Writing the Activism Playbook

Schulte Roth & Zabel's Global Shareholder Activism Group

HAMLIN LOVELL IN CONVERSATION WITH ELEAZER KLEIN AND JIM MCNALLY

With offices in New York, Washington DC and London, Schulte Roth & Zabel (SRZ) is a leading law firm serving the alternative investment management industry, and the firm is renowned for its shareholder activism practice. Marc Weingarten and Eleazer Klein, New York-based SRZ partners, serve as co-chairs of the firm's global Shareholder Activism Group.

The Hedge Fund Journal met with Klein and London-based corporate and funds partner Jim McNally for a wide-ranging discussion on activism. SRZ and Activist Insight hosted a seminar entitled "Shareholder Activism in the UK", that highlighted the continuing growth and success of shareholder activism. SRZ and Activist Insight also recently published *The Activist Investing Annual Review 2016*, which analyses statistics on campaigns, details emerging trends, profiles key players in the activism market and offers predictions. Data collected by Activist Insight suggests that shareholder activism continued to grow worldwide in 2015, with the number of companies subjected to public demands reaching 551, up 16% from 2014. In the majority of cases, activists' demands have been at least partially satisfied, according to Activist Insight.

FASTER SETTLEMENTS

Hamlin Lovell: Activist Insight says the time taken for a company to settle with an activist was 74 days in 2013, and decreased to 56 days in 2015. Why would companies settle faster?

Eleazer Klein: Activism is being recognised as a legitimate asset class and getting more acceptance in the United States. And you're seeing that recognition in the United Kingdom and Europe as well, albeit at a slower pace. As a result of that, companies are looking to avoid the fights which are a distraction and an expense, and the statistics show them that when they go to a vote, in over 60% of cases the activist succeeds in getting people on the board. If you start looking at those numbers, companies that know the odds are more inclined to say this is not worth the fight.

HL: And will this trend continue?

EK: As you're seeing the numbers on time to settlement drop, the more interesting question is will you see a backlash from that? In the sense that, are the investors getting what they need consistently enough through these settlements to make it worthwhile? Because sometimes, by virtue of any settlement, you may not get what you need to take the campaign to fruition. From an activist perspective, if your thesis is "I need to get A, B and C done to fix this company", and as part of the settlement you can only get A done, then fixing A and not being able to have the influence you thought you would have to fix B and C may not work in your favour in the long term.

We'll see if there is a slowing of settlements as activists start thinking they've got to stick to their terms or be willing to not settle, to get the results they need.

HL: How is the dialogue between boards and activists changing?

Jim McNally: There's not necessarily a change in the law or the regulation as to what you must do, but there's a change in the conversations between activists and boards, and they're perhaps more willing to engage at an earlier stage and have a grown-up conversation rather than spending the time and money (the target company's money) fighting a long battle that ends up in an embarrassing defeat.

CRITERIA FOR REPORTING ACTIVIST SHAREHOLDINGS

HL: Are there clear criteria for determining whether you need to submit a 13D filing, allowing for some activism with a stake above 5%, or a 13G filing for a passive investment above 5%?

EK: I'd say there are three situations: sometimes it's obvious who is passive, sometimes it's obvious who is active, sometimes it's unclear. But there are people who, for example, will never file a passive 13G even though they could, and will default always to filing a 13D. You can't file a 13G if you're active, but you can always file the 13D even if you're passive. There are people who don't want to indicate to the market that they're passive, so, they only file 13Ds. So, for them, it's never a question.

In the grey area, there are a lot of questions. Are you going to be an activist? Are you there yet? Have you threatened the company? Are you pushing the company? Are you just talking as an investor (which you're allowed to do without having crossed the line)?

HL: Shifting to the United Kingdom, does the same apply?

JM: In the United Kingdom you don't have to worry quite so much about which kind of filing you're making because you don't have to spill the beans in the same way that you do on 13D; you don't have to say what you're going to do in the same way.

HL: Back to the United States, are the criteria for deciding between 13D and 13G the same as those for deciding the investment-only exemption under Hart-Scott-Rodino (HSR)?

EK: They're very similar but not identical, in that HSR is looking for not exactly the same things. For example, contracts for difference and other derivatives generally don't count for Hart-Scott purposes; HSR counts voting securities, those that have the present right to vote for directors. You can acquire a lot of things that don't give you voting securities that may count for 13D purposes, but they

don't count for HSR purposes. Furthermore, HSR is a prospective obligation; if a filing is required, it needs to be made – and the waiting period must be observed – prior to making the reportable acquisition.

The general question about whether you're passive or active for 13D or 13G filings is very similar to the determination of whether you're eligible for the investment-only exemption under HSR. But it's not identical, and that's a conversation we have all the time with people who are evaluating, should I do an HSR filing or shouldn't I? It's very similar but there are very nuanced differences in terms of what they're looking for. The HSR guidance on the investment-only exemption is very focused on behaviour that would be inconsistent with an intent to acquire solely for the purpose of investment, such as seeking board seats or proposing actions requiring shareholder approval.

However, the FTC's leadership has reiterated that they intend to view the exemption narrowly, so the contemplation of such actions may be enough to make the exemption unavailable.

As a result of recent actions in this area by the governmental agencies, there's been growth in being more conservative about HSR analysis than there was before. The way that HSR is being interpreted is evolving, including some actions where the five-member committee that oversees HSR enforcement at the FTC decided three-to-two to go after people – the two dissenters were very vehement in their disagreement with that – but it shows you how close the call is, even among the governing officials in the FTC and DOJ.

At the end of the day, that three-to-two edge makes you more conservative than it was before, because that carries the day, three wins over two.

HL: And, does the 5% threshold for 13D filings apply across the whole capital structure?

EK: In general, yes, but again there are exceptions to everything. It's more of a complicated question, but for the most part the assumption is yes, it will flow up to the management level because they're the ones that are exercising that type of investment and voting discretion. And that's how it's tested in our rules, so it will flow up across the whole capital structure, with some exceptions.

HL: And, what happens if companies have multiple different share classes? Is the effective threshold then much lower as a percentage of the total issued capital?

EK: It depends. It's really a factual question of analysing the capital structure itself and how it's determined. For the most part, a simple example in the United States involves a public company that has a class A and a class B stock. Even if they're not exchangeable into each other, the starting point is to test it on a class-by-class basis, so you have to cross a threshold on either class A or class B. Depending on similarities between the classes that may not be the ultimate outcome.

Where it becomes more complex is that frequently the one class, which is usually a super-voting class, will be exchangeable into the other class. That exchange right gives you exposure to not just the class you hold, but to the class that you can exchange into under the United States rules. So as a result of that you have to analyse both of them and you may be crossing thresholds in one with the other or both at the same time.

HL: Are shorts within the same firm netted-off against longs for filing purposes?

EK: No, they're not netted. US determination for a beneficial ownership is based on your long exposure, not short exposure. You may have to disclose your short exposure as part of a filing, but it's not netted, meaning, if you own five, and you're short one, it's not netted at four, and therefore you don't have to report. If you're long five, you have to report that.

HL: And if companies are doing share buy-backs, how quickly does the share count get updated?

EK: In the United States, the rules are that it has to be updated on a quarterly basis, so if you're a US reporting company (and not as a foreign private issuer, where reporting is less frequent), you have three quarterly 10-Qs and one annual 10-K as your four quarterly reports, with one of them being an annual report.

A company is required to disclose in those reports what their share count is and what buy-backs they have done. Companies may disclose it earlier through various filings, such as 8-Ks in the United States, but they're not required to. So in terms of absolutely knowing what the share count is at any given time, without asking the company or having the company disclose it in some other manner, the only way you will know is by watching those quarterly or annual reports to see it.

HL: And in the United Kingdom?

JM: Well, the rules are pretty similar in that respect; companies need to publish data as to the number of their shares in issue and in what class, though here in the UK that needs to happen at the end of each month and not quarterly. It is from those figures that activists will work out whether they have a reportable position under the Disclosure and Transparency Rules; for regulated firms disclosure would normally start at 5%, as it does in the United States. It's also worth remembering that where the issuer is subject to a UK takeover offer (or is the offeror of such an offer which includes paper consideration (excepting most kinds of debt securities)), there is a second reporting regime under the UK Takeover Code where the threshold is much lower, at 1%. **THFJ**