

Protecting Long-Term Shareholder Interests In Activist Engagements

- **State Street Global Advisors 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, State Street Global Advisors' 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, 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, State Street Global Advisors 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 State Street Global Advisors 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 continued rise of settlement agreements entered into rapidly between boards and activist investors. In 2018, record highs in campaign activity and board seats gained were set with 247 campaigns initiated and 161 board seats gained by activists. Of these board seats gained, an increasing number are being conceded by companies through settlement agreements. Over a three year period from 2016–2018, 84% of board seats gained by activists were conceded through settlement agreements; a 15% increase over the 2013–2015 period levels, where 73% of seats were conceded through settlement agreements.^{2,3}

At State Street Global Advisors, 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.

Activist Strategies Often Focused on the Short-Term

We have researched the actions of 13 of the largest activist investors in 89 companies over recent years and found that strategies pursued by activist investors differ by activist and from company to company. State Street Global Advisors 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 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, State Street Global Advisors' encourages boards to 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. State Street Global Advisors 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 State Street Global Advisors 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** State Street Global Advisors 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. State Street Global Advisors 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, State Street Global Advisors 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 index 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 Benjamin Colton, Global Co-Head of Asset Stewardship, at Benjamin.Colton@ssga.com.

Endnotes

- 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 is reflective of on activist campaigns targeting companies with market capitalizations above \$500M.
- 3 Lazard's Shareholder Advisory Group. 2018 Review of Shareholder Activism, January 2019.
- 4 Source: State Street Global Advisors.

About State Street Global Advisors

Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals we live our guiding principles each and every day:

- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 27 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's third-largest asset manager with US \$3.12 trillion* under our care.

* AUM reflects approximately \$43.72 billion USD (as of December 31, 2019), with respect to which State Street Global Advisors Funds Distributors, LLC (SSGA FD) serves as marketing agent; SSGA FD and State Street Global Advisors are affiliated.

ssga.com

State Street Global Advisors Worldwide Entities

Abu Dhabi: State Street Global Advisors Limited, Middle East Branch, 42801, 28, Al Khatem Tower, Abu Dhabi Global Market Square, Al Maryah Island, Abu Dhabi, United Arab Emirates. Regulated by ADGM Financial Services Regulatory Authority. T: +971 2 245 9000.

Australia: State Street Global Advisors, Australia Services Limited (ABN 16 108 671 441) (AFSL Number 274900) ("SSGA, ASL"). Registered office: Level 15, 420 George Street, Sydney, NSW 2000, Australia. T: 612 9240-7600. F: 612 9240-7611.

Belgium: State Street Global Advisors Belgium, Chaussée de La Hulpe 120, 1000 Brussels, Belgium. T: 32 2 663 2036. F: 32 2 672 2077. SSGA Belgium is a branch office of State Street Global Advisors Ireland Limited.

Canada: State Street Global Advisors, Ltd., 1981 McGill College Avenue, Suite 500, Montreal, Quebec, H3A 3A8, T: +514 282 2400 and 30 Adelaide Street East Suite 800, Toronto, Ontario M5C 3G6. T: +647 775 5900.

Dubai: State Street Global Advisors Limited, DIFC Branch, Central Park Towers, Suite 15-38 (15th floor), P.O. Box 26838, Dubai International Financial Centre (DIFC), Dubai, United Arab Emirates. Regulated by the Dubai Financial Services Authority (DFSA). T: +971 (0)4-4372800. F: +971 (0)4-4372818.

France: State Street Global Advisors Ireland Limited, Paris branch is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with

company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Ireland Limited, Paris Branch, is registered in France with company number RCS Nanterre 832 734 602 and whose office is at Immeuble Défense Plaza, 23-25 rue Delarivière-Lefoullon, 92064 Paris La Défense Cedex, France. T: (+33) 1 44 45 40 00. F: (+33) 1 44 45 41 92.

Germany: State Street Global Advisors GmbH, Briener Strasse 59, D-80333 Munich. Authorised and regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin"). Registered with the Register of Commerce Munich HRB 121381. T: +49 (0)89-55878-400. F: +49 (0)89-55878-440.

Hong Kong: State Street Global Advisors Asia Limited, 68/F, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. T: +852 2103-0288. F: +852 2103-0200.

Ireland: State Street Global Advisors Ireland Limited is regulated by the Central Bank of Ireland. Registered office address 78 Sir John Rogerson's Quay, Dublin 2. Registered number 145221. T: +353 (0)1 776 3000. F: +353 (0)1 776 3300.

Italy: State Street Global Advisors Ireland Limited, Milan Branch (Sede Secondaria di Milano) is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2.

State Street Global Advisors Ireland Limited (Sede Secondaria di Milano), is registered in Italy with company number 10495250960 - R.E.A. 2535585 and VAT number 10495250960 and whose office is at Via Ferrante Aporti, 10 - 20125 Milano, Italy. T: +39 02 32066 100. F: +39 02 32066 155.

Japan: State Street Global Advisors (Japan) Co., Ltd., Toranomon Hills Mori Tower 25F

1-23-1 Toranomon, Minato-ku, Tokyo 105-6325 Japan. T: +81-3-4530-7380 Financial Instruments Business Operator, Kanto Local Financial Bureau (Kinsho #345), Membership: Japan Investment Advisers Association, The Investment Trust Association, Japan, Japan Securities Dealers' Association.

Netherlands: State Street Global Advisors Netherlands, Apollo Building, 7th floor Herikerbergweg 29 1101 CN Amsterdam, Netherlands. T: 31 20 7181701. SSGA Netherlands is a branch office of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2.

Singapore: State Street Global Advisors Singapore Limited, 168, Robinson Road, #33-01 Capital Tower, Singapore 068912 (Company Reg. No: 200002719D), regulated by the Monetary Authority of Singapore). T: +65 6826-7555. F: +65 6826-7501.

Switzerland: State Street Global Advisors AG, Beethovenstr. 19, CH-8027 Zurich. Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-105.078.458. T: +41 (0)44 245 70 00. F: +41 (0)44 245 70 16.

United Kingdom: State Street Global Advisors Limited. Authorised and regulated by the Financial Conduct Authority, Registered in England. Registered No. 2509928. VAT No. 5776591 81. Registered office: 20 Churchill Place, Canary Wharf, London, E14 5HJ. T: 020 3395 6000. F: 020 3395 6350.

United States: State Street Global Advisors, One Iron Street, Boston, MA 02210-1641. T: +1 617 786 3000.

The views expressed in this material are the views of Rakhi Kumar through the period ended September 30, 2016 and are subject to change based on market and other conditions. This

document contains certain statements that may be deemed forward looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected.

The information provided does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. You should consult your tax and financial advisor. All material has been obtained from sources believed to be reliable. There is no representation or warranty as to the accuracy of the information and State Street shall have no liability for decisions based on such information.

All information has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information and it should not be relied on as such.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without State Street Global Advisors' express written consent.

© 2020 State Street Corporation. All Rights Reserved. ID186508-2399523.2.1.GBL.RTL 0320 Exp. Date: 04/30/2021