

EXECUTIVE SUMMARY

Year-round shareholder activism continues to challenge the American boardroom. As activists accumulate more capital, they are increasing their ability to launch more campaigns, with a greater success rate, against both large and small companies.

This new edition of NACD's *Director Essentials: Preparing the Board for Shareholder Activism* describes trends in activist campaigns, types of companies targeted, key activist issues and methods employed, and the board's role in preparing for and responding to an activist challenge.

Trends in Activist Campaigns

Today, public company shareholders continue to be active as instigators of change in the companies they own, and, in some cases, more broadly.

The methods used to effect this change may range from the "light activism" of a shareholder resolution on a specific governance issue to the "heavy activism" of proxy voting campaigns or tender offers meant to alter board composition. In the first half of 2018 alone 145 such campaigns launched against 136 companies—the highest number of targeted companies ever.¹

Recent conditions encouraging activism include these:

- Target companies' increased ability to follow through on investor demands for dividends, spin-offs, or sale of the company due to cheaper debt from relatively low interest rates
- Gradual spread of activism from traditionally activist labor funds and public pension funds to other types of shareholders, including mutual funds and passive index funds, who are now more willing to back activist challenges
- Growth in the assets controlled by hedge funds—from 2002 to 2017, hedge funds grew from \$526 billion to \$3.2 trillion in assets under management²



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How Boards Can Use This Resource

- Learn about which company characteristics attract activists and the methods activists use to enforce change.
- Determine your company's areas of vulnerability to activist challenges and how to correct them.
- Conduct in-boardroom discussions to prepare for activism.
- Create an activist response plan.

Preparing the Board for Shareholder Activism

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The Types of Companies That Activists Target

Generally speaking, activists do not discriminate on the basis of company size or industry—any company that is deemed to be underperforming is a potential target. According to the 2017–2018 NACD Public Company Governance Survey, activists are focusing closely on smaller companies. Twenty-eight percent of micro-cap companies were approached by an activist within the 12-month period preceding the survey—the largest percentage of any size category.³

Key Activist Issues and Methods of Influence

Shareholder activism falls along a wide spectrum depending on the type of shareholder and the ultimate goal the shareholder wishes to achieve:

Shareholder Activists' Key Issues and Methods of Influence		
Type of Shareholder ⁴	Key Issues	Methods
Hedge Funds	Financial performance <ul style="list-style-type: none"> • Undervaluation and lack of shareholder value • Capital structure <ul style="list-style-type: none"> ○ Sell-offs ○ Spin-offs ○ Restructuring • Business strategy • Change of control 	Hedge funds may employ any of the following methods, listed in order of increasing severity. Most hedge funds will attempt to use the least obtrusive tactics first, and then up the ante on the basis of the response they receive from management. ⁵ <ul style="list-style-type: none"> • Communicate with board/management to increase shareholder value • Look for board representation without confrontation or proxy battle • Submit shareholder proposals or publicly criticize company • Threaten proxy fight or sue company for breaching fiduciary duties • Launch proxy contest • Engage in takeover bid to control company
Mutual Funds	Governance reform and financial performance	<ul style="list-style-type: none"> • Engage management in strategy discussions, which encompass compensation, risk oversight, board refreshment, and the right to proxy access • Say on pay • Back activist hedge funds in proxy fights

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Type of Shareholder	Key Issues	Methods
Public Pension Funds (state- or city-sponsored funds)	Governance reform and social policies	<ul style="list-style-type: none"> • Shareholder resolutions, most typically proxy access, gender equity, political spending or lobbying, environmental concerns, and/or executive compensation⁶ • “Vote no” campaigns • Say on pay
Labor-Affiliated Pension Funds	Governance reform	<ul style="list-style-type: none"> • Shareholder resolutions, most typically employee rights, political spending or lobbying, or executive compensation⁷ • “Vote no” campaigns • Say on pay
Social, Religious, and Policy-Oriented Groups	Governance reform and social policies	<ul style="list-style-type: none"> • Shareholder resolutions, most typically environmental concerns, corporate political spending and lobbying, human rights, and animal rights
Individuals (“corporate gadflies”) owning minimal amounts of stock	Governance reform and financial performance	<ul style="list-style-type: none"> • Shareholder resolutions, e.g., split chair/CEO, special meetings/written consent, voting rules, executive compensation • Comments at shareholder meetings



DIRECTOR ESSENTIALS

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What Should Boards Do?

Boards have a unique oversight role and a duty to help maximize shareholder value. Effective boards discipline themselves to think more like outsiders and view their companies through the eyes of an activist. Recognizing areas of vulnerability, questioning management's presentation of financial and operational data, and identifying underperforming assets can help preempt an activist challenge. NACD encourages directors to make a priority of understanding their shareholder base and communicating with them about company strategy and corporate governance practices.

Boards should be prepared to consider an activist's ideas and create an activist-response team who will serve as the point of contact with the activist.

¹ "Lazard's Review of Shareholder Activism - Q2 2018," lazard.com, July 16, 2018.

² Christine Williamson, "Hedge fund assets end 2017 at record \$3.2 trillion-HFR," *Pensions & Investments*, Jan. 19, 2018.

³ NACD, *2017-2018 NACD Public Company Governance Survey* (Arlington, VA: NACD, 2017), p. 40.

⁴ For more information on the specific shareholder types identified in this table, see the following sources: James Copeland and Margaret M. O'Keefe, "Proxy Season 2017: Season Review," proxymonitor.org; Alon Brav, Wei Jiang, and Hyunseob Kim, "Hedge Fund Activism: A Review," *Foundations and Trends in Finance* 4, no. 3 (2009): 198-199; David Benoit and Kirsten Grind, "Activist Investors' Secret Ally: Big Mutual Funds," *Wall Street Journal*, Aug. 9, 2015; NACD, *Investor Perspectives: Critical Issues for Board Focus in 2016* (Washington DC: NACD, 2015); Diane Del Guercio and Tracie Woidtke, *Do the interests of labor union and public pension fund activists align with other shareholders? Evidence from the market for directors*, October 2012; and three findings from proxymonitor.org's 2014 special report on shareholder proposals at corporations, all authored by James R. Copland: "Special Report: Labor-Affiliated Shareholder Activism" (Finding 3), "Special Report: Shareholder Activism by Socially Responsible Investors" (Finding 4), and "Frequent Filers: Shareholder Activism by Corporate Gadflies" (Finding 5).

⁵ PwC, *How Might the Changing Face of Shareholder Activism Affect Your Company?*, PwC, Jan. 2018, p. 4.

⁶ Based on the proxy resolutions proposed by public employee pension funds (e.g., CalPERS), according to proxymonitor.org (using advanced search function for proponents in this category).

⁷ Based on the proxy resolutions proposed by labor unions in 2017 (e.g., AFL-CIO), according to proxymonitor.org (using advanced search function for proponents in this category).