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Is Activism Moving In-House

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In large measure, institutional investors, particularly the passive indexers, have outsourced oversight of their portfolios to ISS and Glass Lewis and for much of the past decade to activist hedge funds. The result has been enormous profits for activist hedge funds that have attracted investments of more than $200 billion and are now considered an asset class for investment purposes. Concomitantly, in order to lower their profile to activists trolling for targets, virtually every public company has followed the advice to "manage like an activist" and reduced capital expenditures, research and development, employee training and employment. Activism has become a very significant drag on the economy and a threat to the long-term health of the Nation.

Lately several of the major institutions have recognized that while an activist attack on a company might produce an **increase** in the market price of one portfolio investment, the defensive reaction of the other hundreds or thousands of companies in the portfolio, that have been advised to "manage like an activist", has the potential of lower market prices for a large percentage of those companies and a net large **decrease** in the total value of the portfolio over the long term. Laurence Fink, CEO of BlackRock, the world's largest money manager, in a recent letter to S&P 500 CEOs said, "More and more corporate leaders have responded with actions that can deliver immediate returns to shareholders, such as buybacks or dividend increases, while underinvesting in innovation, skilled workforces or essential capital expenditures necessary to sustain long-term growth." Similarly, in a recent speech William McNabb, CEO of Vanguard said, "And, remember, when it comes to our indexed offerings, we are permanent shareholders. To borrow a phrase from Warren Buffet: "Our favorite holding period is forever. We're going to hold your stock when you hit your quarterly earnings target. And we'll hold it when you don't. We're going to hold your stock if we like you. And if we don't. We're going to hold your stock when everyone else is piling in. And when everyone else is running for the exits. In other words, we're big, we don't make a lot of noise, and we're focused on the long term. That is *precisely* why we care so much about good governance. Vanguard funds hold companies in perpetuity. We want to see our investments grow over the long-term. We're not interested in managing the companies that we invest in. But we do want to provide oversight and input to the board of directors. And we count on boards to oversee management."

BlackRock and Vanguard and a number of other major institutions are saying that their support for the long-term plans of a company and their support of its management against activist attacks are conditioned on satisfaction, (1) that the long-term plans have been carefully considered and are understood by the directors, (2) with the company's corporate governance, (3) with the expertise and independence of the directors, (4) with their ability to engage directly with the directors, (5) with frequency and quality of regular evaluation of the performance of the directors and (6) that compensation is tied to performance and total shareholder return. See the attached memo, "Some Lessons from BlackRock, Vanguard and DuPont—A New Paradigm for Governance".

Essentially, DuPont's defeat of Trian Partners' proxy fight to replace four DuPont directors reflects these conditions and is being viewed as confirmation that a well-managed corporation executing a clearly articulated business strategy will have institutional investor support and can prevail against an activist, even when the major proxy advisory services (ISS and Glass Lewis) support the activist. The following lessons from the DuPont-Trian proxy fight, together with the recently announced policies of institutional investors to support the well-conceived business plans of companies that meet their governance standards, indicate a new paradigm for portfolio oversight by these institutions.

Challenges of a Proxy Fight with an Activist. Each proxy contest is unique. For many companies, the risks and potential harm from a public proxy contest may lead the company to consider a negotiated resolution, especially when faced with the likely support of the activist by the proxy advisory services. The issues, tactics, team and approaches to an activist challenge will vary depending on the company, the industry, the activist and the substantive business and governance issues at play, among other factors. For those companies that decide a negotiated resolution is not warranted, or is not achievable on acceptable terms, the ability to wage an effective campaign will depend on advance preparation and actions as outlined in the attached memo, "Dealing with Activist Hedge Funds". The fact that DuPont, a leading American company with a distinguished board and management, a strong track record and a long history of world-class innovation won only by a close vote after a long fight in the face of contrary recommendations from the major proxy advisory services underscores the challenges faced by all companies dealing with activists in the current environment and the critical importance of having the support of the investors who have embraced the new paradigm. Below are the other key takeaways from DuPont-Trian.

Substantive Business Change. DuPont's own value-creating initiatives proved to be a central pillar of its successful defense. Instead of letting Trian define DuPont as defending the status quo, the company demonstrated active management of its business portfolio, accelerated its cost-cutting plans, articulated a disciplined approach to research and development investment, increased return of capital through dividends and share buybacks, and made other productivity and business enhancements. As CEO Ellen Kullman argued, "We have been agents of change. We have restructured. . . . we've got momentum. We are transforming." While Trian sought to take credit for these steps, in reality the company's own board and management was able to show that DuPont moved decisively to execute business and strategic initiatives.

Board Refreshment and Director Involvement. DuPont effectively wielded board change as an offensive tactic, adding two new "super star" directors with relevant expertise (Edward Breen and James Gallogly) to its distinguished board. In addition, the independent directors, alongside the CEO and senior management, tirelessly advocated personally for their vision of DuPont, explained why they had earned—and deserved—the trust and confidence of shareholders and why supporting Trian would result in losing valuable expertise on the board. In large measure the vote can be viewed as an endorsement by the shareholders of CEO Ellen Kullman and the DuPont board as more likely to successfully lead the company than Nelson Peltz and the Trian nominees.

Tying the Campaign to Broader Themes and Securing Influential Third-Party Support. DuPont successfully argued that the excesses of shareholder activism contribute to short-term pressures that undermine economic growth, real innovation and sustained employment, and hinder prudent reinvestment of corporate profits into research and development and other value-creating initiatives. Harvard Professor William George's article, "The DuPont Proxy Contest Is a Battle for the Soul of American Capitalism" made the stakes clear.

Finding Stockholder Champions. Through close and effective engagement, DuPont secured the public, pre-vote support of respected and influential stockholders such as CalPERs and the Canada Pension Plan Investment Board. Anne Simpson, CalPERs' Director of Corporate Governance and Senior Portfolio Manager, Investments, went on record criticizing the activist's thesis as "relatively short term" and expressing concern about "cost cutting which would reduce research and development."

Communicating Effectively with Institutional Investors and Governance and Voting Professionals. DuPont took its case directly to the traditionally "passive" investors and to governance and voting professionals. In doing so, DuPont's executives and independent directors emphasized the unique needs of a global science company in the midst of strategic transformation and proof of outperformance, as well as DuPont's good governance and board practices, effective oversight by independent directors, proven commitment to long-term value creation, aligned executive compensation, and its sustainability and corporate citizenship initiatives.

Communication Tools and Media. Messaging by DuPont included a dedicated campaign website, videos from the CEO and the Lead Director, targeted advertisements, effective use of national, local, and industry press, tailored proxy materials and investor presentations and CEO participation in interviews and magazine profiles with leading publications.

Setting the Record Straight. In the face of frequent "white papers" and aggressive critiques from Trian, DuPont responded comprehensively and in real-time using a variety of methods. These included timely infographics, rebuttals, presentations and letters that presented objective evidence of the company's strong performance and exposed misleading and incomplete claims and analyses by Trian. DuPont also cultivated sell-side analysts effectively.

Engaging with the Activist and Carefully Considering its Ideas. Nearly two years of engagement between DuPont and Trian enabled the company to fully evaluate the activist's proposals. It also allowed DuPont to demonstrate that it was genuinely open to engagement (including settlement possibilities) and to considering new ideas. But once the board concluded that at least some of the recommendations were ill-advised and that fundamental disagreements on business strategy made a settlement on the terms sought by the activist unacceptable, the company relentlessly made its case for why it would not adopt what it considered a "value-destructive, high-risk" agenda to "break up DuPont, burden it with excessive debt and destroy value."

Targeting the Retail Vote. The very high percentage (over 30%) of shares held by retail shareholders, including some former employees, made retail vote turnout a top priority; DuPont used a variety of creative methods to reach this constituency.

Maintaining Employee Morale and Staying Focused on the Business. Every constituency matters in a proxy contest, and DuPont went to great efforts to preserve the focus and loyalty of its employees using employee-specific messaging and other methods. In addition, DuPont worked hard to minimize the distraction of a proxy fight and to preserve management's focus on business execution.

Investing in Innovation. Activist attacks against research and development and other capital expenditures targeted at innovation have increased. Effectively explaining why research and development matters and why a company's board and management can be trusted to be thoughtful and objective regarding research and development-focused investment remains critical for science and technology companies.

Another part of BlackRock CEO Laurence Fink's message is worth keeping in mind: "It is critical, however, to understand that corporate leaders' duty of care and loyalty is not to every investor or trader who owns their companies' shares at any moment in time, but to the company and its long-term owners. Successfully fulfilling that duty requires that corporate leaders engage with a company's long-term providers of capital; that they resist the pressure of short-term shareholders to extract value from the company if it would compromise value creation for long-term owners; and, most importantly, that they clearly and effectively articulate their strategy for sustainable long-term growth. Corporate leaders and their companies who follow this model can expect our support."

As activism moves in-house and the new paradigm becomes pervasive, the influence of the hedge fund activists and ISS and Glass Lewis will shrink. It will be replaced by the policies, evaluations and decisions of the major institutions. While this will be a welcome relief from the short-termism imposed by the hedge fund activists, it raises a new fundamental question—how will the institutions use their power? In an article in "Fortune" discussing the ramifications of the outcome of the DuPont-Trian proxy fight, Ram Charan posed the cogent question: "As the biggest asset managers gain more power and exercise it more freely, they bear a heavy responsibility. They may influence employment, national competiveness, and economic policy for better or for worse. They can ensure a balance between short-term and long-term corporate goals, and between value creation and societal needs. They can keep succession planning near the top of every company's agenda. How they will discharge their responsibility remains to be seen, but we know that the Fortune 500 have entered a new era." I'm more comfortable that the influence of the major institutions will be more favorable to the Nation's economy and society than the self-seeking personal greed of the hedge fund activists.