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The case *for* and *against* activist hedge funds

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(Opinions expressed herein are strictly those of the author)

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A subset of so-called hedge funds, henceforth known as "activists", has latched on the idea that many corporations are not managed or governed in a manner likely to maximize value for shareholders. With the capital they have obtained from pension funds and other institutional investors, they take a small position in the equity of publicly traded companies and push, with a varying degree of aggressiveness, for measures they deem likely to boost targeted companies' stock price.

This is a fast growing business. The number of activist "interventions", some 27 in 2000, has reached 345 in 2014 according to the *WSJ-FactSet Activism Scorecard*[1]. Activist hedge funds have now amassed an estimated $200 billion in managed assets[2]. To achieve more leverage on companies, smaller hedge funds may band in what has been aptly called "wolf packs".

In a by-now familiar scenario, the activist hedge fund calls on the targeted company to name to its board some people of its choosing (threatening a proxy fight if the company is not forthcoming). That is merely a first step, sometimes entirely skipped.

Unless the company swiftly gives in to its demands, the hedge fund will produce a paper, or a long letter, critical of the company's management and board and outlining the remedial actions that, in its view, would benefit shareholders. That document will be broadcast widely so as to gather the support of the company's institutional shareholders, even if a tacit one. In due course, if matters come to a proxy fight, the hedge fund will try to persuade the proxy advisors (ISS and Glass Lewis) to come out in favour of the hedge fund's nominees for the board.

1 See on the Wall Street Journal Website at http://graphics.wsj.com/activism-scorecard/

2 Martin Lipton, Steven A. Rosenblum and Karessa L. Cain, "Some Thoughts for Boards of Directors in 2015," *Memorandum by Wachtell, Lipton, Rosen & Katz*, December 1st, 2014.

THE CASE *FOR* ACTIVIST HEDGE FUNDS

Activist hedge funds can count on a number of supporters in academia and in the media rising up in defense of their actions. No doubt activist hedge funds have found their most persistent academic supporters in Professor Lucian Bebchuk of the Harvard Law School and his co-authors. In several papers, but most particularly in the Bebchuk, Brav and Jiang (2013) paper[3], the authors make several claims, which are summarized in Bebchuk's op-ed piece in the ***Wall Street Journal***:

"Our comprehensive analysis examines a universe of about 2,000 hedge fund interventions during the period of 1994-2007 and tracks companies for five years following an activist's arrival. We find that:

- *During the five-year period following activist interventions, operating performance relative to peers improves consistently through the end of the period;*
- *The initial stock price spike following the arrival of activists is not reversed in the long term, as opponents assert, and does not fail to reflect the long-term consequences of activism;*
- *The long-term effects of hedge fund activism are positive even when one focuses on the types of activism that are most resisted and criticized – first, those that lower or constrain long-term investments by enhancing leverage, beefing up shareholder payouts, or reducing capital expenditures; and second, adversarial interventions employing hostile tactics;*
- *The "pump-and-dump" claim that activists bail out before negative stock returns arrive is not supported by the data; and*
- *Contrary to opponents' beliefs, companies targeted by activists in the years preceding the financial crisis were not made more vulnerable to the subsequent downturn."*

(***Wall Street Journal***, August 8th, 2013)

Basically, Bebchuk et *al*'s argue that their vast base of empirical data does not support the claims made by opponents of activist hedge funds.

Other academic researchers have also produced studies somewhat supportive of hedge fund activism. (See for instance Gow *et al* (2014)[4], Zhu (2013)[5], Krishnan, Partnoy and Thomas (2015)[6], and for an exhaustive survey Denes, Karpoff and McWilliams (2015)[7])

3 Lucian A. Bebchuk, Alon Brav and Wei Jiang, "The long-term effects of hedge fund activism," Working paper available on SSRN, July 2013; Bebchuk et al. issued a new version of their paper in December 2014.

4 Zhu, H. "The preventive effect of hedge fund activism," Working Paper available on SSRN, November 2013, p.36.

5 Nickolay Gantchev, Oleg Gredil and Chotibhak Jotikasthira, "Governance under the gun: spillover effects of hedge fund activism," Working Paper available on SSRN, March 2014.

6 C.N.V. Krishnan, Frank Partnoy and Randall S. Thomas, "Top Hedge Funds and Shareholder Activism", April 2015. Available on SSRN.

7 Matthew Denes, Jonathan M. Karpoff, and Victoria McWilliams, "Thirty Years of Shareholder Activism: A Survey of Empirical Research", SSRN, May 2015.

Then, ***The Economist*** in its February 7th 2015 issue imagines a dystopian world where corporate managers and boards of directors are generally incompetent, most investors are lazy and activist hedge funds have become "a force for good", "capitalism's unlikely heroes" and "the saviours of public companies"[8]. However, these claims are but weakly supported in their piece. [9]

Shortly afterwards the AIMA, the "Alternative Asset Management Association", essentially the hedge funds' advocacy group, issued a long detailed paper, purporting to show how activist hedge funds (or "alternative asset managers" as they prefer to be called) are "unlocking value"[10].

But here is the best case that can be made for these hedge funds:

- *These activists push companies to make a more disciplined use of cash and capital.* Activist hedge funds demand that boards and management be much more disciplined in their use of company resources and their allocation of capital; they believe boards of directors are often poor at enforcing discipline in the use of cash and capital; they urge companies to return any excess cash to shareholders by buying back their shares or paying special dividends; they advocate for effective capital structure, raising leverage where appropriate to reduce the company's cost of capital, using the cash generated thus for additional buy back of shares; they push companies to sell-off or spin-off assets/divisions/subsidiaries with mediocre returns on investment; they urge companies to "simplify" their structure, to shun diversification; they push for the sale of the whole company when they believe a prospective buyer would pay a substantial premium to put its hands on the company; all of these moves, hedge funds claim, make for a more efficient industrial structure, a better allocation of capital overall.

- *They bring an external, uncompromising perspective on a company's "strategic" options;* unhindered by the company's tradition, history and values; they may call for a radical change in the company's course, question its leadership, its level and form of executive compensation; their single-minded objective is to quickly maximize the return for shareholders; typical boards tend to factor in the interests of other stakeholders and to show some deference to the CEO, to the tradition and the values of the company, a complacency in the eyes of activists that only postpones the day of reckoning for the company.

- *They act on the (for them) incontrovertible premise that shareholders are the "owners" of the company and therefore their interests should take precedence in the management of the company. Activist* Carl Icahn founded *The Shareholders' Square Table (SST) as "a platform from which we can unite and fight for our rights as shareholders and steer towards the goal of real corporate democracy".* Activist hedge funds, they claim, give "voice" to passive, dispersed shareholders, and, in particular, to the holders of shares in indexed funds of which the targeted company is a component.

8 ***The Economist***, "Activist funds: An investor calls" and "Shareholder activism: Capitalism's unlikely heroes", February 7th, 2015.

9 Yvan Allaire "The Economist runs an infomercial for activist hedge funds!", Financial Post, February 13th, 2015.

10 Malik, Jon, "Unlocking value: the role of activist alternative investment managers", AIMA and Simmons & Simmons, February 24, 2015.

- *They are pointing out, and capitalizing on, the limitations of current governance practices.* Ever since Sarbanes-Oxley (and even earlier), "good" corporate governance has been defined by the strict observance of fastidious, punctilious rules and principles, foremost among them the obsession with the immaculate independence of a majority of board members.

  Indeed, over the last fifteen years, institutional investors pursued policies of "*soft* activism" urging boards to eliminate the staggered election of board members, to separate the chair and CEO positions, etc. Eventually, faced with what they perceived as the inability or unwillingness of boards to rein in executive compensation, they supported "say-on-pay" initiatives (which then became law in the U.S.). They bought the services of proxy advisors, which thrived on ever expanding rules for "good" governance.

  As a result, board members, generally honest, responsible, dedicated people, operate in a framework of governance prescriptions which actually consolidate the board's dependence on management's vastly superior information, expertise, and experience. Activist hedge funds have tapped into this governance "imperfection"[11]. They believe that management, unless prodded, will not propose the sort of radical, shareholder-centric, measures hedge funds advocate. They also believe that *boards of directors are generally ill-equipped, and unlikely, to pressure management to implement these kinds of measures*. As institutional investors came to believe this argument, boards gradually lost their trust and confidence.

  Increasingly, institutional investors have come to side with, and support with their money, the *hard* activism of hedge funds in their battles with corporate boards and management. A recent study by FTI Consulting shows that 76% of institutional investors had favorable views of shareholder activism, and 84% of them believed that activism did add value to a target company[12].

11 A recent survey by McKinsey showed that only 34% of the directors surveyed agreed that the boards on which they served fully comprehended their companies' strategies. See Dominic Barton and Mark Wiseman, "Where boards fall short, " *Harvard Business Review*, January-February 2015, pp.98-104.

12 FTI Consulting, 2015 "Shareholder activist landscape", 2015.

What should be taken away from this description of the putative benefits of «activist» hedge funds?

That some boards do not perform as well as expected may not be shattering news; the limited power of shareholders to get a reluctant board to act in a shareholder-friendly way has been well documented. However, recent developments in governance (majority election of board members, access to nomination process, elimination of staggered boards, say-on-pay, role of proxy advisors, etc.) have changed the relationship between boards and shareholders, giving the latter a lot more leverage over the former.

Nevertheless, one key argument of activists is valid; the current board governance practices in *widely held corporations* open the door to the activists. Boards are indeed too often dependent on management, and unable or unwilling to take the vigorous actions needed to create enduring wealth for the company.

That is indeed a problem calling for remedial action but not necessarily of the kind offered by activist hedge funds. Their sort of cure may be worse than the disease.

Let's now examine several of the criticisms aimed at these activists.

THE CASE *AGAINST* ACTIVIST HEDGE FUNDS

First, let's briefly review the empirical studies claiming either long-term benefits or the absence of damages from the activities of these hedge funds, foremost among them, the *Bebchuk, Brav, and Jiang papers (2013, 2014)*. Their study deserves a close examination and was indeed subjected to sustained, and largely unanswered, criticism (See Lipton[13], Allaire and Dauphin[14]).

In spite of the stated (and limited) aim of their study (*"whether the long-standing claim that activist interventions are followed by declines in long-term operating performance"*), Bebchuk, Brav and Jiang get carried away and associate hedge fund intervention to the subsequent performance of companies long after the hedge funds have sold their shares.

At this stage and until the authors provide answers to legitimate questions about their data and methodology, their empirical findings may not be retained as evidence in support of this breed of activism. But the authors did trumpet their results in the ***Wall Street Journal*** as the definitive demonstration of their case for activism and did insist on giving instructions to policy makers and regulators as to the right course for them to follow.

13 Lipton, M. "Empiricism and Experience; Activism and Short-Termism; the Real World of Business". *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, October 28, 2013. Lipton, M. "The Bebchuk Syllogism". *The Harvard Law School Forum on Corporate Governance and Financial Regulation,* August 26, 2013.

14 Allaire and Dauphin, "Activist hedge funds: creators of lasting wealth? What do the empirical studies really say?" (July 2014). Allaire and Dauphin, "Hedge fund activism and their long-term consequences: Unanswered questions to Bebchuk, Brav and Jiang", August 2014. Allaire and Dauphin , "Still unanswered questions (and new ones) to Bebchuk, Brav and Jiang", January 2015. All three papers are available on SSRN.

We do believe that when researchers draw adamant policy inferences and recommendations from their research data, they should make their raw dataset available to other researchers, as Reinhart and Rogoff have done for their data on financial crises and Saez, Piketty *et al* for their vast database on income inequality.

The AIMA paper

Produced and published by the association created to defend the interests of hedge funds, their paper makes several carefully worded claims, which, despite their less-than-impartial source, deserves examination:

- *"Activism by alternative investors appears to produce long-term improvements in portfolio companies, on average: The empirical evidence to date indicates that, on average, activist engagement by alternative investors is correlated to improvements in the share price, operating performance and productivity of targeted companies for several years following the engagement, including after the fund exits".* **[They prudently claim a mere correlation not any causation; they stress "on average", meaning that results may countenance many different outcomes and even lead to contrary results with different statistical metrics; this argument is largely based on the Bebchuk *et al* 2013-2014 study, about which see above]**

- *Alternative investment activism leads to greater alignment of interests: Activist alternative investors seek higher standards of corporate governance, which improves alignment of interest between management, shareholders and all other stakeholders and ultimately leads to improvements in the efficient allocation of capital and resources in the economy overall.* **[These claims are not supported by any credible data; the alignment with "all other stakeholders" is spectacularly lacking any empirical support]**

- *Activist alternative investment managers are relatively longer-term investors and are frequently structured as to provide 'patient capital': Alternative investment funds hold activist investments for longer periods than is common in purely trading-oriented strategies - holding periods average 1.8 years for investments, while specialist activist funds have investment horizons averaging almost two years. The average market-wide holding period of stocks is around three months. As a consequence of the relatively long investment horizons, activist funds often employ structural characteristics designed to retain capital for the duration of activist campaigns.* **[This argument is particularly disingenuous. Note the use of averages; actually the median share holding period of institutional investors hovers around 1.8 years and has not changed much since 1985[15]; the median holding period of activist hedge funds is about 9 months per campaign –see below. The "average market-wide holding period of stocks" of around three months reflects the impact of speed traders and other similar trading tactics; thus that "average" is an invalid metric for comparative purposes]**

15 Martijn Cremers , Ankur Pareek and Zacharias Sautner "Stock Duration and Misvaluation", December 17, 2012, Appendix A3, SSRN paper.

- *Alternative investor activism is having a collateral impact on companies not yet targeted by an activist: The increased likelihood of engagement by an activist alternative investor is leading company managers and boards to make pro-active changes to corporate policy that, in general, appear to increase shareholder value and longer-term profitability of yet-to-be-targeted firms.* **[The sad fact that management and boards may pre-emptively take actions of the kind that activists would urge on them only underlines the detrimental impact of this form of activism; if financial engineering moves were adopted by all corporations, would that really improve their long-term performance and that of our economic system?]**

- *Activist alternative investment managers are influencing institutional shareholders: Large institutional shareholders are becoming increasingly supportive of activist alternative investors: by investing ever greater sums in activist funds; by supporting activist proposals and, in some cases, by joining forces with activists. Many are also borrowing from alternative investor activism to adapt their own investment strategies.* **[That is unfortunately true; it only underlines the perverse attraction of short-term gains even for supposedly long-term investors!]**

- *Activist alternative investment managers make use of a variety of tactics but are mostly collaborative in approach: While high-profile proxy contests, lawsuits and other public activist tactics tend to generate headlines, most activism by alternative investors takes the form of behind-the-scenes interventions and other "soft" strategies, such as seeking board representation with management support. Collaborative engagement also appears more likely to achieve success than more assertive approaches, particularly outside the United States.* **[Strangely, the authors of that paper do not connect the dots between their previous observation and this one; the more institutional investors support the actions and tactics of activist hedge funds, the less resistance will be offered by management and boards of targeted companies (and thus the more collaborative the whole process). Furthermore, their document does report in its table 26 the results of Brav *et al* from earlier days, which show that if only a quarter of the hedge fund tactics were initially hostile, more than half became hostile as companies refused to give in to their demands.]**

Table 1

Frequency of U.S. Activist Hedge Funds' Tactics (1994-2011)

	% Initially Hostile	% Ex-post Hostile
Capital structure	20.5	45.5
Business strategy	26.3	62.6
Sale of target company	22.6	56.5
Governance	24.1	59.0

Source of data: Brav, A., Jiang, W. and H. Kim (September 2013). *Hedge fund Activism Updated tables and figures*. Fuqua School of Business, Duke University. Available on Alon Brav's personal home page.

- *Activism by alternative investors is evolving: As alternative investor activism matures, it is evolving in scope and strategic approach. For instance, alternative investors have become more likely in recent years to take activist positions in large or well-performing companies, and are becoming increasingly global in focus".* **[How is that a positive development? As money pours into these activist funds, the larger the preys they can attack]**

The AIMA study seeks to put the best spin possible on the actions of hedge funds. Yet, as with Bebchuk et al, their efforts are strained and unpersuasive.

WHAT LEGITIMATE CONCERNS MAY BE FAIRLY RAISED AGAINST THESE "ACTIVISTS"?

- *First, and most disturbing,* activist hedge funds operate in a world without any other stakeholder than shareholders. They have little sympathy or patience for the view that companies should live by values other than stock price, that companies are the *situ* of commitment, passion, and loyalty. All their actions are predicated on business corporations being like "properties" with a single role: enrich shareholders; theirs is a business world with no responsibility but for the bottom line. Were such a myopic concept of the corporation to become the norm for publicly listed companies, it is bound to create social and economic problems, and raise long-term issues of corporate legitimacy. Enlightened CEOs and boards of directors are well aware of this risk. *"[T]he company's success is inextricably linked to society's success. In order to do well by our shareholders, we also have to take into account the needs and concerns of a wide range of stakeholders. If our financial success comes at the expense of the environment, our consumers or our communities, we will not be viable in the long run".* Indra K. Nooyi, Letter to shareholders, **PepsiCo**'s 2013 Annual Report. Ms. Nooyi is right but, for hedge funds, that statement is anathema, even blasphemous.

- *Then, whether they admit it or not, the game is rigged for short-term pay-offs.* They are in practice ***short-term players***; they, and their academic supporters, argue that their interventions are not strictly-speaking short-term in nature and that they do not cause long-term harm to companies[16]; but their holding period as shareholder is fairly short (see Table 2) and they have no reason to care or worry about what happens to companies once they have exited its stock. For all 1,164 cases included in the study reported in Table 2, hedge funds held the shares for less than 15 months on average and for nine months or less in half the cases. Furthermore, the nature of their compensation system, the terms of their funding and their vulnerability to investor withdrawal of funds are likely to induce them to seek a quick pay-back.

16 See Lucian A. Bebchuk, Alon Brav and Wei Jiang, "The long-term effects of hedge fund activism," Working paper available on SSRN, July 2013.

Table 2

Investment horizon of hedge fund activists (in months)

Percentile	Exit after initial filing	Exit after demand negotiations	Exit after board representation	Exit after proxy contest	Average (per campaign)
25%	0	2	7	10	3
50%	**5**	**6.5**	**15**	**18**	**9**
75%	13	16	27	34	20
90%	25	27	41	64	36
Mean	9.42	10.48	19.43	25.78	**14.66**

Source: Nickolay Gantchev, "The Costs of Shareholder Activism: Evidence from a Sequential Decision Model" *Journal of Financial Economics*, Vol. 107, No. 3, March 2013, pp. 610-631; from a sample of 1,164 distinct campaigns involving 171 hedge funds and 1,023 unique targets, for the period 2000-2007.

- *Their game plan usually consists of some form of financial engineering,* a set of financial measures, well-known to boost stock prices for a short while (see Table 3). Even their request for board changes is but a first step to gain the ability to pressure the company to implement one or a combination of the financial engineering moves of Table 3. These measures may have an immediate impact on stock price, which signals exit time for the hedge fund. What will happen to stock price afterwards is dependent on many circumstantial factors and the hedge fund may or may not bear any responsibility for the longer-term result. Surely, the best way for a hedge fund to generate a substantial return on its investment will come about from selling the company. But that is no way to run companies for the long term. *Nowhere in the public utterances and the investment lexicon of hedge funds will one find references to long-term investments, to increased research expenditures, to concerns for all parties on which the company depends for its long-term success and survival.*

Table 3

Outcomes of activist engagements*

Board changes (replacement of the CEO, Chairman or Non-Executive Directors)	35.8%
Changes to pay-out policy (share buybacks or increased/special dividends)	21.5%
Restructuring (divestitures and spin-offs of non-core assets, and blocking diversifying acquisitions)	20.0%
Takeovers (the target firm is acquired by a strategic buyer or private equity fund)	22.7%

* Outcomes of 1358 engagements occurring between 2000 and 2010 per initial regulatory filing or press disclosure. (Becht, M., J. Franks, J. Grant and H. Wagner, 2014).

- *Wealth creation vs. wealth transfer or "Stealing from Peter to give to Paul".* Assuming that some activist interventions create value for shareholders, where is that additional value coming from? Advocates of hedge fund activism would claim that it results from greater efficiency in managing the company. Yet, Brav, Jiang and Kim (2013), two of them coauthors of the Bebchuk paper and thus strong supporters of the benefits of activist hedge funds, must nevertheless acknowledge that: *Overall, results in this section suggest that target firm workers do not share in the improvements associated with hedge fund activism. They experience a decrease in work hours and stagnation in wages, while their productivity improves significantly. Moreover, the relative decrease in productivity-adjusted wages from above-par levels suggests that hedge fund activism facilitates a transfer of "labor rents" to shareholders which may account for part of the positive abnormal return at the announcement of hedge fund interventions".* (Brav *et al*, 2013, p.22)

  As for transferring wealth from debt holders, Moody's observes: *"Our finding that its [shareholder activism] effect on the creditworthiness of Moody's-rated issuers is almost universally negative, even if only moderately."... "As short-term shareholder activists have become more influential, we have observed numerous examples of concessions to activists that have eroded credit quality contributing to downgrades*[17]*."*

  Klein and Zur also find a similar result[18]: *"...we find that hedge fund activism significantly reduces bondholders' wealth...Confrontational campaigns and the acquisition of at least one seat on the target's board elicit more negative bond returns. We also find an expropriation of wealth from the bondholder to the shareholder".*

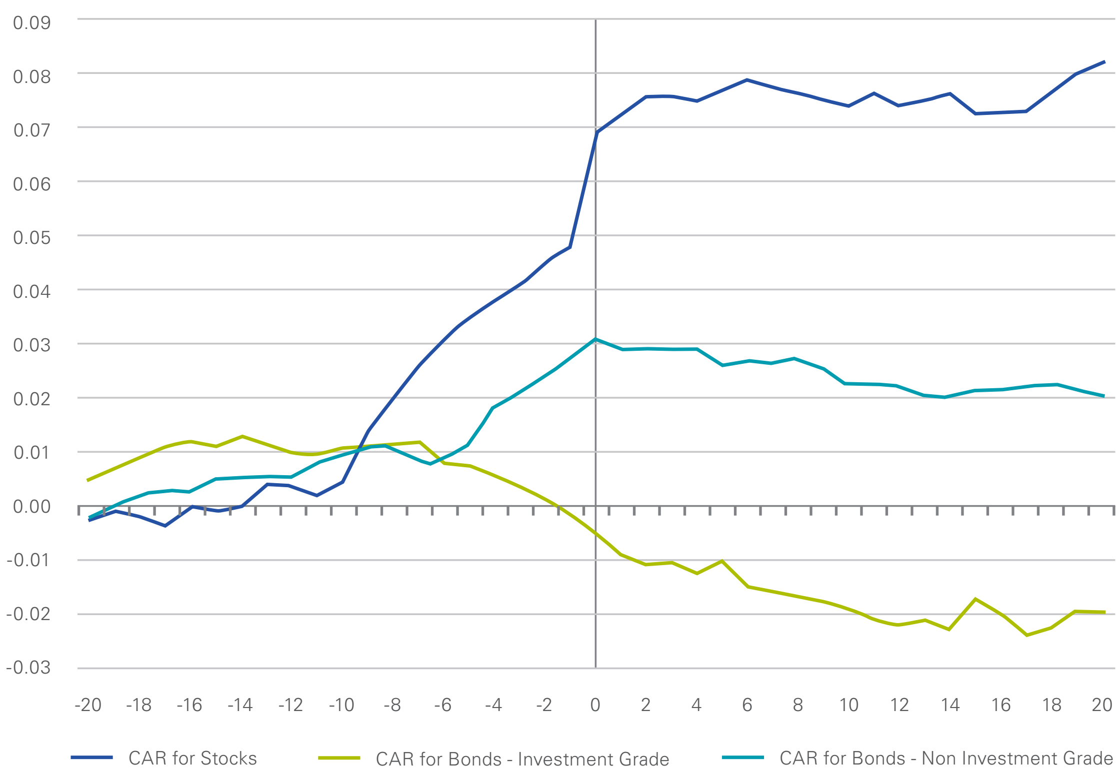
  As Figure 1 vividly shows, as a hedge fund makes public it is targeting a specific company, the company's stock price jumps up in the days following the announcement but the value of its investment-grade corporate debt drops significantly.

17 Byrd, F., D. Hambly & M. Watson. "Short-Term Shareholder Activists Degrade Creditworthiness of Rated Companies", Moody's Investors Services Special Comment, June 2007.

18 Klein and Zur, "The Impact of Hedge Fund Activism on the Target Firm's Existing Bondholders", (2010), SSRN paper.

Figure 1

Cumulative abnormal returns of stocks and bonds of companies targeted by hedge fund activism



Source: adapted from Hadiye Aslan and Hilda Maraachlian, "Wealth effects of hedge fund activism," *Paper submitted to the European Finance Association*, 36th annual conference, February 2009, Figure 2,3 and 4; from a sample of 1,332 target firms, for the period 1996-2008.

- *Their standard prescription, if implemented, would result in companies with little resiliency.* Their demands, when implemented, leave companies with no slack resources, a curtailed ability to invest for the long-term, no diversification of activities to shield the company from industrial sector variations, no buffer for economic downturns; for hedge funds (and some financial theorists) all companies should be *"pure-plays"*, that is, a simple, one-industry operation which grows, matures, then disappears, blown away by the winds of «creative destruction». Here's how recent academic papers by supporters of hedge funds describe the results of hedge fund activism:

- *[I]ncreased divestiture, decreased acquisition activity, higher probability of being acquired, lower cash balances, higher payout, greater leverage, higher CEO turnover, lower CEO compensation, and reduced investment*[19] (Gow, *et al*., 2014, page 24)

- *Firms cut CEO pay, reduce cash holdings and leverage, limit capital investment and R&D expenses, and raise shareholder distributions and CEO turnover*[20] (Zhu, 2013, page 36)

- *They are harbingers of dismal collective outcomes.* Given the frequency of their attacks and their success rate lately, activist hedge funds instil fear in the management of many corporations; to forestall an attack, boards and management are counselled to examine their company as seen through the eyes of activist hedge funds and implement measures they would likely urge on the company's management[21]; as the number of activist hedge funds mushrooms, attracted by the immense pay-offs (and manageable risk) of this business, and companies pre-emptively adopt their short-term policies, the cumulative effects could be quite toxic for a country's industrial health. It may be that the performance of some companies are improved by the preferred measures of activist hedge funds; however, their standard recipes if applied on a broad scale would result in a weakened, vulnerable, low growth corporate sector and a loss of their social legitimacy.

- *Their misguided actions and mistakes inflict collateral damages.* The assumption that their medicine is an appropriate cure for all targeted companies has inflicted costly set-backs on these funds. But those mistakes also damage companies which had to allocate cash and plenty of executive time to fend off the misguided attacks of some hedge fund. Apart from losing some of its investors' money, the hedge fund manager is not held accountable for these damages. *As hedge funds multiply, it is likely that misguided activism will go rampant in the corporate world, inflicting great costs on the economy.*

19 Ian D. Gow, Sa-Pyung Sean Shin and Suraj Srinivasan, "Activist directors: determinants and consequences, " *Harvard Business School Working Paper*, No. 14-120, June 26, 2014, p.24.

20 Zhu, H. "The preventive effect of hedge fund activism," *Working Paper available on SSRN*, November 2013, p.36.

21 Nickolay Gantchev, Oleg Gredil and Chotibhak Jotikasthira, "Governance under the gun: spillover effects of hedge fund activism," *Working Paper available on SSRN*, March 2014.

What should be taken away from this description of arguments against «activist» hedge funds? First of all, the hedge funds' "remedial actions" are well known and could be applied willingly and easily by any company; actually, many do as the massive amount of share buy-backs by corporations bear witness. But the fact that many companies refuse to carry out these financial manoeuvres may be an indication that their management and boards believe that these would be improper and detrimental to the company's long-term interest. Who is right? Why should it be assumed that boards are motivated by crass self-interest or afflicted with chronic incompetence but hedge funds are bearers of wisdom acting in the superior interest of the company and its shareholders[22]? As an observer recently stated, "[C]orporate governance is now more shareholder-centric as a result of the activist movement, with far less deference paid by shareholders and proxy voting advisors to boards of directors."[23]

Then, in the world according to activist hedge funds, companies should pay out to shareholders all potential cash, and operate as resource-poor, cash starved, pure plays. Should they disappear, either bought or bankrupt, that is but the iron law of economics. But is this how the formidable American corporations, the economic engines of the US, were built? The Boeing, GE, IBM, Johnson and Johnson, Apple, Google, Facebook, Amazon, to name a few, would find these prescriptions of hedge funds suicidal. Yet, even they are not beyond reach of these hedge funds as institutional investors keep pouring money into their coffers, unless, as some have done, they adopted a capital structure that keeps the control of the company in the hands of the founding entrepreneurs.

Some activist interventions might help create some real enduring value (and not just wealth transfer). But what are those interventions? What is the context surrounding those events? What are the characteristics of useful interventions? Are there ways to encourage interventions that do contribute to better governance and discourage "interventions" that will only harm companies? Can boards take a more "active" role in governing corporations without infringing on management's prerogatives? Answers to these questions are urgently needed.

22 Leo E. Strine, Jr. "Can we do better by ordinary investors?", *Columbia Law Review*, Vol.114:449, 2014

23 Arthur Crozier, "A watershed year", *Activist Investing 2015*, p.6.

WHAT IS TO BE DONE?

To the extent that hedge fund activism overall is not considered beneficial to the industrial health of a society in the long-term, it raises the question of how to restrain their "interventions". There are several measures which would inhibit the spreading of this activism. Some have low plausibility in the context of American financial markets, although they are quite feasible in other jurisdictions.

1. **Institutional investors should stop backing wholesale activism by hedge funds**

   Institutional investors bear heavy responsibility for the emergence and mushrooming of activist hedge funds.

   A) Their "soft" activism, aided and abetted by proxy advisors and programs like Professor Lucian Bebchuk's *Harvard Shareholder Rights Project*, has taken the form of campaigns to remove all impediments to direct shareholder involvement in decisions that used to be the preserve of boards (staggered boards, poison pills, say-on-pay, majority voting, board nominees, hostile takeovers, etc.)[24]; in doing so, and irrespective of the merits of these proposals, institutional investors unwittingly facilitated the emergence and success of activist hedge funds.

   B) As matters now stand, institutional investors, foundations and public pension funds in particular, are the prime source of funds for these "activist" hedge funds.

   C) Increasingly, pension funds and other institutional investors support the campaigns of activist hedge funds against the management of companies in which institutional investors hold a substantial stake. We all understand the motivation of institutional investors and their need to generate yields on managed assets that match expectations, beat indexes and/or the performance of comparable funds. In that context, the pitch of activist hedge funds may be hard to resist, but resist they should if they come to the conclusion that, too often, their actions bring only short-term benefits and that the "wealth creation" of these activists consists in fact of "wealth transfer" from employees and debt holders.

   Some institutional investors, including BlackRock's Larry Fink, Vanguard's Bill McNabb, and in Canada, Mark Wiseman, CEO of Canada Pension Plan Investment Board and Michael Sabia, CEO of the Caisse de depôt et placement are taking steps to empower companies to focus on long-term, sustainable value and to resist short-term pressures. More funds should follow their lead.

24 For a discussion of this trend, see Andrew L. Bab and Sean P. Neenan, "Poison Pills in 2011," *The Conference Board Director Notes*, Vol 3, No. 5, March 2011.

2. Corporate debt could come with a put against some form of activism

Perhaps, corporate debt underwriters should include a covenant clause allowing debt holders to put the debt up for repayment (with suitable make-whole penalty), should an activist hedge fund call for cash disbursement in the form of share buy-back or enhanced dividends. Given the demonstrated effect of these actions on the value of a company's corporate debt and the spreading popularity of such "activism", that would seem a prudent move.

3. The sacrosanct practice of one-share-one-vote needs to be examined in the context of the contemporary functioning of financial markets.

Financial markets are now rife with empty voting, total return swaps, huge quantity of stock derivatives and so on; there is no easy way to establish the equivalence between economic interest and voting power. Dual class of shares, the bogeyman of financial purists and unsophisticated investors, make that relationship very clear and transparent. That capital structure, when structured with safeguards for minority shareholders, has the very significant advantage in this age of unfettered activism to place a company out of reach of hedge funds. Several American companies of note have adopted this form of capital structure: Berkshire Hathaway; Google; Facebook; Groupon; Expedia, UPS; Tyson; Ford, Nike, The NY Times; News Corp; CBS, Comcast, etc. It also includes some entities one would not expect, given their devotion (for others) to unfettered capitalism and shareholder sovereignty: Blackstone; KKR; Apollo; Pershing Square Holdings, Third Point, etc. Of course, for the large number of widely-held, one-share-one-vote companies already in operation, there is no way back. Entrepreneurs should consider this form of capital structure at IPO time.

4. The right to vote shares should be acquired only after a one-year holding period.

Another dogma of financial markets, the acquisition of voting rights at the time of share purchase, deserves a close examination. It should be pointed out to those, like Mr. Icahn, who advocate for enhanced democratic rights for shareholders, that in all democracies the right to vote is linked to citizenship and, for people not born in a country, that right to vote in that country is acquired after some period of residence. Although paying all pertinent taxes from arrival, immigrants do not get the citizenship and right to vote for a variable period of time. Also, of course, tourists do not have the right to vote if they happen to be in the country for a short visit on Election Day. Yet, when it comes to shareholding, new "immigrants" and "tourists" get to vote. It would be a drastic change, but one for the better, if the right to vote shares would be acquired only after a one-year holding period. That suggestion was made by several observers[25, 26, 27]. The adoption of this measure, combined with reduced support by institutional investors, would greatly curtail the ability of activist hedge funds to bully companies.

5. Boards should become "activists"

No doubt that much improved fiduciary governance was put in place in listed corporations at the express demand of institutional investors. However, this form of governance, with increasingly detailed and fastidious governance practices is quickly reaching a point of diminishing returns. Furthermore, it never addresses the fundamental problem of governance: the asymmetry in information, knowledge, and experience between management and board members. (For an excellent review of these issues, see the Conference Board Governance Center White Paper[28])

Corporate governance of the widely held corporation often becomes a fiduciary façade for shareholders, a simulacrum of decision-making authority over management. Board members, through no fault on their part, remain surprise-prone, dimly aware of various goings-on in the company, poorly informed, dependent on a management that they are ill-equipped to challenge.

25 Yvan Allaire, "Corporate citizenship and the right to vote: A proposal," Institute for Governance of Private and Public Organizations, Policy Paper #2, November 2006.

26 A task force set up by the Aspen Institute to address market short-termism proposed among its recommendations time-phased voting. The signatories of the paper issued on September 9, 2009 and titled *Overcoming Short-termism: A Call for a More Responsible Approach to Investment and Business Management*, include, among others, John C. Bogle, Warren E. Buffet, Louis V. Gerstner Jr., Martin Lipton, Jay, W. Lorsch, Ira Millstein and Lynn A. Stout.

27 Various panels at the World Economic Forum discussed this issue.

28 S. Jain, B. Blackford. D. Dabney, and J.D. Small III "What is the Optimal Balance in the Relative Roles of Management, Directors, and Investors in the Governance of Public Corporations", *The Conference Board Governance Center White Paper*, 2014.

Is that the best we can do? That is the fundamental dilemma of corporate governance. That is also the wedge with which activist hedge funds find their leverage.

Resolution of this dilemma will not come from a further tightening and refining of fiduciary governance. We must develop a new way of governing, a new definition of the role of the board of directors in the widely-held, publicly listed corporation. *Boards must take on a more "activist" role geared towards building long-term sustainable value for the company;* but that is a formidable challenge.

Yet, the boards of widely-held firms must cope with this challenge, lest corporations get shoved around by emboldened, mushrooming, cash-rich activists.

About IGOPP

THE REFERENCE IN GOVERNANCE MATTERS

Created in 2005 by two academic institutions (HEC Montréal and Concordia University – The John Molson School of Business) and the Stephen Jarislowsky Foundation, the Institute for governance (IGOPP) has become a centre for excellence about governance of public and private organizations. Through research, training programs, policy papers and participation in public debates, IGOPP has become a key reference on all issues of governance in the private and public sectors.

OUR MISSION

- Strengthen fiduciary governance in the public and private sectors;
- Make organizations evolve from a fiduciary mode of governance to a **value-creating governance®;**
- Contribute to debates, and the solution, of governance problems by taking positions on important issues and by a wide dissemination of information and knowledge about governance.

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The Institute's activities focus on the four following areas:

- **Policy papers**
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