



Hedge Fund Activism

RECOMMENDATIONS FOR CORPORATIONS AND INVESTORS

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Hedge Fund Activism: Recommendations for Corporations and Investors

The Conference Board Research Working Group on Hedge Fund Activism was instituted in May 2007 and is composed of representatives from industry associations, major pension funds and asset management firms, as well as public corporations at the forefront of corporate governance developments (see p. 9 for the full list of members). Delegates to the Working Group have developed the following set of recommendations to corporate directors, executives, and investment professionals to help them address changes in the investment climate generated by the increasing presence of activist hedge funds. Due to the non-advocacy policy adopted by The Conference Board, the Working Group did not issue any recommendations to legislative bodies or regulatory agencies.

These recommendations are supported by a 72-page report, discussing in detail The Conference Board Research Working Group on Hedge Fund Activism findings. For a copy of the full report, please visit www.conference-board.org/hedgefundactivism



Recommendations for Corporations

Monitoring Securities Holdings

- I. **Remain informed on institutional holdings and securities trading activities**
 - I.A. Management should **actively monitor trading** in the company's securities holdings, including shares, fixed-income, and convertible products, as well as (to the extent possible) derivative instruments. Particular attention should be paid to large accumulations of stock or extraordinary stock purchase patterns. Relations among institutional investors and group voting arrangements should also be investigated to determine whether holders are acting alone or in concert with others.
 - I.B. Companies should consider availing themselves of **securities surveillance services** and other external resources to gather additional intelligence on stock accumulations and changes in beneficial ownership. Before engaging such providers, companies should recognize the possible limited accuracy of their services and ensure that they are conducted lawfully and ethically.
 - I.C. Securities holding intelligence gathered from public filings and surveillance reports should be supplemented and corroborated with non-public information the company can access through **ongoing discussions** with investors.
 - I.D. The corporate board (in its entirety or by means of a committee or designated director) should request and be provided with **regular reports** on this monitoring activity and meet with senior executives to discuss the implications of any material variation in the company's ownership structure.
- II. **Understand hedge fund investment strategies and activist tactics**
 - II.A. Companies should **maintain up-to-date profiles** of any private equity groups, hedge funds, and other private pools of capital with material investments in the company's securities. This normally involves seeking an understanding of the background and the specific investment strategies pursued by such entities, including:
 - prior investment decisions and current portfolio composition;

- sources of capital and redemption practices; and
- fund managers' modes of operations, history of activism, time horizons, compensation structure, and performance targets.

This type of information should be gathered from a variety of sources, including regulatory filings, public statements by fund managers or other representatives, specialized news services, and press logs.

- II.B. Management should become knowledgeable about the types of **intervention strategies** and devices activists may seek to use to advance investor arguments for change in portfolio companies (e.g., shareholder resolutions, proxy fights, shareholder suits, alliances with pension funds and other institutional investors, stock lending/empty voting techniques, "wolf packs," etc.) Companies should also learn how mutual funds and other mainstream investors holding their shares vote on certain issues to anticipate possible voting alliances with activist hedge funds.
- II.C. In-house counsel, financial officers, and governance professionals should be **familiar with the structure** of hedge funds and their performance drivers and recognize hybrid investment vehicles that pursue alternative investment strategies. In addition, legal counsel and governance experts should remain abreast of any case law and legal statutory developments that might influence hedge funds' future behavior.
- II.D. Management should consider establishing internal **educational programs** to engage board members and key employees so they can also remain alert about activists' intentions.

Responding to Requests for Change

III. Be aware of strategic, financial, and governance vulnerabilities, and remain open-minded about change

- III.A. Management and board members should proactively develop (either in-house or with the assistance of outside experts) an **inventory** of strategic, governance, or financial matters that may single out the company as a target. The inventory should include any foreseeable extraordinary corporate events that could trigger activists' initiatives (e.g., the announcement of an acquisition or the issuance of new shares). To facilitate this process, the company should consider designating a corporate governance officer who would report directly to the nominating/governance committee or the full board on emerging best practices. Similarly, boards

should expect senior financial executives and internal audit officers to promptly bring to the attention of the board those financial conditions (e.g., a substantial cash balance) that could make the company attractive to corporate activists. Finally, as part of the regular review of the company's strategic plan and business performance, the board should seek updates of investor expectations, as well as industry benchmarks and the competitive environment.

- III.B. As a preventive measure, companies should renew their **focus on financial performance** and be prepared to justify their capital availability and liquidity positions vis-à-vis strategic goals. Especially where excess cash is available, management should publicly articulate its strategy for retaining that cash, reinvesting it, or returning it to shareholders through special dividend payouts or share repurchases. Similarly, companies should regularly monitor their business portfolio, identify underperforming assets, and, unless there is a compelling strategic reason for retention, consider divesting such assets to focus on long-term business potentials.
- III.C. Boards should understand the rationale behind **emerging governance standards** as well as practices arising from recent proxy seasons or supported by proxy advisors and major shareholder interest groups. Directors should inquire about senior managers' positions with respect to such issues and be persuaded about their arguments. As part of their active oversight responsibilities, directors should encourage the voluntary changes and corrections necessary to avoid being a target. If they choose not to meet current governance practices, managers should be prepared to articulate what motivates their decisions.
- III.D. Boards should not assume that requests for change made by activist hedge funds always reflect a hostile orientation or short-term investment goals. Instead, directors should **be open-minded and analytical** and review strategic- and governance-related demands in light of the company's current strategy, financial and governance analyst reports, the activist's profile, and the long-term interest of all shareholders.
- III.E. To have a full understanding of investors' intentions, management should consider meeting with representatives of activist hedge funds. Boards may wish to

designate one or more directors to also meet with activists should circumstances warrant. However, senior executives and directors should always consult with in-house counsel on legal restraints and internal policies on **shareholder communication**, including compliance with Regulation FD and insider trading (as well as anti-tipping) rules. In certain situations, it may be appropriate to request the hedge fund to enter into a confidentiality agreement (in which case, the company should be prepared for the fund to reject any clause that curtails its freedom to trade).

IV. Participate in formulation of response strategies and ensure their proper implementation

IV.A. Boards should expect to be directly involved with management in formulating responses to requests made by activists. Boards should be prepared to critically analyze (and, when needed, express their constructive skepticism on) management's position. Board members and management should agree to an **actionable response strategy** and, specifically, on whether the company should resist or concede to activists' demands. The company should avoid basing its response strategy on merely ignoring the activists' demands. In no situation should management implement a response strategy that is not supported by the board.

IV.B. Boards should ensure that management is fully equipped to effectively implement the response strategy to which the company has agreed. For this purpose, boards may encourage the formation of a **special execution team** composed of internal and external specialists (including, for example: finance officers, compliance and governance officers, investor relations and communication experts, general counsel and outside legal counsel, investment bankers, etc.). The team should be entrusted with a protocol of actions to be initiated immediately after the response strategy has been finalized. In the course of the activism campaign, the board should expect to be kept constantly informed of the response strategy implementation. Throughout the response strategy implementation, management should also consider how to keep employees involved so that the activism campaign does not impair the company's ability to attract and retain talent. Similarly, in this phase, management should closely monitor (and report to the board on) the company's relationship with other major stakeholders (e.g., customers, suppliers, and local communities where the business operates) to ensure that corporate reputation is adequately protected during the activism campaign.

IV.C. To clearly communicate their response strategy, companies should develop a **sound and coherent message** that will resonate with activist investors as well as other stakeholders. The message should highlight whether the company decided to concede to or resist activists' requests and why this decision is suited to pursue shareholder value creation. Ultimately, the message should stress the company's value proposition as an investment as well as the business' social mission. If the company agreed to a settlement discussion with activists for the purpose of correcting strategic deficiencies or financial- or governance-related shortcomings, the message should clearly state the rationale for the changes. To ensure that the response message or its forms of dissemination do not violate any applicable laws or regulations, the implementation team should retain the advice of a legal expert. Finally, to ensure that the response message is consistently disseminated, the implementation team should assign ultimate communication responsibilities to a leader who can act as the spokesperson for the company.

IV.D. As part of the response strategy, for those situations in which management and directors conclude that activists' requests are not in the shareholders' best interest, companies should have in place **defense plans** against proxy contests or hostile acquisitions. Board members should support management in the advance preparation of such plans. Defense plans should center on facilitating dialogue and implementing communication strategies with shareholding institutions. Defense plans should not rely on entrenchment tools (such as shareholder rights agreements or staggered boards) that might be used *a priori* by senior executives to avoid prudent corporate change and protect the status quo. Even if the activism campaign has become public, management should avoid outright criticism of investors and confrontation as response tactics.

IV.E. In those situations in which there is sufficient evidence that the activist hedge fund is operating under an undisclosed understanding with a group of investors or has otherwise violated applicable securities laws, companies should **consider notifying the regulatory agencies** and be prepared to supplement a public enforcement action by litigating the matter. The board should also be involved and consult with legal counsel to weigh the costs and benefits of either decision.

V. Engage in an open dialogue with investors and gatekeepers

- V.A. Within the parameters of applicable laws and regulations, and in consultation with their legal advisers, board members and senior executives, as fiduciaries, should actively pursue **forms of engagement** with the investment community to safeguard the company's ability to raise capital. Practices that should be considered include inviting investors' representatives to meet with the board, participating in investor conferences, and instituting board sessions to review regularly communications received from larger shareholders. A dialogue with retirement funds and other long-term institutional investors is especially important, as their decision to ally with hedge funds may determine the outcome of an activism campaign launched by those funds. Directors and managers should make certain that their interlocutors at such institutions involve not only asset managers but also those responsible for governance oversight of portfolio companies and voting proxies. Considering that many activist hedge funds use public criticism as a tactic to pursue their objectives, the company's communication experts should also maintain good relations with key media groups and publicity intermediaries.
- V.B. Companies should **monitor their governance and credit ratings** and develop a plan to correct any shortcoming and establish a durable reputation for excellence in corporate governance and creditworthiness. For this purpose, senior executives should consider engaging in constructive dialogue with proxy advisors, rating agencies, and other shareholding groups—within the parameters of applicable laws and regulations gov-

erning corporate disclosures to and communications with the public.

- V.C. In public disclosure documents and public communication strategies, companies should consider explicitly addressing strategic, financial, or organizational issues that may resonate with hedge funds and other activist investors. Companies may wish to expand their **voluntary disclosure** of extra-financial measures of performance to emphasize to all shareholders their commitment to long-term growth, their strategies for achieving it, and their metrics for measuring progress.

Ensuring Voting Integrity

VI. Promote transparency and integrity of the voting process

- VI.A. Within the parameters of applicable state laws and securities exchange standards, companies should **time notices of shareholders' meetings** to ensure that institutional investors engaging in stock lending activities can consider withholding from lending or recalling their shares. Specifically, publication of the meeting agenda and disclosure of the voting record date should take place in advance of the actual occurrence of the record date to allow lenders enough time to assess—based on the lender's governance policies and its long-term investment goals—the importance of each item being put to a vote vis-à-vis the economic return derived from lending the shares.

Recommendations for Investors

Ensuring Voting Integrity

VII. Promote transparency and integrity of the voting process

- VII.A. Institutional investors should set **written policies** regarding stock lending activities and define their scope and prerequisites (e.g., solvency of borrowers and type of acceptable collateral). Policies and historical data on the lending business, including the fees charged to borrowers and the major terms of master lending agreements, should be publicly disclosed on a periodic basis.
- VII.B. Institutional investors engaging in stock lending should establish **internal communication proce-**

dures to ensure full ongoing coordination between lending agents and personnel responsible for voting proxies and implementing corporate governance policies. Proxy voting guidelines and share lending policies should be reviewed and compared to ensure consistency. Lending agents and governance experts should collaborate in compiling “do-not-lend” lists and determining whether previously lent shares should be recalled. Similarly, institutional investors should avail themselves of reliable state-of-the-art technology to interact efficiently with intermediaries in the stock lending process (e.g., brokers, custodian banks, other third-party service providers) should the lender decide to recall its shares.

VII.C. For those situations in which the proxy voting team has no access to the shareholder meeting agenda prior to the voting record date, stock lending policies should exemplify specific **factors to be considered** in assessing the materiality of the proxy vote versus the opportunity cost of not lending (or of recalling) the shares. These factors should include, at the minimum:

- the cumulative stake in the company;
- the investment horizon;
- major financial, strategic, or governance issues of concern, especially in cases of negative publicity;
- items voted on and shareholder resolutions filed in occasion of prior meetings, as well as the outcome of those votes; and
- the likelihood of upcoming special meetings of shareholders to vote on extraordinary business matters.

For the same purpose, proxy voting teams, in collaboration with investment analysts, should monitor portfolio companies and identify those that may be singled out by and become the target of activist value investors. With respect to select companies, the proxy voting team should recommend, on a case-by-case basis, to either suspend the lending program or closely monitor the lent shares so that they can be promptly recalled. As a general rule, securities lending programs should require the systematic recall of enough shares to honor—based on historical trends—the expected number of client voting instructions.

VII.D. Institutional investors' trustees should explicitly prohibit the practice of lending shares to those borrowers whose intention is to influence meetings of shareholders by voting. For this purpose, educational programs should be instituted to train asset managers and the stock lending team on how to remain alert and scrutinize prospective borrowers' practices. In addition, institutional investors' trustees should ensure that the **master lending agreements** entered into with borrowers contain appropriate economic disincentives of empty voting (e.g., by incorporating severe liability and indemnification clauses for damages caused by empty voting to the value of the shares).

VII.E. Institutional investors should monitor the development of national or international **codes of best practice** with respect to stock lending and consider whether or to what extent they should be adopted or reflected in internal policies.

Overseeing Hedge Fund Management

VIII. Perform ongoing due diligence as part of the investment process in activist hedge funds

VIII.A. Institutional investors should invest prudently and consider the suitability of capital allocations in an activist hedge fund in the context of their overall portfolio and in light of their financial objectives, time horizons, distribution requirements, and risk tolerances. Institutional investors' trustees should **not categorically prohibit** or restrict allocations to hedge funds, including activist funds. Instead, they should expect their agents to evaluate such investment as part of their duty to diversify the portfolio and prudently pursue risk/return objectives.

VIII.B. Fiduciaries of pension funds and other institutional investors should ensure that the decision to invest in an activist hedge fund relies on a **thorough due diligence process**, which should draw upon a variety of independent resources (including references and information on reputation among peers) to critically analyze data provided directly by the fund in registration and disclosure documents. For this purpose, investors should request detailed information on the fund's characteristics (including capital and organizational structure, investment strategy, governance practices for managing potential conflicts of interest, and risk policies and tolerance levels) as well as activism tactics and objectives. Specifically, institutional investors should understand what strategic, financial and governance changes are – based on the hedge fund manager's investment history and other available information – perceived as drivers of long-term growth. Additional due diligence should be conducted on:

- the legal and fiscal form of the fund, including applicable laws and regulations based on its domicile, as well as the level of understanding by asset management of the risk the fund faces from potential future geopolitical or regulatory developments;
- the fund advisor's registration with regulatory authorities, whether it qualifies as an ERISA fiduciary, and its disciplinary history, if any;
- key investment personnel, their professional background and performance history, and their current compensation schemes;
- the scope of asset managers' experience, including the variety of market environments in which they operated and their familiarity with multiple investment strategies;

- the full scope of the advisors' activities, including the methodology adopted to ensure fair allocations among different accounts and the involvement in other business activities that may give rise to potential conflicts of interest;
- the level of understanding of the strategic and governance-related issues that may under-value (prospective) portfolio companies;
- the degree of client concentration, the stability of the client base, and (if any) the major terms of special, more advantageous arrangements granted through side letters to certain other investors;
- financial modeling, pricing, and valuation methodologies adopted to assess, monitor, and report on investments and their performance, including the safeguards adopted to ensure the compensation of valuation functions is independent of the fund's performance;
- financial arrangements, sources of leverage, and liquidity risks of single asset categories;
- the professional background and reputation of major counterparties the fund has contractual relationships with, including prime brokers, custodians, and other service providers;
- the methods used to calculate performance fees, which should be based on net dollar value added (i.e., excluding any operating expense and other extraordinary expenses charged to the hedge fund) and paid only after the hedge fund has recouped losses from prior years, if any; and
- the adherence to rigorous compliance and risk management programs, which should be assigned to independent functions whose compensation is not linked to portfolio performance.

VIII.C. Institutional investors with allocations to activist hedge funds should periodically monitor the **compensation policy** adopted by those funds to ensure that their managers' economic interests are aligned with objectives of long-term value creation.

IX. Strengthen governance practices and participate in the discussion and implementation of activist strategies

- IX.A. Within the parameters of applicable laws and regulations, institutional investors should seek regular communication with portfolio hedge funds on their **activism agenda** and be comfortable that it is designed to correspond with the long-term interest of the institutional investors' beneficiaries.
- IX.B. Long-term institutional investors with allocations to hedge funds should monitor the funds' investment decisions and (to the extent it is consistent with their fiduciary responsibilities and investment strategies) should **consider teaming with hedge funds** on their activism campaigns if those campaigns are deemed consistent with the institutional investors' long-term goals and the corporate governance practices they endorse.
- IX.C. Institutional investors with holdings in activist hedge funds should expect hedge fund managers to remain abreast of, become signatories of, and adhere to best practices and **voluntary standards** published by relevant fund associations and other self-regulatory organizations, including standards on transparency and voluntary disclosure as well as risk management best practices.
- IX.D. Institutional investors with holdings in a company contesting an activist's demands should be willing to listen to both the activist and the company with an open mind and should make their ultimate voting decisions based on **all available information** and in furtherance of their fiduciary duties to beneficiaries.

About the Research Working Group on Hedge Fund Activism

The Conference Board Research Working Group on Hedge Fund Activism was instituted in May 2007 and is composed of major companies, investors, and experts in the field of corporate governance. The group was conducted under the auspices of The Conference Board Governance Center and was co-chaired by Stephen Davis and Jon Lukomnik. Matteo Tonello of The Conference Board served as the Working Group research director. Meetings took place in New York City on May 16, 2007; Washington, D.C., on June 20, 2007; and again in New York City on July 24, 2007.

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About the Research Working Group Research Director

Matteo Tonello, LL.M., S.J.D., is a corporate governance and regulatory compliance expert with The Conference Board Governance Center. An international lawyer by background, Tonello has conducted for The Conference Board corporate law and risk management analyses and research in collaboration with leading corporations, institutional investors and professional firms. Also, he has participated as a speaker and moderator in educational programs on governance best practices.

Tonello is widely published on the subject of corporate governance, business ethics, and compliance. Recently, he advised the Italian Commission of Study on Corporate Transparency, established by the Ministry of Finance, about the effects of the Sarbanes-Oxley Act on foreign private issuers, and contributed to the drafting of the two final reports by the Commission. A new securities law enacted by the Italian Parliament in December 2005 was largely based on the Commission's findings and related recommendations.

Before joining The Conference Board, Matteo Tonello practiced corporate law at Davis Polk & Wardwell. He received a Master of Laws degree from Harvard Law School (1997) and a J.D. from the University of Bologna (1994). He also earned a S.J.D. from the St. Anna Graduate School of the University of Pisa (Italy) (1998) and was a Visiting Scholar at Yale Law School (1997).

About the Research Working Group Co-Chairs

Stephen Davis, Ph.D., is project director and fellow at the Millstein Center for Corporate Governance and Performance, Yale School of Management. He is also president of Davis Global Advisors. A Pulitzer Prize-nominated authority on shareholder rights, Davis founded the Global Shareholder Service at the Investor Responsibility Research Center and co-founded the International Corporate Governance Network (ICGN). He has advised investors on such benchmark issues as News Corporation's reincorporation from Australia to Delaware and the New York Times Co.'s two-class share structure. Davis serves as chairman of the board of Hermes Equity Ownership Service, which oversees shareowner engagement operations for the United Kingdom's biggest fund. He is co-author (along with Jon Lukomnik and David Pitt-Watson) of *The New Capitalists: How Citizen Investors are Reshaping the Corporate Agenda* (Harvard Business School Press, 2006), which won recognition from *Financial Times* and *Wall Street Journal* as one of the best books on corporate governance.

Jon Lukomnik is managing director of Sinclair Capital and was recently named program director at the Investor Responsibility Research Center Institute in Washington, D.C. A former chair of the executive committee of the Council of Institutional Investors and co-founder and former governor of the ICGN, Lukomnik was previously the deputy comptroller for the City of New York, where he was investment advisor for the city's treasury and benefit plans totaling \$80 billion in assets and revamped the city's corporate governance policies. He has served as a governance consultant for entities as varied as Fortune 100 companies, the World Bank/International Finance Corporation, and national labor unions. Lukomnik currently advises a number of activist hedge funds and has had key roles in the restructurings of WorldCom/MCI and Adelphia. He is co-author of *The New Capitalists*.

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