



*Journal of*

# APPLIED CORPORATE FINANCE

## In This Issue: **Activist Investors and the Future of the Public Corporation**

Ernst & Young Roundtable on  
**Activist Investors and Their Implications for Corporate Managers**

**8** *Lucian Bebchuk, Harvard Law School; Paul Clancy, Biogen; Don Chew, Journal of Applied Corporate Finance; John Cryan, Fortuna Advisors; Shyam Gidumal, Ernst & Young; Paul Hilal, Pershing Square Capital Management; Patrick Lally, Red Mountain Capital; Greg Milano, Fortuna Advisors; Damien Park, Hedge Fund Solutions; Richard Ruback, Harvard Business School; and David Silverman, Blue Harbour Group. Moderated by Jeff Greene, Ernst & Young.*

**In Search of Unicorns: Private IPOs and the Changing Markets for Private Equity Investments and Corporate Control**

**34** *Keith C. Brown and Kenneth W. Wiles, University of Texas at Austin*

**Revisiting “The Fruits of Genomics”:  
How the Biopharma Industry Lost But Is Now Regaining its Productivity**

**49** *A. Rachel Leheny and Eric W. Roberts, Valence Life Sciences*

**Be Your Own Activist**

**61** *Gregory V. Milano and John R. Cryan, Fortuna Advisors*

**A Long Look at Short-Termism: Questioning the Premise**

**70** *Michael J. Mauboussin and Dan Callahan, Credit Suisse*

**The Activist Investor Process Model:  
Phase One of a Successful Campaign—Identifying a Target**

**83** *Damien Park, Hedge Fund Solutions, LLC and Troy Marchand, Foundry Capital Group*

**The Hazards of Growth**

**88** *Kevin Kaiser and S. David Young, INSEAD*

**The Value of Reputation: Evidence from Equity Underwriting**

**96** *Chitru S. Fernando, University of Oklahoma; Vladimir A. Gatchev, University of Central Florida; Anthony D. May, Wichita State University; William L. Megginson, University of Oklahoma*

**CEOs, Abandoned Acquisitions, and the Media**

**113** *Baixiao Liu, Florida State University, and John J. McConnell, Purdue University*

**How Much Do Expatriate Earnings and Repatriation Taxes Matter to Shareholders?**

**122** *Robert Comment*

**Shrinking to Grow: Evolving Trends in Corporate Spin-offs**

**131** *Marc Zenner, Evan Juneck and Ram Chivukula, J.P. Morgan*

**Creating M&A Opportunities through Corporate Spin-Offs**

**137** *Mieszko Mazur, IESEG School of Management*

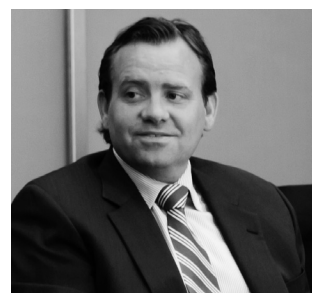
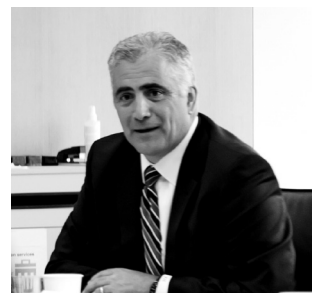
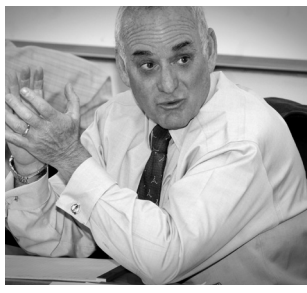
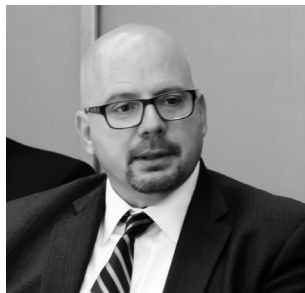
**Multiples, Forecasting, and Asset Allocation**

**144** *Javier Estrada, IESE Business School*

Ernst & Young LLP Roundtable on

# Activist Investors and Their Implications for Corporate Managers

New York | May 28, 2015



**Jeff Greene:** Welcome, everybody, to this discussion of the recent transformation of activist investing, both from an investor and a company perspective. I'm Jeff Greene, the Global Transactions Leader for the Life Sciences Sector here at Ernst & Young LLP. And on behalf of my two colleagues in organizing this event, Greg Milano of Fortuna Advisors and Don Chew of the *Journal of Applied Corporate Finance*, I want to thank you all for taking time out of your busy schedules to talk about this timely and important subject.

In my experience, preparing to receive the attentions and scrutiny of activist shareholders has become a way of life for the boards and C-suites of even the largest companies. While some debate continues as to whether and how activists add value, we're seeing a shift both in the focus of such investors and in the way companies respond. Let me introduce the excellent panel we've assembled to explore these issues:

**Lucian Bebchuk** is the William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance at Harvard Law School. Lucian is also the founder and director of the School's Program on Corporate Governance, as well as a member of the American Academy of Arts and Sciences and the National Bureau of Economic Research. I should also mention that Lucian is one of the co-authors of a newly published study, called "The Long-Term Effects of Hedge Fund Activism," that has received a lot of attention from publications like *The Wall Street Journal* and *The New York Times* and that we expect to play a major role in this discussion.

**Richard Ruback** is also a Harvard professor—although in Rick's case it's the Harvard Business School—where he is the Willard Prescott Smith Professor of Corporate Finance. He teaches corporate finance as well as a very popular course on the financial management of smaller firms with Royce Yudkoff. That class has been so popular that a recent *New York Times* article about the role of women at HBS ended up holding up Rick and Royce's course as a model for the rest of the school.

**Paul Clancy** is the Chief Financial Officer of Biogen, a job he's held for the past eight years. On his first day of taking that job, Paul was informed that Carl Icahn had just purchased a large stake in Biogen, one that he ended up owning for four years. Paul has been with Biogen for a total of about 15 years, after spending 14 years at Pepsico. And from my own long experience in life sciences, I can tell you that Paul is widely regarded as one of the most corporate finance-savvy CFOs in the sector.

We also have four representatives from the activist investing community:

**Paul Hilal** is a partner at Pershing Square Capital Management, a well-known activist hedge fund that today manages about \$20 billion. Paul has been with Pershing for close to a decade, where he has led multiple activist engagements and served as a shareholder representative on the boards of three public companies.

**Damien Park** is the owner of Hedge Fund Solutions, a company he founded 15 years ago whose main activity is advising

both corporations and investors on matters related specifically to activist investing. What's more, Damien just finished leading an activist campaign in which his investor clients will not only get a few members on the company's board, but Damien himself will actually end up joining the board as its Chairman.

**David Silverman** is a Managing Director of Blue Harbour Group, an activist investor fund that was started about ten years ago. The firm generally has as few as 10 to 15 portfolio companies at any given time, and tries to work behind the scenes in a "friendly engagement model."

**Patrick Lally** is a Partner at Red Mountain Capital, which describes itself as a "constructive activist fund" and is based in Los Angeles. They have a long-term investment horizon, take sizable positions in each of their portfolio companies, and engage with management teams on a collaborative basis, often at the board level. Partners of the firm currently sit on the boards of five of the ten companies in which Red Mountain is invested.

**Shyam Gidumal** leads Ernst & Young LLP's client work around activist investors. His group's main focus is helping companies anticipate issues that activists might raise, prepare for their engagement, and then support our clients' interactions with activists when they arrive. Before joining our firm, Shyam was active in private equity and served as CEO and Chief Restructuring Officer for several publicly and privately held companies.

**Greg Milano**, one of the co-organizers of this event, is the CEO and founder of Fortuna Advisors, a shareholder value-focused strategy consulting firm that advises companies on everything from business strategy, portfolio management, and capital deployment to performance measurement and incentives. Greg has been successful in helping managers think more like private owners inside the public company; and by so doing, he has helped persuade companies to do a lot of the same things that activists do before they arrive on the scene, and without all the public argument.

Also joining us is Greg's partner, **John Cryan**, who also did a lot of work in organizing this event. John is the co-founder of Fortuna, where his main role is to try to be a catalyst for helping his clients design and implement strategies for long-term value creation.

**Don Chew** has been the editor of the *Journal of Applied Corporate Finance* and its predecessors for well over 30 years now. He was also a founding partner of Stern Stewart & Co., the well-known corporate finance consulting firm—where Greg Milano, incidentally, was also a partner. During Don's tenure as editor, the *JACF* has been sponsored or owned by a number of financial institutions, including the Continental Bank and Bank of America for about 15 years and, most recently, Morgan Stanley, for nine years.

So, we have a distinguished cast of characters, one that includes two well-known academics, one corporate CFO, and several activ-

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ists and consultants. And given the *JACF's* general approach of starting with the theory and then moving on to practice, let's begin by asking Lucian to summarize the findings of his new study.

Lucian, would you please start us off?

### The Record of Activists: What Do They Accomplish in the Long Term?

**Lucian Bebchuk:** Thanks, Jeff. As Don requested, I will give a brief overview of the main findings of a study by Alon Brav, Wei Jiang, and me that recently came out in the *Columbia Law Review*. The study, titled "The Long-Term Effects of Hedge Fund Activism," empirically tests the validity of the "myopic-activists" claim that has played a central role in debates about activism and about corporate governance generally. The claim is that activist interventions by hedge funds lead to corporate actions that improve short-term performance and stock prices at the expense of long-run performance and shareholder value.

This claim has been made by various prominent participants in the ongoing debate about activism. For example, Bill George, the former CEO of Medtronic and now an HBS faculty member, has argued that activists seek changes that drive up the share price and enable the booking of quick profits, and then "bail out, leaving corporate management to clean up the mess." And Marty Lipton, the prominent corporate lawyer credited with inventing the poison pill, has portrayed activist investors as "preying on American corporations to create short-term increases in the market price of their stock at the expense of long-term value."

This myopic-activists claim, which is

often invoked in corporate governance debates about the proper role and influence of shareholders, has been used to support various measures that insulate boards from shareholders. This claim has been used to justify, for example, staggered boards, limits on the rights of short-term shareholders, low-threshold pills, and tightening the disclosure rules governing stock accumulation by activists. This claim has also been routinely used in urging boards to take an adversarial position vis-a-vis activist investors.

Although the myopic-activists claim has been regularly and forcefully put forward, supporters of this claim have not backed up their assertions with empirical evidence. Instead, they have either relied on anecdotes or simply assumed the validity of this claim. In fact, a couple of years ago, following a debate on the rules governing stock accumulations by activists that Marty Lipton and I had at the Conference Board, Lipton issued a challenge to me to study empirically the long-term effects of activist interventions.

At the time, it was already well documented that activist interventions are accompanied by short-term spikes in the stock price. For Lipton, however, such positive stock price reactions are just a manifestation of an inefficient market that fails to appreciate the adverse long-term effects of the actions sought by activists. In a widely circulated public memorandum, Lipton asserted that the important question to study is how the operating performance and stock returns of targets fare during the 24-month period following the activist intervention.

That's the question that Brav, Jiang, and I answer in our new study. In investigating this question, we used the full

universe of activist interventions during the 14-year period from 1994 through 2007. And we analyzed the long-run operating performance and long-term stock returns that follow activist interventions.

When examining changes in operating performance, we used two standard metrics: Tobin's Q and ROA. We found that, rather than increase in the short-term and then decline in the long term, both metrics tend to be consistently higher three, four, and five years after the time of intervention.

We also failed to find evidence in support of the myopic-activists claim when we looked at stock returns and stockholder wealth. Like prior studies that focused on short-term stock returns, we found a large and significant positive return accompanying an activist's announcement of a stake. Most importantly, when we tested the question that Marty Lipton posed—namely, what happens to stock returns after this short-term increase?—we found no evidence for the feared long-term reversal in the operating performance and stock returns of targets. The evidence is thus inconsistent with the concern that the initial spike represents the market's failure to appreciate the long-term consequences of activism.

Finally, we find no evidence that negative long-term abnormal returns follow the exit of activists—that is, the sale of their stakes. And so the data is inconsistent with the "pump and dump" claim that activists bail out, at the expense of long-term investors, before things start going south.

Our study thus concludes that there is no support in the data for the "myopic-activists" claim that has played a central role in opposition to hedge fund activism.

Our study thus concludes that there is no support in the data for the myopic-activists claim that has played a central role in opposition to hedge fund activism.



Lucian Bebchuk

There are no doubt many other important questions about investor activism that remain to be discussed. But the concern that activist interventions are followed by long-term costs to targets and their long-term investors should not continue to shape the debate going forward.

### The Evolution toward a More Constructive Market for Corporate Control

**Greene:** Thanks, Lucian. Now let's hear from Rick Ruback of the Harvard Business School. Rick, can you reflect on Lucian's study for us?

**Richard Ruback:** In the interest of full disclosure, I should say that I've known Lucian—and Alon Brav, one of his co-authors on this paper—for a couple decades now. And I have enormous respect for their work. Lucian and his colleagues conduct their research like very competent financial economists and statisticians.

When I think about activist investors, I go back to some work I did with Michael Jensen in the 1980s. The focus of that work was a set of transactions that we followed the late Henry Manne in calling the

“market for corporate control.” We were looking at a number of different ways of bringing about changes in corporate control. Back then it was mainly mergers and tender offers. Mike and I were impressed with tender offers at the time because they were more hostile than mergers and, for that reason, tended to produce much better results for the shareholders of the acquiring companies. At the same time, though, we also started to see an increase in these things called “proxy fights.” But in those days, they were typically messy, ineffective tools that rarely succeeded in helping shareholders.

What I find remarkable about today's investor activists is the way that our corporate control markets have succeeded in transforming what was once an incredibly blunt tool—proxy fights—into what I would describe as their “sharpest knife.” What I mean is that today's activism has become the least disruptive of all the possible ways of persuading management, if not to give up control, then at least to change those of its policies that appear to be reducing profitability and value.

And let me explain the reasoning behind this statement: from the takeover literature,

we know that to get a hostile takeover done, a would-be acquirer needs to offer the target company shareholders a premium over current market value of about 30% or 40%. And that in turn implies that values have to be 30% or 40% below what the most efficient users of those assets can reasonably expect to achieve before setting those users in motion and getting them to act. Today's investor activism, by contrast, requires much less of a drop in value to prompt some kind of intervention—and in that sense it's a much more cost-effective tool for ensuring better corporate control.

So what, then, is the theoretical case *against* the activists? Corporate finance theorists who are critical of activist investors tell themselves a story—and it's certainly a theoretically possible story—that goes like this: the corporation is being run reasonably well, but management has some secret strategy that, for some reason, it either can't communicate to the market, or is unwilling to communicate because it thinks its competitors will be able to copy it. And as a result, the value of the firm in the marketplace is well below the “intrinsic value” that the insiders believe with conviction to be its true worth. Typically, there is also some

short-run, more visible but less valuable strategy—like cutting capital investments or costs—that would interfere with the hidden, higher value strategy.

So, what we have, then, is a kind of information problem that creates a “gap” between intrinsic value and the market value. The insiders are sure that this gap is real, and are convinced the hidden strategy makes sense. Then along come these activists who force them to abandon the long-term hidden strategy that will create enormous intrinsic value to force the company to pursue the shorter-term strategy that is less valuable but that they can explain to the marketplace.

Now, although I think this situation is theoretically possible, I find it hard to believe it’s actually true in all but a handful of cases. It is more often somewhere between a hope, a dream, and a fairy tale. Why do I say that? For companies with well-developed track records in which the CEOs have been able to say, “Look, I’ve delivered before, I can deliver again”—my sense is these companies don’t become a target for the activists. I think that management has an obligation to communicate its strategy to the marketplace and build credibility in the market. Generally, management ought to be able to communicate a value-enhancing story to the marketplace, provided there is one.

So, all in all, I’m a fan of activism. And my sense is that the knee-jerk reaction against activism has more to do with preserving the culture and prerogatives of the board and little if anything to do with producing higher returns for the shareholders. I think activism is a force that, for the most part, is working toward more corporate accountability and higher share-

holder value—and it’s doing so without highly disruptive transactions like mergers or tender offers. It is a much less destructive tool than any of the ones we have seen in the past.

### A Corporate Perspective on Activism

**Greene:** Rick, that’s a unique description of the typical justification for resistance to activism as “something between a hope, a dream, and a fairy tale.” And it might provide a nice segue to Paul Clancy’s experiences at Biogen.

**Paul Clancy:** As Jeff told you earlier, I was appointed CFO of Biogen on a Monday and on the next day it was announced that a well-known active shareholder had taken a large position in our stock. Without getting into specifics, let me just say that I think that a lot of what happens when companies are faced with shareholder activists is pure theater—it’s just a sideshow, a distraction from the most important economic events that are taking place. Many activists like to use the media to increase the pressure on boards and management teams.

But that said, both my own experience—and that of other companies I’ve observed—suggests to me that, in general, the increase in investor activism is a positive development. There’s a good deal of truth in the conventional wisdom that activists tend to be attracted to companies that appear to be complacent, have poor performance, or, in some cases, experience some bad luck. Corporations sometimes get too comfortable.

Any combination of these factors can increase the likelihood that an active shareholder takes an interest in a com-

pany. The objective of public corporations is to increase their intrinsic value—that is, the long-run value of their operations—at a rate that is at least equal to their cost of capital, over a long period of time. But you don’t have to do it every quarter. The best companies have been able to earn long-run average rates of return that are well above their cost of capital.

In the world of health care, companies have clinical trial “readouts” that can cause their stock prices to go massively up or down overnight. And the companies may not be doing anything different going into or as a consequence of that readout. During my 15 years at Biogen, I’ve seen both sides of the coin; we’ve had positive outcomes that have caused our stock price to soar, and negative ones in which the price plummets.

The importance of the macro environment is also critical when evaluating corporate performance. My sense is that activists are generally pretty good at taking the macro environment into account because they’re incredibly objective. The reality is that the macro environment has a large impact on management’s ability to create value and on the strategic landscape a company is playing in. One obvious example of this is the level of, and the rationale for, consolidation in a given industry. On a broad level, the pace of consolidation is influenced by whether there are economies of scale in an industry, where the consumer is migrating, and even the interest rate environment.

Another example today of an important outside force is the regulatory environment. Specifically, in a lot of high-margin industries where IP can be moved around, taxes have played a pretty critical role over the last couple of years. And

What I find remarkable about today's investor activists is the way that our corporate control markets have succeeded in transforming what was once an incredibly blunt tool—proxy fights—into what I would describe as their “sharpest knife.” My sense is that activism is a massively more efficient way of exerting corporate control and improving corporate performance than what we've had before.



### Rick Ruback

the combination of some of these issues is more likely to lead to shareholder value creation driven by consolidation. Activists are often very astute at identifying these trends. And this means that companies, in order to maximize their own value, generally have to understand the macro environment, where they play in the industry landscape. For many companies, these macro factors can have a bigger impact on value than their operating performance or management of costs.

Management's deployment of capital is also, without doubt, a very big deal for shareholder value creation. Over a long period of time, making the right acquisitions or failing to make them, returning capital to shareholders or wasting it on low-return investments—these kinds of decisions are critically important in determining whether a company creates value.

And that means that capital allocation is also critically important in whether a company attracts the attention of activist investors.

Also very important is the annual budgeting of capital and other resources for existing businesses, or what I like to call “resource allocation.” In my experience, perhaps the most effective way of doing resource allocation is to set up the P&L on a rolling basis—that is, project not only next year's P&L, but one for the next three years out and one for the next five years. For most companies, the natural or “default” solution is to allocate the same resources to an established business as it spent the previous year. But that's not what great companies do. The best companies are always working hard to force waste out of the system—while at the same time making large investments in

the future of the company. Those are the kinds of companies that, although they may have a down year from time to time, succeed in increasing future cash flow and creating large amounts of value over time.

**Greene:** Paul, Rick Ruback talked about the gap between intrinsic value and market value as partly a failure of management to communicate. Can you give us your view of this short-term/long-term problem?

**Clancy:** One of the biggest challenges facing corporate America right now is getting companies to reduce their focus on short-term P&L measures as the primary yardstick for evaluating performance. Most successful corporate managers get their start in an organization in one of the operating units. Early in your career when you're running an operating unit you are likely

to be evaluated using short-term operating metrics. But by the time you become part of a senior management team or are actually running a large corporation, you discover that the most important decisions involve making investments, making longer-term tradeoffs between today's profits and future earnings and cash flows. But when companies report to Wall Street, most of the discussion continues to focus on those relatively short-term measures, mainly because they're much easier to measure and communicate—measures like annual revenue growth and earnings per share.

My experience at two large and successful companies over the past 30 years has only reinforced my conviction that what really drives the long-term performance and market value of a company is the concept of “intrinsic value” I mentioned earlier. As academics define it, it is the discounted present value of all the future cash flows of a company. Now this value is hard to measure for many reasons: it relies on forecasts that go well out into the future; and as a result, the answer will become clear only with the passage of time. Measuring it is more of a “craft” as opposed to a science.

**Greg Milano:** From a corporate perspective, it's also important to consider the market cycle—and the market's pretty high right now, in part because of the “artificially” low interest rates. At some point, interest rates are likely to be higher, and the market won't be so high; and there are a lot of companies out there now that are insulated from activists mainly by the level of their share price. The upside to the activist is now not large enough. If and when the market falls, I think the possibility of activism will become a lot more real for a lot of companies. Getting

ready now for that reality should be a priority for managements.

**Greene:** That also assumes the gap between intrinsic value and market value will increase when equity prices decline, possibly because investors become more skeptical of management's plans to deliver promised results.

### An Activist's Perspective

**Greene:** Okay, let's turn now to one of our investors. Paul, how do you and your partners at Pershing Square think about this gap that Rick talked about? How large does the gap have to be between your perception of what the company is really worth and where it's trading for you to make a move?

**Paul Hilal:** That's a good question, and it's something we think about all the time—but there is no simple answer. What I can say is that our strategy—which I describe as “capturing value for our investors by catalyzing value-creating change”—requires a higher expected risk-adjusted return than passive strategies.

There are a number of reasons for this. First, when we embark on a project, we are committed to following through. This can be easy and quick if the incumbent leadership of the company engages with us, takes the time to understand the value of our proposals, and acts decisively in the shareholders' best interests. If a company chooses not to, activists have three choices: (a) sell the position and move on; (b) repeat the proposal every quarter in the hopes that the leadership eventually does the right thing; or (c) create an opportunity for the shareholders to elect an alternate slate of directors who embrace the activ-

ist's proposals. We always choose path (c), which is often called a “proxy contest.”

Proxy contests can take multiple annual election cycles, consume many years of our team's time, and they cost tens of millions of dollars. Once the shareholders have installed directors open to an alternate strategy, helping the reconstituted board execute can take years, and it requires many “staff-person-years” of our team's time.

Longer-term projects have become increasingly the norm for us. In our early years we often pursued value-creating transactions, such as the breakup of non-synergistic businesses. Today a majority of our capital is truly permanent so we increasingly focus on longer-term projects, such as operational transformations. Because of all of the time and costs involved to effect operations-intensive proposals versus transactional proposals, we act only if we see an unusually high expected return from a project—again, much higher than a passive investor would require. We also require a high rate of “return on invested brain damage.”

**Greene:** Return on invested brain damage—that's a new metric.

**Hilal:** That's a term Bill Ackman coined and that we use internally. It is a measure of cash return on the expected staff-person-years of internal resource investment needed to earn that return. Our team's time is our scarcest resource.

I also would like to comment on a couple of related topics. First is the misframing of activist engagements as “power struggles” between an activist and the company. Both sides of this framing are off.



One of the roles performed by activists is that they actually take away options. My guess is that in most companies, most of the thoughts around portfolio restructuring and improvements in operating performance are probably kicking around the company. And what activists often do is to force organizations to come to a decision to do some of those things.

### Paul Clancy



First, I don't think it is quite right to say that the "antagonist" is the activist. Because activists rarely own more than 10% of a company, and because effecting change requires a majority vote, activists have no coercive power at all. All activists can do is highlight opportunities for improvement, and give shareholders an opportunity to vote shareholder-selected directors onto the board. Only broad-based shareholder action can actually effect change. So, on one side of the so-called "struggle" is the full shareholder base, not just the activist.

Second, I don't think it is quite right to say that the "defense" here is "the company." Often the only parties opposing us are the minority of directors that comprise a board's leadership, the CEO, and some of the management team. A majority of the other stakeholders—directors not in leadership, many executives, employees, customers, suppliers, unions, etc.—often

side with us, and sometimes even reach out through back channels looking to help us effect our proposals.

In my opinion, the more correct framing is usually one in which the company's shareholders (or stakeholders broadly) are opposing an entrenched board leadership and the CEO. The activist is just a catalyst and coordinator of an otherwise unorganized shareholder base expressing its will.

I would also like to circle back on Rick's comments that entrenched directors sometimes justify opposing the shareholders' expressed will by claiming that the shareholders' judgment doesn't impound non-public information or secret strategies. The directors are effectively saying: "you have lost confidence in us; but trust us, let us stay in office for a while longer because we know things you don't, and if you knew you would agree."

**Ruback:** I gather that you don't find that argument very compelling either?

**Hilal:** As you said, it's conceivable that it could happen every once in a while. But in the vast majority of cases, the company is just underperforming and needs new perspective on the board and perhaps also new executive leadership.

I want to really underscore that the large majority of corporate directors I have worked with over the years are very talented, impressive, accomplished, well-meaning, and conscientious people. I very much enjoy working closely with them, and afterward having a beer or dinner with them. They have seen so much over the years, and there is a lot one can learn from them. They are good, honest people committed to doing a good a job for shareholders and take their stewardship very seriously. And the exceptions to this rule are quite infrequent.

But sometimes groups of very talented, well-intentioned people can miss things, even very big things. “Group think” can set in, and the culture of the board and how it makes decisions can become dysfunctional—for example, a handful of particularly energetic directors can dominate a board and drown out the wisdom of a quieter majority. Because management exercises a lot of influence over the information the board receives, management perception biases and interests can end up distorting the picture that directors have of what is actually going on, compounding the problem.

Presented with an outside shareholder’s proposal, directors must accept either of two possibilities: (a) the outsiders advocating for change just don’t get it; or (b) their missteps over the years have resulted in shareholders missing out on billions of value. It is natural to struggle with objectively seeing facts that can support conclusion (b). This is human nature.

Strong directors will usually rise above any aversion to outside ideas. They will give the shareholder proposals an honest, fair chance even if it means admitting they may have missed some things. We are deeply gratified that, more and more each year, the proposals we advance are received with this kind of reaction.

Sometimes, however, a board won’t be as open as one would think they should be, and will either dismiss the proposals without serious consideration, or fail to see it objectively on its merits. It is a regrettable outcome.

Directors sometimes rationalize taking position (a) by arguing that the shareholders’ preference is due to a shorter-term investment horizon. The “myopic shareholder” rationalization

makes no sense and academics, including Lucien and his colleagues, have debunked this argument using both sound theory and empirical data.

**Ruback:** I agree.

**Hilal:** Rick, you also made a comment about board choices and the desire to preserve the board culture. We see this all the time. It shows up most clearly in boards’ selection of new directors or a CEO. Sometimes boards seek individuals who will fit in with their culture, when they should be thinking of what the company needs. When a company has been on a wrong track, the directors need to shake things up, overturn prior decisions, and disturb in-place culture and power structures. It can be difficult for boards to voluntarily step in that direction. While terrific in many ways, directors are still just people, and people aren’t perfect.

This brings me to the broader disconnect between governance and the challenge of stewarding the modern corporation.

First, the directors’ incentives are not appropriately aligned with the best interests of the shareholders they have been elected to serve. A director’s personal utility function is sometimes dominated by their personal pursuits, other more lucrative endeavors, and the incentive to avoid even attractive risks that could turn out badly. Because director incentives are misaligned, perception biases can sometimes lead directors to perceive things very differently from a shareholder who has enormous skin in the game.

Second, the magnitude of the incentives are not sufficient to compensate the directors for the increasingly complex work

required. The roughly two weeks per year directors are expected and compensated to spend on their stewardship role is simply not enough to do a job that gets harder and more complex each year. Since being appointed to the board of Canadian Pacific three years ago, I have spent roughly twenty percent of my time on board matters. I can justify that because we have a multi-billion dollar investment in the company. I couldn’t do that for just board fees.

Boards can solve both the alignment and complexity problems by giving two or three seats to a large, sophisticated shareholder who can bring its organizational resources to bear on a company’s problems. I think boards will increasingly see such shareholders as a prized asset and will genuinely welcome their rolling up their sleeves and helping out. And I think the results of this collaboration will be very impressive.

**Milano:** In the early to mid ’90s, I spent a lot of time at Stern Stewart working in South Africa. At that time, and it’s still true to some extent today though less so, there were several very large organizations with large stakes in public companies revolving around major insurance companies. They were similar to Warren Buffett’s Berkshire Hathaway. Like Berkshire Hathaway, they had resources and a lot of skin in the game; so they would put people on boards that would oversee and work with management to make sure things stayed on track. And these board members had the time and the incentive and the horsepower to do a good job of governing companies.

Many finance and governance experts felt that the South African governance model was actually much more successful

We very often find the only opposition is the minority of directors that comprise a board's leadership, the CEO, and some of the management team. A majority of the other stakeholders—directors not in leadership, many executives, employees, customers, suppliers, unions, etc.—side with us, and sometimes reach out through back channels looking to help us effect our proposals.

### Paul Hilal



than the U.S. model of highly dispersed stock ownership. And, Paul, it occurred to me that what you're really envisioning here is an ownership structure in which an otherwise dispersed and fragmented group of small shareholders is anchored by one or a few large investors—investors that are highly sophisticated, and have the resources, time, and skin in the game to put real effort into providing management with free advice and with votes that really matter because they have the same sort of upside interest as all the other shareholders.

#### The View of a Small-cap Activist

**Greene:** Paul, given the effect of increasing complexity on the costs of doing the extensive analysis you described, does that mean that activists will be choosing larger targets to go after?

**Hilal:** The amount of work required to help a company make the most of its

opportunities does not necessarily scale in a linear way with the size of the company, so I would say there are certainly some scale economies in activism. But there are also plentiful opportunities in these smaller companies. The smaller companies generally attract less sophisticated management, and they generally have less experienced and less sophisticated board members. So in many cases there can be even more opportunity for improvement—measured on a percentage increase in value—than in large caps. There are opportunities at both ends of the spectrum.

**Greene:** Patrick, you work at a hedge fund called Red Mountain that specializes in small-cap companies. Can you help us understand a bit more about the opportunities you're facing, and what markets want from the vantage point of your activist fund?

**Patrick Lally:** Red Mountain operates exclusively in the small-cap range, which we define as between \$300 million and \$3 billion. While opportunities clearly exist in larger companies, we think the small cap segment is particularly rich in activist targets. These companies fall under the radar of larger funds, are less followed by the Street, and afford greater opportunity for collaborative engagement. We often see thinly staffed and under-resourced management teams and boards that we think could benefit from our interaction. And since the founders of companies are often still serving as senior executives, the CEOs frequently look and act more like COOs, and the CFOs tend to have the profile of controllers. Particularly at these kinds of companies, we believe that Red Mountain has a tremendous amount of value to add.

**Greene:** Patrick, Paul has told us that Pershing's average holding period is four years. How does Red Mountain's holding period compare with that?

**Lally:** Our focus on small cap companies plays an important role in how long we tend to hold our positions, in large part because it affects the kinds of problems that we try to address. When thinking about an activist's time horizon, it is important to recognize how different styles and agendas dictate different horizons. In my experience, the duration of an investment is usually much more a function of the extent of the inefficiencies at the company in question than most people realize.

When we approach a management team, we have in mind a set of operational, capital allocation, and governance changes—and in some case even changes in strategy—that we expect to increase the firm's operating efficiency and long-term returns. But even though we expect all of our initiatives to increase shareholder value, they can require dramatically different amounts of time to accomplish. At one extreme are recapitalizations, major changes in the company's debt or equity structure, which can be completed pretty quickly. At the opposite end of the spectrum are some deeply operational initiatives we have designed to reposition an entire business or provide new growth opportunities. Such initiatives often involve significant input from management and participation from Red Mountain, and so they require a bit more heavy lifting as well as potentially several years to complete.

As for the larger question about why activist opportunities exist, I would like to echo Paul's comment that it is a

challenging job to be a CEO in today's business and market environment. I agree with that wholeheartedly, and I think the same goes for the board of directors. To function effectively, a board should have a tremendous breadth of human capital—a collective body of experience and knowledge that not only spans industries and areas of expertise, but includes experience and insights derived from having managed through economic cycles and in a variety of competitive environments. This requirement creates a complex set of demands that we think generates attractive opportunities for us to partner with management teams and their boards where we see significant room for improvement.

#### **What Gets Activists' Attention—and How Do Companies Respond to Them?**

**Don Chew:** Do the problems and solutions tend to be the same at large and small companies? Is it overinvesting, or the wrong capital structure typically? Or are some companies underinvesting in good opportunities? Or can it be any of those things?

**Shyam Gidumal:** We've done some research on the kinds of problems addressed by activists, and we think we have found one striking pattern. Our work concludes that activists have four main ways of increasing value, four investment theses if you will. One is to sell the company to a new owner who can realize a higher value for it. A second is to leverage the capital structure, dispose of excess assets, and return excess cash to the shareholders through increased dividends or stock buybacks. A third is to restructure the business portfolio, which

typically involves breaking companies apart into pieces and reallocating the capital. And fourth and last are operating improvements, which is the one that Paul and Patrick just emphasized.

When we look at the size of the companies, and at the trend over time, what we see in the case of large public companies is a substantial increase during the last five or ten years in the amount of activity around operational improvement and restructuring of the business portfolio. At the same time, company sales and recapitalizations have fallen off significantly, though they continue to be the largest categories of activist involvements with small and mid-cap companies. In the case of large-cap companies, by contrast, the bulk of the activist involvement today aims to break such companies into pieces and improve their operations. And this shift toward an operating focus has significantly changed the dynamics, the nature of the conversation between activists and corporate managements and boards.

More and more, companies want us to help them prepare for the possibility that an activist is going to invest and challenge their performance, or even their strategy. Many people view activism as primarily a contest between shareholders and management. But the reality is that the arrival of an activist also typically affects the nature of the conversation between the board and management, regardless of whether the activist ends up putting someone on the board or not. All of a sudden, in addition to discussions of earnings, the main subjects of conversation become things like return on invested capital, fully loaded costs, and competitive benchmarks. What are the best performance

measures for evaluating a management team, for holding them accountable in a meaningful way? And how should boards evaluate themselves? And is everybody on the board pulling their weight, performing their role? Are we getting the information that we need and are we making the key decisions that we need to? All these questions—many of them topics that are clearly core responsibilities of a properly operating board, but are often not on the agenda under normal circumstances—suddenly become central when an activist comes on the scene.

What's more, my experience suggests that for every company that has become publicly engaged with an activist, there is at least one other company that has had an encounter in which an activist came and then left without any public disclosure. And to me at least, that's an indication of how well-run, or well-prepared, such companies are. When an activist shows up and says, "We think you should do X, Y, and Z," the company wants to be able to say to him, "We talk about that all the time. We understand exactly why you might say that, we understand exactly how your math works out. We've had that evaluation done several times."

Because activists build their investment thesis from public information, they are at an information disadvantage with the company; there are things they can't know. When the company makes a compelling case that the activist investment thesis is flawed, there are two typical outcomes. In some of these cases, the activist will continue to hold the position passively. But in most they will say, "Thank you very much. I'll sell my position before I have to make it public."

So there is a lot of private activism taking place—and I think that it's on the whole very constructive—and in some cases even value-adding—private activism.

**Chew:** Do these cases show up in Lucian's study?

**Ruback:** They wouldn't show up. I was involved in some work in the early '80s that looked at 13D filings. So, instead of looking at activists, we looked at just everybody who files a 13D for a 5% holding and then traced through what happens. Although that was 25 years ago, my recollection is that, in about a third or even half of those cases, the ownership was either maintained or sold, but there was no transaction—which is consistent with Shyam's point about privately resolved deals. And I assume that those private resolutions are mostly happy endings, right?

**Gidumal:** That's right, and that's what we tell our clients to aim for. You want to be a company the activist believes is aware of and ready to address its problems. Either the activists think you're doing a great job, and therefore they're happy to own the stock and continue to ride it up. Or they say, "Okay, we get it—and they exit."

Now, one of the issues that often gets in the way of activist investment theses is taxes. No matter how much work somebody does from the outside, they generally can't understand the real tax implications of a possible transaction. Because if the tax bill is large enough, the benefit of a transaction or event is pretty much offset, and it no longer makes sense. If you make that known to the activists, they tend to agree that the thesis is flawed.

### Toward a Taxonomy of Activists

**Greene:** Damien, as the founder of a consulting firm called Hedge Fund Solutions, you do a lot of work behind the scenes with your corporate clients, right?

**Damien Park:** Yes, I do. For example, I got a call last week from a CEO who told me—and this is the first time I had ever heard this—that an activist approached him and said, "I've got some great ideas for your company, but I need *you* to sign a confidentiality agreement before I tell you about them." In the end, my client did not sign a confidentiality agreement but there was a constructive exchange of ideas that will likely continue between the activist and the company.

But I agree with Shyam that there is a great deal of activity going on behind the scenes, and it's going to increase dramatically. Why? Because the assets being managed by the activists—whatever the number, somewhere between \$100 billion and \$150 billion, it's really tough to tell—is now rising at a very rapid rate. And because it's still such a very small portion of the total capital invested in equity capital markets worldwide, there's a lot more room to grow.

Last week I advised an institutional investor that manages over \$700 billion and that is trying to figure out internally what kind of activist role they can and should play with their portfolio companies. They have so many investments spread across so many sectors that they're almost an index fund. And although they have a lot of good ideas for improving value, and say they want to engage more actively with companies, they're not quite sure how aggressive they should be and at what level they should be engaging. By charter, they can't be an activist in the

sense of running proxy contests to obtain board seats in companies whose shares they own. But they feel as though it's now become their fiduciary duty to engage with companies.

So, the question for them and many other large institutional investors is this: how actively do we engage by ourselves? Or does it make more sense to take our investment thesis and our significant ownership and voting power and go talk to Paul Hilal at Pershing, and then maybe say to him: "Paul, why don't you take the ball and run with it across the end line for us?"

So, what we're observing and advising on is this phenomenon of larger diversified investors trying to figure out how to play some kind of activist role. But it's going to be universal. Every institutional investor will eventually have some sort of activist aspect to it in the form of engagement with the board and with the company. Just the amount of capital alone in activism suggests that every company is going to be touched over the next five years. At the same time, I'm finding that more directors are meeting with company investors than ever before.

So things have changed a lot since ten years ago, when I'd call a CEO and say to him, "You have an activist in your shareholder base. Although they're sitting below 5%, there's little doubt that they're going to publicize their investment thesis soon and demand dramatic changes to your business." Far too often the response back then was that "we are confident that we're on the right path and not interested in speaking with activists."

But, as I said, things have changed since then. This past year, and for the first time ever, I've started receiving phone calls from board members saying

to me, "Look, we know we have to have this conversation in the boardroom, but we really just don't know where and how to begin. Sure, we've got our proxy solicitors, our law firms, and our investment bankers all weighing in on activism. But we really don't know where to begin the deep dialogue that we think we need."

I began that conversation with several board members this year in a number of different companies. The aim was to re-educate them about activism, what it means for their companies, and how they can be proactive about it. In my opinion, these discussions must begin with an understanding of the meaning of shareholder value. I've written hundreds of letters and press releases for activist investors—about their commitment to pursuing "long-term shareholder value."

And, Lucian, I was present at that debate between you and Marty Lipton a couple of years ago at the Conference Board. We spent a lot of time talking about the challenge of defining and measuring long-term versus short-term value. And I've tried to bring parts of that discussion back into the boardroom by asking everyone to give me their understanding of long-term shareholder wealth.

But let me raise the question here: What does long-term shareholder value mean when you're governing in the boardroom? How do you translate that objective into specific metrics that you can track and report to your investors? These are very difficult questions, and it's one hell of a job getting board members to provide answers. Because most people don't understand how long-run shareholder value is generated. They have a lot trouble grasping the concept of value.

**Greene:** But how do you explain concepts like discounted cash flow and future growth value to board members with little grounding in finance, to somebody who's basically starting from scratch? And how do you make it real when you're talking to management about the kinds of things you want them to do and the metrics you want them to use?

**Park:** It's not for me to dictate the metrics that they use. I let them tell me how they define it, and what they think they have to do to achieve it. Once you have a good understanding of that, you'll have a cohesive board with a single purpose, a definition of what value is, and a tangible goal. Once you have a goal, you can drive the business in that direction.

**Greene:** But what if they're used to thinking primarily in terms of EPS growth and revenue growth because that's what their investment bankers and sell-side analysts are always asking them about? Do you ever try to get companies to reexamine their goals?

**Park:** Yes I do, in the sense that I try to get them to explain to me how they are managing all of the company's assets for long-run value. I ask that they clearly articulate to me, as if I was a potential investor, how they are attempting to manage each of the businesses for long-run value, and why the company as a whole is worth at least the sum of the value of the parts.

**John Cryan:** Many of the problems that Damien's just described go back to what Rick Ruback was saying earlier. Far too many companies believe they

Many people view activism as primarily a contest between shareholders and management. But the reality is that the arrival of an activist also typically affects the nature of the conversation between the board and management, regardless of whether the activist ends up putting someone on the board or not.



## Shyam Gidumal

have a value recognition problem when what they really have is a value creation problem. They believe that “the market is not understanding my story,” instead of recognizing the value creation problem stemming from poor capital allocation or cost management. This leads too many underperforming companies to spend a disproportionate amount of their time trying to come up with the right IR spin—when what they really need to do in most cases is to tackle the value creation problems, and become their own activist.

I can remember the CEO of a materials company telling me, “We’re not feeling the love from the market like we should.” What he wasn’t seeing was that his company had invested hundreds of millions of dollars that failed to produce either new growth or adequate returns. It wasn’t the love of the market that was lacking; it was the fact that they were allocating capital into subpar return projects, making bad acquisitions across a disparate business portfolio that no longer hung together.

I would also say that if a company’s share price continuously declines or lags

its peers’ over long periods—say three to five or even ten years—that’s a pretty reliable sign of a value creation problem. Most management teams, I would hope, would recognize that the market is rarely inefficient for that long. Instead many companies keep telling the market tomorrow will be better.

But for many companies tomorrow never comes. I remember another CEO from a technology company saying in quarterly calls, “We’ve created a lot of shareholder value, it’s just not showing up in our share price.” So it begs the question: what are they looking at inside that company that says they’re creating a lot of shareholder value, and yet the company’s market value has gone down over the last decade? It goes to Damien’s point about being able to articulate how they are creating long-term shareholder wealth.

### How to Communicate with the Market

**Greene:** Paul, you talked in your opening comments about the ups and downs of the biotech business that you’re in. Companies have some great

R&D successes, and then there may be some fallow periods in between the successes. How do you think about your own shareholder value story, the dialogue you’re having with the market and getting investors to be patient so that when you have the inevitable down periods that they’re prepared to hang in there and to prevent the next Carl Icahn from showing up at the door?

**Clancy:** Well, I think this notion that buy-side investors are overly focused on the short term and not thinking about the long term flies in the face of the facts. Even if you’re an investor with a three- or four-year holding period, you have to worry about a company’s performance over at least the next ten years. After all, at the end of year four, the value of your company will be reflecting the company’s actual and expected performance over the next 10, 15, or even 20 years.

I work in an industry that spends one of the highest percentages of its resources on R&D. Our valuation is fundamentally all about the long term, and our investors love that we spend that much capital on



Every institutional investor will eventually have some sort of activist aspect to it in the form of engagement with the board and with the company. Just the amount of capital alone in activism suggests that every company is going to be touched over the next five years.

## Damien Park

R&D as long as they are convinced we are making wise judgments and investments. In conversations I have with investors, they are equally focused on both the short term and the long term. They may be very interested in the launch of a new product while also focused on the long-term pipeline as well as the trajectory of the cash flows.

So I don't agree at all with this argument that investors are focused too much on the short term, especially the buy side investors.

**Chew:** What about the sell side? Are you making distinctions between the buy side and the sell side?

**Clancy:** The very best sell-side analysts—the ones in each industry that the buy side pay a lot of attention to—are focused on the long term as well. As I said earlier, buy side investors—investors like Fidelity, T. Rowe Price, and Wellington—have a very long-term orientation regardless of their actual holding periods.

But, to your point, Don, it would be great to be able to cultivate your share-

holder base. But because all kinds of investors buy when the company's doing well, you just can't fully control who ends up owning your shares.

**Chew:** Do you think your shareholder base has become more long term in its orientation as you have become both more successful and continued to devote a large amount of your cash flow to R&D spending? Has there been any notable change in your shareholder base in the last five years?

**Clancy:** A pretty modest one. Ours probably isn't that much different than that of most of the large biotech pharmaceutical companies. But that said, I think there are companies out there that have done a fabulous job, like Amazon, of cultivating a shareholder base that's totally aligned with and receptive to their story.

### More on Investor Relations and Cultivating a Shareholder Base

**Greene:** David, we haven't heard from you yet. What do you think of this idea

that companies can attract longer-term investors by what they say and do?

**David Silverman:** I basically agree with it—and I think that the idea of a company's cultivating its shareholder base has a lot to do with the idea of cultivating what I like to describe as good corporate habits. And let me tell you about some of them.

At Blue Harbour, we look at a lot of investments. And as part of our process of evaluating companies, we go to a lot of "Analyst Days" and other events that allow for interactions with companies. Until two or three years ago, I had never seen a board member at an Analyst Day. And I found this a little surprising since this is an event where all the important investors and potential investors have the opportunity to meet not only the CEO and the CFO, but also the extended management team. Even if you're a director for only 12 days a year, it would seem that it might be worth spending the 12th day—or maybe the 13th day—going to the analyst meeting, which, by the way, almost always takes



place within one day of a board meeting because they've already assembled the whole management team.

But the good news is that in the past couple of years, I've started to see more board members going to the Analyst Day. They pay close attention to the kinds of questions that get asked of the different managers. That helps them understand the views of shareholders, and it gives the shareholders an indication that the board is engaged.

Another thing I've started seeing for the first time in the past year is that companies have become sufficiently comfortable with their Reg FD training that they let their board members speak with investors and analysts during the Analyst Day. And that, of course, is what should be happening. After all, many if not most board members, as Paul Hilal pointed out earlier, are former or still-serving senior executives with decades of experience and considerable personal wealth—and they have good reasons to want to avoid violating Reg FD. I think it's a very good thing for board members to have these direct conversations with the companies' investors; this way the directors are subjected to an outside challenge, they get an outsider's perspective. And maybe that gives them some ideas for questions they want to ask in the next board meetings.

So, again, I think that's been a positive change. But let me make one other point that I think is important when thinking about the dynamic of activism. Like Paul and Patrick, I too think it's very important to start by recognizing how hard it is to be the CEO of one of today's large public companies. CEOs get challenges from their customers and their competi-

tors—and they face challenges from all kinds of corporate stakeholders. And in well-functioning companies, CEOs should be getting challenges from their board members too—but as a number of people have already suggested, that doesn't always happen.

Now, when faced with all these challenges coming from all sides—internally as well as externally—it seems to me that a CEO should at least consider the possibility of viewing an activist as a potential ally or partner. First of all, most activists have a strong claim to credibility. They've spent enough time learning about the company—and so they've put a lot of capital to work. That's a pretty credible person to have a conversation with about how they can win going forward.

But that being said, we have run across cases—and I suspect there are plenty of them in corporate America—in which the incentives of the CEO are set up such that they are not interested in pursuing a good idea that could make the company worth 30 to 50% more than it is now. And when we run into these situations, we are also happy to talk about helping to change the CEO's incentives. We have found a number of CEOs to be very receptive to such changes because it is easier for everyone to be pulling in the same direction. The target may be some level of revenue growth at one company, or maybe an ROIC target at another company. The comp committee of the board can consider the views of a shareholder and know that it's not the shareholder that is getting the comp—which makes it a different case from when the CEOs are negotiating their own packages.

### Activists, R&D, and CEO Incentives

**Hilal:** David just made a very important point about the importance of CEO incentives in how they respond to activists, and I'd like to tie that into a point that Paul Clancy made about research and development in the biotech and pharma industry. We at Pershing are huge fans of companies that allocate their capital intelligently, and we encourage strong management teams to take advantage of high-expected-return capital projects that create shareholder value. Like the shareholders that Paul deals with, we don't care if the project takes years to pay off if the case for attractive returns is there. For example, Canadian Pacific has *doubled* its capital expenditures from \$750 million to \$1.5 billion during the three years Pershing Square has been on the board. Much of this increased expense is on assets that have a 100-year useful life—now *that's* long-term investing!

But sometimes companies misallocate their resources—R&D and otherwise. This is true whether the investment appears as an operating expense or is capitalized. The incentives that David was talking about contribute to the problem. Our foray into the pharmaceutical space with our purchase of 10% of Allergan provides a good illustration of that. Allergan's total shareholder return over the tenure of the CEO was reasonably good, but it could and should have been a lot better. And part of what reduced the return shareholders enjoyed was the decision of the leadership to spend a lot more on R&D than seemed to make sense. In fact, the aggregate return on Allergan's R&D dollar, based on every estimate that one could reasonably make, was terrible.

Now, in an R&D-intensive business like pharma, you would think that one of the critical levers of the CEO's compensation package would be the company's return on its R&D dollars. Incongruously, Allergan's board keyed the R&D component of CEO compensation to the *volume* of R&D spending, not the *return* on the R&D spend. You can imagine how this incentive might have biased the way the CEO interpreted proposals for additional R&D projects, and how Allergan might have found itself squandering so much cash on misguided projects. And I could come up with other examples of how ill-designed incentives lead to similarly bad outcomes.

But let me add that it's impossible to get incentives just right. There's no perfect compensation system; every compensation scheme you can devise can lead to a perverse outcome under certain cases. But some compensation schemes are more dysfunctional than others, and I just described one. It's hard to get comp completely right; but if you get it materially wrong, it leads to very bad outcomes.

### The Source of the Problem: Myopic Markets or Myopic Managers?

**Greene:** Lucian, can I ask you to jump back in and comment on what you've heard so far?

**Bebchuk:** Well, let me start by commenting on the alleged problem of shortsighted markets that routinely undervalue companies, thereby making them vulnerable to activists, which in turn push them in the wrong direction.

To begin, the claim that the market is excessively focused on current earnings is inconsistent with some clear patterns

in today's markets. Investors are willing to assign high market values to many "growth" companies with little or no current earnings. In such cases, investors are clearly focused on the prospect of corporate earnings and cash flows years down the road.

Furthermore, if the claim of shortsighted markets were correct, then one would be able to earn positive abnormal returns by investing in high-growth companies with large capital expenses because, according to the claim, those companies' values are significantly discounted by markets. However, the finance literature indicates that the realized returns on growth companies have actually tended to be lower over time than the returns on value companies. And this pattern implies that investors have been willing to bid up the stock prices of growth companies to such high levels that the expected returns are lower compared to the returns on value companies.

I also find a good deal of irony in claims by issuers that they are forced to focus on the short term due to outside pressures from shareholders and that boards ought to be insulated from shareholder pressures to be able to focus on long term results. In other words, the presumption is that short-termism is driven by shareholder pressures rather than insider choices.

However, as both David and Paul were just telling us, managerial short-termism is driven by pay structures and can be addressed by reforms in compensation structure. Unlike the adoption of arrangements that insulate boards, compensation reform does not carry with it significant efficiency costs. Such reform is a win-win proposition, and any issuer that would like to make its insiders focus more on the

long term should consider such compensation reforms before lending its support to board insulation arrangements.

There is another insider-driven source of short-termism that I would like to stress. There has been a significant increase in CEO turnover and an accompanying decrease in the length of CEO service. Many CEOs expect to serve in their jobs less than four years and such expectations, which are the product of inside practices and norms, contribute to insider-driven short-termism.

**Gidumal:** I have been the CEO of a company—in fact, a couple of them. One thing that struck me when I was CEO of my first company is that the *harmonics* of the operating company, if you will, are fundamentally different from the harmonics of investing. The investing and payoff cycles are just much longer. And as a fairly direct consequence, I think that the currency that companies trade on internally are qualities like judgment, loyalty, and trust. These are the traits that get rewarded in companies—the ones that lead over time to raises and promotions. And the important thing here is that it generally takes a good deal of time for the genuineness of these qualities to be established.

Investors, however, are looking at a very different timeline. Events happen far more quickly—and investors expect to change things in a shorter timeframe. If you are the CEO of a public company, you want to have a group of people that you trust and a strategy and supporting policies that you and people throughout the organization believe in and work hard to carry out. At the same time, we have to recognize that companies often become

Far too many companies believe they have a value recognition problem when what they really have is a value creation problem. They believe that “the market is not understanding my story,” instead of recognizing the value creation problem stemming from poor capital allocation or cost management.

**John Cryan**



too focused on these qualitative and political characteristics, and aren't recognizing the excess costs that it might build.

It is the board's responsibility to find the right balance between the qualitative, long-term characteristics, and the visible, tangible financial performance. Unfortunately, many boards are not adequately fulfilling that need well, and activists are stepping in. But in many cases, the board members that activists are nominating are not skilled at restructuring companies, so they are not having as much success at getting change as they might like.

**Greene:** Greg, what is your thinking on this short termism question? Are investors the main source of the problem?

**Greg Milano:** My own experience, from first working for a large public company, and then advising a large number of such companies as a consultant for the past 25 years, is that short termism comes mainly from the inside. It comes from features of corporate comp plans like bonuses that encourage managers to

stuff their distribution channels at the end of the year to meet an earnings target—something you would never do if you owned the company. And it's the continuous pursuit of near-term earnings targets—the holding up of steady growth in EPS as the overarching corporate goal—that causes corporate managers to commit the kinds of sins they're regularly accused of: passing up a promising investment opportunity and cutting core competencies to meet a series of quarterly earnings targets. Though sell-side analysts might come in for a share of the blame, it's the companies that should be faulted for letting the analyst set the agenda. And in that sense, short termism can be seen as coming from the inside.

**Gidumal:** In my experience, it is less about short term vs long term, and more about the difference between driving a truck and driving a Ferrari. For example, for a company that's short of people with key technical skills, it takes longer to hire, train, and then respond to changes in competition relying on technology. Investors may think

of such changes as being implemented overnight, when the reality is that it could take years to accomplish a culture change. Maybe they could do them a little faster than they do now, but that may not be nearly as fast as somebody who hasn't run a company of that size thinks it can be done. On the other hand, cost reduction is something that can be done quickly, and companies are often too slow to make those hard choices.

**Milano:** What you say is no doubt true in some cases. But in a great many others, the delays in responding to the need for change have more to do with the poor management skills of the CEO and his cohorts. For example, we knew a company that wanted to sell a business at the bottom of the cycle but couldn't because the price was too low. Then a few years later, when they finally could get a better price, they said, “Well, the business is bringing some good cash flow now, so we'll keep it.” And a few years after that, they were back at the bottom of the next cycle saying, “Why didn't



When thinking about an activist's time horizon, it is important to recognize how different styles and agendas dictate different horizons. In my experience, the duration of an investment is usually much more a function of the extent of the inefficiencies at the company in question than most people realize.

## Patrick Lally

we sell it when we could?" I don't think corporate managers would do this if they owned the whole company.

So, it's not because they're not driving a Ferrari. It's the failure to set down and then adhere to a set of sound management principles. It's a failure to act as they would if they owned the whole company. Many CEOs find it's easier to stick with the status quo and manage for earnings. They are choosing to take the path of least resistance.

Paul Clancy said earlier that some CEOs end up being penalized by investors and activists for "bad luck." I tend to believe it's the combination of bad luck with bad management that really gets the CEOs in trouble with investors because they never really get what they should be doing differently. The opportunity for activists to invest and create a lot of value stems from the CEOs striving for the wrong things. They are pursuing continuous growth in EPS when their market value would rise faster if they instead invested in all investments that create meaningful value while constantly driving higher long-term returns on capital.

**Ruback:** So, your view is that CEOs are not evil, or self-interested; maybe just "ignorant" is a better word?

**Milano:** Well, yes I would say that many are ignorant about how markets work, and what their investors really want to see from them. But I would also say that the majority of CEOs are outstanding CEOs; and thanks in part to them, the U.S. economy and the stock market as a whole have created tremendous wealth during my lifetime and before. But there also seems to be an increasingly large group of CEOs that doesn't seem to really understand the goal or how to achieve it.

I was as excited as most everybody in the room by the findings of Lucian's paper. But the problem I run into whenever I read academic studies is my feeling of near certainty that most CEOs who read this research will say, "I understand that this is true of the average company facing the average activist, but my situation is different. I know what I'm doing, and these findings don't really apply to me." And that means that the real challenge facing

activists, and any outside investor, is convincing managers and boards that maybe they're not unique and, in fact, they do have a problem.

### The Case for Welcoming Activists on Corporate Boards

**Greene:** Paul, you mentioned the tension between activists and boards as a challenge to what you do. Can you elaborate on that?

**Hilal:** As I said earlier, my hope is that, with more time and experience with activists, corporate boards will increasingly see an advantage in having a sophisticated, informed shareholder with a lot of skin in the game seated beside them. Open-minded boards have welcomed us onto their boards, or embraced our proposals, especially in the recent years. This has led to some terrific outcomes, and the incumbent directors who maintained an open mind deserve, and have received, enormous credit.

Regrettably, some financial advisors see financial opportunity from creating

tension and conflict between shareholders and boards through their talk of companies coming under “activist attacks” and the need to “inoculate yourself” against activists as if we were some kind of disease. Such messages to boards are singularly unhelpful. Boards need an opportunity to think proposals through objectively, and find the best path for the shareholders. They don’t need the distractions that some of these advisors create.

**Park:** You’re absolutely right. The trend I’ve been seeing is that in cases involving some of the larger, more reputable activists—the Pershing Squares and Value Acts of the world—there’s been greater willingness by boards to engage and try to work out problems together. But what I’ve also seen this year—and this may be more true of the smaller cap companies and lesser-known activists—is that managements and boards have shown more willingness to resist activist demands. And I think we’re going to see a heck of a lot more fights, primarily because there are all of these different advisors weighing in today and looking to get a portion of the millions a company might pay to keep activists at bay.

**Clancy:** Yes, it’s a plague, a negative development.

**Gidumal:** As one of those advisors, let me defend myself by saying that we advise companies to engage activists on specific topics. And we were offering this advice even four or five years ago, which got us into arguments with advisors who were saying to their corporate clients, “Let’s pull a page from the hostile defense playbook. Keep these guys at a distance. We can fight

them behind the scenes and in Delaware.” And we would say, “No, this is a contest for the hearts and minds of institutional shareholders. A process fight can win a battle but it won’t win the war.”

**Hilal:** I agree with your last point, Shyam. But that doesn’t change the reality that there are parties in this ecosystem—and at the moment it’s advisors—that have a financial incentive to create tension and anxiety among directors, and to get them to perceive the activist and its ideas as a threat.

But I’m hopeful for a day when boards welcome smart, constructive, engaged shareholders. And I think we’ll get there; it’s just a question of when. Each year, we get a better and better reception. We like to think that we have earned that reception by being very careful and thoughtful with our proposals, and by being constructive board participants.

Shyam, you were talking about a disconnect between management’s time cycle and the time cycle of the shareholders. If you look at the analysts at Fidelity and Capital Group and T. Rowe Price, these are pretty smart guys. And if management can’t communicate their long-term vision to these extremely sophisticated shareholders who are eager to come to the right answer, then maybe the management needs to be changed.

**Gidumal:** I agree with the distinction that Patrick made, which is depending on what the agenda is the timeframes can vary. I just think that sometimes activists come into these conversations—not the best and most sophisticated of them, but some of them—come into these conversations without a real good understanding of how long will it take to roll out a program.

Unfortunately, while some activists are nominating very talented board members who know how to get things done on a board and through a company, many do not. Going beyond presenting good ideas and getting the board members who know how to get those ideas implemented in the companies will be the next evolution in activism.

**Cryan:** Shyam, given your background in private equity, you can probably appreciate this. We always try to get our public company clients to ask themselves the question: what would you do if you were a private company? Think about the timeline many private equity firms are able to operate under. When you have a sophisticated management team with strong incentives, it’s amazing how quickly they can transform a company. They cut costs, they divest businesses, they wring out working capital—often in 12 months or less.

There is clearly a disconnect between the corporate cadence for taking action and that of a more motivated owner. It may simply be a willingness to challenge the status quo.

**Park:** This is a gross generalization, of course, but there is a fairly widespread view that in the private equity world people care mainly about what you do right. People in public companies are a lot more worried about, and a lot more exposed to, what goes wrong.

**Greene:** We did an exercise at a major company recently where we said to a senior team, “You’ve been appointed to this special task force charged with maximizing the company’s value. And you don’t have to worry about the stock price, whatever happens in the markets

for the next five years, but in 2020 we expect you to have delivered significant shareholder value. And the CFO said, “If we didn’t have to worry about earnings and stock price, we would do things differently. We would accelerate our most promising R&D projects; we would rationalize our manufacturing and supply chain footprint.”

So there is clearly a mentality that distrusts the ability of financial markets to take the long view, to give companies credit for making promising investments. This CFO is convinced, despite the conversations he’s had with the Fidelitys and Wellingtons and T. Rowe Prices, that he’s got to deliver these short-term results.

**Clancy:** That may be true in some cases. But one of the roles performed by activists is that they actually take away options. My guess is that in most companies, most of the thoughts around portfolio restructuring and improvements in operating performance are probably kicking around the company. And what activists often do is to force organizations to come to a decision to do some of those things. Sometimes just having the conversation with people can get more facts for everybody on the table such as, “Oh, you didn’t realize the tax implications.”

So, my point is that activists’ role in forcing companies to come to a decision on strategic choices, to accept one course of action while rejecting other options, can be constructive.

**Park:** That’s true. I can’t tell you how many phone calls I got after Trian failed to get the endorsement of the majority of shareholders at Dupont. Many reporters

were calling it a huge blow for activists. But my response to this has been, “Wait a second. First of all, before DuPont’s stock went down today because of the vote, Trian was up \$600 million on their investment.” But most important, DuPont, thanks to Trian, now has a CEO who is more focused on and better at articulating the company’s strategy. And it now has a more engaged board of directors, and a shareholder base that completely buys into this strategy. These things all sound like improvements to me. And they wouldn’t have happened anywhere near this quickly without the activist.

So, to me, that was a huge win for both the activists and for the shareholders in general, even after taking account of the \$30 million or so that is now lining the pockets of lawyers and investment bankers. Those costs aside, I think that there was an enormous amount of information and value created through that exercise of working with—or against—or around—an activist.

**Silverman:** I want to elaborate on Paul Clancy’s comment about the value of shutting down some options. But first I want to mention Paul Hilal’s point about helping the right people inside the company get a voice. A lot of the time you’ll see a company where the board members are all very competent, and maybe they were brought in for a series of specific reasons. One is great at marketing, another is a venture capitalist who really understands technology very well. But in the world of venture capital, you don’t necessarily spend a lot of time thinking about the capital structure of your company. So when the CFO says,

“Hey, maybe we should consider this share repurchase program because we have more capital than we need,” people outside of finance will tend to say, “Why would we want to do that? Don’t we want the strategic flexibility of having the cash.” And in many companies this would cause the CFO to say to himself, “Pushing a buyback at this point may not be great for my career.”

In this kind of a situation, an activist could be really helpful in enabling the CFO to make his case. He could say to the board, “This investor has bought 10% of the company, and they also believe in a large stock buyback. And though I agree that having a certain amount of cash gives me strategic flexibility, how much of that cash and flexibility do we really need?”

**Chew:** Right, and a buyback ends up reducing options—which, as Paul Clancy just told us, can be valuable in certain circumstances, notably when most of the options if acted on would end up destroying a lot of value.

### Toward a New Governance Model

**Gidumal:** When I think back to when I came into the business world in the late ’70s, the basic concept that was explained to me was that shareholders buy stock in companies, and if they don’t like what the company is doing, they sell the stock. And then we went through an evolution that provided some new possibilities, new options. You could do what they started doing a lot of in the ’80s, you could do a hostile takeover or take the company private. That changed the world. And now we have another way you can influence the company. With all the changes in the environment, the

I think it's a very good thing for board members to have these direct conversations with the companies' investors; this way the directors are subjected to an outside challenge, they get an outsider's perspective. And maybe that gives them some ideas for questions they want to ask in the next board meetings.

**David Silverman**



idea is that shareholders have opinions and options. They're going to express those opinions—and that companies need to listen to those opinions is now beyond question. And it's important to recognize that this new reality is not going away, we're not going back to the old philosophy of sell the stock if you don't agree with the management. The fact is that shareholders now believe that they have a say in the company.

So to me, the question becomes, "What's the best mechanism for making use of this shareholder voice in the most efficient way?" Right now what's happening is a very inefficient, expensive process. It's expensive on both sides, for companies and for investors. There's a lot of friction in the process, and it's not clear that we're always getting the best outcomes. There are some very sophisticated, well-intentioned activists that are getting involved in these situations; in many cases, they have great ideas, and they've done their homework on their ideas. But at the same time, we've also seen a large number of situations where you just look and

say, "What in the world are these people thinking about?"

**Greene:** So that tells me that for companies preparing for activists, the best defense is a good offense. And increasing the efficiency and value of the company is the most reliable way to discourage or fend off activists.

But, Shyam, are you suggesting there are better ways than activism for dealing with corporate underperformance? I tend to agree with what Rick said at the start, which is that activism is the least invasive, costly and disruptive of our corporate control mechanisms that have been developed over the past three decades.

**Ruback:** That's right. Damien mentioned \$30 million of wasted transactions costs in the DuPont case, but think about what the costs of a real transaction like a hostile takeover would have been. If investors ended up deciding they would have to replace DuPont's management to change its strategic direction, the transactions cost to do a hostile takeover would have been

much more than \$30 million. My sense is that activism is a massively more efficient way of exerting corporate control and improving corporate performance than what we've had before.

**Bebchuk:** I agree, and it's better in two ways. First, the deadweight transaction costs involved in activism are small compared to the costs of the hostile takeovers and private equity deals that you and Mike Jensen wrote about in the early '80s. Second, in a takeover or private equity deal in which public shareholders are bought out, there is a risk of wealth transfers from public investors to the acquirer. In contrast, the beauty of activism is that the activist will make money only if *all* of the other shareholders who continue to hold their shares also make money. This equal treatment of the activist and passive shareholders is a major advantage of activism.

**Gidumal:** Okay, I hear you both. But my feeling is that if we were given the ability to design corporate governance



Preparing to receive the attentions and scrutiny of activist shareholders has become a way of life for the boards and C-suites of even the largest companies. We're seeing a shift both in the focus of such investors and in the way companies respond. Increasing the efficiency and value of the company is the most reliable way to discourage or fend off activists.

## Jeff Greene

from scratch, it would look very different in this new world where shareholders now have a voice and something to back it up. It would not be the way that it was designed in the '50s and the '60s, when managers' domination of the process made it rational for disappointed shareholders to just sell the stock. When companies don't perform today, we talk about changing management. And in a handful of cases, the shareholders have basically been able to demonstrate that the board has failed in its responsibility and succeeded in getting rid of them through an activist proxy process.

But to me that also seems like a second-best solution and outcome. We need more than an activist proxy. We need a way of nominating and electing better boards, and a more effective way of holding boards accountable for their behavior—and I don't only mean individual board members, but boards collectively. We may need a different

governance structure to provide that accountability.

**Hilal:** Shyam, I think that today's activism—or at least the best practitioners of it—contains the seeds of this new model. Boards I think will increasingly value the insights of heavily-invested, sophisticated, long-term-oriented shareholders on the board. While bankers and consultants give advice for an expensive fee, and are not around to enjoy or suffer the consequences of their advice, long-term shareholders provide advice for free and the value of their holdings benefits or suffers accordingly. We hold our activist investments on average for over four years, so we certainly qualify as long term. And our record for delivering value is very good. Perhaps one day, a Pershing 13d filing will be received with a smile.

**Greene:** Have you ever gotten that kind of reception?

**Hilal:** Not quite, not yet. But boards are definitely much more open to us today than they have been in the past. And as I said earlier, constituencies other than the board's leadership circle and the CEO—for example, the directors outside the leadership circle, plus various executives, employees, customers, and suppliers—have become especially supportive. Part of why this is happening is that there is a growing body of executives and directors who have given our proposals a fair shake, and who have invited us into the boardroom. By and large, these people have been very strong referrals for us. We work hard to be worthy of such reviews.

### Activism as a Substitute for More Disclosure?

**Greene:** Paul, you've mentioned that capital allocation at a number of your



target companies has been poor. How much more explicit should companies be about the metrics, the models, the processes?

**Hilal:** In the case of Allergan, it would have been interesting to get more granularity, to understand which of its development projects worked out well; but all you see is the aggregated results. I can understand that a management team might argue that there are competitive reasons why they don't want to disclose how each project fared. But on balance, I think more disclosure is better. And I think U.S.-based companies have great disclosure compared to companies in other parts of the world.

**Ruback:** Even if companies wanted to provide more disclosure, there's always a concern about the potential for litigation.

**Lally:** That's right, there are costs as well as benefits associated with greater disclosure. And we also believe that activism can function in some sense as a substitute for more effective disclosure.

Let's start by recognizing that a management team's track record of capital allocation is public information. The dollars invested and the returns generated, in many cases over a fairly long period of time, are publicly disclosed for investors to analyze and reach their own conclusions. This creates a powerful tool to hold management accountable by benchmarking their capital allocation on an absolute level as well as relative to that of their peers.

We try to uphold this standard of accountability through our interaction with management teams and their boards. And for that reason, Paul's dream of com-

panies embracing activist investors is one that we share. We too view our companies as partners and have a significant portion of the fund's capital invested in the company's shares. We are also in it for the long haul—we enter investments with a thesis that typically spans several years—and thus our interests are well aligned with those of the company's long-term shareholders.

Finally, we often work to protect our own and the other shareholders' investment by serving on the company's board. While this is not right for every situation, representation on the board can be very valuable, both for us and for the companies in which we invest. This gives us complete knowledge of the company's financial and operational situation and allows us considerable influence in the capital allocation process. At any rate, let me echo David's point that decision making at the corporate level is a very complex and an inherently difficult task. And I like to believe that our interaction with management teams and participation on boards provides an independent view that strengthens the process.

**Hilal:** That's right. And a lot of the times we end up finding minority or silent majority voices in the boardroom or on the management team that have been thinking along the same lines as we have. Our presence helps ensure that the idea gets full and proper consideration.

**Greene:** And so you basically can provide cover for that company insider that shares your view. For example, I think that Pershing's Allergan work has shone a brighter light on Valeant's business model, which emphasizes lower R&D spending, among other things. And although it will not be right for all biopharma companies,

that model, at least for the time being, seems to be gaining credibility with some management teams as well as investors.

Now, for those big pharma and biotech firms that haven't done a great job yet of rationalizing costs, the success of the Valeant model raises the possibility that an activist will show up with an analysis showing what the companies would look like if they worked their way into the Valeant cost structure. And in this sense, activists like Pershing have helped shed light on potentially inefficient capital allocation practices.

**Hilal:** Yes. Some pharma companies have done a great job of allocating capital—and this is true of companies in all sectors of the economy. Big pharma has an especially challenging time allocating R&D dollars because the decision makers are playing with shareholder money. Incentives are misaligned.

And in large part for this reason, a lot of people have been arguing that the most efficient form of R&D for the pharma industry is now being done by small entrepreneurial companies. It is being done by people who have left their big pharma company, and who are not getting paid that much, but have a lot of stock. They are investing a lot of sweat equity into these projects, effectively putting their money where their mouths are. So they genuinely believe in what they're doing, and they're working their tails off to make it happen. Many of these companies are being funded by venture capitalists who have done an enormous amount of research assessing the projects, and will make or lose a lot of money if their ventures work out.

### Disclosure by Activists: The Policy Question

**Shyam Gidumal:** Let me ask a different question, which is about the required disclosure by the activists of their positions. There's been a lot of conversation about whether the 10-day filing window should be reduced. Technology has accelerated, but we still have the disclosure timeframes designed with the idea that people fill out forms and mail them to Washington.

So, my question is, should we consider requiring activists to disclose their positions sooner than we now do? Lucian, you commented in your paper that such a change will reduce the incentives of activists to get involved, but I'm not sure I buy that.

**Bebchuk:** There has been a push to tighten the disclosure rules, and a rule-making petition seeking such a change was submitted to the SEC by Wachtell Lipton. In a policy paper with Robert Jackson, and in a subsequent empirical study with Brav, Jackson, and Jiang, we indeed question some of the empirical and conceptual premises of the call for tightening disclosure rules.

Those calling for tightened disclosure assert that recent changes in technology and market practices make it necessary. Our empirical work, however, casts doubt on this assertion. First, our work shows that, in contrast to the premise of Wachtell's rulemaking petition, the blocks of shares accumulated by activists prior to filing of a 13D disclosure have not been increasing significantly over time.

Furthermore, our work demonstrates that this issue should not be assessed sep-

arately from a general discussion of the whole set of rules that govern the balance of power between activists and incumbents. Although supporters of tightened disclosure have been pointing to other jurisdictions with tougher disclosure requirements, they have been overlooking the ways in which U.S. rules are more protective of incumbents than the rules of these other jurisdictions. For example, the United States stands out in terms of the wide latitude it allows incumbents to adopt poison pills with an investor ownership triggering threshold that is set at a low level such as 10%.

In a debate on the 13D question that Martin Lipton and I held at the Conference Board, I asked Lipton whether he would be willing to have tightened disclosure requirements only for those companies that commit not to use this disclosure to put in place a low-threshold pill. He was not willing to accept such a limitation and did not share my concern that issuers would use tightened disclosure requirements to facilitate low-threshold pills. In my view, the interaction between tightened disclosure requirements and low-threshold pills could have pernicious effects on shareholders and should be given careful consideration by SEC officials.

Rather than focusing on the rules governing 13D disclosure, public officials should carry out a big-picture examination of the body of law that shapes the balance of power between activists and incumbents. When this is done, I expect that such an examination will find that the balance of power in the United States favors incumbents, while working to limit shareholder involvement, more than in any other advanced economy in the

world. Overall, U.S. rules should insulate incumbents less, not more.

**Gidumal:** Lucian, I understand the theoretical case you're making. But a lot of our clients want to know why we have these delays in reporting—delays that don't reflect today's technology.

**Ruback:** The delays are meant to enable investors to buy enough shares at low enough prices to preserve the incentives for people to invest in what we consider to be a socially valuable activity. It's the corporate control version of the patent system. If you decided to limit patents for cancer treatments innovations to just three years, you'd get a lot less research by big pharma and biotech. And if you force activists to disclose their positions much sooner, you should expect to get a lot less activist investment and control benefits from that activity.

**Bebchuk:** That's right. And I think it's important to recognize that the pressure for tighter disclosure, as well as the resistance to activism generally, is coming largely from issuers, not from other investors. Although the rulemaking petition for tightening the disclosure rules was filed by Wachtell Lipton several years ago, the SEC comment file displays very little support for it from institutional investors. This dearth of support from institutional investors reflects the growing recognition among such investors that hedge fund activism is beneficial and their reluctance to support actions that could impede such activism.

**Hilal:** As Lucian just pointed out, what we have is really an ecosystem of rules

Short termism comes mainly from the inside. It's the continuous pursuit of near-term earnings targets that causes corporate managers to commit the kinds of sins they're regularly accused of: passing up a promising investment opportunity and cutting core competencies to meet a series of quarterly earnings targets. The opportunity for activists to invest and create a lot of value stems from the CEOs striving for the wrong things.

## Greg Milano



that affect how big of a position activists can take. And it doesn't really make sense to focus on just one aspect of the rules without considering the whole system.

So, as a matter of public policy, I think it's important to start by deciding for ourselves whether we want to make boards more or less accountable to the sophisticated institutional shareholders they are supposed to be serving. If like me, you think accountability is good, then you would oppose rule changes that in aggregate make activism a more difficult, lower-return endeavor. Such changes are a windfall for entrenched boards and CEOs that would otherwise be replaced if shareholders could have their will. And those entrenched interests have been spending corporate—that is, shareholders'—money lobbying Congress in order to reduce the ability of the shareholders they serve to replace them.

If you look globally at economies where management teams and boards

have been able to make themselves almost completely unaccountable to their shareholders, those economies have been stagnant, and sclerotic. Japan for example, whose economy has been stagnant for decades, has finally recognized that increasing the accountability of executives and boards to their shareholders is essential to the economy's vitality. The “third arrow” of Prime Minister Abe's reform package is aimed at structural issues, including board accountability to shareholders. It would be a shame if we harmed our economy by moving in the opposite direction.

**Bebchuk:** Before closing, it's important to recognize that a tightening of disclosure rules is not the only potential deterrent to activism. In particular, state laws that would make it possible for companies to put in place low-threshold poison pills—pills that would be triggered by purchases of less than the standard 10%

percent ownership threshold. Indeed, in my co-authored work on stock accumulations by activists, as well as in a *Dealbook* column I wrote, I explain that the development of such low-threshold pills is pernicious. It has the potential to curtail substantially the benefits of activism that we have discussed.

**Jeff Greene:** Okay, let's leave it there. Gentlemen, that was a great discussion—and I want to end by thanking all of you for coming and taking part in it.

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