Because stockholder activism strikes at the heart of a company’s governance structure – often threatening the continuity of a board and the management team alike – the topic is susceptible to fear, uncertainty and doubt. However, much can be done in advance to both understand common activist motivations as well as be better prepared.

Stockholder Dynamics

The background context for activism has evolved significantly in the recent past because:

- **A Shrunken Population of Public Companies Coupled With an Increase in Activists.** The sheer number of U.S. public companies has shrunk essentially in half – from around 8,000 companies in 1995 to around 4,400 companies today, including a few hundred foreign companies listed in the United States and called foreign private issuers. Of those 4,400’ish companies, the median market capitalization is approximately $750 million, meaning that only 2,000 or so companies have material scale. Moreover, activism has never been more prolific, meaning the chances of a company — even smaller public companies that historically may have slipped under the radar — experiencing an activist campaign are materially higher than in the past.

- **The Rise of Rules-Based Investors.** The continued explosion in assets under management (AUM) at rules-based funds, whether mutual funds such as Vanguard or exchange traded funds (ETF) such as those promulgated by BlackRock and State Street Global Advisors (SSgA) has come at the cost of ‘active’ fund managers, such as T. Rowe Price and Fidelity Investments, an industry group that has seen their AUM shrink in the aggregate. In fact, BlackRock, Vanguard and SSgA—in descending order of size—have become the “Big Three” investors in U.S. equity markets. Those Big Three also vie for differentiation — given that their products are similar, and their margins are razor thin. The result is twofold: The Big Three can afford to invest in larger, robust corporate governance departments and have done so, though not to the extent that some governance proponents advocate is sufficient. Second, they concurrently are less dependent on the recommendations of the two major proxy advisory services, Institutional Shareholder Services (ISS) and Glass Lewis.

- **Stockholder Engagement.** Both routine and event-driven stockholder engagement, including directly by boards and not just management, has become de rigueur. And in the event of a contested proxy, every stockholder is critical, because if The Big Three split their vote (such as what happened when BlackRock and Vanguard diverged in Procter & Gamble’s seminal board contest in 2018), other investors — whether institutions or retail — suddenly become much more relevant. Accordingly, companies should continue a well-thought out regimen of open stockholder engagement.

What is meant by the term “activist”?

An ‘activist’ investor is simply a stockholder who advocates privately, publicly or both for economic or governance changes at a publicly traded company. Some examples of various activist buckets include:

**Economic (Hedge Fund) Activists:** This category best embodies popular notions of activism, consisting of privately held investment funds, or ‘hedge funds’ in common parlance. These funds often are organized around a central principal. A few funds are multi-strategy private investment funds where one part of the business may be arbitraging sovereign bonds while another side is advocating for a board change at a public company. In recent decades, economic activism has risen to record levels of affected companies. Many ‘lieutenants’ to larger-than-life figures have struck out on their own—and, in fact, their own lieutenants sometimes break off to form funds. That said, the pace of activist campaigns has generally held steady in the past couple of years. While
the amount of assets under management (AUM) on the one hand remains orders of magnitude higher than two decades ago, on the other hand, activist funds have seen outflows most recently, mimicking the outflows generally from actively managed investment alternatives while index funds continue to increase their relative market position.

Environmental, Social and Governance (ESG) Activists: This category is wide ranging but includes three principal divisions:

- **Social action groups**, usually focused on a single issue/area, from pay equity to climate change to labor conditions.
- **Pension funds**, such as CalPERS or the New York City Comptroller’s Office, lobbying for governance changes, such as increased board gender diversity or proxy access.
- **Individuals**, including a small but committed band of individuals, popularly labeled ‘corporate gadflies,’ most significantly John Chevedden, James McRitchie and William Steiner, who use the relatively low SEC threshold for submitting stockholder proposals of at least $2,000 of stock held continuously for at least one year to advocate for governance changes such as the ability for stockholders to call for a special meeting or majority voting.

Boards need to monitor and engage with a broad spectrum of the above stockholder constituencies. However, while some pension funds may advocate for ‘withhold’ votes on a board director, ESG stakeholders have not historically spearheaded initiatives to wrest control of the board through a contested proxy for insurgent directors. Accordingly, this article focuses more squarely on hedge fund activists.

**How do economic activists accumulate their position?**

To realize financial benefit, hedge fund activists must accumulate a financial position that will benefit from the expected catalyzing reactions leading to improved stock price performance. This analysis omits discussion of short-sellers, who are betting on decreased stock performance and can be quite vocal in doing so — but are an entirely different flavor to deal with.

**Stock Ownership**

**Run Silent, Run Deep:** The primary mechanism for taking a position is simply purchasing shares, usually on the open market. The activist’s goal is to do so with the lowest cost basis possible. Therefore, secrecy is vital. If the markets learn that a particular activist is accumulating a position in a given company, it will generally boost share price, thereby frustrating the activist’s goal of the lowest cost possible.

**Schedule 13D Grace Period:** If an activist intends to acquire 5% or more of the outstanding stock of a company, the activist will need to file a detailed disclosure form on Schedule 13D, the implications for which are discussed in greater detail below. However, the filing deadline for the Schedule 13 is the tenth calendar day following tripping the 5% acquisition threshold.

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**Stock Surveillance:** The ability to ‘run silent, run deep’ leading up to the 5% level, and then in the 10 calendar day window thereafter, demonstrates the utility of an effective market trading surveillance system by a company’s investor relations department.

- **Small- and Mid-Cap Company Dynamics:** For mid-cap companies, which currently have up to a $1.8 billion market capitalization, where less than 5% would not trigger antitrust approval filing requirements, also described below, an activist has significant leeway in opportunistically acquiring stock up until the 4.99% level. But once the activist crosses into 5% and greater territory, a 10 calendar day stopwatch is ticking.

- **Large-Cap Company Dynamics:** For companies above $1.8 billion in market capitalization, an activist will hit a pre-acquisition antitrust approval requirement at $90 million worth of stock in 2019. In addition, obviously a relatively small percentage ownership in a company can soak up a relatively large portion of available investing dry powder for a given fund. Accordingly, activists may not often reach the 5% filing trigger for a Schedule 13D. It is sometimes tempting for directors or management to dismiss an activist with a hypothetical 1% equity position as immaterial to a stockholder election. But
that position may represent double- or triple-digit millions in absolute value. Moreover, such dismissal also ignores the important state-of-play between activists and other prominent institutional investors.

**Schedule 13D: Why 10 Days?** Some advocates have argued that the Schedule 13D 10 calendar day grace period, which harkens back decades—well before modern technology communications improvements—is antiquated and should be shortened, perhaps to two or three days. The Dodd-Frank Act in 2010 authorized the SEC to reduce the Schedule 13D grace period, as well as incorporate derivatives into Schedule 13D’s definition of beneficial ownership, further described below. However, to date, the SEC has chosen not to act on either. In 2016, certain senators proposed legislation to shorten the grace period to two days. The bill, called the Brokaw Act in reference to a bankrupt town that had a shut-down plant of Wassau Paper Company which had been targeted by activist Starboard Value, has not progressed since Senate hearings in 2018.

**Derivatives**

**What is it?** A derivative is simply a contract for financial value, such as a put, call or swap, whether privately or publicly disclosed or traded. In the case of an activist investor, a common derivative is a cash-settled Total Return Swap (“TRS”) in which the activist’s economic risk mirrors the floating stock price, such that an activist gets paid if a given stock price increases or, in turn, has to pay the counterparty, often an investment bank, if the stock price decreases. Another derivative is a call option that is designed to optimize antitrust notification strategies discussed below.

**Keeping Ears Open:** If a derivative is for a material position, depending on the particular bank’s risk exposure, a bank may, in turn, seek to hedge the counterparty — and so even if a derivative is not disclosed in and of itself, such as on a Schedule 13D, a surge in derivative activity or trading desk calls for a specific stock is something that remains difficult to become aware of but for which a financial advisor with a sophisticated trading desk can keep antennae attuned.

**Not Counted for Triggering Schedule 13D...:** Derivative positions are not captured under Schedule 13D solely for the purpose of determining shares beneficially owned that in turn count to the 5% filing threshold because there is no beneficial ownership of actual shares—i.e., no voting rights—whether for a physically settled or cash-settled derivative. An activist thus can hypothetically acquire 4.99% or less of a given stock and not become publicly known, subject to no antitrust filing requirement, but still acquire “synthetic equity” derivatives to supersize the position.

**...But Disclosable Once Schedule 13D Is Triggered:** Conversely, once a stockholder is subject to Schedule 13D, the stockholder must disclose equity-linked derivative contracts on its Schedule 13D filing.

**Bylaws Derivative Disclosure:** Although the SEC and courts have been reluctant to change that disclosure landscape, companies can attempt to force disclosure in situations where an activist remains under the Schedule 13D 5% filing trigger but wants to force a tangible stockholder action—either through a stockholder proposal or a contested director election. This is accomplished through having the bylaws require disclosure of derivative interests. While there are different flavors of such bylaw requirements, having a lengthy description requirement would not seem to have a downside for a company, since it remains a disclosure-only requirement.
Surfacing in Public: It is the third or fourth move on the chess board, not the first

The first step in an activist’s typical ‘playbook’ will be to screen for companies that meet certain economic criteria. Some of the more common factors, which are discussed in a subsequent section of this article in greater detail, include:

- **Capital Allocation Policies:** Does the company have ‘excess’ cash being ‘hoarded’, or a balance sheet that is perceived as ‘too strong’ and thus capable of having a leveraged recapitalization and dividend to stockholders?

- **Operational Policies:** Has the company suffered execution challenges and thus may be ripe for strategic and operational optimization, such as reducing its cost structure to increase operating income and free cash flow?

- **Strategic Alternative: A Sale:** Is the company in a rapidly consolidating or disrupted industry where it could be asserted that the stockholders are holding a ‘melting ice cube’ and would purportedly realize greater net present value from a sale of the company now rather than continuing to bear execution risk into the future?

- **Strategic Alternative: A Spin-Off:** Has the company grown to become a putative conglomerate that is too large to execute effectively but, conversely, where splitting up the company could ‘unlock’ value because the value of the sum of the future parts would materially exceed expected future market capitalization?

**Could a Campaign Succeed?** A near-simultaneous second step will be to sort by capital structure: Does the company have dual class voting stock, where one class has super-voting rights—customarily 10 votes to each vote of the other class? An activist will likely avoid a dual class voting stock company because it lacks a viable path to exerting leverage if the company remains effectively controlled by the super-voting stock, generally held by founders.

**Rallying Institutional Support:** Once a company has been selected through the screening process, an activist may actively seek input from institutional investors—whether ‘passive’ index funds, also known as ‘rules-based’ funds, or active managers such as mutual funds or pension funds—on the company. An activist will want to be careful to avoid creating a ‘group’ for disclosure purposes under Schedule 13D, but at the same time, can ask seemingly innocuous ‘fact-finding’ questions about an investor’s perception of the company’s financial performance and governance structure. Companies should be cognizant that major activists often will be reticent to launch a campaign without having an informed thesis on whether major stockholders are open to supporting the activist’s goals.

**The Wolf Pack:** An activist may also ping other similarly positioned activist hedge funds. Again, most activists will want to avoid forming a ‘group’ under Schedule 13D, as well as potentially tipping off other buyers who could both drive up stock prices and leak the news to the media. However, pre-public communication can lead, particularly with smaller companies where positions are more affordable, to several activist hedge funds taking positions around a campaign—creating a complex multi-variable dynamic colloquially labeled the ‘wolf pack.’

**Doing the Research:** Many activists will go to great lengths in doing research on a subject company. This may involve engaging contract experts to provide market or personality-specific insights. And some activists will write lengthy white papers both pointing out a company’s shortfalls as well as pushing the activist’s suggested changes. Such research could be ladled out in stages after an activist goes public, or could be held in reserve, particularly early on in a process while the activist assesses the company’s openness to the activist.

**Approaching the Company—the ‘Constructivists’:** Prior to going public, many activists will approach a company’s board either informally or accompanied with a formal letter. Some activists—referred to sometimes as ‘constructivists’ and perhaps most signified by ValueAct Capital—will openly state that they wish to avoid a public spat and will reference their prior engagements and management and board references. These activists are generally perceived as less threatening—or at least less likely to engage in open public hostility, at least at the outset.
Surfacing in Public

All of the above activist preparation can and most often does happen before an activist surfaces publicly. Surfacing may simply be the filing of a dry Schedule 13D, but most often the Schedule 13D contains an advocacy letter that represents the first public broadside against management and the board.

**Schedule 13D:** As described earlier, U.S. securities laws require the filing of a detailed disclosure document, the Schedule 13D, if a stockholder holds at or over 5% of a company’s outstanding stock and has the intent to change or influence control of the company. Thereafter, changes of plus or minus 1% of the company’s outstanding common stock must be disclosed in an amendment that is to be 'promptly' filed which in practice means within two business days.

**Exemptions from Schedule 13D:** An investor with only a ‘passive’ intent—interpreted as voting shares but not otherwise seeking to change or influence control—can file a perfunctory Schedule 13G.

### Schedule 13G Filers

<table>
<thead>
<tr>
<th>Level of Ownership</th>
<th>Qualified Institutional Investors</th>
<th>Passive Investors</th>
<th>Exempt Investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>5%</td>
<td>Within 45 calendar days of end of calendar year of acquisition.</td>
<td>Within 10 calendar days of acquisition.</td>
<td>Within 45 calendar days of end of calendar year of acquisition.</td>
</tr>
<tr>
<td>10%</td>
<td>Within 10 calendar days of month end of acquisition.</td>
<td>Promptly, generally meaning within 2 business days.</td>
<td></td>
</tr>
<tr>
<td>20%</td>
<td>Loss of eligibility. Must file Schedule 13D within 10 calendar days.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Changes of 5% or more</td>
<td>After exceeding 10%, changes of 5% or more must be disclosed within 10 calendar days of the month end of such change.</td>
<td>After exceeding 10%, changes of 5% or more must be disclosed promptly, in practice meaning within 2 business days.</td>
<td></td>
</tr>
</tbody>
</table>

**Schedule 13G Nuances:** Calculating Schedule 13G filing requirements can be a bit complex, with three categories of filers:

- **Qualified Institutional Investors:** Banks, insurance companies, mutual funds and pension funds.
- **Passive Investors:** Not a qualified institutional investor, but has no intent to gain or influence control; excludes by definition directors and officers.
- **Exempt Investors:** Acquired stock pre-IPO and does not further acquire 2% or more in any subsequent rolling 12-month period. If they trip the 2% limit, they have 10 calendar days to file a Schedule 13D and then become subject to amendment requirements under Schedule 13D.
Antitrust and Activists: The Role of HSR

While the Hart-Scott-Rodino Antitrust Improvements Act of 1976 ("HSR") is normally thought of in the M&A context, it also has implications for activist investors, as its filing requirements may force an activist to surface.

**Conventional M&A Context:** HSR is the U.S. pre-closing antitrust approval mechanism for mergers and acquisitions, which is overseen jointly by the Federal Trade Commission and the Department of Justice’s Antitrust Division, a dance that in and of itself has complex dynamics. In M&A deals, following the signing of a definitive agreement, a buyer will then file HSR materials and hopefully have ‘early termination’ of the statutory 30-calendar-day waiting period or, if less fortunate, will receive a ‘second request’ for information or a request to ‘refile’ the initial filing, either of which extends the path to closing.

**But HSR Is So Much More:** However, HSR is not limited to M&A. It applies to any acquisition of voting securities so long as the acquisition triggers the quantitative filing threshold, which in 2019 is $90 million, and the purchaser is not purchasing less than 10% of the company ‘solely for the purpose of investment.’ Antitrust authorities have taken an expansive view that most activist activities disqualify activists from the ‘investment only’ exemption and in the past few years have brought notably expensive enforcement actions against activists who incorrectly attempted to rely on this exemption. This brings a regulatory difference where an activist may not qualify for the ‘investment only’ HSR exemption with the FTC/DOJ, but if an investor generally has only had discussions on business execution, executive compensation or general corporate governance issues with companies, that activity generally would continue to make the investor to be deemed ‘passive’ for purposes of Schedule 13G eligibility with the SEC.

**How HSR Surfaces an Activist:** Prior to acquiring more than $90 million worth of a company’s stock, an activist investor must thus file an HSR application and concurrently notify the applicable company. To the extent that the stock position does not constitute 5% or more of the company (for example, in 2019 a $90 million purchase of a company with market cap of just over $1.8 billion) the HSR filing will alert the company earlier than a Schedule 13D deadline. Moreover, the FTC publicly publishes lists of cleared HSR applications and so savvy media, or other observers can note such announcements, which therefore may prompt an activist to pre-empt it simply launching public disclosure of the position.

**How Activists Can Maneuver Within HSR:** One way to push the timing of an HSR filing is for an activist to purchase call options with unusually high exercise prices such that the economic basis is substantively locked-in, but the activist has not yet acquired actual voting securities unless and until the option is exercised or other stock acquisitions trigger the filing.
A Preparation Checklist for Companies

Companies can take several advance steps to prepare for an activist situation, including:

- **Structural Defense Legal Review:**
  Specifically, scrubbing the bylaws, charter and board corporate governance policies for potential issues.

- **‘Red Team’ Analysis:**
  Companies, often with a financial advisor, can proactively address potential economic arguments. Separately, companies can also have candid and constructive introspection about other likely areas of perceived weakness, such as corporate governance practices, executive compensation or regulatory challenges, as discussed further herein.

- **Coordinate and Enhance Investor Relations:**
  Regularly ensure opportunities for debriefs about contacts that could indicate brewing activity. Assess a strong stock surveillance program.

- **Monitor SEC Filings:**
  Any investment fund with at least $100 million in AUM must file a Form 13F online with the SEC within 45 days after the end of a given quarter that details their holdings of publicly traded companies. These filings, in concert with Schedules 13D and 13G as well as antitrust filings, form a regulatory mosaic of snapshots of holdings by large activist hedge funds.

- **Have a Back-Up Press Release:**
  Draft a short back-up release with commitment to both stockholder engagement and reviewing the activist’s communication substantively. Separately, contemplate beginning the draft of a back-up release that is a more thorough rebuttal of likely associated governance or economic points based on the results of the reviews recommended above.

- **Identify Prospective Advisors/Identify the Team:**
  As discussed further below, interview and gather input on various advisors likely needed.

- **Adopt a Clear Board Communication Policy:**
  Ensure the company’s board has a clear policy on board members communicating with stockholders, including activists. Such a policy may require the board to funnel all attempted contacts to a designated director, such as the board chair or chairs of the compensation committee—given the importance of say-on-pay votes—or of the nomination and governance committee. This protects the current board by ensuring unity of messaging and avoiding Regulation Full Disclosure (Reg FD) inadvertent violations. It is also important for boards that ultimately gain activist nominees as members, who should receive customary onboarding training on compliance with securities laws.

- **Have a Poison Pill ‘On the Shelf’:**
  While shareholder rights plans come in different flavors and are controversial, most companies should consider having their lawyers in advance draft a form of pill and their financial advisors create a financial model to use in pricing the exercise price for the rights when and if they are issued in the future. While rights plans can be adopted on short notice, planning ahead will even further shorten the lead time if and when it is recommended to ‘break the glass’ and adopt a pill.
Assembling the Team

If an activist surfaces, you’ll want a working group to help navigate potentially choppy waters ahead. There is indeed a balance between having too many ‘hangers-on’ in a process, but conversely also risking not getting fulsome and diverse viewpoints from a robust advisory group that collectively has worked on different campaigns and draws on that aggregate experience. General working groups would include:

- **Legal Counsel:** Obviously most public companies will have experienced in-house and external counsel for public reporting and board governance purposes. A company should ensure, however, that it also has counsel—whether at the same law firm or not—that has specific domain expertise in activism.

- **Financial Advisors:** Most large investment banks have dedicated stockholder activism practices, separate and apart from customary industry/company financial advisory coverage. Banks can be helpful in bringing to bear centralized experience, as well as helping assess the commercial/economic landscape. This may include adopting certain financial strategies such as a leveraged recapitalization that is effected either through dividends or stock buybacks. And even routine buybacks may be helped through automatic stock repurchase programs (“ASRs”)—derivative products offered by many banks.

- **Public Relations:** There are a handful of public relations firms that specialize in contested proxy or hostile M&A situations. This is entirely separate from routine PR assistance given to an IR department. As with other advisors, having domain experts who also have significant experience against specific activists or in specific industries is helpful in providing insights.

- **Proxy Solicitors:** Likewise, there are also a handful of proxy solicitor firms that have contested election expertise. Solicitors fulfill three functions: First, they generally are skilled at understanding beneficial ownership positions in terms of which activist historically is known to use a given securities custodian in order to help match-up unusual activity before an activist may surface either in private or public. Such analysis also can be helpful once an activist engagement is underway to understand stock acquisitions or dispositions that don’t reach the level of amending Schedules 13D or for other stockholders who are subject only to Schedule 13G. Second, proxy solicitors have their customary duty of driving the vote for a stockholder meeting. Third, and importantly, proxy solicitors can have a very technical understanding of Delaware voting procedures. Unfortunately, stockholder voting is not straightforward because of an arcane ‘proxy plumbing’ system in the United States arising from beneficial ownerships and intermediaries such as the Depository Trust Company (DTC). Too often in closely contested elections, an election team of proxy solicitors and lawyers will be dealing with ‘hanging chad’ analogous situations that can materially impact election outcomes.
Frequent Activist Objectives

- **Shake Up the Board:** Often an activist will suggest that a board should be refreshed with new members. They may suggest specific candidates for a board to review. And there are times when a board should not hesitate to ask an activist for specific names. Many activists, particularly at smaller funds, will be reluctant to have a fund principal join the board because of the resulting imputed insider knowledge, creating Reg FD issues and making the activist subject to the Company’s insider trading policy which in turn would restrict an activist’s ability to freely buy and sell the Company’s stock. That said, some activists, particularly at some of the largest funds, will frequently have an affiliate as a board nominee. This serves as public evidence that they are not short-term opportunists and results in such funds opting in to insider trading compliance restrictions.

- **Operational Optimization:** Activists will often seek to establish key performance indicators—a minimum operating income percentage or an absolute amount of free cash flow. To achieve this increased financial discipline may require a significant reduction in spending—often feared as a slash to future R&D and investment and thus long-term prospects—to bolster current financial luster. But an activist ‘white paper’ may run the gamut of operational suggestions and delve deep into the company. Perhaps most infamously, Jeff Smith’s Starboard Value fund advocated that Olive Garden’s pasta water needed salt before succeeding in replacing its parent company’s board.

- **Capital Allocation Strategies:** Capital allocation, along with strategic activity, can be a very contentious area of dispute.

  - **Getting Cash to the Company:**
    - **Existing Cash:** A company may simply have a perceived ‘excess’ amount of cash on its balance sheet.
    - **Leveraging Up:** However, an activist may go much further and advocate that the company borrow against its balance sheet either through a private financing or using debt capital markets (DCM), known as a leveraged recap.
    - **Converts:** Finally, similar to a conventional credit facility, an activist may argue for a convertible note offering predicated on the theory that stock price will appreciate in the future from other activist-driven improvements, which would offset dilution from the resulting future note conversion into equity.

- **Getting Cash from the Company to Stockholders:** Activists may advocate for putting dollars back in the pockets of shareholders in a number of ways.

  - **Dividends:** A company can simply send back a dividend, though this is hypothetically problematic because it is tax-disadvantaged, currently at a federal rate of 20%, compared to a simple stock buyback, where no tax payment is due.

  - **Stock Buybacks:** A stock buyback in theory should be a simple linear mathematic equation: Repurchase a certain number of shares that thus reduces the denominator of outstanding shares while holding the numerator of company value constant. In practice, however, buybacks rarely result in directly proportional increases in share prices, though arguably they do not have to in order to be at parity with dividends, given the tax on dividends. A buyback may be accomplished through three means:
    - **10b-18 Repurchase Program:** Similar to a 10b-5 ‘pre-programmed’ purchase plan for insiders, such as directors and officers, a 10b-18 is adopted by a company when it does not possess material non-public information and is then executed algorithmically while a company’s insider trading window may be closed.
    - **Automatic Share Repurchase (ASR) Program:** This is a derivative contract written by an investment bank, where the Company effects a purchase from the bank and the bank must then unwind its position over time. An ASR usually is a one-time, immediate impact for the
Company, while the bank obviously embeds a premium for its own profit margin.

- **Opportunistic Open Market Purchases:** A company may avoid both of the prior alternatives and simply repurchase stock from time to time in the open market so long as the company does not have material non-public information and its general compliance trading window is open. While this ensures hitting the lowest price possible and avoiding paying a bank premium in an ASR, conversely, it may take an extended period of time, which may not accord with an activist’s time horizon.

- **Strategic Activity:** An activist may advocate that a company needs to either be sold outright or should divest certain assets through a sale to a third party or a spin-off to ‘unlock’ value in a ‘sum of the parts’ analysis. Many times, a company’s board may agree in principle with the activist, but not want to publicly acknowledge this because of the inherent uncertainty that would be brought to employees, customers and vendors, as well as disruption to any already-started strategic sale process. However, an activist may want that very public acknowledgment to spark additional bids or drive up the stock price, allowing the activist to then quickly exit at a profit. One avenue of compromise is to have the board form a ‘strategic committee’ that avoids specifically stating an investment banker has been engaged to sell the company on one hand, but on the other hand sends a clear signal that the company is committed to exploring strategic avenues.

- **The Union of Governance and Activism:** Note that the above objectives are economic in nature. However, activists will often use reasons that are not directly economic in order to undermine the credibility of management and directors, particularly on issues that other stockholders explicitly value. These reasons generally fall into two areas: Governance practices and executive compensation, with the following frequent questions:
  
  - In terms of governance practices, does a company have a combined CEO/Chairman position?
  - Does the board have long tenured directors and are directors viewed as potentially too close socially or otherwise to management?
  - Does a company have various technical governance features, such as not allowing stockholders to call a special meeting, that are viewed as challenging?
  - Has a company experienced unique regulatory challenges or enforcement actions?
  - For executive compensation, how has a company’s say-on-pay stockholder advisory approval vote turned out in recent years?
  - Are there any unusual or out-of-market perquisites for management or generous separation or change of control packages?
  - How does pay stack relative to peer groups and to financial performance of a company?

Companies must expect that an activist will take a fulsome approach to criticism. This increases the importance of a company needing to be honest and realistic when performing a self-assessment of potentially vulnerable areas, as well as acting pre-emptively to close off potential areas of criticism that, while not directly financially related, could bolster an activist’s arguments that a company needs change.
How to Respond to Activists at the Outset

• **Keep an Open Mind:** An activist is not necessarily a ‘bad’ thing for a company. Some activists are more accusatory than others. And all hedge fund activists necessarily have an economic motive. But incumbent management and directors in particular should generally keep an open mind at the outset. In addition, many board members have commented that activist-nominated directors often are constructive additions and their service also can often extend well beyond once an activist has exited a given position. Some would stigmatize any activist nominee, but the reality may be far more nuanced depending on the activist and suggested board candidates.

• **Don’t Ignore; Engage:** A board should, as a general matter, listen to all material stockholders. Sometimes a board, usually in concert with a management team, will adopt either the “ostrich head in the sand” strategy, or a “just say no” strategy—whereby the company either attempts to ignore an activist or alternately, digs in from the very outset. Both strategies do not let the company build a record of reasonable engagement and listening to proposals, even if ultimately a board decides that an activist’s ideas are unwise.

• **Resist Unnecessary Escalation:** Institutional stockholders generally are more amenable to voting for a management team and board if there is a record of reasonable engagement, per the above. Companies should resist instincts to match every public salvo from an activist with equal or greater levels of acrimony. Take the high ground. And sometimes starve the fire of oxygen. Obviously in certain situations, once reasonable engagement avenues have been exhausted, it may be time for a fight—and a pretty intense one at that.

• **Resist Short-Termism:** At the other end of the spectrum, most investors expect a robust, well-functioning board that takes reasoned positions. That means that a board that can enunciate a reasonable strategy and believes one or more activist ideas may be destructively ‘short-termist’ may well persevere in a proxy contest. A popular and heated area for this is capital allocation: Loading a company with debt to shovel cash out the door to current stockholders may undermine a company’s ability to invest and execute for the long term. A board should not hesitate to take reasoned, thoughtful positions that reject an activist strategy—but in doing so, also ‘fill the vacuum’ with an action plan of its own to address an activist’s presumable other operational complaints.
Activist Leverage Tools

**Director Nominations:** The most common form of tangible leverage is for an activist to threaten to run new director candidates.

**Nominee Independence and Qualifications:** As noted above, most activists want full freedom to trade a company’s stock without having to worry about insider trading compliance rules. This means that director nominees who end up serving on a company’s board cannot be directly employed and as such be direct affiliates of the particular hedge fund. Once candidates are identified, the company’s nominating and governance committee should undertake both an interview process, as well as receiving customary director questionnaires and conducting routine background checks, just as it would with any other nominee.

**Short Slate vs. Full Slate:** Current SEC rules allow a stockholder to solicit a proxy using a minority of its own candidates and to fill out the remainder of the ‘slate’ with incumbent directors, without the consent of such incumbents. However, an activist cannot suggest a majority (but not all) of new board candidates and fill out the minority of remaining slots with incumbent directors without receiving the incumbent directors’ permission, which in practice is a non-starter. Accordingly, under the current U.S. system, an activist faces a binary choice to propose either a (a) ‘short slate’ of a minority of new candidates rounded out by a majority of incumbents, or (b) ‘full slate’ of all new director candidates to replace the entire board.

**Nominee Deadlines:** Most companies have ‘advance notice’ bylaws provisions for director nominations. The most common formulation is to require such nominations between 90 and 120 days prior to the anniversary date of the last annual meeting. Such provisions have technical requirements that are important for a company to verify an activist’s compliance, specifically evidence of the activist being an actual ‘record holder’ with the company’s transfer agent, rather than simply a ‘beneficial holder’ through a brokerage account or third-party custodian.

**Proxy Cost/Logistics:** Putting forward either a short slate or full slate of dissident director nominees can be expensive, if not very expensive. The proponent must have an SEC-compliant proxy statement drafted by securities lawyers and then have that proxy statement and accompanying proxy card printed and mailed to stockholders. Further, the proponent normally will want to elect to hire a proxy solicitor to rally the dissident vote. This significant total cost historically has been a deterrent for activist campaigns, particularly those at small public companies.

**Proxy Access:** Over 80% of S&P 500 companies have adopted ‘proxy access’ bylaws provisions, the most common formulation of which allows a group of up to 20 stockholders who have held a combined minimum of 3% of outstanding stock for at least three years to nominate up to 20% of a company’s board. The SEC attempted to require this through regulations that it introduced in 2010, but which were subsequently struck down in 2010 on the ‘technicality’ that the SEC had not properly evaluated the additional time and cost burden the regulation would place on companies. However, institutional stockholders have encouraged companies to adopt these provisions on their own, called ‘private ordering.’ When proxy access is adopted by a company, proxy access-eligible nominees must then be included in the company’s proxy statement, avoiding the need for the drafting, printing and mailing of a separate proxy statement. Actual usage of proxy access has been very limited to date. Moreover, these provisions are drafted by companies such that they do not permit stockholders who intend to obtain or influence control to nominate board candidates, thereby stymying activists from using them.

**Universal Proxy Card:** Governance advocates for many years have lamented the complexity and increased risk of confusion from the current system of battling proxy cards, arguing that a company’s card should have to include dissident director nominees in principle. For the first time ever, in 2019, a company used a universal proxy card after pressure from an activist investor. One can expect that large institutional investors may encourage a universal proxy card in future contests. In addition, the issue has been on the SEC’s radar for a prolonged period and is likely to be the subject of continued SEC examination and potential rulemaking.
Stockholder Proposals: Activists may sometimes threaten a stockholder proposal either on a stand-alone basis or in concert with a contested director election. Stockholder proposals are particularly attractive when either an activist has insufficient time before a deadline to provide a fulsome slate of director candidates, or where the activist thesis revolves around a central issue.

Submission Eligibility: Under SEC rules, stockholders may make proposals for inclusion in a proxy statement so long as they have owned ‘of record’ (i.e., again, directly with the company’s transfer agent and not through a beneficial ownership system such as a securities brokerage or custodian) at least $2,000 worth of company stock continuously for at least one year. If a stockholder wishes to resubmit a proposal in subsequent years, the proposal must have received a minimum percentage of votes in the last annual meeting to remain eligible. In November 2019, the SEC proposed new thresholds to increase the barrier to entry for stockholder proposals. The current and proposed minimum requirements are as follows:

SEC Requirements for Stockholder Proposals

<table>
<thead>
<tr>
<th>Period</th>
<th>Current Requirement</th>
<th>Proposed New Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction/First Year</td>
<td>At least $2,000 of stock continuously held for at least one year. Note, must be held ‘of record’ and not beneficially at time of submission of proposal. Requirements above hold for all subsequent years.</td>
<td>At least $2,000 of stock continuously held for three years; or At least $15,000 of stock continuously held for two years; or At least $25,000 of stock continuously held for one year.</td>
</tr>
<tr>
<td>Second Year</td>
<td>Received at least 3% of support at prior meeting.</td>
<td>Received at least 5% of support at prior meeting.</td>
</tr>
<tr>
<td>Third Year</td>
<td>Received at least 6% of support at prior meeting.</td>
<td>Received at least 15% of support at prior meeting.</td>
</tr>
<tr>
<td>Fourth Year and Thereafter</td>
<td>Received at least 10% of support at prior meeting.</td>
<td>Received at least 25% of support at prior meeting.</td>
</tr>
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</table>

Rule 14a-8 Exclusions: Stockholder proposals are subject to a complex regulatory process with the SEC. Often a company will attempt to exclude a stockholder proposal under permitted exemptions stipulated in Rule 14a-8. Historically, a company would then apply to the SEC for a ‘no-action’ letter that significantly helped inoculate the company from stockholder litigation risk for such exclusion. However, the SEC is changing its practice and may no longer issue written no-action letters, which in turn, theoretically, could make exclusion decisions by a company more susceptible to court challenge.

Precatory Proposals: Stockholder proposals are almost always ‘advisory’ in nature. However, the threat of a stockholder proposal is longer term. If an ‘advisory’ proposal passes with majority support, or even a high minority vote turnout, institutional stockholders may not take kindly at the next annual meeting if the company has in the intervening year chosen to ignore the vote from an ‘advisory’ proposal.

Two Forms: Proxy Solicitation or Floor Vote. Under SEC rules, in order for a stockholder proposal to be eligible for inclusion in a company’s proxy statement, it must be submitted at least 120 days from the anniversary of the last annual meeting, or if the date of the current annual meeting has changed from such anniversary by more than 30 days, then a ‘reasonable time’ after the announcement of the current annual meeting. If a stockholder misses a submission deadline, then the stockholder will not be eligible to solicit proxies using the company’s proxy statement. However, subject to complying with individual company bylaws, the stockholder can still appear at the annual meeting and introduce the proposal on the floor of the annual meeting in a ‘floor proposal.’ Absent extraordinary circumstances, a floor proposal is highly unlikely to garner material support because stockholders must be physically present at the meeting rather than having submitted votes through the proxy system.

Conclusion

The above is a preliminary primer for when activism becomes more critical to your company. There are a plethora of factors that impact a given company and, therefore, advice necessarily must be bespoke. However, the overarching message is to remain calm and have a long-term focus—a continuing primary theme of Delaware corporate law. This article is meant to spark ideas and questions: Please contact your advisors for advice and discussion.