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The Hedge Fund LCD 2016 Mid-Year Review: Hedge Fund Activism

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Activist hedge funds continue to grow in number, size, activity and success. Over the last five years, the strategy's assets under management have nearly doubled. The number of activist campaigns are up more than 62% over the same period. Activist managers are increasingly flexing their muscles in Europe and Asia, markets where they've previously experienced strong resistance. And, increasingly, those campaigns are working—generating more and more successful outcomes and strong returns.

As hedge fund activism grows, so too does regulatory scrutiny, as demonstrated by recent settlements struck by ValueAct Capital and Third Point. Still, the regulatory environment surrounding activism remains in flux.

Where Things Stand

Activist Insight Monthly, produced by Olshan Frome Wolosky, Mackenzie Partners and Marathon Partners, shows worldwide activist demands growing 17%, including a record high in the U.K. and 10% growth in the U.S. The number of companies publicly targeted by short-selling activists was up even more sharply, by 35%. But Activist Insight also shows that the number of activist campaigns fell slightly in the first half, from 81 last year to 75 this year.

Still, it seems that hardly a day goes by without news of some activist campaign or other. Buffalo Wild Wings, Forest City Ratner, LifeLock, the London Stock Exchange, Macy's, PulteGroup, SAB Miller, Sotheby's, TheStreet, Volkswagen, WPP, Xerox Corp. and Yahoo! have all attracted activist interest this year. And it's working: According to eVestment, activist hedge funds are one of the best-performing strategies of the year, rising 5.04% through July, in spite of a slow start to 2016.

Those returns continue to attract investors, but activists are also attracting unwanted attention from regulators, legislators and the media. The travails of Pershing Square Asset Management have been widely covered, and, in spite of the generally good returns in the space, some top-name activists, such as Jana Partners, have struggled. In April, the Justice Department took aim at ValueAct Capital Management, accusing it of violating antitrust laws (see below). In addition, amidst the current Wall Street-bashing presidential campaign, Senate Democrats proposed the Brokaw Act, which would give activists less time to disclose new investments, force the disclosure of derivatives and other holdings, and increase the number of investors having to report stakes in excess of 5% of a company's shares. On the bright side, the Securities and Exchange Commission is considering universal proxy cards for contested corporate elections.

The European Union's new [Market Abuse Regulation]—which came into force on July 3—could hamstring activists, potentially classifying the publication or distribution of otherwise publicly-available data as insider information. And in spite of the growth of activism in Asia, there has been significant pushback in China, where bearish analysts are sometimes thrown out of corporate briefings. "Chinese companies are less willing to embrace different opinions," Hong Kong activist Hui Man-cheong told Reuters.

The question of whether activism helps or hurts has also attracted differing opinions. One recent study found that it decreases a target company's long-term value; another argues that activist campaigns strengthen company fundamentals over the long term.

Enforcement Actions

The ValueAct case had the potential to redefine what is and isn't hedge fund activism but the Justice Department's lawsuit against the firm ended in an $11 million settlement last month. The hedge fund stood accused of violating the Hart-Scott-Rodino Antitrust Improvements Act by classifying more than $2.5 billion in investments in the merging oilfield services companies Baker Hughes and Halliburton as passive—and therefore eligible for an "investment-only" exemption from HSR's reporting requirements. The DOJ alleged that ValueAct improperly sought to influence both companies, meeting with them more than a dozen times, prior to formally filing as an active investor under HSR's premerger notification requirement. ValueAct said that the DOJ's strict reading of HSR threatened to violate "the most basic principles of shareholder rights," including "having a relationship with company management."

The hedge fund—which this month took a 2% stake in Morgan Stanley—said it still "fundamentally disagrees" with the DOJ's reading of the law. But given its decision to settle—and pay the largest-ever HSR fine—the matter remains unresolved.

What the Experts Are Saying

Increased Activism

According to Stephen Hinton, counsel at Bradley Arant Boult Cummings, activist investing is increasingly popular but that growth extends over some period of time. "I think it is more popular, but we've been seeing more activist strategies over a number of years. I think part of this increase is just more awareness of the strategy now and more knowledge of what's happening because things are much more public now, and funds are required to make regulatory filings that let people know what they're doing."

In addition to being more popular, activist strategies have also evolved, noted Christopher Hewitt, partner at Tucker Ellis. "In the early days of activist investing, a lot of funds were pretty aggressive in what they did. The activists often did not know much about the companies other than there was an opportunity to make a profit. In recent years, funds have become much more sophisticated and really try to understand the company in which they're investing, what the business is and where there is value. They try to engage management rather than immediately going activist and trying to force actions on a company and taking boards seats. And companies have also evolved from refusing to talk to activist investors to engaging with them."

Impact of ValueAct

Hinton explained, "Activist managers often felt like they had not made the move from passive investors to activist investors until they took some kind of action, whether releasing a press release proposing strategic changes at the company or submitting notice of director nominees for a proxy fight. It was believed that an investor wasn't an activist until the moment to try to influence management arose. What ValueAct showed us is that hedge funds need to be concerned with actions that occur before a specific event, such as internal discussions about what their strategy is with a particular investment or behind the scenes discussions with management. The game plan of silently acquiring shares under the auspices that you're a passive investor until you take an affirmative step has been turned around after ValueAct. Now investors have to think about at what point discussions they have about possible strategies will reach the DOJ's threshold for becoming an activist investor."

Hewitt called the ValueAct case "another stage in the evolution of the 'to and fro' between activist shareholders, other shareholders, companies and regulators as to how investors can invest in companies and execute their strategies."

As for the case's impact on activist investing in general, Hewitt said, "I think the concern here is for passive investors who engage with management but aren't taking an activist position—and don't intend to—and whether that will be considered an activist position by the DOJ or regulators that would require an HSR filing. I don't see it as a real issue down the road, but while the issue is still fresh in everyone's mind there is some concern about what you can and can't do as a passive investor just doing your due diligence and engaging with management at the companies you invest in."

Key Considerations for Managers Seeking to Follow a More Activist Strategy

Hinton advised hedge fund managers entering the activist strategy to include consideration of whether, and when, they will cross over into the activist investing area in their strategy and know when they are no longer able to say they are a passive investor, which is going to be earlier in the process.

"They will also want to carefully monitor any external discussions, whether it be with company management or other shareholders, and if that subject matter discussed would indicate the investor has an activist intent," Hinton said. "They will also want to determine whether, as they are engaging with the company, the things they are proposing to the company can be viewed as influencing management. The SEC released some guidance after ValueAct, but it was intended to reassure investors that normal conversations about corporate governance and executive compensation would still be considered a passive investment for purposes of 13D. We don't know if the DOJ would take that exact position, but it's probably a safe assumption. With that in mind, investors want to make sure that what they're doing falls into those categories of things initially, to avoid being an active investor if they're not ready to take an activist position."

Hewitt recommended managers have someone on their team of the activist fund who is familiar with the strategy, which seems simplistic but is vital to the success of the strategy. "Just as an example, you want to have analysts who can look at investment opportunities and see if there is value there and determine the best strategy for unlocking that value. If you're going to pursue an activist strategy, you have to think about how you're going to approach deals and interact with a target company. That's a unique skillset that's needed if you want to pursue this strategy."

Drawbacks of Activist Investing

Hinton cautioned managers that "activism is a high-stakes game," particularly if the manager plans to go public with a campaign. "Then it goes beyond whether you have good suggestions and can work with the company in a good way and becomes a public referendum of sorts, so if you make a misstep or your proposals do not garner support then you have a very public failure."

An activist campaign could also hurt the target company and, therefore, the fund's investment, Hinton noted.

"If you're not bringing value to the company and you're causing a lot of dissent and distracting management, that can be detrimental to the company's stock price, and if you have a long position that can hurt your fund."

Tips for Addressing

Given the lack of resolution on the heart of the DOJ's case against ValueAct—and the potential for future lawsuits along similar lines—hedge funds and their compliance teams would be well-advised to consider the risks of communicating with portfolio companies involved in mergers and other notable events, and whether it makes sense to invoke one of HSR's exemptions to avoid disclosing investments—especially given the dramatic recent increase in fines under the law, one of the factors that ValueAct cited in its decision to settle.

Firms also need to carefully consider MAR's Recital 28, which imposes restrictions on public commentary about an investor's holdings—violation of which could lead to insider trading enforcement actions.