2000 – 2021
21 Years
2000 – 2021

GOVERNANCE

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The crisis in governance

‘Nevertheless, toothless enforcement against the company directors responsible for scandals and bother still looks likely to remain the order of the day and plague the future nearly as much as it does the present.’

Gerry Brown

Overseeing cyber risk at board level

‘Measuring what matters is key. Directors should ask management about the metrics used to identify and manage risk. By measuring the right things, and having adequate governance attention, corporations can better manage their risk environment.’

Roberta Sydney

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Activism: mind the governance

Luca Giacolone looks at what boards should be doing to lessen the likelihood of being the target of an activist investor.

Introduction

Shareholder activism has evolved from a mostly US phenomenon to a global one, with numerous companies across the UK, Continental Europe, and Japan being subject to a growing number of investor demands, such as selling non-core assets or improving capital allocation. Moreover, as activist funds have continued to grow and their methods have become more widely accepted by traditional investors, companies of all sizes and in all geographies have become potential targets for activists.

Campaigns focused on ESG issues are also becoming more common, with some activists making them a core part of their campaigns with the aim of leveraging all of the target company's vulnerabilities. The latest example being the campaign at ExxonMobil initiated by newly formed Engine No 1, which is challenging the company's slow transition away from fossil fuels.

This increased activism has often shown a lack of preparedness from boards, who find themselves unable to provide reassuring responses to the well-crafted arguments presented by activists. In 2019 SquareWell Partners undertook a survey to better understand how asset managers evaluate activist situations. The respondents to the survey managed approximately $10.4trn in assets and the results highlighted the changing attitudes toward activism. Eighty-seven per cent of the surveyed asset managers considered activism to be a useful market force.

With the increased reach of activists and their ability to gather support from traditional investors, it is imperative for boards to conduct a continuous assessment of the vulnerabilities of the management teams they oversee. This is even more important given the current environment as shareholders will want to understand the lessons learned from the Covid-19 crisis, such as any gaps identified in the company's risk and crisis management strategy and the board's preparedness to respond. Boards are also expected to emerge with a better view on the quality of the management bench, the resiliency of the business, and what skills and experience might be missing in the boardroom. Board members are likely to be held accountable at companies that are perceived not to have taken the necessary measures to manage the crisis, including the protection of its workforce.

Governance flaws attract activists

Boards should carefully review their corporate governance practices and disclosures to uncover and address any potential weaknesses and try to proactively address some of the gaps, or at least have mitigating factors readily available to communicate. Failure to do so may turn into a 'gift' for a potential activist, who will leverage any governance shortcomings to reinforce calls for change and garner the support of traditional investors. In the 2019 survey, 87% of respondents stated that they would be more likely to support an activist if it would result in governance improvements at the target company.

> 'A board's effectiveness is a key focus area for activists when determining whether to initiate a campaign.'

A board's effectiveness is a key focus area for activists when determining whether to initiate a campaign. Any vulnerabilities surrounding topics, such as board independence, board expertise, diversity, or refreshment, are likely to be picked up by activists and used against the company to weaken, and in some cases break, the trust between the board and its shareholders.

SquareWell Partners' review of CEO changes at the world's largest 500 companies shows that almost one-third of the companies that appointed a new CEO in 2020 had an activist on their shareholder register. The choice of CEO is probably the most critical decision that board members will have to make during their tenure and one that reflects the board's quality the most, whether it be the quality of their succession plans or the strength of the executive remuneration policies they craft. On executive pay specifically, whenever pay is not aligned to performance, most investors take this as a sign that the board is 'captured' by the management team they are expected to oversee.

Action items for boards

Know and engage your shareholders

Activists' stakes tend to be around 5% to 10%, and their success in reaching their objectives will depend on their ability to convince other shareholders. While the receptivity to activists varies among institutional investors, with some being more management friendly, monitoring the shareholder base and, most importantly, conducting regular engagements will ensure that boards hear concerns sooner and prepare accordingly.

When engaging with shareholders, having their elected representative, ie an independent board member, will go a long way in establishing trust. Demands for access to board

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members across all geographies is increasing, the latest example being BlackRock which in its 2021 engagement priorities explicitly calls on companies to provide access to an independent non-exec during their engagement.

Furthermore, meetings should be held not only with portfolio managers but also with stewardship teams, which play an increasingly important role at large institutional investors and often act as final decision-makers when deciding to support an activist or not. As large investors have all developed their own voting policies and rely less on the recommendations of proxy advisors, a good understanding of the preferences of investors will allow the company to be in a position to proactively address any concerns and secure the support of large shareholders in the event of an activist campaign.

‘The worst mistake a board of an underperforming company can do is to be complacent and not provide reassurance that shareholders’ concerns are understood.’

Know your weaknesses and control the narrative

Poor performance calls on boards to outline the actions taken to restore performance and ensure investor confidence in the board and management. The worst mistake a board of an underperforming company can do is to be complacent and not provide reassurance that shareholders’ concerns are understood. A lack of an adequate response from the company may signal to investors that the board does not have a clear vision and in turn increase the validity of an activist’s plan. In the context of the Covid-19 crisis, investors are most likely to raise concerns if the company has significantly underperformed during the pandemic, especially relative to their peers. In this respect, boards should scrutinise their companies’ response to the crisis and ask themselves whether the company has taken the necessary steps to take advantage of any opportunities created by the pandemic, and whether the pandemic has highlighted weaknesses in the company’s business model.

Don’t ignore E & S matters

Covid-19 accelerated investors’ interest in ESG. With record flows into sustainability funds and more investors implementing guidelines on these issues, a company’s approach to ESG should be made a standing agenda item during board meetings. A close monitoring of the ratings provided by ESG research and data providers is key in this instance as they largely influence how investors view a company’s performance on ESG.

In addition to Engine No 1’s campaign against ExxonMobil, which criticises the company’s pace of change in responding to the energy transition, another example of activists integrating environmental and social arguments in their campaigns is provided by Third Point’s campaign against US chipmaker Intel Corporation. In this campaign, Third Point raised questions over Intel’s human capital management due to issues with talent retention.

Board quality and effectiveness

As stated above, any potential governance flaws would be used by activists to call for change at the company. As such, it is fundamental for a board to conduct a regular assessment of its composition, independence, expertise, diversity, and overall effectiveness, vis-à-vis the expectations of its shareholder base. The following questions could serve as a starting point:

- Is the board evaluating whether the company has the right executive leadership in place to navigate a post-Covid world?
- Are there any independence concerns? Does the board have an independent Chair and/or has it appointed a lead independent director?
- Does the board have the right skills to oversee management’s execution of the company’s strategy?
- Are there any concerns with regards to long-tenured directors on the board and have any of them contributed to the decisions driving underperformance? Has the board communicated to investors its approach to board refreshment?
- Do all of the directors have a track record of overseeing good governance practices at the companies they served on or are currently serving in an executive or non-executive role?
- Has a robust board evaluation been conducted in the past year? Are weaknesses being addressed?
- Has the board been responsive to shareholders concerns in the past (including on executive pay-related topics)?

Regardless of the outcome, few boards come out of an activist campaign unharmed. As such, to avoid the time-consuming, costly, and long-lasting reputational harm caused by activist campaigns, boards should accelerate making tough decisions, if necessary, on leadership changes and board composition. Prevention is better than remedy.

Luca Giacolone is an ESG Adviser (Vice President) who started his career as an auditor for PricewaterhouseCoopers (PwC) in Milan, Italy. Most recently he worked as a research analyst at a governance research and data platform company in London, UK. In such role, Luca developed in-depth knowledge of corporate governance issues while providing compliance solutions for issuers and regulators. He holds a Master’s degree in Law and Accounting from the London School of Economics and Political Science.

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