THE ACTIVIST REPORT

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The Misconceptions and Faulty Assumptions That Led to the 13D Rule Amendments

Since 2006, I have been running an institutional research service solely dedicated to shareholder activism, 13D filings and corporate governance. Our clients run the entire gamut from the top activists to the top activist defense advisors and include, among others, the large institutional and passive investors in the middle of the spectrum. Over the 16 years we have reviewed every single 13D filing and generated reports on all material activist campaigns. Suffice it to say there is no one more immersed in 13D activism that we are.

The SEC has submitted a long and detailed proposal to amend the 13D rules with three basic material changes: (i) decreasing the time to file a 13D from 10 calendar days after exceeding 5% ownership to 5 calendar days, (ii) amending the definition of a group to include anyone who the 13D filer tells in advance about the 13D filing and who buys stock in the underlying company prior to the 13D filing and (iii) including cash settled swaps in the definition of beneficial ownership for 13D purposes. This third proposal should also be viewed in connection with a contemporaneous SEC rule proposal requiring swap owners to disclose certain swaps within one day after taking the swap position.

Commentators and people we have talked to have found many problems with these proposed rules. We do not view them as problems as much as symptoms of a bigger problem - the entire proposal is based on several misconceptions and faulty assumptions the SEC and others have about shareholder activism and 13Ds.

Misconception #1
13D Activism is a Widespread Phenomenon

The SEC's proposal would shorten the window to file a 13D from 10 days to 5 days on all 13D filings to prevent 13D filers from taking advantage of others in the market who do not know about material, market-moving information - the imminent 13D filing. By the scope of the SEC proposals, one would think that shareholder activism is much more widespread than it is. In fact, the type of activism the SEC proposals address, 13D activism, is a relatively infrequent, niche strategy. Last year there were 1,557 13D filings, but the vast majority of those filings were technical or non-material filings that had no real effect on the stock price of the underlying company. Of those 1,557 13D filings, there were only 28 activist 13D filings during 2021 – the type that are material, market-moving information. The SEC's proposal would shorten the window to file a 13D from 10 days to 5 days on all 1,557 of these 13D filings when really the issues they are concerned with only relate to 28 of those filings. Moreover, shortening the window from 10 to five days would only affect activist 13D filings where shares were purchased during the second half of the 10-day window. In 2021, of those 28 activist 13D filings, only 11 used the second five days of the 10-day window to buy shares. The total value of all of the purchases of those 11 filings was $503 million. This may seem like a big number, but it is over a full calendar year where $151 trillion is traded on US equity exchanges. So, this is a "problem" that affects roughly .0003% of trades. But not really. Of those 11 situations, more than half declined to below the pre-13D filing price within three weeks after the 13D filing, giving any seller during that 5 day period a quick opportunity to buy back the stock now with full knowledge of the activist's existence.

Misconception #2
The Value of 13D Activism Occurs Primarily Around the 13D Filing

A second misconception is that the value of shareholder activism primarily occurs around the 13D filing and the bump that occurs in the stock price upon the filing. This is a major assumption for the SEC in that they are trying to protect selling investors from selling prior to this bump by (i) shortening the 10-day window and (ii) changing the definition of a group.

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13D RULE AMENDMENTS (cont'd. from pg. 1)

The SEC cites in its proposal data that the average bump from 13D filings is 2%. This is consistent with a 2011 study 13D Monitor did looking at 13D filings on billion-dollar minimum market cap companies by the premier activists (i.e., the ones that you would expect to get the biggest bump). That study saw an average one-day bump of 2.6%. But, unlike the SEC's data, our study did not stop there. Our study also saw an average 13D holding period of 15 months and an average return on the 13D filings of 15.2% after the bump versus an average of -.09% for the S&P500 during the same time periods. This 16.1% average outperformance over an average 15-month period is the real value of shareholder activism.

Misconception #3
Sellers are Hurt by Selling to Activists During the 10-Day Period

The SEC continues to be focused on the short-term bump that sellers lose by selling before the announcement of the 13D filing, in the mind of the SEC, unfairly enrichening the activist. However, that argument is not convincing if you look at all of the data, not just the five-day period prior to the 13D filing. Of those 11 13D filings in 2021 where an activist purchased shares during the second five-day period, the average one-day bump after the 13D filing was 6.91%. That is the gain the SEC is claiming the activist cost the seller by acquiring its shares knowing it would be filing a 13D shortly. However, during just the ten-day period, the average return on those 11 stocks was 4.96%, in large part from the buying volume of the activist. Moreover, from the low price that the activist began starting to buy stock in the prior 60 days (as reported in the 13D) to the price of the stock the day before the 13D filing, the average return on those 11 stocks was 16.39% - over a 60-day period. Clearly, the existence of the activist allowed the seller to sell at a much higher price that he would have been able to sell without the involvement of the activist, despite the seller not being able to participate in the bump. Yes, it would be nice if all investors could participate in the bump too, but that is obviously not possible, and by discouraging the activist from launching those activist campaigns the SEC is not only harming the other stockholders who do not sell during the 10-day window, but also harming the ones who do – the same exact investor the SEC is trying to protect.

Misconception #4
Shareholder Activists are Short-Term Minded Investors

Shareholder activists are primarily hedge fund investors who take a large position in public companies that they believe are undervalued and generate a plan to be the catalyst to close the valuation gap. They are not corporate raiders like many were in the 1980s and most are not short-term financial engineers like we saw 15 years ago. They generally come in with an operational, strategic or governance plan that gives other shareholders an option. They often take board seats for many years and have an average holding period longer than the average actively managed fund (excluding index funds, who we believe to be long term owners, but not investors). Moreover, even if you consider two or three years as short-term, shareholder activists are certainly not short-term minded, which is much more important than their holding period. They institute a plan that puts the company on a much better long-term trajectory. A study done by 13D Monitor showed that not only do shareholder activists outperform the markets in the 18 months following the 13D filing, but those companies continue to outperform the markets in the five years following the activist's 13D exit. Moreover, shareholder activists can only be successful with the support of the broader shareholder base. If they have shareholder support, the activists pays all of the expenses and puts up all of the time and resources to implement the plan that will benefit all shareholders, short-term and long-term. Additionally, they are the foot soldiers for instituting better corporate governance practices that benefit shareholders well into the future. For years the SEC, ISS and large institutional shareholders have promoted better corporate governance practices like unitary boards, majority voting in uncontested elections and separating the roles of the Chairman and CEO. The activists are the ones on the ground implementing these corporate governance practices.

Misconception #5
Shareholder Activists are the Enemies of Corporate Boards and CEOs

Every activist I have ever spoken with believes that corporate directors and CEOs for the most part are competent, hard-working, responsible stewards of shareholder capital. The activists only engage the tiny minority who are not. It is hard to deny that like any other group, there will always be a bottom 10%, many of whom need intervention from an activist. Accordingly, despite the popularity of shareholder activism on CNBC and in the Wall Street Journal, it is important to remember that shareholder activists only engage with fewer than 5% of public companies each year, and a small subset of those are through 13D filings. And almost all of these situations involve serial underperforming companies and/or under-engaged, conflicted or entrenched boards.

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13D RULE AMENDMENTS (cont'd. from pg. 2)

Misconception #6
The 13D Filer is in Possession of Material Information

The sixth misconception and faulty assumption the SEC relies on is that the activist is in possession of material information that needs to be publicly disseminated as soon as possible – the fact that the activist has a position and will be filing a 13D. The SEC does implicitly acknowledge that this is not the type of material insider information that is illegal to trade on. If it were, there would be no need for this new rule. But even so, the activist does not have an informational advantage over the seller as much as an analytical advantage. The activist developed its plan from hard work, research, knowledge and experience. Isn't this the exact type of behavior we want to encourage in the markets, as opposed to penalize? This is the activist's plan, not the market's plan. Why does the SEC think that all investors should share equally in the benefits of this plan? Why is it bad for the activist to get the full benefit of its plan by being able to take a full position prior to disclosing it?

The SEC states in its proposal that: "Market-moving information, such as the accumulation of a significant equity stake, would be made available more quickly, improving opportunities for more efficient and more accurate price discovery." Why should the identity of the buyer be "price discovery"? This is not information that reflects on the business or assets of the Company and has no effect on the intrinsic value of the Company. Sophisticated investors care about value, inexperienced investors care about price. The SEC seems to be endorsing inexperienced investing.

Misconception #7
The Activist Always Creates Value

Why does the SEC believe that the seller is always going to lose over the long term by selling to the activist? The truth is that activist 13D filings outperform as much as they underperform. Of the 1,250 activist 13Ds filed and exited between April 1, 2006 and May 2, 2022, exactly 627 (50.12%) have outperformed the S&P500 over their holding period. So, the seller of the stock pre-13D has an equal chance of being benefited from the sale as it does being hurt from it. Of course, had the seller held through the 13D and sold right after the bump, it would often make an above market return, but that would put the SEC in a position of creating a rule to protect short-term investing to the detriment of long-term investing. The SEC should be focused more on what activists do over the long term, than who is getting affected in the five days on either side of a 13D filing.

Activism in any other form is applauded by society. A parent taking the time to go on their child's school board is revered. A tenant who wants to be more involved by going on its condo board is respected. But an investor who takes an active interest in its fiduciary duty and attempts to be more involved in its portfolio by making suggestions or looking for board representation is for some reason denigrated by many in the market and the SEC. Yes, corporate raiding and greenmail existed in the 1980s but in fast moving markets like we have, that is a lifetime ago and has absolutely no resemblance to modern-day shareholder activism where the activist is ***always*** aligned with the other shareholders. Even modern-day shareholder activism has evolved over the past 15 years to a more operational and long-term minded approach. This evolution continues and is even making significant inroads into ESG activism for the benefit of the environment and society. Is this really the time SEC wants to stifle this activity?