Shareholder activism 2.0

LEAD DIRECTOR NETWORK

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King & Spalding

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With the pace of shareholder activism accelerating and activists taking on more and larger targets, activist investing remains near the top of the agenda for board members and executives. Consider two examples from 2017: Procter & Gamble faced a bitter proxy fight with activist Nelson Peltz's Trian Fund Management and General Electric, also under pressure from Trian amid lackluster performance and a falling stock price, replaced CEO Jeff Immelt and granted Trian co-founder Ed Garden a seat on its board.[1]

On October 24, Lead Director Network (LDN) members and their general counsel (GC) guests were joined by Jim Woolery, head of King & Spalding's mergers and acquisitions and corporate governance practice, to explore the current environment of shareholder activism and ways to avoid a proxy battle. *"If you are faced with a proxy contest, you are losing. Even when you win, you don't win,"* Mr. Woolery said. *"So the question is, How do you mitigate or avoid an activist attack?"* This *ViewPoints* synthesizes that discussion. A companion *ViewPoints* synthesizes another discussion at the meeting related to crisis preparedness and response. *For further information about the LDN, see page 4. For a list of participants, see the appendix on pages 5-6.*

Structural market changes have yielded greater opportunities for activists

Mr. Woolery pointed out that changes in the structure of the US equities market—including the concentration of share ownership, trading dynamics that promote volatility in share prices, and the influence of event-driven hedge funds in setting prices—have created an environment that is conducive to activist investing.

Ownership of shares is increasingly concentrated

Recent years have seen an accelerating concentration of share ownership. Mr. Woolery noted that as few as four to eight investors can own 40% of a company's stock, and he predicted that ownership concentration would grow in coming years. Many active portfolio managers are being outperformed by index funds, especially when fees are factored in, so a great deal of money is flowing to the indexes, further concentrating share ownership. This means that activists can target their campaigns at a few large shareholders and quickly magnify their influence.

The dynamics of trading are changing

Index funds do not trade as frequently as actively managed funds or event-driven or quantitative hedge funds.[2] As a result, fewer shares are being traded overall and the funds that do trade have a heavy impact on day-to-day pricing.

Mr. Woolery noted that an increasing number of trades are executed by machines, with algorithms responsible for up to 90% of trades on a given day. The algorithms tend to respond powerfully to price shifts, resulting in large moves in a firm's stock price: *"When you see a company restate its guidance, you will see a move that's like 15%. That's a big move, and the reason why is that it is a machine that is operating and reacting to that news."*

Mr. Woolery summed up the situation: *"Say you have 100 shares of stock. In any given year eight to 10 shares are trading; of that, 70% are hedge funds, and of that, up to 90% are machines. These are the trades that set that price. That is a big part of the reason we have separation growing between intrinsic value and prices."*

Event-driven hedge funds wield price-setting influence

The connection between these trading dynamics and activist investing lies in the inherent affinities between the business models of event-driven hedge funds and activist investors. Event-driven hedge funds look for stocks that appear to be undervalued and for which there is a large potential upside if there were to be a *"catalytic event,"* such as selling a division or changing management. Once they have identified such an event, hedge fund managers sometimes reach out to activists to encourage them to push for that catalytic event. If the event takes place, both the event-driven funds and the activist investors will reap a short-term windfall if the stock price rises as predicted.

An atypical approach to shareholder engagement may be beneficial

With structural conditions in the US equities market favoring activism, Mr. Woolery suggested that boards and management teams consider new approaches to shareholder engagement. Companies should think of investors as the US Electoral College, with big institutional investors like BlackRock, Vanguard, and State Street playing a role akin to that of California, New York, and Florida in a presidential election. *"Pay attention to where the votes are. Companies invest a ton of time trying to satisfy the noisy small states when instead they should make sure they have as productive a relationship as possible with the states with the most influence,"* Mr. Woolery said.

In such a context, ongoing and proactive engagement—especially with the big institutional investors—can help ensure that when activists show up, major investors are less likely to side with them. Mr. Woolery emphasized that boards *"need to go on offense, which means understanding shareholders' business models. The board has to say, We need to know how stock is voted in these shareholders inside and out. How do decisions get made?"* He pointed out that the business models of index funds, actively managed funds, and event-driven hedge funds are all different: while the index funds are policy-driven, active fund managers are primarily fundamental or economic investors, while the event-driven funds typically look for catalysts to move the stock price.

Mr. Woolery emphasized the importance of engaging with big institutional investors as part of a strategy in which *"rather than let the market decide what your shareholder base is, you construct* *a shareholder base that supports your long-term strategy. Companies need to build a 40% wall in the shareholder base that they know with confidence is with them—the shareholders who understand where the company is going and are with you."*

Boards are determined to keep the focus on long-term value creation

Both directors and GCs, expressed concerns that the environment Mr. Woolery described reinforces short-term thinking. One member said, *"It is a little alarming, if you think about our companies and country, in terms of long-term value creation. This really seems to be all about mobilizing and trading—it's short-term thinking on steroids. How do you ensure that you are not just reacting and getting ahead of short-termers as opposed to doing the right thing to be here for 10 to 20 years?"*

In the face of this environment, boards and executive teams recognize that they have to make a concerted effort to focus on the long term. *"We have to know what we are protecting: the long-term interest of our companies. Period,"* one director said. *"The idea of paying attention to short-term interests—I don't want to pay any attention to them at all. Our job all day is to recruit long-term shareholders. The board has to be doing that all day, every day."* Another director said the board needed to keep the company focused on its mission and values: *"That's why a board needs a North Star—regardless of what forces are there, you have to have a view on how we create long-term value and what is our strategy to do that. And you stick to it."*

Director engagement with investors can be effective

Participants pointed out that companies recognize the value of having board members engage with their shareholder base, and firms are increasingly making directors available to their large institutional investors. One GC observed, *"There is a shift in what the investor wants from the board directly versus from management. In the past, boards tended to stay behind management. Now, the feeling is that investors want to sit down with a director or two and for management to step back and directors to step out and be heard."* Mr. Woolery agreed: *"That's what they want. What they really want is for the director to hear them. It is a fair comment to say to big shareholders, We're going to listen. I'm going to hear you directly."*

One director reported that after the company had lost a say-on-pay vote, the lead director and other board members went out to discuss strategy with many of their large institutional investors. *"The reaction was very different to the same thing management was saying when directors were saying it,"* he said. *"It's remarkable. Some of investment analysts are buying the stock because directors went out to see them."* He added that although investor engagement is usually management's job, *"sometimes the directors have a role to play."*

The Lead Director Network (LDN) is sponsored by King & Spalding and convened by Tapestry Networks. The LDN is a group of lead independent directors, presiding directors, and non-executive chairmen drawn from America's leading corporations who are committed to improving the performance of their companies and to earning the trust of their shareholders through more effective board leadership. The views expressed in this document do not constitute the advice of network members, their companies, King & Spalding, or Tapestry Networks.

ViewPoints *reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.*

Appendix: meeting participants

The following general counsel participated in the meeting:

Audrey Andrews, Senior Vice President and General Counsel, Tenet Healthcare

Brian Berube, Senior Vice President and General Counsel, Cabot

Michelle Bryan, Executive Vice President, General Counsel, and Chief Administrative Officer, Intelsat

Greg Butler, Executive Vice President and General Counsel, Eversource Energy

Sheila Cheston, Corporate Vice President and General Counsel, Northrop Grumman

Rhonda Ferguson, Executive Vice President and Chief Legal Officer, Union Pacific

John Finneran, Executive Vice President, General Counsel, and Corporate Secretary, Capital One Financial Corporation

Bernhard Goepelt, Senior Vice President and General Counsel, The Coca-Cola Company

Jim Kerr, Executive Vice President, General Counsel, and Chief Compliance Officer, Southern Company

Suzette Long, General Counsel and Corporate Secretary, Caterpillar

Nicole Maddrey, Senior Vice President, General Counsel, and Secretary, Graham Holdings

Monique Mercier, Executive Vice President, Corporate Affairs, and Chief Legal and Governance Officer, TELUS

Tom Moriarty, Executive Vice President, Chief Policy and External Affairs Officer, and General Counsel, CVS Health

Kellye Walker, Executive Vice President and General Counsel, Huntington Ingalls Industries

Barbara Wall, Senior Vice President and Chief Legal Officer, Gannett

The following Lead Director Network members participated in the meeting:

Dick Auchinleck, Lead Director, ConocoPhillips; Non-Executive Chair, TELUS

Bobby Burchfield, Partner, King & Spalding

Dave Calhoun, Independent Chair, Caterpillar

Sandy Cloud, Lead Trustee, Eversource Energy

Don Felsinger, Lead Director, Archer Daniels Midland and Northrop Grumman

Ann Hackett, Lead Director, Capital One Financial Corporation

Dixie Johnson, Partner, King & Spalding

Doug Johnson, Lead Director, Aflac

Mike McCarthy, Lead Director, Cabela's and Union Pacific

Jack O'Brien, Lead Director, TJX; Non-Executive Chair, Cabot

Cal Smith, Partner, King & Spalding

Doug Steenland, Non-Executive Chair, AIG and Performance Food Group

Dick Walker, Partner, King & Spalding

Jim Woolery, Partner, King & Spalding

Endnotes

[1] Thomas Gryta, David Benoit, and Joann S. Lublin, "GE Gives Activist Trian a Seat on the Board," *Wall Street Journal*, October 9, 2017.

[2] Exchange-traded funds such as the SPDR S&P 500 from State Street Global Advisors and index funds such as the Vanguard Total Stock Market Index Fund own large swaths of the market and adopt a passive investment strategy. Quantitative funds like Renaissance Technologies trade based on the analysis of market patterns by algorithms, whereas event-driven hedge funds, such as BlackRock's Event Driven Equity Fund, look for significant corporate events to trade against.