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Preventing Activism

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As long predicted, shareholder activism is now a fact of life for listed companies around the world. The variety, number and success of activist campaigns have ballooned. Activists are attracting both dollars and votes from long-term institutional investors. Celebrity hedge fund managers are featured in the media as creators of value, defenders of shareholder rights and a force for market efficiency. Target companies, on the other hand, are routinely characterized as poorly run, inefficient or self-serving.

In this turbulent environment, companies are being bombarded with advice, most of which focuses on defensive strategies - how to defeat hedge funds, discredit activists and deflect shareholder demands.

In our view, much of this advice distorts the problem. It overlooks a basic presumption about the relationship of companies and investors: businesses create economic value, while investors observe the process from an external perspective. Shareholder activists can indeed be effective in spotting inefficiencies and demanding improvements in policy or strategy, but their initiatives cannot substitute for good management and the internal health of businesses. Boards and managers, not shareholders, must run businesses and define strategic goals. The shareholder tail should not wag the business dog.

Because of these fundamental truths – companies, not shareholders, create economic value; boards and managers, not shareholders, run the business – Sodali has always advised clients that prevention rather than defense should be their goal in dealing with shareholder activism. It is better to manage the business well and stay off activists' radar screen than to raise defensive barriers, treat shareholders as the enemy and wage war against them.

Understanding and preventing activism was the subject of **Sodali's 2012 client memorandum**, published in September 2011. We described the rise of "value activism" (also sometimes referred to as "operational activism" or "strategic activism") and outlined practical steps to help companies assess their vulnerability and avoid being targeted. Given the continuing ascendancy of activism, the issues are even more urgent today.

So here once again is our advice to help companies stay out of the activist game:

I - ASSESS YOUR VULNERABILITY

Companies with the following characteristics are predictable targets for value activism:

- *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 share 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 or special privileges for control groups;*
- *companies in industries targeted by protest movements and the media, including Wall Street firms and "too big to fail" financial institutions.*

To this list we would now add companies whose boards of directors:
- have not implemented policy changes supported by majority shareholder votes;
- are not deemed to be transparent in explaining their decisions and policies;
- have not articulated policies relating to risk oversight and control;
- have not articulated policies relating to environmental, societal, ethical and human rights issues;
- lack diversity or specific competencies deemed essential to the business;
- fail to assess director and board performance at least annually.

We intentionally do not add to the vulnerability list those well-run companies with excess cash or other assets on their balance sheet that are targeted by activists demanding a stock buyback, extraordinary cash dividend or other immediate return of capital to shareholders. In such cases Sodali advises targeted companies NOT to accede to activist demands and to oppose them aggressively. Executive management and the board of directors are responsible for determining the most productive use of the company's cash. Fortunately, there is growing evidence that long-term institutional investors are questioning the value of this type of short-term activism. They recognize that it often crosses the line into micromanagement. A recent example is the vigorous opposition by institutional investors to Carl Icahn's demand for Apple to return its cash hoard to shareholders. The development of Stewardship Codes for institutional investors will have a big impact: it will increase engagement, but it will also add a strong bias in favor of long-term over short-term value creation.

II - BE PREPARED.

In our view, market research and rigorous self-assessment are essential tools for dealing with shareholder issues as well as for managing business operations and reducing risk. Here are the 2011 action steps that we continue to recommend for companies to monitor their relations with investors:
- *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, 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 shareholder 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.*

In addition, we now recommend that the board of directors' role be viewed even more expansively than in 2011. During the past few years most of the barriers to direct communication between boards and shareholders have been overcome, shifting the governance spotlight to activities inside the boardroom (as described in **Sodali's 2011 Client Memo**), increasing the importance of the annual shareholder meeting and the board's role in it (our **2013 Client Memo**) and laying the groundwork for governance software and programs to make boards truly autonomous (our **2014 Client Memo**). In parallel with burgeoning shareholder activism, the board's external activities and its responsibility for dealing with governance and shareholder issues will continue to grow.

Although we are now in a period dominated by strong public support for activism and mistrust of business, companies should not respond with a defensive mindset. Indeed, in this difficult environment it is all the more important for companies to take ownership of the issues and maintain a positive and constructive attitude toward shareholders. As in dealing with customers, companies should take full responsibility for dealing with the demands of shareholders and the inefficiencies of the financial markets. These tasks are part of the deal struck by every company that made the decision to go public.