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# The 2012 Annual Meeting Season: Targeted "Value Activism" Will Displace Traditional Governance Activism

*By John C. Wilcox*

Sodali's forecast for the 2012 annual meeting season contains both bad news and good news for companies. The bad news is that there will be a substantial increase in shareholder activism. The good news, which outweighs the bad, is that (1) activism in 2012 will be qualitatively different from previous years; (2) companies will be able to predict their vulnerability; and (3) companies that are well prepared can avoid being targeted.
These predictions are based on our analysis of both fundamental changes in governance trends that have been developing over the past two decades as well as important events that have occurred during the past year.

## The Legacy of 2010

A year ago we described the legacy of 2010 - developments leading into the 2011 annual meeting season that constituted a major shift in the focus of corporate governance and a fundamental change in relations between companies and shareholders. Those developments were rooted in two decades of governance reforms as well as the financial crisis of 2008 and the resulting economic downturn. The legacy of 2010 altered the governance landscape and relations between companies and shareholders in the following ways:

- With the theoretical work of corporate governance completed, implementation is the major concern of investors and regulators.

- Shareholders are focusing on business fundamentals, performance and board accountability rather than governance compliance and external metrics.

- Targeted, company-specific, value activism is increasing, while generic governance activism continues to decline.

- Proxy advisory firms are under growing pressure to increase their knowledge of local markets, improve transparency, engage with companies, avoid box-ticking and customize their vote recommendations.

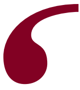
- Both companies and investors acknowledge that ESG (environmental, social and governance practices) and non-financial metrics are integral to business risk, financial performance and long-term sustainability.

- Regulators and private sector groups are turning their attention to the governance, fiduciary duties and business conduct of institutional investors and financial service providers.

## Developments in 2011

Against this background, a number of important developments and regulatory initiatives have occurred during the past year:

- The European Commission (EC) published in April a green paper entitled "The EU Corporate Governance Framework" that raises fundamental questions about the efficacy of the principles-based, comply-or-explain governance system. The green paper asks whether greater regulatory oversight and more prescriptive rules are necessary to ensure accountability. In the face of this challenge, European companies are under pressure to voluntarily improve their governance practices and the quality of their explanations without delay. The 2012 annual meeting season may be the last chance to demonstrate that the comply-or-explain governance system is effective in practice.



- The United Kingdom Stewardship Code, published in July 2010, has established a strong precedent that calls for institutional investors to engage with companies, vote responsibly and explain how they fulfill their duties and manage conflicts of interest. The U.K. code is having a global impact, stimulating work on similar codes in other countries during the past year. In 2012, institutional investors will be under pressure to monitor and engage with portfolio companies, disclose their proxy votes and demonstrate that their practices are in line with their fiduciary duties. The proxy voting records of institutions will be subject to close scrutiny and second-guessing by shareholder advocacy groups and regulators.

- In France, the country's financial markets authority - the Autorité des Marchés Financiers (AMF) - published new practice guidelines for proxy advisory firms. The AMF guidelines require proxy advisors to increase their interaction with companies and to be more transparent with respect to their conflicts of interest and their methodology in formulating policies and vote recommendations. The EC and the U.S. Securities and Exchange Commission (SEC) have both made comparable proposals. Whether they issue regulations or not, proxy advisors' practices will be under the microscope during the 2012 proxy season.

- The United Nations' Global Compact's Principles for Responsible Investment (UNPRI) have steadily gained influence in the global business and investment community since 2005 and are now closely linked with the corporate governance movement. Today's list of 927 UNPRI signatories is a powerful endorsement of both the content of the Principles and support among both businesses and investors for voluntary accountability in lieu of regulation. The Global Compact describes itself as "a strategic policy initiative for businesses that are committed to aligning their operations and strategies with ten universally accepted principles… ." In light of recent environmental disasters such as TEP/Fukushima and BP/Deepwater Horizon and the continuing economic downturn, it is clear that UNPRI will play a critical role in relations between companies and investors on environmental, social, ethical and sustainability issues. For the same reasons, the Global Reporting Initiative (GRI)-a network-based organization that produces of one of the most widely used standards for sustainability and governance reporting-is increasingly associated with governance reform, shareholder rights and board accountability.

- Twelve countries now require some form of shareholder vote on compensation. In a few countries, most notably the United States, controversy over the mechanics of Say-on-Pay (SOP) has overshadowed its benefits. Elsewhere companies have taken the vote requirement in stride and there is now a global consensus that SOP generates useful dialogue between companies and investors, thereby improving compensation fundamentals and linking pay to performance. In Europe, however, the EC's green paper raises questions as to whether a voluntary, comply-or-explain approach is effective in moderating pay abuses. The challenge for European companies in 2012 will be to improve the quality of their explanations for pay decisions or face more prescriptive rules from the EC. U.S. companies face a far more difficult challenge to supplement the management's Compensation Discussion and Analysis (CD&A) with a narrative explanation of the board's views on compensation incentives and strategic policy objectives.

- The prolonged struggle in the U.S. over shareholder proxy access appeared to reach a conclusion with the July ruling from the U.S. Circuit Court of Appeals for the D.C. Circuit that invalidated SEC Rule 14a-11 (which would have mandated procedures for shareholder-nominated board candidates to be included in a company's proxy statement). However, the Commission's decision to permit shareholder resolutions on access under Rule 14a-8 keeps the issue alive. From a global perspective, shareholder access is a side show, reflecting idiosyncrasies in the U.S. governance system. The issue may have long-term consequences, however, because of the District Court's insistence that comprehensive economic cost/benefit analysis is a prerequisite for governance regulation. The court (and perhaps the SEC itself) seemed to give little weight to the prophylactic function of governance rules. Prevention is critically important but difficult to measure in economic terms. The intent of many governance rules is to influence board conduct and prevent abuses before-the-fact rather than to facilitate shareholder action after abuses occur. If the SEC cannot find ways to quantify the costs and benefits of governance rules in hard numbers, there will likely be less regulation in the future. In any case, the access drama will continue in 2012 with a high volume of shareholder proposals at U.S. companies.

- Despite the setback on proxy access and the new requirement for cost/benefit analysis, the SEC is expected to propose new rules implementing its July 2010 concept

release on proxy system reform in time for the 2012 annual meeting season. It is not yet clear whether the rules will introduce fundamental changes to the proxy system structure and mechanics, increase oversight of proxy advisory firms, give companies greater access to beneficial owners, establish new transparency requirements for trading in stocks and derivatives, or all of the above.

- The Occupy Wall Street movement and other forms of social protest represent a wild card in relations between companies and shareholders. If the global economic downturn continues into 2012, these populist initiatives and the media attention they attract could encourage a backlash among retail shareholders against the entire business community without consideration of individual company achievements. High-profile expressions of popular discontent could escalate political and social pressure on institutional investors to support dissidents and activists or to vote against controversial management proposals. All these factors increase the likelihood of greater confrontation between companies and shareholders rather than a search for common ground and solutions to shared economic problems.

- Social networking, still used primarily for non-business communication, is a development that requires close monitoring by the business community. Social networks present both a challenge and an opportunity-a tool for dissenters to mobilize support and a method for companies to communicate more effectively. Institutional investors are already studying the potential of social networking techniques. For example, at the June annual conference of the International Corporate Governance Network, about 50 twitter accounts extended the conference reach from the 500 delegates present in Paris to an estimated 55,000 people around the globe, demonstrating the power of social networks to reach a wide audience virtually instantaneously. The 2012 annual meeting season will produce more examples of social networking by shareholders, activists and companies.

## Targeted Value Activism

These developments provide the ingredients for a perfect storm of shareholder activism in 2012. All the principal players-shareholders, regulators, companies and boards-are under pressure to change in fundamental ways. Institutional investors (and their advisors) are being confronted with new codes, fiduciary expectations, regulatory evaluation and pressure from peers. Regulators, under the scrutiny of politicians and industry watchdog groups, are moving aggressively to improve the accountability of corporations, institutional investors and the financial services industry. The general public, angry and frustrated because of the prolonged economic downturn, is in an activist, dissenting mood.

The focus of these forces will be on corporations, CEOs and boards of directors. Companies with the following characteristics are the predictable targets for value activism in 2012:

- companies with compensation practices that are egregious or out of step with peers, particularly when accompanied by downsizing and layoffs;

- companies with weak financial performance or undervalued stock;

- companies that do not comply with corporate governance best practices, particularly when high levels of dissent or votes in support of shareholder resolutions have been disregarded;

- companies with conflicts of interest, corrupt practices, scandals or a high negative profile in the media;

- companies with a poor record on environmental practices, social policy, ethics, or risk oversight;

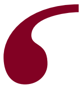
- companies experiencing unusual market volatility, short selling, or substantial changes in ownership;

- companies that lack transparency, have inadequate disclosure programs or poor board communications;

- controlled companies (including those with family or state ownership) that have inadequate protections for minority shareholder rights;

- companies in industries targeted by protest movements and the media, including Wall Street firms and “too big to fail” financial institutions.

Value activism directed at these types of targets is qualitatively different from governance activism. Building on the model of strategic activism used by hedge funds and dissidents, value activists focus on individual companies’ business fundamentals, performance and board accountability in addition to their governance practices. Value activists usually do not have



a specific strategic agenda and are not seeking control; their value proposition is to change the behavior of the target company's board and management, thereby reducing risk and improving performance and sustainability.

## Be prepared

In today's unstable environment, it is not enough for companies to publish a corporate governance report and comply with proxy advisors' guidelines. To avoid being targeted, a company should conduct a comprehensive self-evaluation that analyzes environmental, social and governance (ESG) practices, financial performance, business strategy and reputation. The board and management should examine their conduct and their communications through the hard eyes of fiduciary investors, special interest groups, governance purists, disgruntled minority shareholders, labor union activists, opportunistic short-term investors and strategic activists. To avoid being the target of activism, it is necessary to think like an activist.

A company's annual self-evaluation, conducted in preparation for the annual shareholder meeting but commencing at least six months before the meeting date, should include the following activities:

- Conduct a comprehensive ESG benchmarking against peer companies and global standards.

- Review and analyze the voting results and shareholder feedback from last year's annual meeting.

- Prepare an updated shareholder identification and ownership profile, analyzing the implications of recent ownership changes and market activity.

- Identify voting decision-makers at top institutional investors and compare them with Investor Relations contacts.

- Review the voting policies of proxy advisory firms and institutional investors and compare them with company practice.

- Assemble an internal team, including the General Counsel, Company Secretary, Investor Relations, Human Resources and Compensation executives and, as necessary, the CFO, CEO, Board Chairman and appropriate board committee chairs.

- Assemble a team of outside advisors that can provide legal and financial advice, as well as expertise in compensation, institutional investor relations, cross-border share voting, communications, public relations and crisis management.

- Review the company's legal and structural defenses with respect to takeover bids or election contests.

- Review feedback from investor relations meetings and road shows during the past year.

- Review recent correspondence and communications with top shareholders, both local and global, including members of controlling groups or families.

- Review analyst reports, media coverage and market commentary about the company and the industry.

- Organize outreach to major shareholders if controversial management proposals or shareholder resolutions are expected to be on the annual meeting agenda.

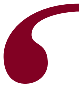
- Prepare an objective analysis for the board and senior management that outlines the company's risks and vulnerabilities and recommends a plan to deal with them.

- Determine the appropriate role for the board of directors in engagement with shareholders before, during and after the shareholder meeting.

If the economic and regulatory environment continues to be unstable during 2012, these preparations will be more important than ever before. Companies that are not strategically prepared will be at risk of losing control of the agenda and being forced into a defensive posture at their annual meeting. A defensive posture will in many cases be a losing posture.

## Long-term Challenges

Preparation is essential for companies to avoid surprises and maximize support from shareholders at annual meetings. Over the long term, however, more fundamental changes will be needed in relations between companies and shareholders to break the cycle of confrontation and short-termism. Directors and managers should look beyond quarterly financial reporting and find new ways to ensure that shareholders are well informed about the company's business, policies and long-term strategy. To accomplish this goal, companies will have to overcome three difficult challenges:



1. **Give directors a voice**-Board communication is the most important and difficult long-term corporate governance challenge. Because shareholders place the board at the apex of the corporate governance triangle, they expect to be kept fully informed about how the directors are fulfilling their duty to act in the best interest of the company. In the U.S., directors will have to find ways to "tell the company's story" beyond the constraints of prescriptive disclosure rules, without increasing their legal exposure. If not, they will face ever-increasing levels of shareholder activism. In Europe, boards must provide meaningful and substantive explanations for their decisions and policies. If not, they risk losing the benefits of voluntary, principles-based governance. Improvements in board communication must come from within the boardroom. Only the directors themselves can open the windows and turn on the boardroom lights.

2. **Develop holistic investor relations**-Most listed companies have investor relations programs that systematically communicate financial information from management to investors. However, few companies appreciate the need for a parallel program of institutional investor relations to communicate about ESG and board-level issues. A holistic investor relations program manages both the financial and governance expectations of shareholders. It identifies and establishes relationships with institutional investors' policy and voting decision-makers as well as the analysts and portfolio managers. It reaches out to proxy advisory firms, global custodians, sub-custodians and the back offices of intermediaries in the ownership chain. In addition to quarterly earnings, it deals with annual meeting disclosure and cross-border share voting. Defining, staffing and implementing a holistic investor relations program-integrating financial results with board policies and coordinating all levels of board and management communications-is the second major long-term challenge for companies.

3. **Implement metrics for ESG and non-financial performance**-The third challenge is for companies to introduce performance metrics and incentives that support ESG and board-level goals. Academic and professional studies have made a persuasive case that non-financial performance measures are essential for effective management, risk reduction and long-term business success. The case is even more compelling in the context of corporate governance and relations with stakeholders, as many issues are not easily described or measured in financial terms. Responsibility falls on the board of directors, as the caretakers of corporate culture and reputation, to ensure that metrics and incentives within the company are aligned with the board's key oversight responsibilities and their duties to shareholders and stakeholders. The UNPRI and GRI offer a useful starting point, but each company's board and management must structure metrics customized to their business strategy and circumstances. This challenge is complicated by institutional investors' overreliance on financial models in making investment decisions. Ultimately, the cycle of short-termism will be broken only when both companies and institutional investors integrate non-financial metrics and long-term goals into their decision-making.

Shareholder advocates have an old saying: "Every company gets the shareholders it deserves." The truth in this statement is not that companies are victims of the marketplace, but that companies can-by their own actions-influence which investors they attract. Companies also can build a stable and supportive base of long-term owners by keeping shareholders well-informed and confident that their interests and the company's are aligned.