

2015 PRIVATE FUND REPORT: THE ROLE OF ACTIVIST FUNDS



LOWELL MILKEN INSTITUTE
FOR BUSINESS LAW AND POLICY



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INTRODUCTION

Joel A. Feuer, *Lowell Milken Institute for Business Law and Policy*



The Lowell Milken Institute for Business Law and Policy at UCLA School of Law is pleased to present its second annual Private Fund Report. This year, we focused on the role of activist funds – a topic that is discussed daily in the business press. Activist funds based in California took a high profile role in a number of widely-publicized activist situations; and similarly, several companies headquartered in California were the target of shareholder activism. The significance of private fund activity in California, a motif of our **2014 Private Fund Report: A View From California**, echoes through this year's Report as well.

We solicited articles from participants in the world of activist funds as well as respected commentators on shareholder activism. In our solicitation, we invited the participants to write on any subject regarding activist funds of interest to them. To stimulate their thinking, we suggested some questions of interest to us:

- What are the implications for activist funds now that they have been declared an “asset class”?
- For the future, will more activist funds remain invested in companies where they have effected change and, if so, will that influence the types of changes that they will seek?
- Will activist funds replace some private equity funds because the activist funds mode of operating does not require the capital investment or long term horizon of the traditional PE firm?
- What are the biggest challenges that activist funds face in the near future?

The result is a collection of perspectives reflecting some of the conversations within the private fund industry.¹

Steve Wolosky is a partner and the chair of the activist and equity investment practice at the law firm Olshan, Frome & Wolosky. He describes the 2014 ground-breaking proxy battle, successfully waged by his client, the activist fund, Starboard Value LP, to replace the entire board of directors of Darden Restaurants, Inc. (Olive Garden restaurant and other chains). The Olshan firm was named the No. 1 legal advisor to activist funds in 2014 by *The Wall Street Journal*.

Glenn W. Welling is the Chief Investment Officer of Engaged Capital LLC, an activist fund based in Newport Beach, California. He writes about how activist funds satisfy the investment horizons of investors including those with long-term investment designs. Engaged Capital has been a leader in a number of activist situations including Rentech, Inc., Oplink Communications, Inc., Silicon Image, Inc. and Jamba, Inc.

Christopher Kiper is co-founder and managing director of activist fund, Legion Partners Asset Management, based in Beverly Hills. He set as his task a detailed explanation of his firm's expectations regarding executive compensation for companies in which Legion invests. Legion has recently been involved in activist situations with Perry Ellis International, Inc. and RCM Technologies. California State Teachers' Retirement System (CalSTRS) is a major investor in Legion.

David Karp is a corporate partner at Wachtell, Lipton, Rosen & Katz and one of the firm's leaders in shareholder activism defense. He looks at the need for companies to plan for shareholder activism. He advocates for the



development by the board and management of a proactive approach to shareholder relationships. Wachtell Lipton was named the No. 1 legal advisor to companies defending against activists in 2014 by *The Wall Street Journal*.

Stephen Bainbridge, the William D. Warren Distinguished Professor of Law at UCLA School of Law, is a leading scholar on corporate governance and frequent commentator on shareholder activism. His books and articles are required reading for the growing scholarship that focuses on the debate over the merits of shareholder activism. Professor Bainbridge's article proposes a schema for assessing activist hedge fund activity, suggesting that at least one category of activist activity – encouraging and even forcing changes in the target's business strategy – is problematic within the context of corporate governance principles.

James R. Gregory is the Chairman of Tenet Partners and an expert on corporate brands. Neither an activist fund manager nor the director of a target of activist activity, James

Gregory's "outsider" perspective looks at the effect of shareholder activism on brands. David Bogoslaw author of the publication, *Corporate Secretary*, conducted a study of some of the effects of shareholder activism on corporate brands based upon data collected over many years by James Gregory's company. Mr. Gregory has written an introduction to the study, which is reproduced in this Report, with the kind permission of *Corporate Secretary* and Mr. Bogoslaw.

Timothy Spangler, Director of Research at the Lowell Milken Institute and a partner in Sidley Austin LLP, provides an annual update on regulation affecting private funds.

The Lowell Milken Institute for Business Law and Policy at UCLA School of Law was created in 2011 to support the UCLA Law faculty in preparing students to be future leaders in business law and related careers. The Institute helps faculty develop cutting-edge business law curriculum, creates outstanding co-curricular programs and provides a forum for the broader businesses and business law communities for the

discussion of current and significant legal and business issues facing California and beyond. A goal of the Institute is to foster an environment for thoughtful conversation and debate of business law issues by a wide-range of stakeholders including business executives, company directors, attorneys, judges, academics, students and the public.

Our **2015 Private Fund Report: The Role of Activist Funds** and companion Private Fund Conference on March 18, 2015 are intended to provide a forum for a conversation about the many and important issues surrounding activist funds in our economy. We look forward to your participation.

This Report was prepared under the guidance of Timothy Spangler and Joel Feuer with assistance from Steven Bank, Sarah Korobkin and Rachel Estrada. Special thanks to Corporate Secretary and David Bogoslaw for their permission to reprint their study.

¹ Detailed biographies of each author are set forth at the end of the Report.

LESSONS LEARNED FROM DARDEN

Steve Wolosky, Olshan, Frome & Wolosky

On October 10, 2014, Starboard Value LP achieved a landmark and unprecedented victory when it ousted the entire board of directors of a Fortune 500 company, Darden Restaurants, Inc., the owner of Olive Garden, Longhorn Steakhouse and several other restaurant chains. After a long and contentious proxy battle leading up to Darden's 2014 annual meeting (the "Annual Meeting"), shareholders elected to remove all twelve of Darden's incumbent directors and replace them with Starboard's entire slate of director candidates. While there is little question that shareholder activism has become a dominant force across corporate America, Starboard's unparalleled success at Darden was unique and offers invaluable insight and lessons for activist investors and target companies alike.

In fact, Darden represented the perfect storm. It is not every day that a board of directors of a Fortune 500 company is completely removed and replaced with a dissident's slate of director candidates while being advised by the nation's leading financial and legal advisors. But it is also not every day that a board of directors ignores the will of its shareholders by entering into an important transaction prior to holding a shareholder-requested special meeting to first discuss the transaction. Importantly, Starboard ran a sophisticated, thorough and aggressive campaign, including the publication of a 294-page detailed investor presentation, which was developed alongside leading consultants and advisors hired by Starboard.

While there are a myriad of reasons why activist investors are generally gaining more widespread support and success in this unprecedented era of shareholder activism,



Starboard's campaign at Darden was truly unique in that it embodied all of these emerging trends. Although another Darden situation is unlikely in the near future, an analysis of the facts and circumstances provides a useful roadmap for the emerging issues that will continue to shape shareholder activism and provides a cautionary tale for management teams and boards of directors facing pressure from activist investors.

Situations for Control Like Darden Defy the Defense Pundits' Argument that Activists are Short-Term Focused

The landscape of activism has significantly changed in the past few years. Gone are the days when an activist's sole objective is to extract an immediate, short-term profit at the expense of the long-term development of the company by forcing management to, for example, return excess capital or force a quick sale of the company. So-called

"corporate raiders" or "one-trick ponies" are no longer the mainstream as activists are increasingly focused on effectuating long-term value creation by developing strategies and goals that support the future growth and profitability of a company. Today's activists are focused on R&D, general and administrative expenses, gross margins and capital expenditures and/or adopting and developing new products or services, which require a long-term oriented focus and commitment.

The reasons for this shift toward long-term shareholder value creation are three-fold. First, the activists themselves are much larger as the amount of money invested in activist hedge funds has increased from \$12 billion to over \$100 billion in the last decade. Such an influx of additional capital provides activists with the tools and resources necessary to run more sophisticated campaigns against much larger companies. Second,

principals of activist hedge funds are going onto the boards of companies directly, thereby subjecting themselves to significant trading restrictions that are applicable to insiders of public companies. Such restrictions limit the ability of activists to quickly exit the company and reflect their desire to effectuate long-term changes that support the future growth of the company. Lastly, activists have increasingly prepared detailed operational white papers and presentations committing themselves to multi-year plans and phases, which cannot be implemented or achieved overnight.

Starboard's campaign at Darden underscores this shift toward long-term value creation. Starboard's 294-page presentation focused on the long-term strategies and goals necessary to create value for Darden, including a detailed turnaround plan for Darden's largest brand, Olive Garden, which was developed alongside highly reputable advisors and consultants.¹ Furthermore, Starboard identified ten independent, highly qualified nominees with direct experience relevant to all aspects of Darden's business to assist with developing, and to eventually lead Darden through, the turnaround plan. Starboard also included two principals, Jeff Smith and Peter Feld, in its slate of nominees, thereby subjecting itself to significant restrictions once they joined the Board. Situations like Darden highlight this shift toward long-term shareholder value creation and defy the archaic stigma that activists are "corporate raiders" aimed at extracting only short-term profits.

A Formal Mechanism for a Referendum of Shareholders Is a Very Powerful Tool

While special meetings of shareholders and consent solicitations have always been important mechanisms for shareholders to voice their opinions and seek to effectuate change, the Darden defeat provides an invaluable lesson for companies, namely, listen to your shareholders and value their opinions. In fact, boards of directors will often argue that they have spoken with their

large shareholders and that such shareholders support their strategies or plans, which is precisely what Darden did with respect to its proposed sale of Red Lobster. A formal mechanism like a special meeting request or consent solicitation, however, removes the "he said, she said" and adds transparency to the process to provide a clear picture of how shareholders genuinely feel about a given strategy or plan.

The Darden Board essentially sealed its own fate when it ignored the clear will of its shareholders by divesting its Red Lobster business prior to holding the shareholder-requested special meeting (the "Special Meeting") as a forum for shareholders to express their opinions on the proposed transaction. Starboard went through the

nominees at the Annual Meeting. In making their recommendations, ISS and Glass Lewis emphasized the significance of Darden's failure to listen to the will of its shareholders and hold the Special Meeting, which offers invaluable insight to companies moving forward. As ISS stated in its recommendations for the Special Meeting and Annual Meeting, respectively:

"A shareholder vote, moreover, has the significant additional advantage that it is public and transparent — unlike the private engagement process Darden advocates instead, which inherently lacks transparency, results in answers whose credibility relies on the credibility of the very board whose judgment is being challenged, and may never reach a moment of denouement. Engagement can be a very effective mechanism

Despite the fact that the Red Lobster sale did not require a shareholder vote, such a strong showing of shareholder support should have alerted the Board to first consider the views of its shareholders. Darden's failure to respect such an important shareholder right undoubtedly caused its shareholders to lose faith in the judgment of the Board and its ability to protect their best interests.

arduous process of soliciting the support of the holders of approximately 57% of Darden's outstanding shares to call the Special Meeting, which represented approximately 80% of the shares realistically available to vote on such a matter.² Despite the fact that the Red Lobster sale did not require a shareholder vote, such a strong showing of shareholder support should have alerted the Board to first consider the views of its shareholders. Darden's failure to respect such an important shareholder right undoubtedly caused its shareholders to lose faith in the judgment of the Board and its ability to protect their best interests.

The two leading independent proxy voting advisory firms, Institutional Shareholder Services and Glass Lewis & Co., took the atypical step of recommending that shareholders vote "FOR" Starboard's entire slate of

for providing the board with insight; for settling complex questions about the company's future, however, lacks the definitive authority of the shareholder vote itself.

The board was within its legal right to sell that business without the approval of shareholders. To have done so in the face of a clear and substantial mandate from shareholders, however, begs the question of whose interests it was really protecting. To defend such an action, at the very least, one has to argue that shareholders cannot be trusted to understand the business or strategic issues, or know what is best for them."

Glass Lewis agreed, stating in its recommendation for the Annual Meeting that:

"Regardless of shareholders' opinions of the Red Lobster sale, one way or the other, it's notable that shareholders representing 57% of Darden's

shares outstanding – a clear majority – expressed a desire, by agreeing to Starboard’s solicitation of consents, to at least have an opportunity to cast a vote (even if only an advisory vote) on any proposed sale of Red Lobster. In our April 2014 Proxy Paper on Starboard’s solicitation of consents to call a special meeting, we recognized the merit of Starboard’s arguments and recommended that Darden shareholders consent to such solicitation. While the board may have had its reasons for quickly executing a sale of Red Lobster in spite of this clear expression from shareholders, the episode could equally be argued as a blatant disregard of shareholders’ rights and input.”

Highly Reputable Experts, Executives, Consultants, and Advisors are Aligning with Activist Investors

Activists in general are running more sophisticated campaigns focused on creating long-term shareholder value, largely due to their increased access to capital. Part of this shift toward long-term value creation is the hiring of experts, consultants and advisors to assist in performing in-depth analyses on target companies and preparing detailed white papers and presentations. Activists are also nominating highly qualified director nominees to serve on the boards of companies, including top executives of public companies, which

suitable for the long-term development of a company, activists have largely rid the stigma they once had.

Starboard’s campaign at Darden exemplifies this shift. In fact, Starboard assembled what one may dub a “dream team” of advisors and nominees that undoubtedly facilitated its success at Darden. Starboard hired leading real estate, investment banking and marketing advisory firms to assist in the analysis and preparation of Starboard’s detailed turnaround plan for Darden. Starboard also engaged in a meticulous search for the most qualified director nominees with diverse skill sets and perspectives directly relevant to Darden’s business and challenges, including experienced restaurant operators, and experts in real estate, finance, turnarounds, supply chain, effective public company governance and executive compensation. Notably, among Starboard’s slate of director nominees were several leading executives with direct experience successfully leading Olive Garden or overseeing similar turnarounds at competing casual dining companies such as Brinker International.

Starboard’s nominees were not only the right people to lead Darden with direct experience in the industry but were integral in assisting Starboard in developing its turnaround plan

Darden unsuccessfully argued throughout the proxy contest.

Activist White Papers are Becoming More Sophisticated and Detailed

Activists’ white papers and presentations are likewise becoming increasingly more sophisticated and detailed. In fact, activists’ diligence on target companies is outpacing the information that company directors, themselves, know about their company. Moreover, activists flushed with capital are now able to conduct highly sophisticated research, including analyst and consultant research and surveys and interviews with top-ranking former executives, all of which add tremendous value and professionalism to an activist’s materials.

Starboard’s various white papers, plans and presentations for Darden underscore this shift toward increased sophistication and detail. Notably, its 294-page presentation was extremely sophisticated and thoroughly focused on the long-term strategies and goals to turnaround Darden, including, among others (i) a thorough analysis of company-wide margin improvement opportunities, (ii) a detailed turnaround plan for Darden’s largest brand, Olive Garden, (iii) a real estate valuation and potential spin-off of the specialty restaurant group, (iv) franchising opportunities and (v) a 100-day plan which outlined the immediate actions to be taken if Starboard’s nominees were elected to the Board. Starboard also prepared detailed white papers and presentations in connection with its special meeting request on the proposed sale of Red Lobster.

The development of such detailed presentations and plans helps bolster the credibility of an activist and proves its commitment to the long-term development of the company. Moreover, leading proxy advisory firms such as Glass Lewis and ISS study such plans and presentations in detail prior to making their recommendations to shareholders.

“[A]ctivists flushed with capital are now able to conduct highly sophisticated research, including analyst and consultant research and surveys, and interviews with top-ranking former executives, all of which add tremendous value and professionalism to an activist’s materials.”

was not always the case five years ago.

Why the change? Industry experts and director candidates appear less concerned about the reputational harm that used to accompany working with activists. Activists have refined their images by running more sophisticated campaigns aimed at creating long-term shareholder value. Now seen as investors with constructive goals and strategies

for Darden. Even ISS and Glass Lewis recognized the superiority of Starboard’s slate of nominees in making their recommendations, stating that Starboard’s slate was “endowed with an embarrassment of riches” and “far more compelling”, respectively. Importantly, the time-consuming and costly process Starboard undertook to assemble its slate of nominees defies the argument that activists’ slates are “hand-picked nominees” which

Performance is Paramount, But Governance and Compensation Practices Still Matter

While a target company's poor performance is almost always the paramount feature of an activist's campaign, governance and compensation practices still matter and play important roles in an activist's platform. Moreover, corporate governance and compensation practices are similarly scrutinized by proxy advisory firms like ISS and Glass Lewis and if egregious, play a large role in their recommendations to shareholders.

Prior to Starboard's investment in Darden, the company maintained numerous shareholder-unfriendly corporate governance provisions, as evidenced by ISS giving Darden a governance QuickScore of 10, indicating the highest possible governance risk. Once Starboard surfaced as an activist investor and during the midst of its special meeting solicitation, Darden made a slew of governance changes that further disconnected it from its shareholders, including amending its bylaws to provide for more stringent nomination notice and business proposal requirements and to permit the Board to further delay the Annual Meeting. Rather than trying to improve its already egregious governance practices, the Board took reactionary steps to further entrench itself. While companies oftentimes amend their corporate governance documents to make it more difficult for activists to effectuate change, doing so during the midst of a proxy contest can have serious consequences. In fact, ISS' statements with respect to Darden's problematic governance practices are telling:

"On March 19, 2014 the company announced several changes to its bylaws which would 'update the bylaws to address current market practices.' However, some of the bylaw changes appear to go beyond modernization, and – in the context of an extant challenge from shareholders – call into question the board's motivation... the nature of these particular changes, coupled with the last-minute cancelation of its formerly annual

"It was the ensuing actions on behalf of Darden's management team and Board that ultimately lead to Starboard's platform for control as it became quite obvious that the current management team and Board were not suited to lead Darden in the direction necessary to create value for shareholders."

two-day analyst conference in March, may suggest cause for concern to shareholders. At the very least, one has to wonder why the board chose this particular time to 'modernize' the bylaws by granting itself powers to obstruct, or otherwise raising defenses against, shareholders who might wish to use the annual meeting to hold directors accountable. This is a particularly resonant question when the board is also arguing that a special meeting to request shareholders be allowed to ratify or reject a major strategic transaction is an 'unsatisfactory' approach."

No Two Activist Campaigns Are Alike and You Never Know What Path an Activist Involvement May Take

Darden did not have the makings of a campaign for control at the outset. Starboard invested in Darden because it believed there were significant opportunities available to enhance shareholder value and opposed Darden's proposed divestiture of its Red Lobster business. It was the ensuing actions on behalf of Darden's management team and Board that ultimately lead to Starboard's platform for control as it became quite obvious that the current management team and Board were not suited to lead Darden in the direction necessary to create value for shareholders. Importantly, Darden underscores the seismic shift that can occur if a company ignores the clear will of its shareholders.

Darden was truly a unique set of circumstances with unanticipated moves and surprises at every turn of the game. In fact, the outcome of Darden is telling as it unequivocally demonstrates that companies and activists alike have to be ready, willing and able to adapt and change course as circumstances and dynamics change.

Despite all the lessons learned, there will be another Darden someday and somewhere.

Regardless of the outcome of Darden, however, it is important to emphasize that situations like Darden and shareholder activism in general, particularly in light of the increased focus on long-term shareholder value creation, have created better performing and more engaged public company boards.

¹ Starboard's presentation on Darden can be viewed at the following link: http://www.sec.gov/Archives/edgar/data/940944/000092189514002031/ex991dfan14a06297125_091114.pdf

² Approximately 20% of Darden's outstanding shares were held by retail investors (who generally have extremely low vote totals) and, based on the short interest in Darden, approximately 10% of the outstanding shares were out and on loan and therefore were not eligible to vote as of the record date for the Special Meeting. Starboard's receipt of written requests from holders of approximately 57% of Darden's outstanding shares therefore represented approximately 80% of Darden's outstanding shares, given the limited number of shares realistically available to vote.

ACTIVISTS AND THEIR INVESTMENT TIME HORIZONS

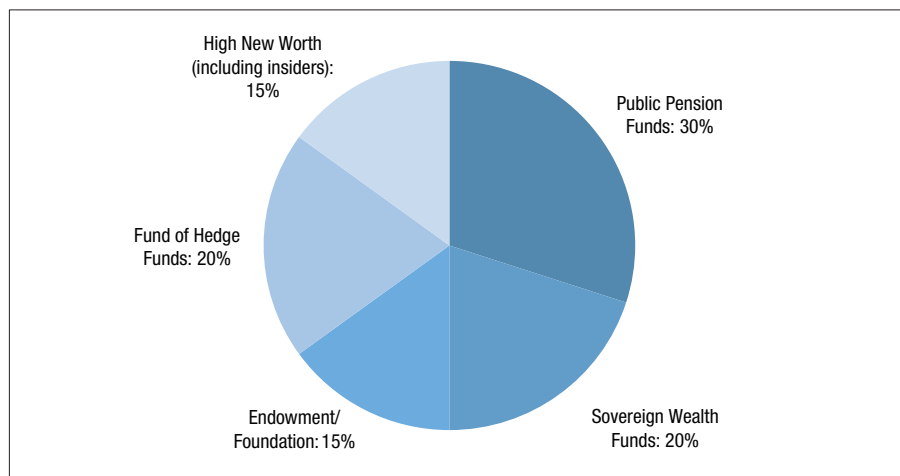
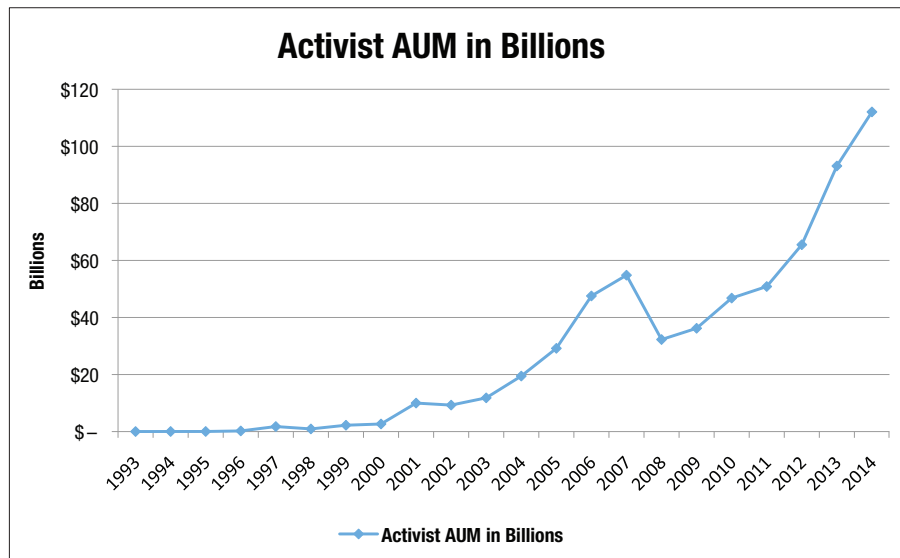
Glenn W. Welling, *Engaged Capital LLC*

In the future, will more activist funds remain invested in companies where they have effected change and, if so, will that influence the types of changes that they will seek? Will two categories of activist funds develop – a category that seeks quick change, takes the profits and exits and a category that seeks change and remains?

The answers to these two questions can be found by understanding who the underlying investors are in activist funds. Today, there are estimated to be \$112 billion (as of 3Q14 HFRI data) of assets in activist coffers, from less than \$40B after the 2008 recession.

While we have not seen any independent studies that break down the \$112 billion by type of investor, we estimate the break-down of investors within the activist community as reflected in the pie chart (right).

This information tells us that at least two-thirds of the funds managed by activists are from investors that have extremely long-term (three years or longer) investment horizons (pension funds, sovereign wealth funds and endowments/foundations). We can surmise that the activists managing this capital have aligned their liquidity terms and thus investment horizons and strategies with their investors' long-term goals. These activists have developed multi-year share classes with liquidity terms that look similar to but less onerous than private equity managers – two, three, four, five or even eight year locked share classes are the norm. This long-term capital enables these activists to invest in companies where they can catalyze changes that drive value over the medium and long-term, as opposed to more event driven, short-term catalysts. These include



changes in cost structure, financial and strategic planning processes, operations, capital allocation, governance and executive compensation to name a few. Changes in these important areas of a company can pay dividends over many years but can take many years to change.

The rest of the capital (probably less than a third) in activist funds comes from shorter-

term investors, like hedge funds of funds. Some of this capital is invested in activist funds whose capital bases are dominated by longer-term investors and are subject to the same strategy as the longer-term capital. However, some of this capital is invested in shorter duration firms or event driven funds that also consider themselves activists. By definition, this capital, which has quarterly or even monthly liquidity terms, is looking

“It is typical that an activist’s value creation agenda is multi-faceted; and as a result, the implementation of the entire agenda may take years.”

for returns sooner than two or three years. With these activists, you will see investments with much shorter term catalysts, like capital structure changes or a proposed sale of the company. This category of activist tends to come from long-short hedge funds who may or not be “full-time” activists. With the distributed ownership that exists in today’s shareholder base, there is often a void in bringing an owner’s perspective into the company’s decision making process. As a result, many large shareholders have started to become “activists” by engaging with the managements and the boards of their troubled investments. Short-term or longer-term focused, all these investors/activists play a very important role in making the capital markets more efficient. However, their time horizons for change may differ.

Depending on the type of activist and make-up of their asset base, you will get a different time horizon on their investment period. The majority of capital invested in activist strategies is from investors with longer term horizons. This means that these investors can be more patient and thoughtful at driving the process related changes that enable a company to outperform over longer periods of time.

the company’s management and board also impacts the value creation timeframe.

Now to the question of how long activists stay or should stay in their investments.

Whether or not an activist remains in an investment once they have implemented their agenda is driven by the assessment of three factors:

- uncaptured performance remaining in the investment;
- projected time to capture this performance in order to achieve your target IRR; and
- downside risk and market beta in the investment.

A successful activist investment, regardless of the managers projected tenure for the investment, needs to accurately measure both the downside and upside target price for each investment and must possess a strict buy and sell discipline based on valuation. This is critical to avoid falling into a situation where your prior investment gains are erased by downside beta. This can sometimes become complicated by the commitment an activist makes to drive changes on behalf of the rest of the shareholder base. It is often difficult to exit exactly when you want given the

through the activist engagement they often have a better strategy, are better managed and are better governed.

However, with that said, all activists have one over-riding goal: make money for their investors. Yes, we all seek to accomplish this in different ways, but the only way an investor stays an investor is to deliver satisfactory returns to their clients. So, the tenure of an activist investment must allow for the implementation of the managers agenda while still achieving their target IRR. Valuation (stock price) should always dictate the tenure of an investment even if you have not completed your agenda. You may have to sell earlier than you want or stay longer than you anticipated, but the forecast return and your target IRR have to remain job #1.

The face of activism has been created through the investors in activist funds and the desire for shareholders to have their views represented in the boardroom. With so much long term capital invested in the space, you can expect to see activist investment managers driving short, medium and long term changes for years to come.

“With so much long term capital invested in the space, you can expect to see activist investment managers driving short, medium, and long term changes for years to come.”

As private equity investors in the public domain, there are many levers activists have at their disposal to unlock embedded value. It is typical that an activist’s value creation agenda is multi-faceted; and as a result, the implementation of the entire agenda may take years. Additionally, the receptivity of

myriad of changes that you may be trying to catalyze inside the company. Successful activists desire to leave companies in better condition than when they began their investment so that these companies can outperform for years to come. They outperform for years because after having gone

EXECUTIVE COMPENSATION

Christopher Kiper, *Legion Partners Asset Management*



Legion Partners

Legion Partners is an SEC registered activist fund focused on producing superior risk-adjusted long-term returns. Our strategy is focused on North American small-cap equities, and we are structured in a manner that is well aligned with our investors. Our track-record demonstrates the strengths of a highly constructive, long-term oriented ownership approach combined with targeted activist engagements.

Introduction

Throughout our activist investing experience, we have found that many underperforming companies had a major recurring problem – the lack of a well-defined and thoughtfully constructed compensation plan. Many times, the very behaviors that were leading to shareholder value destruction were directly attributable to incentives in the existing compensation plan.

The purpose of this white paper is to provide a shareholder perspective on executive compensation program practices and general guidelines for companies when designing and managing a responsible executive

compensation program. Given unique circumstances at each company, this document is intended to provide an overall framework rather than a prescriptive set of rules.

Executive Compensation Philosophy

Executive compensation programs should be grounded in the following principles:

- **Well-defined purpose.** Foster sustainable long-term value creation by aligning executive, company and shareholder interests with competitive compensation practices designed to attract, retain and motivate highly skilled employees.
- **Transparent design and clear disclosure.** Promote accountability and understanding of the compensation programs through clear, simple and transparent design as well as clear and robust disclosure.
- **Performance-based.** Link a significant portion of executive compensation to short-term and long-term objectives which create sustained superior value creation.
- **Cost-effective.** Ensure a competitive and efficient cost structure, providing a clear delineation between ensured elements of pay (such as base salary) and those intended to provide performance incentives. This distinction should take into account that variable pay in-and-of-itself is not necessarily efficient performance-based compensation.

Executive Compensation Design

Executive pay levels and compensation program design decisions should be informed by competitive market data (i.e., peer group

and/or surveys), however, peer data alone is not sufficient rationale for supporting target pay levels or program design. This decision must also be made within the context of each company's circumstances (industry, capital cycle, current challenges/opportunities, strengths and weaknesses, etc.), and these factors must be discussed as an integral part of disclosures.

The companies in the peer group should be selected through objective screening based on several factors:

- Industry;
- Size (e.g., revenue, assets); and
- Business characteristics.

Although the use of competitive market data is an important reference point, each company should consider its unique situation when determining the pay levels for each executive position. The company's practice of benchmarking compensation elements to market must be defensible to shareholders.

The key elements of an executive compensation program are:

- Base salary;
- Performance measurement framework;
- Short-term incentives;
- Long-term incentives;
- Perquisites;
- Benefits; and
- Post-employment compensation.

It is important to consider the overall compensation program and total potential reward value when designing each compensation element. In other words, any consideration of pay mix must include all forms of compensation, including for example, perquisites, retirement benefits and

...perquisites, retirement benefits, and severance/change in control arrangements. ...may have a material impact on alignment and risk taking, and therefore are an integral consideration in the overall pay mix.

severance/change in control arrangements. These elements of pay may have a material impact on alignment and risk taking, and therefore they are an integral consideration in the overall pay mix. A substantial portion of an executive's total compensation should be in the form of performance-based or "at-risk" compensation. Long-term incentives should typically constitute 60% of total compensation for CEOs.

The proportion of long-term incentives to short-term incentives should be greater as job level increases. In addition, larger companies should typically provide a greater portion of pay as variable compensation and a higher portion in long-term versus short-term incentives.

Base Salary

Base salary determination should be based on the individual's responsibilities, qualifications and experience. Base salary adjustments should be determined by changes in role, individual performance and market adjustments. Due to the fact that adjustments to base salary typically also affect the value of the bonus opportunities, long-term incentive awards (if defined as a percentage of base salary) and benefits costs, the impact on total rewards should be carefully considered when making base salary adjustments.

Performance Measurement Framework

Selecting appropriate performance measures and setting goals for incentive programs are critical components of an effective compensation program. The Compensation Committee is responsible for evaluating performance measures to ensure that the

measures do not lead to excessive pay, misalignment with shareholder interests or the undertaking of inappropriate risks. An understanding of the potential range of pay and performance outcomes is critical. Related performance processes, such as a robust appraisal and evaluation process as well as a succession management process, must be aligned with pay practices.

Performance Measures: Metrics should be selected based on a variety of factors including the company's business model and lifecycle, capital intensity and strategy. Short-term incentive program measures should align with short-term business objectives. Long-term incentive measures should align with sustained creation of shareholder value and execution of strategic/operational goals over an appropriate time horizon, typically at least several years. The overall selection of measures should reflect a balance between short and long-term performance, growth vs. returns and absolute and competitive success which in aggregate will create sustained shareholder value.

In general, there are several commonly used measures that companies should avoid using as a default or even primary performance indicator:

- Revenue: may lead to unprofitable growth and may misalign incentive payouts with overall program cost-effectiveness;
- Earnings per share (EPS): can be affected by changes in accounting policy and does not account for cost of capital; results can be affected by non-performance related decisions (e.g., share buybacks or new share authorizations); and

- Total shareholder return (TSR): impacted by factors outside of management control or influences; unclear line-of-sight to executives; includes expected future performance as well as actual performance.

Funding Measures: Incentive program (both short-term and long-term) funding should be based purely on financial measures at the corporate level for simplicity, transparency, affordability and alignment. To the extent that the minimum funding targets are not achieved, the incentive plans will not be funded and no payouts can occur. Some degree of diversity in the drivers of funding measures is recommended, as this helps mitigate unintended risks and helps balance the plan. If discretionary payouts are provided despite poor overall company performance, the company must limit the payout to the highest performers and clearly communicate the rationale for providing the award. In certain circumstances, a company with a diverse portfolio might include business unit level performance. In select cases, non-financial measures (e.g., customer satisfaction) might be used to fund a small percentage of a pool. If so, transparency and alignment to shareholder value are important tests.

Allocation Measures: Individual incentive payouts should be based on the funding level and allocation mechanism. It is important to use measures that are quantifiable and controllable for each executive level (e.g., include business unit/subsidiary level measures for business unit/subsidiary executives). In addition to financial measures, allocation measures can include strategic or other non-financial measures (e.g., market share, leadership development and succession planning). Each company will have its own set of circumstances that lead to the determination of optimal plan allocation measures.

Weighting: The weighting of allocation measures for each level or position should represent the appropriate blend of corporate, business unit (if applicable) and individual results.

Goal setting: The performance goals must be aligned with the business strategy and linked to shareholder value creation. Goals should be informed by business forecasts, market conditions and competitive performance. Furthermore, goals should not be changed during the performance period except in the event of extraordinary corporate transactions, such as mergers or divestitures. When goals are changed, the rationale for changes and the calculations supporting such changes should be clearly communicated.

Some degree of diversity in the drivers of funding measures is recommended, as this helps mitigate unintended risks and helps balance the plan.

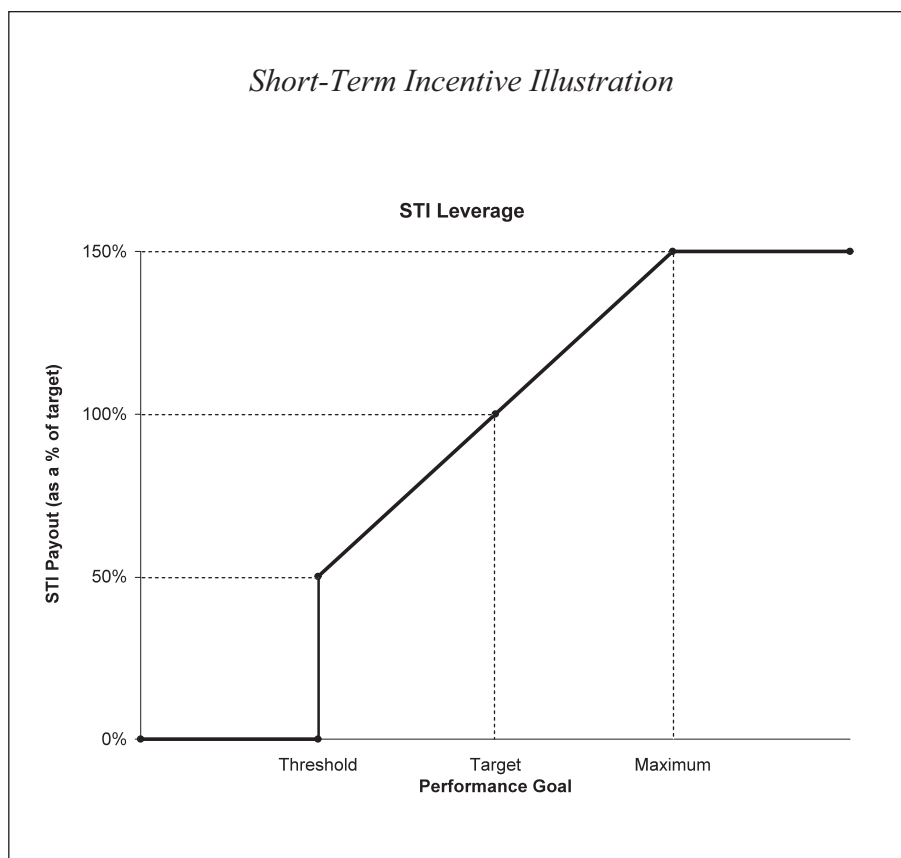
Short-Term Incentives

Along with base salary, annual short-term incentive (“STI”) amounts should be considered in the positioning of the executive’s total cash compensation. STI should be cash-based and assessed annually. Threshold, target, and maximum payouts (e.g., payout leverage) should be predetermined, well defined in relation to the potential value transfer for any specified level of performance (percentage of base salary is a common basis) and tied to specific goals so that funding is formulaic and transparent. STI leverage should be capped at 150% to 200% of target for executives.

The leverage curve slope (as shown above), and any inflection points, should be carefully determined because they represent the “sharing” of performance between the company and its executives and are a signal of risk.

Long-Term Incentives

Long-term incentive (“LTI”) awards are intended to reward performance over a multi-year period and provide a retentive



element to executive compensation. The awards should be granted annually to create an overlapping of awards. Large one-time grants can lead to an inconsistent level of incentive and retention value and may provide an incentive for inappropriate risks, and therefore should be avoided.

Companies should use multiple LTI vehicles to balance reward upside, risk, performance (e.g., intermediate or long-term) and retention. Smaller companies may prefer to limit LTI programs to a single vehicle for simplicity.

LTI should be provided in the form of performance-based awards, which may include one or more of the following tools: stock options, performance cash, performance shares, performance contingent options, stock appreciation rights, and indexed options. The table (as shown above) describes commonly used performance-based equity vehicles:¹

The performance periods for performance-based LTI awards should be consistent with

each company’s capital cycle, and at least 2 to 3 years at a minimum, which also provides overlapping performance cycles.

Annual LTI grant guidelines should be established as a percentage of base salary rather than a fixed number of shares or units so that share price does not impact the value of the annual grants. Mega-grants (e.g., large one-time grants) should be avoided.

In addition to financial measures, allocation measures can include strategic or other non-financial measures (e.g., market share, leadership development, succession planning). Each company will have its own set of circumstances that lead to the determination of optimal plan allocation measures.

	Advantages	Disadvantages
Stock options	<ul style="list-style-type: none"> • Simple to understand • High upside • Can be enhanced with performance-based restrictions 	<ul style="list-style-type: none"> • Tied purely to stock price • Stock price affected by factors outside of management control • May transfer substantial value due simply to market movement
Performance cash	<ul style="list-style-type: none"> • Simple to understand • Allows linkage to performance measure other than stock price appreciation • Non-dilutive 	<ul style="list-style-type: none"> • Requires measure selection and goal setting • No share ownership • No direct linkage to share price
Performance shares	<ul style="list-style-type: none"> • Provides dual leverage (stock price increase and increase in # of shares received) • Allows linkage to performance measure other than stock price appreciation 	<ul style="list-style-type: none"> • Requires measure selection and goal setting • Stock price affected by factors outside of management control
Performance contingent options	<ul style="list-style-type: none"> • Simple to understand • High upside • Allows linkage to performance measure other than stock price appreciation 	<ul style="list-style-type: none"> • Requires measure selection and goal setting • Stock price affected by factors outside of management control • Relatively higher levels of dilution for same value • 162(m) regulation may prevent deduction of excise tax
Stock appreciation rights	<ul style="list-style-type: none"> • Simple to understand • High upside • Strong alignment with shareholders • Non-dilutive 	<ul style="list-style-type: none"> • Tied purely to stock price • Stock price affected by factors outside of management control • Requires cash payouts • No share ownership
Indexed options	<ul style="list-style-type: none"> • Rewards relative performance • High upside • Strong alignment with shareholders 	<ul style="list-style-type: none"> • Requires index (e.g. S&P500, peer group) for comparison • Stock price affected by factors outside of management control • Relatively higher levels of dilution for same value

In the case of extreme stock price volatility, the grant value may require adjustments. As with STI, a performance shares/cash program (if used) should incorporate a fixed threshold, target and maximum (leverage) payout curve.

Stock Ownership Requirements: In order to promote ownership of the company's common stock by executive officers and thereby more closely align their interests with the interests of shareholders, companies should adopt stock ownership guidelines. Stock ownership requirements should be defined as a multiple of salary or annual grant value (usually 4x – 8x salary for CEOs, tapering down through executive levels) rather than as a fixed number of shares. Companies should not credit unexercised stock options, unvested shares or performance-contingent

awards toward the ownership requirements. Executives should achieve the applicable ownership guidelines within five years of first becoming subject to these guidelines. Further, executives should be precluded from hedging their company stock holdings in any way or pledging their stock holdings as collateral for margin loans.

Stock Holding Requirements: To further encourage stock ownership, companies should establish post-vesting holding requirements before the equity can be monetized. Recipients should be able to sell shares to meet tax obligations and should be required to hold a minimum of 50% of the equity incentive for an extended period beyond vesting. Companies that experience a significant degree of monetization of

equity awards should re-examine the premise by which equity grants are made in the first place.

Perquisites

Perquisites must have a reasonable and legitimate business purpose. Executives should be responsible for paying personal expenses including family personal travel, personal corporate jet usage, club memberships, car allowances (other than for miles driven as provided under IRS guidelines) and so forth. In most situations, the aggregate value of perquisites should be a nominal amount of an executive's total compensation, and have a clear business case.

Benefits

Benefits should be provided on the same terms as they are offered to other company employees. If the company provides executives with value in the form of post-retirement benefits (e.g., defined benefit pension, or SERPs), the company must consider this value when determining the overall executive compensation program. Further, any return provided relative to amounts under deferred compensation plans for executives should not exceed a market rate of return.

Post-employment Compensation

Post-employment compensation is an area of particular focus, and shareholders tend to be skeptical of the magnitude of potential payouts associated with both severance and change in control arrangements, as well as the potentially significant ramifications on overall alignment. Given these factors, post-employment compensation arrangements should be carefully evaluated in each instance, and should be clearly and thoroughly disclosed.

Severance (non-Change in Control): The stated purpose of severance is typically to protect the executive in the case of job loss under very specific circumstances (e.g., termination without cause, disability, retirement).

Severance programs should provide only moderate levels of compensation to executives, and should be carefully evaluated to avoid motivating and rewarding unintended and inappropriate risk taking. Severance programs should take into consideration the value of equity grants previously provided to executives, in order to avoid duplicative compensation programs.

The following are guidelines for executive severance (non-change in control) provisions:

- For the CEO position, the cash severance payout should be defined as a multiple of salary and bonus (usually target). Typical multiples for the CEO are 1x to 2x the sum of salary and bonus. The cash multiple for other executives should be lower.
- Typically, a continuation of health care benefits are provided for a period equal to the cash severance multiple (e.g., 1x payout and 1 year of benefits continuation value).

The following are guidelines for executive CIC provisions:

- Severance, accelerated vesting of equity, and any other CIC contingent benefits should be “double trigger” whereby an executive must be terminated without cause or for good reason within a specified time period (two years should be the maximum window) following a CIC. “Good reason” should be defined to require termination of employment.
- Excise taxes should not be grossed up. Rather CIC benefits should be limited to the Internal Revenue Code Section 280G safe harbor, unless the executive would receive a greater amount after paying the tax.
- Cash severance benefits should not exceed 3x base and target bonus for the CEO. Other senior executives should generally have lower multiples. Benefit continuation should be limited to periods mandated by

services, security and the like should be eliminated.

Governance

Both the Board and the Compensation Committee are responsible for developing and reviewing annually the compensation program based on the principles described above. The Board and Compensation Committee are responsible for setting the pay of the CEO and reviewing the appropriateness of contracts over time. The CEO may provide recommendations on pay levels for other senior executives, but the Board and/or Compensation Committee must maintain full control and a complete understanding of the entire executive compensation program. Shareholders have a significant economic interest in ensuring that executive compensation plans are effective and efficient, this is evidenced by increasing involvement in this area in recent years. For this reason, Boards should carefully consider shareholder feedback on compensation programs. In cases where compensation plans are receiving negative feedback from shareholders based on the outcome of “say-on-pay” votes, boards need to work with shareholders to address concerns in an expedited and transparent manner. Shareholders should have the right to cast a vote on a binding proposal to approve all LTI plans.

Boards should retain independent third-party experts to advise on matters of compensation policy, review compensation plan proposals and support the Compensation Committee as it discharges its review and approval responsibilities. This advisor should perform no other work for the company. In particular, the advisor should not be involved in any aspect of the design and implementation work pertaining to compensation programs it is reviewing and on which it is advising the Compensation Committee. Management and/or the Compensation Committee may retain whatever additional resources are necessary (including a “non-independent” advisor) to perform the design, implementa-

Shareholders have a significant economic interest in ensuring that executive compensation plans are effective and efficient, this is evidenced by increasing involvement in this area in recent years. For this reason, Boards should carefully consider shareholder feedback on compensation programs.

- Perquisites should not be provided beyond termination of employment.
- Tax gross-ups should be not provided.

Change in Control: The stated purpose of an enhanced severance arrangement for termination in the context of a change in control (“CIC”) is to improve executive impartiality for evaluating and potentially executing transactions that may be in the interest of shareholders, but could jeopardize the security of the executives’ position. The rationale for severance programs should take into consideration the value of equity grants previously provided to executives, in order to avoid duplicative compensation programs.

COBRA. Reasonable outplacement assistance is appropriate.

Clawback Provisions: The Compensation Committee should develop and implement clawback provisions that, at a minimum, extend beyond the CEO and CFO to cover at least all senior executives. These provisions will allow for the recapture of incentive awards, including gains, which were improperly awarded because of executive misconduct or fraudulently prepared financial statements. The clawback provision should also directly apply to any restatement of financial statements.

Post-employment Perquisites and Benefits: Retirement perquisites such as apartments, use of corporate aircraft, financial planning



tion, and other responsibilities pertaining to compensation programs.

Communication/Disclosure

To ensure the full effectiveness of the program, the overall philosophy and design of the compensation programs must be disclosed to shareholders and should also be clearly communicated to the executives. The “how” and “why” of specific compensation decisions should be fully explained as this degree of clarity is necessary to ensure shareholder support over the long-term. Using easily understandable language, the company should disclose its compensation philosophy, specific performance metrics and weighting factors used to make compensation decisions. The Compensation Committee, and finance, legal and human resources departments should work together to prepare the Compensation Discussion

and Analysis (CD&A). The disclosure should:

- Provide the rationale for defining comparative market data (e.g. peer group, surveys);
- Describe the amount of compensation for key executives and how the compensation plan is synchronized with the performance goals and objectives of the company (including disclosing performance targets);
- Provide the rationale for defining performance measures (including weighting) and detail clearly and concisely the weightings and metrics used to calculate amounts earned under both STI and LTI plans; and
- Provide a clear rationale behind any change in control and severance provisions.

Conclusion

The preceding compensation philosophy and design guidelines have been developed based on best practices and emerging trends. Executive compensation programs should align the interests of executives with those of shareholders and create a system of incentives where management focuses on creating sustainable long-term shareholder value. Properly designed programs should provide a balanced set of incentives which will align pay and performance. Complete transparency is critical in allowing shareholders to better understand the executive incentive plans.

¹ Pure time-based equity tools, such as Restricted Stock Units (RSUs) are excluded because they are not performance-based equity vehicles.

DEALING WITH THE RISE OF ACTIVISM AND ITS CONSEQUENCES

David Karp, *Wachtell, Lipton, Rosen & Katz LLP*



Activist investment strategies have been in clear ascendance over the past several years. Assets under management by activist hedge funds have grown from approximately \$36 billion in 2009 to well over \$100 billion as of early 2015. Multi-billion dollar companies increasingly discover that activists have invested over a billion dollars in their companies, even if that correlates with a percentage ownership in the low single digits. As a result, public companies, without regard to industry, size or success, have been the subject of both public and private pressures from shareholders seeking specific governance, financial and strategic business changes. In 2000 there were 27 activist proxy campaigns, rising to almost 250 in 2014. While the issues raised by this phenomenon are many, the most basic questions that must be answered in regard to it are: (1) what has caused it, (2) is it a good thing, and (3) what kind of response, if any, does it demand?

Ironically, the trend toward shareholder activism may in large measure be a consequence of passive investment strategies. Index-tracking mutual funds and exchange-traded products

continue to grow market share at the expense of actively managed funds. The success of these cheaper, lower-margin, index products has put significant pressure on actively managed funds to “deliver alpha” to justify their higher fee structure and thereby retain and attract assets to manage. This has resulted in more traditional investment managers experimenting themselves with activism, as well as partnering with dedicated activist hedge funds in sponsoring activist attacks.

Traditionally, stock-picking was the means by which active managers delivered alpha. If a portfolio manager picked a stock that performed poorly they would often follow “the Wall Street Rule” and close out the position. But activist strategies pursued by some hedge fund managers can “bail out” an active manager sitting on a poorly performing position. It has been reported that many actively managed mutual fund portfolio managers are in close contact with activist hedge funds. While reputational and expense concerns may limit the portfolio manager of an actively managed fund from directly pursuing activist strategies, that active portfolio manager

can indicate to an activist hedge fund manager that he or she would be supportive of the hedge fund launching a campaign for change at a particular company. In large measure, the influence of an activist derives from its ability to mobilize the power of the institutional investors who hold a majority of the shares of the target.

If that explains the reason for the ascendance of activism as its own asset class, the success of activist strategies in forcing corporate change has been facilitated by the steady erosion of public company takeover defenses over the past several decades and the rise of shareholder-centric governance. Today Institutional Shareholder Services is functionally the largest voting shareholder in U.S. public companies despite holding no economic interest in these companies. ISS frequently supports activists in their campaigns and has historically supported governance policies that make boards of directors vulnerable to shareholder pressure. This mostly unregulated power in the hands of ISS is problematic for a number of reasons that are outside the scope of this paper, but there can be no doubt about the substantial influence ISS has on corporate behavior and the increasing responsiveness of corporations to the short-term agendas of some shareholders.

The impact of these developments is also reflected in the growth of what has become known as “wolf packs.” Wolf packs are loose networks of activist shareholders who act alongside one another, but not in such close coordination that they would be viewed as a “group” for purposes of SEC disclosure rules. By avoiding formal “group” status, these wolves can join together to bring down big prey, subtly (or not so subtly) signaling

their portfolio positions to one another. Together, they can quietly accumulate significant blocks of a company's stock much more cheaply than if earlier disclosure were required, and can do so without the targeted company learning of the accumulation in time to effectively mitigate the impact through defensive action. Equally significant is that these tactics permit accumulation of commanding blocks of stock from unsuspecting shareholders who may sell at uninformed market prices.

The reach of shareholder activism now extends well beyond the companies they target. Most companies have heard, and follow, the advice that they can reduce their risk of being attacked by activists if they view themselves through the activist lens and pursue changes designed to preempt the typical activist agenda. This includes aggressive balance sheet management through stock buybacks and large dividends and restructuring involving spinoffs and outright sales of companies to strategic and private-equity buyers alike. In many cases these actions result in significant underinvestment in long-term capital-intensive projects. Many value-creating investments have time-horizons that last longer than the average holding periods of hedge funds. Activists and their supporters often argue that expected returns on long-term investments are capitalized into today's stock prices, so time horizons should not be relevant. If that argument is correct and the market was so perfectly efficient, one would have to wonder why the activist investors themselves exist.

While not every activist is wrong in approach or substance, and not every board and management team infallible, it cannot be a good thing for boards and management teams as a class to become mere ministers of corporate assets on behalf of activist short-term oriented shareholders. Professional corporate management, privy to proprietary corporate knowledge and long-developed expertise regarding the corporate assets they manage would seem to have many built-in advantages over outside investors regarding corporate

strategy. It is also far from clear that activists are more appropriately incentivized than boards and management teams to drive sustainable, long-term oriented strategies.

Activist hedge funds point to their own performance to argue that they create value. First, it is important to note that activist hedge funds as a group, while beating the universe of hedge funds in recent years, have regularly trailed the performance of passive investment strategies. Second, positive returns earned by activist hedge fund investors does not necessarily imply that they create value. Among the other explanations for their returns is that activist strategies may expropriate value from existing or future investors

flexible in responding to changing tactics. Companies must regularly adjust strategies and defenses to meet changing market conditions, business dynamics and legal developments.

A key aspect of this preparation is engagement by corporate boards and management with shareholders. This engagement must be designed to cultivate relationships with long-term oriented investors who may be willing to pass up opportunities to obtain short-term increases in a stock price with the goal of pursuing more patient long-term growth. Companies may need to broadly review their shareholder engagement and broader communications programs, ensuring

Index-tracking mutual funds and exchange-traded products continue to grow market share at the expense of actively managed funds. The success of these cheaper, lower-margin, index products has put significant pressure on actively managed funds to “deliver alpha” to justify their higher fee structure and thereby retain and attract assets to manage.

or other corporate stakeholders, including employees and debt-holders. This can happen in either a zero-sum environment, in which no value is created, or even worse, a value-destructive one.

As to what to do, it is clear that companies and boards of directors cannot ignore the short-term focus of many of their shareholders. Preparing for an activist attack remains an essential task for any board and management team that hopes to deal with short-term oriented agendas. To forestall an attack, a company must continuously review its business portfolio, strategy and its governance and executive compensation issues sensibly in light of its particular needs and circumstances. In addition to a program of advance engagement with investors as discussed below, it is essential to have – and leverage – a sophisticated team of internal and external resources to ensure the company is able to mount a defense quickly and to be

that the company is explaining to its investors the key value drivers for the company, how long-term investments are selected, horizons for delivering returns on them and the metrics that the company uses to assess success over time. Unfortunately it may be the case that the capital markets are developing toward a situation in which the only real long-term shareholders left are passive investors who have the least financial incentive to spend money engaging back. Firms like Blackrock and Vanguard, willing to spend money on corporate engagement may become the exception rather than the rule. To the extent that is the case, policy response may be the only meaningful hope for restoring long-term investment horizons to the U.S. economy.

ASSESSING ACTIVIST HEDGE FUND INTERVENTIONS

Stephen M. Bainbridge, *UCLA School of Law*



“No company is too big to become the target of an activist, and even companies with sterling corporate governance practices and positive share price performance, including outperformance of peers, may be targeted.”
– Martin Lipton (2013)

In the early 1990s, various governance activists and academics began arguing that corporate governance activism by institutional investors was becoming a critical mechanism for aligning management and shareholder interests. Institutional investors, they argued, typically own larger blocks than individuals, and have an incentive to develop specialized expertise in making and monitoring investments. As a result, institutions could be expected to more actively monitor firm performance and make changes in the

boards composition when performance lagged. Until recently, however, there was relatively little evidence that institutional investor activism mattered. A comprehensive 1998

ability or desire to decide company-specific policy questions. They rarely conducted proxy solicitations or put forward shareholder proposals. They did not seek to elect repre-

Accordingly, it is not surprising that although “some studies have found positive short-term market reactions to announcements of certain kinds of activism, there is little evidence of improvement in the long-term operating or stock-market performance of the targeted companies.”

literature review found relatively little evidence that shareholder activism mattered.¹ Even the most active institutional investors spent only trifling amounts on corporate governance activism. Institutions devoted little effort to monitoring management; to the contrary, they typically disclaimed the

representatives to boards of directors. They rarely coordinated their activities. Most importantly, empirical studies of U.S. institutional investor activism found “no strong evidence of a correlation between firm performance and percentage of shares owned by institutions.”²

Today, setting aside the special case of hedge funds and private equity firms (discussed below), institutional investor activism remains rare. It is principally the province of union, state and local public employee pension funds and mostly takes the form of securities

market reactions to announcements of certain kinds of activism, there is little evidence of improvement in the long-term operating or stock-market performance of the targeted companies.”⁶ Hedge funds, however, appear to be a different story.

potentially differ from those of other institutions, as does the extent of their activism.

As potential activists, hedge funds have several advantages. First, hedge funds are not subject to the sort of conflicts of interest that discourage activism by mutual funds and other financial institutions with relationships with corporate management. Second, hedge funds are not subject to the regulatory limitations applicable to mutual funds on the size of the stake they hold in portfolio companies. Hedge funds thus can take larger positions in portfolio companies than traditional mutual and pension funds, allowing them to capture a larger share of any gains. Third, because hedge fund compensation structures award them a percentage of any gains earned by the fund, hedge fund managers have a higher incentive than those of mutual or pension funds to pursue activities that raise the value of their stake even if other investors are able to free ride on their efforts. Finally, the free rider problem is further mitigated when multiple hedge funds band together in so-called *wolf packs* to target a specific company, sharing the costs and gains of activism.

Activist pension funds are typically reactive, intervening where they perceive (or claim to perceive) that a portfolio company is underperforming. In contrast, hedge fund activism often is proactive, first identifying a firm whose performance could be improved and then investing in that firm.

fraud litigation rather than corporate governance activities. (Choi & Fisch 2008) With a few notable exceptions, most funds do not engage in such core governance activities as nominating directors or making shareholder proposals.³

Activism by union, state and local public employee pension funds, moreover, is suspect because it may be motivated by interests not shared with investors at large. As Delaware Chancellor Leo Strine observes, “institutions more inclined to be activist investors are associated with state governments and labor unions, and often appear to be driven by concerns other than a desire to increase the economic performance of the companies in which they invest.”⁴ With respect to union and public pension fund sponsorship of Rule 14a-8 proposals, for example, Roberta Romano observes that “potential benefits which would be disproportionately of interest to proposal sponsors are progress on labor rights desired by union fund managers and enhanced political reputations for public pension fund managers, as well as advancements in personal employment. ...Because such career concerns – enhancement of political reputations or subsequent employment opportunities – do not provide a commensurate benefit to private fund managers, we do not find them engaging in investor activism.”⁵

Accordingly, it is not surprising that although “some studies have found positive short-term

A 2007 study by Robin Greenwood found that hedge fund activism was becoming an important part of the corporate governance landscape. Greenwood observed that “between 1994 and 2006, the number of public firms targeted for poor performance by hedge funds grew more than 10-fold.”⁷ Strikingly, as hedge fund interventions grew, they also began to draw support from otherwise passive institutional investors. Hedge fund managers, “such as Carl Icahn and Bill Ackman, who agitate for change at companies they believe to be sub-par, are increasingly

[D]o we really think a hedge fund manager is systematically going to make better decisions on issues such as the size of widgets a company should make than are the company’s incumbent managers and directors?

getting a hearing with institutions ranging from the most staid mutual fund to the state-run pension fund.”⁸

Shareholder activism by hedge funds differs in a number of respects from that of other institutional investors. Activist pension funds are typically reactive, intervening where they perceive (or claim to perceive) that a portfolio company is underperforming. In contrast, hedge fund activism often is proactive, first identifying a firm whose performance could be improved and then investing in that firm. As a result, both the forms and goals of hedge fund activism

A number of commentators have therefore claimed that hedge fund activism has had a growing positive impact on corporate governance. Greenwood argues, for example, that “hedge funds may be up to the task of monitoring management – a number of recent academic papers have found that hedge funds generate returns of over 5 percent on announcement of their involvement, suggesting that investors believe these funds will increase the value of the firms they target.”⁹

A particularly influential study by Lucian Bebchuk, Alon Brav, and Wei Jiang of 2000

activist hedge fund interventions between 1994 and 2007 found “no evidence that interventions are followed by declines in operating performance in the long term; to the contrary, activist interventions are followed by improved operating performance during the five-year period following

their short-term focus, are unlikely “to devote time and energy to a task delivering long-term value. After all, there are no guarantees that the effort will pay off, or that other shareholders would recognize the increase in value by paying a higher price per share.”¹²

It was not a hedge fund manager who invented the iPhone, after all, but it was a hedge fund manager who ran TWA into the ground.

these interventions.”¹⁰ (Bebchuk et al. 2013) A contemporaneous literature review by Bebchuk concludes that shareholder interventions on the aggregate are “beneficial for companies and their shareholders both in the short term and the long term.”¹¹ These arguments are flawed, however, because they fail to differentiate between the various forms activist interventions take. I propose a five-category schema for hedge fund activism:

- 1 Addressing general target undervaluation to maximize shareholder value.
- 2 Promoting corporate governance changes (e.g., rescinding takeover defenses, ousting one or more top managers), board composition and executive compensation.
- 3 Changing the target corporation’s capital structure (e.g., demanding an equity issuance, restructuring of debt or a recapitalization).
- 4 Addressing change of control transactions, such as:
 - a. encouraging the target to sell itself;
 - b. opposing a sale of the target (e.g., where price is perceived as too low);
 - c. opposing an acquisition by the activist’s targeted corporation.
- 5 Encouraging changes in the target’s business strategy.

It is the final category that seems problematic. Greenwood argues that hedge fund managers generally are poorly suited to making operational business decisions and, with

Likewise Professor Lawrence Mitchell asks:

“Do we really want speculators telling corporate boards how to manage their businesses? Those who say ‘yes’ want to increase short-term management pressure and thus share prices, regardless of the corporate mutilation this induces. They do not seem to care that their profits come at the expense of future generations’ economic well-being. But if our goal is to give expert managers the time necessary to create long-term, sustainable and innovative businesses, the answer is a clear ‘no.’”¹³

Their arguments are supported by empirical studies finding that it is difficult to establish a causal relationship between improved firm performance, if any, and business strategy changes effected at companies targeted by shareholder activists.¹⁴

In sum, even if we grant Bebchuk’s claim that hedge funds have incentives to pursue what he calls “PP Action”—e.g., corporate courses of action that will have positive effects on both short- and long-term value – do we really think a hedge fund manager is systematically going to make better decisions on issues such as the size of widgets a company should make than are the company’s incumbent managers and directors? Of course, a hedge fund is more likely to intervene at a higher level of generality, such as by calling for the company to enter into or leave certain lines of business, demanding specific expense cuts, opposing specific asset acquisitions, and the like, but

the argument still has traction. Because the hedge fund manager inevitably has less information than the incumbents and likely less relevant expertise (being a financier rather than an operational executive), his decisions on those sorts of issues are likely to be less sound than those of the incumbents. It was not a hedge fund manager who invented the iPhone, after all, but it was a hedge fund manager who ran TWA into the ground. Operationalizing this insight by developing workable regulations will prove difficult, of course. At a minimum, however, the analysis herein suggests that courts and regulators should be receptive to target company arguments that poison pills and other defenses are necessary to protect the company from ill-conceived activist business plans.

¹ Bernard S. Black, Shareholder Activism and Corporate Governance in the United States, 1 The New Palgrave Dictionary of Economics and the Law 459 (1998).

² Id.

³ Stephen J. Choi & Jill E. Fisch, On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance, 61 Vand. L. Rev. 315 (2008).

⁴ Leo E. Strine, Jr., Response to “Increasing Shareholder Power”: Toward a True Corporate Republic: A Traditionalist Response to Bebchuk’s Solution for Improving Corporate America, 119 Harv. L. Rev. 1759, 1765 (2006).

⁵ Roberta Romano, Less Is More: Making Shareholder Activism A Valued Mechanism Of Corporate Governance, 18 Yale J. Reg. 174, 231-32 (2001).

⁶ Stuart Gillian & Laura Starks, The Evolution of Shareholder Activism in the United States, 19 J. App. Corp. Fin. 55, 69 (2007).

⁷ Robin Greenwood, The Hedge Fund as Activist, HBR Working Knowledge (2007), <http://hbswk.hbs.edu/item/5743.html>.

⁸ Jessica Toonkel & Spyoung Kim, Activist Investors Find Allies in Mutual, Pension Funds, Reuters—DealTalk (2013), <http://www.reuters.com/article/2013/04/09/funds-activist-idUSL2N0CIQQG20130409>.

⁹ Greenwood, *supra* note 7.

¹⁰ Lucian A. Bebchuk et al., The Long-Term Effects of Hedge Fund Activism (2013), http://www.columbia.edu/~wj2006/HF_LTEffects.pdf.

¹¹ Lucian A. Bebchuk, The Myth the Insulating Boards Serves Long-Term Value, 113 Colum. Law Rev. (forthcoming).

¹² Greenwood, *supra* note 7.

¹³ Lawrence Mitchell, Protect Industry From Predatory Speculators, Fin. Times, July 8, 2009.

¹⁴ Gillian & Starks, *supra* note 6.

Do Activist Campaigns Help or Hurt Companies? An Introduction

James R. Gregory, *Tenet Partners*

Last year, David Bogoslaw of *Corporate Secretary* — a leading publication for professionals who work in corporate governance, risk, compliance and ethics — produced a study of the effect of shareholder activism on corporate brands. CoreBrand, which recently merged with another company and was renamed Tenet Partners, among other things, studies, analyzes and consults on corporate brands. We partnered with *Corporate Secretary* and provided it with significant data on corporate brands including changes in the value of corporate brands over time. The study, reproduced after this introduction, received attention from the financial press and is part of the public debate on the financial and social value of shareholder activism.¹

A corporate brand is a direct examination and evaluation of the health and vitality of a company. It is derived from quantitative research of knowledgeable business leaders. These leaders have demonstrated a remarkable ability to understand the strengths and weaknesses of a company and its management. Our firm recognized the importance of this audience decades ago when it conducted research for GE and the Association of National Advertisers (ANA) to identify the impact of communications on a company's performance. This ongoing study called the CoreBrand Index[®] has been fielded without interruption, with 10,000 interviews per year, since 1990—making it a remarkably consistent examination of the image nearly 1,000 companies industries included in the study.

The CoreBrand Index has generated insights into value creation of companies. We know for example that, on average, 5-7% of market cap is attributable to the corporate brand — what we call “Brand Equity.” We know that

every industry achieves a range of Brand Equity. We also know that every company within every industry achieves different levels of Brand Equity depending on the health of their corporate brands. So, you have a full spectrum from high performers to low performers specific and unique to each industry. Studying these industries and the companies comprising each of them provides an instant analysis of the company's health and the value creation ability of the corporate

A corporate brand is a direct examination and evaluation of the health and vitality of a company.

brand. Every industry is different, the electric utility industry for example only attributes on average about 2% of its market cap to the corporate brand, while the consumer facing beverage industry averages 9%. We know these averages change according to economic conditions such as interest rates, the price of crude oil and other factors.

We also know that communications directly impact the Familiarity and Favorability scores of a company, which in turn affect the value of its brand. All forms of communications by and about a company, whether intended or not, will impact the Favorability score that is included in the company's Brand Value. Planned communications include: advertising, public relations, investor relations, etc. Unplanned communications include the kind of unwanted publicity that comes with a crisis — the BP Gulf oil spill is an example.

When we studied the companies which had been through a shareholder activist campaign,

we were skeptical whether our data would reveal any relevant findings. Many activist campaigns after all are not fought in the public arena. Therefore, we did not expect to find inflection points in the Brand Value of a company correlated with shareholder activist activity. An inflection point in Brand Value is a key indicator of a sea change in a company. We were surprised to find that nearly all of the companies that qualified for our study had clear and unambiguous inflection points and most of those points indicated the beginning of a long-term negative trend in the companies' Brand Values.

Even when the trend was positive, it was generally short lived before turning downward. There are exceptions of course such as Family Dollar which is discussed in the accompanying article. The data can be examined to find similar targets of opportunity — the weak fish in an industry — and to build and leverage long-term value.

So many activist campaigns start out by claiming a desire to create long-term value for a company's shareholders. There are many ways value can be created without damaging the viability of a company's survival. Activists, long-term investors and corporate managers should consider this potentially long-term consequence on a company as a result of activist activity.

¹ See e.g., <http://www.nasdaq.com/article/new-data-under-scores-impact-of-investor-activism-on-brands-cm405458>;

SHAREHOLDER ACTIVISM'S IMPACT ON BRAND VALUE

David Bogoslaw, *Editor, Corporate Secretary*

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First study of activism and brand value finds predominantly negative impact on brand value extending long beyond original activist campaign

There has been a lot of research in recent years showing that a specific form of shareholder activism known as hedge fund activism has had an adverse impact on shareholder value, as measured by stock price performance and market cap, in the wake of an activist campaign. Harvard Law School professor, Lucian Bebchuk and his associates have questioned the 'scientific' validity of this research from varied sources, but he and his supporters are a small minority.

What hasn't been studied until now, however, is the impact of shareholder activism on corporate brand value. To produce this research analysis, Corporate Secretary partnered with CoreBrand, a natural choice given the latter's impressive database of nearly 1,000 companies from 54 key industries and more than 20 years' expertise in studying the elements of brand value and advising clients on how to strengthen their corporate brand and capitalize on their brand value.

Each year, CoreBrand surveys 10,000 business decision makers from the top 20 percent of US businesses with annual sales above \$50 million to arrive at scores for familiarity and favorability, which reflect company size/recognition and quality, respectively. Familiarity represents a weighted percentage of survey respondents who recognize the brand being evaluated. Only respondents who are familiar with a brand – knowing more than just the company name – are asked to rate the three dimensions of favorability on

a four-point scale: overall reputation, perception of management and investment potential.

Familiarity and Favorability scores are then combined into a single BrandPower score and the scores are used to calculate the brand equity value (BEV) – comprising BrandPower, Familiarity and Favorability – of each company, both as an absolute dollar value and as a percentage of the company's market cap.

Event-driven Impacts

With data extending back to the early 1990s, CoreBrand is able to measure changes in a company's BEV from a specific event such as a major earnings restatement or a CEO's removal. This lets CoreBrand determine the magnitude of the impact the event has had on BEV, both as an absolute dollar amount and as a percentage of market cap. 'Brand is an intangible asset, but it does have value and can be measured [even though] it's not on the balance sheet,' says CoreBrand CEO James Gregory.

Once CoreBrand has calculated a base level of BrandPower based on a company's revenue size and quality (as reflected in shareholder value), this expected level of BEV becomes zero for the sake of measuring changes that may result from a particular event, such as an activist announcement. This explains why some companies show dips in BEV percentage and dollar value to negative numbers. Because the corporate brand contributes millions or even billions of dollars to a company's stock price and market valuation, any changes in it can have a significant impact on stock performance.

Using a list of activist campaigns (provided by FactSet SharkWatch) conducted against S&P 500 companies related to value creation, board seat and CEO/officer removal announced since January 1, 2006, CoreBrand analyzed 66 companies, all but eight of which show a clear inflection point in their Familiarity and/or Favorability scores in the year of the activist campaign.

'We're trying to identify inflection points that start a trend going in one direction or another,' Gregory explains. 'It's not necessarily that activism is driving it – it may not even have caused the direction – but it's an identifiable point in time that brings attention to an issue, and that attention can continue' beyond the activist campaign.

Eight of the 66 companies analyzed proved inconclusive, with insufficient current data to see a trend, leaving a base of 58 companies in the study. Thirty-six (62 percent) of those reflect a major inflection point of their corporate brand in the year of the activist campaign; 15 (26 percent) show a small impact on the corporate brand; and six (10 percent) indicate no impact from the activist campaign.

Based on the results, CoreBrand finds that shareholder activism is likely to have a significant impact on a corporate brand. Of the 36 companies with a large inflection point:

- 19 show significant long-term declines in favorability, indicating perceived quality of the company
- Seven show modest improvement in favorability

- Two show improvement in familiarity, while favorability remains flat
- Eight have mixed results showing short-term gains followed by declines in the corporate brand.

The second conclusion reached by the research is that the impact of investor activism on the corporate brand appears to be long term. Third, the impact can be significant and longer-lasting on the downward side, while the upside of investor activism tends to be modest or short-term in nature. Fourth, even when there is modest upside impact, the long-term trend is often negative.

Long-term Decline in Favorability

CoreBrand provided three case studies to exemplify various insights about the impact investor activism has on brand equity value. Two of the companies – Electronic Arts and Marsh & McLennan – are from the group showing long-term declines in favorability, while the third company, Family Dollar Stores, is from the group where there was modest improvement in favorability.

For Electronic Arts (see below), BEV as a percentage of market cap declined from 3.2 percent to 0.9 percent and the value of the brand plunged from \$207 million to \$70 million

million between 2011 and 2013. These changes mirror declines in Favorability and Familiarity, as well as revenue, even as the company's market cap grew from \$6.6 billion to \$7.1 billion over the same time period.

Declines in perception of management and overall reputation in 2006 overrode an essentially flat investment potential between 2006 and 2010 to initiate the overall decline in Favorability. Erosion in Electronic Arts' brand from 2011 to 2013 identifies a failure of management to see an opportunity to increase enterprise value by adjusting through brand, CoreBrand concludes.

The name Electronic Arts has very low familiarity for a company whose major brands, EA Sports and EA Games, are so widely known. The company could have created billions of dollars of shareholder value by simply changing its name to EA in as early as 2006, according to CoreBrand. It's the corporate brand that matters when companies confront a proxy battle, Gregory emphasizes.

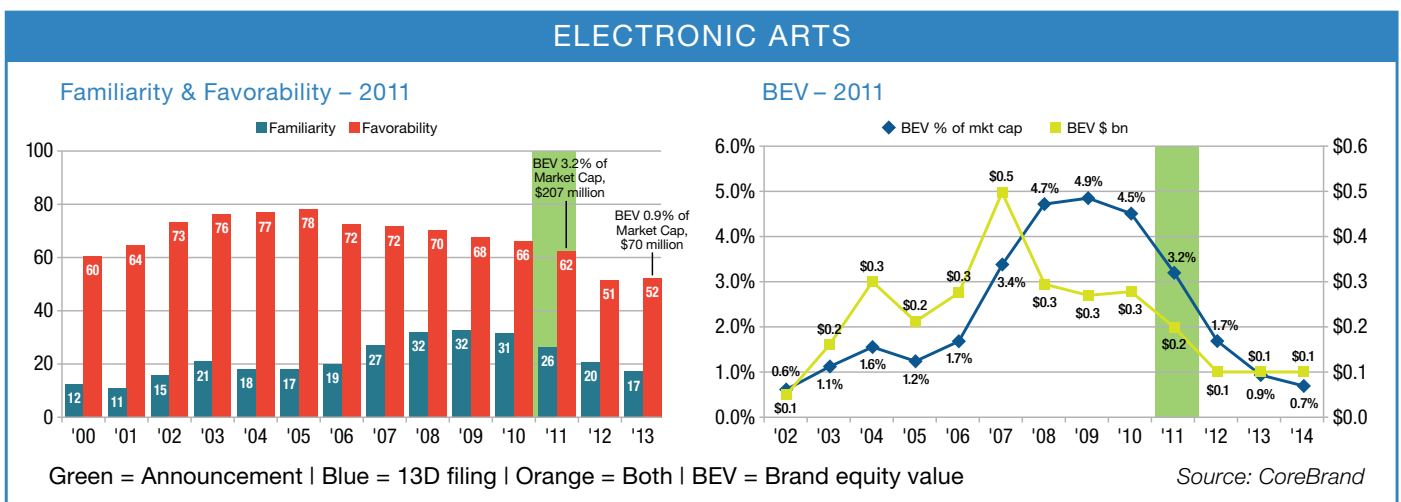
Unfortunately, the details of the proxy battle announced in May 2011 by Relational Investors in pursuit of a board seat don't seem relevant to the drop in Electronic Arts' brand value, which had already begun in 2009. It could be that Relational, having witnessed a \$641 million loss in the fourth

quarter of 2008, layoffs of 17 percent of the workforce in late 2009 and other signs of trouble, saw weakness in management that it believed it could exploit to win a board seat, though why it waited two years is unclear.

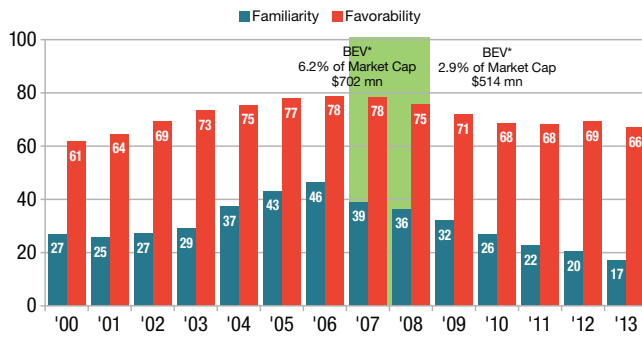
The proxy fight, however, was reportedly undisclosed until a settlement had been reached with Electronic Arts' board, giving Relational the option to place one director on the board. It's unlikely the activist campaign by itself caused the brand value's continued decline from 2011 to 2013, so there were probably other factors.

Elsewhere, Marsh & McLennan's revenue declined slightly between 2007 and 2010, while market cap increased from \$11.3 billion to \$14.9 billion (see page 24). Both familiarity and favorability dropped and, as a result, the BEV percentage of market cap fell from 6.2 percent to 2.9 percent.

Along with the decline in BEV percentage, in dollar terms, brand value fell from \$702 million to \$514 million between 2007 and 2010, despite a 31.9 percent rise in market cap. Had Familiarity and Favorability not declined and had the company maintained its BEV at 6.2 percent of market cap, the value of the brand should have climbed to \$924 million in 2010. Marsh is a case of creating shareholder value at the expense of brand health.

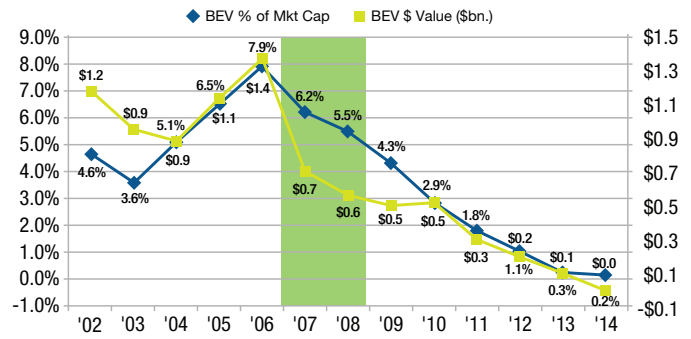


Familiarity & Favorability – 2007



Green = Announcement | Blue = 13D filing | Orange = Both | BEV = Brand equity value

BEV – 2007 – 2008



Source: CoreBrand

Improvement in Favorability

The third case study, Family Dollar Stores, demonstrates one of the few examples where brand value improved as a result of an inflection point in the year of an activist campaign. In March 2011 Trian Fund Management made an unsolicited takeover offer for Family Dollar. The company rejected the offer of \$55-\$60 per share and quickly adopted a poison pill to protect itself from hostile bids. It later granted Trian one board seat in exchange for a cessation of its takeover efforts.

Family Dollar's Favorability score had begun to trend up from being flat at 46 in 2007 and 2008 to 48 in 2009 (see below), at least a year and a half before Trian made its move.

But the uptrend became more pronounced in 2011 after the hostile takeover bid and poison pill, with favorability rising from 50 to 55 and continuing its ascent to 63 by 2013. Similarly, Familiarity – which had been inching up one point per year between 2008 and 2010 – rose three points to 77 in 2011 and extended its gradual increase through 2013.

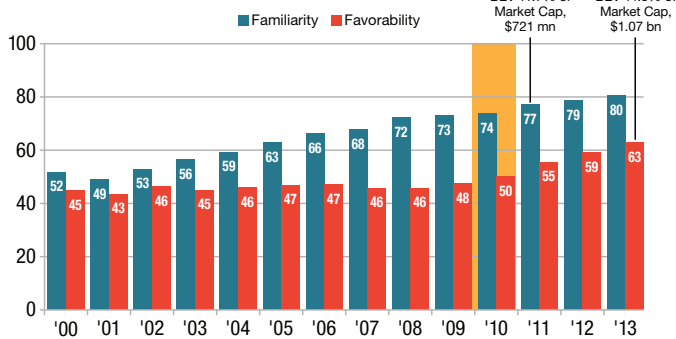
Looking at a breakdown of the three dimensions of Favorability, CoreBrand notes that investment potential had been gradually rising from 2003 while overall corporate reputation, and perception of management in particular, flagged. It's possible that Trian's 2011 announcement may have spurred subsequent growth, although the chart indicates that the other two attributes were already in an extended uptrend by 2010.

Mirroring the Favorability trend, Family Dollar's BEV percentage, in a steady uptrend since 2003, had an inflection point in 2011, when the uptrend steepened and kept rising until 2013 before flattening out at 14.5 percent. BEV rose from \$721 million to \$1.07 billion in the same period. Family Dollar appears to be a case of well-managed shareholder activism, where lethargy in Favorability was 'activated' by what seems to have been a well - orchestrated effort to create value and ultimately sell the company, according to CoreBrand.

Rival discount retailer Dollar Tree offered to buy Family Dollar on July 28 this year for an enterprise value of almost \$9.2 billion, or \$74.50 per share, a 23 percent premium over the closing price on Friday, July 25.

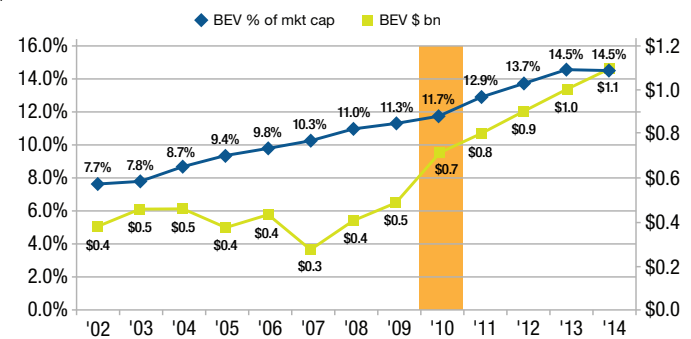
FAMILY DOLLAR STORES

Familiarity & Favorability – 2010



Green = Announcement | Blue = 13D filing | Orange = Both | BEV = Brand equity value

BEV – 2010



Source: CoreBrand

The Wall Street Journal reported that the offer came amid veteran activist investor Carl Icahn's push for a sale of Family Dollar and threats to replace the board after CEO Howard Levine overhauled the sales strategy earlier this year.

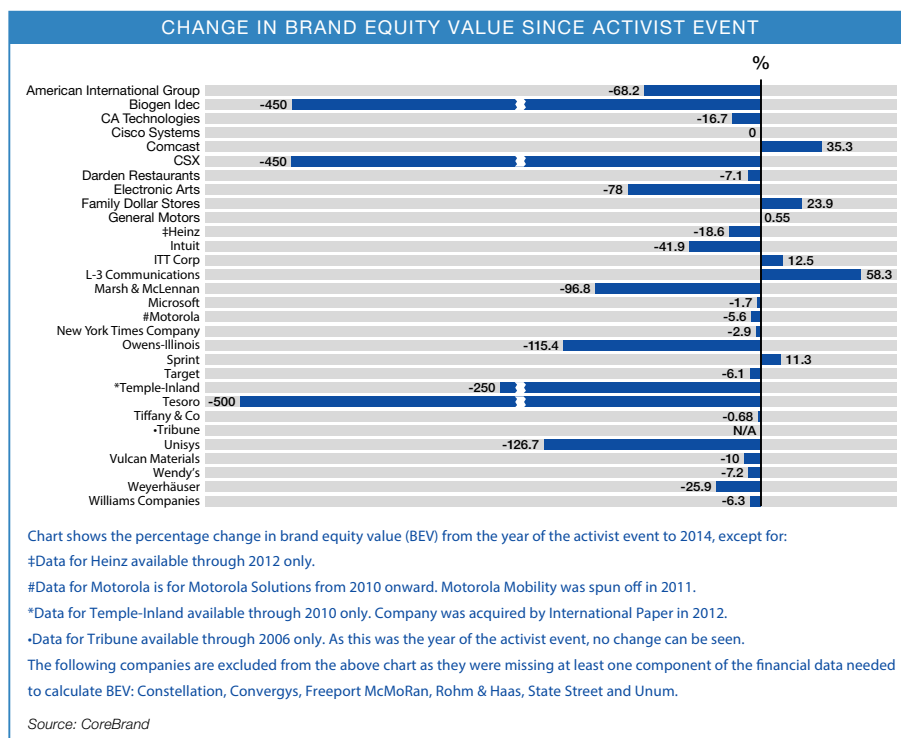
Other Effects

There are cases where BEV changes for a company don't clearly track its favorability trend. Marsh's Favorability stabilized at 68 points in 2010 after falling from a peak of 78 in 2007, the year KJ Harrison & Partners submitted a proposal for the 2008 annual meeting recommending that the company spin off the Kroll and Mercer units to enhance shareholder value. But BEV percentage continued to decline, from 2.9 in 2010 to 0.2 in 2014, which suggests an even longer-lasting adverse impact on brand equity value than the Favorability change indicates.

While Favorability had stabilized, the continuing decline in Marsh's Familiarity score from 26 in 2010 (compared with 39 in 2007) to 17 in 2013 seems to account for the continued drop in brand power, according to CoreBrand.

Weyerhaeuser's BEV percentage continued to drop from 2006 to 2014, even as favorability bottomed out in 2010 before rebounding by 2013 to above its 2006 level. In 2006, Franklin Mutual suggested the timber company modify its corporate structure to become more tax-efficient by converting to a real estate investment trust. Like Marsh, the subsequent decline in Weyerhaeuser's BEV percentage appears to have tracked along with Familiarity, with the increase in BEV percentage in 2011 corresponding to a rebound in Familiarity that same year.

A company's Familiarity score may fall after an activist event if, as a result of the event, there are enough changes in corporate structure or assets that business leaders



surveyed are no longer certain what transpired, says CoreBrand.

Fifteen activist campaigns for 12 companies led to proxy fights. CoreBrand calculated average changes in Familiarity, Favorability, BEV percentage and BEV dollar amounts for four groups of companies according to the outcome of the proxy contest – management win, dissident win, split and settlement/concession. Most of the averages indicate declines in all scores. The only average gain is in BEV percentage change for companies that settled with dissident shareholders.

Biogen Idec was one of the few companies that had declines in Familiarity and Favorability after the activist campaign announcement, which may indicate the company stopped communicating after the activist event. That's one option a company can choose, especially if it lacks confidence in its story – 'but it's a self-fulfilling prophecy,' warns Gregory. 'If you don't communicate, a negative will fill that vacuum,' ensuring a decline in brand equity value.

More companies are paying attention to their CSR positioning, but Gregory sees those efforts being wasted when companies don't take care to nurture their brand. Not only is that potentially costing them customers and market share, but it's also having an impact on employee morale and media coverage. When corporate brand value is being preserved, 'you're getting more positive stories from the media, and not having to spend as much on PR,' he concludes.

2015 REGULATORY UPDATE

Timothy A. Spangler, *Lowell Milken Institute for Business Law and Policy and Sidley Austin LLP*

Private fund managers continued to face evolving and expanding priorities from U.S. regulators over the past year. Although not on the scale of dramatic change caused by the recent reforms that were part of the Dodd-Frank Act, these regulatory concerns must nonetheless be addressed by private equity firms and hedge fund managers in order to ensure that they do not encounter regulatory troubles in the future. In addition,

has not validly been given. A particular focus is on expense allocation between the manager and its clients, and among a manager's clients (e.g., separate accounts, co-investment vehicles and funds). Historically, these issues have not been a priority to regulators, or even to many investors.

In addition to expense allocation, the SEC is also looking into a range of other practices

only be responsible for those fees and expenses that have been disclosed and agreed.

Cybersecurity

As the unfortunate events surrounding Sony Pictures and the film "The Interview" made clear, cybersecurity is a concern for all businesses in 2015, including private funds. The SEC staff has made cybersecurity preparedness a priority, and private fund managers must adopt and implement policies and procedures reasonably designed to protect confidential data and the firm's information technology system. Firms will need to ensure that such products and procedures are appropriate for their particular businesses. At a minimum this should include identifying and assessing the cybersecurity risks, ensuring that they can detect any unauthorized activity that occurs, and being able to adequately respond to an actual cyber attack. If a cyber attack and resulting disclosure or theft of confidential data were to occur, the SEC could determine that the absence of adequate policies and procedures constitutes a breach of the manager's fiduciary duty to its clients.

CFTC Issues CPO Registration Relief

On October 15, 2014, the CFTC staff issued a letter ("Letter 14-126") providing no-action relief to certain commodity pool operators (CPOs) from the requirement to register as a CPO with the CFTC. CPOs that have delegated investment management authority as a CPO of a commodity pool to another CPO registered with the CFTC may be exempt if they comply with the conditions set forth in Letter 14-126.

OCIE Director Andrew J. Bowden noted that "when we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of law or material weaknesses in control over 50% of the time."

global regulatory reforms mean that the opportunities for U.S.-based private fund managers to market their funds to international investors are evolving in China and presenting new challenges in the European Union.

Private Equity Fees and Expenses

In May 2014, OCIE Director Andrew J. Bowden noted that "when we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of law or material weaknesses in control over 50% of the time."¹ Since then the SEC has made clear that the manner in which fees and expenses are charged to fund investors will remain a key focus in the coming months.

The SEC is concerned that investor disclosure is often inadequate and, as a result, investor consent to expense allocation and fee practices

related to expenses that give them concern, including hidden fees, inflated fees, unclear language regarding how fees are calculated, the practice of charging certain types of fees to portfolio companies and the timing of fee payments. Underlying these practices is the appearance that their primary function is to shift expenses from the manager to the fund without the investors fully understanding or agreeing upon the expense-shifting. For example, the use of "operating partners" at the portfolio company level could be questioned when the individual partner appears to be a full member of the manager's team.

Private fund managers should review their private placement memoranda and other investor communications to ensure that there is adequate disclosure regarding the fees and expenses. It is important to ensure that the fund manager's expense allocation policies are up-to-date and followed. A fund, and therefore its investors, should

Letter 14-126 replaces the CFTC's May 2014 letter ("Letter 14-69") that created a "streamlined" process through which delegating CPOs could request registration no-action relief if they met certain specific criteria. As a result of Letter 14-69, the CFTC received numerous requests for relief and eventually questions were raised about the applicability of certain criteria for that relief. Letter 14-126 replaces the streamlined no-action request process provided under Letter 14-69 with self-executing relief based on substantially the same eligibility criteria set forth in Letter 14-69, but with certain clarifications.

Delegating CPOs who have received no-action relief through the streamlined approach can continue to rely on that relief, but the CFTC will not accept further requests submitted under the Letter 14-69 streamlined approach. Since the relief now granted in Letter 14-126 is self-executing, neither the delegating CPOs nor the designated CPOs needs to file any notice or claim, or make any form of certification, to take advantage of the exemption.

Enforcement Actions

Last year, the SEC brought a number of important enforcement actions that shine a light on their current priorities in the private fund space.²

- Pay-to-Play and Exempt Reporting Adviser Status. The SEC brought its first-ever en-

forcement action under the Advisers Act "pay-to-play" rule, charging a venture capital fund adviser with providing advisory services within two years after prohibited contributions to two political candidates. The SEC also charged the firm and an affiliated adviser with improperly acting as unregistered advisers. Each of the

advisers, which had significantly overlapping businesses, separately claimed status as an "exempt reporting adviser." However, the SEC found that the firms were operationally integrated. As a result, they should have been integrated as a single adviser for purposes of registration requirements. Therefore, they were not eligible to rely on the claimed registration exemptions.³

Measures for the Supervision and Administration of Private Investment Funds (Measures). The Measures provide much-awaited clarifications to a number of issues facing the private fund regime in China.

The Measures define "private investment funds" as investment funds that are established through private fund raising from

Each of the advisers, which had significantly overlapping businesses, separately claimed status as an "exempt reporting adviser." However, the SEC found that the firms were operationally integrated.

- Private Equity Fund Fees and Expenses. As discussed above, fees and expenses in the private equity space are a key concern of the SEC. Last year, the SEC brought its first action against a private equity fund manager, alleging fraud in the allocation of expenses to funds managed by the firm.⁴
- Missed or Late Filings. The SEC is now using quantitative analytics to identify high rates of filing deficiencies. This new initiative resulted in the SEC bringing charges against 34 individuals and companies for violating Securities Exchange Act of 1934 filing requirements (such as Section 13(d), Section 13(g) and Section 16). This is an example of the SEC's "broken windows" approach to enforcement. By seeking to uncover and address even the

investors in the People's Republic of China. The registration, fund raising and operation of private funds are now subject to the Measures. Funds that are established in corporate or partnership form for investments, whose assets are managed by fund managers or general partners, are covered by the Measures. Private funds may invest in stocks, bonds, futures, options, fund units or other investments defined in the investment agreement.

The regime established by the Measures focuses on five key topics: (i) registration and filing; (ii) qualified investors; (iii) fund raising; (iv) fund operation; and (v) special rules for venture capital funds.

AIFMD Implementation

The European Union's Alternative Investment Fund Managers Directive (AIFMD) was required to be implemented in EU member states by July 22, 2013. However, AIFMD contained a one-year transitional period within which EU alternative investment fund managers (AIFMs) could apply for authorization under the AIFMD. Several EU member states made this one-year transitional period available to non-EU AIFMs marketing their alternative investment funds (AIFs) in those member states. The transitional period expired on July 21, 2014.

The regime established by the Measures focuses on five key topics: (i) registration and filing; (ii) qualified investors; (iii) fund raising; (iv) fund operation; and (v) special rules for venture capital funds.

smallest infractions, the SEC staff hopes to be able to prevent or at least identify earlier larger potential problems.

China Issues Final Private Fund Rules

On August 21, 2014, the China Securities Regulatory Commission issued the Interim



A number of large non-EU AIFMs marketed their AIFs under the applicable national private placement regimes (NPPR) of the relevant EU Member States. However, other large AIFMs have abstained from EU marketing, either because their funds are closed to new investors, or the non-EU AIFM does not have a significant EU investor base, or simply because the non-EU AIFM is well-known enough to EU investors that reverse solicitations are sufficient. Many smaller AIFMs have decided to refrain from marketing actively in the EU altogether. Their reasons may include a lack of understanding of how NPPRs in each EU member state operate, the perceived complexity and cost of complying with the NPPRs, and the desire not to disclose staff remuneration.

The most popular member states for non-EU AIFMs to market their funds appear to have

been the United Kingdom, the Netherlands, Finland and Sweden. Each of these countries elected to adopt only the minimum AIFMD NPPR requirements without any so-called “gold-plating.” The minimum requirements address disclosure to investors, regular reporting to regulators, the preparation of an annual report and certain asset stripping and notification requirements. By contrast, members states such as Germany and Denmark have also imposed a “depository-lite” requirement. As a result, many non-EU AIFMs appear to be excluding these countries from their marketing. Other obstacles that are making other EU member states less attractive for non-EU AIFMs include (i) the relevant cooperation arrangements not being in place for the relevant non-EU countries; or (ii) the local NPPR effectively requiring that the non-EU AIFM be fully compliant

with AIFMD; or (iii) the relevant AIF would have to satisfy certain conditions which would be impractical for the non-EU AIFM.

¹ Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations, Speech: “Spreading Sunshine in Private Equity,” Private Equity International (PEI), Private Fund Compliance Forum 2014, May 6, 2014, available at <http://www.sec.gov/News/Speech/Detail/Speech/1370541735361>.

² See SEC Press Release 2014-230, “SEC’s FY 2014 Enforcement Actions Span Securities Industry and Include First-Ever Cases” (October 16, 2014), available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543184660>.

³ SEC Press Release 2014-120, “SEC Charges Private Equity Firm With Pay-to-Play Violations Involving Political Campaign Contributions in Pennsylvania” (June 20, 2014), available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542119853>.

⁴ SEC Press Release 2014-41, “SEC Announces Charges Against Arizona-Based Private Equity Fund Manager in Expense Misallocation Scheme” (February 25, 2014), available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540849548>.

CONTRIBUTORS

Stephen Bainbridge is the William D. Warren Distinguished Professor of Law at UCLA School of Law. Professor Bainbridge is a prolific scholar, whose work covers a variety of subjects, but with a strong emphasis on the law and economics of public corporations. He has written over 90 law review articles and his most recent books include: *Corporate Governance After the Financial Crisis* (2012); *Business Associations: Cases and Materials on Agency, Partnerships, and Corporations* (8th ed. 2012) (with Klein and Ramseyer); *Agency, Partnerships, and Limited Liability Entities: Cases and Materials on Unincorporated Business Associations* (3d ed. 2012) (with Klein and Ramseyer); *Mergers and Acquisitions* (3d ed. 2012); and *The New Corporate Governance in Theory and Practice* (2008). In 2008, 2011, and 2012, Professor Bainbridge was named by the National Association of Corporate Directors' *Directorship* magazine to its list of the 100 most influential people in the field of corporate governance. His blog, ProfessorBainbridge.com, has been repeatedly named by the *ABA Journal* as one of the Top 100 Law Blogs.

James R. Gregory is Chairman of Tenet Partners. Mr. Gregory is a leading expert on brand management and has developed new strategies for measuring the power of corporate brands and their impact on a corporation's potential financial performance. Mr. Gregory focuses on valuing and managing corporate brands like other business assets. Prior to Tenet Partners, Mr. Gregory was the CEO of Tenet's predecessor, CoreBrand, a global brand consulting firm and leader in corporate brand and brand identity for more than 25 years.

David C. Karp is a Partner at Wachtell, Lipton, Rosen & Katz, a leading law firm for the representation of corporations and their boards in shareholder activist situations. Mr. Karp's practice concentrates on mergers and acquisitions, corporate governance, shareholder activism defense and corporate and securities law matters. Mr. Karp was named Dealmaker of the Year by the *American Lawyer* in 2006 for his work advising the New York Stock Exchange in its acquisition of Archipelago Holdings and the NYSE's subsequent initial public offering. In 2008, the *International Financial Law Review* recognized the cross-border merger of the NYSE Group and Euronext, in which Mr. Karp advised the NYSE Group, as the M&A Deal of the Year. Mr. Karp earned a J.D. with honors from the University of Chicago Law School in 1993, where he was a member of *The University of Chicago Law Review* and an A.B. magna cum laude from Harvard in 1990. Following graduation from law school, he clerked for the Honorable J. Daniel Mahoney of the United States Court of Appeals for the Second Circuit.

Christopher Kiper is a Partner and Managing Director for Legion Partners Asset Management, which engages in shareholder activism. Prior to founding Legion Partners, Mr. Kiper was involved in shareholder activism including serving as Portfolio Manager of the Shamrock Activist Value Fund. While at Shamrock, Christopher led proxy contests that resulted in the election of multiple directors and the passing of a variety of governance related shareholder proposals. Mr. Kiper began his career as an auditor with Ernst & Young LLP, where he primarily focused on the financial services industry. He is a former director of Reddy Ice Holdings. He graduated magna cum laude from the University of Nebraska at Omaha with a B.S.B.A in Accounting.

Timothy Spangler is the Director of Research of the Lowell Milken Institute and a partner in Sidley's Los Angeles and New York offices. Timothy practices in the Investment Funds, Advisers and Derivatives group, where he regularly advises sponsors on the formation, structuring and negotiation of a wide variety of investment vehicles, as well as on the full spectrum of securities and regulatory issues typically associated with such transactions. Timothy has worked on a wide range of funds, including hedge funds, private equity funds, venture capital funds, funds of funds and funds investing in particular countries or sectors. Such vehicles have been formed in numerous jurisdictions, including the United States, the United Kingdom, the Cayman Islands, the Channel Islands, the Isle of Man, Bermuda, Mauritius, the Netherlands, Luxembourg, Germany and Ireland. His clients have included a full range of parties associated with funds – promoters, managers, advisers and investors.

Glenn W. Welling is the Founder and Chief Investment Officer of Engaged Capital, a Newport Beach, California based activist hedge fund. At Engaged Capital, Mr. Welling is responsible for overseeing all aspects of the firm. Since its inception, Engaged Capital has fulfilled its goal of promoting change in companies such as Abercrombie & Fitch, AeroVironment and Rentech. Prior to Engaged Capital, Mr. Welling was a Principal and Managing Director at Relational Investors, a \$6 billion activist equity fund. Mr. Welling also teaches executive education courses at the Wharton School of Business at the University of Pennsylvania, his alma mater.

Steve Wolosky is a partner at Olshan Frome Wolosky LLP, which has been consistently recognized as one of the leading firms for shareholder activist. Mr. Wolosky has spearheaded the firm's Activist & Equity Investment Practice for more than 20 years. He is one of the leading lawyers in the country advising hedge funds and investment partnerships on activist situations in the United States and worldwide. Most notably, Mr. Wolosky led the pre-eminent proxy contest of 2014 representing Starboard Value's unprecedented, victory in its election contest against Darden Restaurants, Inc. In international news-making cases, Mr. Wolosky represented foreign clients who successfully obtained board representation for the first time in both Japan and South Korea. Mr. Wolosky has led over 300 proxy contests for board representation in his career. He received his juris doctorate from Benjamin N. Cardozo School of Law in 1980 where he was a member of the Benjamin N. Cardozo School of Law, *Law Review*. He received his B.A. from Brooklyn College of the City University of New York in 1977.