THE CONFERENCE BOARD

Hedge Fund Activism

Confronting the Newest Force in Corporate Governance

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Agenda

- The Conference Board Research Working Group
- The Facts About Hedge Fund Activism
- Monitoring Securities Holdings
- Responding to Requests for Change
- Ensuring Voting Integrity
- Overseeing Hedge Fund Management

The Conference Board Research Working Group

Research Working Group Members

- Alcoa, Inc.
- The Altman Group
- American Express Company
- Apco Worldwide
- Applebee's International, Inc.
- Barclays Global Investors
- Bulldog Investors
- The Coca-Cola Company
- The Conference Board, Inc.
- Dade Behring Holdings, Inc.
- DLA Piper
- Florida State Board of Administration
- Freddie Mac
- Global Advisors, Inc.
- Icahn Associates Corporation
- Infovest21
- RiskMetrics Group, Inc. (formerly ISS)
- Jones Day
- Managed Fund Association
- McGuire Woods, LLP
- Moody's Investors Service
- National Investor Relations Institute
- OneCapital Management Partners, LLC
- Pfizer, Inc.
- Sinclair Capital
- Spencer Stuart
- Standard & Poor's
- TIAA-CREF
- Weil Gotshal & Manges

The Report

www.conference-board.org/hedgefundactivism

Four Sections of Findings/Recommendations:

I. Monitoring Securities Holdings

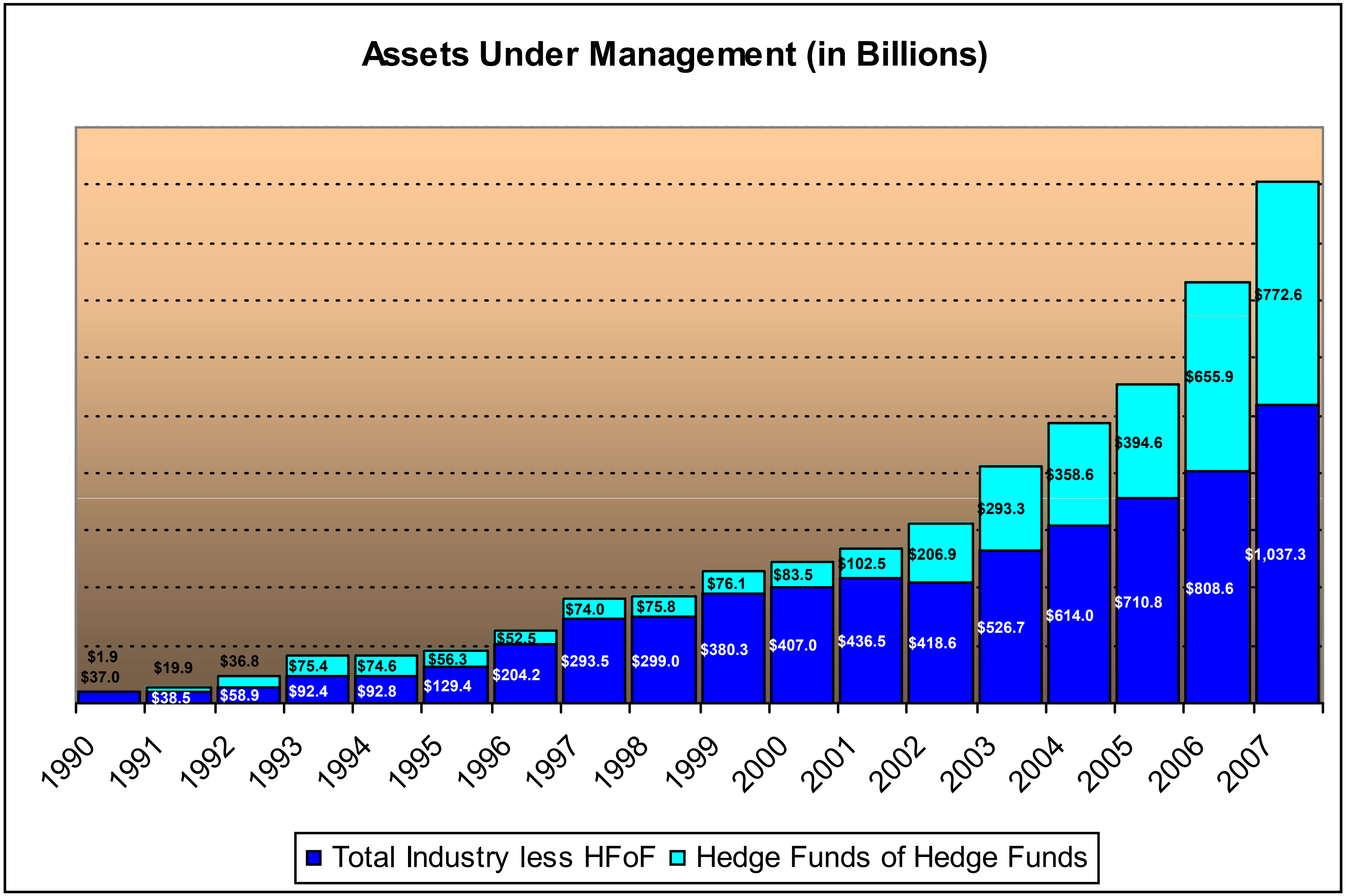
II. Responding to Requests for Change

III. Ensuring Voting Integrity

IV. Overseeing Hedge Fund Management

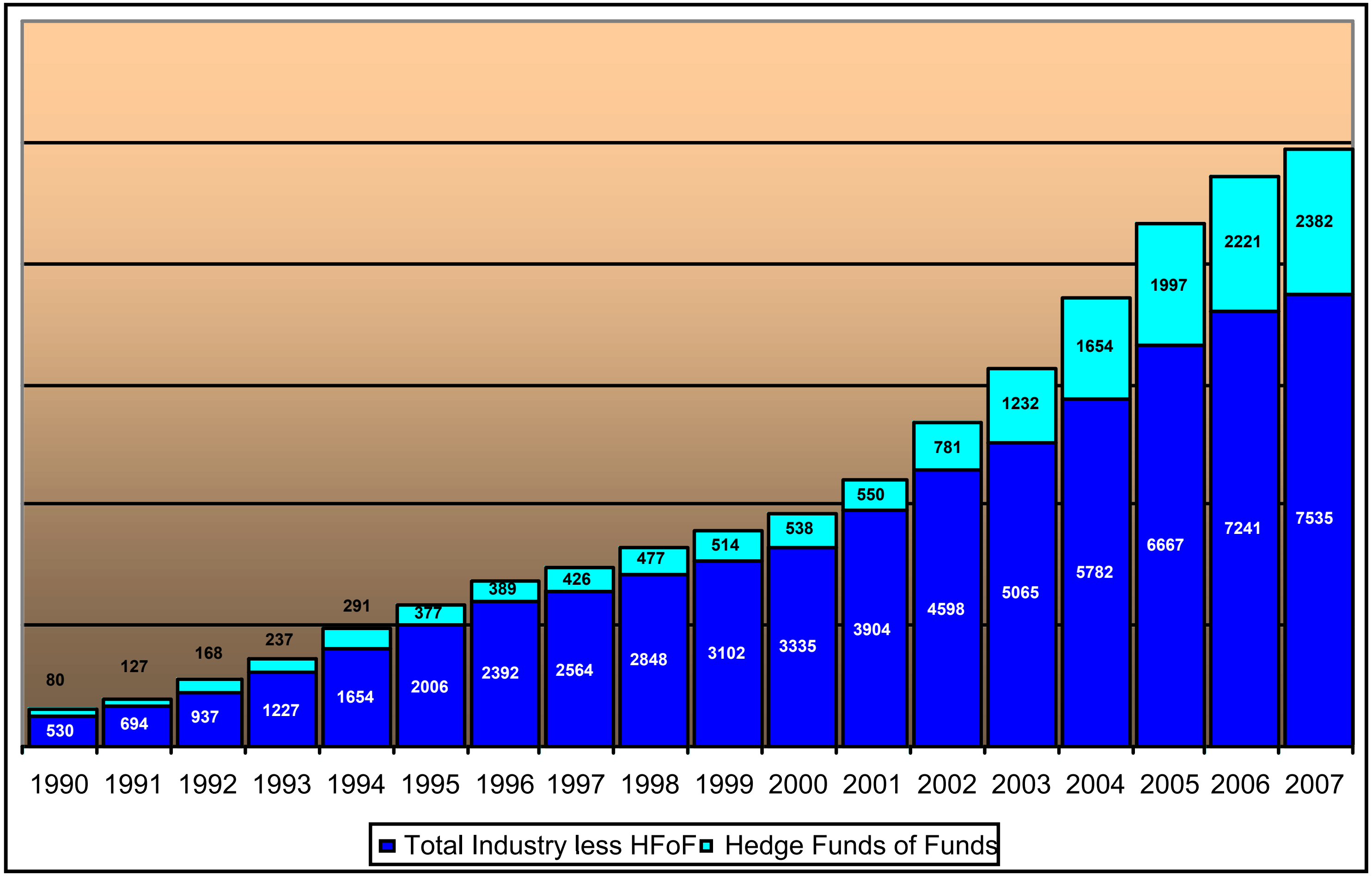
The Facts About Hedge Fund Activism

The Hedge Fund Industry: Assets



Source: *2007 Databook*, Pensions & Investments, 2007

The Hedge Fund Industry: Number

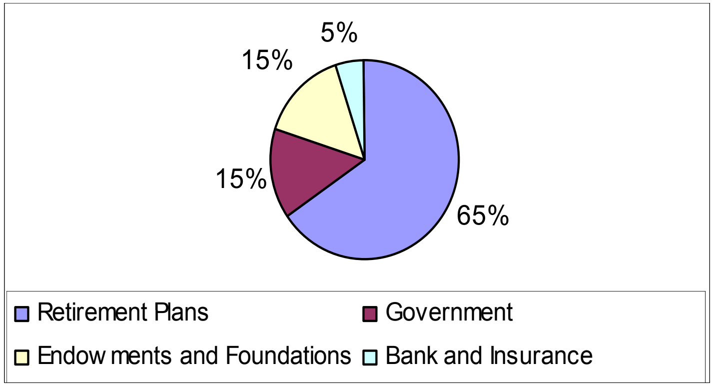


Source: *2007 Databook*, Pensions & Investments, 2007

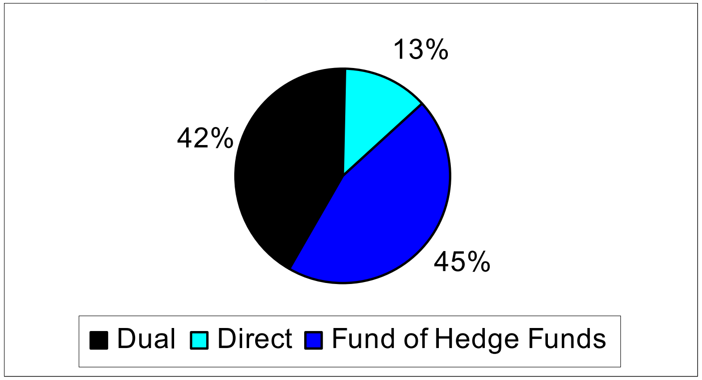
The Hedge Fund Industry: Constituents

- Wealthy Individuals
- Smaller Retail Investors
- Large Institutions (Pension Funds; Endowments; Foundations)

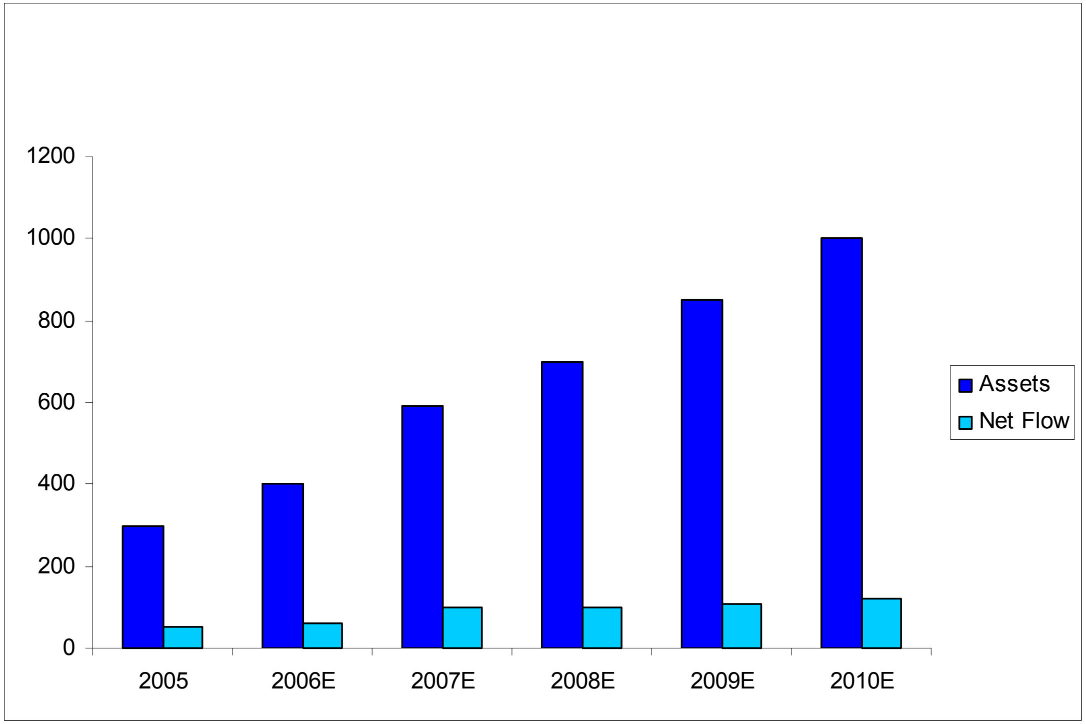
Projected Net Flow by Type (2006-10)



Current HF Investing Models



Projected New Flow from Institutions (2006-10)



Source: The Bank of New York/Casey Quirck & Associates, 2006

The Hedge Fund Industry: Investment Strategies

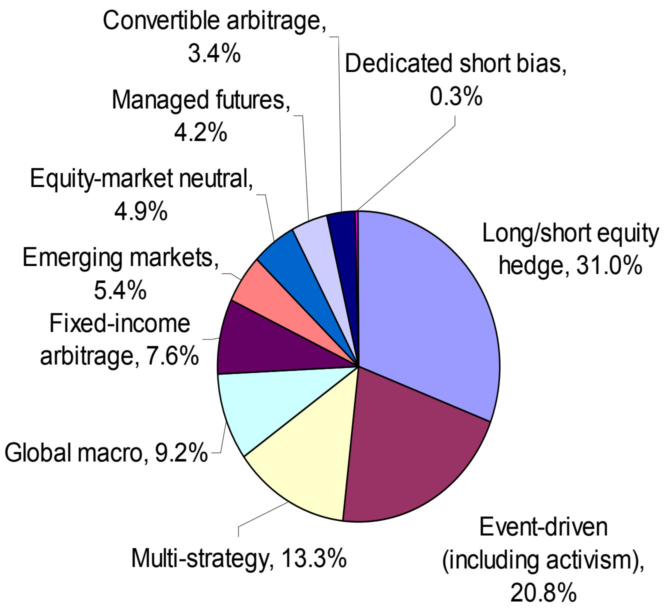
Activist Hedge Funds

- Cumulative capital (worldwide): about $100 billion
- As of September 2007, approximately 150 out of 10,000 hedge funds worldwide (not including occasional activists)
- Since 2001, steady increase of activist hedge funds and activism campaigns mounted by HFs:

2001: 39 funds 97 events

2007: 126 funds 252 events

2008: 72 shareholder resolutions filed (first 6 weeks)



Source: Tremont Asset Flows Report, 2006; Brav et al., 2007-8

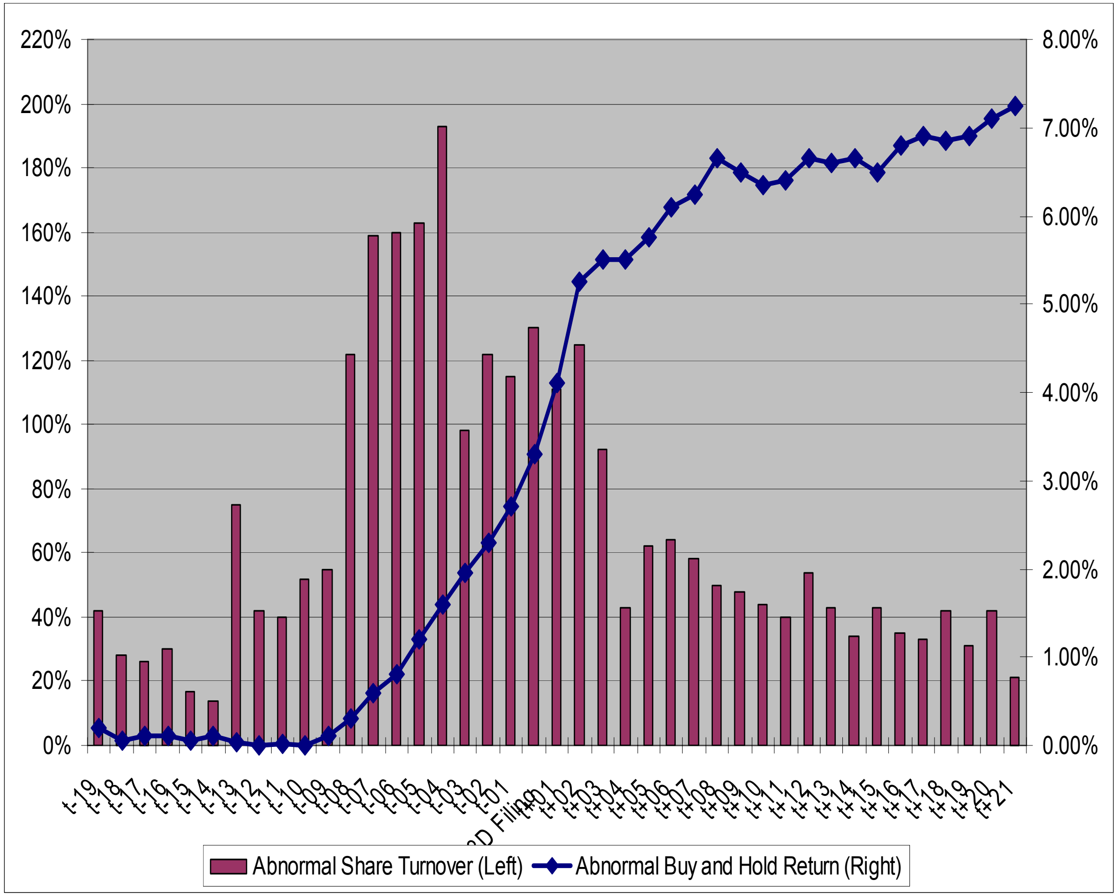
The Driving Factors of HF Activism

1. Fewer regulatory restraints
2. Contract as primary source of regulation of HF investor rights
3. Compensation structure and performance incentives
4. Absolute return metrics and no peer-benchmarking
5. Ability to reconsider and change investment tactics
6. Pressure from intensifying competition
7. Recent credit crunch
8. Reduction of free-rider barriers

Market Return and Firm Performance

Stock Market Analysis of Pre- and Post-Activism Event Periods:

- **Average excess stock return**
  - Average 5-7% increase (20-day window)
  - As high as 17% increase when objective is financial or strategic
  - Higher (+5.14%) increase when tactics are hostile
- **Trading volume**
  - Peaks in 10-day window prior to event
  - Mimicking phenomenon
- **Firm profitability/Performance indicators**
  - No immediate increase
  - EPS may decline
  - R&D investment or capital expenditures unvaried
  - Dividend per share x2 in 1-year window following the event



Sources: Brav et al., 2007-8; Klein and Zur, 2006

Monitoring Securities Holdings

Gathering ownership intelligence is more art than science…

- In today's financial markets, transactions are executed with the click of a mouse and ownership positions constantly change

- Investors have various disclosure obligations re: their holdings. However, the regulatory system:
  - is fragmented (new requirements were added over the years in response to contingent needs to adapt the 1940s system of disclosure to today's markets)
  - was not designed for the complex derivative instruments used by many hedge funds as part of their investment strategies

- Tools available to companies:
  - Public filings
  - NOBO lists
  - Securities surveillance services and Wall Street perception audits

Public Filings

Public filings alone may be insufficient to draw an accurate picture of a company's ownership. Examples:

- SEC Section 13(f) ownership forms

  - only periodic; outdated by the time they're filed
  - not due by investors with less than $100 million in assets
  - only equity securities are disclosed (no debt; no options; no equity swaps)

- Confidential Treatment exemption (U.S. Freedom of Information Act)

  - can be claimed when there is "likelihood of substantial harm to investors' competitive position by the public disclosure of its securities portfolio"

- Schedule 13D (beneficial ownership disclosure)

  - designed to inform companies of possible tender offers/hostile takeovers (5% ownership of class of equity securities)
  - does not tell of activist hedge funds whose positions are well below 5% threshold but rely on wolf pack tactics or the impromptu support from fellow investors

NOBO Lists

Shareholder lists that can be requested by banks/brokers ("record owners") for communication purposes (SEC Rules)

- available for a fee
- can also be purchased from ADP/Broadridge

Also helpful, but incomplete:

- lists only include "non-objecting beneficial owners" (NOBOs)

- most shareholders (statistically, 75% or more) object to the disclosure of their identity and can only be contacted directly by banks/brokers or their agents

Securities Surveillance Services

Offered by a number of investor relation consulting firms

They track trade settlements and info on trading order origination obtained from custodians

Can help integrate/corroborate information gathered through public filings searches and NOBO lists, especially if:

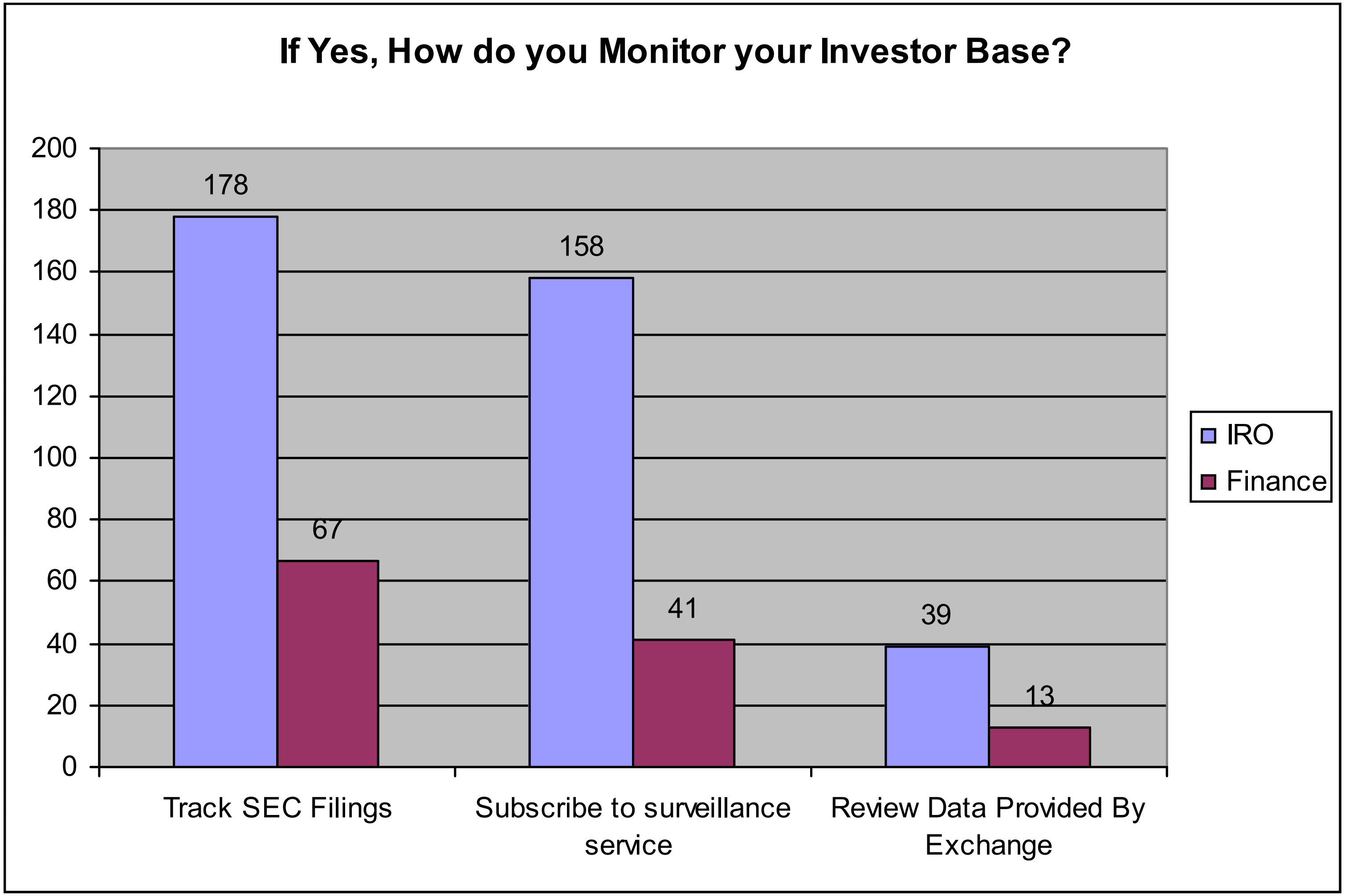
- the company is aware of financial or governance-related shortcomings which might single it out as a target
- the company has noticed abnormal trading activities (e.g. unusual volumes; excessive volatility; sudden rise of short interests)

Possible issues:

- **Accuracy**. Surveillance reports contain a combination of quantitative data (derived from custodian banks) and qualitative analysis. Methodology and quality should be probed.

- **Legitimacy**. Prior incidents of providers using improper means to gather information (e.g. 2005 SEC investigation of allegations that a provider had offered gratuities to custodian banks' employees for leaking confidential information). Reputation should be verified.

Intelligence Gathering Tools - Summary



Source: CFO Magazine/NIRI Survey, 2007

The Working Group Recommendations to Corporations

I. Remain informed on holdings and trading activities

- Look for large accumulations
- Look for extraordinary trading patterns
- Look for group voting arrangements and signs of possible informal understandings among investors
- Use securities surveillance and other intelligence gathering services
  - Be mindful of legitimacy and accuracy issues
- Talk to large institutional investors to gather additional information

The Working Group Recommendations to Corporations

II. Understand hedge fund investment strategies and activism tactics

- Maintain up-to-date investor profiles
  - managers' background
  - prior investment history
  - sources of capital
  - investment time horizons
- Learn about activists' tactics
  - shareholder resolutions and proxy fights
  - shareholder suits
  - empty-voting techniques
  - wolf packs and group arrangements
- Learn how mainstream investors vote on certain issues
  (to anticipate possible alliances)

Responding to Requests for Change

Profile of a Target

Recent cases of HF activism help design a profile of the company that is more likely to become a target

Brav et al., 2007/8—based on a manually compiled database of hundreds of activism events since 2001 (Schedule 13Ds and other public sources)

Major finding: unlike more conventional activist investors, activist hedge funds do not choose underperforming companies. Instead, they are value investors who tend to choose firms that:

- are profitable
- have sound operating cash flows
- and yet are undervalued

Profile of a Target (Cont.d)

Key Attributes of a Target (one or more of the following):

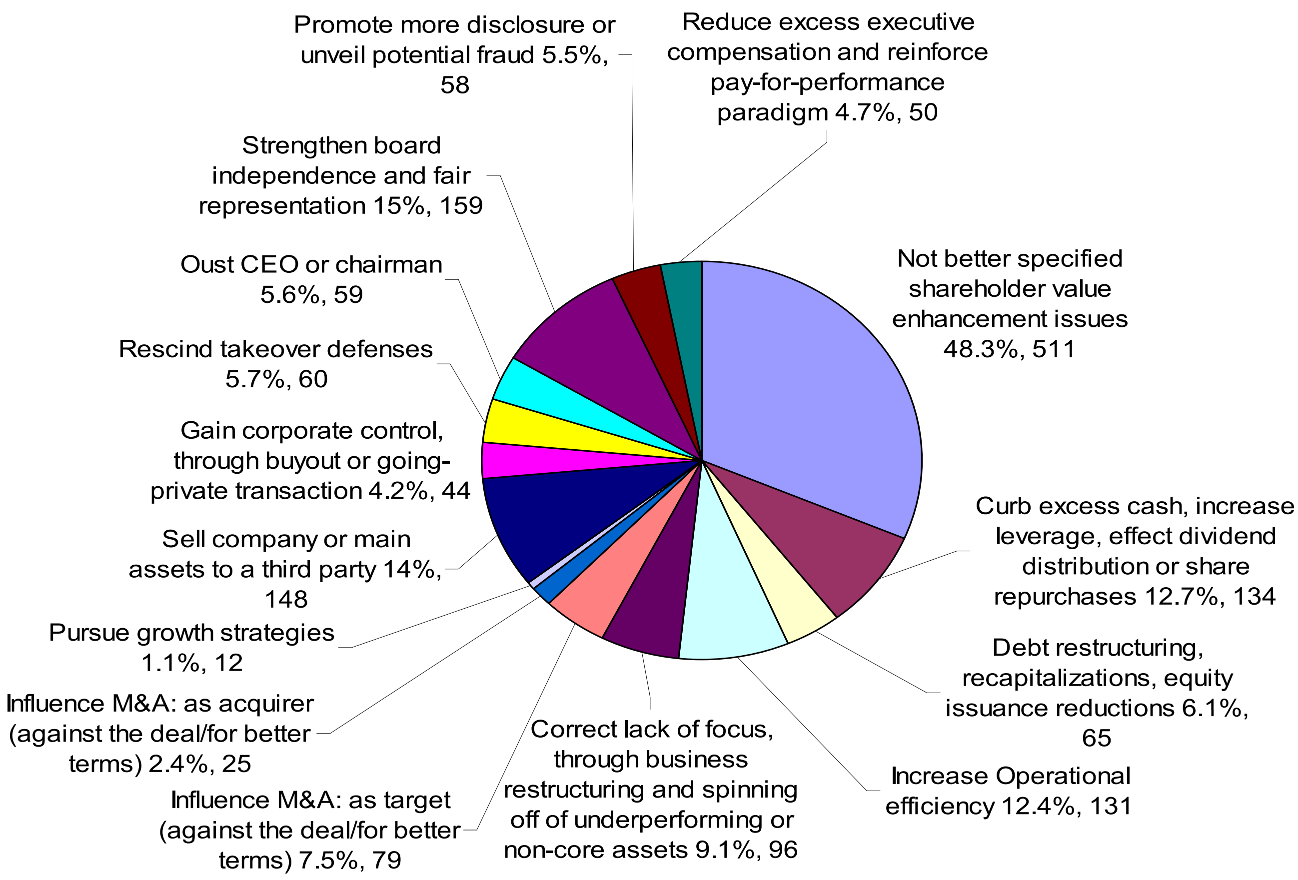
- Low capitalization
- High trading liquidity
- Undervaluation
- Good operational performance
- Cash availability
- Debt capacity
- Asset diversification
- Low R&D expenditures
- Excess takeover defenses and control enhancement devices
- Extensive institutional ownership
- Poor disclosure and governance practices

Demands

Activist hedge funds may try to:

- Influence financial/capital structure decisions
- Influence strategic decisions
- Effect corporate governance or risk management changes
- Simply engage in regular discussions with senior managers or board members
  to identify new avenues of shareholder value enhancement

Demand Types

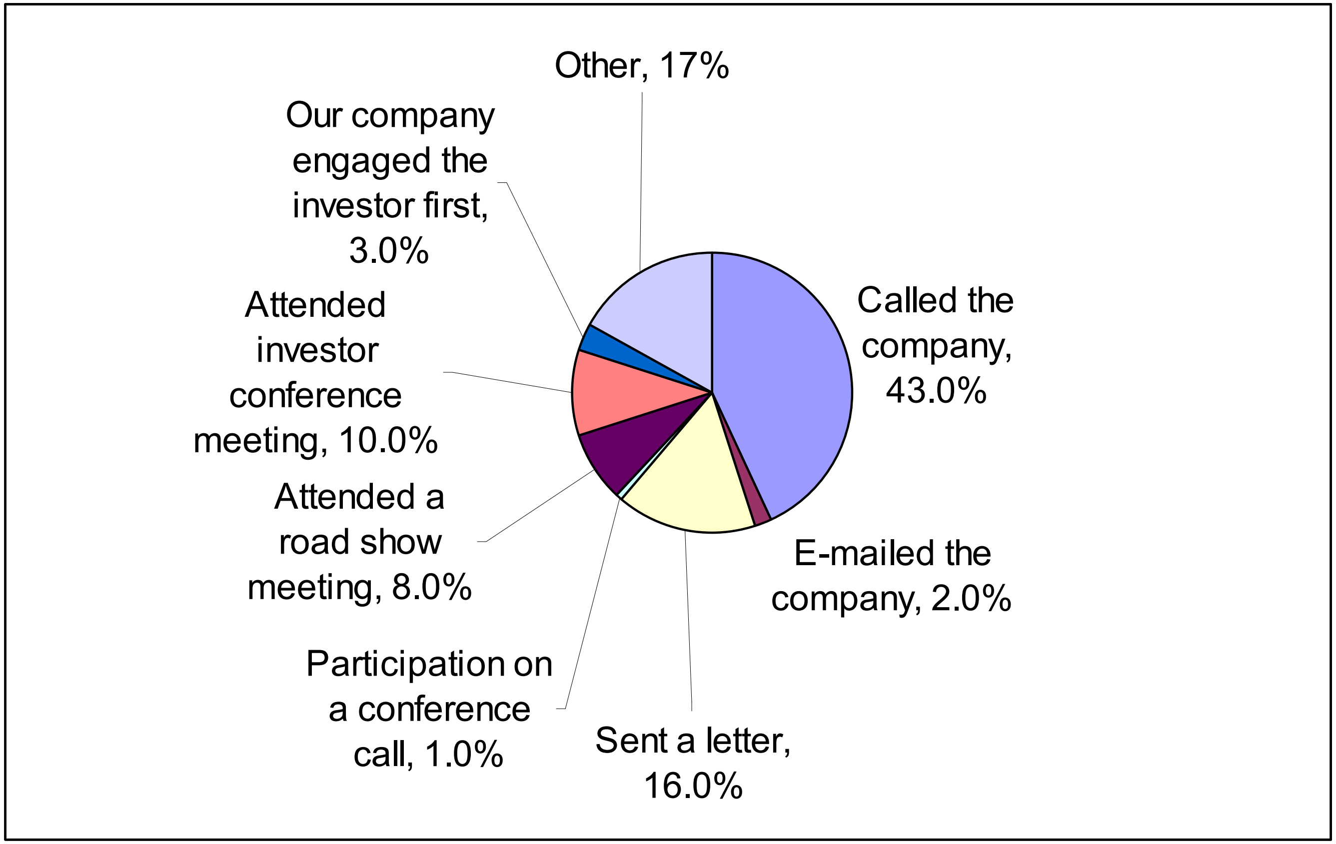


Source: The Conference Board, Inc., from data by Brav et al., 2007. Based on a sample of 1,059 hedge fund activism events occurred during the 2001-2006 period.

Non-Confrontational Tactics

(Often as a form of first engagement)

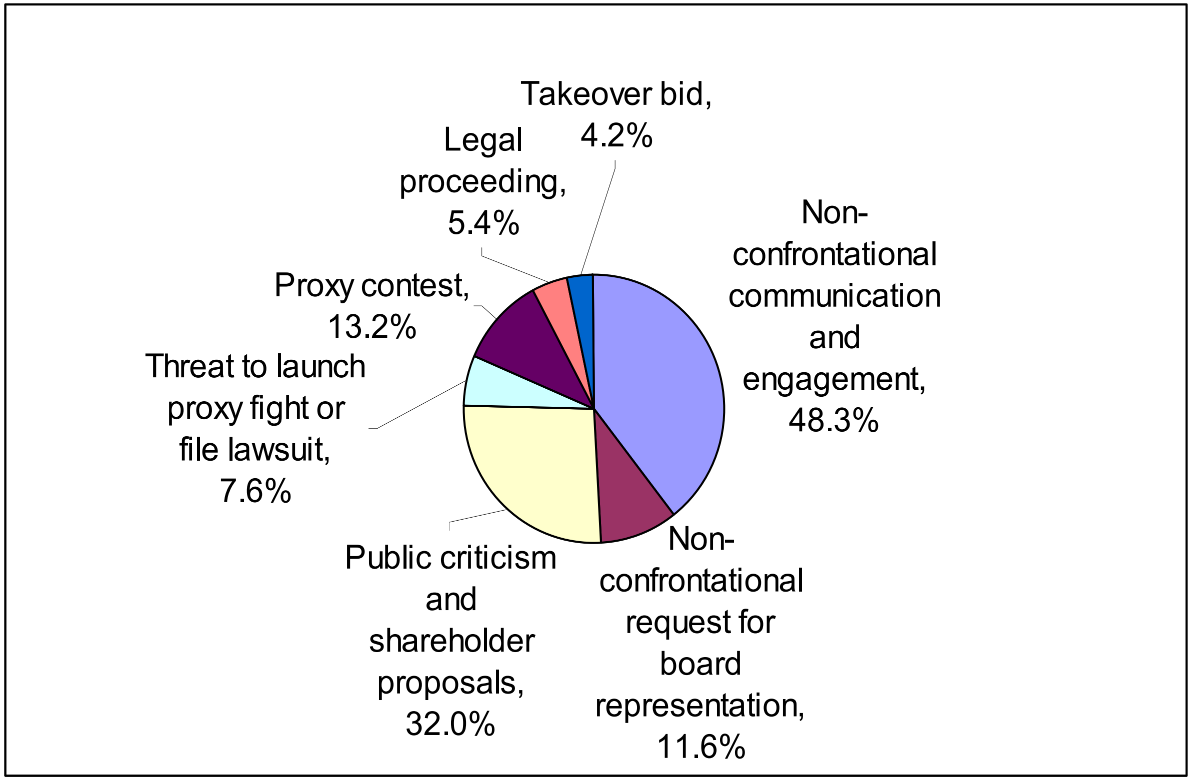
- Letters to management
- Phone calls to IR officers
- Attendance of road shows or earnings' calls



Source: The Conference Board, Inc.; data by Brav et al., 2007

Confrontational Tactics

- Expressing public criticism of the company or single members of management or board
- Filing a formal shareholder proposal
- Threatening to engage in a proxy contest
- Threatening to initiate a litigation proceeding against the company or its directors for breach of fiduciary duties
- Launching a proxy contest
- Filing a lawsuit
- Launching a hostile takeover bid



Source: The Conference Board, Inc.; data by Brav et al., 2007

Seeking the Support of Fellow Investors

The support of fellow investors allows activists to pursue their agenda while:

- Limiting capital expenditures in the campaign
- Controlling risk exposure

Group Activism

Based on a formal arrangement to work together

- group deemed as "single person" for purposes of Schedule 13D filings (SEC rules)
- 27% of Schedule 13D filings involve groups (Brav et. al, 2007)

Wolf Packs

Based on an informal understanding (on the future behavior of like-minded investors)

- some funds take the position that mere brainstorming/discussions do not constitute a disclosable "plan or proposal" under SEC rules
- also a means to avoid triggering the ownership threshold set by typical shareholder rights plans

Seeking the Support of Fellow Investors (Cont.d)

Remora Funds (Fund Mimicking)

Impromptu, unplanned support by other investors merely copying the activist's investment decisions to get a "free ride" on the lead fund's effort to create shareholder value

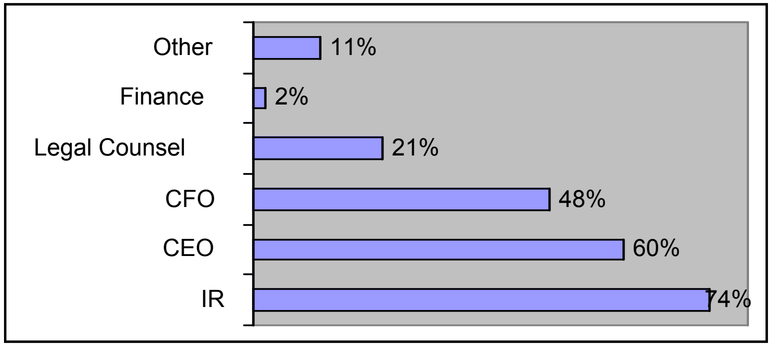
Reliance on Exemptions from Proxy Solicitation Rules

Hedge funds seeking the support of fellow investors may rely on:

- Ten-or-fewer rule
  - Solicitation of up to 10 shareholders without delivering proxy statement
- Free communication provision
  - Unlimited solicitation prior to proxy statement filing if contestant proves true intent of filing
  - By the time the filing is due, company and investors are likely to have settled
- Shareholder e-forums
  - E-forum shall occur more than 60 days prior to shareholder meeting
  - No solicitation of proxy authority is allowed

Corporate Responses

Who in your company responded?



Multiple responses allowed.

IR Officer Role

In most cases, the IR office remains the communication interface between executives/board and activists

Outside Expertise

Only 37% of surveyed companies availed themselves of external experts to develop a response strategy

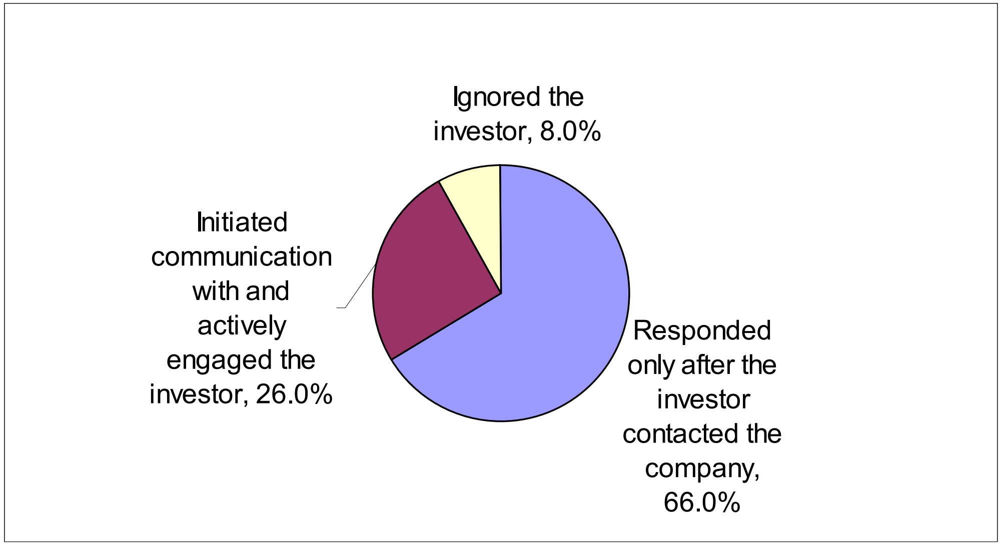
The Backlash Effect

A publicly confrontational response may bring attention to the campaign and help the activist obtain the support of fellow investors

Legal Action/Report to SEC

If there is clear evidence that the activist is operating under an undisclosed arrangement with a group or has otherwise violated applicable securities laws

How did your company respond?



Source: CFO Magazine/NIRI, 2007. Based on survey of 2,310.

Outreach as a Response and Preventive Measure

Establishing a **continuous dialogue** with large investors allows management to be sensitive to their concerns and ensures that the rationale of strategic, financial, or governance-related decisions is fully understood

Pfizer's experience

a) Regular meetings of large shareholders with the board

- admission to shareholders owning, in aggregate, approximately 35% of shares

b) Participation in investors' conferences

c) Special board sessions for reviewing letters/emails from investors

Campaign Outcomes

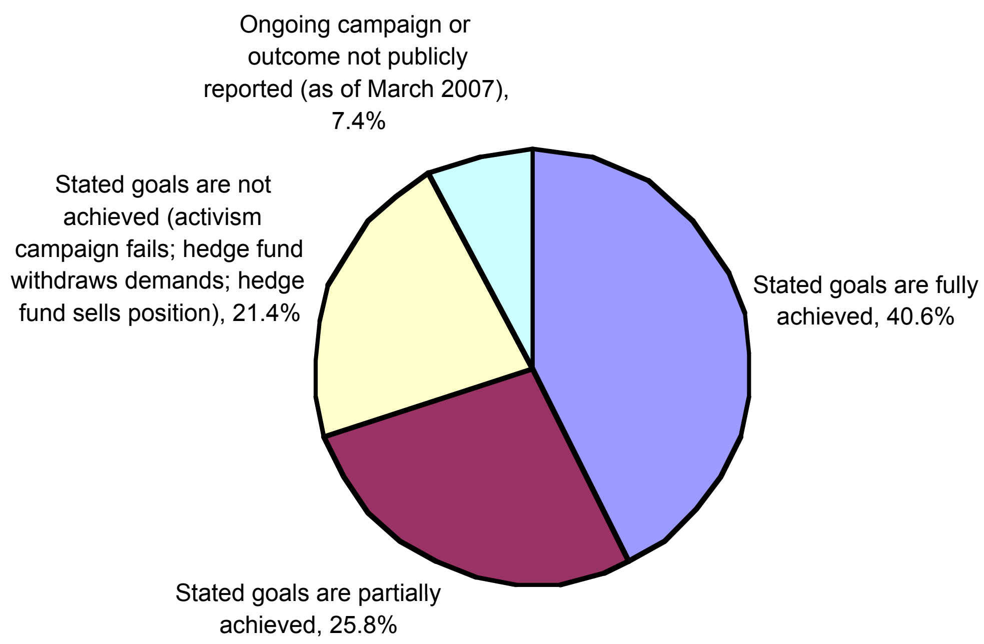
Overall Success Rate: 66% (either immediate acquiescence in the demands or major concessions and settlement)

Full Success Rate by Tactic/Demand Type:

Demand Type	Non-Confrontational Tactic	Confrontational Tactic
Financial (e.g. cash distribution)	41.3%	23.1%
Strategic (e.g. oppose M&A deal)	33.3%	18.2%
Governance-related (e.g. rescind takeover defense)	29.4%	18.6%

Source: Brav et al., 2007.

Success Rates



Source: Brav et al., 2007.

General Observations on Findings re: Outcomes

1. **Confrontation generates confrontation**. Target companies tend to resist if the requests are aggressively pursued, making an only-partial success more likely

2. **Strategic goals are the hardest**. Companies are generally less willing to let investors influence their strategic vision and plan. Therefore, hostile tactics are more prevalent for these types of demands

3. **Threat as a successful tactic**. In cases of mere threat of hostility, the outcomes are not significantly less favorable to the investor

   - perception in the marketplace that hedge funds (unlike active pension funds) have the actual resources to engage in a costly hostile campaign. This is used by some hedge funds as a tool of its own

   - hedge funds are becoming very sophisticated in the way they influence public opinion (e.g. press releases on their vision/intentions; slide shows; even white papers unveiling the company's shortcomings and arguing for change)

4. **Support by proxy advisors**. When the case becomes public. Proxy advisors (e.g. RiskMetrics) tend to side with activists and urge institutional investors to vote in their favor (72% of media-reported contests)

The Working Group Recommendations to Corporations

III. Be aware of strategic, financial, and governance vulnerabilities and remain open-minded about change

- Remain open-minded and critically evaluate requests for change
- Keep an inventory of issues (e.g. governance-related shortcomings; financial issues such as substantial cash balances; strategic weaknesses or risk exposure)
- Seek updates on investors' confidence and expectations
- Monitor proxy seasons and emerging governance practices
- Be prepared to justify capital availability/liquidity positions vis-à-vis strategic goals

  - why are cash reserves necessary?

  - why is the company retaining non-core assets?

  - why did the company depart from a certain widespread governance practice?

The Working Group Recommendations to Corporations

IV. Participate in the formulation of response strategies

- Boards should be expected to be involved and instill criticism in the process
- Form a special execution team to implement the response strategy
- Develop a sound and coherent message that can resonate with activists
  - Why did the company decide to concede/resist to requests?
  - Why is the decision suited to pursue shareholder value creation?
  - What is the rationale for agreeing to settle?
- Designate a spokesperson to ensure consistency in dissemination of message
- Retain legal counsel to ensure message/communication strategy does not violate securities laws (in particular, ensure fair disclosure)
  - However, do not rely on legalistic defenses
- Consider notifying regulatory agencies or bring legal action
  - If companies believe that more investors are acting as a group based on an undisclosed understanding/arrangement

The Working Group Recommendations to Corporations

V. Engage in open dialogue with investors and gatekeepers (within the parameters of applicable laws)

- Pursue active forms of engagement with directors
  - Invite investors to meet with the board
  - Participate in investors' conferences
  - Convene board sessions to regularly review communications from shareholders

- Pursue dialogue with proxy advisors and rating agencies to improve reputation for excellence in governance/creditworthiness

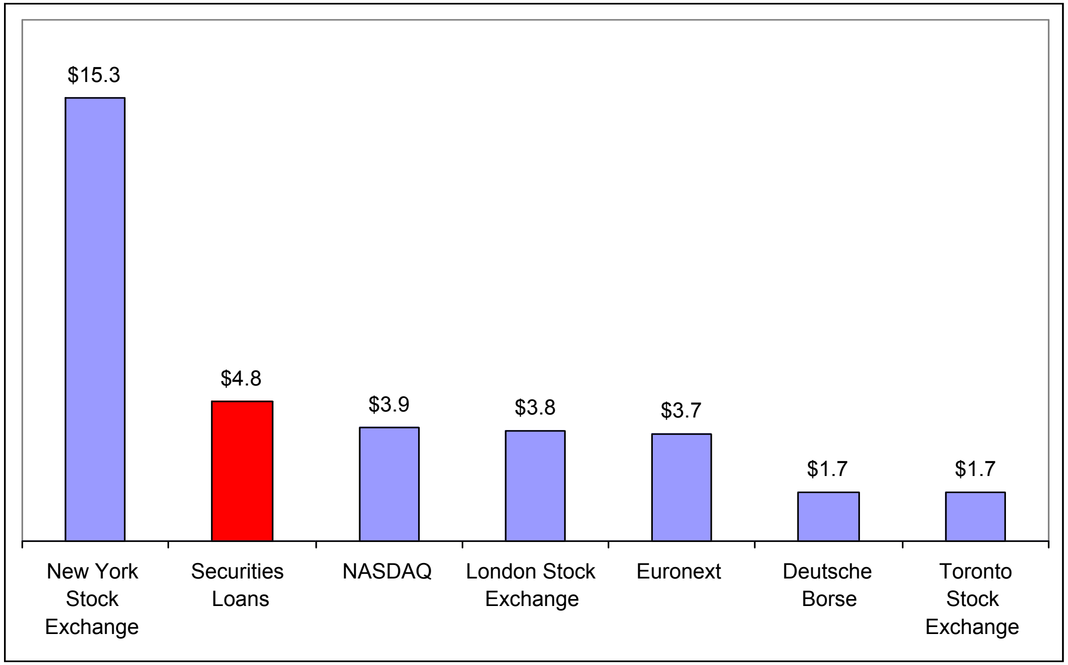
Ensuring Voting Integrity

The Stock Lending Market

Stock Lending

Services offered for a fee by most large institutional investors to permit the execution of short sales and other lawful hedging transaction

Capitalization of Major Exchanges vs. Global Lending Market ($ trillion)



Source: World Federation of Exchanges; Vodia Group, 2007.

A **large market** and a significant source of income for institutional investors, brokers, and custodian companies

Instances of **abuse** by certain borrowers with activist agendas

Separation of economic and voting rights

1. **Empty voting**

   The practice of borrowing shares for the sole purpose of exercising their voting rights and influencing the outcome of a shareholders' meeting

2. **Overvoting**

   When lent shares are voted not only by their borrower but also by their beneficial owner (who does not receive any notice of the lending transaction)

Extent of these phenomenon is difficult to assess because of:

a) growth in exchange and over-the-counter derivatives

b) recourse to anonymous modern trading techniques

Henry Hu and Bernard Black, *Journal of Corporate Finance*, 2007 (major study identifying about 20 instances of empty voting)

Self-Regulatory Initiatives

ICGN's Securities Lending Code of Best Practice (2007)

- Internal policy All lending activities conducted by institutional investors should comply with an internal policy on the recall of shares for the purpose of voting them

- Oversight Institutions should remain vigilant about any possible abuse of lending service and discourage stock borrowing for the purpose of empty voting

International Securities Lending Association (2005 White Paper)

- Transparency Recommendation All shareholders should have access to necessary information in time to make informed decision

- Consistency Recommendation Lenders should consistently enable their governance professionals to determine whether the fees received from lending securities are more important than exercising voting rights on those securities

The Working Group Recommendations to Corporation

VI. Promote transparency and integrity of the voting process

- Time notices of shareholders' meeting so as to ensure that institutional lenders have enough time to consider withholding from lending or recalling their shares
- Publish the meeting agenda in advance of record date so that lenders can assess the importance of each item being put to a vote vis-à-vis the economic return derived from lending the shares

The Working Group Recommendations to Institutional Investors

VII. Promote transparency and integrity of voting process

- Set written policies defining scope and prerequisites of lending activities (e.g. solvency of borrowers; type of acceptable collateral)
- Discourage the practice of borrowing shares for empty voting purposes
  - e.g. by imposing severe liability and indemnification clauses in all lending agreements
- Publicly disclose data on lending business (including fees charged and weight on total revenues)
- Establish internal communication procedures to coordinate lending agents and personnel responsible for voting proxies
  - compile do-not-lend lists
  - adopt recall protocol and identify triggering events
- Monitor the development of national or international codes of best practices in stock lending and consider adoption

Overseeing Hedge Fund Management

Increasing institutional investment in hedge funds

Driving factors

1. Need to pursue higher return and reduce volatility to meet actuarial projections
2. Competitiveness of traditional investment strategies and pressure to diversify portfolio
3. Expanding familiarity with alternative investment vehicles
4. More aggressive marketing by hedge funds as a result of the 2006 U.S. Pension Protection Act's relaxation of the "25%-test" rule to qualify a hedge fund as a plan-asset fund subject to ERISA

    - foreign benefit plans and U.S. governmental plans exonerated from inclusion to 25%-test

Demand for more oversight and due diligence

State Street Survey (March 2007)

Many boards of trustees called for more stringent oversight on allocation decisions as well as due diligence standards for the screening and selection of alternative investment vehicles

SEC Staff's Study of 24 Pension Funds' Advisers (May 2005)

More than half has failed to disclose significant conflicts of interests to their pension fund clients, including lucrative affiliations or business arrangements with hedge funds

Former SEC Chairman William Donaldson's Testimony Before the U.S. Committee on Banking, Housing, and Urban Affairs (2004)

Report on growth in hedge fund fraud (e.g. gross performance overstatement; payment of undisclosed commission; misappropriation of client assets by using parallel unregistered advisory firms and hedge funds)

Demand for more transparency and risk management accountability

Principles and Guidelines Regarding Private Pools of Capital (2007)

Issued in the U.S. by the President's Working Group on Financial Markets (PWG) as a set of guidelines for U.S. regulators addressing public policy issues associated with growth of private equity and hedge funds. Focus is on:

- enhanced disclosure
- coherent valuation methods
- rigorous risk management systems

Sound Practices for Hedge Fund Managers (November 2007)

Issued by the Managed Fund Association. They design a framework of internal policies with respect to:

- management, trading, and information technology control
- responsibilities to investors
- determination of net asset value
- risk management
- regulatory controls
- additional voluntary disclosure

Accompanied by a Model Due Diligence Questionnaire to assist prospective hedge fund investors.

Demand for more transparency and risk management accountability (Cont.d)

Principles for the Valuation of Hedge Fund Portfolios (March 2007)

Issued by IOSCO as globally-accepted auditing standards of portfolio value information disclosed by hedge funds.

Hedge Fund Standards (January 2008)

Issued in the U.K. by a self-regulatory group of hedge funds. They focus on:

- voluntary additional disclosure to investors and counterparties
- valuation best practices (e.g. segregation of valuation and portfolio management functions)
- the establishment of an internal risk management framework
- the establishment of a fund governance structure
- measures to prevent market abuses by fund managers (e.g. insider dealing)

The Working Group Recommendations to Institutional Investors

VIII. Perform ongoing due diligence as part of the investment process in activist hedge funds

- Consider suitability of investment in the context of overall portfolio and in light of:
  - financial objectives
  - time horizons
  - distribution requirements
  - risk tolerances
- Trustees should expect managers to evaluate their investment in activist hedge funds as part of their duty to diversify the portfolio
  - Do not categorically prohibit or restrict allocations to hedge funds, including activist funds
- Establish thorough due diligence protocol
  - Request info on fund characteristics (e.g. capital structure; investment strategy; performance history; activism objectives and tactics)
  - Understand what strategic, financial, and governance-related changes are perceived by the hedge fund as drivers of long-term growth
- Periodically monitor the compensation policy adopted by the activist hedge fund to ensure that managers' interests are aligned with the institutional investor's objectives

The Working Group Recommendations to Institutional Investors

IX. Strengthen governance practices and participate in the discussion and implementation of activist strategies

- Seek regular communication with portfolio hedge funds on their activism agenda, within the parameters of applicable laws
- Consider teaming with the hedge fund on its activism campaign if objectives are deemed consistent with the institutional investor’s long-term goals and corporate governance policies
- Expect hedge fund managers to remain abreast of, become signatories of, and adhere to best practices and voluntary standards published by self-regulatory associations and other relevant organizations, including standards on transparency and risk management