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Abstract

Publicly-traded companies have the power to pass sunlight bylaws to address hedge fund activism. Sunlight bylaws would require activist hedge funds to publicly disclose any strategic proposals and their financial interests in companies earlier and at thresholds lower than current securities laws. Sunlight bylaws would also require disclosure of additional information, including: (1) the percentage of the fund's portfolio invested in the company; (2) the fund manager's compensation; (3) the fund manager's investment in the fund; (4) the fund's portfolio turnover; and (5) the fund's prior holding periods after any announcements of an ownership interest and a strategic proposal. Academic proponents of hedge fund activism defend activism based on the theory that activist hedge fund managers are systematically better agents for long-term stockholders than the incumbent board and executive management. These proponents argue that fund managers have large stakes in their funds, the funds' profitability is highly contingent on the financial performance of its investments, and the funds hold relatively few concentrated investments. Sunlight bylaws would target factual information essential to that claim and require its disclosure in succinct, summary form. Sunlight bylaws would also state that if a stockholder violates them, that stockholder cannot nominate a candidate for a seat on the board or propose any issue for the next stockholders' vote. But institutional investors and proxy advisory firms support hedge fund activism in the abstract, and a board that passed a sunlight bylaw might precipitate litigation or a proxy fight. Public companies should therefore, on a case-by-case basis, request the same or similar information when an activist that has held shares for a brief period of time makes a strategic proposal. Public companies should negotiate confidential treatment of any disclosures for a period of time so that the activist can reap the full benefit of the short-term increase in share price after the disclosure of its investment and strategic proposal some academics and institutional investors think necessary to incent activism. But public companies should also make very clear that they reserve the right to publish any questions that the activist refuses to answer or for which it insists on confidential treatment. And the other stockholders, who likely invest over longer timeframes, should carefully consider any information that the activist discloses—or, equally importantly—refuses to disclose.

KEYWORDS: Hedge Funds

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*Ms. Mead is a shareholder at Stearns Weaver Miller Weissler Alhadeff & Sitterson, P.A. and thanks the following individuals for helpful comments on earlier drafts: Marc Wolinsky, Martin Lipton, John Huber, Guhan Subramanian, Eugene Stearns, David Marcus, Garrett Moritz, Andrea Nathan, and Anthony Casey. Rachel Purcell provided valuable research assistance. The author is a member of the Florida bar and a member of the New York bar but not a member of the Delaware bar. All views and any errors are the author's.

TWO NEW TOOLS FOR ADDRESSING ACTIVIST HEDGE FUNDS—SUNLIGHT BYLAWS AND RECIPROCAL DISCLOSURES

Grace Lee Mead[*]

ABSTRACT

Publicly-traded companies have the power to pass sunlight bylaws to address hedge fund activism. Sunlight bylaws would require activist hedge funds to publicly disclose any strategic proposals and their financial interests in companies earlier and at thresholds lower than current securities laws. Sunlight bylaws would also require disclosure of additional information, including: (1) the percentage of the fund's portfolio invested in the company; (2) the fund manager's compensation; (3) the fund manager's investment in the fund; (4) the fund's portfolio turnover; and (5) the fund's prior holding periods after any announcements of an ownership interest and a strategic proposal. Academic proponents of hedge fund activism defend activism based on the theory that activist hedge fund managers are systematically better agents for long-term stockholders than the incumbent board and executive management. These proponents argue that fund managers have large stakes in their funds, the funds' profitability is highly contingent on the financial performance of its investments, and the funds hold relatively few concentrated investments. Sunlight bylaws would target factual information essential to that claim and require its disclosure in succinct, summary form. Sunlight bylaws would also state that if a stockholder violates them, that stockholder cannot nominate a

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candidate for a seat on the board or propose any issue for the next stockholders' vote.

But institutional investors and proxy advisory firms support hedge fund activism in the abstract, and a board that passed a sunlight bylaw might precipitate litigation or a proxy fight. Public companies should therefore, on a case-by-case basis, request the same or similar information when an activist that has held shares for a brief period of time makes a strategic proposal. Public companies should negotiate confidential treatment of any disclosures for a period of time so that the activist can reap the full benefit of the short-term increase in share price after the disclosure of its investment and strategic proposal some academics and institutional investors think necessary to incent activism. But public companies should also make very clear that they reserve the right to publish any questions that the activist refuses to answer or for which it insists on confidential treatment. And the other stockholders, who likely invest over longer timeframes, should carefully consider any information that the activist discloses—or, equally importantly—refuses to disclose.

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INTRODUCTION

Activist hedge funds have repeatedly invested in public companies, successfully pushed for the adoption of their strategic proposals, and then exited within one or two years. Companies can enact sunlight bylaws, which would require such funds to disclose online any such proposal within one day and to disclose any direct and indirect financial interest in the company above 5%. Other information bearing on the fund's incentives, such as the fund manager's compensation, the fund and fund manager's compensation based on performance and the amount of money managed, the percentage of the fund's assets the investment represents, and the fund's portfolio turnover, would also be disclosed. If an activist hedge fund violated the sunlight bylaw, its strategic proposal or director nominee could not be proposed for a stockholder vote without board approval.

But support from a public company's institutional stockholders for a sunlight bylaw may often be lacking, and a sunlight bylaw may precipitate litigation or a proxy fight. Thus, public companies should begin, as a first step, by requesting that any activist making a strategic proposal also make voluntary, reciprocal disclosures in response to the same questions posed by sunlight bylaws. The public company could make the activist's disclosures confidential for a period of time. That would enable the activist to realize the entire short-term gain caused by its disclosure of a strategic proposal and investment and should not reduce an activist's short-term profits. The public company, in its request for reciprocal disclosure, should also make clear that it can publish to stockholders any questions the activist refuses to answer, any questions that it has agreed to answer only confidentially, the terms of any negotiated confidentiality agreement, and the activist's refusal to update answers.

Part I of this Article outlines the debate over activist hedge funds.[1] An activist hedge fund typically identifies a target company it deems ripe for intervention, buys shares in the open market, and then publicly announces its beneficial ownership and a strategic proposal by making a filing under the securities laws.[2] Research has shown about a 5% increase in the company's share price in the twenty days up to and including the activist's disclosure, followed by about a 2% increase in share price in the next twenty days.[3] Lead activists frequently communicate with other hedge funds while acquiring a financial interest in the company, and those other funds acquire their own interests and support the lead activist's strategic proposal.[4] Hedge funds acting collectively have been dubbed "wolf packs."

Proponents of activist hedge funds claim that hedge fund managers have strong incentives to boost short-term share price and systematically make proposals that increase both net present value and long-term value. They assert that hedge fund managers' compensation depends highly on performance, hedge funds hold few concentrated investments, and hedge funds use derivatives and other financial instruments to amplify their investments. They assume that the hedge fund managers' incentives are systematically stronger than the company's executive management and directors' incentives to increase share price.

In response, many with enormous practical experience, such as Delaware Supreme Court Chief Justice Leo Strine, corporate lawyer Martin Lipton, and Blackrock Chairman and CEO Laurence Fink, point to activist hedge funds' short average holding periods of one or two years in the company's stock and high portfolio turnover to argue that hedge funds' focus on short-term returns can harm long-term value.[5]

1. *See infra* Part I.
2. *See infra* Parts I, V.A.
3. *See infra* Part I.A.
4. *See infra* Part I.C.
5. *See infra* Part I.B.

They claim that activists often force cuts in long-term investments like research and development in favor of financial engineering that boosts share price in the short-term to the detriment of net present value and long-term value.[6]

Empirical studies accepted for publication about activists' intervention and long-term value conducted by those who defend hedge fund activism have shown that over the five years following activist hedge fund interventions firm value sometimes increases and sometimes decreases.[7] Other studies have shown that activist interventions decrease research and development spending and long-term return on assets.[8]

Part II describes the debate surrounding activists' current disclosure obligations under the federal securities laws.[9] Section 13(d) of the Securities Exchange Act of 1934 (the "Exchange Act") requires activists to publicly report any strategic proposals ten days after acquiring over a 5% beneficial ownership of a company's outstanding shares, but does not count derivatives or short positions toward that threshold.[10] Activists have increased their ownership up to as much as 27% in the ten days between hitting the reporting threshold and the disclosure deadline. In part because activists in modern financial markets can increase their stake so quickly, Wachtell, Lipton, Rosen & Katz petitioned the United States Securities and Exchange Commission (the "SEC") to require large stockholders to report any strategic proposals a day after acquiring a financial interest above 5%, counting derivative ownership structures and short positions.[11] The SEC has yet to act on that petition.

But since that petition was filed, the disclosure issues have become more acute. Activists now frequently coordinate in wolf packs where each member owns a smaller stake. Thus, many members of the wolf pack never reach the Section 13(d) disclosure threshold and never need to disclose their net economic positions in the company's stock. They could even take undisclosed net short positions.[12] And although public companies must disclose material information about their decision-

6. *See infra* Part I.B.
7. *See infra* Part I.B.
8. *See infra* Part I.B.
9. *See infra* Part II.
10. *See* 15 U.S.C. § 78m(d) (2012); 17 C.F.R. § 240.13d-1 (2015).
11. *See infra* Part II.
12. *See infra* Parts I.C, II.

makers' compensation and interests in the stock, hedge funds have no parallel disclosure requirements. Directors and other stockholders can only guess at any hedge fund's investment as a percentage of its portfolio, portfolio turnover, prior holding periods, fund managers' compensation, and the ownership interests held by a wolf pack based on spotty public reporting. Thus, the activist defenders' assertions about hedge fund managers' incentives cannot be tested, and the facts bearing on those incentives are unknown and unknowable in any activist campaign.

Part III outlines the structure of the proposed sunlight bylaws. Sunlight bylaws would accelerate hedge funds' disclosure obligations consistent with the Wachtell Lipton petition. They would also expand the scope of disclosure beyond what Section 13(d) and its implementing rules require. Critical additional disclosures, spelled out below, include: (1) those parties to which the fund has communicated non-public information about a prospective strategic proposal and that have agreed to trade, traded, or agreed to continue to hold a financial interest in the company's securities; (2) the fund's ownership interest in the company as a percentage of the fund's overall portfolio; (3) the fund manager's compensation; (4) the fund manager's investment in the fund; (5) the turnover in the fund's portfolio; and (6) the fund's prior holding periods after any announcements of a financial interest and a strategic proposal.[13] All requirements would also apply to all wolf pack members, even if they do not individually reach the reporting threshold. Such disclosures would allow a company's board and the other stockholders to make better and more informed decisions in light of the hedge fund's incentives.

A sunlight bylaw would also state that unless the activist complies with it, the activist's strategic proposal or nominee for the board cannot be considered at a stockholder vote absent board approval. Public companies will be able to detect any non-compliance. The lead activist must first publicly announce its strategic proposal before a stockholder vote to persuade other stockholders to vote for it, which lead activists currently do by filing a Schedule 13D under Section 13(d).[14] If the activist reached the ownership threshold for reporting without disclosing

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13. *See infra* Part II.A.
14. *See infra* Parts I, V.A.

under the sunlight bylaw it would be proof positive of a violation. There would then be no vote on that proposal or nominee absent board approval. Part III also explores how sunlight bylaws would reveal critical facts bearing on the hedge funds' incentives and the possibility that they would incent better activism.

Part IV explains that sunlight bylaws should withstand any facial challenge because Delaware law authorizes their passage.[15] Delaware General Corporation Law ("DGCL") section 109(b) authorizes them because they "relate to" the "rights" and "powers" of stockholders.[16] Consistent with Delaware Supreme Court precedent, they are process-oriented and agnostic to the substance of any strategic proposal or identity of any board nominee.

Nor could a challenger meet its burden of showing the sunlight bylaw would be inequitable in all circumstances. Requiring enhanced disclosure is consistent with directors' fiduciary duties.[17] According to some recent Delaware court decisions, directors have a fiduciary duty to enhance long-term value.[18] Directors certainly must consider the implications of strategic proposals for the net present value of the company, which requires considering a strategic proposal's implications for more than the hedge funds' generally short holding periods. In fact, Chief Justice Strine has pointed out that enhanced disclosures are important to the stockholder's franchise because the hedge fund's financial interests are critically important to evaluating its proposals.[19] That task is made much more difficult while the activist hedge funds proposing them remain a black box.

Part V explains that sunlight bylaws would also generally be lawful as applied, although much would depend on the particular facts.[20] Sunlight bylaws enhance the stockholder franchise, promote better decision-making by boards, cannot be shown to materially reduce beneficial activism, and may incent better activism.[21] In addition, the burden on the activist and other stockholders is minimal: the disclosures

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15. *See infra* Parts IV.A-B.
16. *See infra* Parts IV.A-C.
17. *See infra* Parts IV.D, V.B.
18. *See infra* Parts IV.D, V.B.
19. *Infra* Part V.B.4.
20. *Infra* Part V.
21. *Infra* Parts III.B-C, IV.D, V.B.4.

are based on information the activists have readily available; compliance permits the activists to avoid any delayed vote on its proposal; and if the disclosure is slightly belated or incomplete, the board can demand any necessary amendments and exercise its discretion to put the proposal up for a stockholder vote.

To analyze a sunlight bylaw as applied, Part V considers what a sunlight bylaw would have revealed and whether it would have been upheld in the activist hedge fund Trian's proxy fight against DuPont's board.[22] In that campaign, Trian adopted the common tactic of attacking executive compensation relative to performance at DuPont.[23] But one can compare DuPont's publicly-reported share price and its then Chair and CEO Ellen Kullman's compensation to what *Forbes* has reported for Trian and its principal, Nelson Peltz. In 2013 and 2014, DuPont performed better than Trian, but Kullman averaged about $12.3 million in total compensation while Peltz averaged over twenty-four times her compensation—$300 million. [24] Back-of-the envelope math based on the little publicly-available information suggests that Trian had a guaranteed income from management fees of about $226 million in 2014.[25] DuPont's directors and executive management, the market, and other stockholders were entitled to consider more precise and reliable disclosures regarding Trian when evaluating whether it better represented the interests of other stockholders than DuPont's directors and executive management.

Part VI explores the idea of, in particular activist campaigns, requesting reciprocal disclosures from activists that would reveal much of the same information as sunlight bylaws.[26] Institutional investors and proxy advisory firms have generally embraced the notion that activist hedge funds serve as a useful counter-weight to incumbent boards and executive management, and many could therefore oppose a proposed sunlight bylaw. A board may not believe that its stockholders would support a sunlight bylaw or may believe that it would precipitate wasteful litigation or a proxy fight. If so, when that board is confronted with a strategic proposal by an activist hedge fund, it should informally

22. *See infra* Part IV.B.
23. *See infra* Part IV.B.
24. *See infra* Part IV.B.
25. *See infra* Part IV.B.
26. *See infra* Part V.

request that the fund provide the equivalent information in reciprocal disclosures and, if requested and lawful, agree to give that information confidential treatment for a period of time.

The directors and executive management should also reserve the right to publish the questions that the activist refuses to answer or for which it requests confidential treatment. This would provide institutional investors and the proxy advisory firms with fodder for follow-up questions. Recent research shows that activist hedge funds that intervene by taking a larger stake in the company generate higher abnormal returns, and perhaps rightly so. But rather than guessing at the hedge fund's stake or incentives based on incomplete public disclosures and news reports, the board and institutional stockholders should demand that the activist hedge fund disclose the information in a succinct, summary form. If the activist hedge fund's incentives truly are better aligned with other stockholders than the directors and executive management, it should be happy to oblige. If not, that tells the other stockholders something too.[27]

I. THE DEBATE OVER ACTIVIST HEDGE FUNDS

Both sides of the debate on hedge fund activism agree that it has risen sharply, with influence on major companies ranging from Apple to Proctor & Gamble to Whole Foods to DuPont.[28] Much ink has been spilled debating whether hedge fund activism helps or harms other stockholders, so only the outlines are sketched here.

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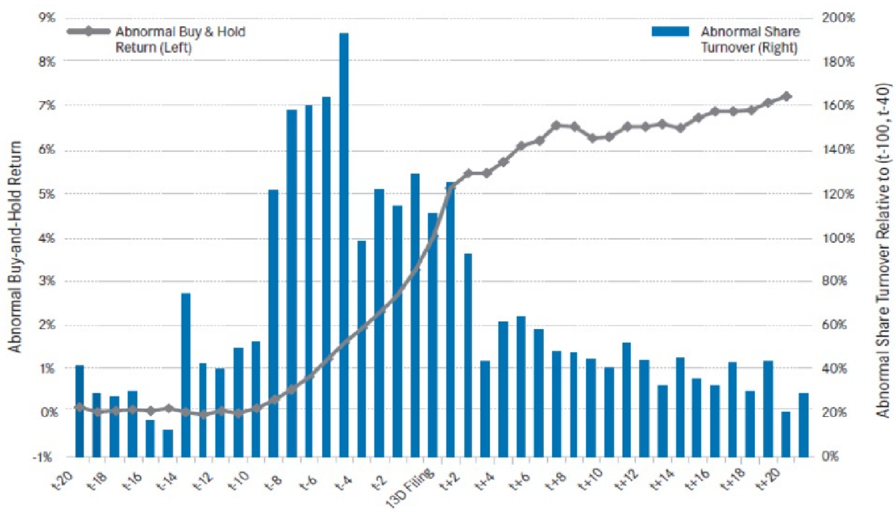
27. The term "sunlight" comes from Justice Louis Brandeis' observation that "[p]ublicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." LOUIS BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (1914). *Other People's Money*—a screed against the entire banking and investment banking industry—influenced many of the securities law reforms of the 1930s. While the author does not endorse all of Justice Brandeis's views, fundamentally, if equity markets are to operate in the sunlight, then all of those seeking to change a public company's strategy can reasonably be required to do so.

28. Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1087 (2015); Martin Lipton, Wachtell, Lipton, Rosen & Katz, *Dealing with Activist Hedge Funds*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Nov. 6, 2014), http://corpgov.law.harvard.edu/2014/11/06/dealing-with-activist-hedge-funds-3/ [http://perma.cc/EJ4R-W99Q].

A. INCREASES IN SHARE PRICE SURROUNDING ACTIVIST HEDGE FUNDS' DISCLOSURES

Professor Alon Brav and his co-authors published an early study in the *Journal of Finance* showing that activist hedge funds' securities filings under Section 13(d) were surrounded by an abnormal share price return of about 7% without reversal during the subsequent year.[29] They compiled their data from Schedule 13D filings under Section 13(d) and internet searches, and cross-checked them against hedge funds' quarterly Schedule 13F filings,[30] which do not require disclosure of many indirect interests and often receive confidential treatment.[31]

Their results, since replicated, showed:



Graph 1. Buy-and-Hold Abnormal Return Around the Filing of Schedule 13Ds[32]

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29. Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FINANCE 1729 (2008).

30. *Id.* at 1736-38.

31. Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 864, 871-72 (2006); George O. Aragon, Michael Hertzel & Zhen Shi, *Why Do Hedge Funds Avoid Disclosure? Evidence from Confidential 13F Filings*, J. FIN. & QUANTITATIVE ANALYSIS, June 2012, at 6-7.

32. Brav, Jiang, Partnoy & Thomas, *supra* note 29, at 1756.

Most of the increase in share price—all but 2%—occurs in the period before and on the date of the Schedule 13D filing. Professor Brav and his co-authors theorized that the price increase reflected the soundness of the strategic proposals based on hedge funds' superior incentives to enhance value because "[h]edge funds employ highly incentivized managers," "can hold highly concentrated positions in small numbers of companies," and "use leverage and derivatives to extend their reach."[33]

They also noted a spike in abnormal trading volume before the filing.[34] They speculated that this might be related to either tipping by the filer or coordination among activists acting together, but admitted that "[g]iven the informal and secretive nature of such communication, our data do[es] not allow for a formal testing of these two explanations."[35] They also found that, in the following year, companies showed improved return on assets and operating profit margins.[36] They reported a median holding period of about one year, calculated from the filing date of the Schedule 13D to its amendment to reflect that the fund no longer held a significant stake.[37]

Momentarily lost in the ensuing debate was the disclosure asymmetry. On one hand, publicly-traded companies must disclose all material information about their assets, share repurchases, dividends, executive management's compensation and interests in the stock, and directors' compensation and interests in the stock. For decades, academics have used these detailed and highly regulated disclosures in order to craft studies about potential agency issues. In specific campaigns, the disclosures can give activists information about facts bearing on the incentives of the company's decision-makers with which to attempt to sway the market and other stockholders.

On the other hand, not all activist hedge funds need even disclose their net economic position in the company. Those shy of the Section 13(d) reporting threshold could take a net short position and simultaneously encourage others to vote for a strategic proposal that

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33. *Id.* at 1730.
34. *Id.* at 1756.
35. *Id.* at 1757.
36. *Id.* at 1770-71.
37. *Id.* at 1731, 1765.

they believe will tank the stock a few years after adoption. And activists need not disclose the investment as a percentage of their portfolio, or disclose any other information about their portfolio turnover, their investment horizons, or their decision-makers' compensation or other incentives, although limited information can be gleaned from Section 13F filings, news reports, and the Internet.[38] This distorted disclosure landscape means that activist hedge funds and their defenders can always articulate some agency issue at least theoretically faced by the directors or executive management, but neither the board nor other stockholders can evaluate the facts bearing on the activist hedge funds' incentives. On this uneven playing field, activists drive up short-run share prices and win stockholder votes.

And, of course, scholars like Professor Robert Shiller believe that short-term stock price movements often reflect speculation, fads, and overreactions driven by psychological factors,[39] which may cause an increase in share price after an activist files a Schedule 13D. In 2014, back-of-the-envelope math suggests that the top twenty-five hedge fund managers earned over $11 billion collectively, while only half of the top ten funds recorded returns that exceeded that of the S&P 500.[40] In 2015, preliminary reports indicated that the average hedge fund outperformed the S&P 500's decline of 0.75% for the first time in seven years, but the average fund only gained 0.03%.[41] Reports published in 2016 described 2015 as "an annus horribilis for many big hedge funds" and cited losses

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38. Hu & Black, *supra* note 31, at 864, 871-72.

39. ECON. SCI. PRIZE COMM. OF THE ROYAL SWEDISH ACAD. OF SCI., SCIENTIFIC BACKGROUND ON THE SVERIGES RIKSBANK PRIZE IN ECONOMIC SCIENCES IN MEMORY OF ALFRED NOBEL 2013: UNDERSTANDING ASSET PRICES 30-35 (2013) [hereinafter UNDERSTANDING ASSET PRICES], http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/2013/advanced-economicsciences2013.pdf [http://perma.cc/R53S-6KKK].

40. Alexandra Stevenson, *For Top 25 Hedge Fund Managers, a Difficult 2014 Still Paid Well*, N.Y. TIMES: DEALBOOK (May 5, 2015), http://www.nytimes.com/2015/05/05/business/dealbook/top-25-hedge-fund-managers-took-bad-14-all-the-way-to-the-bank.html? ref=dealbook [http://perma.cc/HM67-W8YU].

41. Alexandra Stevenson & Matthew Goldstein, *Battered, Apologetic and Still Pitching Their Hedge Funds*, N.Y. TIMES: DEALBOOK (Dec. 15, 2015), http://www.nytimes.com/2015/12/16/business/dealbook/battered-apologetic-and-still-pitching-their-hedge-funds.html?_r=0 [http://perma.cc/5Q3D-GY4L].

from large funds ranging from about 5% to 20%.[42] Perhaps hedge funds have built an undeserved reputation for financial acumen; indeed, it appears that investors poured more than $18 billion into hedge funds in 2014 despite high fees and a poor average performance.[43] That could also drive the short-term increase in share price.

B. THE DEBATE OVER SHORT-TERMISM

Activist hedge funds' interventions and early empirical work quickly elicited a short-termism argument from those with more practical experience.[44] The short-termism criticism ran: (1) activist investors have short investment horizons;[45] (2) activist hedge funds' "real goal is a short-term bump in the stock price," because "[t]hey lobby publicly for significant structural changes, hoping to drive up the share price and book quick profits," and "[t]hen they bail out, leaving corporate management to clean up the mess;"[46] and (3) activist hedge funds often push for cuts in long-term "research and development expenses, capital expenditures, market development, and new business ventures, simply because they promise to pay off only in the long-term"

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42. Steven Davidoff Solomon, *Activist Investors May Have Met Their Match: A Down Market*, N.Y. TIMES: DEALBOOK (Jan. 26, 2016), http://www.nytimes.com/2016/01/27/business/dealbook/activist-investors-may-have-met-their-match-a-down-market.html [http://perma.cc/BSX3-96U9].

43. Carl Richards, *A Mystery in Hedge Fund Investing*, N.Y. TIMES (Mar. 9, 2015), http://www.nytimes.com/2015/03/09/your-money/a-mystery-in-hedge-fund-investing.html [http://perma.cc/P45Q-Q6RK].

44. *See, e.g.*, Martin Lipton, Wachtell, Lipton, Rosen & Katz, *Further Recognition of the Adverse Effects of Activist Hedge Funds*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Apr. 13, 2015), http://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.23902.15.pdf [http://perma.cc/CT5J-WWQ9]; Letter from Laurence D. Fink, Chairman and CEO, Blackrock, to Shareholders (Mar. 31, 2015), http://www.blackrock.com/corporate/en-us/literature/publication/long-term-value-letter-041415.pdf [http://perma.cc/MFH8-6D9D].

45. Bebchuk, Brav & Jiang, *supra* note 28, at 1093-94.

46. *Id.* at 1094 (quoting Bill George, *Activists Seek Short-Term Gain, Not Long-Term Value*, N.Y. TIMES: DEALBOOK (Aug. 26, 2013, 10:56 AM), http://dealbook.nytimes.com/2013/08/26/activists-seek-short-term-gain-not-long-term-value/?_r=0 [http://perma.cc/9ZZ4-Z4N3]).

for mergers, spin-offs, share repurchases, or dividends that increase share prices in the short-term.[47]

In industries that require making enormous capital outlays based on confidential information about the potential yield of research and development programs, like pharmaceuticals, the directors and executive management must decide issues with impacts that can span decades. Professor Lucian Bebchuk and one of his co-authors have acknowledged the market's focus on short-term returns can mean that "[u]nderinvestment will occur when the market has incomplete information about the level of investment undertaken," as is the case for "investments which must be kept secret from competitors such as new product designs and developments." [48] Making such long-term investments may also create enormous social value. Cutting those outlays and foregoing their long-term value to increase earnings, pay a portion in dividends, or spin-off a portion of the company may bump up stock price or operating performance for as long as five years, while harming the company's stockholders and society over a twenty-year period.[49]

Professor Bebchuk responded by explaining why activists may sometimes promote long-term value. Professor Bebchuk theorized that the premises of those critical of short-termism do not rule out activists seeking actions that increase long-term value. Activists would have incentives to do so "when the action's effect on short-term value is expected to at least partly reflect its positive effect on long-term value,"

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47. *Id*. (quoting Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 210 (1991)).

48. Lucian Arye Bebchuk & Lars A. Stole, *Do Short-Term Objectives Lead to Under- or Overinvestment in Long-Term Projects?*, 48 J. FINANCE 719, 726 (1993).

49. John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance* 49-51, 82-85 (Columbia Law & Econ., Working Paper No. 521, 2015), http://ssrn.com/abstract=2656325 [http://perma.cc/4TKF-K7KN]; Martijn Cremers, Erasmo Giambona, Simone M. Sepe & Ye Wang, Hedge Fund Activism and Long-Term Value 3-4, 13-14, 24-28 (Nov. 19, 2015) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2693231 [http://perma.cc/SYJ4-JKD4].

and "it is plausible for short-term and long-term changes in value to be at least positively correlated."[50]

Revisiting the finance research on the efficient capital markets hypothesis yields an additional important insight: hedge funds have no unique ability to understand the market as a class of investors. Since Professor Eugene Fama published his seminal paper on the efficient capital markets hypothesis in 1970, "[a] remarkably large body of evidence suggests that professional investment managers are not able to outperform index funds that buy and hold the broad stock market portfolio."[51] Indeed, Warren Buffett is handily winning his bet with a New York hedge fund manager that the hedge fund would underperform Buffett's investment in an S&P index fund over a ten-year period: by early 2014, the hedge fund had underperformed by about 30%.[52]

Professor Bebchuk has argued that opponents of activism assume market inefficiencies because they also assume that short-term share price increases do not reflect long-term consequences,[53] but his theory is incompatible with an efficient market that rapidly incorporates all publicly-available information. He argues that activist hedge funds target underperforming and presumably undervalued companies and know why they are undervalued.[54] But the activist hedge funds' ability, as a class of investors, to target those firms is called into doubt by the general tenets of the efficient capital markets hypothesis and the reporting on the returns of hedge funds. Hedge funds cannot identify undervalued companies with recently enacted business and governance changes that are likely to perform better than the market generally, so it

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50. Lucian A. Bebchuk, *The Myth That Insulating Boards Serves Long-Term Shareholder Value*, 113 COLUM. L. REV. 1637, 1663 (2013).

51. Burton G. Malkiel, *The Efficient Market Hypothesis and Its Critics*, 17 J. ECON. PERSP. 59, 77 (2003).

52. *See* Mitch Tuchum, *Warren Buffet on Track to Win Hedge Fund Bet*, MARKETWATCH (Dec. 4, 2014, 5:51 PM), http://www.marketwatch.com/story/warren-buffett-on-track-to-win-hedge-fund-bet-2014-12-04 [http://perma.cc/SE32-P5VZ]; *see also* Carl Richards, *A Mystery in Hedge Fund Investing*, N.Y. TIMES (Mar. 9, 2015), http://www.nytimes.com/2015/03/09/your-money/a-mystery-in-hedge-fund-investing.html?_r=0 [http://perma.cc/T9K2-K756] (reporting on ten years of Vanguard data showing that index funds outperformed hedge funds).

53. Bebchuk, Brav & Jiang, *supra* note 28, at 1089.

54. *Id.* at 1090, 1105-06.

seems unlikely that they can identify undervalued firms to determine which are ripe for intervention. On top of that, they then must succeed at the complex task of picking the right business and governance changes out of a large range of possibilities to boost long-term operating performance and share price. A strong version of the efficient capital markets hypothesis casts doubt on their unique ability to do this.

And notable critics of strong versions of the efficient capital markets hypothesis would not assume that activist hedge funds can accurately predict returns based on particular business or governance changes with an investment horizon of one or two years. Over the last four decades, "systematic evidence" has developed "that returns on exchange-traded stocks are somewhat predictable over short horizons, but that the degree of predictability is so low that hardly any unexploited trading profits remain, once transaction costs are taken into account."[55] Only over the longer term do investors like Buffett or scholars like Professor Shiller, who criticize the limits of the efficient capital markets hypothesis, think it possible to reliably identify undervalued companies and profit from their return to a valuation that more accurately reflects the business's prospects. The most prominent detractors of the efficient capital markets hypothesis like Professor Shiller claim that metrics such as book-to-market value can predict stock prices over the course of business cycles.[56]

As Professor Shiller put it colloquially in a *New York Times* opinion piece: the efficient capital markets hypothesis is a "half-truth."[57] Professor Shiller explains:

> If the theory said nothing more than that it is unlikely that the average amateur investor can get rich quickly by trading in the markets based on publicly available information, the theory would be spot on. I personally believe this, and in my own investing *I have avoided trading too much*.[58]

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55. UNDERSTANDING ASSET PRICES, *supra* note 39, at 14.

56. *Id.* at 42.

57. Robert J. Shiller, *Sharing Nobel Honors, and Agreeing to Disagree*, N.Y. TIMES (Oct. 26, 2013), http://www.nytimes.com/2013/10/27/business/sharing-nobel-honors-and-agreeing-to-disagree.html [http://perma.cc/5BTG-DT2E].

58. *Id.* (emphasis added).

Hardly an amateur, Professor Shiller apparently would not turn over his portfolio at the up to 300% rate that hedge funds do each year.[59] Such a churn is highly unlikely to yield profits in the long term and makes suspect the claim that such activist hedge funds systematically and correctly identify targets for intervention to improve long-term value.

Professors John Coffee and Darius Palia seem to embrace the idea that activist investing is a way for hedge funds to circumvent the limited profitability created by efficient equity markets, but they fail to explain why an activist investor would not first have to pick stocks and make judgments equally or more difficult than those required in the market to identify an underperforming target and make strategic proposals to remedy its underperformance.[60] In that same paper, they also conclude that when looking at three- and five-calendar year returns before and after the filing of a Schedule 13D, studies find that stock returns are not statistically significant from zero, using a four-factor model to predict alternative returns on equity investments elsewhere in the market.[61] In other words, activist interventions do not enable the targeted firms to beat the market.

Bereft of evidence that hedge funds are better at stock picking, Professor Bebchuk returned to where Professor Brav began—he relied on agency arguments to cast the average activist hedge fund manager in the role of Robin Hood.[62] He assumed that hedge fund managers with access to only publicly-available information and with compensation that depends on the performance of the fund's fractional interest in one of many investments will systematically push for business and governance decisions that create positive externalities for other investors after the hedge funds have reaped their profits and exited. He also assumed that the hedge funds are systematically better positioned and incentivized to make those decisions than the company's directors and executive management, despite the latter's access to proprietary

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59. Leo E. Strine, Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449, 478 n.87 (2014).

60. Coffee & Palia, *supra* note 49, at 18.

61. *Id.* at 69.

62. Bebchuk, *supra* note 50, at 1663-64.

information, compensation, and continued employment linked directly to the performance of that company.[63]

Fast forward to the present, and now there seems to be agreement on each side about five general empirical features of hedge fund activism: (1) the number of activist hedge fund challenges to public companies has skyrocketed; (2) there is a short-term spike in target companies' stock prices surrounding an activist hedge fund's Schedule 13D filing; (3) an activist hedge fund that acquires shares prior to hitting the reporting threshold under the securities laws for filing a Schedule 13D stands to gain an immediate profit once the Schedule 13D is filed; (4) activist hedge funds usually exit within one or two years after the filing of the Schedule 13D;[64] and (5) hedge funds turn over their portfolios at around 100% to 300% each year.[65]

Empirical studies have also focused on the correlation between activist interventions and agency costs. Professors Coffee and Palia survey studies of the effect of activist interventions to change corporate governance and executive compensation and conclude that "most of the evidence shows that the positive abnormal returns are not statistically significantly related to" changes in corporate governance or reduction of excessive managerial compensation.[66]

Empirical studies have also recently focused on the correlation between activist interventions and long-term value. Professor Bebchuk, his co-authors, and others have attempted to support their claims about activists through empirical studies that lump all activists together, but any overall increase in long-term stockholder value that follows activist interventions ranges from nonexistent to tiny. Professors Coffee and Palia explain that studies have found that it is "unclear that there is any significant positive long term-price reaction" absent a proposed take-over or restructuring and it is "doubtful that operating performance improves after activist interventions."[67] Professor Yvan Allaire and François Dauphin have pointed out that Professor Bebchuk and his co-authors' industry-

63. *Compare id.* (arguing that activists can indeed produce long-term benefits), *with* Strine, *supra* note 59, at 451 (criticizing Bebchuk's argument).
64. Coffee & Palia, *supra* note 49, at 36, 80.
65. Strine, *supra* note 59, at 478 n.87.
66. Coffee & Palia, *supra* note 49, at 75-76.
67. *Id.* at 80.

specific tables in their latest study measuring return on assets show "a performance infinitesimally smaller than industry performance [in year one] to a performance infinitesimally better than industry performance" in year five.[68] Indeed, Professor Bebchuk and his co-authors themselves describe their study as principally proving a negative; namely, that activist interventions are not followed by declines on operating performance or stock price in the ensuing five years.[69] These studies reveal that activist interventions are sometimes followed by positive results and sometimes by negative results.

Professor Martijin Cremers and his co-authors published a paper reporting the results of a study that attempts to control for the selection bias created by hedge funds' typical tactic of targeting underperforming companies.[70] They created a matched sample where for each firm targeted by a hedge fund they assigned a control non-targeted firm with similar characteristics. They found that hedge fund activist interventions *reduce* long-term value at targeted firms over three years by about 9.8% compared to their control sample of matched underperforming firms.[71] And they found that innovative firms decline in value by about 50% after being targeted.[72] They are currently dueling with defenders of hedge fund activism over the data.[73]

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68. YVAN ALLAIRE & FRANÇOIS DAUPHIN, INST. FOR GOVERNANCE OF PRIVATE & PUB. ORGS., "ACTIVIST" HEDGE FUNDS: CREATORS OF LASTING WEALTH? WHAT DO THE EMPIRICAL STUDIES REALLY SAY? 9 (2014), http://www.wlrk.com/docs/IGOPP_Article_Template2014_Activism_EN_v6.pdf [http://perma.cc/T7G6-DRB2].

69. Bebchuk, Brav & Jiang, *supra* note 28, at 1089.

70. Cremers, Giambona, Sepe & Wang, *supra* note 49.

71. *Id.* at 7, 14-20.

72. *Id.* at 8, 24-26.

73. *E.g.*, Lucian Bebchuk, Alon Brav, Wei Jiang & Thomas Keusch, *The Long-Term Effects of Hedge Fund Activism: A Reply to Cremers, Giambona, Sepe, and Wang*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Dec. 10, 2015), http://corpgov.law.harvard.edu/2015/12/10/the-long-term-effects-of-hedge-fund-activism-a-reply-to-cremers-giambona-sepe-and-wang/ [http://perma.cc/2HQT-AX6H]; Martin Cremers, Erasmo Giambona, Simone M. Sepe & Ye Wang, *Reply*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Dec. 19, 2015), http://corpgov.law.harvard.edu/2015/12/19/reply/ [http://perma.cc/VP9Q-ND63].

Professor Allaire and Dauphin have reported the results from a study that tries to catalogue the different hedge fund interventions.[74] They surveyed nine studies on activist campaigns and noted that their data sets included widely divergent numbers of campaigns.[75] They then drilled down into the data captured by the *Wall Street Journal-FactSet Activism Scorecard* to categorize activist campaigns.[76] Their findings show that hedge funds adopt the tactic of publicly criticizing the company in about 28% of cases with about a 59% success rate.[77] Their findings also show that activist hedge fund interventions are followed by slashing research and development until the third year after the intervention, by which time most activists have liquidated their investments, while the median research and development for a random sample of firms increased substantially.[78] They found slight improvements on return on assets, but most of those improvements were driven by financial engineering in the form of selling assets, repurchasing shares, or cutting investments.[79] They also found that, although stock price tends to increase slightly compared to a random sample, in many cases it is driven by the sale of targeted firms, spin offs, or stock repurchases.[80]

Professors Coffee and Palia explain: "[B]ecause management generally has better information than outsiders, coupled with a strong incentive to maximize the firm's stock price, one can no longer begin from the premise that investment projects favored by management are the product of an inefficient preference for 'empire-building.'"[81]

Finally, Professors C.N.V. Krishnan, Frank Partnoy, and Randall Thomas published a paper reporting that the abnormal returns for hedge funds that make the largest investments are correlated with higher initial

74. Yvan Allaire & François Dauphin, *The Game of 'Activist' Hedge Funds: Cui Bono?*, INT'L. J. DISCLOSURE & GOVERNANCE, Dec. 2015, at 4-5.
75. *Id.* at 3-4.
76. *Id.* at 4-5.
77. *Id.* at 6-7.
78. *Id.* at 11.
79. *Id.* at 8-12.
80. *Id.* at 24-25.
81. Coffee & Palia, *supra* note 49, at 84.

abnormal stock price returns, higher returns on assets, and higher research and development spending.[82]

C. THE RISE OF WOLF PACKS

Recently, activist hedge funds have coordinated and acted as "wolf packs" agitating for corporate changes collectively, but in a way that does not require classifying them as a "group" for reporting under Section 13(d) of the Exchange Act.[83] These non-groups often buy on the knowledge, shared among them, that at least one will shortly file a Schedule 13D that discloses a strategic plan for a potential sale or break-up of the company.[84] After all, sales of public companies are usually accompanied by control premiums, and some finance theory predicts, all else being equal, that conglomerates in the aggregate trade at a discount to the sum of the value of their pure play segments. And companies have often responded to activists' threats of proxy contests with share repurchases and dividends.[85]

Wolf packs raise unique agency and disclosure issues. Because each member owns a smaller interest individually, the inference that it is more likely to promote the interests of long-term stockholders than the company's executive management and directors seems particularly strained.

Wolf packs are also more opaque because they can collectively own more shares before triggering the reporting requirements under Section 13(d). They also effectively evade the federal securities laws' requirement that a beneficial owner of above 10% of a company's stock automatically forfeit any short-swing profits if it sells within six

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82. *See, e.g.*, C.N.V. Krishnan, Frank Partnoy & Randall S. Thomas, *The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise* (Vanderbilt Law & Econ., Research Paper No. 15-9, 2015), http://ssrn.com/abstract=2589992 [http://perma.cc/VGC5-3K4V].

83. Coffee & Palia, *supra* note 49, at 23-36, 42.

84. *Id.*; Martin Lipton, Wachtell, Lipton, Rosen & Katz, *The Threat to Shareholders and the Economy from Activist Hedge Funds*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 14, 2015), http://corpgov.law.harvard.edu/2015/01/14/the-threat-to-shareholders-and-the-economy-from-activist-hedge-funds/ [http://perma.cc/V7RA-WJCW].

85. Coffee & Palia, *supra* note 49, at 30.

months.[86] Therefore, it is probably no coincidence that studies of Schedule 13D filings show that individual activists' average ownership is about 8.3% and wolf packs' average, collective ownership is about 13.44%.[87] Of course, that latter number may well be a substantial underestimate because it is unclear that all members of any wolf pack meet Section 13(d)'s requirements: at least sometimes additional members likely lurk below its reporting threshold, undisclosed and uncounted.[88] Members could even take turns in campaigns, at times serving as a lead agitator and at other times simply as an opportunistic buyer and seller that could buy shortly before and sell shortly after the filing of the Schedule 13D for a guaranteed profit. Naturally, this opacity complicates efforts to study and understand wolf pack behavior.

Some academics have also raised concerns about the undisclosed decoupling of share ownership from voting rights, which is particularly acute for wolf pack members.[89] Professors Henry Hu and Bernard Black have explained that by buying shares while simultaneously taking short positions through swaps and other derivatives, investors can engage in "empty voting": the investor can structure its economic interest so that it holds more votes than shares and may even have an undisclosed net short position.[90] This would "give[] the investor an incentive to vote in ways that reduce the company's share price."[91] Given that these shorts are not disclosed by wolf pack members that never reach the threshold at which they may have to disclose that information on a Schedule 13D filing, there is no way to know the extent of this problem.[92]

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86. Credit Suisse Sec. LLC v. Simmonds, 132 S. Ct. 1414, 1417, 1417 n.1 (2012).

87. John C. Coffee, Jr., *The DuPont Proxy Battle: New Myths, Old Realities—And Even Newer Data About Hedge Fund Activism*, CLS BLUE SKY BLOG (Apr. 20, 2015), http://clsbluesky.law.columbia.edu/2015/04/20/the-dupont-proxy-battle-new-myths-old-realities-and-even-newer-data-about-hedge-fund-activism/ [http://perma.cc/D4CX-KFYS].

88. *Id.*

89. *See generally* Hu & Black, *supra* note 31.

90. *Id.* at 812.

91. *Id.* at 815.

92. *Id.*

II. ENHANCING DISCLOSURE REQUIREMENTS UNDER SECTION 13(D)

The limits of the current knowledge about activist hedge funds, their collective net economic interests, and their activities below current reporting thresholds have constrained companies' ability to evaluate activist proposals and academics' ability to research the issue.

In 2011, as a partial remedy, Wachtell Lipton petitioned the SEC to enact revised rules under Section 13(d) that would require stockholders to file a Schedule 13D disclosure within one business day rather than ten after passing the 5% ownership threshold.[93] This would effectively lower the reporting threshold by counting derivatives and short interests toward it.[94] Professors Coffee and Palia have suggested that the proposed rules could be further revised to make any activist that traded on a shared strategy part of the group.[95]

Professor Bebchuk and one of his co-authors responded to the Wachtell Lipton petition with many of the same claims about the value of activist hedge funds but extended his argument even further. He added the claim that enhancing disclosure requirements would be so burdensome that it would deter a material amount of beneficial activism.[96] In response to the hedge fund's disclosure, the target company can enact a rights plan that effectively caps the activist's investment.[97] And, regardless of whether a rights plan is enacted, Professor Bebchuk theorized that the marginal profits hedge funds make buying an increased stake at a level higher than an amended reporting threshold but lower than the current reporting threshold are necessary to incentivize them to benefit long-term stockholders.[98] But concerns about the theoretical possibility that moderate limits on the profitability of hedge funds' investments will disincentivize beneficial activism ignore

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93. Letter from Wachtell, Lipton, Rosen & Katz to Ms. Elizabeth M. Murphy, Sec'y, SEC (Mar. 7, 2011), http://www.sec.gov/rules/petitions/2011/petn4-624.pdf [http://perma.cc/2HTM-DZZS].

94. *Id.*

95. Coffee & Palia, *supra* note 49, at 94-95.

96. Lucian A. Bebchuk & Robert J. Jackson, Jr., *The Law and Economics of Blockholder Disclosure*, 2 HARV. BUS. L. REV. 39, 50-51 (2012).

97. Third Point LLC v. Ruprecht, Nos. 9469–VCP, 9497–VCP, 9508–VCP, 2014 WL 1922029, at *17-21 (Del. Ch. May 2, 2014).

98. Bebchuk & Jackson, *supra* note 96, at 50.

the massive surge in activism recognized by all. There hardly seems to be a shortage of incentives to engage in it.

Professors Coffee and Palia have identified eight separate legal and financial changes that have increased activism by hedge funds, including: (1) the decline of staggered boards so all directors stand for election at the same time and are more vulnerable to proxy contests; (2) the rise of proxy advisors due in part to the need for low-cost pensions and mutual funds to cheaply meet relatively new regulatory standards of care for voting their shares; and (3) the prohibition against brokers, which used to routinely vote with management on strategic proposals, voting shares held in street name for their clients without instructions.[99] None of these three changes would be affected by enhanced disclosure requirements imposed on hedge funds. Because of these many complex variables contributing to the rise in activism, Professor Bebchuk has failed to articulate why the reduction in profit-taking caused by enhanced disclosure would deter a meaningful level of beneficial activism.

Recent evidence of activism across twenty-three countries also may show that its level is relatively insensitive to differences in disclosure and corporate governance regimes. As Wachtell Lipton noted in its petition, the United Kingdom, Germany, and Hong Kong require disclosure more quickly after reaching ownership thresholds than the United States.[100] Professor Marco Becht and his co-authors, however, have recently reported that activism is also frequent in Europe and Asia, that it generates short-term abnormal returns comparable to the United States, and that activists appear to adapt tactics to each country's corporate governance and disclosure regime.[101] This naturally leads to the question of what disclosure and governance regime best promotes beneficial activism, even if it might be one that reduces the overall level of activism.

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99. Coffee & Palia, *supra* note 49, at 18-46.

100. Letter from Wachtell, Lipton, Rosen & Katz, *supra* note 93, at 2.

101. Marco Becht, Julian Franks, Jeremy Grant & Hannes Wagner, *The Returns to Hedge Fund Activism: An International Study* 2, 12, 13 (European Corp. Governance Inst., Working Paper No. 402/2014, 2015), http://ssrn.com/abstract=2376271 [http://perma.cc/7H5C-GE6E].

III. SUNLIGHT BYLAWS WOULD REVEAL NECESSARY INFORMATION

Public companies can pass sunlight bylaws to require what the outdated rules under Section 13(d) fail to mandate. Those bylaws would also require activist hedge funds to provide specific facts bearing on the general claims made by their defenders.

A. OUTLINE OF THE PROPOSED SUNLIGHT BYLAWS

Borrowing heavily from the Wachtell Lipton petition and Professors Coffee and Palia's paper, the bylaws would require:

(1) the stockholder to post on the internet an affidavit from its highest-ranking financial officer within one business day after acquiring a financial interest above 5% of the outstanding shares of the company on behalf of itself and those with which it is coordinating for any of the purposes listed in Item 4 of the regulations governing Schedule 13D disclosures;[102]

(2) the term "financial interest" would encompass ownership of any financial instrument that creates the opportunity, directly or indirectly, to profit or share in any profit derived from any increase or decrease in the value of the company's securities;

(3) the affidavit must separately disclose any indirect interests held by the stockholder in the company, including short interests, derivatives, or swap positions;

(4) those parties with which the stockholder is coordinating would include those that the stockholder shares non-public information about a prospective strategic proposal, an affidavit to be published as required by the sunlight bylaw, a Schedule 13D filing, or a proxy campaign and that have agreed to trade, traded, or agreed to continue to hold a financial interest in the company's securities;

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102. 17 C.F.R. § 240.13d-101 (2015). This threshold could be adjusted depending on the market capitalization of the company, and, in fact, might be far too low for a company like DuPont with a market capitalization of about $68 billion during Trian's activist campaign. By the date that Trian filed its definitive proxy there, it owned about 24.5 million shares, only about 2.7% of those outstanding. The Trian Group, Proxy Statement (Schedule 14A) (Mar. 25, 2015).

(5) the affidavit must disclose those parties outside the stockholding institution to which the stockholder has communicated non-public information about a prospective strategic proposal, an affidavit to be published as required by the sunlight bylaw, a Schedule 13D filing, or a proxy campaign;

(6) those parties with which the stockholder is coordinating would have to separately disclose, consistent with the bylaw's requirements, within one business day after receiving the shared, non-public information and agreeing to trade, trading, or agreeing to continue to hold even if they individually did not pass the 5% threshold;

(7) the affidavit must disclose the stockholder's investment in the target company as a percentage of the stockholder's total investments;

(8) the affidavit must disclose any compensation scheme, any total actual compensation, actual compensation based on the percentage of assets under management, actual compensation based on any performance fee for realized gains, actual compensation based on any performance fee for unrealized gains, and any investment in or options for investment in the stockholder for the current year and each of the past five years for those making decisions about the stockholder's investment in the company or any strategic proposals for the company;

(9) the affidavit must separately disclose the stockholder's return on investment quarterly for the past five years for all investments, all publicly-traded equity investments, all investments that the stockholder has held for at least three years, and all publicly-traded equity investments that the stockholder has held for at least three years;

(10) the affidavit must disclose the stockholder's annual portfolio turnover for each of the past five years for publicly-traded equity investments and all investments;

(11) the affidavit must disclose the stockholder's prior Schedule 13D filings or disclosures under sunlight bylaws, any subsequent material purchases or sales, when it amended its Schedule 13D or disclosures under the sunlight bylaw to reflect those, and the total length after filing it held a material number of shares in those companies;

(12) the affidavit must disclose all of the other information required in a Schedule 13D filing;

(13) the stockholder must email a copy of the affidavit and an internet link to it to a designated company email address;

(14) if there are any material changes to any of the information disclosed in the affidavit, the stockholder must amend the filing one business day after the change, following the same procedures;

(15) if a stockholder violates the sunlight bylaw, it would foreclose the business or nominee supported by the activist from being considered at a stockholder vote absent board approval; and

(16) any stockholder required to make and that made Section 13G filings for the prior three calendar years would be exempt from the requirements of the sunlight bylaw.

More detailed work is necessary to spell out the precise language of sunlight bylaws, but this Article will assume the above framework to evaluate their validity and enforceability.

B. SUNLIGHT BYLAW DISCLOSURES WOULD ANSWER KEY QUESTIONS ABOUT ACTIVIST HEDGE FUNDS

Besides having all the benefits that Wachtell Lipton's petition for rule-making would bring, sunlight bylaws have some unique, additional advantages. They can answer, in the context that matters most, many of the factual disputes between activist hedge funds' proponents and detractors.

Under any view of the efficient capital markets hypothesis, it is difficult to understand why activist hedge funds can so improve business or governance based on publicly-available information. The proponents of activist hedge funds believe them to be better agents for other stockholders than the directors and executive management. But rather than simply continuing to assume, theorize, or study that generalization based on spotty data, the activist hedge funds should have to disclose the specific information bearing on it.

As explained, Professors Brav's and Bebchuk's theoretical defense of activism claims it is only beneficial at times, and, at bottom, rests entirely on the notion that activists are better incentivized than the company's executive management and directors.[103] And the subsequent empirical work by defenders of activism shows that lumping activist hedge funds and their campaigns together reveals mixed results.[104] Their

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103. *See supra* Part I.A-B.
104. *See supra* Part I.B.

work therefore demonstrates that activist hedge funds sometimes harm net present value and long-term value.[105]

To be more concrete: Professor Bebchuk has argued that detractors of activist hedge funds assume their investment horizons are shorter than they really are.[106] But a sunlight bylaw would require each activist hedge fund to disclose its portfolio turnover and prior holding periods after publicly announcing its financial interests and strategic proposal. That tells everyone, directly, the fund's general approach to holding assets, its general investment horizon, and when, in the past, it has decided that the value of its investment has peaked.

Professor Brav and his co-authors have argued that because hedge funds invest in fewer companies, hedge funds invest more money in each, and because hedge fund managers take a larger percentage of the profits, they have stronger incentives to research, monitor, invest, and intervene.[107] Again, rather than theorizing about this possibility, sunlight bylaws would require disclosure of the activist hedge fund's direct and indirect investment in the company as a percentage of its portfolio and the compensation of the hedge fund's decision-makers. That would allow stockholders to compare the incentives of the company's decision-makers to those at the activist hedge fund, which is the relevant comparative agency issue.

C. SUNLIGHT BYLAWS COULD IMPROVE THE QUALITY OF ACTIVIST PROPOSALS

Sunlight bylaws might also encourage activists to better align their incentives with other stockholders.

If activist wolf pack members engage in empty voting, by buying shares and the accompanying voting rights while taking a smaller or short net economic position, sunlight bylaws would expose that. Professor Thomas Briggs recognized long before wolf pack activism reached its current heights, that "[h]edge funds know as well as anyone else that sunlight is the best disinfectant" and "a competently advised hedge fund that is truly bent on behavior that might not do well in the

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105. *See supra* Part I.B.
106. Bebchuk, *supra* note 50, at 1660-61.
107. Brav, Jiang, Partnoy & Thomas, *supra* note 29, at 2, 7.

sun is simply not going to purchase enough shares to require a Schedule 13D filing."[108]

Forcing comprehensive and systematic disclosure of short positions, including those taken through swaps and derivatives, would require wolf pack members lurking below current disclosure thresholds to evaluate carefully how that disclosure would affect any lead activist's ability to sway the institutional stockholders that control the bulk of the voting power. This type of disclosure might also encourage wolf pack members to take long positions and think twice before joining a meritless campaign simply to cash in on the short-term increase in stock price that surrounds the filing of a Schedule 13D. "[F]or the institutional shareholders who ultimately decide whether to support an activist's proposal, the fact that the activist takes a greater economic stake based solely on the performance of the stock is a credible signal of a high-quality proposal . . . ."[109]

Activist hedge funds and wolf pack members, which are sophisticated, savvy, and experienced institutions, would well understand these dynamics ex ante.[110] Forcing disclosure of these derivative and potentially short positions might dissuade them from ever launching campaigns where many members have a close-to-zero or net short economic interest in the company's share price. Thus, sunlight bylaws, even if they reduce the total amount of activism, might increase the quality of activist proposals.

IV. SUNLIGHT BYLAWS ARE FACIALLY VALID

Activists would likely sue soon after the enactment of a sunlight bylaw to challenge its facial validity. When companies, including Federal Express and Chevron, passed forum selection bylaws, a dozen lawsuits challenging their facial validity were filed in Delaware.[111]

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108. Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681, 703-04 (2007).

109. Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 913 (2013).

110. Coffee & Palia, *supra* note 49, at 28-32 (describing wolf packs generally).

111. Boilermakers Local 154 Ret. Fund v. Chevron Corp., 73 A.3d 934, 938 (Del. Ch. 2013).

Activist hedge funds are not bashful, and at least one could sue immediately after a public company passed a sunlight bylaw.

A. STANDARD FOR DETERMINING FACIAL VALIDITY

A corporation's bylaws are "presumed to be valid, and the courts will construe the bylaws in a manner consistent with the law rather than strike down the bylaws."[112] "In an unbroken line of decisions dating back several generations," the Delaware "Supreme Court has made clear that the bylaws constitute a binding part of the contract between a Delaware corporation and its stockholders."[113]

Delaware courts have upheld bylaws of Delaware corporations that require stockholders to vote at a later date,[114] sue in specified forums,[115] and pay attorneys' fees if they lose litigation.[116] Although recent changes to the DGCL limit forum selection bylaws and eliminate fee-shifting bylaws, the cross-section of Delaware lawyers representing the major constituencies recommending the change recognized that "[t]he DGCL is broadly enabling and gives wide authority to boards—and stockholders—to adopt binding bylaw and charter provisions."[117]

To be facially valid, a bylaw must be authorized by the DGCL, must be consistent with the certificate of incorporation, and must not be otherwise unlawful.[118] A party mounting a facial challenge to a bylaw "must show that the bylaws cannot operate lawfully or equitably *under any circumstances*" and "can never operate consistently with the law."[119]

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112. ATP Tour, Inc. v. Deutscher Tennis Bund, 91 A.3d 554, 557 (Del. 2014) (citation and internal quotation omitted).

113. *Chevron*, 73 A.3d at 955.

114. Kidsco Inc. v. Dinsmore, 674 A.2d 483, 495-97 (Del. Ch. 1995), *aff'd and remanded*, 670 A.2d 1338 (Del. 1995).

115. *Chevron*, 73 A.3d at 939.

116. *ATP*, 91 A.3d at 558.

117. Francis Pileggi, *Delaware Proposes New Fee-Shifting and Forum Selection Legislation*, DEL. CORP. & COMMERCIAL LITIG. BLOG (Mar. 6, 2015), http://www.delawarelitigation.com/2015/03/articles/commentary/delaware-proposes-new-fee-shifting-and-forum-selection-legislation/ [http://perma.cc/MZU9-KP3G].

118. *ATP*, 91 A.3d at 557-58.

119. *Chevron*, 73 A.3d at 948.

B. Sunlight Bylaws Are Authorized by DGCL Section 109(b)

1. The Text Authorizes Sunlight Bylaws

DGCL section 109(b)'s plain meaning is dispositive.[120] The statute enables a company to pass otherwise lawful bylaws "relating to . . . the rights or powers of its stockholders."[121]

Dictionaries define "powers" to include any "ability to act or produce an effect" and "legal authority."[122] Sunlight bylaws, by requiring activist hedge funds to make disclosures not required by current law for their proposals to be considered, limit their "ability to act," ability to effect stockholder approval, and authority to put business to a stockholder vote. Sunlight bylaws thus "relat[e] to" stockholders' "powers."

Dictionaries define "rights" to include any "power" or "privilege" that is "secured to a person by law."[123] Sunlight bylaws delimit the legal privileges afforded to activist hedge funds to put business to a stockholder vote without making disclosures and therefore "relat[e] to" their rights.

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120. Angstadt v. Red Clay Consol. Sch. Dist., 4 A.3d 382, 388, 388 n.5, 390 (Del. 2010).

121. DEL. CODE ANN. tit. 8, § 109(b) (2015).

122. *Power*, MERRIAM-WEBSTER ONLINE UNABRIDGED DICTIONARY, http://www.merriam-webster.com/dictionary/power [http://perma.cc/J9H5-8PXY]; *see also Power*, THE OXFORD ENGLISH DICTIONARY, http://www.oed.com/view/Entry/149167?rskey=oXGRuw&result=1#eid [http://perma.cc/3PM3-NJJR]; *Power*, BLACK'S LAW DICTIONARY (10th ed. 2014); *Power*, BLACK'S LAW DICTIONARY (4th ed. 1968); 8 THE OXFORD ENGLISH DICTIONARY 669 (Oxford University Press 1961) (1884-1928).

123. *Right*, BLACK'S LAW DICTIONARY (10th ed. 2014); *see also Right*, MERRIAM-WEBSTER ONLINE UNABRIDGED DICTIONARY, http://www.merriam-webster.com/dictionary/right [http://perma.cc/AX2L-TTZ4]; *Right*, THE OXFORD ENGLISH DICTIONARY, http://www.oed.com/view/Entry/165853?rskey=96JvHS&result=1&isAdvanced=false#eid [http://perma.cc/U87V-GSZE]; *Right*, BLACK'S LAW DICTIONARY (4th ed. 1968); 7 THE OXFORD ENGLISH DICTIONARY 1218 (Oxford University Press 1961) (1884-1928).

2. Sunlight Bylaws Are Process-Oriented

Sunlight bylaws are also authorized by Delaware law because they set forth rules and procedures that bind a corporation and its stockholders and dictate no particular outcome.

In *CA, Inc. v. AFSCME Employees Pension Plan*, the Delaware Supreme Court found that a stockholder-proposed bylaw that would have required reimbursement for dissident stockholder proxy contest expenses was authorized by section 109(b).[124] The company opposing the proposed bylaw did not even argue that section 109(b)'s broad language did not authorize it, but instead argued that it contradicted another provision of the DGCL not relevant here.[125] The court nonetheless relied on the breadth of authority granted under section 109(b) and the DGCL more generally to dispose of the argument. The court explained that "[b]ylaws, by their very nature, set down rules and procedures that bind a corporation's board and its shareholders."[126] The court noted that "procedural, process-oriented" bylaws such as those regulating proxy contests are firmly ensconced in Delaware law, and therefore found that the DGCL authorized the proposed bylaw.[127] And, although Delaware courts rarely consider hypotheticals when confronted with facial challenge to bylaws, the Delaware Supreme Court, in the unique procedural posture of answering a certified question from the SEC,[128] found the bylaw inequitable because reimbursement could sometimes violate the incumbent directors' fiduciary duties.[129]

Sunlight bylaws would not be the first time that companies have followed up on the SEC's failure to pass effective rules by modifying and adopting them as bylaws. Mary Schapiro was the SEC Chair when it issued the shareholder proxy access rule permitting holders of 3% or more of shares for the past three years to add director nominees to the company's proxy, which was vacated by the D.C. Circuit. But she now sits on the board of General Electric, which has passed a bylaw similar

124. CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227 (Del. 2008)
125. *Id.* at 233-34.
126. *Id.* at 234.
127. *Id.* at 235-36.
128. *Chevron*, 73 A.3d at 949 n.62.
129. *AFSCME Emps.*, 953 A.2d at 240.

to that invalidated rule.[130] And General Electric's bylaws also provide that non-compliance with the procedural requirements for gaining access to General Electric's proxy forecloses the business proposed by the stockholder from being conducted at the stockholder meeting.[131]

Although sunlight bylaws regulate stockholders at a different stage of the process, they are procedural, process-oriented bylaws. As part of the process of acquiring a significant ownership stake in a company and making a strategic proposal, raising business that could be the subject of a proxy vote, or seeking to elect a director, stockholders must make additional disclosures.

C. Sunlight Bylaws Do Not Fall within the Scope of DGCL Section 202

Activists might argue that the sunlight bylaws fall within the scope of DGCL section 202 and therefore cannot bind non-consenting stockholders, but they do not. Section 202 governs "restrictions on the transfer or registration of transfer of a security of a corporation, or on the amount of the corporation's securities that may be owned by any person or group of persons."[132] But sunlight bylaws do not restrict transferability or limit ownership: the activist hedge fund can still buy and sell as many shares as it likes. Sunlight bylaws are therefore quite different from the examples of restrictions listed in the statute, such as those that give the company the right of first refusal, obligate the company to purchase the securities under certain conditions, require the company's consent to a sell, obligate the holder to sell to someone else, or prohibit or restrict the transfer of shares to designated persons.[133] Thus, section 202 does not bar sunlight bylaws.

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130. Ted Mann & Joann S. Lublin, *GE to Allow Proxy Access for Big Investors*, WALL ST. J. (Feb. 11, 2015, 6:40 PM), http://www.wsj.com/articles/ge-amends-bylaws-to-allow-proxy-access-for-big-investors-1423698010 [http://perma.cc/NYH4-4VQR].

131. GENERAL ELECTRIC CO., BYLAWS 5 art. VII.D (2016).

132. DEL. CODE ANN. tit. 8, § 202 (2015).

133. *Id.* § 202(c).

D. A Challenger Could Not Show Sunlight Bylaws Would Never Operate Lawfully

In a facial challenge, an activist could not meet its burden of showing that sunlight bylaws cannot operate lawfully or equitably under any circumstance. As explained, sunlight bylaws would enhance the stockholder franchise, would promote better board decision-making, cannot be shown to materially reduce beneficial activism, and may promote better activism.

And sunlight bylaws would not necessarily make an incumbent board's view of the proper strategy for the company more persuasive, let alone entrench the board. If a hedge fund with an investment strategy akin to Berkshire Hathaway's, with what Buffett has described as its preferred holding period of "forever," publishes an affidavit disclosing its portfolio turnover and prior holding periods, it could make a long-term stockholder more likely to support the hedge fund. If the hedge fund manager's large and long-standing ownership stake in the fund creates an overall incentive structure that skews toward rewarding long-term performance while the company's management is heavily compensated based on salary, it may also be a selling point for the hedge fund. And, finally, if a fellow stockholder is looking for a short-term gain, then it may prefer the proposal of a hedge fund with a high portfolio turnover.

V. A Sunlight Bylaw and a Hypothetical As-Applied Challenge

Legal challenges to sunlight bylaws could also arise in an activist's push for a strategic proposal that escalates into litigation between the activist and the company. Although every case must be judged individually, sunlight bylaws should pass muster if thoughtfully adopted and administered.

A. The Campaign Against DuPont

Consider the following facts from the activist hedge fund Trian's two-year campaign against DuPont that culminated in a proxy fight. In

June 2013, Trian contacted DuPont and made strategic proposals, including breaking up the company into four different segments and reducing research and development spending.[134] On August 14, 2013, Trian filed a Schedule 13F disclosing beneficial ownership of over 5 million shares or about 0.65% of DuPont's stock.[135] Over years of engagement, DuPont spun off a chemicals segment, reduced research and development spending by about $9 billion, and bought back about $2 billion in shares, but rejected the more radical break-up.[136] In the Fall of 2014, the negotiations broke down and Trian's principal Nelson Peltz demanded that, absent the appointment of Trian nominees to the board of directors, Trian would launch a proxy fight.[137] DuPont refused, and the fight ensued.[138]

DuPont defeated the insurgent slate of directors, largely because it successfully appealed to three index funds—Vanguard Group, Blackrock Inc., and State Street Corp.—and retail investors.[139] DuPont prevailed despite the recommendations from the two leading proxy advisors, Institutional Shareholder Services Inc. and Glass Lewis & Co, in favor of voting in Peltz as a director.[140]

But the two-year battle was enormously costly, forced the DuPont board to make moves to increase short-term value such as the spin-off and a substantial stock buy-back, and whipsawed the market price of a $68 billion company.[141] Indeed, Professors Coffee and Palia conclude

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134. E. I. du Pont de Nemours & Co., Proxy Statement (Schedule 14A) (Mar. 23, 2015).
135. *Id.*
136. *Id.*
137. *Id.*
138. *Id.*
139. Jacob Bunge & David Benoit, *DuPont Defeats Peltz, Trian in Board Fight*, WALL ST. J. (May 13, 2015), http://www.wsj.com/articles/dupont-appears-poised-to-win-over-peltz-1431521564 [http://perma.cc/C8XM-SQPW].
140. *Id.*
141. Jacob Bunge & David Benoit, *DuPont Repels Push by Peltz to Join its Board*, WALL ST. J. (May 13, 2015, 8:23 PM), http://www.wsj.com/articles/dupont-repels-push-by-peltz-to-join-its-board-1431562720 [http://perma.cc/8SDW-P7JK]; Bill George, *Peltz's Attack on DuPont Threatens American's Research Edge*, N.Y. TIMES: DEALBOOK (Apr. 9, 2015), http://www.nytimes.com/2015/04/10/business/dealbook/peltzs-attacks-on-dupont-threaten-americas-research-edge.html?_r=0 [http://perma.cc/FM8A-LJHE].

that "DuPont survived largely intact by preempting Trian's strategy—with the result that, whether management wins or loses in the proxy contest, [research & development] expenditures decline."[142] And Peltz still lost by only about 8% of the shares voted.[143] Since DuPont "won" that proxy fight, its CEO has resigned "and the new CEO announced that the company would pursue some of the strategies Trian [] had urged in the proxy fight."[144] And now, under continuing pressure, DuPont has proposed a complicated merger with Dow Chemical that will result in a combined company with over 100,000 employees destined in two years to be split into three new companies focused on agriculture, material sciences, and specialty products like nutrition and electronics.[145] That is despite the fact that the last unit DuPont spun off—the chemicals unit spun off in part as an effort to appease activists—lost three quarters of its value in less than a year after its separation.[146]

B. THE DUPONT HYPOTHETICAL

Consider what would have happened if DuPont had passed a sunlight bylaw, and Trian exceeded its thresholds but flaunted it.

1. Detection of the Activists

In DuPont, Trian first made its strategic proposals in June 2013 and filed a Schedule 13F in August 2013, more than a year-and-a-half before the stockholder vote. The Schedule 13F filing and other communications with Trian would have tipped DuPont off. Assuming it did not already have a sunlight bylaw in place, DuPont

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142. Coffee & Palia, *supra* note 49, at 59.

143. E. I. du Pont de Nemours & Co., Current Report (Form 8-K/A) (June 9, 2015).

144. Martin Lipton, Wachtell, Lipton, Rosen & Katz, *Some Thoughts for Boards of Directors in 2016*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Dec. 9, 2015), http://corpgov.law.harvard.edu/2015/12/09/some-thoughts-for-boards-of-directors-in-2016/ [http://perma.cc/5RRS-RYWB].

145. Steven Davidoff Solomon, *Remaking Dow and DuPont for the Activist Shareholders*, N.Y. TIMES: DEALBOOK (Dec. 15, 2015), http://www.nytimes.com/2015/12/16/business/dealbook/remaking-dow-and-dupont-for-the-activist-shareholders.html [http://perma.cc/8ZZ5-LFMV].

146. *Id.*

could have enacted one, and Trian would have faced the choice between complying or refusing to comply and having its strategic proposal and any director nominees become ineligible for the stockholder vote. Trian never reached the ownership threshold on its own that would have triggered an obligation to file a Schedule 13D or Schedule 13G, so there is a question of whether it would reach the ownership threshold required under a sunlight bylaw. But that trigger could obviously be adjusted based on factors such as the size of a company measured in market capitalization, where, as was true of DuPont, 5% of the company's outstanding shares cost billions.

2. What a Sunlight Bylaw Might Have Revealed

Consider what a sunlight bylaw might have revealed in the activist campaign against DuPont and why Trian might need to sue to invalidate it.

Trian issued numerous white papers and press releases, but consider its last white paper before the stockholder vote. It begins with the disclaimer that "[n]either the Participants nor any of their affiliates shall be responsible or have any liability for any misinformation contained in any third party, SEC or other regulatory filing or other third party report" and "Trian [] disclaims any obligation to update the data, information or opinions contained in this presentation."[147] Query whether Trian is attempting to disclaim any obligation to be accurate in its own SEC filings about its holdings. Regardless, it plainly disclaims any obligation to update any information.[148]

Trian attacks DuPont's growth as purely cyclical, not driven by value added by management, and followed the common tactic of engaging in a highly detailed discussion of executive compensation under the title: "Poorly Constructed Compensation Programs: High Annual Payouts Despite Poor Performance."[149]

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147. TRIAN PARTNERS, DUPONT: A REFERENDUM ON PERFORMANCE AND ACCOUNTABILITY 2 (2015), http://www.sec.gov/Archives/edgar/data/30554/000093041315000509/c80237_ex1.pdf [http://perma.cc/LLD4-DD6P].

148. *Id.*

149. *Id.* at 16. Activist hedge funds commonly attack executive compensation. *See, e.g.*, Liz Hoffman, *Activist Funds Put Executive Pay Formulas Under Microscope*,

Although Trian need not disclose its principals' compensation or its annual yields, one can compare DuPont's disclosures to news reports. According to DuPont's 2014 Proxy, in 2013, its then-Chairman and CEO Ellen Kullman earned about $12.5 million while its stock price increased by about 42%;[150] according to its 2015 Proxy, in 2014, Kullman earned about $12 million while its stock price increased 16%.[151] According to Forbes—again, the best one can do—in 2013, Trian's principal Nelson Peltz earned $430 million while the fund yielded about 40%;[152] in 2014, Peltz earned $170 million while the fund yielded about 11%.[153] In other words, for generating an average yield in 2013 through 2014 that was less than DuPont's, Peltz earned average compensation that exceeded DuPont's CEO's by over twenty-four times.

Trian touts the $11.3 billion of assets under its management,[154] but consider what this might mean for Trian's guaranteed income. Under the "standard compensation structure . . . hedge fund managers charge annually 2% of the assets under management plus a performance fee of 20%."[155] Two percent of $11.3 billion in assets under management would result in a fixed, annual management fee of about $226 million, suggesting compensation for its executives not directly tied to performance that dwarfs that of executive management at DuPont.

WALL ST. J. (June 11, 2015, 5:39 PM), http://www.wsj.com/articles/activist-funds-put-executive-pay-formulas-under-microscope-1434058799 [http://perma.cc/MXW2-EYSN]; Yonca Ertimur, Fabrizzio Ferri & Volkan Muslu, *Shareholder Activism and CEO Pay*, 24 REV. FIN. STUD. 535 (2011).

150. E. I. du Pont de Nemours & Co., Proxy Statement (Form DEF 14A) (Mar. 14, 2014).

151. E. I. du Pont de Nemours & Co., Proxy Statement (Form DEF 14A) (Mar. 23, 2015).

152. Nathan Vardi, *The 25 Highest-Earning Hedge Fund Managers and Traders*, FORBES (Feb. 26, 2014, 9:47 AM), http://www.forbes.com/pictures/mdg45eejfh/16-nelson-peltz/ [http://perma.cc/E6HJ-7962].

153. Nathan Vardi, *The 25 Highest-Earning Hedge Fund Managers and Traders*, FORBES (Feb. 25, 2015, 9:45 AM), http://www.forbes.com/pictures/mdg45ehmel/23-nelson-peltz/ [http://perma.cc/4G3P-J7F9].

154. TRIAN PARTNERS, *supra* note 147, at 30.

155. Coffee & Palia, *supra* note 49, at 48.

Trian also recites its long-term investments in Wendy's, Tiffany's, Heinz, and Family Dollar.[156] But this selective recitation of examples is not a catalogue of its prior holding periods after every intervention, does not disclose its percentage annual portfolio turnover, and is nothing close to the detailed information DuPont must report about its assets annually and update quarterly under the securities laws.

Trian also touts its ownership of about $1.9 billion in DuPont shares compared to about $20 million in shares owned by management.[157] But that, of course, appears to be only about 17% of Trian's assets, and many DuPont directors and executives likely have a far higher percentage of their wealth tied to DuPont's future.

To the extent that the discussion here of news reports concerning Trian is much more general or based on less reliable sources than Trian's discussion of DuPont, that is because of the disclosure asymmetry. The information culled from Trian's disclosures and news reports simply hints at the size and direction of what might be gleaned from disclosures under sunlight bylaws.

Even this superficial review, reveals that Trian's investment and the compensation and incentives of its decision-makers likely do not comport with the incentives assumed by Professors Brav and Bebchuk. Knowing this, Trian may well have sued to invalidate any sunlight bylaw.

DuPont should win.

3. DuPont's Certificate of Incorporation and Bylaws

As explained, a sunlight bylaw would have been consistent with the DGCL. It also would have been consistent with DuPont's certificate of incorporation and bylaws.

DuPont's certificate of incorporation states that subject to the power of stockholders to make and repeal bylaws, the board has the power "to make By-laws; and, from time to time, to alter amend or

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156. TRIAN PARTNERS, *supra* note 147, at 31.
157. *Id.* at 33.

repeal any By-laws."[158] DuPont's bylaws specify that a special meeting requested by stockholders will not be held if the business proposed "is not a proper subject for stockholder action under applicable law" and "[b]usiness transacted at all special meetings shall be limited to the matters stated in the Company's notice" or stockholder business proposed in compliance with the bylaws.[159] DuPont's bylaws require stockholders to give advanced notice of any such business from 90 to 120 days before the meeting, and any violation prohibits the business from being considered.[160] Finally, the bylaws confirm that a majority board vote can adopt, amend, or repeal the bylaws.[161] A sunlight bylaw would be consistent with DuPont's certificate of incorporation and bylaws.

4. Validity of the Sunlight Bylaw As Applied

In *Third Point LLC v. Ruprecht*, ("*Sotheby's*"), the court upheld the rights plan designed by Wachtell Lipton with thresholds based on Schedule 13D filings to protect Sotheby's from the threat of creeping control.[162] There, Vice Chancellor Parsons applied the *Unocal* standard of review and rejected the more stringent standard urged by the activist,[163] but this Article will examine them under the most stringent standard. That analysis, of course, applies with even greater force under the *Unocal* standard.

Chief Justice Strine, while a Vice-Chancellor, interpreted Delaware Supreme Court precedent governing an incumbent board's power to pass bylaws affecting voting rights as requiring the incumbent board to show: (1) "a legitimate corporate objective served by its decision," (2) "that their motivations were proper and not selfish," (3) "that their actions were reasonable in relation to their legitimate objective," and (4) that their actions "did not preclude the

158. E. I. du Pont de Nemours & Co., Restated Certificate of Incorporation 7-8 (May 29, 1997).
159. E. I. DU PONT DE NEMOURS & CO., BYLAWS art. 1, § 2 (2013).
160. *Id.* at art. 1, § 8.
161. *Id.* at art. VII.
162. Third Point LLC v. Ruprecht, Nos. 9469–VCP, 9497–VCP, 9508–VCP, 2014 WL 1922029 (Del. Ch. May 2, 2014).
163. *Id.* at *15-17.

stockholders from exercising their right to vote or coerce them into voting a particular way."[164] Even harkening back to the most restrictive view of the board's ability to pass bylaws affecting voting rights in *Blasius Industries, Inc. v. Atlas Corp.*, does not change the analysis.[165] According to *Blasius*, a board cannot act "for the primary purpose of preventing or impeding an unaffiliated majority of shareholders from expanding the board and electing a new majority," without satisfying the difficult burden of "demonstrating a compelling justification for such action."[166]

A properly drafted and administered sunlight bylaw serves the legitimate corporate objective of promoting disclosure that would enable other stockholders and the board to better evaluate activist hedge funds' incentives and proposals. The fit between means and ends is reasonable because it requires the disclosure of readily available information, it cannot be shown to deter a material amount of beneficial activism, it might lead to more beneficial activism, and it regulates process rather than dictating an outcome.

The sunlight bylaw enhances the stockholder's franchise, rather than detracting from it. It allows other stockholders to evaluate not only any facts creating potential agency issues for the company's board and executive management, but also information relevant to potential conflicts of interest between the activist hedge fund managers and other stockholders. Chief Justice Strine has explained why enhancing Section 13(d)'s disclosure requirements would promote better stockholder decision-making and enhance their electoral rights:

> If [Bebchuk's] argument is there is no reason to fear that hedge funds or other activist investors can threaten long-term value because longer-term investors will hold the balance of voting power, it logically follows that the voting electorate should have up-to-date, complete information about the economic interests of a hedge fund holding a large bloc of a corporation's shares and proposing that the

164. Mercier v. Inter-Tel (Del.), Inc., 929 A.2d 786, 810-11 (Del. Ch. 2007).
165. Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988).
166. *Id.* at 652, 661.

> corporation make business strategy changes it is suggesting. Precisely how "long" the fund's investment in the company is and in what manner the hedge fund is long is relevant information for the electorate to consider in evaluating the hedge fund's interest. So is how "long" the activist is committed to owning its shares. This is consistent with Bebchuk and his allies' belief that corporate managers should fully disclose their interests. When an investor is seeking to influence corporate strategies, especially by seeking status as a fiduciary or by using threat of an election campaign to gain concessions, that investor is taking action that affects all the company's investors. If the electorate is to play the role Bebchuk envisions, he should support requirements to make sure that up-to-date, complete information about the proponents' economic holdings and interests is available.[167]

His analysis applies with equal force to a sunlight bylaw passed and approved by the elected DuPont board.

The sunlight bylaw would also facilitate decision-making by the board of directors. Vice Chancellor Laster has explained that "[u]nder the DGCL, unless a Delaware corporation provides otherwise in its certificate of incorporation, its existence is perpetual."[168] He concluded that "[t]he directors' fiduciary duties therefore require that they maximize the value of the corporation over the long term for the benefit of the providers of longterm (i.e., presumptively permanent) capital."[169] Although basing fiduciary duties on a perpetual existence may stir up some controversy,[170] the directors must consider the impact of a strategic proposal on net present value. In doing so, they are entitled to consider facts bearing on the implications of strategic proposals for the company

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167. Strine, *supra* note 59, at 495-96.

168. J. Travis Laster & John Mark Zeberkiewicz, *The Rights and Duties of Blockholder Directors*, 70 BUS. LAW. 33, 49 (2015).

169. *Id.*; *see also In re* Rural/Metro Corp. S'holders Litig., 102 A.3d 205, 253-54, 253 n.28 (Del. Ch. 2014); *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 36-37, 37 n.5 (Del. Ch. 2013).

170. Jack Bodner, Leonard Chazen & Donald Ross, Covington & Burling LLP, *Vice Chancellor Laster and the Long-Term Rule*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Mar. 11, 2015), http://corpgov.law.harvard.edu/2015/03/11/vice-chancellor-laster-and-the-long-term-rule/ [http://perma.cc/5R77-R646].

and its stockholders over time frames longer than the average activist's investment.[171]

DuPont could point to substantial additional support in Delaware case law to argue that its sunlight bylaw was equitable and lawful.

First, the Delaware Supreme Court has recognized that a company may create the freedom to resist short-term pressures and focus on long-term value. In *Williams v. Geier*, the Delaware Supreme Court upheld, under the business judgment rule, a stockholder-approved recapitalization plan granting ten votes per share to stockholders who owned as of the record date and one vote per share to their subsequent transferees until they had held the stock for three years.[172] The Delaware Supreme Court recognized that the board recommended the plan to, among other things, "[m]aintain ability to maximize long-term value," "[p]rotect long-term commitment to continued growth and investment," and "[r]educe [the] level of exposure to raiders seeking to capitalize on corporate vulnerability due to short-term business cycles."[173] Even though the recapitalization would have "the effect of strengthening" a family's long-standing and majority interest in the company, the court found there was no evidence the board was interested, entrenching itself, or controlled by the family, and therefore the board's recommendation passed muster under the business judgment rule.[174]

Second, the Delaware Supreme Court has recognized the need for the board to have an orderly process before a stockholder vote that ensures the quality of director nominees. In *Stroud v. Grace*, the Delaware Supreme Court upheld, under the business judgment rule, stockholder-approved changes to the certificate of incorporation and bylaws regulating the disclosures by and qualifications of nominees for board positions.[175] The bylaw required stockholders proposing a board candidate to include in the notice of nomination submitted no less than fourteen days before the stockholder vote a statement of how the nominee qualified and empowered the board to prevent unqualified

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171. Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del. 1989).
172. Williams v. Geier, 671 A.2d 1368, 1370, 1382-84 (Del. 1996).
173. *Id.* at 1372.
174. *Id.* at 1378-79.
175. Stroud v. Grace, 606 A.2d 75, 94-96 (Del. 1992).

nominees from running.[176] The Delaware Supreme Court held that it did not present such a severe, hypothetical risk of injury to the stockholders' franchise it had to be stricken down.[177] In the bylaw, the incumbent board reserved the discretion to make the subjective judgment about whether certain candidates "had substantial experience in line . . . positions in the management of substantial business enterprises or substantial private institutions."[178] But the *Stroud* court emphasized "our entire legal system makes liberal use of the word 'substantial' and its derivatives as a qualifier in a broad range of rules and statutes."[179]

Third, Delaware courts have recognized the importance of improving board and stockholder decision-making. In *Kidsco Inc. v. Dinsmore*, the company had entered a stock-for-stock merger agreement.[180] Days before the stockholder vote on the merger, a competing bidder disclosed a tender offer and an intent to solicit stockholders to demand a special meeting to replace the current board with members who would dismantle the rights plan.[181] The company negotiated with the original merger partner to increase consideration, but time was short, and the company therefore passed a bylaw amendment enlarging the time in which to respond to any stockholder demand for a proxy vote on replacing the directors by about twenty-five days.[182] The Delaware Chancery Court upheld the bylaw amendment and rejected an entrenchment argument because the bylaw would only leave the board in place for an additional twenty-five days, would enable the board to negotiate the highest and best offer in the stock-for-stock merger and consider alternatives, and would not perpetuate the board members' positions in office for an extended period.[183] The Delaware Supreme Court affirmed in an unpublished opinion.[184]

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176. *Id.* at 80.
177. *Id.* at 94-96.
178. *Id.* at 92-95 (emphasis omitted).
179. *Id.* at 93-94.
180. Kidsco v. Dinsmore, 674 A.2d 483, 486 (Del. Ch. 1995), *aff'd and remanded*, 670 A.2d 1338 (Del. 1995).
181. *Id.* at 487.
182. *Id.* at 488-89.
183. *Id.* at 493, 495-96.
184. Kidsco Inc. v. Dinsmore, 670 A.2d 1338 (Del. 1995).

The sunlight bylaw would promote the goal of providing information to the board and other stockholders so they have the option of considering the impact of the strategic proposal over time, would allow the strategic proposal or nominee to go to a stockholder vote without delay if the activist complied, and would only prevent particular issues or nominees from being considered at the vote if violated. And, although the sunlight bylaw would reference materiality, the word material is as common as the word substantial in our legal system, and the sunlight bylaw contains many other, more objective measures of compliance. Cases striking down bylaws for entrenching incumbents are far afield.[185]

Trian could argue that by deferring their proposals or nominees, the board was effectively denying them, but that would be a mischaracterization. Sunlight bylaws are agnostic to the content of the investor proposal. To obtain a stockholder vote, the investor need only make the required disclosures. If the activist made an otherwise appropriate disclosure slightly late and with a good excuse, the company could approve it and there might be no delay or it might well be as short as the twenty-five days in *Kidsco*. If the board acted with alacrity and sensitivity to its obligations to the stockholders and

185. *See, e.g.*, Black v. Hollinger Int'l Inc., 872 A.2d 559, 561, 563 (Del. 2005) (finding invalid bylaws proposed by the CEO after being confronted with "findings of improper self-dealing and material misrepresentations" in public filings; bylaws would have empowered the CEO to "unilaterally to block any material sale of assets, to prevent the signing of a merger agreement," and to block a shareholder rights plan designed to thwart the CEO's self-dealing transaction); MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1126, 1132 (Del. 2003) (incumbent board member testified and the Chancery Court found that the director defendants "amended the bylaws to provide for a board of seven and appointed two additional members of the Board for the primary purpose of diminishing the influence of" two individuals standing election for positions as directors); Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 438-39 (Del. 1971) (after learning of potential proxy fight, the incumbent board refused to provide dissident stockholders with a list of stockholders and accelerated the date of the annual meeting by a month); Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 658 (Del. Ch. 1988) (finding "the evidence is powerful, indeed compelling, that the board was chiefly motivated" to expand the board by adding friendly directors "to forestall or preclude the possibility that a majority of shareholders might place on the . . . board eight new members sympathetic to" a recapitalization plan that was the subject of "vital policy differences").

to ensure a process that enables orderly consideration of strategic proposals and nominees, it would enhance the other stockholders' rights.

Trian might argue that the remedy is akin to that for violating an advanced notice bylaw and the same constraints should apply. Advance notice bylaws, which are common, usually require prospective nominees for the board and stockholders proposing business or governance changes to submit certain information at least sixty days before the stockholders' meeting and vote.[186] "Advance notice bylaws are often construed and frequently upheld as valid," and "function to permit orderly meetings and election contests and to provide fair warning to the corporation so that it may have sufficient time to respond to shareholder nominations."[187] While they are stricken down when they "unduly restrict the stockholder franchise or are applied inequitably,"[188] sunlight bylaws promote rather than restrict the franchise, and boards can exercise care when determining whether to approve belated disclosures under the sunlight bylaw and to permit the issue to go to a stockholder's vote.

The activists might calculate that if they published sunlight bylaw disclosures months or years into their campaign but shortly before the stockholder vote, then the board would be compelled to put their proposal or nominees on the ballot. Such belated disclosure, however, would defeat the point of the sunlight bylaw. The Delaware Chancery Court found that a board properly refused to waive the requirements of an advance notice bylaw where it found "it would be unfair to the remaining stockholders" and "if it did issue a waiver, the bylaws would lack meaning."[189] Waiving belated compliance with a sunlight bylaw could also be unfair to other stockholders who assumed compliance was required and could defeat the purpose of requiring disclosures sufficiently in advance of the vote for other

186. R. Franklink Balotti & Jesse A. Finkelstein, DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 7.9 (3d ed. 2016 Supp.).

187. Openwave Sys. Inc. v. Harbinger Capital Partners Master Fund I, Ltd., 924 A.2d 228, 238-39 (Del. Ch. 2007); *see also* AB Value Partners, LP v. Kreisler Mfg. Corp., No. 10434-VCP, 2014 WL 7150465, at * 3 (Del. Ch. Dec. 16, 2014).

188. *Openwave Sys.*, 924 A.2d at 239.

189. *Id.* at 242.

stockholders to consider the information, but the board's decision should and would hinge on actual facts in a specific case.

5. A Rights Plan

The DuPont board might still need to enact a rights plan, although Trian's campaign does not appear to have been based on the sort of vote-buying found in *Sotheby's*. The pace of the campaign and the increase in ownership by a lead activist and its allies might force the company to do so. And, of course, the rights plan could use Schedule 13D filings and any information from sunlight bylaw disclosures to determine the thresholds.

But in such a case, any analysis of the validity of the sunlight bylaw and the rights plan should distinguish between the two instruments. The sunlight bylaw encourages disclosure and a better process for board and stockholder decision-making. It is not a defensive or protective device and should not be confused with one, even though it can provide information to the company before it adopts a rights plan and inform how it tailors the rights plan. Depending on the pace of the activist share purchases, their ownership levels, and the content of their strategic proposal, a rights plan with thresholds sensitive to sunlight bylaw disclosures may be necessary and equitable.

And any additional disclosure combined with a more tailored rights plan would allow the Delaware courts to draw finer distinctions and plumb more deeply into what happened in the activist campaign in any litigation. Lawyers draft initial discovery requests based on publicly-available information and information from their clients. Expedited discovery and trials are common in Delaware. Absent any reporting under a sunlight bylaw, the identities of at least some wolf pack members lurking below Section 13(d)'s reporting thresholds will probably remain unknown at least until the depositions of those working for the lead activist, after completing the bulk of document discovery, and too late to depose any employees or representatives of those members. Time will likely not permit connecting all the dots. The financial interests and incentives of the entire wolf pack may never be uncovered in discovery or presented to any court. Asymmetrical public disclosure thus has a path-dependent effect on the scope of litigation discovery and the record before the court.

In the long run, if compliance with sunlight bylaws became routine, developing this information in the public sphere would then lead to more complete records for deciding expedited cases in Delaware.

VI. RECIPROCAL DISCLOSURES AS A FIRST STEP

"The [nuclear] bomb may have ended [World War II] but radar won it."[190] So said many radar researchers and workers in August 1945, when the news of the atomic bomb upstaged a planned Time magazine cover story about the MIT Radiation Laboratory's part in the war effort.[191] That concept is not lost on activist hedge funds, which have used the information public companies are rightly required to disclose as a weapon while operating in the shadows, without disclosure. The activist hedge funds would likely not give up that advantage readily, and they could create two principal risks for boards that implement sunlight bylaws—litigation risks and the risk of a proxy fight.

Although, as explained, sunlight bylaws should pass muster under Delaware law, they would likely precipitate litigation. In a recent decision, the Delaware Chancery Court refused to dismiss a claim under *Unocal* for the passage of bylaws that required the disclosure of options and short interests by shareholders requesting special meetings, submitting nominations, or submitting strategic proposals and vesting substantial authority in the chair at the meeting.[192] The court reasoned that "the reasonableness of a defensive response whose munitions include the ability to foreclose the use of special meetings to hold elections requires an explanation not evident on the face of these pleadings."[193] The validity of sunlight bylaws as-applied would therefore likely turn on specific facts in the context of an as-applied challenge, and passing them would create litigation risk.

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190. LOUIS BROWN, A RADAR HISTORY OF WORLD WAR II: TECHNICAL AND MILITARY IMPERATIVES, at x (1999).

191. *Id.*

192. *In re* Ebix, Inc. Stockholder Litig., No. 8526–VCN, 2016 WL 208402, at *7, *20 (Del. Ch. Jan. 15, 2016).

193. *Id.* at *20.

Sunlight bylaws might also precipitate a proxy fight and alienate important institutional stockholders. Professor Allaire and Dauphin found that the most popular hedge fund tactic was to publicly criticize companies, which is successful 59% of the time, and that although activist hedge funds more rarely threaten or launch proxy contests, doing so leads to success over 80% of the time.[194] In part, that is because 76% of institutional investors have favorable views of shareholder activism, and 84% believe it adds value.[195]

Certain institutional investors also opposed Wachtell Lipton's proposal to expand reporting requirements under Section 13(d), citing a fear that accelerated, public reporting requirements would deter beneficial activism.[196] ISS—one of the two principal proxy advisory firms—has also opposed advanced notice bylaws that would require enhanced disclosures surrounding director nominees' outside sources of compensation for service as a director.[197]

Support for activist hedge funds means that that—rightly or wrongly—any board that passed a sunlight bylaw might well face a revolt at the next proxy vote. Consider then reciprocal disclosures as an alternative, which should be more palatable to institutional investors wary about deterring beneficial activism.

Boards, institutional investors, and proxy advisory firms should request that activist hedge funds making strategic proposals also disclose the information required to be disclosed under sunlight bylaws voluntarily. Much like Schedule 13F disclosures, public companies could entertain requests for time-limited confidential

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194. ALLAIRE & DAUPHIN, *supra* note 68, at 8.

195. Yvan Allaire, The Case For and Against Activist Hedge Funds 5 (May 28, 2015) (unpublished manuscript), http://ssrn.com/abstract=2613154 [http://perma.cc/6BTK-5GWL].

196. Letter from Andrew N. Vollmer, Wilmer Cutler Pickering Hale & Dorr LLP, on behalf of certain members of the Managed Funds Ass'n, to Elizabeth M. Murphy, Sec'y, SEC (Aug. 5, 2011), http://www.sec.gov/comments/4-624/4624-5.pdf [http://perma.cc/B89E-MRVT].

197. JASON D. SCHLOETZER, THE CONFERENCE BD., DIRECTOR NOTES: ACTIVIST HEDGE FUNDS, "GOLDEN LEASH" SPECIAL COMPENSATION ARRANGEMENTS, AND ADVANCE NOTICE BYLAWS 10 (2015), http://www.conference-board.org/retrievefile.cfm?filename=TCB-DNV7N5-Activist-Hedge-Funds1.pdf&type=subsite [http://perma.cc/TWF4-ULME].

treatment or any other lawful form of confidential treatment. Simply delaying the disclosure until some twenty days after the activist hedge fund publicly announces its strategic proposal would allow it to reap the benefits of the short-term abnormal returns that some theorize as necessary to incentivize beneficial activism.

The reciprocal disclosures would focus on issues of acute interest to institutional stockholders. Institutional investors have recently signaled that they—unsurprisingly—wish to make the best decision on the merits to promote long-term value. In 2015, Blackrock's CEO Laurence Fink wrote about "the importance of taking a long-term approach to creating value" while emphasizing that "some activist investors take a long-term view and have pushed companies and their boards to make productive changes."[198] Vanguard's CEO wrote that, as the holder of about 5% of every publicly-traded stock in the United States, Vanguard believes that boards have an obligation to engage with and listen to activist hedge funds but "it doesn't mean that the board should capitulate to things that aren't in the company's long-term interest." He also wrote that Vanguard is focused on "[s]hareholder voting rights that are consistent with economic interests" and "[s]ensible compensation tied to performance."[199] Queries to activist hedge funds about their investment horizons, portfolio turnover, the percentage of their assets the investment represents, communications with their supporters, the correlation between their economic interests and voting rights, and fund manager's compensation go to the heart of these issues. As explained, recent empirical evidence suggests that activist hedge funds that acquire a higher stake generate higher returns, presumably because the market cares about their incentives, or better incentives lead to better strategic proposals. All of the other facts bearing on their incentives identified in the proposed sunlight bylaws should also influence votes.

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198. Letter from Laurence D. Fink, *supra* note 44, at 1.

199. F. William McNabb III, Chairman and CEO, Vanguard, *Getting to Know You: The Case for Significant Shareholder Engagement*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (June 24, 2015), http://corpgov.law.harvard.edu/2015/06/24/getting-to-know-you-the-case-for-significant-shareholder-engagement/ [http://perma.cc/3MN3-QPWA].

And a recent survey of institutional investors showed that 29% have holding periods of six months to two years while 71% have holding periods of over two years.[200] 88% of these institutional investors also perceive excessive executive compensation or inadequate corporate governance as somewhat to very important triggers for hedge fund activism, although, as explained, interventions to address those issues are seldom followed by significant improvements in operating performance or share price.[201] Again, requiring activists to disclose information bearing on their incentives and investment horizons speaks directly to the issues on which the institutional investors are focused and the areas in which their interests and the activists' may diverge.

Reciprocal disclosures could be negotiated in a way that would pose no risk of reducing beneficial activism. When the activist first makes a strategic proposal to the company—particularly if it owns very little stock—the board could agree to treat any reciprocal disclosure confidentially for a period of time and the activist could then reap the full benefit of the short-term increase in share price in the forty days surrounding the filing of its Schedule 13D. Institutional investors, if not already requiring the disclosure of this information from activist hedge funds, should also do so.

Public companies should carefully reserve the right to publish any questions that the activist hedge fund refuses to answer, any questions that it will answer but not permit disclosure of its answer, or its refusal to update answers as the campaign unfolds. If the activist hedge fund refuses to disclose this information or refuses to permit its public disclosure sufficiently before a stockholder vote, it provides a good indication it is unwilling to operate in the sun. That refusal, which the board could and should publicize if a proxy fight occurs, would speak volumes.

According to political myth, when President Lyndon B. Johnson was running a tough campaign against a well-respected opponent for

200. Joseph A. McCahery, Zacharias Sautner & Laura T. Starks, *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, J. FINANCE (forthcoming) (manuscript at 6), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1571046 [http://perma.cc/TF23-XEH4].

201. *Id.* at 20.

office in Texas, he instructed his campaign to spread the rumor that his opponent had sex with pigs. When one of his advisors complained that the story was false and no one would believe it, President Johnson said "I know, but let's make [him] deny it."[202] Activist hedge fund campaigns are no less hard fought than political elections, and hedge funds often use harsh rhetoric to negatively characterize the voluminous information contained in public companies' disclosures; it is a difficult task indeed for the public company to respond in a way that does not sound defensive; and any response by the public company only provides half of the necessary information. Information from the public company alone can seldom—if ever—answer whether the activist hedge fund manager is a better agent for long-term stockholders.

Public companies must at least ask the questions that would expose any inconsistencies, obscured by current disclosure laws, between what an activist hedge fund does and what it says. For example, activist hedge funds routinely grand-stand about excessive executive compensation at public companies, but, according to news reports, appear to award their managers extremely lucrative compensation packages despite, at best, modest returns. At the very least, in response to a request for reciprocal disclosure, the activists should be forced to assert that their own compensation schemes are the finance equivalent of the secret formula for Coca-Cola and cannot be disclosed. If they do so, it will be more difficult for them to reasonably dismiss the argument that public companies need pay their executives well to attract and retain them.

Reciprocal disclosures could also lay the groundwork for sunlight bylaws. The information disclosed by activist hedge funds under them could serve useful to academics, although keep in mind that activist hedge funds will likely avoid disclosing the most damaging information, so some limits to current disclosures will persist. Reciprocal disclosures will also allow public companies, their lawyers, and their investment bankers to develop a body of experience with crafting such requests before enshrining reporting

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202. HUNTER S. THOMPSON, FEAR AND LOATHING ON THE CAMPAIGN TRAIL IN '72 (1973).

requirements in bylaws that are more difficult to pass, amend, and repeal.

CONCLUSION

Each activist hedge fund, each campaign, each strategic proposal, and each company is complex and unique. But the limits of current disclosure laws mean that, although much is publicly disclosed about the company, little is disclosed about the hedge funds. Those limits prevent boards from evaluating activists' proposals and incentives on a case-by-case basis with the required speed. Wearing blinders, the board is thus forced to choose among fighting, capitulating, or something in between. Making such decisions on materially incomplete information advances no one's interests but those of the activists. If boards or stockholders decide to pass sunlight bylaws or request reciprocal disclosures so that those who seek to wield power have a fraction of the disclosure obligations imposed on those with responsibility, then those judgments should be respected.