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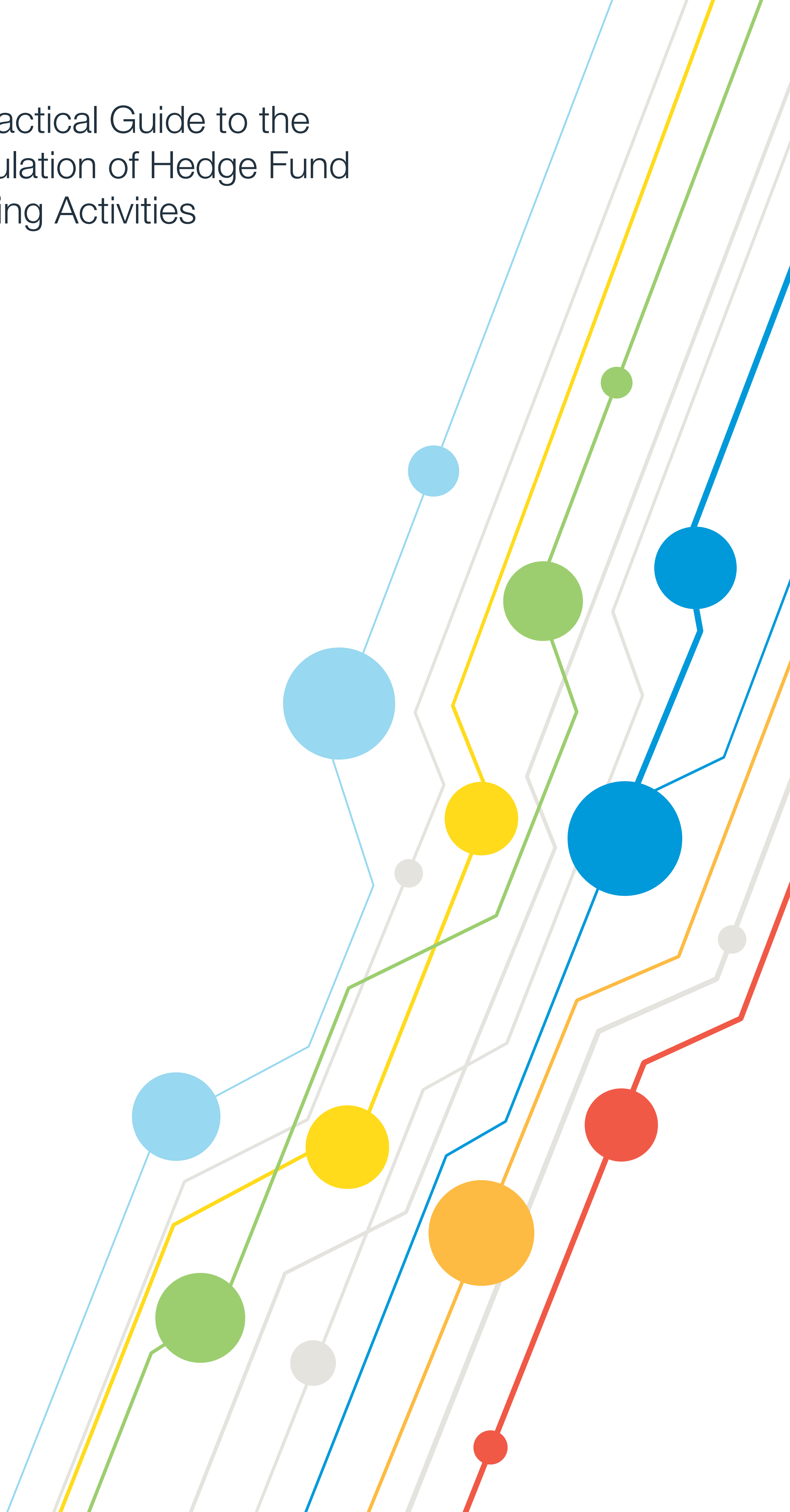
A Practical Guide to the Regulation of Hedge Fund Trading Activities



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Proskauer's Practical Guide to the Regulation of Hedge Fund Trading Activities is being offered as a service to our clients and friends. It is designed only to provide general information on the topics actually covered. It is not intended to be a comprehensive summary of legal issues or developments, treat exhaustively the subjects covered, provide legal advice, or render a legal opinion. Thus, it is not intended to provide legal advice to any particular fund or in connection with any specific transaction, and it should not be relied upon in making a decision or taking a course of action that implicates regulatory issues.

Executive Summary

The trading activities of hedge funds raise a number of complex issues under the federal securities laws. Proskauer's **Practical Guide to the Regulation of Hedge Fund Trading Activities** offers a concise, easy-to-read overview of the trading issues and questions we commonly encounter when advising hedge funds and their managers. It is written not only for lawyers, but also for investment professionals, support staff and others interested in gaining a quick understanding of the recurring trading issues we tackle for clients, along with the solutions and analyses we have developed over our decades-long representation of hedge funds and their managers.

The Guide will be published in installments (with previews of future installments) so that our readers may focus on each chapter, ask questions and provide any comments.

Chapter 1:
When Passive Investors Drift into Activist Status

Chapter 2:
Insider Trading: Focus on Subtle and Complex Issues

Chapter 3:
Special Issues under Sections 13(d) and 16 for Hedge Funds

Chapter 4:
Key Requirements and Timing Considerations of Hart-Scott-Rodino

Chapter 5:
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Chapter 6:
When Passive Hedge Funds Decide to Become Activist

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Chapter 6: When Passive Hedge Funds Decide to Become Activist

Author: Frank Zarb

Chapter 6: When Passive Hedge Funds Decide to Become Activist

Passive hedge funds are increasingly considering active roles when they are dissatisfied with the management of specific portfolio companies. After describing such a scenario, the author discusses the steps a dissatisfied fund can take short of a full-scale proxy fight. He then closes with some important decisions a fund must make in that full-scale option.

Passive hedge funds increasingly are taking on activist roles at one or more portfolio companies. While this is an expected part of a broader trend toward increasing shareholder activism, such funds are not typically interested in becoming activist funds generally, but rather in using all the tools available to rectify perceived deficiencies at an under-performing portfolio company. Hedge funds are the most active proxy contest dissidents, representing more than half of campaigns brought against Russell 3000 companies in 2018.[1] Many, if not most, of these insurgent hedge funds are "activist" funds, although passive hedge funds have increasingly considered activist roles with respect to specific portfolio companies.[2]

This article is the sixth chapter of a series of articles on regulatory issues impacting hedge fund equity trading (the "Trading Manual Series").[3] As compared to the first chapter in that series, which addressed scenarios where a fund inadvertently drifts into "activist" status for regulatory purposes, this chapter addresses scenarios where the fund makes a deliberate decision to assume an activist role and to address regulatory issues.

There are a variety of methods for a hedge fund to assume an activist role. A hedge fund could take a limited approach and merely engage privately with management or publicly criticize management. Neither strategy would trigger the SEC's proxy rules, although the efforts could require the fund to file a Schedule 13D to replace a pre-existing 13G filing. Along the same lines, the fund may follow a proxy rule exemption to announce how it intends to vote on the company's — or another shareholder's — proxy proposal, and why. Or the fund could play a larger role, by launching what we describe below as a "mini-proxy contest," or even a full- scale proxy contest, or a tender offer.

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1 The Conference Board, Proxy Voting Analytics (2015-2018), at 171.

2 Over the past several years, the number of campaigns brought by "infrequent activists" has increased, with "infrequent activist" defined as a firm that has brought five or fewer campaigns since the beginning of 2014. Review and Analysis of 2018 U.S. Share-holder Activism, Harvard Law School Forum on Corporate Governance and Financial Regulation (April 5, 2019), at Section E.

3 All six chapters of A Practical Guide to the Regulation of Hedge Fund Trading Activities are *available at* https://www.proskauer.com/report/a-practical-guide-to-the- regulation-of-hedge-fund-trading-activities.

The Scenario

Consider the following scenario to be used for illustrative purposes. Software Fund, LP has been a long-term investor in Alliance Cloud, Inc., which is traded on Nasdaq. As the beneficial owner of 4.1% of the company's outstanding shares, the fund is Alliance's third largest investor. The company's stock price has lagged the market for the past two years, trading flat or slightly down during that period, when the rest of the market has surged. Software Fund believes that the company has focused on developing the wrong products, or the wrong updates to existing products, and has a weak marketing department. Over the past year, Software Fund has engaged in several private discussions with management. Management has listened, nodded in apparent agreement, and stated that it would make sure that the company's board was fully briefed. Management has not provided any substantive feedback, pointing out that if it were to communicate material, non-public information to the fund, the fund would be precluded from trading and the company would be in violation of the SEC's Regulation FD.

While the company's lead independent director did indeed attend the fund's last meeting with the company several months ago, and the company replaced its marketing head three months ago, the company has not, in the fund's view, sufficiently addressed the deficiencies that the fund has outlined. The fund believes that a major change in direction is required and has lost confidence in the company's board and management. It has concluded that it must take its efforts "to the next level" if it is to see any results. The fund's principals have called in outside counsel to review the options. The company's annual shareholder's meeting is scheduled to take place in five months and the fund is considering ways to put decisive pressure on the company in the context of that meeting.

Regulatory Backdrop of The Scenario

In this scenario, the regulatory considerations could be more complex than they are, since Software Fund beneficially owns less than 5% of the company's outstanding shares. As noted in Chapters 1 and 3 of the Trading Manual Series, if the company beneficially owned more than 5% (individually or together with a "group"), it would be subject to Exchange Act Section 13(d), and even meeting with management on operational and strategic issues could compel the filing of long-form Schedule 13D. If the fund owned in excess of 10%, its transactions in equity and derivatives would be subject to Section 16 reporting and short-swing profits liability. Based on its current beneficial ownership, it need not be concerned about either of those two regulatory regimes.

Software Fund, however, does need to consider Hart- Scott-Rodino ("HSR"). A "passive investor" that has not crossed the 10% threshold need not file. The fund's engagement with management to date, however, may be inconsistent with the HSR "passive investor" exemption. The good news is that the fund has not acquired any new shares and the value of its common stock holdings has not crossed the $90 million HSR reporting threshold for 2019. An HSR filing is not necessary at this point.[4]

What we are left with are the different strategies that Software Fund can follow under the federal proxy rules. The proxy rules have to be followed if either the company or any other person decides to "solicit" votes for or against any proxy proposal presented by anyone at either the annual or a special meeting of shareholders. Proposals may, for example, seek to remove members of the board of directors and replace them with the proponent's own candidates. Or they may seek to influence actions to be taken in connection with proposals made by the company, such as by soliciting shareholders to vote against the company's "say-on-pay" proposal.[5]

[4] *See* Chapter 4 in the Trading Manual Series, *Key Requirements and Timing Considerations of Hart-Scott-Rodino*.

Software Fund has a smorgasbord of choices, beginning with options that involve limited effort and expense, as well as little publicity, to others that involve substantial publicity, effort, and/or expense. The fund may engage only in the more limited options, often referred to as "activism light," and stop there, or may rely on a limited option as a first step in a larger campaign. Among the numerous proxy-rule exempt solicitations that are brought each year, relatively few are brought by hedge funds, so for Software Fund to pursue activism-light to the exclusion of a formal proxy contest would be outside the norm, but it may very well make sense to a passive fund "dabbling" in activism.[6]

The principal options for such a first, limited step include the following, which could be pursued individually or in combination:

- publication of a statement in the press or other public forum about how the fund intends to vote on a proxy proposal, and why (the "Publication Exemption");
- submission of a generally non-binding shareholder resolution to be included in the company's proxy materials (the "Shareholder Proposal Submission"); and
- private communications with up to 10 other investors to encourage them to vote a certain way on one or more of the company's or another shareholder's proxy proposals (the "Ten-Investor Exemption").

The first alternative, the Publication Exemption, is the most simple and straightforward. Software Fund can publicly express how it intends to vote and why. One of the fund's principals could provide an interview in which he or she explains that the fund intends to vote against board members because of operational and strategic blunders, and the failure of management to provide satisfactory responses in private meetings with the fund. Or if the fund desires, it could issue a press release or print advertisements in newspapers — or even rent a billboard on the Long Island Expressway. While the fund could couple this strategy with other "solicitations" that come within a proxy rule exemption — such as making a Shareholder Proposal Submission — it could not follow up with a full-scale proxy contest. Statements made in reliance upon the Publication Exemption, however, are not subject to the federal proxy anti-fraud rule, which would take some of the force out of the company's efforts to hinder the fund with charges that its statements are materially misleading. That is because the proxy anti-fraud rule is the most obvious basis for such claims, at least in federal court, the only other options being state anti-fraud rules.

The Shareholder Proposal Submission rules require the company to include on its proxy card a proposal submitted by a shareholder that has held shares worth at least $2,000 in market value for at least one year, so long as the shareholder has complied with specified procedures. The principal drawback to this approach is that companies are permitted to exclude proposals on a wide range of subject matters, including most operational and strategic issues. Moreover, while the company may not exclude many general corporate governance proposals, it may exclude a proposal to nominate a candidate for the board or to recommend a vote against one of the company's nominees.

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[5] A company's say-on-pay proposal is a required advisory proposal that asks shareholders to express support (or disapproval) of the company's executive compensation package.

[6] The Conference Board, Proxy Voting Analytics (2015-2018), at 190.

Accordingly, Software Fund could not compel the company to include in its proxy materials proposals to change its product mixture or reform its marketing department. Nor could it compel the company to include a proposal to nominate its own candidate for the board. However, if a shareholder's complaint about the company is about general corporate governance or executive compensation, a proposal by the shareholder on the subject likely would have be included in the company's proxy materials. While most shareholder proposals must be drafted as recommendations to the board (i.e., even if adopted by shareholders, the company would not be legally required to implement the proposal), many proposals need not be mere recommendations, so long as the "mandatory" shareholder proposal is permitted under state law. Finally, the fund could solicit votes in favor of its shareholder proposal without filing a proxy statement.

The Ten-Investor Exemption can be used effectively to influence the vote on one or more of the company's proxy proposals if other large or institutional investors hold a significant proportion of the outstanding shares and are receptive to communications by other investors. For example, if 10 investors in Alliance Cloud collectively hold 46% of the outstanding shares, such a campaign could be effective. One downside of this approach is that Software Fund would have to be careful (and well scripted) in discussions with other investors so as not to form a Section 13(d) "group." If such a group were formed, Software Fund's 4.1% beneficial ownership would be aggregated with the shares beneficially owned by other members of the "group" in determining whether the threshold has been crossed for purposes of filing a Schedule 13G or 13D, as well as for reporting and incurring liability under Section 16. For example, assume that Software Fund approaches Momentum Investors, which holds 2% of the company's outstanding shares. If Momentum agrees with Software Fund to oppose the company's candidates for the board, then a "group" has arguably been formed. That "group" would hold 6.1%, subjecting both funds to Section 13(d) reporting. Because each investor is trying to influence a proxy vote, they would both have to file on long-form Schedule 13D. A 13D has disclosure requirements, including a narrative on the filer's "plans or proposals" relating to the portfolio company.

The other drawback of using the Ten-Investor Exemption is that if the approach to other investors fails to garner sufficient support, it is difficult to convert the campaign to a full-scale proxy contest. A full-scale contest by definition involves soliciting an indefinite number of investors, not just 10, and would arguably undermine the initial reliance on the Ten-Investor Exemption to cover the insurgent shareholder's initial solicitation efforts. Thus, as a practical matter, a fund using the Ten-Investor Exemption should try to rule out any interest in elevating the effort if it fails. It often is unclear whether 10 other investors approached by an investor will be willing to make time for a meeting, and if they do, whether they will be receptive.

Another exemption is the "Junior Proxy Contest Exemption," which requires a greater effort than the three listed above and is subject to restrictions that could undermine Software Fund's efforts. Under this exemption, an investor that is unaffiliated with the company may solicit an indefinite number of other shareholders, so long as it does not seek to obtain executed proxy cards. As a practical matter, this means that the exemption is more useful in opposing a proxy proposal made by the company or another shareholder, rather than furthering the investor's own proposal. For example, assume that the investor wishes to oppose the re-election of three members of the board's compensation committee, as well as the company's say- on-pay proposal. That investor could approach an indefinite number of shareholders, so long as it does not seek the revocation of any proxies that have been executed. Under this exemption, an investor with over $5 million in the target company's securities must file a notice with the SEC, as well as any written materials used in the solicitation. (An investor with less than $5 million need not file a notice or written materials.) Because the use of this exemption assumes a widespread solicitation,

it is likely to require more effort and expense than the three "activism light" methods noted above. If this exemption is relied upon, the rules preclude converting the effort into a formal proxy contest.

The First Level of The Decision Tree

In our scenario, Software Fund has the resources to commence a formal proxy contest, but it is reluctant to do so without first trying less extensive methods. For one thing, certain of Software Fund's own investors may not react favorably to the publicity associated with a full-scale activist campaign. Furthermore, its principals lack experience in mounting activist campaigns, so they would face a steep learning curve. Software Fund accordingly decides to start with alternatives short of a full-scale proxy contest.

Submitting a shareholder proposal to the company is not appealing, since the company would be able to exclude a proposal addressing its grievances — product strategy and marketing.

Nor does it make sense to utilize the Ten-Investor Exemption. There are only four institutional investors other than Software Fund with material positions in Alliance Cloud. One of the four is affiliated with the company, and unlikely to support an activist campaign. Another of the four has been known to take substantial short positions, so its interests may not be aligned with those of Software Fund. The remaining two may be interested, but their last reported beneficial ownership levels were only 2.5% and 3% of the outstanding shares, respectively. Furthermore, the principals of Software Fund do not have a relationship with those investors, so there is no way to predict whether they will be receptive to being approached. In addition, use of the Ten-Investor Exemption could likely foreclose the launch of a full-scale proxy contest.

At least as a first step, Software Fund does find appealing the use of the Publication Exemption, the exemption for statements made in a public forum where an investor states how it intends to vote and why. In order to exert maximum pressure on the company, the fund wants to generate some publicity, and perhaps hint that it could launch a proxy battle. The founder of Software Fund has scheduled an interview on a business talk show the following week, along with a handful of press interviews. Together with its PR consultant, the fund has prepared a set of talking points, which state that the fund may oppose nominees for the company's board of directors at the upcoming annual shareholders meeting, explain the fund's criticisms of the company's marketing and product strategies, and describe the company's non-responsiveness to date. While the company has not yet filed or mailed its proxy statement for its annual shareholders meeting, it will inevitably include nominations of candidates for its board, so the fund's statements about targeting board seats could be viewed as a "solicitation" under the proxy rules. After this initial publicity campaign, the fund can talk to the company to see if it will be more responsive to its grievances. If not, it will consider whether to take the next step.

Software Fund's public statements have limited success. The financial press's interest in the fund's criticism of the company is less than overwhelming, and the company appears to have taken it in stride. The fund's statements in opposition to the company's board candidates may create publicity that generates pressure on the company, but it is not likely to have a practical effect. The fund is not at this point overtly threatening to nominate its own candidates for the board. While the company has a policy that a director who does not receive a majority of the votes must submit his or her resignation, the board has authority to decline to accept the resignation.[7] Further, there is some skepticism among members of management that a passive hedge fund would actually launch a proxy battle at the annual meeting.

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[7] Under the laws of many states, a director who is not approved at the annual meeting can "holdover" until his or her successor is elected or appointed. Many companies, including most Fortune 500 companies, have adopted a majority voting standard for director elections, as well as a policy for what happens if a director does not receive majority approval. Counsel of Institutional Investors, FAQ: Majority Voting for Directors (2019). Typically, under such policies, a director's resignation needs to be accepted based on various factors.

A few other investors reach out to Software Fund, however, in response to the latter's publicity campaign. One institutional investor (the third of the four described above) tells Software Fund that it had the same concerns over the company's product strategy, and has additional concerns about the company's cost structure, including its executive compensation package. Another institutional investor stated that it sees some basis for Software Fund's critique of the company, and is keeping an open mind, but lacks special expertise in software development, and accordingly is reluctant to second-guess the decisions made by management, noting that management is respected and experienced in the industry.

The Second Phase of an Activist Campaign

With little confidence in the long-term success of Alliance Cloud, Software Fund decides that it has to either ramp up its efforts in a material way, or accept its losses and sell its position. There is a deadline, since the company — like nearly all companies — has an advance notice requirement in its bylaws if a shareholder intends to solicit proxies for a proposal to be presented at its annual meeting. The fund would have to comply with this requirement if it were to propose its own board nominees to replace those nominated by the company. The notice is due in 30 days, and it must be accompanied by additional information about the fund's board nominees, as well as about the fund's beneficial ownership of the company's common stock, and any related derivatives. The fund's counsel advises submitting the package to the company early, so there is time to respond to any deficiencies identified by the company.

Software Fund also considers a step short of a formal proxy contest: The Junior Proxy Contest Exemption for soliciting an indeterminate number of shareholders without seeking a proxy card. It could make use of this exemption without preparing or filing a proxy statement, and without complying with the company's advance notice bylaws. The fund could reach out to a large number of shareholders with its critique of the company, and make a voting recommendation on the company's board nominees, but would lack the ability to collect actual proxy votes (or revocations of votes) for the company's nominees. Furthermore, it would not be able to nominate its own candidates. As a result, the effort would be mostly cosmetic; while it may t be possible to preclude one or more of the company's directors from receiving majority support, the fund could not guarantee any actual changes in the board's composition. Any such board changes would merely shrink the existing board, not add new directors with a different point of view. Of course, the fund could recommend "no" votes for any other proposals made by the company, including its say-on-pay proposal, and those efforts could actually lead to the failure of such proposals.

Using the Junior Proxy Contest Exemption, it would not be possible to convert the campaign into a full-scale proxy fight, and all written solicitation materials would have to be filed with the SEC. While use of this exemption would relieve the fund of having to prepare and file a formal proxy statement, it would have few other advantages compared to a full-scale proxy fight, while requiring the fund to incur many of the same costs. Software Fund's main concern about this alternative is that it would be "toothless" since it would not actually result in a material change to the composition of the board. It could threaten the company's say-on-pay proposal, but the fund's criticisms of company management are not focused on executive compensation.

Software Fund decides to prepare for a full-scale proxy contest. A major benefit of focusing on a formal proxy contest is that the fund can start its campaign without restriction (other than the federal anti-fraud rules), even well before it prepares and files a proxy statement. Once the fund intends in good faith to file a proxy statement, there are no restrictions on its ability to orally solicit other shareholders. Written solicitations are also permitted, but must be filed with the SEC, where they will be subject to monitoring by the staff. This permissive use of oral and written solicitations remains available even if — and up to the time when — the fund later decides not to proceed with the proxy contest (or file a proxy statement), as a result of a settlement or otherwise. Another benefit is that the fund's announced intention of mounting a proxy contest, coupled with concrete steps (e.g., the submission of written advance notice in compliance with the company's bylaws), will exert maximum pressure on management, and could lead to a settlement between the company and the fund before

actually investing significant money and effort in the formal proxy campaign.

In addition to procedural steps, including the submission of a notice to the company and preparation of a proxy statement, the fund will have important decisions to make about the scope and nature of the proxy contest. These include the following:

Decide whether the fund should seek to replace a minority of the board or a majority. Contests for control of a majority of the board are statistically less likely to succeed, but, if successful, bring greater assurance that the fund's goals will be achieved. However, even a single, well-respected director can have a significant impact. Proctor and Gamble, Inc., for instance, credited activist investor Nelson Peltz and his firm, Trian Fund Management, with improvements in profitability after Mr. Peltz joined the board following a proxy fight.[8] Among proxy contests brought in 2018, the vast majority sought one or more seats on the company's board of directors, and about a quarter of those sought board control.[9]

Identify director candidates. Should the fund nominate candidates from among their friends and insiders? Independent, well-respected candidates could be more appealing to other investors in seeking their support, but inclusion of one or more insiders can help to ensure that the fund's objectives remain in focus. If the board includes insiders of the fund, the fund's ability to trade the company's common stock will be restricted, and there may be additional restrictions under Exchange Act Section 16:

- Identify any elements that could inhibit the proxy contest, such as the existence of a "shareholder rights plan," which could limit the acquisition of additional securities, and any provisions of a trust indenture, or other agreement or instrument that may be triggered by the acquisition of control;
- Identify and retain members of the "deal team." Essential team members include a proxy advisory firm, to help identify and communicate with other investors, a law firm, and a financial advisor if there are financial or restructuring issues. Other non-legal strategic advisors may become involved; and
- Consider whether to seek a settlement with the company, and, if so, the timing of such an effort, and the terms upon which the fund might be willing to settle. The most common outcome of proxy contest is a settled resolution.[10]

Conclusion

Engaging in shareholder activism involves a complex set of factors and considerations that even the most experienced investors can find challenging. The interplay of these considerations could be even more challenging for a fund that lacks experience in such campaigns. This is particularly the case if one were to include issues involving Exchange Act Sections 13(d) and 16, as well as HSR, which were assumed away in our scenario. Nonetheless, an inexperienced investor will gain a working level of experience from even a single, limited campaign. Once the fund has publicly engaged with a portfolio company, it should be taken more seriously in the future, and could move quickly if it decides to try again.

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[8] *See, e.g.,* "P&G CEO Taylor, activist investor Peltz laugh off proxy battle as stock soars," Cincinnati Business Courier, Sept. 20, 2019.

[9] The Conference Board, Proxy Voting Analytics (2015-2018), at 170.

[10] The Conference Board, Proxy Voting Analytics (2015-2018), at 180.

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