Protecting Long-Term Shareholder Interests In Activist Engagements

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Key Takeaways

- State Street Global Advisors (SSGA) recognizes that activists can bring positive change to underperforming companies, especially when boards or management ignore investor concerns about poor corporate governance practices.
- As near permanent capital, SSGA's main goal is to ensure that activists are helping to promote long-term value creation in whatever way they choose to engage with companies.
- However, a recent rise in settlement agreements entered into rapidly between boards and activists and without the voice of long-term shareholders concerns us, as we see evidence of short-term priorities compromising longer-term interests.
- We believe boards should protect the interests of long-term shareholders in all activist situations, and carefully evaluate settlement agreements. In particular boards need to consider the interests of long-term shareholders as they assess: 1) duration of the agreements; 2) ownership thresholds and holding period requirements for continued board representation; and 3) risk to the company's share price posed by a lack of board oversight on significant pledging activities by activists serving on the board.
- To help inform and explain our voting decisions on the election of directors in activist situations, we will assess settlement agreements according to how they address the concerns highlighted in this paper.

Focusing on Long-Term Value Creation in Activist Situations

As a provider of long-term, near-permanent capital to listed companies through our index investing, SSGA is focused on maximizing the probability of long-term value creation on behalf of our clients. Our primary emphasis is on good corporate governance practices, which is a precondition for sustained, long-term performance. In the case of activist investors,[1] we acknowledge the positive changes these investors can often drive. In the past, we have supported activist investors in their objective to improve shareholder returns at companies in which boards had failed to address investor concerns around long-term underperformance and/or poor corporate governance. However, we are wary of activist models of engagement that favor short-term gains at the expense of long-term investor interests.

We acknowledge the inherent tension between short-term and long-term investors. Our view is that transparent debate around this tension is part of good shareholder democracy. We also recognize that each activist situation is different and that different ways exist for activists to engage with companies. While SSGA does not have a view on settlements versus other models of activist engagement, we do want boards to address issues in agreements that could affect the interests of long-term investors. Proxy contests, though often protracted and costly (and can pose reputational risk), give long-term investors and other market participants an opportunity to provide their views on long-term strategy, capital allocation and corporate governance issues such as board composition. By contrast, when companies quickly enter into settlement agreements with activist investors, long-term shareholders often do not have a voice.

For these reasons, we are concerned with the recent rise of settlement agreements entered into rapidly between boards and activist investors. Over the past three years, companies have conceded a steadily increasing number of board seats to activists through settlement agreements. Data on activist campaigns targeting companies with market capitalizations above $500M show that as of August 2016, 49 companies had conceded 104 board seats to activists, almost on par with the 106 seats conceded by 54 companies in all of 2015.[2] When reviewed in the context of total new director appointments at companies with similar market capitalizations, board seats conceded to activists account for approximately 13% of the 816 new board appointments[3] so far in 2016. Moreover, less than 10% of board seats that were conceded in 2015 and 2016 were through a proxy contest.[2] Most seats were conceded by companies in settlement agreements; by contrast, in 2014, 34% of seats were conceded through proxy contests.[2]

At SSGA, while we recognize that negotiated settlements between companies and activists might benefit boards and management by reducing time, expense and reputation risk, we are concerned that in some cases these settlements are being reached too quickly and without any input from other shareholders.

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Activist Strategies Often Focused on the Short-Term

We have researched the actions of 13 of the largest activist investors in 89 companies over the past 3 years and found that strategies pursued by activist investors differ by activist and from company to company. SSGA has identified certain actions as potential red flags for long-term investors as they raise questions about the motivations behind the actions and potential implications for sustainable value creation. These include:

- Significantly increasing CEO pay without explanation
- Changing pay drivers in C-Suite compensation plans by incorporating earnings per share (EPS) as the primary determinant of CEO compensation, which we believe can overly focus management on short-term stock performance and often favors activities such as share buybacks over allocating capital for the long-term
- Focusing on financial engineering such as share buybacks, leveraged dividends, spin-offs and M&A, which could add value in the short-term but may also undermine long-term value

Each of these practices can have a lasting impact on a company's corporate governance and business strategy. Given that passive index investors will continue to hold the stock after many activist investors have exited, the interests of long-term shareholders must be considered by boards at the time of negotiating settlements with activists.

Protecting Long-Term Shareholders in Settlement Agreements

Recognizing that settlements are increasingly the outcome of engagements between companies and some activists, SSGA desires that boards identify and address issues in agreements that could affect the interests of long-term investors. We reviewed key settlement terms commonly included in agreements between companies and activists and found that while these agreements usually protect the board and management, they can fail to adequately consider the interests of long-term shareholders. In particular, we identified the following issues:

- **Duration of Settlement Agreements** Typical settlement agreements range from six to eighteen months and are designed to prevent activists from publicly airing their concerns in return for board seats.[4] If there is value for companies to concede board seats and change the profile of the board, we ask boards to consider whether the agreements should be entered into for longer periods. By simply lengthening the time horizon of the agreement, both companies and activists will be more sensitive to long-term factors and incorporate these into the settlement terms and strategic actions.
- **Time Period for Holding Shares** Few agreements explicitly require activist investors or their director nominees to continue owning shares for a stated period after receiving board seats. Instead, agreements are typically designed to prevent activists from increasing their stake in the company above a certain threshold during the agreement period.[4] Alternatively, if settlement agreements are designed to appropriately consider and align the interests of activist investors with those of long-term shareholders, boards would be less concerned about preventing activists from increasing ownership levels and would instead value the activist's investment and commitment to the company. SSGA believes that an activist firm should be required to hold its shares for long periods from the date of the settlement to align them with longer-termed shareholders.
- **Minimum Ownership Thresholds or Director Resignation Requirements for Board Representation** Typical agreements allow activists to reduce their stake to 1–2% below ownership levels at the time of settlement.[4] SSGA would like agreements to specify minimum ownership levels for longer periods in exchange for any board representation. Further, we believe that companies should require directors who are affiliated or not fully independent of the activists to tender their resignation if the activist investor's ownership in the company falls below a minimum threshold. Recognizing that effective directors are valuable, boards can nominate these same directors to stand for re-election after tendering their resignation. This will ensure that a clean break occurs between activist firms and independent directors identified by the activist.
- **Risk to Share Prices from the Pledging of Activist Shareholdings** SSGA found that activist investors who own a considerable stake in target companies often pledge a significant portion of their stake in margin accounts. While settlement agreements limit an activist's ability to engage in short sales, there are no restrictions on the pledging of shares. We believe this could create perverse incentives for the activist firm, which could result in their director nominees pursuing aggressive strategies to maintain share prices in the short-term. SSGA believes that boards should evaluate carefully the pledging practices of activists and develop robust mechanisms to oversee and mitigate any potential risk from the pledge positions to the stock price.

Engagement and Proxy Voting Implications

Given the increasing prevalence of settlement agreements in activist situations, it is important for long-term shareholder interests to be considered in these agreements. Consequently, we believe companies and boards should require settlement terms that promote the interests of all shareholders and consider safeguards that protect long-term investors. We also believe that long-term owners, boards and activists should debate and together develop principles that protect the interests of long-term shareholders in settlement agreements.

Going forward, to help inform our voting decisions on the election of directors in activist situations, SSGA will assess settlement agreements according to how they address these issues. Further, we will engage with companies that pursue unplanned financial engineering strategies within a year of entering into a settlement with an activist to better understand the reasoning behind the strategic change. Finally, we call on boards to view passive investors as long-term partners and to communicate how the company's strategies, including their engagement with activists and board seat concessions, help create sustainable long-term value for all shareholders.

Please direct any questions or comments regarding this guidance to Rakhi Kumar, Managing Director and Head of ESG Investments and Asset Stewardship, at Rakhi_Kumar@SSGA.com

[1] An individual or group that purchases large numbers of a public company's shares and/or tries to obtain seats on the company's board with the goal of effecting a major change in the company, Investopedia.

[2] Data provided by Lazard's Board Preparedness Group as of August 19, 2016.

[3] Data provided by Institutional Shareholder Services as of August 31, 2016.

[4] Source: SSGA Governance Team.

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