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WHEN PASSIVE HEDGE FUNDS DECIDE TO BECOME ACTIVIST

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

By Frank Zarb *

Passive hedge funds increasingly are taking on activist roles at one or more portfolio companies. While this is an expected part of a broader trend toward increasing shareholder activism, such funds are not typically interested in becoming activist funds generally, but rather in using all the tools available to rectify perceived deficiencies at an under-performing portfolio company. Hedge funds are the most active proxy contest dissidents, representing more than half of campaigns brought against Russell 3000 companies in 2018.¹ Many, if not most, of these insurgent hedge funds are “activist” funds, although passive hedge funds have increasingly considered activist roles with respect to specific portfolio companies.²

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

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

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

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

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

* FRANK ZARB is a partner at Proskauer Rose LLP. His e-mail address is fzarb@proskauer.com.