Hedge Fund Activism in Technology and Life Science Companies

**Highlights**

- There has historically been a view that R&D companies (such as technology and life science companies) are not typically targeted by hedge fund activists, in part due to factors such as the complexity of their businesses and their dependence on founding shareholders. However, a review of campaigns of 33 hedge funds from 2005 through the end of 2011 indicates that they are not only targeted, but disproportionately so relative to companies in other industries.

- There are many attributes of technology and life science companies that may make them attractive targets, such as the available pool of potential acquirers, the volatility of their industries, and their tendency to accumulate cash.

- Most technology and life science companies have a market cap of less than $20 billion, which is the upper limit of companies in our review group that were targeted. Small companies are the most vulnerable. Approximately 80 percent of the campaigns reviewed involved targets of less than a billion dollars in market cap. While newly public companies typically make poor targets, almost one-third of campaigns involved companies that had been public for 10 years or less.

- Different hedge funds pursue different strategies and tactics, from the modern equivalent of raiders, at one extreme, to long term investors that pursue occasional activism on a non-confrontational basis, at the other. It is important for targeted companies to recognize the funds they are dealing with and incorporate it into their response strategy.

- After a sharp drop in the number of campaigns in 2009, the number increased during the last two years and is expected to increase again in 2012, based on the level of hedge fund assets under management.

- Campaigns can be time consuming and disruptive, some of them lasting for several years. Approximately one-third of campaigns in our review group involved the sale or liquidation of the company, and these had a success rate of above 60 percent.

- While takeover defense strategy typically focuses on structural defenses that prevent against unsolicited changes of control, a strategy for dealing with hedge fund activism should have a broader focus. Activist hedge funds typical acquire minority share positions and need the support of other shareholders to succeed in their campaigns. As an important part of an effective strategy, technology and life science companies should maintain good relations with their long term shareholders, and ensure that their business, operational and governance strategies are well understood by the market and not easily undermined by activists.

- Structural defenses are nonetheless important because inadequate structural defenses undermine the ability of boards to respond to attacks. In particular, targets with staggered boards were more successful than targets without them at preventing activist
hedge funds from both gaining any board seats, and gaining board control. Companies should consider this loss of protection when evaluating whether to declassify their boards.

Introduction

Hedge fund activism has received a lot of attention in the legal and financial communities since the middle of the last decade, and has been identified as a major threat to U.S. public companies. Some of the early literature suggested that hedge funds avoid companies with high levels of R&D (such as technology and life science companies), in part because their businesses are more complicated and it takes longer for efforts of the hedge funds to be appreciated by the investment community and to generate returns. There has also been an assumption among legal practitioners that many technology and life science companies are dependent on the skills of their founders, and thus a hedge fund campaign faces the risk that the main assets of the company may walk out the door. However, a review of campaigns of 33 hedge funds from 2005 through the end of 2011 indicates that hedge fund activism is not only a significant risk that technology and life science companies face, but one that may disproportionately target them relative to companies in other industries. This Commentary summarizes some of the findings regarding the funds involved and their campaigns, and makes recommendations to technology and life science companies on how to address the risks.

Hedge fund activism typically entails hedge funds taking a minority position, frequently between five and 10 percent, in undervalued companies and then pressuring them to take action in order to generate a return on the hedge fund’s investment. Activism can take a number of forms, such as trying to influence a company to make operational or governance changes, opposing a proposed acquisition or sale transaction, or launching a proxy contest targeted at ultimately forcing a sale of the company. Part One of this Commentary gives a brief explanation of the rise of shareholder activism by hedge funds. It looks at the rate of hedge fund activism since 2005, both across all industries and focusing on companies with one of 13 technology-related SIC codes or one of five SIC codes related to the life sciences industries. Part Two considers the type and size of the 33 hedge funds reviewed, and focuses on 60 campaigns they have run targeting technology and life science companies. Part III draws some conclusions regarding the vulnerability of technology and life science companies to hedge fund campaigns, including several characteristics that make them attractive targets. Part III also makes some recommendations for technology and life science companies on how to address the risks.

Part One: The Rise of Hedge Fund Activism

Hedge fund activism can be seen as the confluence of two developments that have principally occurred during the last 25 years: the proliferation of hedge funds and the rise of shareholder activism.

Proliferation of Hedge Funds

There is no accepted definition of hedge fund. They have been broadly described as entities that raise funds through private placements, hold a pool of securities and possibly other assets, and are not registered under the Investment Company Act of 1940. Typical investors include pension plans, endowments, foundations and wealthy individuals. The hedge fund industry occupied a very small portion of the financial community in 1990. It grew steadily throughout the 1990s, expanded rapidly in the 2000s, dropped significantly during the global financial crisis, and is now growing again. The following is a chart showing total assets under management in the hedge fund industry from 1997 until 2011, based on data from BarclayHedge.
The popularity of hedge funds is partially attributable to the wide range of investment goals and strategies they are free to pursue, compared to more regulated entities like mutual funds. Only a small portion of aggregate funds under management is devoted to shareholder activism.¹

Hedge funds that engage in shareholder activism are conceptually distinct from private equity and venture capital funds in that they focus on taking minority ownership positions in public companies and agitating for change. However, the campaigns we reviewed include a few by private equity funds that also engage in activism, and by hedge funds that also engage in venture capital.

**Shareholder Activism**

Shareholder activism is an outgrowth of the separation between ownership and control of corporations and the risk, first observed in a seminal 1932 treatise, that boards employ the proxy machinery to become self-perpetuating bodies.² This observation sparked a contentious and unresolved debate regarding the appropriate scope of shareholder monitoring and control of boards. According to advocates of a shareholder-centric model, greater shareholder protections are needed because in modern corporations with large retail ownership, shareholders are too widely dispersed to effectively monitor and control boards. Proponents of a director-centric model counter that unlike managers of partnerships, boards of corporations have intentionally been vested with significant power under state codes. They are subject to direct shareholder oversight in limited areas, such as mergers and charter amendments, and are further constrained by their fiduciary duties. This allocation of power has worked well, they argue, because corporations operating under it have proven to be extremely efficient entities at generating wealth.

What started as an academic debate has spawned numerous legal, regulatory and judicial developments, particularly during the last 25 years. As share ownership has become increasingly institutionalized and the institutions have become more politically organized, the balance of power has ratcheted in favor of the shareholder-centric model. Several legal and regulatory developments have contributed to the shift. Liberalization of the proxy rules has made it easier for activists to communicate with other shareholders.³ Legislation such as the Sarbanes-Oxley Act of 2002 and the say-on-pay provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”) have put boards under increased pressure and contributed to making shareholder activism more socially acceptable.⁴ The rise of proxy advisory firms, such as Institutional Shareholder Services, is rooted in a Department of Labor ruling in the late 1980s that the fiduciary duties of pension funds in management plan assets extends to the voting of proxies.⁵ As the name “Institutional Shareholder Services” suggests, proxy advisory firms adopt a shareholder-centric approach. Not only have they shown a willingness to recommend in favor of activist campaigns, but through their voting policies they have significantly contributed to the erosion of companies’ structural defenses because the defenses do not conform to their views of best practices in corporate governance.

Developments in technology have also contributed to the rise in shareholder activism. The internet, in particular, has made it much easier for activists to disseminate their messages and
rally support. Schedules 13D have turned from perfunctory compliance documents into platforms where activists attach open letters to other shareholders and lengthy position papers in support of their campaigns. In many instances, activists have also created websites, similar to those created for political campaigns.

The shift towards shareholder activism has created an opportunity for hedge funds. Controlling large amounts of capital and having the legal and contractual flexibility to deploy it, activist hedge funds have positioned themselves as champions of shareholder rights.

**Hedge Fund Activism Since 2005**

The graph below is based on data from the 33 funds covered by our review. The graph indicates that hedge fund activism increased significantly from 2005 through 2008, then dropped sharply, and is now on the rise again.

The blue line in the graph shows the number of campaigns of hedge funds in our review group that were commenced from 2005 – 2011. The numbering is on the left vertical axis. The green line shows the aggregate dollar amount of assets under management at year end, based on Schedule 13F filings of the reviewed funds. The dollar amount is on the right vertical axis.

The graph shows a strong correlation between assets under management at year end and the number of campaigns commenced the following year. Assets under management peaked at the end of 2007, and the number of campaigns peaked during 2008. There was a significant drop in assets under management at the end of 2008 (which corresponds to the industry drop shown in the chart on page 3), and a significant drop in activism during 2009. The graph shows that assets under management at the end of 2011 exceeded those at the end of 2010. Given the relationship between assets under management at year end and the number of campaigns the following year, the graph indicates that the number of hedge fund campaigns in 2012 is likely to increase relative to 2011.

The distance between the two graph lines has expanded, indicating that the level of activism appears disproportionately to lag the 2007 level, relative to the drop in assets under management. One possible reason is a decrease in the number of smaller activist hedge funds that commenced operations prior to the financial crisis. In our sample group, six of the smaller funds either ceased operating or are currently in the process of winding down their operations. These funds had a much greater focus on shareholder activism compared to many of the larger funds with more diversified strategies. Given the current difficult fundraising environment for hedge funds relative to the period prior to the financial crisis, the ranks of small hedge fund activists are unlikely to be repopulated in the immediate future.

**Rate of Activism in Technology and Life Science Companies**

The graph below shows the number of hedge fund campaigns directed at targets with the specified technology and life sciences SIC codes during the 2005 – 2011 period.
The graph shows a similar peak in 2007, low point in 2009 and subsequent increase to below the 2007 peak to that illustrated above for activism in all industries. Because assets under management increased in 2011, we can expect that, if the correlation between assets and activism continues, activism in technology and life science companies will increase in 2012 relative to 2011, although probably not yet to the 2007 levels.

Our review indicates that technology and life science companies were disproportionately targeted relative to their representation on Nasdaq or NYSE. The following chart shows the percentages of targets with the specified technology or life science SIC codes and the percentages of companies listed on either NASDAQ or NYSE having the same SIC codes:13

Comparing these percentages indicates that life science companies were approximately 1.5 times more likely to be the subject of hedge fund attacks by the reviewed funds, and technology companies 2.2 times more likely, than listed companies in other industries.14

Part Two: The Funds, Campaigns and Targets

Types of Funds Involved

The hedge funds under review vary significantly in size. The following chart contains information about the value of assets under management as of December 31, 2011, for 23 of the funds that
are both still operating and for which sufficient information is available on EDGAR:

As shown in the chart, fund sizes range from fewer than $250 million in assets under management to more than $5 billion, the most common size being $1 billion to $5 billion. Fund size is a measure of the number and size of campaigns a fund can pursue, as illustrated in the following simplified calculations. Activist funds typically diversify risk by engaging in a small number of campaigns at one time, usually less than a dozen. As indicated under “Types of Campaign” below, most campaigns involve a share ownership position of between 5 percent and 10 percent on first announcement. For an unleveraged fund with $1 billion under management and five active positions, the average investment could be as high as $200 million, assuming all funds were deployed. Assuming a share ownership of between 5 percent and 10 percent, this equates to target companies having a market cap of between $2 billion and $4 billion. With leverage, the number and size of campaigns could increase, subject to limitations, such as under margin lending rules.

Funds pursue a range of strategies. At one end are long term investors that occasionally engage in activism when faced with a deteriorating investment, or to oppose a company transaction. At the other end are the modern equivalent of the corporate raiders of the 1980s, which primarily invest in companies if there is the possibility of generating a short term return through forcing events such as company sales or divestitures. In the middle there are funds that, like raiders, engage in activism as their primary strategy, but, like long term investors, also target value creation through longer term operational, governance or structural improvements.

Funds can employ a wide range of tactics. Some activists routinely engage in proxy contests and commence litigation, others rely more on open letters to shareholders, and some hold most of their discussions with boards and management behind closed doors.

While funds can pursue different strategies and tactics in different campaigns, it is generally possible to categorize them based on a review of all their campaigns. The following is a grid that categorizes the 33 funds reviewed by the groupings described above:

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Value Investor</th>
<th>Primary Activist</th>
<th>Raider</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tactics</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Most aggressive tactics; frequent use of proxy contests and/or litigation</td>
<td>3</td>
<td>8</td>
<td>7</td>
</tr>
<tr>
<td>Less aggressive; open letters and other public communications</td>
<td>5</td>
<td>5</td>
<td>0</td>
</tr>
<tr>
<td>Mainly private communications</td>
<td>2</td>
<td>3</td>
<td>0</td>
</tr>
</tbody>
</table>
Types of Campaign

This section considers 60 of the funds’ campaigns that targeted technology and life science companies. The first sub-section looks at the time during the fiscal year when the campaigns were first publicly announced, the ownership percentage on first announcement, and the duration of the campaigns. The second sub-section looks at the campaign objectives, such as board representation, operational changes or the sale or liquidation of the company, and the success rate of those campaigns. The third sub-section looks at the tactics employed by the funds, such as a proxy contest, litigation or public offer to acquire the target. The last sub-section looks at the way the funds exited their investments, such as through a sale or liquidation of the target, or through selling their shares.

The Timing and Size of Campaigns

Campaigns can commence at any time of the fiscal year, although 60 percent of the campaigns reviewed were started during the period from 3 months prior to fiscal year end to 3 months following it. This period can be seen as the run-up to advance notice deadlines for annual meetings, given that annual meetings typically occur 4 or 5 months after the start of the fiscal year, and advance notice deadlines typically occur 60 or 90 days prior to the annual meeting. The data therefore suggests there is a slightly increased chance of a campaign starting during the run-up to the advance notice deadline.

Most fund ownership positions were between 5 percent and 10 percent upon first announcement of the campaign. The following chart shows the range of sizes on first announcement in the campaigns reviewed:

![Pie chart showing the range of sizes on first announcement in the campaigns reviewed.]

The greater incidence of positions between 5 percent and 10 percent is not surprising, given the 5 percent filing threshold under Schedule 13D. Some of the higher percentages are attributable to long term shareholders who accumulated large positions filing on Schedule 13G, and then switched to Schedule 13D upon commencement of activism.

Campaigns can last from a few days to several years. The following chart shows the range of durations for the reviewed campaigns. The end point in each case is either achievement of an objective, settlement with the issuer, express renunciation of the objective or implicit renunciation through dropping to less than 5 percent beneficial ownership or switching forms to a Schedule 13G.
Campaign Objectives and Outcomes

Campaign objectives can fall within one or more of the categories in the chart below. The chart shows the percentages of campaigns involving each objective, and gives a further breakdown showing the portion of those campaigns that were either wholly successful, partially successful or wholly unsuccessful (excluding ongoing campaigns, and excluding campaigns for board representation, which are discussed in more detail below):

(1) Includes matters such as amending bylaws, declassifying board or splitting roles of Chairman and CEO
(2) Includes events such as divestitures, dividends and share repurchases

Three points stand out from the chart above. First, board representation was targeted in the highest percentage of campaigns. That is not surprising, because board representation is frequently sought in conjunction with other objectives. For example, board representation may be sought in a proxy contest to gain control of the board, prior to forcing a sale of the target company.

A second point is the vulnerability of companies to campaigns involving the sale or liquidation of the company. Not only do these objectives represent over one-third of all campaigns, but the campaigns have a success rate of above 60 percent.

A third point is that a significant percentage of campaigns do not involve either the sale or liquidation of the company or another strategic event, which are the types of event-driven campaigns that are frequently associated with raiders looking for short term gain. This illustrates the importance of understanding the funds and their objectives, and not simply assuming that all funds are raiders.
In order to review the success rate of campaigns involving board representation, campaigns can be divided into those involving targets that have staggered boards and those that do not. Of the campaigns in our review that involved board representation, 46 percent of them involved targets with staggered boards and 54 percent of them involved targets with non-staggered boards. The following charts provide information on seats sought and obtained by hedge fund activists in campaigns involving staggered boards:

<table>
<thead>
<tr>
<th>Seats sought:</th>
<th>Seats obtained:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>&lt;50% of class</td>
</tr>
<tr>
<td>% of campaigns</td>
<td>9.5%</td>
</tr>
<tr>
<td></td>
<td>0 seats</td>
</tr>
<tr>
<td>% of campaigns</td>
<td>36.4%</td>
</tr>
</tbody>
</table>

The above charts show that activist funds were completely unsuccessful in trying to gain control of boards where the target companies had staggered boards. This reaffirms the importance of staggered boards as a defensive mechanism.

The following charts provide information relating to seats sought and obtained for campaigns involving non-staggered boards:

<table>
<thead>
<tr>
<th>Seats sought:</th>
<th>Seats obtained:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Up to 25 % of Board</td>
</tr>
<tr>
<td>% of campaigns</td>
<td>7.7%</td>
</tr>
<tr>
<td></td>
<td>0 seats</td>
</tr>
<tr>
<td>% of campaigns</td>
<td>26.1%</td>
</tr>
</tbody>
</table>

The above charts show that minority representation in non-staggered boards was sought by fund activists in more than one-half of all campaigns. It is generally easier for activists to obtain support of proxy advisory firms where minority representation is sought.

The charts also indicate that funds were unsuccessful in gaining any seats in 26.1 percent of campaigns, compared to 36.4 percent of campaigns involving staggered boards. They obtained control of the board in 13 percent of campaigns, compared to 0 percent for staggered boards. Target companies with staggered boards were therefore more successful at preventing funds from gaining any seats, as well as preventing them from gaining board control.

**Campaign Tactics**

The following chart shows the occurrence rate of various tactics for the campaigns reviewed. Multiple tactics were used in many campaigns, such as litigation in connection with a proxy contest.
Campaigns involving a proxy contest include those where director nominations were made, even if a mailing campaign was not started. The high incidence of proxy contests is not surprising, given the high percentage of campaigns involving board representation noted above.

Settlements were reached in 44 percent of campaigns, and settlement agreements entered into by issuers and activists in 33 percent. The hedge fund was provided expense reimbursement in 72 percent of settlement agreements. Settlements are clearly a common practice to avoid the expense and distraction of proxy contests. Different funds appear to adopt different practices with regard to expense reimbursement.

**Types of Exit**

The following chart shows the type and frequency of methods through which activist funds exited their investments during the various campaigns.

About two-thirds of the exits in connection with a sale of the target relate to campaigns that expressly targeted the sale of the company. This statistic, together with the 5 percent of campaigns that involve either the liquidation of the target or the sale to the activist fund, is consistent with the observation above regarding the vulnerability of companies to campaigns involving the sale or liquidation of the company.

**Types of Companies Targeted**

This section looks at the size of the target companies and the number of years that they had been public at the time of first announcement of the hedge fund campaign in order to see whether size and maturity have a bearing on vulnerability to attack. The section also looks at whether companies were targeted because they had weak structural defenses, by comparing the frequency of each of five structural defenses to their frequency in companies in the Russell 3000 and S&P 500 indices.
Size of Target Companies

The technology and life science targets ranged in size from a few millions dollars in market cap to several billions of dollars. The chart below on the left shows the distribution of sizes for targeted technology companies, and the one on the right for life science companies.

It is common for hedge funds to take activist positions in companies that are several times larger than the total assets under management of the fund. The largest target companies in our survey had market caps approaching $20 billion. Most life science and technology companies are therefore not too big to come under attack.

Approximately 80 percent of the campaigns reviewed involved targets of less than a billion dollars in market cap. There are several possible reasons why smaller companies may attract more hedge funds. First, there are more of them. According to S&P Capital IQ, approximately two-thirds of all companies with the specified technology and life science SIC codes that are listed on Nasdaq or NYSE have a market cap of less than $1 billion. Second, they are subject to attack by a greater number of funds. As indicated under “Types of Funds Involved” above, it is uncommon for small funds to target large companies, given the relationship between the size of the fund and the number and size of campaigns it can pursue. However, small companies can be targeted by funds of any size. Another reason is that smaller companies are likely to have more concentrated share ownership. Funds will therefore have to persuade fewer shareholders to support their campaigns, which will make campaigns easier and less costly. A fourth reason is that smaller companies tend to have simpler operations. As a result, it is easier and quicker for hedge funds to analyze them, and easier for funds to communicate their strategies to other shareholders.

Maturity of Companies

The following chart shows the break-down of campaigns based on the number of years that the target company had been public.
As shown above, companies that had been public for less than 5 years were significantly less likely to be attacked than long-standing public companies. This may be partly due to many of the newer public companies still being controlled by founders and venture capital funds, or heavily dependent on founding scientists. Another possible factor is that technology and life science companies tend to go public during windows when their products are considered very promising. During some windows, valuations can be very high, as occurred during the internet and genomics bubbles in the late 1990s and appears to be occurring currently for social media companies. Companies with high valuations or that are otherwise viewed positively by the investment community will generally make poor targets for activist hedge funds.

**Structural Defenses**

The following chart shows the percentages of the target companies that had a staggered board, poison pill, prohibition on shareholder action by written consent, inability of shareholders to call a special meeting, director removal only for cause, and advance notice bylaws. Corresponding percentages are also shown for companies in the Russell 3000 and S&P 500 indices (except in the case of advance notice bylaws, for which data was not available).  

The above chart suggests that the targeted companies did not have structural defenses that left them significantly more vulnerable to attack than the average company in the S&P 500 or Russell...
3000 indexes. They had stronger defenses in some areas, such as poison pills, and weaker ones in others. Their possession of a level of structural defenses that is comparable to those of companies in broad company indexes indicates that structural defenses do not typically prevent attacks. Given that some campaigns focus either partially or wholly on governance matters, excessive structural defenses may even be counter-productive and increase the likelihood of an attack.

That does not mean that structural defenses are not important. On the contrary, inadequate structural defenses undermine the ability of boards to adequately respond to attacks. As indicated in “Types of Campaign – Campaign Objectives & Outcomes” above, targets with staggered boards were more successful in defending against attacks than targets without them. To illustrate the point further, of the five companies with none of the first five defenses noted above, the activist obtained board representation in each case, and three of the companies underwent a sale or other change of control transaction while the activist was represented on the board.

The graph indicates two areas where some of the target companies appeared to have slightly weakened defenses relative to other groups. The first is with regard to permitting shareholder action by written consent. Companies should evaluate this defense in light of their overall defensive profile. For example, for companies with staggered boards, where directors can only be removed for cause, and which have charter supermajority voting requirements, it will be less of a defensive gap than for companies without these other protections.

A second area is the low rate of advance notice bylaws among the life science companies reviewed relative to technology companies. It will be significantly more difficult for companies to adequately prepare for activist campaigns in connection with annual shareholder meetings without this basic structural protection. Advance notice bylaws generally elicit less opposition from proxy advisory firms and governance activists than defenses like poison pills. Moreover, given current developments relating to regulation of proxy access, they are likely to have an increasingly important role in corporate governance in the future.18

Part Three: Conclusions & Recommendations

Our review indicates that life science and technology companies are frequently targeted by hedge fund activists, possibly disproportionately so relative to companies in other industries. The complicated nature of their businesses, based on high levels of R&D, is not a deterrent to activists. There has also been a suggestion that hedge funds may have been deterred from targeting technology companies in the past due to difficulties in valuing intellectual property. However, financial markets are now much more comfortable valuing intellectual property assets.19

There are many attributes of technology and life science companies that may make them attractive targets. In both industries there is a vibrant M&A market. Mature industry players regularly engage in strategic acquisitions to fill out their product offerings or development pipelines. The typical life cycle of a technology or life science company is to go from idea, through venture funding, to IPO and then get acquired. Such an environment lends itself to activist sale or divestiture strategies because of the available pool of potential acquirors.

Another characteristic of these industries is their volatility. This creates opportunities for activists to commence campaigns during one of the down cycles, attribute the depressed company performance to poor management, and agitate for change.20 A third characteristic is that companies in both industries have a tendency to accumulate cash, whether generated through operations or raised in financings to fund product development. If a company is trading near or below its net cash value, that presents an opportunity for a fund to pressure for a sale or liquidation. Alternatively, an activist fund may be able to realize short term value through pressuring for a dividend or share repurchase.

Most technology and life science companies have market caps of less than $20 billion, which is the upper size limit of companies in our review group that were targeted. The most likely targets are companies with a market cap of under $1 billion that have been public for more than 5 years. The size of that pool of targets is likely to increase as new waves of companies go public in response to new technology or life science trends. Many of the tech companies that went public during the internet bubble have already been subject to hedge fund activism. The current wave of
social media companies are unlikely to face much activism for several years, after their valuations have dropped and they are no longer controlled by the founders and VC funds that have taken them public.

Structural defenses do not typically prevent attacks, but are important in defending against them. Structural defenses should not, however, be the only form of protection against hedge fund attacks. They are imported from the realm of takeover defense, and are principally geared to protecting against unsolicited and opportunistic changes of control. Hedge fund activism works slightly differently. It typically entails hedge funds taking minority positions in target companies and soliciting the support of other shareholders, based on claims of poor management or governance, or inefficient capital allocation. Companies should view their relations with their long term investors as an important part of their defense strategy. Companies should ensure that their business, operational and governance strategies are well understood by the market, and that their shareholders will not be easily persuaded by competing views of activists.

Attacks can be time consuming and disruptive to management, and may lead to the sale or liquidation of the company. Approximately one-third of campaigns in our review involved the sale or liquidation of the company, and these campaigns had a high success rate.

After a significant drop in hedge fund campaigns following the global financial crisis, the number of attacks has been steadily increasing during the last two years, and is expected to continue increasing during 2012. Given the frequency with which life science and technology companies have been attacked and the potential consequences, companies should take some basic precautions, such as the following:

- Hedge fund activists typically need the support of other shareholders in order to succeed. As part of their corporate governance arrangements, companies should maintain effective channels of communication with their long term shareholders designed to ensure that their shareholders understand the companies’ business, operational and governance strategies.

- Companies should analyze their vulnerabilities, considering factors such as the following:
  - Companies should have adequate structural defenses. There is a trade-off: too few can leave a company overly vulnerable to attack; too many can be criticized as poor corporate governance, alienate long term shareholders, or even attract a hedge fund attack. For most companies, it will be prudent to at least have an advance notice bylaw and a poison pill on the shelf. A well drafted advance notice bylaw will not only eliminate an activist’s potential timing advantages in campaigns in connection with annual meetings, but also provide important information about the activist, its stock ownership position and the qualifications of its nominees.
  - Companies should consider their overall defensive profile before acceding to shareholder pressure to declassify their boards. In the campaigns we reviewed, staggered boards provided significantly better protection from hedge fund attacks than non-staggered boards.
  - Board composition is frequently attacked as resembling a “country club”. Consider new candidates to either replace directors who have served more terms than the industry norm, or to expand the board. One of the challenges activists face is putting forward their own qualified nominees, so this is an area where companies can gain the upper hand.
  - Companies should consider their operational weaknesses, such as expensive new real estate, or risky long term R&D projects, and consider how to justify them or mitigate costs.
  - Consideration should be given to underperforming or non-core lines of businesses, and how to respond to arguments an activist could make that they should be divested or shut down.

- Companies should monitor their stock for signs of hedge fund activity. There are several organizations that provide stock monitoring services. It should be kept in mind that some funds use derivative instruments as part of their strategies. It should also be kept in mind that activist funds have been adept at coordinating activity with other funds without expressly triggering the “group” filing requirements of Schedule 13D.
• Companies should monitor what analysts and other third parties say about them for signs of potential weaknesses that hedge funds can exploit. Companies should proactively deal with significant issues raised, by either fixing them or publicly explaining them in a way that complies with applicable disclosure laws. Shareholders can also be an important source of information. Sometimes questions raised on earnings call can form the basis of an activist attack.

• Hedge funds frequently reach out to management before going public with their campaigns. An advance process needs to be put in place to deal with their approaches. A person should be designated as the contact person. Basic information concerning the fund and its method of operation should be obtained in order to assist in formulating strategy. As indicated above, there is a wide disparity between types of fund and strategies they employ, and this should be factored into a response strategy. The board needs to be integrally involved in the process. Companies should be prepared to bring in outside advisors at the outset, including lawyers, investment bankers, and possibly proxy solicitation firms and public relations firms. Discussions with the fund should be conducted in accordance with applicable disclosure laws, such as Regulation FD. It is rarely a good idea to simply ignore the fund or be overly dilatory, because these tactics are frequently portrayed very negatively in Schedules 13D.

• Technology and life science companies should consider the risks of hedge fund attacks as part of their pre-IPO planning. Private companies typically consider their vulnerabilities to hostile takeover attempts before going public, and implement takeover defenses designed to address that risk. However, as indicated in Part II above, almost one-third of all campaigns reviewed involved technology and life science companies that had been public for 10 years or less. Private companies should therefore conduct a broader review to also address the risk of hedge fund activism after going public. They should consider the various factors noted in the bullet points above and elsewhere in this Commentary when designing their structural, governance and operational systems and policies.

Endnotes
1 The technology-related SIC codes are 3571, 3572, 3575, 3576, 3577, 3670, 3672, 3674, 7370, 7371, 7372, 7373 and 7374. The life sciences-related SIC codes are 2834, 2835, 2836, 3841 and 3845. These SIC codes provide a representative sample of companies in technology and life science industries, but are not the only SIC codes for these industries.
2 This Commentary is based on information available on the SEC’s EDGAR database (including, for consistency, where Latham & Watkins represented the target company), including mainly Schedules 13D and 13F, proxy filings and Forms 8-K. In our experience, a lot of less confrontational forms of activism go unreported because the 5 percent beneficial ownership trigger under Schedule 13D is not reached, the activist has not yet determined to switch from Schedule 13G to Schedule 13D or the activism is conducted under cover of a generic description in Item 4 of Schedule 13D. See Staff Report to the United States Securities and Exchange Commission, Implications of the Growth of Hedge funds (September 2003).
3 The portion of hedge fund assets under management that is available for activism has been cited as between 5 percent and 10 percent. See, e.g. Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U.Pa. L. Rev. 1021, 1046 (2007); National Investor Relations Institute Executive Alert, Hedge Fund Activism: What You Need to Know and What You Can Do About It (April 13, 2007)
5 In particular, 1992 amendments to the proxy rules abolishing the SEC’s role in pre-clearing supplemental proxy solicitation material from proxy filing requirements has made it a lot easier for activists to rapidly disseminate voluminous information. The same amendments also facilitated solicitations by exempting certain oral communications from the proxy statement delivery requirements. Amendments in 1999 permitted unlimited solicitations before a proxy statement is filed, as long as no proxy card is used.
8 Campaigns were deemed commenced when a Schedule 13D or amendment thereto was filed containing Item 4 language that showed an express intent to engage in a campaign. Campaigns were excluded if there was no such item 4 language in the original Schedule 13D or any amendment thereto. For the sake of expediency, a small number of campaigns were excluded where the original Schedule 13D was filed prior to 2005 but the campaign started in 2005 or later. The data for the early years in the graph may therefore slightly undercount the number of campaigns in those years.
9 Funds for which data was either not available or clearly unreliable were excluded for all years. Given that data was excluded for all years, the shape of the assets curve in the graph is unlikely to be significantly impacted.
10 There has been speculation that the repeal of an investment advisor exemption from registration under Title IV of Dodd-Frank may also negatively impact hedge fund assets under management. The speculation was that the exemption
An additional reason hedge fund attacks may increase in 2012 is that there is expected to be more M&A activity due to increased cash holdings by strategic acquirors. Based on information in recent Forms 10-K, many of the large repeat acquirors in the technology and life science industries are sitting on higher levels of cash than in previous years, and thus are in a position to engage in more acquisitions that in the past. This buy-side demand may create an incentive for activist hedge funds to put more targets in play.

In connection with adopting an appropriate advance notice bylaw, companies should consider related matters such as qualification standards for directors, responsibilities of the nominating committee, and bylaws relating to board processes. See Private Ordering in the Brave New World of Proxy Access (Nov. 2010), available at http://www.lw.com/upload/pubContent/_pdf/pub3801_1.pdf; see also Proxy Access Commentary.