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The Mainstreaming of Shareholder Activism in 2013

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The 2013 proxy season was in many ways unremarkable, yet in important respects it illustrates the developing nature of shareholder activism in our era of corporate governance. The issues in dispute, the voting results, and the overall trends were not significantly different from those in recent years. Nonetheless, there is an important takeaway from the 2013 season: Shareholder activism has gone from fringe to mainstream. While individual gadflies and labor union pension funds are still the most prolific sponsors of shareholder proposals,[1] some elements of their agendas have begun to find support among traditional investors.

Not too long ago, large, profitable corporations were considered immune from economically-motivated activist attacks, and activism was not central to the agendas of establishment players in the corporate arena. In 2013, it became clear that even household-name companies with best-in-class corporate governance and rising share prices are liable to find themselves under siege from shareholder activists, often represented by well-regarded investment banks, law firms, public relations firms and other advisors. Even some academics praise shareholder activists' latest exploits. Shareholder activism, in its latest incarnation, is no longer a series of isolated approaches and attacks; instead, it is an environment of constant scrutiny and appraisal requiring ongoing monitoring, awareness and engagement by public companies. Proxy statement disclosures are an important tool in shareholder engagement and have been a focal point for companies in the 2013 season. In particular, companies successfully enhanced their proxy disclosures regarding executive compensation, shareholder outreach efforts, the qualifications, expertise and diversity of their board members, and audit committee reports.[2] Companies also have been successful at communicating with investors throughout the year to minimize conflict during the proxy season. Some major institutional investors have established in-house proxy departments to engage directly with corporations and make voting decisions without relying on the recommendations of proxy advisory firms.

There are two primary types of shareholder activism. The first is corporate governance-related activism that centers on issues such as board structure, takeover defenses, compensation, and political, social and environmental concerns.[3] The second might be called strategy-related or economically-motivated activism, frequently associated with hedge funds—sometimes viewed as the modern-day corporate raiders—and it aims to fundamentally alter the destiny of a corporation by, for example, replacing one or more directors or ousting senior management, with the intent to create short-term gains by returning capital to shareholders, causing the disposition of major assets through a sale or spin-off or instigating the sale of the entire corporation. Shareholder activism in both of these forms has been growing over the last decade, and both were prominent in the 2013 proxy season.

2013 PROXY SEASON RESULTS

In 2013, shareholder proposals increased slightly overall for the second year in a row, and proposals made by hedge funds also increased slightly after a decline in 2012.[4] The number of corporate governance-related proposals represented a smaller share of the total this year, due in part to the fact that so many companies have, in recent years, taken steps such as instituting majority voting, declassifying their boards of directors, eliminating takeover defenses and splitting the roles of chairman and chief executive officer.[5] According to recent statistics, only 7 percent of S&P 500 companies have a poison pill in place, 15 percent have a classified board, and 8 percent have not adopted a majority or plurality-plus vote standard to elect directors.[6]

Board leadership structure remains a hot topic, however; more proposals were submitted to separate the chairman/CEO roles this year than ever before, though the levels of support for the proposals that went to a vote were lower than in recent years.[7] It is possible that the successful model of independent lead or presiding directors has taken some of the steam out of proposals to separate the two roles.[8] Board declassification proposals represented over 11 percent of the total number of corporate governance proposals submitted at Russell 3000 companies this year, as opposed to over 14 percent in 2012.[9] The primary driver of board declassification proposals was the Shareholder Rights Project, operated by Harvard Law School. Now in its second year, the Shareholder Rights Project reportedly works with seven large pension funds and a foundation to sponsor governance proposals at companies whose shares are owned by the funds and the foundation.[10] These proposals received, on average, nearly 80 percent support, slightly lower than last year's level but still the most widely endorsed proposal across ownership types.[11] In light of the proposals' popularity and the potential negative consequences of the failure to declassify a board following a majority vote, at least 35 companies agreed to declassify after being approached by the Shareholder Rights Project this year. Overall, management at more than 70 companies sponsored declassification proposals on their own initiative in 2013, presumably to forestall critical attention from shareholders.[12] It also appears that governance activists are starting to target smaller companies, which tend to have fewer resources available to resist the pressure from activists than their larger brethren.

There was a noticeable increase in the number of proposals relating to executive compensation, as proponents focused on specific pay practices such as tax gross-ups, death benefit payments, and severance agreements, and support for compensation-related proposals on these three topics averaged above 35 percent.[13] There was also an increase in proposals on social and environmental policy issues, as well as in proposals on political spending and lobbying. Support in each of these categories hovered around 20 percent, though in recent years many of these proposals have seen a steady, albeit small, increase in favorable votes.[14]

Companies sought more no-action requests this year from the Securities and Exchange Commission (SEC) to exclude shareholder proposals, yet the percentage of exclusions granted was lower as shareholders carefully crafted their proposals in accordance with prior SEC responses and comments.[15] On the other hand, the percentage of proposals that were withdrawn rose significantly, perhaps due to increased engagement and accommodation on the part of both companies and activists.[16] Increased outreach and communication were also crucial for companies attempting to turn around failed say-on-pay votes from last season. Sixty companies experienced failed management say-on-pay votes in 2012; of the 48 that had held their votes by July 31, 39 had obtained shareholder approval.[17] Nearly all of the 39 successful companies specifically mentioned shareholder outreach in their proxy statements, and many gave detailed descriptions of the extent of their communications efforts.[18]

The number of proxy contests rose significantly this year, from 24 in 2012 to 35 in 2013 for the Russell 3000 companies.[19] Notably, large companies were among the targets. Fourteen of the 35 companies had market capitalizations of over $1 billion at the time the proxy contests were announced.[20] Overall, large companies received a disproportionately high percentage of shareholder proposals this year, particularly regarding executive compensation and social and environmental policy issues.[21] Institutional investors such as mutual funds that in the past typically did not participate in activism and proxy fights now are taking a more active role, which has emboldened activists to launch campaigns directed at large and prosperous corporations.[22]

One target was Walt Disney, which reported high profits and completed a successful major acquisition in the past financial year. The company’s success was rewarded not with deference but with an activist-led attempt to separate chief executive Bob Iger from his role as chairman of the board. Though the initiative was defeated, it was a sign of the times that such a vigorous campaign would be waged against the governance structure of a company that, by all metrics, had a terrific year.[23] No company is immune in the current environment, though it is still true that weak performance makes companies more likely to capitulate to activist demands.

DECLINING RELIANCE ON PROXY ADVISORS

Two recent developments illustrating the changing nature of shareholder activism are the declining influence of proxy advisory firms and the establishment of in-house proxy departments at large investment funds.

There are two significant proxy advisory firms, Glass Lewis and Institutional Shareholder Services (ISS), and their recommendations have been powerful forces in influencing corporate behavior and voting results. Companies try very hard to avoid a negative recommendation from these two advisors, both for the sake of their upcoming vote and because of the unpleasant publicity it would generate. In the last decade, the influence of proxy advisory firms has increased. One factor has been the steadily growing emphasis on corporate governance ever since the fall of Enron and the adoption of the Sarbanes-Oxley Act of 2002. Another factor is the SEC's 2003 rule, designed to minimize potential conflicts of interest, that—along with no-action letters that followed—effectively created a safe harbor for fund managers who, in accordance with pre-determined policy, relied upon the proxy voting recommendations of a third party.[24] This past July, SEC Commissioner Daniel Gallagher expressed concern about the influence wielded by proxy advisory firms and lamented the SEC's role as "a significant enabler" of the tendency of institutional investment advisers to "view their responsibility to vote on proxy matters with more of a compliance mindset than a fiduciary mindset."[25] He indicated that the SEC should issue Commission-level guidance (as opposed to staff no-action letters) "clarifying to institutional investors that they need to take responsibility for their voting decisions rather than engaging in rote reliance on proxy advisory firm recommendations[.]"[26] The Commissioner's view is a sensible one, and the release of Commission guidance as he describes would, in our view, be a modest yet highly beneficial reform.

Similarly, the Canadian Securities Administrators (CSA), an umbrella organization of Canada's provincial and territorial securities regulators, recently issued an update on their ongoing, consultative process concerning possible regulation of proxy advisory firms.[27] The CSA has been concerned—like SEC Commissioner Gallagher—that proxy advisory firms have, to an alarming extent, effectively imposed uniform and somewhat arbitrary corporate governance standards on companies through investors' over-reliance on proxy advisors' voting recommendations.[28] Following feedback from market participants on the impact proxy advisors are having on the integrity of Canadian capital markets and whether a response from the CSA was even necessary, the CSA has concluded that a response from Canadian securities regulators is indeed warranted. The CSA expects to develop a policy-based regulatory approach that would "promote transparency and understanding" and provide guidance on recommended practices and disclosure. The CSA's proposed approach is expected to be published for comment in the first quarter of 2014.

Yet even as the SEC takes note of proxy advisory firms' heretofore outsize influence, the power of Glass Lewis and ISS seems to be waning, at least slightly. With respect to say on pay votes, for example, 261 companies received negative ISS recommendations in 2013, yet only 18 percent failed to win majority approval.[29] Moreover, in a highly anticipated and hotly contested battle, JPMorgan Chase succeeded in defeating an activist proposal for an independent board chair, for the second year in a row. Despite the recommendations of both major proxy advisory firms, the proposal received only slightly more than 30 percent of votes at the 2013 annual meeting, prompting a Glass Lewis executive to comment: "Our power is probably shrinking a bit."[30] While in 2012 100 companies reacted to negative vote recommendations from proxy advisors by filing supplemental materials, in 2013 only 59 companies did so.[31] Supplemental filings can be useful in certain circumstances, but the significant drop may be one more indication that proxy advisors' vote recommendations are viewed by companies as less influential than they have been in recent years.

More significant than the results of any individual vote campaign, however, is the fact that major investors are internalizing the function of proxy analysis and vote determinations. In 2012, BlackRock—which manages nearly $4 trillion and is the world's largest asset manager—sent a letter to the leadership of 600 U.S. public companies encouraging them to engage directly with the asset manager.[32] BlackRock had been frustrated that companies typically did not reach out to communicate regarding upcoming votes, perhaps because of an assumption that BlackRock would simply follow the recommendations of the major proxy advisors. Not so, BlackRock's chief executive wrote in the letter:

> We reach our voting decisions independently of proxy advisory firms on the basis of guidelines that reflect our perspective as a fiduciary investor with responsibilities to protect the economic interests of our clients.[33]

BlackRock has, through its voting decisions, demonstrated that its policies on certain governance issues differ from those of Glass Lewis and ISS. While BlackRock has never sponsored a shareholder proposal, it engages actively with companies to work through contentious issues. According to the top corporate governance executive at BlackRock, "the firm generally votes against a director or a company proposal only when a behind-the-scenes 'engagement' has failed."[34]

The actions by investment funds to voluntarily assume more of the responsibility that had been outsourced to proxy advisory funds is exactly what Commissioner Gallagher hopes to promote through the prospective guidance he outlined in his July speech. He stated that institutional investors should be "actively researching the proposals before them and ensuring that their votes further their clients' interests" and implied that indeed, their fiduciary duties require them to undertake these tasks.35 Though many institutional investors have been performing this function internally for years, merely supplementing their own policies and research with those of proxy advisory firms, the highly public communication from

BlackRock is meaningful.[36] It is a step toward returning proxy advisory firms to their proper role—as advisors, not dictators—and it is a step toward increasing the engagement between investors and companies and making dialogue the first step in any "activist" agenda. At a certain point, some forms of shareholder engagement may start looking less like a nuisance and more like a beneficial, dynamic relationship between investors and corporations.

SHAREHOLDER ACTIVISM'S FUTURE

One communications expert noted recently that:

> Funds engaged in activism have matured, and they are less combative and more responsible in how they approach being activists…. That makes it a lot easier for mainstream, blue-chip companies to be associated with activism.[37]

As activism goes mainstream, it is to be hoped that some of its more objectionable features—such as naked short-termism and one-size-fits-all corporate governance dogma—may be minimized as activist shareholders attempt to make their agendas more palatable to traditional investors.

As a general matter, companies should be wary of implementing changes at the behest of activist shareholders that cannot easily be reversed, such as eliminating a classified board structure. Not only is a classified board a valuable takeover defense, but it also may help companies resist some of the more aggressive activist tactics on the governance side as well. ISS has announced that, beginning in 2014, it will recommend voting against the election of directors at companies that have not fully implemented majority-approved shareholder proposals. (The prior policy, only slightly less aggressive, was that a shareholder proposal had to receive majority approval for two years to trigger a negative vote recommendation against directors.)[38] This sort of extortive policy—a blanket response to a situation with any number of important variables—represents the least thoughtful variety of activism. The policy is not specific enough to further the interests of shareholders of any given company and yet attempts to substitute the judgment of not only shareholders but also proxy advisors for that of the board. Eliminating a classified board structure simply makes directors and public companies more vulnerable to activist campaigns, especially those of the economically motivated variety.

The big question remains: Does shareholder activism help or hurt companies? While this question is still relevant, and by no means settled,[39] for many companies it is becoming a practical question of how companies can engage with major shareholders in order to respond to shareholders' concerns, make the case for the corporate strategy, and avoid capitulation to harmful demands from shareholder activists. Indeed, the value of shareholder engagement has been endorsed in the past year by entities as diverse as the SEC,[40] BlackRock,[41] and ISS,[42] as well as by a host of corporate executives, lawyers and commentators. At the end of the day, this is the practical approach companies are utilizing to attempt to handle a difficult issue in a flawed system.

But in our view, the bottom-line is very clear: If activist pressure—or the threat of activist pressure—causes companies to focus on short-term results, it is bad for companies, shareholders and the American economy as a whole. As Chancellor Strine eloquently noted:

> As a whole, institutional investors have pushed for corporate managers to be highly responsive to the immediate pressures and incentives of the capital markets. The upside of this is that the boards of public corporations have never been more sensitive to what the corporate electorate wants at any given moment. The downside of this, however, is that if the electorate itself does not have the correct incentives and does not push an agenda that appropriately focuses on the long term, the responsiveness of managers to the incentives they face can result in business strategies that involve excessive risk and, perhaps most worrying, underinvestment in future growth.[43]

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Endnotes:

1. See Jackie Cook, "Proxy Season Roundup: Shareholder Resolutions," CookESG Research, July 2013, at 2 available at www.fundvotes.com/downloads/2013 Proxy Season Roundup_Shareholder Resos_CookESG.pdf.

2. See, e.g., Ernst & Young LLP, "Key Developments of the 2013 Proxy Season," June 2013 ("E&Y Report"), at 11, available at www.ey.com/Publication/vwLUAssets/Key_developments_of_the_2013_proxy_season/$FILE/Key-developments-of-the-2013-proxy-season.pdf; see also James D.C. Barrall et al., "Disclosure Lessons from the 2013 Proxy Season," Director Notes, The Conference Board, August 2013 (examines the key disclosure issues and challenges facing companies during the 2013 proxy season and provides examples of company responses to these issues taken from proxy statements filed during the first half of 2013), available at www.conference-board.org/retrievefile.cfm?filename=TCB_DN-V5N17-131.pdf&type=subsite.

3. Thomas Singer, Social Issues in the 2013 Proxy Season, Director Notes, The Conference Board (September 2013) (more than half of the shareholder proposals on social issues submitted at Russell 3000 companies that held meetings during the first half of 2013 went to a vote, constituting 21.1 percent of voted shareholder proposals during the January-June 2013 period, with the vast majority related to political issues, specifically those urging companies to disclose details of their lobbying policies and their total spend on lobbying activities), available at www.conference-board.org/retrievefile.cfm?filename=TCB_DN-V5N19-131.pdf&type=subsite.

4. The Conference Board/FactSet, Proxy Voting Analytics (2009-2013) Executive Summary (PVA 2013 Summary) at 3. The report is based on shareholder meetings held at Russell 3000 and S&P 500 companies and is available at www.conferenceboard.org/proxy2013.

5. See PVA 2013 Summary at 3, 4.

6. See Ning Chiu, "Poison Pill & Declassification Proposals: Bucking the Trend of S&P 500 Companies," DealLawyers.com (Sept. 24, 2013) (statistics from SharkRepellent), available at www.deallawyers.com/Blog/2013/09/poison-pill-declassification-proposals-bucking-the-trend-of-sp-500-companies.html.

7. See "2013 Proxy Season Review: United States," ISS, Aug. 22, 2013 ("ISS 2013 Review") at 26. The ISS report includes data from all U.S. public companies with meeting dates from Jan. 1, 2013 through June 30, 2013. See also PVA 2013 Summary at 6.

8. See E&Y Report at 4.

9. See PVA 2013 Summary at 5.

10. See Gretchen Morgenson, "New Momentum for Change in Corporate Board Elections," NYTimes.com, July 6, 2013, available at www.nytimes.com/2013/07/07/business/new-momentum-for-change-in-corporate-board-elections.html?pagewanted=all.

11. See PVA 2013 Summary at 5.

12. See ISS 2013 Report at 28; PVA 2013 Summary at 5.

13. See PVA 2013 Summary at 5-6.

14. See ISS 2013 Review at 22; PVA 2013Summary at 3-4, 6-7.

15. See PVA 2013 Summary at 4-5.

16. See E&Y Report at 4; see also PVA 2013 Summary at 4.

17. See Georgeson Report, "Facts Behind 2013 'Turnaround' Success for Say on Pay Votes," Aug. 28, 2013, at 1, available at www.georgeson.com/us/resource/Pages/sayonpay.aspx.

18. See id. at 4.

19. See PVA 2013 Summary at 8. The PVA 2013 report notes that in the S&P 500, where proxy fights are less common, the number increased from 2 in 2012 to 5 in 2013.

20. See PVA 2013 Summary at 8.

21. See PVA 2013 Summary at 4.

22. See Brittaney Kiefer, "Shareholder Activism Rising, Big Companies in Crosshairs," PRWeek.com, Sept. 1, 2013, available at www.prweekus.com/shareholder-activism-rising-big-companies-in-crosshairs/article/308954/.

23. See "Corporate Governance: Shareholders at the Gates," The Economist, March 9, 2013, available at www.economist.com/news/business/21573134-americas-proxy-season-will-pit-management-against-owners-never-shareholders.

24. Investment Advisers Act of 1940, Rule 206(4)-6. See also Leo E. Strine Jr., "One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?" Business Lawyer (November 2010) ("The problem of short-termism is also illustrated by the policies of proxy advisory firms whose growth was fueled by the Labor Department's informed voting requirements for regulated investment funds"), available at www.ecgi.org/tcgd/2011/documents/Strine Fundmental Corp Gov Q 2011 Bus L.pdf.

25. SEC Commissioner Daniel Gallagher, Remarks at Society of Corporate Secretaries and Governance Professionals, July 11, 2013 (Gallagher Speech), available at www.sec.gov/News/Speech/Detail/Speech/1370539700301.

26. Id.

27. CSA Notice 25-301, Update on CSA Consultation Paper 25-401, "Potential Regulation of Proxy Advisory Firms," Sept. 19, 2013, available at www.osc.gov.on.ca/en/SecuritiesLaw_csa_20130919_25-301_update-25-401.htm.

28. See CSA Consultation Paper 25-401, "Potential Regulation of Proxy Advisory Firms," June 21, 2012, available at www.osc.gov.on.ca/en/SecuritiesLaw_csa_20120621_25-401_proxy-advisory-firms.htm.

29. See Ted Allen, "A Review of the 2013 U.S. Proxy Season," IR Update, September 2013, at 17.

30. See Robert A. Profusek, "2013 Proxy Season: A Turning Tide in Corporate Governance?" Harvard Law School Forum on Corporate Governance and Financial Regulation, Aug. 23, 2013, available at blogs.law.harvard.edu/corpgov/2013/08/23/2013-proxy-season-a-turning-tide-in-corporate-governance/.

31. See Allen, supra.

32. See Suzanne Craig, "The Giant of Shareholders, Quietly Stirring," NYTimes.com, May 18, 2013, available at www.nytimes.com/2013/05/19/business/blackrock-a-shareholding-giant-is-quietly-stirring.html?pagewanted=all.

33. Id.

34. Id.

35. See Gallagher Speech, supra.

36. See Profusek, supra.

37. See Kiefer, supra.

38. See Allen, supra, at 20-21.

39. See, e.g., Martin Lipton, "The Bebchuk Syllogism," Harvard Law School Forum on Corporate Governance and Financial Regulation, Aug. 26, 2013, available at blogs.law.harvard.edu/corpgov/2013/08/26/the-bebchuk-syllogism/.

40. See Gallagher Speech, supra.

41. See Craig, supra.

42. See ISS 2013 Review at 38.

43. Leo E. Strine Jr., "One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?" Business Lawyer (November 2010), available at www.ecgi.org/tcgd/2011/documents/Strine Fundmental Corp Gov Q 2011 Bus L.pdf.