Congress, boards shifted the bulk of CEO pay from cash to stock and stock options, and became less patient with CEOs at struggling companies. The idea was to put executives under greater pressure to perform.

So what happened? CEO tenure is shorter. Pay is much higher. But the statistical correlation between CEO pay and corporate performance at S&P 500 companies is zero, reports Baruch Lev in his 2012 book Winning Investors Over. Returns to investors have been alarmingly close to zero in recent years as well.

One could spin this as a tale of wily, self-interested managers’ taking advantage of investors—because it is. But it’s also a case of shareholders’ pushing for change and then proving incapable of controlling it. The adversarial, stock-market-oriented approach to pay appears to have motivated executives to think more like mercenaries and less like stewards.

This situation might be workable if shareholders were willing and able to be effective policemen. But evidence from the latest development in executive compensation—“say on pay,” included in the Dodd-Frank financial reform legislation—suggests that they aren’t. As codified early last year by the SEC, “say on pay” requires companies to put their executive pay practices to a (nonbinding) shareholder vote at least once every three years. This has certainly resulted in more scrutiny: In the first six months under the new rule, Institutional Shareholder Services recommended a no vote on the pay packages at 289 companies out of the 2,313 it examined.

But a majority of shareholders actually voted no at only 39 of those companies, and that was mostly in the wake of significant share price declines or negative earnings; at just a few did large increases in executive pay seem inconsistent with performance. An interpretation: Shareholders are perfectly capable of expressing dissatisfaction with companies that perform extremely poorly. But they’re not so good at—or interested in—distinguishing good pay packages from bad ones.

To provide adequate liquidity, an asset market needs lots of fickle short-term speculators. A market composed solely of buy-and-hold investors wouldn’t be very useful. But a market composed mostly of short-termers presents its own problems. And short-termers have been taking over the stock market. In the 1950s the average holding period for an equity traded on the New York Stock Exchange was about seven years. Now it’s six months. Similar trends can be seen in other markets around the world. In a more recent development, high-frequency traders whose holding periods can sometimes be measured in milliseconds now account for as much as 70% of daily volume on the NYSE.

This shift to the short term has three causes: First, regulators in many nations have pushed successfully for lower transaction costs—most notably through the deregulation of brokerage commissions in the 1970s and 1980s, but also through initiatives such as price decimalization in the late 1990s. Second, advances in technology, in the form of financial engineering as well as computing and communications hardware and software, have enabled many new forms of trading. Third, the individual investors who once dominated stock markets have been pushed aside by professionals—and those professionals face incentives and pressure to trade much more frequently than individuals do.

In 1950 households owned more than 90% of the shares of U.S. corporations. Now institutions hold approximately 50% of the domestically owned shares of public companies (see the exhibit "The Decline of the Individual Investor"). Add in institutional owners from overseas (foreign ownership of U.S. shares isn't broken down between individuals and institutions) and hedge funds (which are counted mostly under households), and the true institutional share is probably closer to 65% or 70%. For the biggest corporations, the percentage is even higher.

The Decline of the Individual Investor

In 1950 households owned more than 90% of shares in U.S. corporations. Now they own only 30% to 40%.

Increasing institutional ownership has combined with other forces to transform the equity market landscape. Brokerage commissions have been lowered for everyone, but lowered most for institutional investors. Institutions also have the resources to take advantage of cutting-edge financial, computing, and communications technologies. And although individuals can pursue long-term strategies that ignore fashion and day-to-day market fluctuations, institutions that are

managing other people's money generally cannot: If returns trail the market for too long, customers will pull their money out.

The more influence short-term traders have on market prices, the more volatile those prices will be—because they are less rooted in the fundamental value of the corporations whose shares are being traded. Of course, some volatility is good. It gives people a reason to trade, thus keeping markets liquid. But past a certain point, volatility kills liquidity. Think of the financial crisis of 2007 and 2008, when uncertainty over prices halted trading in many mortgage-related securities. Or the Flash Crash of 2010, when shares in hundreds of companies suddenly lost half their value—and then regained it within a few minutes. Overall, as documented by the Bank of England's Andrew G. Haldane, stock market volatility in the U.S. and the UK has been much greater over the past two decades than it was before. There's no evidence that this has had a negative impact generally on corporations' ability to raise money or transact in their shares. But there are indications that certain companies—namely the cash-hungry start-ups discussed at the beginning of this section—are struggling in the new market environment. Initial public offerings have been on a downward trend for decades in the United States, interrupted only briefly by the internet stock mania of the late 1990s. The accounting firm Grant Thornton has argued in a series of research papers that more-frequent trading and superlow transaction costs are partly responsible, because brokers no longer make enough on commissions to justify research on young companies.

Yet modern securities regulation has been developed within a paradigm in which there is no such thing as too much liquidity, too much trading, or too much volatility. Lowering transaction costs is seen as an unalloyed good. The tax code is different: In most countries short-term trading is subject to higher capital gains tax rates than long-term investing. But the impact of this tax preference is lessened by the fact that in the U.S., many of the biggest investors (pension funds, foundations, endowments) are exempt from income taxes.

In the wake of the Flash Crash, the U.S. Securities and Exchange Commission is considering new circuit breakers and trading stops to be used in the event of sudden market volatility. That marks at least a modest change in direction, but it's time for a broader reexamination of rule making and legislation around trading. Market frictions have their uses. There is such a thing as too much liquidity. One much-discussed policy proposal is a small tax on all financial transactions, variously called the Tobin tax and the Robin Hood tax. The issues with such a tax go well beyond the purview of this article, but the possibility that it would decrease liquidity should not be seen as a slam-dunk argument against it.

2. Information

The stock market is one of the world's great aggregators of information. Since the 1960s, finance scholars have been documenting its remarkable ability to sniff out and assess information about companies. Event studies show that market prices react to news with staggering quickness—often moving even before the news is public—and tend to see through accounting conventions and subterfuges to the real economic value of a company's earnings.

This means that the next time you hear a CEO arguing that investors are failing to give his company adequate credit for improvements in its income statement, it's a safe bet that the market is right and the CEO and his accountants are blowing smoke. Also, while public stock markets are often assailed for short-termism and impatience, there is ample statistical evidence that stock prices—especially for companies in the early stages of growth—factor in potential earnings decades down the road.

But there's also evidence (again compiled by Andrew Haldane) that investors' willingness to look into the future is on the decline. And stock markets have never been anywhere close to infallible in their assessment of companies' prospects. If they were, rational investors and speculators would have no incentive to expend resources and intelligence trying to dig up information and outsmart the market. Financial markets need imperfection—"noise," to use the term popularized by the finance scholar Fischer Black—if they are to work. So how well do stock market prices reflect underlying corporate fundamentals? Black's guesstimate was that "at least 90%" of the time the prices prevailing on financial markets are "more than half value and less than twice value."

That may be adequate for the purposes of capitalism, but it's way too large a margin of error for executives and boards seeking information and guidance. Sometimes they get pure misinformation: In a study described in the January–February 2012 issue of HBR, the executive recruiter James M. Citrin found that companies whose stock prices dropped sharply upon the naming of a new CEO subsequently outperformed—by a lot—those whose prices rose sharply when a new CEO was named. Also, comparative stock price movements (how Coca-Cola performs relative to Pepsi, for example) are usually more informative than absolute price movements, for which macroeconomic factors and market psychology tend to rule the day. Financial markets, the late economist Paul Samuelson said, are microefficient and macroinefficient.

When shareholders are widely dispersed, how can they keep managers in check? Only by selling shares or casting votes.

This helps explain why executives complain about the short-term focus of the stock market even as finance scholars find evidence that markets still look deep into the future. Using the right statistical tools, you can separate useful, rational signals from the market's noise. But if you look at what your company's stock did today—or even this month—you are likely to see hyperactive chaos. Human nature dictates that we give more attention to simple recent signals than to complex long-run trends—especially when we are paid to give attention to them, as most top executives have been over the past two decades.

Suggested Reading

Lucian A. Bebchuk, “The Case for Increasing Shareholder Power,” Harvard Law Review, January 2005

Fischer Black, “Noise,” The Journal of Finance, July 1986

Andrew G. Haldane, “Patience and Finance,” speech, September 9, 2010 (available at bankofengland.co.uk)

Andrew G. Haldane and Richard Davies, “The Short Long,” speech, May 11, 2011 (available at bankofengland.co.uk)

Lynn A. Stout, The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public (Berrett-Koehler, 2012)

Prices aren’t the only way shareholders convey information to executives. They can also just talk to them. In many instances well-informed investors—from venture capitalists with a start-up to Warren Buffett with the Washington Post Company—have offered crucial information, analysis, and advice to management. But such behavior is not really encouraged in the current market environment.

Regulation Fair Disclosure, adopted by the SEC in 2000, requires that all substantive corporate disclosures be released immediately to the public. The goal was to level the informational playing field for investors, which seems admirable enough. But some of the results have been troubling. One study, by Armando R. Gomes, Gary B. Gorton, and Leonardo Madureira, found that in the wake of Reg FD, small companies and complex companies have struggled to attract analysts’ attention and capital. By forcing all communications into the public sphere, Reg FD may have made it harder to communicate nuance and complexity.

The rule says nothing about communications from shareholders to managers, but by making managers warier of such meetings and reducing the incentives for shareholders to participate in them, it has most likely impeded that information stream as well. Communication between corporate managers and the investor community now takes place mostly during the conference calls that follow the release of quarterly earnings. The participants in these calls are a mix of actual investors and analysts from brokerages and independent research firms. In our experience, analysts ask most of the questions, and they tend toward the superficial and the short term.

Bringing back the old days in which some analysts and investors had special access to corporate information is probably a nonstarter. Then again, some investors do still have special access: Shareholders who own more than 5% of a company or hold a seat on its board are exempt from Reg FD—they are considered corporate insiders and are subject to different restrictions and disclosure requirements. It might be time to look for a middle ground in which long-term investors

who aren't technically insiders are allowed to exchange some but not all of their maneuvering room for franker interactions with management.

Short of a change in the rules, more informal communication between long-term shareholders and managers is a good idea. Such interactions bring useful market information to executives and allow them to build relationships with shareholders that can lead to less adversarial, more-effective governance. Communication between board members and shareholders is also helpful, but it seldom happens now. Many top executives seem to think that board members cannot be trusted with such interactions. Yet if directors cannot be trusted to meet with and listen to shareholders, how can they be expected to competently govern a corporation? In meetings between shareholders and board members that one of us (Lorsch) has observed, the result has been greater trust and stronger relationships that can be drawn on in future crises.

3. Discipline

Because corporate executives are "managers of other people's money," Adam Smith wrote in The Wealth of Nations, they cannot be expected to look after that money with the care that, say, partners or sole proprietors would. This has come to form the central quandary of corporate governance: How can we get managers to do their jobs well—and what exactly does doing well mean?

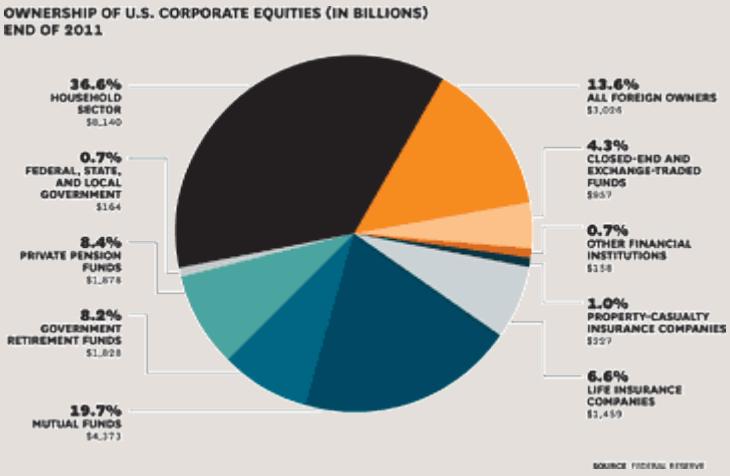
The modern understanding of this difficulty has been defined to a large extent by an academic article written in 1976 by Michael C. Jensen and William H. Meckling, who framed the issue as a conflict between what they called "principals" (shareholders) and "agents" (managers). If an agent owned the business, Jensen and Meckling argued, there was no conflict. But as the ownership percentage went down, agents inevitably faced the temptation to do things that benefited themselves rather than the principals. The main challenge of corporate governance was keeping agents from taking advantage of principals.

Why, exactly, were shareholders (as opposed to employees, customers, or citizens of the community where a company was based) the only principals worth worrying about? "Since it is logically impossible to maximize in more than one dimension," Jensen explained years later, "purposeful behavior requires a single valued objective function." If there has to be just one objective of the corporation, maximizing shareholder value seems an obvious choice. It wasn't exactly Jensen's choice: He argued that maximizing enterprise value—which counts both a company's equity and its debt—was the appropriate goal. But shareholders and debt holders often have different interests and priorities, so shareholder value became the shorthand goal that executives, investors, academics, and others latched on to.

It is difficult to overstate the power of this idea. It is elegant. It is intuitive. There's even evidence to back it up: Marianne Bertrand and Sendhil Mullainathan found that public companies with a large (more than 5% of shares outstanding) shareholder who isn't the CEO are better governed, pay their executives more rationally, and outperform companies that have no such "principal" minding the store. What's missing, though, is a clear answer to the question of what to do in the absence of such a principal. When shareholders are widely dispersed, how can they keep managers in check?

Who the Shareholders Are

Institutional investors—mutual funds, pension funds, insurance companies—have become the chief owners of the shares of U.S. corporations. The data below actually understate the institutional share by leaving out hedge funds, which don't disclose enough information for government statisticians to track them reliably, and thus fall mostly in the "household" category.



They have only two major tools at their disposal—selling shares or casting votes. Both are problematic. Selling can be said to discipline managers by driving the stock price down, but it's awfully hard for one shareholder, even a big one, to have a discernible impact. Also, among the biggest shareholders are index funds, which can't choose to sell—they must own all the stocks in a given market index. And more generally, as we've seen, stock prices are noisy and fitful in their conveyance of information.

That leaves the vote, which has its own weaknesses. The biggest is that so many investors don't hold on to their shares for long—and, obviously, short-termers aren't as good as long-termers at disciplining and guiding managers. A study by José Miguel Gaspar, Massimo Massa, and Pedro P. Matos found that companies with a large percentage of high-turnover shareholders sold themselves in mergers at a discount, overpaid for acquisitions, and generally underperformed the market. Another issue is that big institutions, which own the lion's share of stock, tend to have widely diversified portfolios. Owning shares in hundreds or even thousands of companies makes it difficult to focus on the governance and performance of any of them.

As a result, most professional money managers have come to rely heavily on intermediaries—the market leader is Institutional Shareholder Services—to tell them how to vote. It's better than nothing, which is what most individual investors do, but it's a standardized and usually superficial sort of oversight. ISS focuses on a handful of governance practices disclosed in public documents, and the evidence that these factors correlate with more-effective governance or corporate success is so far lacking.

Some investors do go beyond the check-the-box approach. The California Public Employees' Retirement System, or CalPERS, chooses certain companies from its portfolio whose performance and corporate governance practices it regards as below par. It then communicates privately and publicly with the boards and management of those companies to encourage changes in their boardrooms and strategies. Does this work? Early research showed evidence of a positive "CalPERS effect" on the stock price of targeted companies; but since then the effect has faded. Even more activist are the few hedge funds that take large positions in a single company they believe is undershooting its potential and then agitate for changes in strategic direction or the management team. These funds apparently do succeed in increasing stock prices over the medium term—although, as the legal scholar Lynn Stout points out, raising a target company's stock price is not necessarily equivalent to creating economic value.

Still, even if you believe that the threat of takeovers and hedge fund activism can have a healthy disciplinary effect on managers, the cost of these efforts is so high that they will always be rare. Most institutional investors simply lack the motivation and the time to effectively discipline or otherwise oversee management. And investors have differing time frames and priorities; they aren't all necessarily seeking the same things. Top corporate executives, meanwhile, are highly paid, highly motivated, and highly skilled full-time professionals who—except in times of great corporate distress—will find it easy to outmaneuver or outlast disgruntled investors.

Giving shareholders more things to vote on won't change this. It may even make things worse, by spurring a culture of conflict between shareholders and managers and incentivizing the latter to become ever more mercenary and self-interested. Yet the appeal of "shareholder democracy" is so great that most changes in corporate governance over the past few years have involved strengthening the shareholder franchise. In the U.S. there's "say on pay," a provision of the 2010 U.S. Dodd-Frank financial reform legislation that requires companies to put their executive pay practices to a (nonbinding) shareholder vote at least once every three years. Dodd-Frank also called for "proxy access"—allowing some big shareholders to nominate their own director candidates—although the SEC rule to this effect was struck down by the U.S. Supreme Court, and prospects for the proposal are currently unclear. Shareholder activists have pushed for, and often gotten, governance changes at individual corporations that range from requiring that directors get a majority vote of all shareholders (not just a majority of those voting) to annual voting for all directors (as opposed to staggered voting in which only a few directors are up for election each year) to the dissolution of "poison pill" arrangements meant to dissuade hostile takeovers.

Most institutional investors lack the motivation and the time to discipline or otherwise oversee management.

All this has transpired in the name of giving more power to the owners of corporations. But remember, shareholders aren't quite the same as owners. A simple illustration: If you own a car, you're liable for damages in an accident even if they exceed the value of the car. But shareholders are on the hook only for what they've invested. And although some shareholders behave much like owners, most of them are effectively renters—often ultra-short-term renters. In real estate, renters are entitled to legal protection but seldom given a formal say in how a

property is managed or whether it can be bought or sold. That seems appropriate for short-term shareholders as well.

The “say on pay” rule includes a first step in this direction: Only those who have owned shares in a company for more than two years get to vote. We advocate more-sweeping change. One possibility that has been suggested is a sliding scale on which voting power increases with length of ownership. A simpler approach would be to restrict voting in corporate elections of any kind to those who have owned their shares for at least a year.

Such changes would give more clout to the shareholders who are presumably least interested in day-to-day stock price and quarter-to-quarter earnings changes—thus tempering short-termism. And separating long-haul shareholders from the rest could enable more communication and trust between them and boards and managers. The key would be to shed the notion of shareholder democracy that animates much discussion of corporate governance and move toward granting more say to those shareholders most likely to have something to contribute.

Then there’s the question of how boards are chosen. The proxy access rule struck down by the Supreme Court was an attempt to make it easier for shareholders to nominate rival board candidates. But the rule as contemplated would probably have been invoked only when a company was already in serious difficulty. More important, if contested board elections did somehow become common, one likely impact would be to discourage competent people from serving on boards. It’s a rare businessperson who relishes a contentious election campaign. There’s also no evidence that bringing in more outside board members improves governance. Of the many studies done on the impact of board composition, most show no effect at all, and a substantial minority show a correlation between more insiders and better performance.

Approaches that encourage shareholder input but not confrontation and conflict are more likely to succeed in improving boards. For example, large shareholders could suggest board candidates—either informally or through an advisory group of shareholder representatives. This would resemble current practice in Sweden, where a committee representing the largest shareholders recommends nominees for a board.

The Way Forward

In the 1970s many big corporations in the United States had a complacency problem. Managers saw themselves as the stewards of important institutions and were resistant to change despite big shifts in the competitive landscape. In response, shareholders became impatient, and academics devised theories about how to keep self-interested managers toeing the line. The result was a revolt that goaded managers into being less risk-averse and more willing to embrace change. But shareholders have not proved successful at controlling the more aggressive breed of managers that the revolt helped spawn. How could they? Except when a company is in trouble (generally the only time that shareholders succeed in cobbling together antimanagement majorities), conflict between shareholders and managers is asymmetric warfare, with shareholders in no position to prevail.

Paying too much attention to what shareholders say they want may actually make things worse for them. There's a growing body of evidence (for example, Rosabeth Moss Kanter's "How Great Companies Think Differently," HBR November 2011) that the companies that are most successful at maximizing shareholder value over time are those that aim toward goals other than maximizing shareholder value. Employees and customers often know more about and have more of a long-term commitment to a company than shareholders do. Tradition, ethics, and professional standards often do more to constrain behavior than incentives do. The argument here isn't that managers and boards always know best. It's simply that widely dispersed short-term shareholders are unlikely to know better—and a governance system that relies on them to keep corporations on the straight and narrow is doomed to fail.

Given how many unintended and unwelcome consequences have flowed from the governance and executive pay reforms of the past few decades, we're wary of recommending big new reforms. But we do think that giving a favored role to long-term shareholders, and in the process fostering closer, more constructive relationships between shareholders, managers, and boards, should be a priority. So should finding roles for other actors in the corporate drama—boards, customers, employees, lenders, regulators, nonprofit groups—that enable those actors to take on some of the burden of providing money, information, and especially discipline. This is stakeholder capitalism—not as some sort of do-good imperative but as recognition that today's shareholders aren't quite up to making shareholder capitalism work.

Justin Fox is the editorial director of HBR Group. Jay W. Lorsch is the Louis E. Kirstein Professor of Human Relations at Harvard Business School and the author of *The Future of Boards: Meeting the Governance Challenges of the Twenty-First Century* (HBR Press, 2012).

The Harvard Law School Forum on Corporate Governance and Financial Regulation
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Corporate Short-Termism – In the Boardroom and in the Courtroom

Posted by June Rhee, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Friday April 26, 2013

Editor's Note: Mark Roe is the David Berg Professor of Law at Harvard Law School, where he teaches bankruptcy and corporate law.

Last month I posted to SRRN Corporate Short-Termism – In the Boardroom and in the Courtroom, which the *Business Lawyer* will publish this August.

In this paper, I examine a long-held view in corporate circles has been that furious rapid trading in stock markets has been increasing in recent decades, justifying more judicial measures that shield managers and boards from shareholder influence, so that boards and managers are freer to pursue sensible long-term strategies in their investment and management policies.

However, when I evaluate the evidence in favor of that view, the evidence turns out to be insufficient to justify insulating boards from markets further. While there is evidence of short-term distortions, the view is countered by several under-analyzed aspects of the American economy, each of which alone could trump the board isolation prescription. Together they make the case for further judicial isolation of boards from markets untenable.

First, even if the financial markets were, net, short-term oriented, one must evaluate the American economy from a system-wide perspective. As long as venture capital markets, private equity markets, and other conduits mitigate, or reverse, much of any short-term tendencies in public markets, then a short-term problem is potentially local but not systemic. Second, the evidence that the stock market is, net, short-termist is inconclusive, with considerable evidence that stock market sectors often overvalue the long term.

Third, mechanisms inside the corporation are important sources of short-term distortions and the impact of these internal short-term favoring mechanisms would be exacerbated by further insulation of boards from markets. Even if short-termism were in play, these negatives for potential solution need to be weighed in the mix.

Fourth, some of the focus on short-termism may have the effect of persuading courts to consider isolating boards from markets. But courts are not well positioned to make this kind of basic economic policy, which if determined to be a serious problem is better addressed with policy tools wider than those available to courts. Courts are reluctant to make narrower business judgments when reviewing the business decisions of boards. They should be even more reluctant to consider such economic policies as even tiebreakers in rendering normal judicial corporate decisions.

Lastly, the widely held view that short-term trading has increased dramatically in recent decades may over-interpret the data; the duration for holdings of many of the country's major stockholders, such as mutual funds like Fidelity and Vanguard, and major pension funds, does not seem to have shortened. Rather, a high-velocity trading fringe has emerged, and its rise affects average holding periods, but not the holding period for the country's ongoing major stockholding institutions.

The view that stock market short-termism should affect corporate lawmaking fits snugly with two other widely supported views. One is that managers must be free from tight stockholder influence, because without that freedom boards and managers cannot run the firm well. Whatever the value of this view and however one judges the line between managerial autonomy and managerial accountability to stockholders should be drawn, short-termism provides no further support for managerial insulation from the influence of financial markets. The autonomy argument must stand or fall on its own. Similarly, those who argue that employees, customers, and other stakeholders are due more consideration in corporate governance point to pernicious short-termism to further support their view.

Again, the best view of the evidence is that the pro-stakeholder view must stand on its own. It gains no further evidence-based, conceptual support from a purported short-termism in financial markets. Overall, system-wide short-termism in public firms is something to watch for carefully, but not something that today should affect corporate lawmaking.

The full paper is available for download here.

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Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law

Posted by Kobi Kastiel, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Wednesday May 7, 2014

Editor's Note: The following post is based on a recent *Columbia Law Review* article, earlier issued as a working paper of the Harvard Law School Program on Corporate Governance, by Leo Strine, Chief Justice of the Delaware Supreme Court and a Senior Fellow of the Program. The article, Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law, is available here. The article is a response essay to an earlier *Columbia Law Review* article by Professor Lucian Bebchuk, available here and discussed on the Forum here.

Leo Strine, Chief Justice of the Delaware Supreme Court Review and a Senior Fellow of the Harvard Law School Program on Corporate Governance, recently published in the *Columbia Law Review* a response essay to an essay by Professor Lucian Bebchuk published in the *Columbia Law Review* several months earlier. Professor Bebchuk's essay, The Myth that Insulating Boards Serves Long-Term Value, is available here and was featured on the Forum here. Chief Justice Strine's essay, titled Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law, is available here.

The abstract of Chief Justice Strine's essay summarizes it briefly as follows:

> In his essay, *The Myth That Insulating Boards Serves Long-Term Value*, Professor Lucian Bebchuk draws a stark dichotomy between so-called "insulation advocates" and proponents of shareholder-driven direct democracy. This Essay begins by rejecting this crude divide between "good" and "evil," and focuses instead on the practical realities surrounding increases in stockholder power in an era where there is a "separation of ownership from ownership." That separation arises because the direct stockholders of private companies are typically not end-user investors, but instead money managers, such as mutual funds or hedge funds, whose interests as agents are not necessarily aligned with

> the interests of long-term investors. These practical realities suggest that Bebchuk's crusade for ever more stockholder power may not actually be beneficial to ordinary investors, and that his contention—that further empowering stockholders with short-term investment horizons will not compromise long-term corporate value—is far from proven. This Essay concludes with some thoughts on improvements that could be made in the system that we have. These suggestions are not radical in either direction and they do not involve rolling back the rights of stockholders. Rather, these suggestions recognize that the fiduciaries who wield direct voting power over corporations should do so in a manner faithful to the best interests of those whose money they control, include proposals to require activist investors to bear some of the costs they impose and to disclose more information about their own incentives so that the electorate can evaluate their motives, and provide incentives that better align the interests of money managers and ordinary investors toward sustainable, sound long-term corporate growth. Taken as a whole, these suggestions would create a more rational accountability system by making all of the fiduciaries for ordinary investors focus more on what really matters for investors, citizens, and our society as a whole—the creation of durable wealth through fundamentally sound economic activity.

Chief Justice Strine provides a more detailed account of the analysis of his Essay in the introduction:

> "According to my dear friend and colleague, the distinguished Professor Lucian Bebchuk, everyone who has at any time questioned the extent to which public corporations should be direct democracies whose board of directors and managers must follow the immediate whim of a momentary majority of stockholders can be labeled and lumped together as an "insulation advocate," in order to create an intellectual straw man for him to burn down easily. Bebchuk is the sincere champion of one group of "agents" wielding power and authority over others' money—the money managers who control most of the investments belonging ultimately to ordinary Americans who are saving to pay for their retirements and for their children's education—against another group of "agents" that he believes is somehow more conflicted—the agents who actually manage corporations that make real products and deliver useful services (i.e. "productive corporations"). The fact that he is an advocate for the power of one group of privileged "haves" against another might lead a dispassionate observer to expect that Bebchuk would be cautious in drawing stark lines, on one side of which are

the good and faithful agents—the money managers—and on the other side are the suspect and presumptively faithless agents—the managers of productive corporations. In fact, such an unwitting observer might infer that someone passionate about constraining the agency costs of those who directly manage productive corporations would also be passionate about constraining the agency costs of the money managers who directly hold other people's money.

But Bebchuk is not an Adolf Berle who is concerned that all who wield economic and political power in a republican democracy are accountable for their responsible use of that power. That is not how Bebchuk approaches things. For him, there is only one set of agents who must be constrained—corporate managers—and the world will be made a better place when corporations become direct democracies subject to immediate influence on many levels from a stockholder majority comprised not of those whose money is ultimately at stake, but of the money manager agents who wield the end-users' money to buy and sell stocks for their benefit.

In this crude divide between good and evil, Professor Bebchuk is not alone. Arrayed against him and his fellow "money manager advocates" are scholars, corporate lawyers, and businesspersons who view stockholders as having little to no utility in helping corporations generate wealth and who seem to wish stockholders would simply go away. As with Bebchuk's fellow money manager advocates, there are differences among those who wish to constrain stockholder influence. In some cases, these skeptics go so far as to deny that boards of directors must, within the constraints of the law, make the best interests of stockholders the end goal of the governance of a for-profit corporation. Instead of accepting that a prerequisite to the application of the business judgment rule is that the directors have the same interest as the stockholders—i.e., in making the decision that will make the corporation the most profitable—these skeptics argue that the business judgment rule is really just a beard to give boards the cover they need to treat the stockholders' best interest as only one of many permissible ends, including the best interests of the communities in which the corporation operates, the corporation's consumers and workers, the environment, and society as a whole. In their minds, iconic cases like Dodge v. Ford and Revlon, which hold the opposite, are mere aberrations; really, the law is that boards can treat all constituencies equally in terms of the ends of management.

Inconvenient to this notion on two levels is an indisputable reality of American corporate law. That is the reality that if American corporate law makes all constituencies an end of corporate governance, American corporate lawmakers chose a decidedly unusual way to enable that equality. In American corporate law, only stockholders get to elect directors, vote on corporate transactions and charter amendments, and sue to enforce the corporation's compliance with the corporate law and the directors' compliance with their fiduciary duties. An unsubtle mind might believe that this statutory choice to give only stockholders these powers might have some bearing on the end those governing a for-profit corporation must pursue. But regardless of whether that is so as a matter of law, this allocation of power has a profound effect as a matter of fact on how directors govern for-profit corporations. When only one constituency has the power to displace the board, it is likely that the interests of that constituency will be given primacy.

More nuanced participants in the debate do not quibble with the notion that the end goal of for-profit corporations is the best interests of stockholders. But these participants argue that the best way to ensure that corporations generate wealth for diversified stockholders is to give the managers of corporations a strong hand to take risks and implement business strategies without constant disruption by shifting stock market sentiment. Those in this more measured place are troubled by the fact that traditional rights granted to stockholders may have a less desirable impact on the ability of corporations to generate wealth given important market developments, such as the realities that: Money manager intermediaries constitute a supermajority of those wielding actual stockholder rights rather than the long-term investors whose money is actually invested; activist investors are able to engage in hedging strategies that limit their exposure if their preferred strategies for the corporation do not turn out to be sound; putting together a momentary majority is easier today because of more concentrated ownership patterns and the Internet; and institutional investors have emerged who seem to be motivated by a desire for engagement for reasons unrelated to investment value. Even when the debate is narrowed to focus on the best interests of equity investors, these commentators worry that the demands of money managers and their advocates for additional rights will compromise the ability of corporations to pursue the most profitable courses of action for those whose money is ultimately at stake—the end-user investors saving to pay for college and retirement—because managers will be distracted and disrupted by constant mini-referendums and continual election seasons initiated by activist investors.

As may fit their shared experiences as Dungeons & Dragons aficionados, Bebchuk and his sparring partners share an affinity for exploring “myths” and engaging in rhetorical jousts where no real world blood is shed. One area of sharp disagreement between his money manager advocate team and the stronger insulation advocate team members is whether more wealth will be created for end-user investors by corporations if corporate managers are given more or less room to pursue strategies without fearing displacement of themselves or those strategies by stockholders. In this new essay, Bebchuk claims that there is no rational basis to believe that operating corporations under a direct democracy model will result in any reduction in the ability of corporations to generate profits in a durable manner. Even if the money managers who directly act as stockholders do not hold stock for more than the blink of an eye in real business terms, giving them more power for constant intervention is not worrisome because there is no empirical evidence that making corporate managers accountable to direct stockholder influence at all times, rather than periodically, reduces corporate value. In other words, Bebchuk argues that even if the activists proposing corporate action hold their shares for a few years at most and the electorate considering their proposals holds for months at a time, that does not necessarily mean that their incentives are distorted in any sense that might lead them to favor strategies that are inconsistent with the corporation’s ability to create the most long-term, sustainable economic value for stockholders and to honor its obligations to creditors and society as a whole.

By contrast, Bebchuk’s intellectual adversaries are skeptical that money managers, who buy and sell stocks rapidly in defiance of the core insight of the efficient capital market hypothesis (ECMH), are focused on whether strategies proposed by hedge funds are well-thought-out in terms of their effect on the corporation’s capacity to comply with its legal duties and generate strong profits on a long-term basis. Many of them view it as likely that money managers—who do not intend to be around when the consequences of corporate policies proposed by activist hedge funds come to fruition—will give great weight to the short-term effect of policies, without adequately considering whether those policies create too little long-term investment or too much leverage and externality risk. For end-user investors who depend on their portfolio’s ability to generate sustainable long-term growth, bubbles in equity prices that come at the expense of more durable and higher long-term growth are counterproductive. For society as a whole, further empowering money managers with short-term holding periods subjects Americans to lower long-term growth and job creation,

wreckage from corporate failures due to excessive risk taking and debt, and the collateral harm caused when corporations face strong incentives to cut regulatory corners to maximize short-term profits.

As I understand the primary purpose of Bebchuk's essay, it is to impose on the so-called insulation advocates the burden of proving that any limitation on the direct democracy model that money manager advocates favor is justified. Absent empirical proof that stockholder activism directed at corporations reduces stockholders' returns, insulation advocates should be mute and accept Bebchuk's view that corporations should be governed as direct democracies subject to the will of whatever majority happens to own their stocks at any particular time. Bebchuk marshals various empirical studies to support his contention that insulation advocates cannot meet the burden he puts before them. Although his essay is lengthy, his empirical claims are essentially two in nature and related. First, as to corporate governance rules of the road affecting how easy it is to replace a corporate board or effect a takeover—such as whether a corporation has a classified board—there is evidence that corporations without strong antitakeover defenses have higher values than similarly situated corporations with such defenses. In other words, Bebchuk contends that corporate managers who are more vulnerable to displacement by the market for corporate control deliver better returns. Second, and relatedly, Bebchuk argues that it has not been shown that long-term returns have been harmed because of the greater influence that reduced takeover defenses and increased electoral vulnerability for directors gives to activist investors such as hedge funds proposing that corporations change their business strategies. Because Bebchuk reductively focuses on equity returns, he blinds himself to any consideration of externality effects or the larger economic outcomes of the American economy for its citizens. Although he does not say so explicitly, one would suppose that he would argue, as others have, that what is good for equity holders as the so-called residual claimants is good for everyone else, and that if corporations can produce higher returns to equity, they will be better able to pay their other bills and honor their obligations to society.

I will not pretend to have had sufficient time nor training in statistical "social science" to evaluate whether Bebchuk's review of the empirical evidence is convincing. I must admit to having a healthy skepticism whenever the "law AMPERSAND" movement cranks up its machinery and tries to prove empirically a contestable proposition about a complicated question involving the governance

of a human community of any kind. I am particularly skeptical about claims that actions have no, this, or that effect in the long-term by reference to short-term period effects, justified by the argument that long-term effects cannot be measured because they are drowned out by "noise." I cannot and will not claim that my respected friend Professor Bebchuk misstates the results of the studies he cites or that the one he himself conducted was done with anything but the greatest accuracy and rigor. I leave to others whose full-time job is writing academic articles to engage with the cited studies on those terms.

I do note that Bebchuk's view—that there is no empirical reason to doubt that further moves toward the direct democracy model he favors will be good for long-term stockholder interests and those of society as a whole—is not universally shared. Respected scholars who are not fans of unconstrained corporate management believe that there are substantial reasons why a move to direct democracy might harm long-term corporate value. As they note, it is a solar system from the central claim of the ECMH—that it is unlikely that any person pursuing an active trading strategy is likely to outperform the market as a whole—to presuming that the stock market price of a particular company on a particular day represents a reliable estimate of the company's future expected cash flows. They point to real world evidence that the companies most heavily engaged in and exposed to the risks of the financial practices that led to the financial crisis had received a premium in the stock market for doing so, despite the existence of public information suggesting that these practices were unsustainable in the long run and posed substantial risk. Bubble run-ups in the value of these companies' stock might have provided value to stockholders engaged in rapid trading, but the companies' stuck-in stockholders (such as those who were indexed) took the whole ride, which in some cases ended in a ravine. Furthermore, these scholars note that it is difficult to measure the system-wide costs of making corporate managers more directly accountable to changing market sentiments, but point out that such accountability could be dangerous to our economy's long-term prospects for growth when a survey of corporate managers revealed that many of them would fail to pursue net present value positive capital investments if they feared that those projects would result in an inability to meet near-term earnings estimates. Some of Bebchuk's debating adversaries even venture a more macro-level critique, wondering why proponents of direct democracy believe that the strong directional inertia in their favor should not be braked when a forest-level look at outcomes reveals: (i) much higher executive compensation and a growing disparity between CEO and

average worker pay; (ii) unimpressive returns to stockholders; (iii) stagnant economic growth; (iv) the need for huge government subsidies for corporations and industries that engaged in speculative and excessively risky conduct in pursuit of stockholder profit; and (v) sharp declines in the number of American public corporations. Put simply, they wonder what big-picture results for stockholders, or Americans more generally, have come from the sharp move in the last quarter century toward making corporations more responsive to stockholder pressure that might justify the efforts of Bebchuk and his allies to continue to push corporations even closer to the direct democracy model.

Interestingly, Bebchuk's debating adversaries have overlooked what might be seen as an admission on his part that increasing demands on corporations to manage to immediate stock market pressures might not be good for stockholders or society generally. Consistent with his distrust of agents who run actual corporations, Bebchuk has expressed concern about rewarding corporate managers for increasing the stock price without contractual protections requiring them to hold on to their equity for a long-term period. The reason: Bebchuk fears that if managers can benefit from short-term stock price increases without bearing the long-term risks that the policies causing those increases entail, they may propose and implement measures that sacrifice long-term, sustainable growth for short-term gain. In his own words: "Executives who are free to unload shares or options may have incentives to jack up short-term stock prices by running the firm in a way that improves short-term results at the expense of long-term value."

Likewise, although Bebchuk's career-long obsession has been advocating that corporate managers should be directly responsive to the immediate demands of the current stockholder majority, in recent writings he has expressed concern that paying corporate managers equity-based compensation could lead managers to implement excessively risky strategies that create a potential for bankruptcy and cause harm to creditors, employees, and society as a whole. The long-term stockholders who hold the stock when such risks come to fruition would, of course, suffer too.

It is likely that corporate managers, in contrast with activist investors such as hedge funds, are actually far more dependent on their employer firm's sustainable value and would thus be more, not less, immune to the temptation of forsaking long-term value for a short-term stock pop coming from an unduly risky

business strategy. But the logic that drives Bebchuk to worry about these temptations does not seem to trouble him when he is dealing with anyone claiming the title “stockholder,” regardless of whether their investment horizons and portfolio likely make them far less invested in the corporation’s long-term fate than a typical corporate manager. A dispassionate observer, however, might note that the analytical force of Bebchuk’s analysis of the dangers of paying corporate managers in a way that breaks the link between short-term reward and accompanying long-term risk cannot be confined to that specific context. Ideology can be blinding, even apparently when one’s secular faith involves the simple creed that those who own stocks are presumptively selfless while those who manage corporations are presumptively selfish and untrustworthy.

There is another oddment to Bebchuk’s continuing push for direct democracy. For years, he and his allies pushed to make corporate directors more accountable directly to stockholders and to shift power within the boardroom to independent directors meeting stricter definitional standards. They were successful in this effort. Most boards are comprised not simply of a majority of independent directors, but almost exclusively of independent directors, with the CEO often being the only nonindependent director. Key board committees like compensation, audit, and nominating must be comprised solely of independent directors. But, rather than the increasing power of independent directors providing a relaxation of the need to move further toward a direct democracy model, Bebchuk and his fellow money manager advocates have instead proposed that these newly empowered independent directors be subject to the specific direction of stockholders on virtually every important aspect of management, including compensation, charter and bylaw changes, and change of control transactions. They also propose that these independent directors be removable from office not just when beaten at the polls by an actual human candidate, but also through a de facto recall vote in the form of a withhold campaign.

As, or more, important than the composition of boards, easy financing and the sharp reduction in the prevalence of antitakeover defenses have made the market for corporate control more vibrant as a disciplinary tool. Although Bebchuk will likely not admit the extent to which his world view helped to form a more open market for corporate control, that does not mean it is not a reality. With managers regularly subject to the type of discipline that Bebchuk and others thought would keep managers on their toes, the need for further ballot initiatives

is not evident. Of course, Bebchuk might note the decline in hostile takeovers. But the reason is telling: Serious bidders have no need to go hostile; they can get a fair opportunity to buy just by making an offer. The more expensive and risky route of hostility is not necessary, as most boards are happy to consider selling at a genuinely attractive price.

To the extent that Bebchuk claims that the empirical evidence regarding average increases in value at firms targeted by hedge fund activism supports deviating from board insulation at current levels, he must confront the possibility that increasing the leverage that hedge funds have against boards will generate less positive results. If, as Bebchuk and others posit, the market is now working well because hedge funds and the board each have clout and can debate their respective positions, leaving the solid center of the stockholder electorate to decide which is right and to encourage both hedge funds and boards to move toward policies that increase stockholder profitability in a durable way good for most investors, his contention that this relationship should be further tilted in favor of the insurgents itself requires more support. As a respected scholar notes, “[S]ince the mid-2000s . . . management has responded to shareholder demands as never before.”

The need for fuller and more timely disclosure about the interests of activist investors who propose changes in the business plans of corporations but are not prepared to make a fully funded, all-shares offer to buy the corporation is arguably made more advisable because of these market developments. At the beginning of the takeover and merger boom that began in the early 1980s, scholars sharing Bebchuk’s viewpoint that stockholders should get the final say on whether to accept a takeover bid argued that the optimal blend for stockholders was one where the traditional values of the business judgment rule gave managers room to innovate and take risks, with the takeover market acting as a protective check to ensure that stockholders could exit through a premium if a buyer believed it could do better in managing the assets than incumbent management. With easy access to financing available for buyers and the decline in structural takeover defenses, it has never been easier to make a full company offer and get it accepted. When a buyer purchases the entire company, it signals that it and its financing partners are willing to fully absorb the future risk of its business strategy. By contrast, when an activist argues that a corporation would be more valuable if it changed its business strategy, but is not prepared to buy the company or to even commit to hold its stock for any particular period of time,

there is good reason to make sure that the other stockholders have full information about the precise economic interests of that activist. With the sharp decline in structural takeover defenses, the plush access to deal financing, the prevalence of boards with supermajorities of independent directors, the increasing ease of running proxy contests and withhold campaigns due to increased institutional ownership, and the inexpensive nature of internet communication, the barriers to takeover bids, corporate governance and business strategy proposals, and changes to the board itself are lower than ever. Put simply, it is not clear that Bebchuk's findings do not support the conclusion that the current status quo, with all of its real world human blemishes, strikes, as a general matter, a reasonable balance between stockholder and management power. And Bebchuk's own articulation of the dynamic, which is shared by other distinguished scholars who may not agree with him on other particulars, suggests that modest policy moves that better enable the solid center of the investor community to more effectively evaluate activist proposals so that sound ones are more likely to become corporate policy and excessively risky ones are more likely to be rejected might even appeal to him.

I do not presume that there is any way to bridge the great divide between Bebchuk, on the one extreme, and those like Lynn Stout, on the other, as their positions are so starkly divergent. A far more modest goal might be in reach, though, suggested by the preceding discussion of disclosure regarding hedge fund activists' economic interests. That is, it may be possible to find some common ground between these dueling camps that might allow us to improve the corporate governance system we actually have, given the allocation of legal and market power that in fact exists. For example, it might be possible for all participants in the debate to acknowledge three things. First, stockholders have formidable power under our system of corporate governance. Second, the direct stockholders of productive corporations primarily consist of institutional investors who are themselves susceptible to conflicts of interests and other incentives that may lead them to act in ways that diverge from those whose capital they are controlling. Third, all fiduciaries within the accountability system for productive corporations should themselves be accountable for acting with fidelity to the best interests of the end-user investors whose money is ultimately at stake. If there is agreement on these mundane grounds, it might be possible to improve the system as it actually exists so that it works better for both investors and society more generally.

To the extent that Bebchuk accepts his sparring partners' contention that it is important that corporations be governed in a manner likely to create the most sustainable wealth for their investors and society, this means that both he and they should want a process of corporate accountability where there is adequate and effective representation of the interests of investors who have entrusted their capital to the market for the long term. To the extent that Bebchuk believes that stockholder input on key corporate issues is valuable, one would assume he believes that stockholder input should be based on a genuinely thoughtful deliberative process that involves careful consideration of what is in the interests of the ultimate investors for whom the stockholder is acting. In particular, if Bebchuk believes that any dangers posed by certain stockholders who have short-term investment horizons are checked because institutional investors representing long-term investors cast most of the votes, he should support ensuring that the representatives of long-term investors in fact think and vote in the manner faithful to their investors' unique interest in sustainable, durable wealth creation. Likewise, if Bebchuk believes that facilitating a reasoned debate between management and activist stockholders about important issues where the argument is settled by mainstream elements of the institutional investor community will produce good results for investors, one would also assume that he would not want those mainstream investors deluged with thousands of annual votes that are impossible to consider in a careful, cost-effective way.

Although it would be difficult to find much acknowledgement in his work, Bebchuk is likely to agree that innovative and competent management remains the key driver of returns for stockholders. Certainly his sparring partners would. Therefore, it might be that Bebchuk would recognize that it is counterproductive for investors to turn the corporate governance process into a constant Model U.N. where managers are repeatedly distracted by referenda on a variety of topics proposed by investors with trifling stakes. Giving managers some breathing space to do their primary job of developing and implementing profitable business plans would seem to be of great value to most ordinary investors. Likewise, Bebchuk and his sparring partners might agree that business strategies do not tend to be proven successful or not within the space of a year and that an effective system of accountability would be one where stockholders periodically have an enhanced opportunity to displace the board or change corporate policies such as compensation plans based on their assessment of several years of data regarding the company's performance and the consequences of the board's policies. In other words, if it was wise of our Founders to put in place a system

> where Abraham Lincoln would be subject to removal based on his performance in 1864, rather than every year, perhaps that sensible notion of holding vibrant elections after a rational time frame that takes into account the incumbent's performance over a period more relevant to the governance of a sophisticated entity is one that ought to be considered in determining how often to hold stockholder votes on issues like executive compensation and how often to enhance the chances of a proxy contest through subsidies like proxy access or reimbursement.
>
> In the pages that follow, I will venture some thoughts on improvements that could be made in the system that we have. As befits someone who embraces the incrementalist, pragmatic, liberal tradition of addressing the world as it actually is, these suggestions are not radical in either direction. They do not involve rolling back the rights of the stockholders of productive corporations. Rather, they involve accepting the reality that stockholders have strong rights and trying to create a system for use of those rights that is more beneficial to the creation of durable wealth for them and for society as a whole. Consistent with Bebchuk's concern that humans controlling others' money should be accountable for faithfully using that power, they do involve some modest requirements: that the fiduciaries who wield direct voting power over productive corporations do so in a manner faithful to the best interests of those whose money they control, and that stockholders who propose corporate actions that cost other stockholders money have a sufficient economic stake to justify the substantial costs imposed by ballot measures. Likewise, they recognize that activist stockholders who seek to act on the corporation and cause it to change its business strategy are taking action that affects all stockholders, and that the electorate should therefore have information about the activists' economic incentives in considering whether their proposals are in the best interests of the corporation.
>
> With that framework in mind, I hazard some specific thoughts about what a more sensible system of corporate accountability might involve."

Chief Justice Strine's response essay is available here.

The Harvard Law School Forum on Corporate Governance and Financial Regulation
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Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Tuesday February 26, 2013

Editor's Note: Martin Lipton is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy. This post is based on a Wachtell Lipton memorandum by Mr. Lipton.

The activist-hedge-fund attack on Apple—in which one of the most successful, long-term-visionary companies of all time is being told by a money manager that Apple is doing things all wrong and should focus on short-term return of cash—is a clarion call for effective action to deal with the misuse of shareholder power. Institutional investors on average own more than 70% of the shares of the major public companies. Their voting power is being harnessed by a gaggle of activist hedge funds who troll through SEC filings looking for opportunities to demand a change in a company's strategy or portfolio that will create a short-term profit without regard to the impact on the company's long-term prospects. These self-seeking activists are aided and abetted by Harvard Law School Professor Lucian Bebchuk who leads a cohort of academics who have embraced the concept of "shareholder democracy" and close their eyes to the real-world effect of shareholder power, harnessed to activists seeking a quick profit, on a targeted company and the company's employees and other stakeholders. They ignore the fact that it is the stakeholders and investors with a long-term perspective who are the true beneficiaries of most of the funds managed by institutional investors. Although essentially ignored by Professor Bebchuk, there is growing recognition of the fiduciary duties of institutional investors not to seek short-term profits at the expense of the pensioners and employees who are the beneficiaries of the pension and welfare plans and the owners of shares in the managed funds. In a series of brilliant speeches and articles, the problem of short-termism has been laid bare by Chancellor Leo E. Strine, Jr. of the Delaware Court of Chancery, e.g., One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?, and is the subject of a continuing Aspen Institute program, Overcoming Short-Termism.

In his drive to enhance the shift of power over the management of companies from directors to shareholders, Professor Bebchuk has announced that he is pursuing empirical studies to prove

his thesis that shareholder demand for short-term performance enforced by activist hedge funds is good for the economy. We have been debating director-centric corporate governance versus shareholder-centric corporate governance for more than 25 years. Because they are inconvenient to his theories, Professor Bebchuk rejects the decades of my and my firm's experience in advising corporations and the other evidence of the detrimental effects of pressure for short-term performance. I believe that academics' self-selected stock market statistics are meaningless in evaluating the effects of short-termism. Our debates, which extend over all aspects of corporate governance, have of late focused on my effort to obtain early disclosure of block accumulations by activist hedge funds and my endorsement of an effort to require institutional shareholders to report their holdings two days, rather than 45 days, after each quarter. It is in the context of these efforts, opposed by the activists who benefit from lack of transparency, that Professor Bebchuk has announced his research project.

If Professor Bebchuk is truly interested in meaningful research to determine the impact of an activist attack (and the fear of an activist attack) on a company, he must first put forth a persuasive (or even just coherent) theory as to why the judgments as to corporate strategy and operations of short-term-focused professional money managers should take precedence over the judgments of directors and executives charged with maximizing the long-term success of business enterprises. There is nothing persuasive about his view, whether as theory or experience. Furthermore, he must take into account the following:

- 1. As to all companies that were members of the Fortune 500 during the period January 1, 2000 to December 31, 2012, what was the impact on the price of the shares of a company that missed the "street estimate" or "whisper number" for its earnings for a quarter and what adjustment did each of those companies make to its capital expenditures, investment in research and development and number of employees for the balance of the year of the miss and the following year.
- 2. For companies that are the subject of hedge fund activism and remain independent, what is the impact on their operational performance and stock price performance relative to the benchmark, not just in the short period after announcement of the activist interest, but after a 24-month period.
- 3. Interviews with the CEOs of the Fortune 500 as to whether they agree or disagree with the following statements:
    - a) From the Aspen paper, "We believe that short-term objectives have eroded faith in corporations continuing to be the foundation of the American free enterprise system, which has been, in turn, the foundation of our economy. Restoring that faith critically requires restoring a long-term focus for boards,

managers, and most particularly, shareholders—if not voluntarily, then by appropriate regulation."

- b) From a 2002 interview with Daniel Vasella, CEO of Novartis in Fortune Magazine, "The practice by which CEOs offer guidance about their expected quarterly earnings performance, analysts set 'targets' based on that guidance, and then companies try to meet those targets within the penny is an old one. But in recent years the practice has been so enshrined in the culture of Wall Street that the men and women running public companies often think of little else. They become preoccupied with short-term 'success,' a mindset that can hamper or even destroy long-term performance for shareholders. I call this the tyranny of quarterly earnings."

The Harvard Law School Forum on Corporate Governance and Financial Regulation
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Current Thoughts About Activism, Revisited

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Tuesday April 8, 2014

Editor's Note: Martin Lipton is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy. This post is based on a Wachtell Lipton memorandum by Mr. Lipton, Steven A. Rosenblum, and Sabastian V. Niles. Wachtell Lipton's earlier memorandum on current thoughts on activism is available here, their earlier memoranda criticizing an empirical study by Bebchuk, Brav and Jiang on the long-term effects of hedge fund activism are available here and here, and their earlier memoranda criticizing the Shareholder Rights Project are available here and here. The Bebchuk-Brav-Jiang study is available here, Lucian Bebchuk's earlier response to the criticism of the Shareholder Rights Project is available here, and the Bebchuk-Brav-Jiang responses to the Wachtell Lipton criticisms of their study are available here and here.

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

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

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

> Many commentators lament the short-term demands of the capital markets. We share those concerns, and believe it is part of our collective role as actors in the global capital markets to challenge that trend. Corporate leaders can play their

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

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

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

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

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

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

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

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

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

- SEC Commissioner Daniel Gallagher, who has wide knowledge and deep understanding of the securities business and corporate governance, recently questioned whether "investment advisors are indeed truly fulfilling their fiduciary duties when they rely on and follow recommendations from proxy advisory firms" and expressed "grave concerns" about institutional investors engaging in "rote reliance" on proxy advisory firm advice. He attributed this in part to the unintended consequences of two SEC staff no-action letters from 2004, which he noted were not approved by the Commission and did not necessarily represent the view of the Commission or the Commissioners, that had "unduly increased the role of proxy advisory firms in corporate governance" by "essentially mandating the use of third party opinions." *New Commission-level guidance could replace these staff interpretations and, instead, encourage proxy voting based on individual evaluation of each company and its long-term best interests. Other agencies may also wish to keep this illustration of unintended and undesired outcomes in mind as appropriate.*
- Commissioner Gallagher has also recently called attention to activist shareholders taking advantage of Securities Exchange Act Rule 14a-8 to force the inclusion, year-after-year and notwithstanding prior failures, of corporate governance and business-related shareholder proposals in public company proxy statements that have little connection to effective governance or the creation of long term shareholder value. These proposals can be misused to exert leverage over companies, and dealing with them distracts from the business and requires significant time and resources. *We endorse Commissioner Gallagher's call to revisit Rule 14a-8 to raise the bar on inclusion of shareholder proposals. This could include more substantial and longer-term ownership requirements*

to be eligible under Rule 14a-8, and exclusion of proposals in subsequent years that did not obtain a truly meaningful level of support (current rules prohibit a company from excluding a repeat proposal the following year unless 97% of the shares reject it the first time or 90% of the shares reject it at least three times, standards that are far too low.

- Proxy advisory firms, such as Institutional Shareholder Services (ISS) and Glass, Lewis & Co., have disproportionate influence over voting decisions made by every public company's institutional shareholder base and regularly support activist shareholders and hedge funds. Their recommendations and analyses may also contain material inaccuracies, and companies have little visibility into the preparation of these reports and the proxy advisory firms' methodologies. *We believe that the proxy advisory firms should be held to reasonable standards to ensure transparency, accuracy and the absence of conflicts and the special treatment.*
- Activist hedge funds have recently exploited loopholes in existing 13(d) regulatory requirements to accumulate significant, control-influencing stakes in public companies rapidly without timely notice to the market. These techniques are facilitated by the widespread use of derivatives, advanced electronic trading technology and increased trading volumes. Many non-U.S. securities markets have already taken action to address the risks of such rapid, undisclosed accumulations. A rulemaking petition, pending before the SEC since March 2011, would require acquirers of 5%+ stakes to disclose such positions to the public within one day, instead of the current ten-day window established forty years ago. *We believe approval of this rulemaking petition will help curb abuses and bring the rules current with contemporary practices and technologies.*
- Companies face significant difficulty engaging with their institutional shareholder base because the current reporting regime does not provide timely information to companies as to who their shareholders are. A second rulemaking petition pending before the SEC, submitted in February 2013, requests that the SEC shorten the deadline for institutional investors to report their positions on Forms 13F from 45 days to two business days after quarter-end and increase the frequency with which shareholders report their position. The petition also supports reform of the 13(d) stock accumulation rules. *We believe approval of this rulemaking petition will promote market transparency and facilitate engagement between companies and shareholders.*
- Harvard Law School Professor Lucian Bebchuk, who believes that shareholders should have the right to control all of the material decisions of the companies they invest in, has established the Harvard Law School Shareholder Rights Project (previously discussed here) to promote corporate governance—based on his policy beliefs—that facilitates activist hedge fund attacks on companies. He has also published several articles and editorials arguing that activist attacks are beneficial to the targeted companies and should

be encouraged. His articles and editorials are widely used by activist hedge funds and institutional shareholders to justify their actions. *We believe that the statistics Professor Bebchuk uses do not establish the validity of his claims that activist attacks are beneficial. We believe that attacks, and the threat of attacks, by activist hedge funds and pervasive activism are major causes of underinvestment, unemployment and slow growth of GDP. We believe that the recent academic studies by:*

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

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

Tab 2: Current Issues Regarding Short-Termism

Tab 3: Classified Boards and Annual Elections

The Harvard Law School Forum on Corporate Governance and Financial Regulation
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Toward Board Declassification in 100 S&P 500 and Fortune 500 Companies: The SRP's Report for the 2012 and 2013 Proxy Seasons

Posted by Lucian Bebchuk, Scott Hirst and June Rhee, Shareholder Rights Project, on Tuesday February 25, 2014

Editor's Note: Lucian Bebchuk is the Director of the Shareholder Rights Project (SRP), Scott Hirst is the SRP's Associate Director, and June Rhee is a counsel at the SRP. The SRP, a clinical program operating at Harvard Law School, works on behalf of public pension funds and charitable organizations seeking to improve corporate governance at publicly traded companies, as well as on research and policy projects related to corporate governance. Any views expressed and positions taken by the SRP and its representatives should be attributed solely to the SRP and not to Harvard Law School or Harvard University. The work of the SRP has been discussed in other posts on the Forum available here.

The Shareholder Rights Project (SRP) just released its final report for the 2012 and 2013 proxy seasons, the SRP's first two years year of operations. As the report details, major results obtained include the following:

- 100 S&P 500 and Fortune 500 companies (listed here) entered into agreements to move toward declassification;
- 81 S&P 500 and Fortune 500 companies (listed here) declassified their boards; these companies have aggregate market capitalization exceeding one trillion dollars, and represent about two-thirds of the companies with which engagement took place;
- 58 successful declassification proposals (listed here), with average support of 81% of votes cast; and
- Proposals by SRP-represented investors represented over 50% of all successful precatory proposals by public pension funds and over 20% of all successful precatory proposals by all proponents.

Expected Impact by End of 2014: As a result of these outcomes and the ongoing work of the SRP and SRP-represented investors, it is estimated that, by the end of 2014, the work of the SRP and SRP-represented investors will have resulted in:

- About 100 board declassifications by S&P 500 and Fortune 500 companies;
- Declassification of the boards of over 60% of the S&P 500 companies that had classified boards as of the beginning of 2012; and
- A decrease in the incidence of classified boards among S&P 500 companies to less than 10%.

Below is more detailed information about the results and work described in the SRP's 2012-2013 report:

- **100 Companies Agreeing to Declassify**: Negotiated outcomes—whereby the companies have entered into agreements agreed to bring management proposals to declassify—have been obtained with 100 S&P 500 and Fortune 500 companies (see details here); these companies represent over 85% of the companies receiving shareholder proposals from SRP-represented investors in 2012 and/or 2013.
- **81 Board Declassifications**: A total of 81 S&P 500 and Fortune 500 companies (listed here) declassified their boards during 2012 and 2013 following agreements with SRP-represented investors and/or successful precatory proposals by SRP-represented investors. The 81 companies whose boards were declassified have aggregate market capitalization exceeding one trillion dollars (as of December 31, 2013). These companies represent about two-thirds of the companies with which engagement took place, and over 50% of the 126 S&P companies that had classified boards as of the beginning of 2012.
- **58 Successful Proposals**: 58 precatory declassification proposals brought by SRP-represented investors during 2012 and/or 2013 passed by substantial margins—with average support of 81% of votes cast—at annual meetings of S&P 500 and Fortune 500 companies (listed here). These 58 successful proposals represent 95% of the precatory declassification proposals brought by SRP-represented investors that went to a vote at 2012 and/or 2013 annual meetings.
- **A Significant Contribution to Successful Shareholder Engagement**: The successful shareholder proposals submitted by SRP-represented investors represented over 50% of all successful proposals by public pension funds in 2012 and 2013, and over 20% of all successful shareholder proposals in that period.
- **Many Additional Future Declassifications**: In addition to the 81 board declassifications that have already taken place, we expect many additional declassifications by S&P 500 and Fortune 500 companies to result from (i) seven agreed-upon management proposals already committed to by companies entering into agreements during 2012 or 2013 and (ii) a substantial number of additional agreed-upon management proposals that are

expected to result from ongoing engagements and the submission of proposals for 2014 annual meetings.

- **Expected Results**: Overall, the SRP expects that, by the end of 2014, the work of the SRP and SRP-represented investors will have resulted in about 100 board declassifications by S&P 500 and Fortune 500 companies, and a decrease in the incidence of classified boards among S&P 500 companies to less than 10%.
- **Benefits of Declassification**: Annual elections are widely viewed as corporate governance best practice. Board declassification and annual elections could make directors more accountable, and thereby contribute to improving performance and increasing firm value. The substantial shareholder support for board declassification, and the significant empirical evidence consistent with this support, are described in two pieces by the SRP's director, entitled Giving Shareholders a Voice and Why Wachtell Lipton was Wrong about the SRP, and in the SRP's 2012-2013 Report.
- **SRP-Represented Investors**: The institutional investors that worked with the SRP during 2012 and/or 2013 are the Florida State Board of Administration, the Illinois State Board of Investment, the Los Angeles County Employees Retirement Association, the Massachusetts Pension Reserves Investment Management Board, the Nathan Cummings Foundation, the North Carolina State Treasurer, the Ohio Public Employees Retirement System, and the School Employees Retirement System of Ohio. These investors serve more than three million members and manage assets with a total value of more than $400 billion. Additional information about each of the SRP-represented investors is available here.
- **SRP Work**: The SRP provides SRP-represented investors with a range of services, including assistance in connection with selecting companies for proposal submission, designing proposals, submitting proposals on behalf of represented investors, engaging with companies, negotiating and executing agreements by companies to bring management declassification proposals, and presenting proposals at annual meetings.

The updated and final version of the SRP's 2012-2013 Report is available here. This report updates the SRP's preliminary report, which was released on October 29, 2013, to reflect subsequent outcomes through the end of 2013.

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Harvard's Shareholder Rights Project is Wrong

Posted by Martin Lipton and Theodore Mirvis, Wachtell, Lipton, Rosen & Katz, on Friday March 23, 2012

Editor's Note: Martin Lipton is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy. Theodore Mirvis is a partner in the Litigation Department at Wachtell Lipton. This post is based on a Wachtell Lipton memorandum by Mr. Lipton, Mr. Mirvis, Daniel A. Neff, and David A. Katz. This post discusses the 2011/2012 activities of the Harvard Law School Shareholder Rights Project, which are described in an earlier post here.

The Harvard Law School Shareholders Rights Project (SRP) recently issued joint press releases with five institutional investors, principally state and municipal pension funds, trumpeting SRP's representation of and advice to these investors during the 2012 proxy season in submitting proposals to more than 80 S&P 500 companies with staggered boards, urging that their boards be declassified. The SRP's "News Alert" issued concurrently reported that 42 of the companies targeted had agreed to include management proposals in their proxy statements to declassify their boards – which reportedly represented one-third of all S&P 500 companies with staggered boards. The SRP statement "commended" those companies for what it called "their responsiveness to shareholder concerns."

This is wrong. According to the Harvard Law School online catalog, the SRP is "a newly established clinical program" that "will provide students with the opportunity to obtain hands-on experience with shareholder rights work by assisting public pension funds in improving governance arrangements at publicly traded firms." Students receive law school credits for involvement in the SRP. The SRP's instructors are two members of the Law School faculty, one of whom (Professor Lucian Bebchuk) has been outspoken in pressing one point of view in the larger corporate governance debate. The SRP's "Template Board Declassification Proposal" cites two of Professor Bebchuk's writings, among others, in making the claim that staggered boards "could be associated with lower firm valuation and/or worse corporate decision-making."

There is no persuasive evidence that declassifying boards enhance stockholder value over the long-term, and it is our experience that the absence of a staggered board makes it significantly

harder for a public company to fend off an inadequate, opportunistic takeover bid, and is harmful to companies that focus on long-term value creation. It is surprising that a major legal institution would countenance the formation of a clinical program to advance a narrow agenda that would exacerbate the short-term pressures under which American companies are forced to operate. This is, obviously, a far cry from clinical programs designed to provide educational opportunities while benefiting impoverished or underprivileged segments of society for which legal services are not readily available. Furthermore, the portrayal of such activity as furthering "good governance" is unworthy of the robust debate one would expect from a major legal institution and its affiliated programs. The SRP's success in promoting board declassification is a testament to the enormous pressures from short-term oriented activists and governance advisors that march under the misguided banner that anything that encourages takeover activity is good and anything that facilitates long-term corporate planning and investment is bad.

Staggered boards have been part of the corporate landscape since the beginning of the modern corporation. They remain an important feature to allow American corporations to invest in the future and remain competitive in the global economy. The Harvard Law School SRP efforts to dismantle staggered boards is unwise and unwarranted, and – given its source – inappropriate. As Delaware Chancellor Leo Strine noted in a 2010 article: "stockholders who propose long-lasting corporate governance changes should have a substantial, long-term interest that gives them a motive to want the corporation to prosper."

The Harvard Law School Forum on Corporate Governance and Financial Regulation
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Harvard's Shareholder Rights Project is Still Wrong

Posted by Martin Lipton and Daniel Neff, Wachtell, Lipton, Rosen & Katz, on Friday November 30, 2012

Editor's Note: Martin Lipton is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy. Daniel A. Neff is co-chairman of the Executive Committee and partner at Wachtell Lipton. This post is based on a Wachtell Lipton memorandum by Mr. Lipton, Mr. Neff, Andrew R. Brownstein, Adam O. Emmerich, David A. Katz, and Trevor S. Norwitz. This post discusses the 2012/2013 activities of the Shareholder Rights Project, which are described in an earlier post here.

A small but influential alliance of activist investor groups, academics and trade unions continues — successfully it must be said — to seek to overhaul corporate governance in America to suit their particular agendas and predilections. We believe that this exercise in corporate deconstruction is detrimental to the economy and society at large. We continue to oppose it.

The Shareholder Rights Project, Harvard Law School's misguided "clinical program" which we have previously criticized, today issued joint press releases with eight institutional investors, principally state and municipal pension funds, trumpeting their recent successes in eliminating staggered boards and advertising their "hit list" of 74 more companies to be targeted in the upcoming proxy season. Coupled with the new ISS standard for punishing directors who do not immediately accede to shareholder proposals garnering a majority of votes cast (even if they do not attract enough support to be passed) — which we also recently criticized — this is designed to accelerate the extinction of the staggered board.

While the activist bloc likes to tout annual elections as a "best practice" on their one-size-fits-all corporate governance scorecards, there is no persuasive evidence that declassifying boards enhances shareholder value over the long term. The argument that annual review is necessary for "accountability" is as specious in the corporate setting as it is in the political arena. In seeking to undermine board stewardship, the Shareholder Rights Project and its activist supporters are making an unsubstantiated value judgment: they prefer a governance system which allows for a greater incidence of intervention and control by fund managers, on the belief that alleged principal-agent conflicts between directors and investors are of greater concern than those

between fund managers and investors. Whether these assumptions and biases are correct and whether they will help or hurt companies focus on long-term value creation for the benefit of their ultimate investors are, at best, unknown. The essential purpose of corporate governance is to create a system in which long-term output and societal benefit are maximized, creating prosperity for the ultimate beneficiaries of equity investment in publicly-traded corporations. Short-term measurement and compensation of investment managers is not necessarily consistent with these desired results. Indeed the ultimate principals of investment managers — real people saving for all of life's purposes — depend not on opportunism, shareholder "activism" or hostile takeovers, but rather on the long-term compound growth of publicly-traded firms.

As we have said, it is surprising and disappointing that a leading law school would, rather than dispassionately studying such matters without prejudice or predisposition, choose to take up the cudgels of advocacy, advancing a narrow and controversial agenda that would exacerbate the short-term pressures under which U.S. companies are forced to operate. In response to our critiques, the activists resort to ad hominem attacks, suggesting that, "as counsel for incumbent directors and managers seeking to insulate themselves from removal" we "advocate for rules and practices that facilitate entrenchment." The fact is that the board-centric model of corporate governance has served this country very well over a sustained period. A compelling argument should be required before those corporate stewards who actually have fiduciary duties, and in many cases large personal and reputational investments in the enterprises they serve, are marginalized in favor of short-term-oriented holders of widely diversified and ever-changing portfolios under the influence of self-appointed governance "experts." Indeed a just published comprehensive study by a distinguished group of professors at the London School of Economics demonstrates that the statistical analyses relied on by these experts are seriously flawed and that the shareholder-centric governance they are trying to impose was a significant factor in the poor performance by a large number of banks in the financial crisis.

Tab 4: Poison Pills and Low-Threshold Poison Pills

The Harvard Law School Forum on Corporate Governance and Financial Regulation
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Don't Make Poison Pills More Deadly

Posted by Lucian Bebchuk, Harvard Law School, on Thursday February 7, 2013

Editor's Note: Lucian Bebchuk, professor of law, economics and finance at Harvard Law School, is co-author (with Robert J. Jackson Jr.) of The Law and Economics of Blockholder Disclosure. This post draws on Professor Bebchuk's *New York Times* DealBook column Don't Make Poison Pills More Deadly.

In a column published today on the *New York Times* DealBook, as part of my column series, I focus on an important but largely overlooked aspect of the SEC's expected consideration of tightening the 13(d) rules governing blockholder disclosure. The column, titled "Don't Make Poison Pills More Deadly," is available here, and it develops an argument I made in a Conference Board debate with Martin Lipton, available here.

The column explains that an unintended and harmful effect of the considered reform may be that it will help companies adopt low-threshold poison pills – arrangements that cap the ownership of outside shareholders at levels like 10 or 15 percent. The SEC, I argue, should be careful to avoid such an outcome in any rules it may adopt.

The SEC is planning to consider a rule-making petition, filed by a prominent corporate law firm, that proposes to reduce the 10-day period, as well as to count derivatives toward the 5 percent threshold. The push for tightening disclosure rules is at least partly driven by the benefits that earlier disclosure would provide for corporate insiders. Supporters of the petition have made it clear that tightening disclosure requirements is intended to alert not only the market but also incumbent boards and executives in order to help them put defenses in place more quickly.

The drafters of the Williams Act envisioned a landscape that would allow outsiders who were not seeking to control a company to keep accumulating shares, provided that they made the required disclosures. But companies in the United States have been increasingly using poison pills with low thresholds to limit the stakes of outside shareholders they disfavor.

Indeed, among the 637 companies with poison pills in the FactSet Systems database, 80 percent have plans with a threshold of 15 percent or less. No other developed economy grants corporate insiders the freedom to cap the ownership of blockholders they disfavor at such low levels.

The current ability of insiders to adopt low-threshold poison pills is a highly relevant factor for any assessment of the rules governing the relationship between incumbents and outside shareholders. In particular, the SEC should recognize that tightening disclosure requirements could impose costs on public investors and the economy by facilitating the use of such pills.

If the SEC does decide that tightening disclosure requirements is desirable, it should design the rules to avoid aiding the use of such poison pills. This could be done by limiting the application of tightened disclosure requirements to companies whose charters do not permit the use of low-threshold poison pills.

Proponents of the petition, which has thus far failed to attract any supportive comments from institutional investors, should endorse including such a limitation in any reform. Doing so is necessary to address concerns that tightened disclosure requirements might be aimed at protecting entrenched insiders rather than public investors.

Even if the petition's proponents keep pressing for rules that would facilitate low-threshold poison pills, the SEC should avoid serving this objective. As the investor's advocate, the SEC should ensure it does not take any action that would harm investors by facilitating the pernicious use of such poison pills.

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Delaware Court Denies Activist's Motion to Enjoin Sotheby's Shareholder Meeting

Posted by Victor I. Lewkow, Cleary Gottlieb Steen & Hamilton LLP, on Monday May 5, 2014

Editor's Note: Victor Lewkow is a partner at Cleary Gottlieb Steen & Hamilton LLP. This post is based on a Cleary Gottlieb memorandum by Benet J. O'Reilly and Aaron J. Meyers, and is part of the Delaware law series, which is cosponsored by the Forum and Corporation Service Company; links to other posts in the series are available here.

On May 2, 2014, the Delaware Chancery Court denied a motion to preliminarily enjoin Sotheby's annual stockholder meeting based on allegations by an activist stockholder, Third Point LLC, that the Sotheby's board of directors violated its fiduciary duties by adopting a rights plan (or "poison pill") and refusing to provide a waiver from its terms in order to obtain an advantage in an ongoing proxy contest. Applying the two-prong *Unocal* test, Vice Chancellor Parsons held that the plaintiffs failed to demonstrate a reasonable probability of success on the merits of their claims. Notably, the Chancery Court accepted that the threat of "negative control" (i.e., disproportionate influence over major corporate decisions) by a stockholder with less than 20% ownership and without any express veto rights may constitute a threat to corporate policy justifying responsive action by a board, including the adoption and retention of a right plan.

Background

Beginning in early 2013, Third Point and two other activist hedge funds established a position in Sotheby's stock, with Third Point ownership eventually reaching approximately 9.6% and the collective ownership of the three funds reaching approximately 19%. In August 2013, Sotheby's management met separately with Third Point and one of the other funds, Marcato, with the funds suggesting potential changes to Sotheby's strategy and leadership.

In October 2013, Third Point filed an amended Schedule 13D attaching a letter from Daniel Loeb, Third Point's CEO, to William Ruprecht, Sotheby's Chairman, President and CEO, raising concerns about Sotheby's and suggesting, among other things, that several new directors recruited by Mr. Loeb be added to Sotheby's board. Inferring the letter to be part of an "all out assault" intended to destabilize Sotheby's, the board adopted a two-tiered rights plan, triggered at

a 10% ownership level, but allowing any "passive" stockholder to acquire up to 20%. By its terms, the rights plan would expire in one year unless approved by a vote of Sotheby's stockholders and would not apply to a tender offer for all outstanding Sotheby's shares that remained open for at least 100 days.

In February 2014, Third Point and Sotheby's engaged in negotiations in an attempt to avoid a proxy contest in the lead up to Sotheby's annual meeting scheduled for May 6. Third Point sought, among other things, two seats on Sotheby's board and for the rights plan's trigger to be raised to 15%. Sotheby's offered Third Point a single board seat, subject to certain conditions including a standstill agreement capping Third Point's ownership at approximately 10%. The parties failed to reach agreement and, in March 2014, Third Point requested a waiver from the rights plan to allow it to purchase up to a 20% stake in Sotheby's. Sotheby's board was aware that the proxy contest was a "dead heat" and that an increase in Third Point's stake may have improved its likelihood of success. The board denied the request and Third Point filed suit, alleging that the board adopted and enforced the rights plan against Third Point for the primary purpose of inhibiting its ability to wage a successful proxy contest, without any compelling justification for doing so.

Applicable Legal Framework: *Unocal* and/or *Blasius*?

In evaluating the probability that Third Point's claims would succeed on their merits, the Chancery Court held that the board's compliance with its fiduciary duties as they relate to the rights plan must be assessed under the *Unocal* standard. The *Blasius* stringent "compelling justification" standard, though not mutually exclusive of the *Unocal* standard, could be applied only where "the primary purpose of the board's action is to interfere with or impede exercise of the shareholder franchise and the shareholders are not given a full and fair opportunity to vote effectively". Vice Chancellor Parsons noted that the plaintiffs had not cited any case in which *Blasius* was invoked to examine a rights plan, and suggested that the "reasonableness" prong of *Unocal* may adequately deal with any rights plan that adversely affects the shareholder franchise, making the application of *Blasius* unnecessary.

In any event, the Chancery Court concluded that the plaintiffs did not have a reasonable probability of demonstrating that the board adopted the rights plan for the *primary* purpose of interfering with any stockholder's franchise. In so concluding, the Chancery Court focused on the absence of any inference of entrenchment on the part of the board and the fact that the rights plan is neither coercive (since it does not impose any consequences on stockholders for voting their shares as they wish) nor preclusive (as the parties conceded that the proxy contest could be won by either side).

With respect to the board's refusal to grant Third Point's request to waive the 10% trigger, however, the Chancery Court described the question of the applicability of *Blasius* as "uncomfortably close", noting that the board's refusal came soon after it learned that Third Point's acquisition of an additional 10% stake likely would ensure Third Point's victory in the proxy contest. Vice Chancellor Parsons was "not unsympathetic" to the plaintiffs' position, but noted that in *Moran* the Delaware Supreme Court held that some incidental reduction of the stockholder franchise as a result of the adoption of a rights plan was acceptable so long as a proxy contest remained a viable option, and that subsequent case law had expanded the scope of threats justifying an incidental reduction of the franchise beyond the hostile takeover context. Nevertheless, the Vice Chancellor indicated that the plaintiffs' claims in this respect raised important policy concerns that deserved careful consideration under *Unocal*.

Application of the *Unocal* Standard

The Chancery Court applied the two-prong *Unocal* standard separately to its review of Sotheby's adoption of the rights plan and the board's subsequent denial of Third Point's request for a waiver from its 10% trigger, in each case concluding that Third Point had failed to demonstrate a reasonable probability that the board would not be able to demonstrate that it had satisfied the relevant test.

The "reasonableness" prong of the *Unocal* test requires the board to have had reasonable grounds for believing that a legally cognizable threat to Sotheby's corporate policy and effectiveness existed, both when Sotheby's adopted the rights plan and when it refused Third Point's waiver request. With respect to the initial adoption of the rights plan, the Chancery Court focused on the threat of "creeping control" by the activist hedge funds, who may form a "wolfpack" to jointly acquire large blocks of a target company's stock. As to the board's refusal to waive the rights plan's 10% trigger and allow Third Point to buy up to 20% of Sotheby's, the Chancery Court relied on the threat of "negative control": the possibility that Third Point, as a 20% stockholder, could exercise disproportionate influence over major corporate decisions, even without any explicit veto power. Earlier Delaware case law relating to negative control had involved *explicit* veto power obtained via contractual rights or by ownership of a stake sufficient to block actions requiring a supermajority vote. Nevertheless, on the basis of the aggressive and domineering manner in which Mr. Loeb conducted himself in relation to Sotheby's and that, at 20% ownership, Third Point would be Sotheby's largest single stockholder by far, the Chancery Court found that the board could have an objectively reasonable basis to believe Third Point could control important corporate actions, presenting a threat legally cognizable under *Unocal*.

The "proportionality" prong of the *Unocal* test requires the board to demonstrate that its defensive response was reasonable and proportional in relation to the threat posed. The Chancery Court considered that a 10% threshold would allow any activist stockholder to hold a substantial ownership position relative to that of Sotheby's board (which collectively held less than 1%), that Third Point at just under 10% ownership was Sotheby's largest single stockholder, and that a trigger level much higher than 10% would make it easier for a small group of activist investors to achieve control without paying a premium.

Lessons Learned

The Chancery Court's opinion provides various important reminders for Delaware corporations, including:

- When considering whether to adopt, redeem, amend or waive any stockholder rights plan, directors should focus at all stages on the types of legally cognizable threats that will pass muster under the "reasonableness" prong of the *Unocal* test—the focus remains on threats to control of the company, including "creeping control" and "negative control".
- An independent board, advised by competent outside financial and legal advisors, will be granted additional deference in its determination of the threats posed by an activist investor. The Vice Chancellor highlighted that the Sotheby's board included only one member of management and ten of the eleven other directors were independent under NYSE standards, and that the average board tenure of 7.1 years was three years less than the average for the S&P 500.
- Another reminder that all written and electronic communications may be subject to discovery and subsequently revealed in litigation. The parties introduced numerous and candid emails among members of the board; among members of Sotheby's financial advisors; and among the Third Point investment team—and the Chancery Court's opinion even refers to personal emails exchanged between Sotheby's CEO and his sister. The candid sharing of ideas among independent directors is critical to a healthy board debate, but is best reserved for a meeting or conversation. The likelihood of potentially embarrassing communications can be reduced by providing sufficient and regular opportunities for directors to engage in in-person discussions.
- More generally, a rights plan is of limited utility in connection with shareholder activism and therefore boards ought to continue to take into account the considerations and advice conveyed in our recent memorandum, Selected Issues for Boards in 2014 (discussed on the Forum here).

Tab 5: Incentive Schemes for Nominees of Activist Investors

The Harvard Law School Forum on Corporate Governance and Financial Regulation
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Incentive Schemes for Nominees of Activist Investors

Posted by Noam Noked, co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Wednesday June 5, 2013

Editor's Note: The following post comes to us from Neil Whoriskey, partner focusing on mergers and acquisitions at Cleary Gottlieb Steen & Hamilton LLP. This post is based on a Cleary Gottlieb memorandum by Mr. Whoriskey.

Golden leashes – compensation arrangements between activists and their nominees to target boards – have emerged as the latest advance (or atrocity, depending on your point of view) in the long running battle between activists and defenders of the long-term investor faith. Just exactly what are we worried about?

With average holding periods for U.S. equity investors having shriveled from five years in the 1980s to nine months or less today, the defenders of "long-termism" would seem to have lost the war, though perhaps not the argument. After all, if the average shareholder is only sticking around for nine months, and if directors owe their duties to their shareholders (average or otherwise), then at best a director on average will have nine months to maximize the value of those shares. Starting now. Or maybe starting nine months ago.

But this assumes that the directors of any particular company have a real idea of just how long their particular set of "average" shareholders will stick around, and it also assumes that the directors owe duties primarily to their average shareholders, and not to their Warren Buffett investors (on one hand) or their high speed traders (on the other). So, in the absence of any real information about how long any then-current set of shareholders will invest for on average, and in the absence of any rational analytical framework to decide which subset(s) of shareholders they should be acting for, what is a director to do?

Here is what I think directors do, in one form or fashion or another:

They say to themselves, "I have a good sense of what the company's opportunities are, in terms of long-term growth, and in terms of shorter-term options, like a share buyback, a spin-off, or a sale. Since I don't know how long any of my shareholders will be sticking around for, what seems fair, is to probability weight the various outcomes of share price increases from a long-term

growth strategy versus the various shorter-term strategic alternatives, and decide based on the net present value of those probability-weighted outcomes, what yields the highest current net present value." While no directors probably think exactly this way (unless they are confronted with a clear choice between, e.g., doing a stock buyback versus embarking on an expensive capex program), I do think this reflects (albeit in a cartoonishly precise way) what directors are doing when they choose a strategic direction.

Assuming perfect knowledge and universal agreement on the correct probability weighting, risk tolerance and present value methodology, this approach should yield the highest share price at all times – regardless of any investor's timeframe – thus resolving once and forever the false debate between short-termism and long-termism.

Sort of. In fact, the problem still exists in the real world, due to the unfortunate lack of perfect knowledge,[1] and equally unfortunate disagreements regarding probability weighting, risk tolerances and, to a lesser degree, present value discount rates and methodologies. The short-termers (henceforth, in order to continue the theme of cartoonish oversimplification, "activist hedge funds") and the long-termers (in a similar vein, henceforth known as "management"), in particular seem to clash over probability weighting and, less openly though perhaps as fundamentally, risk tolerances.[2]

According to this narrative, activist hedge funds are constantly pushing for short-term actions – share buybacks, spin-offs, sales – either because they more heavily discount the probability of success of long-term actions (or simply think the broader market will too heavily discount the probability of success of a long-term strategy), or because they have a lower risk tolerance than management. Management, per this same narrative, is always too certain of the success of its long-term plans, or alternatively – in the most vitriolic forms of this narrative – they are entrenched self-dealing types who just don't care about their shareholders.

It may be worth pausing for just a moment on the two aspects of this analysis – probability weighting and risk tolerances – that are the implicit subject of many a long-term v. short-term battle.

In one sense, probability weighting of the success of various alternative strategies – though it is at the heart of the director's job – presents the simpler issue for our immediate purpose of

[1] *See* Sanford J. Grossman and Joseph E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. REV. 393 (1980).

[2] Getting enough information into the market about a particular long-term strategy seems to be less of an issue between the two camps – perhaps because it is fairly clearly management's responsibility – but, as discussed below, curing market inefficiencies by getting information to the market may be one of the most important ways to bridge the long-term/short-term gap. There may be cases where confidentiality concerns prevent the proper explanation of a longer-term strategy, but in that case no one should be surprised if the market undervalues that long-term strategy.

determining which forms of incentives offered by activists to their board nominees may be improper. Either the Board is correct in probability weighting the success of various strategies, or it is wrong to one degree or another. Individual shareholder preferences do not come into play – regardless of who the shareholders are; there is a right answer and a wrong answer. As in any "right or wrong" issue, the shareholders who are right in doing the probability weighting will be able to make money from investors who are wrong, and those who are wrong will lose money. And of course, if the Board is wrong, then shareholders in the aggregate will lose money, regardless of their individual long- or short-term orientation. Accordingly, it is hard to imagine that an activist investor would wish to incentivize one of its board nominees to make the wrong analysis of the probability-weighted success of various alternative strategies open to the corporation – nobody makes money from directors shutting their eyes.

Risk tolerances are a bit different, as they reflect individual investor preferences, and they may be affected by the investor's time horizon. An example might be helpful.

Consider a case where directors are faced with a choice between Strategy A – implementing a leveraged stock buyback plan, which has a 100 percent chance of adding $1 to the share price in the short term – and Strategy B – a long-term capex plan, that has a 60 percent chance of adding $2 per share (on a net present value basis) to the market price two years from adoption. The immediate risk-adjusted value of the long-term capex alternative would be $1.20, but whether this is actually more attractive to the Board than the $1 per share "sure thing" will depend on its collective risk tolerance. Interestingly, the Board might have a lower risk tolerance than its shareholders for a simple reason: the Board (and the company) has only one shot at achieving the desired result, with a 40 percent chance of not succeeding. If the Board had two shots at getting it right, they would have only a 16 percent of getting nothing, a 48 percent chance of getting (on average) $1, and a 36 percent chance of getting (on average) $2. The more times the Board has to roll the dice, the more likely they are to realize (on average) the risk adjusted value of $1.20. In other words, the more times the Board can roll the dice, the more they reduce the 40 percent chance that they end up with zero.

What is interesting about this is that shareholders with a diversified portfolio may have more than one company in their portfolio facing similar odds – in effect, the shareholders get to roll the dice multiple times. Accordingly, one would think that shareholders, rather than pressing for the short-term payoff, would more typically be pressing for the riskier long-term payoff, which is clearly at

odds with the cartoon scenario depicted above.[3] Again, there are two traditional explanations that can be employed to solve this conundrum.

Fans of activist shareholders will argue that management's risk tolerance is inappropriately high – that they are incentivized to seek to increase the option value of their control by extending the length of their control – effectively increasing their risk tolerance for long-term strategies (and possibly impairing their judgment of the probability-weighted success of long-term plans). In other words, management is improperly incentivized to think long-term "especially if because of poor performance and strategy [the option value of its control] is then out of the money."[4]

On the other side of the equation, there may be another dynamic at work that lowers the risk tolerances of short-term investors. If shareholders are going to trade out, on average, within nine months – in fact in 4.5 months on average after any given announcement – they have to judge not only whether management has made the correct probability weighting, but also whether the market will give management full credit for its choice *before* they trade out. Even the most dedicated efficient market theorists will concede that it takes some time for all information about a particular strategic course to be filtered into and absorbed by the market. It seems reasonable to assume that the longer-term and riskier the strategy, the more time the market may need to absorb and judge.[5] If a board chooses Strategy B above (the option giving a 60 percent chance of a $2 return and 40 percent chance of zero return), and the market only gives $0.90 of credit for the choice in those first few months after the announcement, then the short-term shareholders will prefer the less risky Strategy A, yielding a 100 percent chance of a $1 return. So the risk tolerance of shareholders – particularly short-term shareholders – may be reduced by the inefficiencies of the market.

One could question why institutional holders would not simply hold their shares until the full $1.20 price increase was realized – everyone loves an undervalued stock, right? But regardless of whether you believe that investors have predetermined investment timeframes, there is another layer to the analysis that might cause diversified institutional shareholders, constantly on the lookout for the best value proposition, to prefer the less risky strategy.

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[3] Note however that, anecdotally at least, activist hedge funds are often thought to have significantly less diversified portfolios than other institutional investors, given their focus on effecting change at select targets, as opposed to locking in relative returns across a broad portfolio. Accordingly, based on this metric alone – which is of course but one of many – the risk tolerance of activist hedge funds might rationally be closer to that of the target board than that of its fellow institutional investors.

[4] Ronald J. Gilson and Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. (forthcoming May 2013).

[5] A board's announcement that it is waiting for the business cycle to turn is certainly less likely to move the market than a merger proposal. However, as was evidenced in the great Airgas/Air Products battle, a board's decision to wait for the business cycle to turn may well be a better strategic choice than selling into a premium offer. In that situation, the board (including independent directors nominated by the bidder Airgas) rejected Airgas's premium offer of $70 per share, in the face of very strong shareholder sentiment in favor of a deal. Ten months after the bid was abandoned, the stock was trading at $75 per share. *See Air Products and Chemicals, Inc. v. Airgas, Inc.*, 16 A.3d 48 (2011).

To continue with the example above, assume on the day the Board makes its decision, the stock was at $5 per share. On the day after the Board selects Strategy B, the price per share increases not to $6.20 but only to $5.90. In simplest terms, the shareholder is now holding a stock with a 60 percent upside opportunity of $1.10 (risk adjusted upside of $0.66) and a 40 percent downside risk of $0.90 (risk adjusted downside of $0.36). (This compares with our theoretical pre-decision profile of a risk adjusted upside opportunity of $1 or $1.20 (depending on the strategy chosen) and zero downside risk.) In other words, the risk profile changes significantly, and, when compared to other opportunities in the market, may well push the institutional holder toward an immediate sale. Knowing this, and knowing that the market may take some time to give full value to the longer-term strategy, can only make diversified institutional shareholders – regardless of any fixed time horizon[6] – strong advocates for the lower risk alternative, which will allow them to capture the $1 gain immediately and then move on to greener pastures.

(And note that market inefficiencies may build on themselves. A sale by investors at $5.90 may look like the market is reacting negatively to the board's choice of the long-term strategy – the market likely taking it as a vote of non-confidence in the strategic choice, rather than a rebalancing of a portfolio after a partial realization of a potential gain – which will put downward pressure on the company's shares, making it even less likely that the company will get full credit in the short term for its choice of a long-term strategy.)

So, to sum up, no one will want to incentivize a director to make a poor analysis of probability-weighted outcomes, but there are differences in risk tolerances among investors – which may be driven in part by market inefficiencies (or simply by fears of market inefficiencies). An investor may wish to incentivize a director to adopt that investor's risk tolerance, which may or may not be similar to the market in general or to the "average" shareholder or to any theoretical "optimal" risk tolerance.

The question of whether there is an "optimal" risk tolerance in any situation – high or low – is left to greater minds. But it may be worth noting that risk tolerances may be the least easily quantifiable of all the factors discussed above and the most prone to situational influences. Accordingly, even those most partial to hard and fast rules may view prescribing a particular optimal risk tolerance for all situations as impossible and admit to the necessity of deferring to the business judgment of the board – the honest broker between management and activist.

Which brings us, finally, to golden leashes.

[6] It seems more likely that diversified institutional holders focus less on holding shares for any particular length of time and more on optimizing their potential returns at all times.

Lately, in the context of a difficult proxy battle, Agrium Inc. complained mightily about the "golden leashes" placed by JANA Partners on JANA's nominees for five (out of 12) Agrium board seats. These leashes consisted of payments to the JANA-nominated directors of a percentage of JANA's profits from its investment in Agrium. JANA questioned how incentivizing board members to maximize share price could create a conflict of interest for directors.[7]

So what was Agrium worried about?

First, they may have been worried that otherwise nominally independent directors cannot possibly be truly independent if they are getting paid by one particular shareholder with a particular point of view – regardless of the form of payment. That seems to be a fairly fundamental objection, and shareholders prior to voting will presumably need to satisfy themselves that the proposed directors are in fact qualified, independent businessmen of sound judgment, and not lackeys of the insurgent. This question will get asked regardless of whether the insurgent provides any separate compensation to its nominees. JANA in response would argue that in order to get high quality, independent nominees to step into a contentious situation, something more than the usual director's fee is appropriate and, in fact necessary. Again, absent misaligned risk tolerances, all investors should have the same interest in hiring directors best able to evaluate and correctly probability weight the various alternatives open to the company. So, if you assume all investors have the exact same risk tolerance (and further assume the intellectual honesty of the nominees), paying certain directors more to do this job should not be an issue.

Sadly for those who love simplicity, assuming that all shareholders have the same risk tolerance is certain to be contra-factual. This may explain why Agrium seemed to be more agitated by the *form* of the payment than the mere *fact* of the payment. Here, the argument gets more interesting. It is one thing if the nominees simply get a flat fee for services rendered, regardless of how they are rendered; it is quite another if the nominees get a share of JANA's profits. Sharing JANA's profits raises the question rather directly as to whether the amount of the payment to be received by the nominees depends on the timeframe in which the shares will be sold by JANA, and, if the timeframe will determine the ultimate price realized, whether it is appropriate for an honest broker to have a cash incentive to adhere to a particular timeframe, which is outside of the nominees'

[7] JANA went on to lose the proxy fight, and the story lost any further instructive value at that point. Other recent examples include Elliott Management placing "golden leashes" on its short slate of nominees to the board of Hess Corporation, consisting of a payment for each percentage point by which Hess outperformed its peers at the end of a three-year period. Elliott's nominees waived their rights to these payments, saying they had become a distraction. In Carl Icahn's proxy battle with Forest Laboratories, Inc., he offered his nominee one percent of his profits over a certain share price (which was about 30 percent over the market price at the time of the proxy fight).

control.[8] In other words, does the lack of control of the time of disposition mean that the nominees will be incentivized to adopt the risk tolerance of the insurgent?

To be fair, it did not appear that JANA had announced any specific timeframe for its exit, so at the time of nomination there would not seem to have been any attempt to influence the nominees on that basis.[9] On the other hand, JANA certainly had not handed over the disposition decision to its independent nominees – nor is it likely JANA could do so, having fiduciary duties to its own investors. Accordingly, there remained the specter of JANA tugging on that golden leash by announcing, for instance, that it would sell all its holdings within x months, or, more likely, that it thought strategy x would certainly lose money for the company, leaving the nominees to divine what sort of action would follow if strategy x were pursued. In short, the arrangement did seem to vest JANA with a means, however attenuated, of influencing the pocketbook of the nominees, and not just influencing their informed opinion.[10]

Courts will always scrutinize these arrangements to see if they will tend to make honest brokers any less honest. Any arrangement that potentially unhitches a director's financial incentives from the exercise of his or her best judgment is bound to be viewed skeptically. And even if rational economic theory would tell us that all shareholders with the same risk tolerance should have the same interest at heart, courts will always scrutinize closely the independence of nominees with any sort of economic incentive to act on behalf of their proponents – even if there is no standard available for judging whether one sort of risk tolerance is better than another.[11]

[8] One could also consider whether getting a share of JANA's profits would incentivize the nominees to adopt JANA's view of the correct probability-weighted value of the different alternatives. Again, there would not seem to be much reason for the nominees (or JANA) to shut their eyes to a better value proposition, so long as they judged that value proposition with the same risk tolerance (informed by the same perception of market inefficiencies).

[9] The nominees would be entitled to a deemed profit on any shares still held by JANA after a three-year period, so effectively the scheme provided a strong incentive to maximize the share price on that date, to the extent JANA had not previously sold its shares. It should be noted that there are those who do not think three years is a "long-term" commitment to a corporation. For others, it seems almost impossible that it would take three years for the markets to efficiently value the prospects of a publicly traded company.

[10] The Deal Professor in his April 2, 2013 DealBook posting raised a great point about both the JANA and Elliott versions of golden leashes – both are upside-only payments. This creates an incentive that, taken to its extreme, might encourage a director to prefer a strategy with a 20 percent chance of making $10 and an 80 percent chance of losing $100 to a strategy with a 100 percent chance of making $2. Of course, as he also points out, this is also true to some extent of out-of-the-money options regularly awarded to management. Query whether upside-only incentives properly align the nominees' interests with activist funds that presumably have millions invested in the target stock and millions of potential downside. *See* Steven M. Davidoff, *Upping the Ante in a Play for a Stronger Board*, N.Y. TIMES (Apr. 2, 2013), http://dealbook.nytimes.com/2013/04/02/upping-the-ante-in-a-play-for-a-stronger-board/.

[11] Some might argue, reasonably, that a risk tolerance skewed in favor of short-term actions is preferable, as it reflects the reality that most shareholders are in fact short-term shareholders. Whether that is good policy is another question entirely. As is the question as to whether one could adopt measures to eliminate or reduce market imperfections that lead to delays in the market reflecting a proper risk-weighted valuation for target's shares (and that, as a result, skew risk tolerances).

The Harvard Law School Forum on Corporate Governance and Financial Regulation
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Disqualifying Dissident Nominees: A New Trend in Incumbent Director Entrenchment

Posted by Carl Icahn, Icahn Enterprises, on Wednesday February 12, 2014

Editor's Note: Carl Icahn is the majority shareholder of Icahn Enterprises. The following post is based on a commentary featured today at the Shareholders' Square Table.

There are many good, independent boards of directors at public companies in the United States. Unfortunately, there are also many ineffectual boards composed of cronies of CEOs and management teams, and such boards routinely use corporate capital to hire high-priced "advisors" to design defense mechanisms, such as the staggered board and poison pill, that serve to insulate them from criticism. Recently, these advisors have created a particularly pernicious new mechanism to protect their deep-pocketed clients—a bylaw amendment (which we call the "Director Disqualification Bylaw") that disqualifies certain people from seeking to replace incumbent members of a board of directors. Under a Director Disqualification Bylaw, a person is not eligible for election to the board of directors if he is nominated by a shareholder and the shareholder has agreed to pay the nominee a fee, such as a cash payment to compensate the nominee for taking the time and effort to seek election in a proxy fight, or compensation that is tied to performance of the company.[1]

We believe that the Director Disqualification Bylaw is totally misguided. It is absolutely offensive for an incumbent board to unilaterally adopt a Director Disqualification Bylaw without shareholder approval, and shareholders should also reject a Director Disqualification Bylaw if their incumbent board puts one up for a vote in the future. For the reasons explained below, we believe it is more appropriate for shareholders to continue, as they have in the past, to evaluate candidates individually based on their merits, including their experience, relationships and interests, all of which is required to be fully disclosed in a proxy statement.

[1] It is important to note that the law provides incumbent board members with unlimited license to spend shareholder capital in a proxy fight. Thus, the Director Disqualification Bylaw essentially amounts to authorizing an incumbent mayor, already authorized to use unlimited taxpayer dollars to wage his re-election campaign, to also be able to select his own opponent! That is why we call the Director Disqualification Bylaw "particularly pernicious."

As of November 30, 2013, thirty-three (33) public companies had unilaterally (i.e. without shareholder approval) amended their bylaws to include a Director Disqualification Bylaw.[2] In response, on January 13, 2014, Institutional Shareholder Services ("ISS") stated that it may recommend a vote against or withhold from directors that adopt a Director Disqualification Bylaw without shareholder approval. In adopting this new policy position, ISS noted, as we do below, that "the ability to elect directors is a fundamental shareholder right" and that Director Disqualification Bylaws "unnecessarily infringe on this core franchise right."

The law firm of Wachtell, Lipton Rosen & Katz LLP ("Wachtell Lipton"), which has long history of advising corporations in responding to activists, has accused ISS of "establishing a governance standard without offering evidence that it will improve corporate governance or corporate performance" and ignoring the "serious risks that [outside director compensation] arrangements pose to fiduciary decision-making and board functioning." In reality, it is those promoting Director Disqualification Bylaws who fail to provide evidence that outside director compensation arrangements (which, in a typical PR-savvy distortion of the facts, they have dubbed "golden leashes") actually pose "serious risks…to fiduciary decision-making and board functioning," and that is because in truth the risks that they focus on—"conflicted directors, fragmented and dysfunctional boards and short-termist behavior"—are just as likely (if not even more likely) to arise if directors can unilaterally disqualify potential candidates without consequence. Further, the recent Wachtell Lipton posting to The Harvard Law School Forum on Corporate Governance and Financial Regulation advises boards of directors regarding the adoption of variants of the Director Disqualification Bylaw, thereby ensuring that this issue remains a continuing controversy (and lucrative source of fees for advisors).

Perquisites for Incumbent Directors—Creating a Real Conflict of Interest

For decades, perquisites have been lavished on so called "independent" directors of public companies, even in times of declining profitability at the companies they supposedly oversee. Boards have routinely teamed up with management to establish mutually beneficial "arrangements" (a cynic may call them "bribes") to make available to one another such perks as access to private planes, box seats at premier sporting events, country club memberships, re-pricing of underwater stock options, tax gross-ups and, of course, massive cash payments, all at the cost of shareholders and to the benefit of directors, management and other entrenched powers. One particularly good example occurred at Chesapeake Energy Corp. before we took a position in the company. During fiscal year 2011, under company policy, non-employee directors were permitted forty (40) hours of personal use of the company's fractionally owned aircrafts,

[2] It is not surprising that 14 of the 33 companies that have embraced the Director Disqualification Bylaw also have staggered boards, compared to less than 11% of companies in the S&P 500 index.

while the company's CEO received, with board approval, total compensation of almost $18 million. Unfortunately for Chesapeake shareholders, the stock price did not fare nearly as well in fiscal 2011 as incumbent directors and management did—as of the end of the year the company's share price had declined over 37% from its 52-week high. It is that kind of mutual profiteering at the expense of shareholders that has resulted in a market in which CEOs of failing companies make 1000 times the wages of the average worker and then, when they are finally shown the door, exit with multi-million dollar "golden parachutes."

Nevertheless, the propriety and legality of perquisites for incumbent directors is viewed as "business as usual." It is therefore particularly irksome that apologists for incumbent boards are now cynically raising questions about whether activist shareholders should be permitted to compensate their nominees for board membership. One supposed justification for the Director Disqualification Bylaw is that compensation arrangements between activist shareholders and their nominees create a conflict of interest. But these cynics conveniently turn a blind eye when management and directors at Service Corporation International, one of the 33 companies that adopted a Director Disqualification Bylaw, allow themselves personal use of private airplanes at the expense of shareholders. Similarly, they are not bothered that most of the outside directors of International Game Technology ("IGT"), another one of the 33 companies that has adopted a Director Disqualification Bylaw, received total compensation of over $300,000 last year. Perhaps the apologists think that is fair compensation since IGT's stock has only underperformed its peers by approximately 60% over the last three years. Regardless of the reason, those defending the Director Disqualification Bylaw, ignore the fact that corporate perks and inflated director compensation at the expense of shareholders create an environment where board members are more loyal to current management than they are to the shareholders, which is the real conflict of interest we should all be concerned about.

Disparate Positions of Board Members—The Inherent Norm

Those promoting the Director Disqualification Bylaw claim that it is necessary to prevent conflicts of interest among directors. But, in reality, disparity among board members has always existed in the past and will always exist in the future. For example, one director may have been on a board for many years, be highly dependent on board compensation to pay his expenses and have accumulated a large position in company stock due to his years of service. Another board member may be newly elected—perhaps he is an independently wealthy former executive of a large supplier of materials to the company, holding only a small number of shares of company stock but a large number of shares of stock in his former employer. A third could be a grandson of the founder of the company. He may also serve as trustee for certain family trusts holding large numbers of company shares, and some of his family members may be pushing the trust (and the

board) to increase the dividends that they live on, while other family members may be supporting greater company investment in research and development. The point is that the personal positions of all of these people will inevitably create different interests and priorities—but these competing interests and priorities do not disqualify them from board service. Rather, such disparate situations are part of the normal reality of board membership and have, since the creation of the corporation as a business form, been dealt with at the board level through time-tested processes, such as, among other things, board members abstaining from voting in certain circumstances, satisfaction of fiduciary obligations and transparency in the election process. No one is suggesting (nor should they) that these very real differences among board members should disqualify anyone from board membership. Similarly, the particular circumstances of a nominee who has agreed to receive additional compensation from a shareholder create no novel issues that justify a "solution" as draconian as the Director Disqualification Bylaw. Clearly, the Director Disqualification Bylaw is, in actuality, simply another entrenchment device purposely designed to separate management from owner (i.e. shareholder) influence and limit the ability of an activist shareholder to build a slate of highly-qualified nominees to challenge incumbent directors and the status quo.

Compensation by Activist Shareholders—Aligning the Interests of Nominees and Shareholders

Apologists for incumbent boards also ignore the most obvious facts about the compensation paid to shareholder nominees for board membership. Compensation arrangements between activist shareholders and their nominees have historically come in two forms: (i) fees in recognition of the time commitment and effort inherent in participating in a contentious proxy fight, and (ii) incentive compensation tied to the performance of the company. The fees paid to nominees in recognition of the time commitment involved in participating in a contentious proxy fight are paid *prior* to becoming a director. In fact, in many cases these fees are not payable *at all* if the nominee is ultimately elected or appointed to the board of directors (in which case the nominee will instead receive customary director compensation from the company). But of vastly more significance is the fact that compensation arrangements based on the performance of the company, such as those that were at issue in last year's contested proxy fights at Hess Corp. and Agrium, Inc., only reward directors when a company is succeeding. In other words, even when a director will receive compensation from an activist shareholder, the amount of which will be determined based on the performance of the company, the interests of that director remain fully aligned with those of shareholders—*it is in their economic interest to see the value of the company increase*.

Shareholder Choice

Under our federal securities laws, shareholders are required to be informed of all facts material to electing directors, which includes full disclosure of any compensation arrangement between a nominee and an activist shareholder. **It is then up to those shareholders to determine, with full knowledge of the facts, including the precise terms of any compensation arrangement, whether to elect an activist's nominee or some golfing buddy of the current CEO.** Therefore, in considering the Director Disqualification Bylaw and the issue of nominee compensation by activists, we pose the following questions: **If fully informed shareholders wish to elect a nominee who has agreed to be compensated by an activist to the board of directors of the company they own, who then are the incumbent board members to say that they cannot do so? And why should any bylaw prohibit or infringe on this choice? This is the most obviously objectionable characteristic of the Director Disqualification Bylaw—the fact that it undermines the most basic right of shareholders—the right to decide, through an election, who shall serve on the board of directors of a company *owned* by those very shareholders**.

The Importance of Activists as a Market Force

The value of activist shareholder interventions is demonstrable and significant. For example, from November 15, 2008 to November 15, 2013 (a five year period), Icahn nominees joined the boards of directors of 20 public companies. A person that invested in each company on the date that the Icahn nominee joined the board and sold on the date that the Icahn nominee left the board (or continued to hold through November 15, 2013, if the nominee did not leave the board) would have obtained an annualized return of 28%. Similarly, Professor Lucian Bebchuk of Harvard Law School and his colleagues Alon Brav of Duke University's Fuqua School of Business and Wei Jiang of Columbia Business School, studied about 2,000 activist interventions from 1994 to 2007 and found that activist interventions are typically followed by a five-year period of improved operating performance. (The study is discussed on the Forum here.) This kind of success has inspired a generation of activist investors, and as a movement I believe that we are empowering shareholders. Nevertheless, despite such tremendous success at enhancing shareholder value and improving operating performance, companies and their highly-paid "advisors" continue to erect obstacles to prevent activists from seeking direct shareholder representation on boards of directors. The Director Disqualification Bylaw is just the latest device developed by self-interested, entrenched powers that threatens to deprive shareholders of the increase in value and improved operating performance that often comes when an activist shareholder campaigns (at its own expense) for change at an underperforming company.

* * *

In summary, the perquisites doled out by companies to directors, such as access to private planes, come at the sole cost of shareholders while providing benefits *only* to entrenched directors and management[3] and creating an environment where board members are more loyal to current management than they are to shareholders. Compensation arrangements between a nominee to a board of directors and an activist shareholder, on the other hand, come at the sole cost of the activist shareholder, create no novel conflicts of interest among directors and provide benefits to all shareholders. That is why I encourage all shareholders to oppose any directors who seek to insulate themselves from competition by unilaterally adopting a Director Disqualification Bylaw and to oppose any proposal by incumbent board members to adopt a Director Disqualification Bylaw at their company.

DO NOT LET INCUMBENT DIRECTORS LIMIT YOUR MOST VITAL RIGHT AS A SHAREHOLDER—*THE RIGHT TO ELECT DIRECTORS OF YOUR CHOICE*.

[3] ISS describes companies that unilaterally adopt a Director Disqualification Bylaw as "effectively creat[ing] a powerful entrenchment device without providing shareholders ***any*** offsetting benefits" (emphasis added).

Tab 6: Section 13(d) Reporting Requirements

WACHTELL, LIPTON, ROSEN & KATZ

MARTIN LIPTON
HERBERT M. WACHTELL
BERNARD W. NUSSBAUM
LAWRENCE B. PEDOWITZ
PAUL VIZCARRONDO, JR.
PETER C. HEIN
HAROLD S. NOVIKOFF
KENNETH B. FORREST
MEYER G. KOPLOW
THEODORE N. MIRVIS
EDWARD D. HERLIHY
DANIEL A. NEFF
ERIC M. ROTH
ANDREW R. BROWNSTEIN
MICHAEL H. BYOWITZ
PAUL K. ROWE
MARC WOLINSKY
DAVID GRUENSTEIN
STEPHEN G. GELLMAN
STEVEN A. ROSENBLUM

STEPHANIE J. SELIGMAN
JOHN F. SAVARESE
SCOTT K. CHARLES
DAVID S. NEILL
JODI J. SCHWARTZ
ADAM O. EMMERICH
GEORGE T. CONWAY III
RALPH M. LEVENE
RICHARD G. MASON
DOUGLAS K. MAYER
MICHAEL J. SEGAL
DAVID M. SILK
ROBIN PANOVKA
DAVID A. KATZ
ILENE KNABLE GOTTS
DAVID M. MURPHY
JEFFREY M. WINTNER
TREVOR S. NORWITZ
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JAMES H. FOGELSON (1967-1991)

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WILLIAM T. ALLEN
PETER C. CANELLOS
DAVID M. EINHORN
THEODORE GEWERTZ
RICHARD D. KATCHER
THEODORE A. LEVINE
ROBERT B. MAZUR
PHILIP MINDLIN
ROBERT M. MORGENTHAU
ERIC S. ROBINSON
PATRICIA A. ROBINSON*
LEONARD M. ROSEN
MICHAEL W. SCHWARTZ
ELLIOTT V. STEIN
WARREN R. STERN
PATRICIA A. VLAHAKIS
J. BRYAN WHITWORTH
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COUNSEL

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PAULA N. GORDON
NANCY B. GREENBAUM
MAURA R. GROSSMAN
IAN L. LEVIN
J. AUSTIN LYONS
AMANDA N. PERSAUD
HOLLY M. STRUTT

RACHELLE SILVERBERG
DAVID C. BRYAN
STEVEN A. COHEN
GAVIN D. SOLOTAR
DEBORAH L. PAUL
DAVID C. KARP
RICHARD K. KIM
JOSHUA R. CAMMAKER
MARK GORDON
JOSEPH D. LARSON
LAWRENCE S. MAKOW
JEANNEMARIE O'BRIEN
WAYNE M. CARLIN
JAMES COLE, JR.
STEPHEN R. DiPRIMA
NICHOLAS G. DEMMO
IGOR KIRMAN
JONATHAN M. MOSES
T. EIKO STANGE
DAVID A. SCHWARTZ

JOHN F. LYNCH
WILLIAM SAVITT
ERIC M. ROSOF
MARTIN J.E. ARMS
GREGORY E. OSTLING
DAVID B. ANDERS
ADAM J. SHAPIRO
NELSON O. FITTS
JEREMY L. GOLDSTEIN
JOSHUA M. HOLMES
DAVID E. SHAPIRO
DAMIAN G. DIDDEN
ANTE VUCIC
IAN BOCZKO
MATTHEW M. GUEST
DAVID E. KAHAN
DAVID K. LAM
BENJAMIN M. ROTH
JOSHUA A. FELTMAN

March 7, 2011

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Petition for Rulemaking Under Section 13 of the Securities Exchange Act of 1934

Dear Ms. Murphy:

Wachtell, Lipton, Rosen & Katz[1] respectfully submits this petition[2] to the Securities and Exchange Commission (the "Commission") requesting that the Commission initiate a rulemaking project regarding the beneficial ownership reporting rules under Section 13 of the Securities Exchange Act of 1934 (the "Exchange Act")—specifically, to propose amendments to shorten the reporting deadline and expand the definition of beneficial ownership under the reporting rules. We believe that the current reporting regime fails to fulfill its stated purposes, and outline in this letter a number of recommended amendments that we believe would be beneficial to investors, issuers and the market as a whole.

[1] Wachtell, Lipton, Rosen & Katz is a New York based law firm that specializes in mergers and acquisitions, strategic investments, takeovers and takeover defense, corporate and securities law and corporate governance. We counsel both public and private acquirors and targets.

[2] Rule 192(a) of the Rules of Practice and Rules on Fair Fund and Disgorgement Plans of the Securities and Exchange Commission.

In particular, we believe that the current narrow definition of beneficial ownership and the ten-day reporting lag after the Section 13(d) ownership reporting threshold is crossed facilitate market manipulation and abusive tactics. It has become both simple and commonplace for aggressive investors to intentionally structure their acquisition strategies to exploit the gaps created by the current reporting regime, to their own short-term benefit and to the overall detriment of market transparency and investor confidence. Current tactics show that the very purposes for the Section 13(d) reporting requirement are being undermined.

There is no valid policy-based or pragmatic reason that purchasers of significant ownership stakes in public companies should be permitted to hide their actions from other shareholders, the investment community and the issuer; indeed, the need for transparency, fairness and equality of information in our financial markets has never been higher. Recent events have highlighted the potential extremes to which these acquisition tactics may be taken, and make clear the urgent need for meaningful, comprehensive reform, both to clearly prohibit these types of abuses and to conform with the current norm for developed markets throughout the world. The reporting regime in the United States must evolve if it is to continue to perform the vital function for which it was initially implemented.

Recent legislation has made clear that the Commission has the necessary authority to take these remedial steps, and that the time for decisive action has come.[3] Indeed, Section 766(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") highlights the need for prompt action by creating significant uncertainty as to the continued validity of long-standing interpretations of the reporting rules with respect to the treatment of derivatives. The Staff of the Commission has publicly indicated that it intends to act to resolve such uncertainties.[4] We applaud these statements, but urge the Commission to take this opportunity to undertake the comprehensive reform that is so sorely needed, rather than limiting its actions to a narrow rulemaking confined to the specific issues raised by Section 766(e) of the Dodd-Frank Act. Closing the ten-day window and requiring the proper reporting of derivative ownership are vital and pressing actions that should be a priority.

Historical Purpose of the Section 13(d) Reporting Rules

Since its adoption by Congress in 1968 as part of the Williams Act, the stated purpose of the beneficial ownership reporting regime has been to compel the release of information to the investing public with respect to the accumulation of substantial ownership of an issuer's voting securities.[5] In particular, Congress noted a troubling absence of disclosure regulations for accumulations outside of the context of proxy contests, despite the fact that policy reasons

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[3] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (hereafter "Dodd-Frank Act"); see in particular §§ 766(e) and 929R.

[4] See, *e.g.*, Joshua Gallu, *Secret Corporate Raids to Get Harder Under SEC Rule Change*, Bloomberg, Feb. 22, 2011; Yin Wilczek, *Shortening of Disclosure Period for Beneficial Owners*, Corp. Coun. Wkly., Feb. 16, 2011.

[5] See, *e.g.*, S. Rep. 90-550, at 1 (1967) ("There are, however, some areas still remaining where full disclosure is necessary for investor protection but not required by present law. One such area is the purchase of substantial or controlling blocks of the securities of publicly held companies").

dictate similar disclosure obligations in all circumstances.[6] Simply put, the purpose of the Section 13(d) disclosure rules has always been to "alert investors in securities markets to potential changes in corporate control and to provide them with an opportunity to evaluate the effect of these potential changes."[7]

This purpose is no longer being properly served. As the Commission has publicly observed for nearly three decades, the ten-day reporting lag leaves a substantial gap after the reporting threshold has been crossed during which the market is deprived of material information, and creates incentives for abusive tactics on the part of aggressive investors prior to making a filing.[8] Such investors may – and frequently do[9] – secretly continue to accumulate shares during this period, acquiring substantial influence and potential control over an issuer without other shareholders (or the issuer) having any information about the acquiror or its plans and purposes at the time stockholders sell their shares. This serves the interest of no one but the investor seeking to exploit this period of permissible silence to acquire shares at a discount to the market price that may result from its belated disclosures.

The Ten-Day Reporting Window

The pragmatic reasons which may have motivated the inclusion of a ten-day reporting lag in the Williams Act are simply obsolete. Changes in technology, acquisition mechanics and trading practices have given investors the ability to make these types of reports with very little advance preparation time. The impact of these advances and corresponding need for change in the Section 13(d) reporting timetable was noted as early as 1983[10] in the report of an advisory commission established by the Commission, and has only become more compelling with the passage of time. The advent of computerized trading has upended traditional timelines for the acquisition of shares, allowing massive volumes of shares to trade in a matter of seconds. The increasing use of derivatives has accelerated the ability of investors to accumulate economic ownership of shares, usually with substantial leverage. Furthermore, the markets rely on the expectation that material information will be disseminated promptly and widely, in no small part

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[6] See, e.g., S. Rep. 90-550, at 2 (1967) ("The failure to provide adequate disclosure to investors in connection with a cash takeover bid or other acquisitions which may cause a shift in control is in sharp contrast to the regulatory requirements applicable where one company offers to exchange its shares for another, or where a contest for control takes the form of a proxy fight").

[7] *Wellman* v. *Dickinson*, 682 F.2d 355, 365-66 (2d Cir. 1982), citing *GAF Corp*. v. *Milstein*, 453 F.2d 709, 717 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972).

[8] Advisory Committee on Tender Offers, SEC, Report of Recommendations (July 8, 1983), reprinted in Fed. Sec. L. Rep. (CCH) No. 1028 (Extra Edition) 22 ("The 10-day window between the acquisition of more than a 5% interest and the required filing of a Schedule 13D was found to present a substantial opportunity for abuse, as the acquiror 'dashes' to buy as many shares as possible between the time it crosses the 5% threshold and the required filing date.") (hereafter, "Tender Offer Advisory Committee Report"); *see also* Letter from Harold M. Williams, Chairman, SEC, to the Senate Banking Committee (Feb. 15, 1980) (hereafter, "Williams Letter"); Hearings Before the Subcomm. On Telecomm. And Fin. of the House Comm. on Energy and Commerce Concerning Pending Legislation Regarding Contests for Corporate Control, 100th Cong. 2 (1987) (statement of David S. Ruder, Chairman, SEC).

[9] See, *e.g.*, Andrew Ross Sorkin, Dealbook, *Big Investors Appear Out of Thin Air*, N.Y. Times (Nov. 1, 2010). For additional examples, see text accompanying footnotes 23-26.

[10] Tender Offer Advisory Committee Report at 1.

due to the impact of the internet and online information exchange. In today's world, ten days is an eternity.

These changes and trends have been explicitly recognized by the Commission in the context of other reporting rules, both through the implementation of additional disclosure requirements and the shortened timelines that have been adopted for other types of filings. In 2004, the deadline for filing Current Reports on Form 8-K, the primary mechanism by which issuers make ongoing disclosure to the Commission and the public, was shortened to four business days following the triggering event.[11] The Commission explicitly linked this change to the Sarbanes-Oxley mandate to provide investors with disclosure of material corporate events on a "rapid and current basis,"[12] in recognition of the fact that the previous fifteen-calendar-day deadline was too lengthy to accomplish this goal. This step followed an accelerated filing requirement imposed on officers, directors and 10% shareholders of corporate issuers with respect to reporting transactions in the issuer's securities, to the second business day following the triggering transaction.[13] In perhaps the most extreme example, following the enactment of Regulation FD in 2000, issuers are generally required to inform the market broadly of any material, non-public information *simultaneously* with its intentional disclosure to any outside party.[14] These examples illustrate a marked trend by the Commission toward more immediate disclosure of information material to investors, which should now be applied to the Section 13(d) reporting rules.

Lower reporting thresholds and shortened deadlines have been required for years in other developed financial markets, including the United Kingdom, Germany, Australia and Hong Kong. The U.S. should, at a minimum, offer investors an equivalent level of available information on as timely a basis as other markets, in order to maintain investor confidence in the integrity of the U.S. trading markets. For example, Australia requires disclosure of any position of 5% or more within two business days if any transaction affects or is likely to affect control or potential control of the issuer, or the acquisition or proposed acquisition of a substantial interest in the issuer.[15] The United Kingdom imposes a two-trading-day deadline for disclosure of acquisitions in excess of 3% of an issuer's securities.[16] Germany requires a report "immediately," but in no event later than four days after crossing the acquisition threshold.[17] Hong Kong securities laws require a report within three business days of the acquisition of a "notifiable interest" under the law.[18] No special policy or practicality concerns mandate that the

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[11] Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Release Nos. 33-8400, 34-49424; File No. S7-22-02 (Mar. 16, 2004).

[12] Id.

[13] Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Release Nos. 34-46421, 35-27563, IC-25720; File No. S7-31-02 (Aug. 27, 2002).

[14] Selective Disclosure and Insider Trading, Release Nos. 33-7881, 34-43154, IC-24599; File No. S7-31-99 (August 15, 2000) (adopting Regulation FD).

[15] Australian Takeover Panels Guidance Note 20.

[16] Chapter 5 of the Financial Services Authority's Disclosure Rules and Transparency Rules.

[17] See Part 4 of the German Securities Trading Act.

[18] See Part XV of the Securities and Futures Ordinance.

U.S. retain its outdated, overly permissive reporting deadlines or definitions of beneficial ownership.

There are various options to be considered with respect to shortening the reporting deadline in order to re-align the Section 13(d) reporting rules with their intended purpose. We recommend that the Commission require that the initial Schedule 13D filing be made within one business day following the crossing of the five percent ownership threshold, using the same "prompt" disclosure standard that the Commission requires with respect to material amendments to existing Schedule 13D filings.[19] While some may argue that this deadline would impose an unreasonable deadline and reporting burden on investors, we disagree. The type of investor who acquires a 5% stake in a public company will almost always be a sophisticated, experienced investor, with the resources to submit the required filings promptly, particularly as these forms can be substantially prepared prior to crossing the 5% threshold.

Furthermore, to curtail the incentive towards abusive tactics currently inherent in the lag between crossing the ownership threshold and the reporting deadline, we recommend that acquirers be prohibited from acquiring beneficial ownership (under a broadened definition discussed below) of any additional equity securities of the issuer during the time between acquisition of a 5% ownership stake until two business days after the filing of the required Schedule 13D. This short "cooling-off period" would be similar to, but less restrictive than, the cooling-off period rules governing formerly passive investors switching from Schedule 13G filers to Schedule 13D filers, which prohibit such persons from voting, directing the voting of, or acquiring an additional beneficial ownership interest in, equity securities of the issuer from the time they develop a control intent until ten days after the filing of the required Schedule 13D.[20] As stated by the Commission in adopting the 1998 beneficial ownership reporting amendments, "[t]he cooling-off period will prevent further acquisitions or the voting of the subject securities until the market and investors have been given time to react to the information in the Schedule 13D filing."[21] The same policy concerns are at work here, and the recommended rule would be less onerous. The two business day cooling-off period would provide time for the investment community to review and assess the potential market impact of the initial Schedule 13D disclosures.

In enacting the Dodd-Frank Act, Congress specifically authorized the Commission to shorten the filing window: Congress modified Section 13(d)(1) of the Exchange Act to read "within ten days after such acquisition, *or within such shorter time as the Commission may establish by rule*."[22] This explicit grant of authority demonstrates Congress' recognition of the need for prompt corrective action, as exemplified by recent dramatic abuses of the ten-day window period.

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[19] 17 C.F.R. §240-13d-2(a).

[20] 17 C.F.R. §240-13d-1(e)(2).

[21] Amendments to Beneficial Ownership Reporting Requirements, Release No. 34-39538; File No. S7-16-96 (Jan. 12, 1998) at p. 10.

[22] Dodd-Frank Act §929R (emphasis added).

The recent acquisitions of J.C. Penney stock by Pershing Square Capital Management and Vornado Realty Trust vividly illustrate the extent to which savvy investors are able to exploit the gaps in the current Section 13(d) reporting rules – in this case, acquiring beneficial ownership of more than 25% of J.C. Penney's outstanding common stock before any public disclosure was made. Pershing Square first acquired 4.9% ownership through open market purchases, and then Pershing Square and Vornado rapidly acquired a total of approximately 27% ownership through open market purchases, forward purchases, call options and total return swaps during the ten-day window after crossing the 5% threshold in late September 2010 and prior to filing their initial Schedule 13D ten days later.[23] In the first full trading day after Pershing Square and Vornado filed their Schedule 13D reports, J.C. Penney's stock closed at $33.12, compared to the average closing price of $28.31 over the prior ten days while Pershing Square and Vornado were engaging in their aggressive accumulation program after crossing 5%, resulting in a substantial transfer of value to these two investors from the public shareholders who sold their shares during the ten-day window without knowledge of the investors' plans. In January 2011, representatives of each of Pershing Square and Vornado were appointed to J.C. Penney's board of directors, demonstrating the influence and control that these investors were able to obtain as a direct result of their secret share acquisitions during the ten-day window period.[24]

Pershing Square employed similar tactics in its recent acquisition of the stock of Fortune Brands. Pershing Square first acquired slightly less than 5% of Fortune Brands' common stock. During the ten-day period following its crossing of the 5% threshold in late September 2010, Pershing Square then acquired common stock and cash-settled total return swaps, ultimately accumulating ownership of 10.9% of Fortune Brands' common stock prior to filing its initial Schedule 13D on October 8, 2010.[25] In the first full trading day after Pershing Square filed its Schedule 13D report, Fortune Brands' common stock closed at $55.50, compared to the average closing price of $49.55 over the ten days prior to the filing while Pershing Square acquired ownership of an additional 6% of Fortune Brands' common stock. Just two months after the initial 13D filing, Fortune Brands announced plans to split up the company as had been reportedly pressed by Pershing Square, further illustrating the influence and control that can be secretly acquired during the ten-day window period.[26]

The prospect of possible closing of the ten-day window has already generated vocal opposition by the hedge fund activists who have gamed the window to their own advantage. One well-known activist has argued that the ten-day window period is needed to incentivize hedge funds to make sizable investments in companies seeking to force company actions that generate short-term profits arguably for the benefit of the issuer's shareholders.[27] However, the purpose

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[23] See, *e.g.*, Maxwell Murphy, Deal Journal, *How Bill Ackman Stalked J.C. Penney*, Wall St. J., October 8, 2010; Joann S. Lublin & Karen Talley, *Big Shoppers Bag 26% of J.C. Penney*, Wall St. J., October 9, 2010.

[24] Press Release, J.C. Penney Company, Inc., JCPenney Agrees to Name William Ackman and Steven Roth to Board of Directors (Jan. 24, 2011).

[25] See, *e.g.*, Matt Phillips, MarketBeat, *Ackman in Action*, Wall St. J. (Oct. 8, 2010).

[26] David Kesmodel, *Fortune Brands Plans to Split Up*, Wall St. J. (Dec. 8, 2010).

[27] See, *e.g.*, Joshua Gallu, *Secret Corporate Raids to Get Harder Under SEC Rule Change*, Bloomberg, February 22, 2011 (quoting William Ackman as saying that closing the ten-day window would decrease the number of activist

of the 13D window period was never to grant a license to hedge funds to make extraordinary profits by trading ahead of the undisclosed, market-moving information contained in their delayed 13D filings, nor to provide additional inducements to spur hedge fund activity. The activists' purported rationale for the window period is directly contrary to the overall purposes of the 13D reporting requirements – namely, to inform investors and the market promptly of potential acquisitions of control and influence so that investors have equal access to this material information before trading their shares. Indeed, the initial 10% reporting threshold in the Williams Act was amended to 5% in 1970 because of concerns that even 5% ownership conferred significant control rights and should require public disclosure.[28] The advent over the last four decades of computerized trading and extraordinary derivative opportunities to acquire substantial share positions has effectively neutralized the impact of the 1970 amendment, as investors have filed initial 13D forms reporting substantially over 10 percent ownership due to rapid acquisitions during the window period. The need for reform could not be clearer.

Derivatives and Beneficial Ownership

The concept of beneficial ownership, as used throughout the reporting rules and in the calculation of when the minimum ownership threshold has been reached, encompasses only those securities over which an investor (or group of investors) holds either "voting power" or "investment power," including the power to "dispose of, or to direct the disposition of," a security.[29] Other forms of ownership, including through derivatives, are currently explicitly counted for purposes of the 13(d) reporting rules only where they confer upon the holder the right to acquire beneficial ownership (*i.e.*, either voting power or investment power) over the underlying security within sixty days.[30] This paradigm fails to adequately address many ways in which modern investors may acquire economic exposure to a security, including through the purchase of non-traditional or cash-settled derivatives. Perhaps more importantly, it fails to recognize circumstances in which an investor may amass influence or control over both the voting and disposition of substantial blocks of securities, while maintaining the bare legal fiction that a third party holds such rights. We have extensively discussed elsewhere our concerns with this trend towards "empty voting," or otherwise decoupling the economic impact of security ownership from voting control,[31] and continue to believe that it poses a threat to the efficient

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investors challenging corporate management because "[i]f forced to disclose the position, the opportunity to buy at an attractive price disappears").

[28] See, *e.g.*, Staff of S. Comm. on Banking and Currency, Subcomm. on Securities, Report on Additional Consumer Protection in Corporate Takeovers and Increasing the Securities Act Exemptions for Small Businessmen 1 (Comm. Print 1970) ("Ten percent of the stock of large corporations, indeed even 5 percent, can . . . have a significant impact on corporate control.").

[29] 17 C.F.R. § 240.13d-3(a).

[30] 17 C.F.R. §240-13d-3(d)(1).

[31] See, *e.g.*, Adam O. Emmerich and William Savitt, *Stealth and Ambush Equity Accumulation – Use of Synthetic Ownership Arrangements Continues to Pose Danger to Securities Markets and Public Companies* (2010), http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.18056.10.pdf; Theodore N. Mirvis, Adam O. Emmerich and Adam M. Gogolak, *Beneficial Ownership of Equity Derivatives and Short Positions – A Modest Proposal to Bring the 13D Reporting System into the 21st Century* (2008) (hereafter "A Modest Proposal"), http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.15395.08.pdf; Theodore N. Mirvis and Adam O. Emmerich, *De-Coupling of Economic and Voting Power in Public Companies – Equity Ownership*

operation of our public corporations and financial markets. In addition, we believe that recognition of the rise of this phenomenon by the Commission in the context of the beneficial ownership reporting rules is vital if such rules are to serve their intended purposes.

As a result of these developments, the current definition of beneficial ownership does not account for the realities of how derivatives and other synthetic instruments and ownership strategies are used today in complex trading strategies. To address this issue, the definition of beneficial ownership for Section 13 reporting purposes should encompass ownership of any derivative instrument which includes the opportunity, directly or indirectly, to profit or share in any profit derived from any increase in the value of the subject security.[32] Derivative instruments should include, subject to certain exceptions, any instrument or right "with an exercise or conversion privilege or a settlement payment or mechanism at a price related to an equity security or similar instrument with a value derived in whole or in part from the value of an equity security, whether or not such instrument or right shall be subject to settlement in the underlying security or otherwise."[33] In addition, it should be made explicitly clear that the definition encompasses ownership of short positions in a security, as such positions have the same potential as long positions to influence the trading of the subject security.

Each of these types of derivative transactions permits an acquiror to exercise the type of market control in the relevant security, and potentially to exert the type of influence over the issuer, that the Section 13(d) reporting obligations are designed to address, yet are currently conducted outside of the disclosure regime. This deprives the market, and other investors, of valuable information that might influence their trading behavior if it were made accessible. Even in the absence of voting or dispositive power, participants in large hedging transactions gain influence in a number of ways. The shares subject to the hedge may be eliminated from the universe of voting shares entirely, depending on the terms of the transaction. In other situations, voting of the shares may be subject to counterparty influence or control, either directly or because the counterparty is motivated to vote the hedged shares in a way that will please the investor and induce them to continue to transact with such counterparty. Net short positions further create price pressure both through the influence of the short sales themselves, and also due to the need for their counterparties in such transactions to purchase shares to meet their potential obligations. Even those derivatives that are characterized as "cash-settled" may ultimately be settled in kind, creating further market pressure as the participants need to acquire shares for such settlement.

Derivatives are increasingly being employed to accumulate "empty voting" positions in an issuer's stock or to accumulate large stakes prior to making any Section 13(d) disclosures,

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Derivatives Create Unforeseen Dangers (2008), http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.15268.08.pdf.

[32] See "A Modest Proposal" at 3. We note that we do not currently believe that equivalent changes are required or advisable with respect to the definition of "beneficial ownership" with respect to Section 16 of the Exchange Act and the rules promulgated thereunder, which we do not believe present the same risk of abuse as the Section 13 reporting rules.

[33] See "A Modest Proposal" at 3.

such as in the CSX proxy contest,[34] the Jana/CNET situation[35] and, more recently, J.C. Penney and Fortune Brands as described above. These illustrate the need for these reforms, but are only a fraction of the instances where the revised rules would have the impact of compelling much-needed material disclosure.

We do not believe that enacting these changes to the definition of beneficial ownership would create undue confusion or burden on reporting investors, a belief we base in large part on the fact that similar changes have been adopted in a number of other jurisdictions (including the United Kingdom,[36] Germany,[37] Switzerland,[38] Australia[39] and Hong Kong,[40] each of which use a broadened definition of beneficial ownership encompassing a range of derivative mechanisms). The shift to a broad, modernized definition of beneficial ownership in these jurisdictions and elsewhere both demonstrates that it is a workable construct and, we believe, compels the Commission to enact related reforms, lest the United States markets continue to remain more susceptible to manipulative maneuvers than other nations with similarly developed financial markets.

In addition to clarifying the Commission's authority to act, the Dodd-Frank Act creates added urgency for rulemaking with respect to Section 13 reporting. Section 766(e) of the Dodd-Frank Act, discussing security-based swaps,[41] arguably will reverse, and certainly creates confusion with respect to, currently settled rules and practice with respect to derivatives and beneficial ownership absent Commission action. Section 766(e) provides that ownership of security-based swaps constitutes ownership of the underlying security only to the extent that the Commission deems it so by rule.[42] In the absence of prompt action by the Commission in advance of this provision's July 2011 effective date, even the protections currently in place with respect to the treatment of derivatives for beneficial ownership purposes could be lost. This would be an unwarranted and harmful step in the wrong direction. It is imperative that the Commission act to prevent this occurrence, and take action to address the other significant gaps in the reporting rules discussed herein.

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[34] *CSX Corp.* v. *Children's Inv. Fund Mgmt. (UK) LLP, et al*, 562 F. Supp.2d 511 (S.D.N.Y. June 11, 2008), *affirmed without opinion* by *CSX Corp.* v. *Children's Inv. Fund. Mgmt. (UK) LLP, et al.*, .292 Fed. Appx. 133 (2d Cir. 2008).

[35] See, *e.g.*, Andrew Ross Sorkin, Dealbook, What is Jana Doing?, N.Y. Times (Feb. 7, 2008).

[36] See Chapter 5 of the Financial Services Authority's Disclosure Rules and Transparency Rules.

[37] See Part 4 of the German Securities Trading Act. A bill further expanding the universe of derivatives captured by German disclosure requirements (including, for example, cash-settled options) has passed the Bundestag (the lower house of German Parliament), and has been referred to the Bundesrat (the upper house) for an additional required approval. See *Gesetz zur Starkung des Anlegerschutzes und Verbesserung der Funktionsfahigkeit des Kapitalmarkts* (*Anlegerschutz-und Funktionsverbesserungsgesetz*) (Feb. 11, 2011), available at http://www.bundesrat.de/cln_161/nn_8694/SharedDocs/Drucksachen/2011/0101-200/101-11,templateId=raw,property=publicationFile.pdf/101-11.pdf).

[38] See Article 20 of the Federal Act on Stock Exchange and Securities Trading in Switzerland.

[39] See The Australian Takeover Panels Guidance Note 20.

[40] See Part XV of the Securities and Futures Ordinance.

[41] Dodd-Frank Act §766(e).

[42] Id.

Remedies

Even if our recommended amendments were to be adopted, the risk that the Section 13 reporting rules will continue to be disregarded or manipulated by sophisticated investors would remain high unless appropriate remedies are made available to issuers and investors. Currently, there is no clear path for an issuer facing flagrant reporting violations by an investor to obtain relief or protection for its stockholders. The CSX Corporation proxy contest provides a stark example of this state of affairs. After finding that an activist investor had intentionally used derivative instruments "as part of a plan or scheme to evade the reporting requirements of Section 13(d)" in connection with substantial share acquisitions in advance of a proxy contest[43], a federal court concluded that existing law did not permit it to enjoin the investor from voting its shares, despite a statement by the court that it would otherwise grant such relief.[44] The lack of an effective remedy even in such extreme situations will encourage certain investors to flout the rules, whether or not they are updated. We recommend that, in connection with the amendments described herein, the Commission undertake a study of enhanced remedies for violations of the Section 13 reporting rules.

Conclusion

Investor confidence in our financial markets depends in large part on the kind of transparency that the Section 13 reporting rules are designed to, and should, provide with respect to the acquisition of potential control positions in public companies. We firmly believe that closing the ten-day window and adapting the definition of beneficial ownership to fully address the reality of the way securities are currently traded is both workable and integral to the future proper functioning of the United States securities markets, and urge the Commission to undertake these reforms promptly.

Please feel free to contact Theodore N. Mirvis, Andrew R. Brownstein, Eric S. Robinson, Adam O. Emmerich, David M. Silk, Trevor S. Norwitz, David C. Karp or William Savitt at 212-403-1000 to discuss any of these matters in more detail.

Very truly yours,

Wachtell, Lipton, Rosen & Katz

cc: Meredith Cross
Michele Anderson

[43] *CSX* at 548 (S.D.N.Y. 2008).

[44] Id. at 573-74.

Working Draft, May 2013

PRE-DISCLOSURE ACCUMULATIONS BY ACTIVIST INVESTORS: EVIDENCE AND POLICY

Forthcoming, *Journal of Corporation Law*, Volume 39, Fall 2013

Lucian A. Bebchuk, Alon Brav, Robert J. Jackson, Jr., and Wei Jiang[*]

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Electronic copy available at: http://ssrn.com/abstract=2258083

Abstract

The SEC is currently considering a rulemaking petition requesting that the Commission shorten the ten-day window, established by Section 13(d) of the Williams Act, within which investors must publicly disclose purchases of a 5% or greater stake in public companies. In this Article, we provide the first systematic empirical evidence on these disclosures and find that several of the petition's factual premises are not consistent with the evidence.

Our analysis is based on about 2,000 filings by activist hedge funds during the period of 1994-2007. We find that the data are inconsistent with the petition's key claim that changes in market practices and technologies have operated over time to increase the magnitude of pre-disclosure accumulations, making existing rules "obsolete" and therefore requiring the petition's proposed "modernization." The median stake that these investors disclose in their 13(d) filings has remained stable throughout the 17-year period that we study, and regression analysis does not identify a trend over time of changes in the stake disclosed by investors. We also find that:

* A substantial majority of 13(d) filings are actually made by investors other than activist hedge funds, and these investors often use a substantial amount of the 10-day window before disclosing their stake.

* A significant proportion of poison pills have low thresholds of 15% or less, so that management can use 13(d) disclosures to adopt low-trigger pills to prevent any further stock accumulations by activists—a fact that any tightening of the SEC's rules in this area should take into account.

* Even when activists wait the full ten days to disclose their stakes, their purchases seem to be disproportionately concentrated on the day they cross the threshold and the following day; thus, the practical difference in pre-disclosure accumulations between the existing regime and the rules in jurisdictions with shorter disclosure windows is likely much smaller than the petition assumes.

* About 10% of 13(d) filings seem to be made after the 10-day window has expired; the SEC may therefore want to consider tightening the enforcement of existing rules before examining the proposed acceleration of the deadline.

Our analysis provides new empirical evidence that should inform the SEC's consideration of this subject—and a foundation on which subsequent empirical and policy analysis can build.

JEL Classification: D21, G32, G34, G35, G38, K22

Electronic copy available at: http://ssrn.com/abstract=2258083

I. INTRODUCTION

The Securities and Exchange Commission is currently considering revising the rules governing blockholder disclosure. A rulemaking petition recently submitted to the Commission by the senior partners of a prominent law firm urges the Commission to accelerate the timing of the disclosure of 5% stock accumulations in public companies.[1] While the Commission's rules have long required public-company investors to disclose their ownership within ten days of crossing the 5% threshold, the Petition proposes to shorten this period to one day.

The Commission subsequently announced a rulemaking project in this area, and members of the Commission's staff have signaled that the staff is examining the subject. Former SEC Chairman Mary Schapiro, acknowledging the "controversy" surrounding these important rules, has indicated that the Commission is actively considering whether to adopt the changes proposed in the Petition,[2] and the SEC staff have recently signaled that responding to the Petition is part of the Commission's regulatory agenda.[3]

Notably, the Petition offers no systematic evidence on stock accumulations. Instead, the Petition repeatedly refers to several anecdotes concerning recent cases in which activist hedge funds purchased large amounts of stock (or securities convertible to stock) prior to disclosure. The Petition argues that these anecdotes underscore a new, more general phenomenon of secret stock accumulations made possible by changes in trading technologies that demand immediate changes in the disclosure rules. Recent developments in market

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[1] Letter from Wachtell, Lipton, Rosen & Katz to Elizabeth M. Murphy, Secretary, U.S. Sec. & Exch. Comm'n (Mar. 7, 2011), *available at* http://www.sec.gov/rules/petitions/2011/petn4-624.pdf [hereinafter Petition].

[2] *See* Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, Remarks at the Transatlantic Corporate Governance Dialogue (Dec. 15, 2011), *available at* http://www.sec.gov/news/speech /2011/spch121511mls.htm.

[3] *See* Securities and Exchange Commission, *Beneficial Ownership Reporting*, *in* OFFICE OF MANAGEMENT AND BUDGET, OFFICE OF INFORMATION AND REGULATORY AFFAIRS, UNIFIED AGENDA 2013 ("The Division is recommending that the Commission issue a concept release to . . . modernize the beneficial ownership reporting requirements . . . . [including], among other things, shortening the filing deadlines . . . ."), *available at* http://www.reginfo.gov/public/do/eAgendaViewRule? pubId=201210&RIN=3235-AK42 (last accessed January 21, 2013).

practices, the Petition contends, render the existing rules under Section 13(d) of the Securities Exchange Act of 1934, which governs blockholder disclosure, obsolete. And an article published by senior attorneys at the firm that filed the Petition similarly asserts that these developments are widely understood by market participants—but offers no evidence in support of this understanding.[4]

In two separate comment letters filed with the SEC, the four of us cautioned that the Petition does not rest on systematic empirical examination of the publicly available data, and that such empirical investigation is called for before any changes to the existing rules are seriously considered.[5] In a subsequent article, two of us stressed the need for such an empirical examination and discussed the empirical issues such an examination should seek to address.[6]

In response, in a recent article four senior partners of the firm that filed the Petition dismissed our claim that an examination of the evidence beyond the anecdotes described in the Petition is necessary.[7] The authors expressed concern that such an examination would be difficult and time-consuming and likely delay the "modernization" of Section 13(d) that they view as desirable.[8] Similarly, in a public debate at the conference board with one of us, Martin Lipton, the senior partner of the firm that authored the Petition, rejected the need for an empirical

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[4] David Katz & Laura A. McIntosh, Corporate Governance Update: Section 13(d) Reporting Requirements Need Updating, N.Y. L.J., Mar. 22, 2012.

[5] Letter from Lucian A. Bebchuk, Professor, Harvard Law School & Robert J. Jackson, Jr., Associate Professor, Columbia Law School, to Elizabeth M. Murphy, Secretary, U.S. Sec. & Exch. Comm'n (Jul. 11, 2011), *available at* http://www.sec.gov/comments/4-624/4624-3.pdf; Letter from J.B. Heaton, Alon Brav & Wei Jiang to Elizabeth M. Murphy, Secretary, U.S. Sec. & Exch. Comm'n (July 5, 2011), at 2, *available at* http://www.sec.gov/comments/4-624/4624-2.pdf.

[6] Lucian A. Bebchuk & Robert J. Jackson, Jr., *The Law and Economics of Blockholder Disclosure*, 2 HARV. BUS. L. REV. __ (2012).

[7] Adam O. Emmerich, Theodore N. Mirvis, Eric S. Robinson & William Savitt, *Fair Markets and Fair Disclosure: Some Thoughts on* The Law and Economics of Blockholder Disclosure (Columbia Law and Economics Working Paper No. 428) (Aug. 27, 2012), *available* at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2138945.

[8] *See, e.g.*, *id.* at 19 (such an examination "is neither prudent nor legally required," and moreover would "sacrifice [the Petition's objectives] on the altar of endless and ultimately inconclusive academic debate about the costs and benefits of shareholder activism").

examination of these questions.[9] In our view, however, given that data on Section 13(d) filings is publicly available, the SEC should not proceed with rulemaking before examining this evidence.

In light of the SEC's expected consideration of the Petition, this Article uses data based on Section 13(d) filings to provide the first empirical analysis of this subject. We find that some key factual premises of the Petition—such as claims that pre-disclosure accumulations have increased over time due to changes in market practices and opportunities—are incorrect. Furthermore, our analysis provides empirical evidence that can inform the SEC's consideration and a foundation on which subsequent work, by SEC staff or other researchers, can build.

The Article proceeds as follows. Part II describes the universe of pre-disclosure accumulations we study and provides evidence about the incidence and magnitude of such accumulations. We examine the universe of all Section 13(d) filings by activist hedge funds from 1994 through 2007. We find that hedge fund activists do indeed use the opportunity not to disclose immediately upon crossing the 5% threshold, with over 40% taking advantage of a large part of the ten-day window. Indeed, we find that about 10% of all filings are made after the specified ten-day window, which suggests that the Commission should consider more effective enforcement of the existing deadline before examining whether the deadline should be shortened.

Moreover, our examination of the ownership stakes revealed in Section 13(d) filings indicates that the five anecdotes noted in the Petition are not representative of the magnitude of stakes accumulated by hedge fund activists prior to disclosure. The evidence shows that hedge fund activists typically disclose substantially less than 10% ownership, with a median stake of 6.3%.

Part III investigates a key claim of the Petition: that changes in market practices have, over time, enabled activist investors to increase the magnitude of pre-disclosure accumulations, making existing rules obsolete and requiring "modernization." We show that the evidence does not support this claim. In contrast to the concerns expressed in the Petition and subsequent work by the

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[9] *See* The Conference Board, *Director Roundtable: The Law and Economics of Blockholder Disclosure* (Nov. 11, 2012), *available at* http://www.conference-board.org/governance/index.cfm?id=13474.

Petition's authors,[10] the size of pre-disclosure accumulations of stock have not increased over time. Indeed, the median stake at the time of disclosure has remained relatively stable throughout the 14-year period we study, and more extensive regression analysis does not identify a time trend. Thus, changes in existing rules can at most be justified as necessary to address longstanding policy questions, not as a "modernization" required by changes in the market place.

Part IV examines the costs of tightening the rules under Section 13(d). Requiring activist investors to disclose their stakes in public companies more quickly will reduce these investors' returns by giving them less time to acquire shares before disclosing their presence—and will therefore reduce the incidence and magnitude of outside blockholdings in such companies. This reduction will in turn carry two costs for other investors in public companies. First, *ex post*, investors in general will benefit less frequently from the superior returns that have long been associated with the arrival of an activist blockholder. Second, investors can be expected to lose the gains associated with the mere possibility that a blockholder will emerge and reduce agency costs and managerial slack—because, *ex ante*, the probability that such an investor will emerge is reduced by the tightening of the rules under Section 13(d).

Part V provides data with respect to an aspect of the subject that seems to have been overlooked by the authors of the Petition but that the SEC should take into account when considering changes to the rules under Section 13(d). While the Petition and its authors have focused on activist investors, we show that Section 13(d) filings by activist hedge funds represent only a small minority of all such filings.

We document the large number of filings made under Section 13(d) by investors other than activist hedge funds—and show that it is common for these investors, too, to make full use of the ten-day period prior to disclosure to accumulate more than 5% ownership in the firm by the time they disclose their stakes. Thus, in examining the consequences and costs of the proposed tightening of the Commission's rules under Section 13(d), it is important to take into account that most of the investors to which tightened rules would apply would not be the activist hedge funds on which the Petition has focused.

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[10] *See* Emmerich et al., *supra* note 6, at 4.

In Part VI, we investigate how activists' purchases beyond 5% ownership are likely distributed in the ten-day window after the investors cross the 5% threshold. We investigate this subject by identifying abnormal trading turnover during the ten-day period. We find that, even when activists choose to wait the full ten days after crossing the 5% threshold to disclose their stakes, their purchases are likely concentrated on the day they cross the threshold as well as the following day. Thus, whatever the benefits of the existing ten-day period for activist investors, the practical difference in pre-disclosure accumulations between the existing regime and the rules in jurisdictions with shorter disclosure windows—which the Petition holds out as a model for modern reform—is likely much smaller than the Petition assumes.

Finally, in Part VII we consider the relationship between the Petition's proposed tightening of the disclosure rules under Section 13(d) and the recent proliferation of low-threshold poison pills in the United States. We present evidence indicating that a significant proportion of poison pills at public companies have thresholds that fall substantially short of a controlling block. We argue that any consideration of reforming the rules under Section 13(d) should take into account the interaction of such reform with the use of these poison pills.

In particular, we suggest that the SEC should avoid adopting any reforms that would facilitate the use of these pills to cap the stakes that outside investors can acquire in public companies. To the extent that the SEC does choose to tighten its disclosure rules under Section 13(d), any such tightening should apply only to companies that adopt corporate-law arrangements that preclude the adoption of low-trigger poison pills.

Before proceeding, we would like to stress that, because we focus only on the evidence available from disclosures under Section 13(d), our analysis is limited to only a few of the empirical questions that an adequate assessment of the rules governing blockholders' acquisitions of public-company stock should consider. Any such assessment should include analysis of the benefits conferred on shareholders by outside blockholders as well as the effects of existing disclosure rules and state law on the incidence and size of block holdings in public companies.[11] The preliminary evidence provided in this Article, however, offers no support for the Petition's proposed change in the existing rules under

[11] *See* Bebchuk & Jackson, *supra* note 5, at ___-___.

Section 13(d)—and provides some basis for concern that the proposed changes would have adverse effects on public-company investors.

Finally, we note that we are open to serious reconsideration of the Section 13(d) rules that govern blockholder disclosure. It may be that changes are needed to the structure that Congress originally selected. The choices that Congress made may reflect an ad-hoc choice that may not be the product of optimal analysis of all of the implications of these rules. In our view, however, any reconsideration of these rules—and the rules governing the relationship between incumbents and outside blockholders more generally—should be based upon a full analysis of all of the available empirical evidence. In this Article, we offer a first step toward the systematic empirical analysis that should be the basis for any changes to the existing rules governing blockholder disclosure.

II. THE INCIDENCE AND MAGNITUDE OF PRE-DISCLOSURE ACCUMULATIONS

In this Part, we examine the frequency and magnitude of hedge-fund activists' accumulations of significant blocks of stock in public companies. As we explain below, a systematic review of the evidence suggests that the concerns and anecdotes described in the Petition are not representative of the evidence on activist hedge fund behavior more generally.

In Section A, we describe the source of the data we present throughout the Article—public disclosures filed by activist hedge funds under Section 13(d) over a fourteen-year period—along with summary statistics describing the incidence of these filings and the size of the blocks disclosed by activist hedge funds. In Section B, we examine the timing of these disclosures—and the relationships between the timing of these filings and the size of the stake that investors disclose. And in Section C we show that investors commonly violate existing rules by waiting more than ten days to disclose—suggesting that, before modifying these rules, the SEC should consider more consistent enforcement of existing law.

The Harvard Law School Forum on Corporate Governance and Financial Regulation
SUPPORTED BY: CSC CORPORATION SERVICE COMPANY

Should the SEC Tighten its 13(d) Rules?

Posted by Lucian Bebchuk, Harvard Law School, and Robert J. Jackson, Jr., Columbia Law School, on Wednesday June 27, 2012

Editor's Note: Lucian Bebchuk is Professor of Law, Economics, and Finance at Harvard Law School. Robert J. Jackson, Jr. is Associate Professor of Law at Columbia Law School.

The upcoming issue of the *Harvard Business Law Review* will feature our article The Law and Economics of Blockholder Disclosure. The article is available here, and PowerPoint slides describing the paper's main points are available here.

The Securities and Exchange Commission is currently considering a rulemaking petition submitted by Wachtell, Lipton, Rosen & Katz (available here) that advocates tightening the rules under the Williams Act and, in particular, reducing the amount of time before the owner of 5% or more of a public company's stock must disclose that position from ten days to one day. Our article explains why the SEC should not view the proposed tightening as a merely "technical" change necessary to meet the objectives of the Williams Act or modernize the SEC's regulations. The drafters of the Williams Act made a conscious choice not to impose an inflexible 5% cap on pre-disclosure accumulations of stock to avoid deterring investors from accumulating large blocks of shares. We argue that the proposed changes to the SEC's rules require a policy analysis that should be carried out in the larger context of the optimal balance of power between incumbent directors and these blockholders.

We discuss the beneficial role that outside blockholders play in corporate governance, and the adverse effect that any tightening of the Williams Act's disclosure thresholds can be expected to have on such blockholders. We explain that there is currently no evidence that trading patterns and technologies have changed in ways that would make it desirable to tighten these disclosure thresholds. Furthermore, since the passage of the Williams Act, the rules governing the balance of power between incumbents and outside blockholders have already moved significantly in favor of the former—both in absolute terms and in comparison to other jurisdictions—rather than the latter.

Our analysis provides a framework for the comprehensive examination of the rules governing outside blockholders that the SEC should pursue. In the meantime, we argue, the SEC should not

adopt new rules that would tighten the disclosure rules that apply to blockholders. Existing research and available empirical evidence provide no basis for concluding that the proposed tightening would protect investors and promote efficiency. Indeed, there is a good basis for concern that such tightening would harm investors and undermine efficiency.

Below is a more detailed account of the analysis in our article:

Our article begins by explaining why policy analysis weighing the advantages and disadvantages of tightening these rules is needed before the SEC proceeds with the proposed tightening. It might be argued that more prompt disclosure is unambiguously desirable under principles of market transparency and was the clear objective of the Williams Act, which first established these rules by adding Section 13(d) to the Securities Exchange Act in 1968. Thus, at first glance one might conclude that the SEC should tighten the rules without consideration of the costs and benefits of doing so. Unlike ordinary disclosure rules that require insiders to provide information to investors, however, the Williams Act imposed an exception to the general rule that outside investors in public-company stock are entitled to remain anonymous. Moreover, tightening is not needed to achieve the objectives of the Williams Act: The drafters of the Act made a conscious choice not to impose a hard 5% limit on pre-disclosure accumulations of shares, instead striking a balance between the costs and benefits of disclosure to avoid excessive deterrence of the accumulation of these outside blocks. Thus, in deciding whether to tighten the rules in this area, the SEC should be guided by the general requirement that any costs associated with changes to its rules should be outweighed by benefits for investors rather than general intuitions about the desirability of transparency.

The second part of our article therefore proceeds to provide a framework for the policy analysis that the SEC should conduct. We begin by considering the costs of tightening the rules on blockholders. We begin by explaining that certain benefits of blockholders for corporate governance may be reduced or lost if these rules are tightened. We review the significant empirical evidence indicating that the accumulation and holding of outside blocks makes incumbent directors and managers more accountable, thereby reducing agency costs and managerial slack. Tightening the disclosure requirements for blockholders, we argue, can be expected to reduce the returns to blockholders and thereby reduce the incidence and size of outside blocks as well as blockholders' investments in monitoring and engagement—which, in turn, could result in increased agency costs and managerial slack.

The third part of our article considers the asserted benefits of tightening the rules that are described in the petition. We explain that there is no empirical evidence to support the petition's

contention that tightening these rules is needed to protect investors from the risk that outside blockholders will capture a control premium at the expense of other shareholders.

The final part of the article considers whether the proposed tightening is justified by changes in trading practices, changes in legal rules in the United States, or changes in legal rules in other jurisdictions that have occurred since the passage of Section 13(d). We first explain that there is no systematic empirical evidence supporting the suggestion that investors can now acquire large blocks of stock more quickly than they could when Section 13(d) was first enacted. We then show that changes in the legal landscape since that time, and particularly the emergence of the poison pill, have tilted the balance of power between incumbents and blockholders against the latter—and therefore counsel against tightening the rules in a way that would further disadvantage blockholders. We also explain why comparative analysis of the regulation of blockholders in other jurisdictions does not justify tightening the rules governing blockholders in the United States.

We conclude by recommending that the SEC pursue a comprehensive examination of the rules in this area along the lines we put forward. Such an examination should include an investigation of the empirical questions we identify. In the meantime, however, existing research and empirical evidence offer no basis for tightening the disclosure obligations of outside blockholders.

The Harvard Law School Forum on Corporate Governance and Financial Regulation
SUPPORTED BY: CSC CORPORATION SERVICE COMPANY

Activist Abuses Require SEC Action on Section 13(d) Reporting

Posted by Theodore Mirvis, Wachtell, Lipton, Rosen & Katz, on Monday March 31, 2014

Editor's Note: Theodore N. Mirvis is a partner in the Litigation Department at Wachtell, Lipton, Rosen & Katz. The following post is based on a Wachtell Lipton memorandum by Mr. Mirvis, Andrew R. Brownstein, Adam O. Emmerich, David A. Katz, and David C. Karp. Work from the Program on Corporate Governance about about Section 13(d) and blockholder disclosure includes The Law and Economics of Blockholder Disclosure by Lucian Bebchuk and Robert J. Jackson, Jr., discussed on the forum here.

Three years ago we petitioned the SEC to modernize the beneficial ownership reporting rules under Section 13(d) of the Securities Exchange Act of 1934 (see our rulemaking petition, our memos of March 7, 2011, April 15, 2011, March 3, 2008 and our article in the Harvard Business Law Review). Since we filed our petition, activist hedge funds have grown more brazen in exploiting the existing reporting rules to the disadvantage of ordinary investors.

The Wall Street Journal this week documented several, though not all, of the types of market abuse and manipulation that the current outmoded reporting rules permit and facilitate. The existing rules give activists an over-long 10-day period before they are required to report crossing the 5% ownership threshold in publicly traded companies. According to *The Wall Street Journal*, during the 10-day reporting window, activist hedge funds are "tipping" each other regarding their plans as they coordinate wolf-pack attacks, while ordinary investors and the targeted companies are left in the dark. When finally made, the 13(d) reports are often market-moving. This delivers outsized returns to the activist and those they tip, while injuring investors who are deprived of the same knowledge.

In an era of high frequency trading, the 10-day reporting window adopted by the Williams Act in 1968 simply makes no sense. It is time for the SEC to act on our petition to shorten the reporting window to one day, to adopt a "cooling-off period" of two business days following the public filing of an initial Schedule 13D, during which acquirers would be prohibited from acquiring additional beneficial ownership, and to modernize the definition of "beneficial ownership" under the Section 13 reporting rules to prevent activists from acquiring significant influence and control using a

variety of stealth techniques and derivative instruments to evade Section 13D reporting requirements.

The SEC must also act now to shorten the reporting period for institutional investors under 13(f), as proposed by NYSE Euronext, the Society of Corporate Secretaries and Governance Professionals and the National Investor Relations Institute (see our February 7, 2013 post).

These changes are necessary to protect investors and ensure the integrity and fairness of U.S. public securities markets. Only by comprehensively modernizing the reporting rules can the SEC reinvigorate the investor protections originally intended by the Williams Act and prevent the kinds of brazen abuses reported this week.

Tab 7: The Current Landscape of Shareholder Activism

2014

ACTIVIST INVESTING

An annual review of trends in shareholder activism

Activist Insight

In association with

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Shareholder activism: 2013 and beyond

Schulte Roth & Zabel partners Marc Weingarten and David E. Rosewater, co-heads of the firm's Shareholder Activism practice, on what they expect for 2014

Schulte Roth & Zabel's Shareholder Activism practice was at the forefront of the industry in 2013, advising our clients in a number of proxy contests. These are our observations from a busy year.

Rapid growth with many new entrants

By almost any measure, shareholder activism became more popular in 2013 than ever. With assets under management quickly growing and returns consistently outperforming the average hedge fund, the activist sector has seen an influx of new activist-oriented funds. As activist investors have appeared on the cover of *Time* magazine and filled the pages of *Vanity Fair* throughout the year, it is clear that investors and boards are not the only ones interested in learning more about shareholder activism.

Size is no longer a deterrent

A shareholder activist targeting a large-cap company with deep pockets used to be a one-off event that would dominate headlines for months. A few years ago, almost no one would have predicted that giants such as Apple, Procter & Gamble and Hess would become attractive targets for activists. Over the past year, however, such activist activity has become the norm rather than the exception. Today, almost one-third of shareholder activism takes place in companies with market capitalizations of more than $2 billion. While activists have long recognized that a greater variety of strategic alternatives are likely available for large companies, the persistent targeting of such companies has only been made possible by the influx of capital into activist funds over the past few years and the ever-increasing willingness of passive investors and institutional shareholders to side with the concerns of activists.

> "By almost any measure, shareholder activism has become more popular this year than ever"

More majority slates

Activist campaigns seeking a majority of seats on a board have historically been, and continue to be, difficult to win. Incumbent boards have long argued that such campaigns are ploys by activists to gain control of the company without paying shareholders a control premium. This argument, however, appears to be losing ground with shareholders, as majority board campaigns in 2013 have garnered significant shareholder support in contests such as the ones between TPG-Axon and SandRidge Energy, or Clinton Group and Stillwater Mining Company.

Activists incentivize nominees

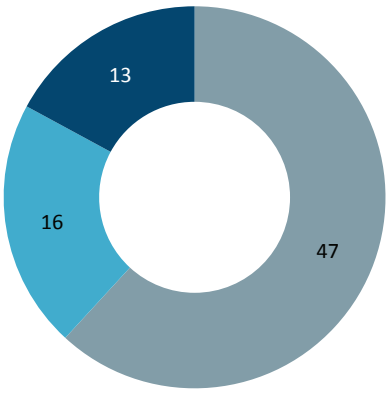
In proxy contests involving Hess and Agrium in 2013, activist shareholders offered their nominee slates compensation arrangements with payouts tied to the targeted company's performance, launching an intense debate over the propriety of such arrangements. A number of boards have since adopted bylaws that purport to prohibit nominee compensation. In November, ISS entered the fray and recommended that shareholders withhold votes from directors at Provident Financial Holdings after the company adopted a bylaw prohibiting such arrangements.

What lies ahead in 2014

Given the consistently high returns for the activist sector, one could expect the flow of capital into activist funds to continue to grow. More asset managers are likely to dip their toes into activism as portfolio managers who are value investors can unlock additional shareholder value—and increase returns—by serving as catalysts for their investment theses. Ultimately, it seems likely that 2013 will prove to be more akin to 'the end of the beginning' of the first phase of an invigorated age of shareholder activism rather than just the peak of a brief trend.

The year in review

While much activism is practiced out of the public eye, Activist Insight has observed an increase in public actions, whereby activists play a clear role in changing the strategy or governance of companies they have invested in. Public actions were launched at 237 companies in 2013, compared to 218 in 2012. As well as this measure of growth, there are also signs that activist campaigns are becoming more forensic, with an average of two actions per campaign in 2013, compared to 1.6 in 2012.



Routes to achieving board representation by number

- Proxy access (62%)
- Proxy contest (21%)
- Settlement (17%)

Activists maintained a relatively high level of success in 2013, achieving their objectives in 59% of resolved cases—a figure that rises to 78% when partially satisfied objectives are included. With 36% of campaigns ongoing—some 83 decisions waiting to be made at companies around the world—2014 is already looking busy.

The year of the proxy battle

Increasing numbers of activists set out to prove themselves by winning proxy battles in 2013, with 67 activists seeking board representation, compared to 58 last year. In contrast to 2012, when only a third of efforts to gain board representation saw activists threaten a proxy contest, 46% of campaigns saw activists threaten or fight a proxy contest in 2013.

Asking companies politely may be the safer approach for activists, however, with negotiated board seats accounting for around 86% of all successful outcomes. ValueAct, which notably gained a board seat at Microsoft in the past year, is said to request references from companies it has targeted. Activists regularly say that expensive and time-consuming proxy battles are a 'last resort,' and the evidence suggests this might be true. Of the campaigns tracked by Activist Insight, only 11 proxy fights went to a vote and saw the activist win, but 21 proxy contests were called off with a settlement—often one favorable to the activist.

"EXPENSIVE AND TIME-CONSUMING PROXY BATTLES ARE A 'LAST RESORT'"

237

Number of companies publicly targeted by activists worldwide in 2013

9%

Increase in number of companies publicly targeted by activists worldwide since 2012

Larger and better established activists mostly had less need for proxy contests in 2013, with Bulldog Investor's Phil Goldstein telling Activist Insight it had become easier to gain board representation without a fight. Meanwhile, Carl Icahn added directors to the boards of six companies this year without a proxy fight. JANA Partners surprised observers by going all the way to a vote for the first time in its history, and though it failed to gain board seats at Canadian fertilizer giant, Agrium, sources said it was satisfied with the changes the company was forced to make to win over institutional shareholders.

Regional splits

US companies continued to account for 71% of all companies publicly targeted by activists in 2013, while European companies rose from 14% of the total to 19%. Canada, described as a 'promised land' for activism, was consistent at around 6%. While the much anticipated growth in Japan has yet to be statistically significant, the optimism for activism outside of the US is growing.

Two high-profile campaigns

How-to and how-not-to-be an activist became the question every columnist sought to answer when referencing Bill Ackman's abortive campaign at JC Penney. The Pershing Square CEO left the board after differences emerged over pricing strategies, and long-time foe Carl Icahn wasted no time in saying that Ackman had got too involved in the company's day-to-day business. Ackman himself said the disastrous choice of Ron Johnson as CEO of the retailer was more of a collective decision by the board than he got credit for, but the sense that activists are more suited to discussing questions of capital allocation and governance than strategy will be hard to shake off.

Carl Icahn's campaign to prevent Michael Dell from taking the technology company he founded in the 1980s private felt like it might never end. Indeed, we might be on the 150th rescheduled special meeting by now, had Dell not changed its by-laws to allow insider owners the right to vote on the leveraged buyout. Icahn wanted his alternative proposal voted on at the same time to reduce risk for shareholders, but the Delaware Chancery Court ruled that Dell's voting standards were permissible. Despite saying he would seek appraisal, Icahn sold out shortly afterwards, leaving a group of shareholders including T. Rowe Price wondering whether the $13.75 per share deal was good value.

Popular tactics - a cash-rich climate

Winning board seats remained the most visible objective voiced by activists in 2013, with just under 30% of all publicly disclosed activist objectives concerned with gaining access to the inner sanctum. Traditional sources of value, such as spinning off subsidiaries—the kinds of campaigns seen at Timken, Ashland and most recently at Darden Restaurants—are also consistent features of the activist playbook. However, it is in cash-exploitation that activism has surged this year, with 13% of all activist campaigns seeking larger dividends or share repurchase programs, compared to 8% last year. It is a trend Carl Icahn exemplifies especially well, with his repeated assertion that 'Apple is not a bank' and his precatory proposal for a non-binding shareholder vote on a buyback worth around $50 billion.

Indications that the current M&A climate might be unfavorable are reflected in the drop in number of companies activists say should be sold, an objective seen publicly only 26 times in 2013, compared to 47 times in 2012. In December, Clinton Group announced that it was exploring financing options for a takeover of Wet Seal, as the company's results continued to drag. Most experts are expecting M&A to pick up in 2014, so this change could be short-lived. Given that 20 unique activists publicly called for the sale of a company in 2013, it remains a feature of activist investing.

The kinds of activism used in 2014 will likely be influenced by economic conditions, and particularly by a flight from bonds to equities. As a result, share buybacks, and M&A could be pushed further up the agenda. However, as we make clear elsewhere in this review, governance changes will also be a staple of activist objectives.

A new source of value

The hostile M&A climate of the 1980s gave rise to the stereotype of the 'corporate raider'—an investor only interested in engineering a short-term spike in stock prices, or other financial engineering schemes. Today's activist investors are almost equally focused on corporate governance, however, with 47% of all requests involving board or bylaw reforms. Here, Activist Insight explores what activists look for in a company's corporate governance profile, and what they might seek to change.

11

Instances of activists attempting to remove staggered boards in 2013

7

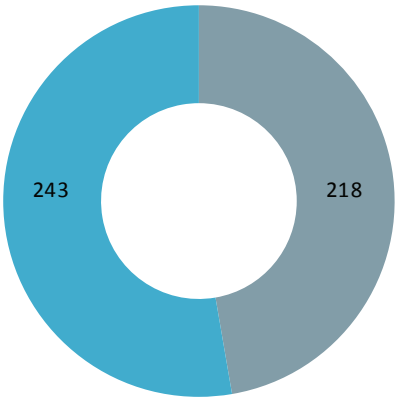
Instances of activists attempting to remove poison pills in 2013

Carl Icahn has long championed the interests of shareholders. Yet even many who had watched him for years were surprised by the vehemence of his Wall Street Journal Op-ed after withdrawing from the shareholder vote on Dell's leveraged buyout.

"Is it fair that CEOs make 700 times what the average worker makes, even if the chief executive is doing a terrible job and thousands of workers are laid off?" Icahn asked. "Why do CEOs get awarded huge bonuses by friendly boards when the share prices are down by double digits and then get their options reset to lower levels as an 'incentive'?" Icahn undoubtedly struck a chord. The phrase 'divine right of boards' was on quite a few people's lips after that editorial, and nearly a hundred thousand people took Icahn up on his offer to share his musings on shareholder rights with them via Twitter. On October 24, Icahn launched a new website, The Shareholder's Square Table, hosting articles about the evils of poison pills and golden parachutes.

Whatever your opinion of Icahn, today's activists are clearly not the corporate raiders of 1980's legend. For a start, they tend to leave companies in good shape, even after exiting their investments. Moreover, some, although not all activists, now see corporate governance as a key part of their investment process. For a start, more institutional shareholders and pension funds like Change to Win Investment Trust, CalPERS, CALSTRS are turning to activism. These investors often target companies with pre-planned campaigns or objectives. Change to Win targets companies with poor

"REMOVING A POISON PILL CAN FOCUS THE MIND WONDERFULLY"



Activist objectives in 2013 by number

- Capital-related (53%)
- Governance-related (47%)

47%

Governance-related objectives as a proportion of total in 2013

Say on Pay results, for instance, while CalSTRS successfully prevailed on 77 companies to adopt majority voting rules during its busy 2013 proxy season.

The more traditional activist, who is essentially a value investor and is therefore more likely to focus on share buybacks or arbitrage, could perhaps learn something from these reformist funds. Indeed, Relational Investors and CalSTRS recently put their heads together and came up with a full plan for Timken, which involved the company spinning off its steel business. In a public letter, the two noted that "the family-dominated board chooses to perpetuate a business structure that apparently only serves their interests."

Ask an activist of this second type what he thinks of corporate governance, and you tend to find him reflective. Engaged Capital's Glenn Welling says that every one of his investments begins with a deep look at the company's corporate governance profile. This includes how individual directors performed in re-election votes and how the company as a whole performed in 'Say on Pay' votes—the non-binding shareholder referenda on executive remuneration.

Activist Insight research suggests around 40% of activist objectives involve board personnel changes. If even half the activists who set about removing directors and gaining board representation have a corporate governance angle to their campaigns, the correlation between poor governance standards and activism may indeed be significant.

Governance for Owners CEO Stephen Cohen says that bad corporate governance can often be the root of bad capital allocation policies, but that best practice doesn't always lead to boards making good decisions. That requires frank discussions. Describing his thorough investment and research process, Cohen says, "All kinds of things can add value. Sometimes, creating new incentives by changing remuneration can change the dynamic. Removing a poison pill can focus the mind wonderfully."

However, there is a paradox in that issues such as poison pills, remuneration and classified boards appear neither to take up a great deal of activists' time, nor be part of a fixed formula. For instance, Jason Ader, Co-CEO of the new activist fund, Owl Spring Asset Management, says that he approaches the issue of whether to separate Chairman and CEO roles on a case-by-case basis.

Nonetheless, just because corporate governance is understood in many different ways, activists should not necessarily be written off. More time needs to be spent understanding how they operate and explaining that modus operandi. A greater focus on shareholder best practice would further rehabilitate activists and give them a means of gaining influence with company secretaries and proxy advisors.

More importantly, it could add value without hostile proxy fights. Activist Insight data shows that when activists lobby for the removal of plurality voting or poison pills, the results are impressive, with average annualized returns of 81% and 62% respectively since 2010 (ex. dividends). As activism becomes more widespread, we may not get closer to the definition of perfect governance, but there will certainly be a healthier debate.

The Harvard Law School Forum on Corporate Governance and Financial Regulation
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Shareholder Activism in M&A Transactions

Posted by Alan M. Klein, Simpson Thacher & Bartlett LLP, on Wednesday February 26, 2014

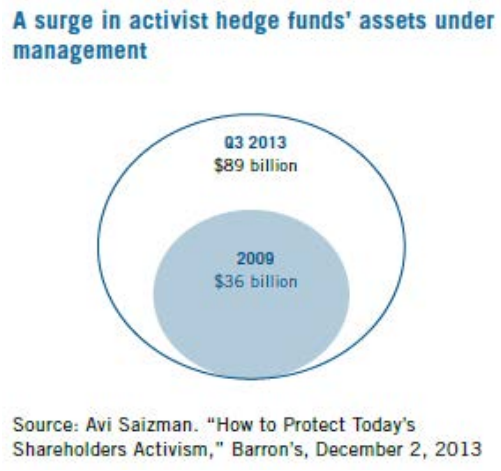
Editor's Note: Alan M. Klein is a Partner in the Corporate Department at Simpson Thacher & Bartlett LLP. The following post is based on a Simpson Thacher memorandum.

Shareholder activism, which has increasingly occupied headlines in recent years, continued along its sharp growth trajectory in 2013. The number of activists, as well as the amount of capital backing them, has increased substantially, as has the sophistication and effectiveness of their tactics.

In addition, last year was particularly noteworthy for the role shareholder activism played in the M&A sector, including a number of high-profile attacks on announced business combination transactions. In November 2013, we hosted a conference to discuss the rise of shareholder activism as it relates to M&A activity. We gathered a number of industry-leading experts to discuss significant recent developments and emerging trends and to explore tactics and responses from a company and an activist perspective. The panel discussions at this conference provided a number of interesting insights, observations and data points, and several of the key themes and highlights are outlined below.

Continued Growth of Shareholder Activism

As of the end of the 3rd quarter of 2013, various estimates indicate that activist funds have $80+ billion in assets under management. In addition to the growth in capital under management, there has been a proliferation of new players in recent years. The expectation among conference participants was that both new and old players will be increasingly aggressive in order to promote their "brand" in what has become a progressively competitive asset class. In addition, the stigma historically associated with being an activist fund



Source: Avi Saizman. "How to Protect Today's Shareholders Activism," Barron's, December 2, 2013

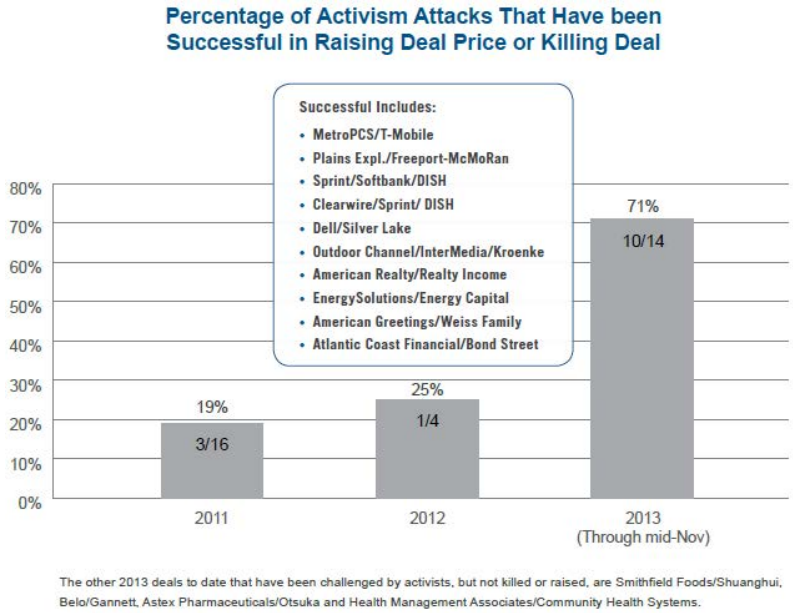
has significantly diminished and institutional investors and pension funds now regularly and openly engage in and support activism and invest in activist funds.

Activism Reaching Larger Companies and Using an Increasingly Sophisticated Playbook

Shareholder activists are increasingly willing to target large cap companies, and the targets of activist campaigns are not limited to underperforming companies. In addition, activist investors have become significantly more sophisticated in their analyses and critiques of target companies, as well as more varied in their proposals for changes in target company strategies. In the past year, for example, there are a number of examples of activist funds hiring headhunters to increase the quality of their board candidates, using outside investment banks or consultants to prepare detailed "white papers" and effectively using various forms of media in furtherance of their campaigns.

Rise in Successful Activist Attacks on Announced Deals

A key element of the M&A landscape throughout 2013 was the number and "success" of activism attacks on announced M&A transactions. The Dell buyout transaction probably garnered the most headlines, but there were a number of high-profile attacks throughout 2013 in which an activist fund publicly opposed an announced deal unless the buyer agreed to increase the purchase price (so-called "bumpitrage"). Most notably, over two thirds of activist attacks on announced deals through mid-November 2013 were successful in raising the deal price or terminating the transaction.



The other 2013 deals to date that have been challenged by activists, but not killed or raised, are Smithfield Foods/Shuanghui, Belo/Gannett, Astex Pharmaceuticals/Otsuka and Health Management Associates/Community Health Systems.

Click image to enlarge

The implications of this development remain to be seen, including whether it results in a potential chilling effect on M&A or enhanced shareholder value and how it affects the behavior of, and agreements put in place by, buyers and sellers in M&A transactions.

Activist Designees in the Boardroom

The rise in overall shareholder activism campaigns coupled with the increased propensity of target companies to settle has resulted in a growing number of activist designees on company boards. These changes to board composition often have resulted in boards considering, or re-considering, the strategic direction and alternatives for the target company. They also have caused companies and their advisors to grapple with certain collateral issues. Such issues include the ability of activist director-designees to share confidential information with the sponsoring activist fund and possible payments by the activist fund to its designee directors.[1] We expect issues such as these to continue to be a focus in the coming year and to result in litigation.

Preparing for Shareholder Activism

Preparation must be part of a company's usual routine these days. This includes regular engagement and dialogue with the company's significant shareholders and a periodic (and critical) self-assessment at both the senior executive and board levels. Companies and their boards and advisors also should be ever-mindful of the potential for activism in connection with any significant corporate transaction, including a possible M&A transaction. For example, carefully planned and ongoing use of the media, which has long been a key component of announcing a business combination transaction, is more important than ever in contributing to the success of an announced transaction.

[1] One particular topic that the conference participants discussed in this regard was the possible use of bylaw provisions to disqualify director nominees who receive third-party compensation, such as the type proposed to be paid by Elliott Management Corp. to its director-designees in connection with its proxy fight with Hess Corp. We note that on January 13, 2014, Institutional Shareholder Services (ISS) issued FAQs in which it indicated that it may consider a board's unilateral adoption of such bylaw provisions as a material failure of governance that would lead it to recommend voting against directors and boards adopting such a bylaw. For additional information, please click here to see the Firm's memorandum on this topic.