Keeping up with Changes in Share Ownership in Light of COVID-19

Over the past several weeks, we've witnessed the most sudden and significant downturn in the history of the U.S. capital markets. The COVID-19 crisis has affected almost every corner of the worldwide economy. Those companies that are not battling for survival are striving to adapt to the new market reality that was almost entirely unexpected just a few months ago. In this environment, we are seeing dramatic volatility coupled with significant price declines,[1] both set against a backdrop in which shareholder activism is a constant threat to public companies. This is in contrast to the previous financial crisis in 2008, which occurred prior to the emergence of activism as we know it today.

During this time of uncertainty, we believe that it is more important than ever for investor relations professionals and issuers in general to be mindful of changes in their ownership base. In early March, as companies were first coming to grips with COVID-19, CEO and Chief Investment Officer of activist firm Starboard Value, Jeff Smith, appeared on Bloomberg TV, proclaiming that "volatility in the marketplace is a good opportunity for [Starboard]." Likewise, activists like Engaged Capital and Land & Buildings are raising new capital, while Pershing Square's Bill Ackman exited the firm's hedges, generating proceeds of $2.6 billion, hoping to take advantage of the opportunity presented by recent market dislocations.

Apart from activist hedge funds, issuers should also be wary of new opportunistic interest from strategic and financial acquirers. And of course, with the recent wave of volume comes an influx of new shareholders, as well as the potential departure of former "anchor" investors, either of which can create unanticipated challenges for companies seeking shareholder approval for important items like equity plan proposals, stock authorizations, or Say-on-Pay at their upcoming annual meetings.

That said, despite the recent uptick in volatility, issuers should bear in mind that not all of that volatility will result in true changes in stock ownership. For one thing, volume in the U.S. equity market is dominated by algorithmic trading. The true amount of algorithmic trading varies from day-to-day depending on overall volatility and other factors, but we generally estimate that only 20-30% of a stock's reported daily volume results in true ownership changes, as opposed to "churn" generated primarily by high-frequency trading. As a result, for a company that sees 10 million shares trade on a daily basis, only about 2.5 million of those might be changing hands between fundamental discretionary traders. On days of increased volatility, where trading is driven not by earnings or other company fundamentals but general market sentiment, that number could decrease even further as the market "noise" driven by algorithmic traders overwhelms true ownership changes. An experienced stock surveillance firm should understand which custodians cater to high-frequency traders, which custodians cater to institutional buyers, and which cater to retail investors, allowing issuers to make sense of the noise. For example, one recent macro trend we have observed involves long-only institutions selling large amounts of equity to retail brokers and hedge funds.

Another one of the market phenomena that IR professionals should be aware of during the current market sell-down is dollar-cost averaging. Dollar-cost averaging involves spreading stock purchases over a period of time as a way of smoothing out volatility in terms of the

[1] Nine of the ten largest point changes in the history of the Dow Jones Industrial Average occurred in March 2020. At the time of writing, the Dow had fallen approximately 30% from its record high of 29,551.42 set on February 12, 2020.

purchase price. Many IR professionals are familiar with the concept in the context of shareholder activism; look at any activist 13D filing and you're likely to see a series of modest accumulations, at various price points, over the course of weeks or even months. But the concept also applies in bear markets as well. In these environments, opportunistic activists may look to "buy the dip," taking advantage of a temporary dislocation in the share price to lower their average cost basis as the price falls, thus positioning themselves for a windfall when the stock recovers.

To protect themselves against this kind of opportunistic buying, many companies are reconsidering the use of poison pills. In the early 2000s, poison pills were common, even in the absence of any clear threat. Over the past 20 years however, a gradual weakening of corporate takeover defenses prompted by increased pressure from shareholder rights advocates has led to a sharp decline in the use of poison pills, to the extent that they are now relatively rare. The perspectives of investors and the proxy advisory firms have evolved to a point where poison pills are viewed fairly unfavorably, even when they comply with generally accepted "best practices." However, in our recent conversations with them, investors and proxy advisory firms have indicated that they understand that they will likely see many more poison pill proposals than they otherwise would, given the recent drop in share price value. And while they are making every effort to be flexible and reasonable given the unique circumstances surrounding the current situation, both have suggested that issuers should clearly and extensively disclose their rationale for adopting the pill in the first place. Issuers should make it as easy as possible for investors to understand the background of the situation and any unique factors, particularly as they apply to the key features of any poison pill, the triggering threshold, term, and qualifying offer exceptions. For companies that are unable to put the pill to a shareholder vote immediately due to timing issues with this year's annual meeting, they should consider disclosing an intention to do so as soon as practicable.

On the other hand, some activists may shy away from accumulating stakes via the equity markets during these times of elevated volatility and may instead focus their attention on derivatives, which can enable them to accumulate a significant economic interest in a company while also protecting them against losses. By using derivatives, activists commit less capital than would be required by an ordinary common stock investment. It's important to note that an activist would need to exercise their derivative exposure prior to the record date in order to vote those shares at an annual or special meeting, but many well-known activists like Carl Icahn and Starboard Value have demonstrated an appetite for doing so. An increased use of derivatives, however, may present unique challenges for IR teams, as quarterly 13F filings typically do not disclose derivative positions. Without a stock surveillance firm, a company may have limited advance warning of an activist accumulating a significant economic interest through derivatives.

Another issue facing companies in 2020 is the fact that 13F filings may be substantially delayed. On March 4, 2020, the SEC issued an order providing companies and other entities subject to SEC reporting obligations with an additional 45 days to file reports that would otherwise have been due between March 1 and April 30, 2020. On March 25, the SEC updated that exemptive order to cover filings due on or before July 1, 2020. There are two things worth noting with respect to this order. First, it does not apply to entities required to file 13Ds or 13D amendments, so activists that cross the 5% stock ownership threshold must still disclose their holdings on a timely basis; either two or ten business days after crossing specific thresholds. Second, and perhaps more importantly, this order *does* apply to 13F filings for the calendar quarter ending on March 31, which would otherwise have been due on May 15.

Issuers will undoubtedly be challenged by the fact that they will now have even less visibility into their shareholder base than usual and will have to rely more heavily on the analysis surveillance firms provide. A 13F filing delay introduces further uncertainty into share ownership positions, particularly given the substantial volatility during the intervening period. For many issuers, the delay comes at a particularly inopportune time. As the majority of companies are preparing for their annual meetings, any delayed reporting of ownership positions makes scenario planning and vote projections particularly difficult. To mitigate this risk, companies should consider engaging a proxy solicitation firm, which would be able to use the analysis provided by their surveillance teams and overlay it with additional company-specific shareholder lists (registered lists, NOBO lists, respondent bank lists, and DTC participant lists) to address the discrepancy that inevitably exists between the latest public filings and the record date for the annual meeting, providing a more accurate view of the shareholder base. Likewise, the investor relations function will be critical, as it can provide up-to-the-minute intelligence on interactions with shareholders, which could yield valuable insight into how their shareholder base has been changing and how each shareholder views the proposals at hand.

For companies dealing with depressed stock prices, engaging a stock surveillance firm should be a near-term priority for the IR team. While it is certainly possible for skilled professionals to determine, at least within a reasonable margin, the size of an activist's position *after* the fund makes itself known—perhaps via a call into the company's IR team seeking to schedule an informational call, or by attending the company's latest quarterly earnings call—it is beneficial to monitor the stock on an ongoing basis for accumulation anomalies that can be precursors to activists making their campaigns public. Additionally, by using a surveillance provider to notify them of potential activist accumulations before they are made public, IR professionals will be able to better formulate a thoughtful, proactive internal response plan.

Ultimately, when it comes to shareholder activism, volatility creates opportunity. Up until earlier this year, we had been operating under a fairly benign environment, relatively speaking: an unprecedented bull market, with fairly modest volatility. Despite this, the past several years have seen a significant increase in shareholder activism. As the markets stabilize and activists once again develop an appetite for risk, there will be no shortage of opportunities—fundamentally sound businesses available at steep discounts to intrinsic value, or obvious laggards whose recovery has trailed that of their industry peers. We would encourage all issuers to remain vigilant during and after the current crisis. While it may seem that COVID-19 has brought a welcome respite from proxy contests, we believe that the combination of reduced stock prices, market volatility, and general uncertainty could create an opportunity for historic volume of activism activity once the crisis has dissipated. When that occurs, the importance of strong investor relations teams and stock surveillance will once again be drawn into sharp focus.