Proxy Advisors and Shareholder Activism

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Proxy Advisors

What are proxy advisors and why do they matter?

- Proxy advisors offer guidance to institutional investors on how to vote at shareholder meetings
  - Some institutional investors robotically follow a proxy advisor's voting recommendation, while others use it as one input in reaching their voting decision
  - Larger institutions are more likely to have their own voting policies, while smaller institutions are more likely to rely on a proxy advisor
- Proxy advisors are important: Studies have shown that a negative vote recommendation from a proxy advisor can result in a proposal getting 13% – 38% less support
- Proxy advisors have outsized influence on setting corporate governance best practices
  - Most significant trends in corporate governance best practices over the past 15+ years are the result of positions taken by proxy advisors
- Proxy advisors continue to move the goalposts on what constitutes a best practice
  - For example, a recent policy change now generally mandates a "withhold" recommendation from directors if, prior to or in connection with a company's public offering, the company or its board adopted bylaw or charter provisions that are materially adverse to shareholder rights (for example, a classified board), or implemented a multi-class capital structure in which the classes have unequal voting rights

Who are the key proxy advisors?

- ISS and Glass Lewis are the two leading proxy advisory firms
- ISS (Institutional Shareholder Services)
  - Leading proxy advisory firm in terms of size and influence
  - Approximately 60% market share
  - More than 1,200 clients: institutions, mutual funds, corporate and public pension funds, hedge funds, college endowments and other ISS followers
  - Many institutions strictly follow ISS recommendations when voting their shares
  - Can typically influence 20 – 30% of the vote at an annual meeting
  - Provides consulting services to companies on a variety of topics, including how to secure a favorable voting recommendation from ISS
  - Owned by Vestar Capital Partners
- Glass Lewis & Co.
  - Many of the largest institutions, mutual funds, index and public pension funds subscribe to Glass Lewis (generally also subscribe to ISS)
  - Approximately 35% market share
  - Can typically influence 10% or more of the vote at an annual meeting
  - Does not provide consulting services
  - Owned by Ontario Teachers' Pension Plan Board and Alberta Investment Management Corp.

Why are there proxy advisors?

- Most shares at public companies are owned by institutional investors
- Institutional investors have obligations under the Investment Advisors Act and ERISA to vote shares in the beneficiaries' best interests and disclose any conflicts
  - Many institutional investors use proxy advisors to help in meeting these obligations
  - The SEC has said that following the recommendation of independent third parties may cleanse an institutional investor's conflict in voting

What do proxy advisors base their recommendations on?

- Both ISS and Glass Lewis publish polices each year that explain how they reach their voting recommendations
- ISS updates its policies based on input from clients, institutional investors, companies, directors and others
  - Fairly public process, with comments solicited each year on draft policy updates
- Glass Lewis updates its policies based on discussions with clients
  - Less transparency in how policies are set than ISS
- Both ISS and Glass Lewis keep copies of their current policies available free of charge on their websites

What is the process for proxy advisors to issue reports on companies?

- Both ISS and Glass Lewis issue their reports 2 – 3 weeks before a company's shareholder meeting
- The reports contain voting recommendations on each proposal being voted on at the meeting and average 10 – 15 pages
- The reports are not publicly available
  - A company can request a free copy of its ISS report from ISS, but must pay for a copy of its Glass Lewis report
  - Reports are available to anyone who subscribes to the proxy advisor, and companies often get copies of their reports through their proxy solicitors
- ISS provides S&P 500 companies with an opportunity to correct errors in their reports (generally 24 – 48 hours prior to release)
- Other companies can correct errors after publication of their report
- In practice, it can be hard to convince a proxy advisor to change its report unless there is a manifest error

What are the key things to understand about proxy advisors?

- Companies must understand both the level of influence that the proxy advisors have in their shareholder base and their thinking on the company's governance practices
  - For example, which proxy advisors are influential at which shareholders? Which shareholders make their own voting decisions?
- Directors should understand the basic governance positions of ISS and Glass Lewis
  - For example, directors should understand why proxy advisors oppose classified boards
- Understand the key differences in the polices of ISS and Glass Lewis
  - Independence
  - Compensation plan formulas

Shareholder Activism

What is “governance activism”?

- Key players: CalPERS, CalSTRS, Council of Institutional Investors, CtW Investment Group, Pension Funds
- Relentless focus on expansion of shareholder rights
- Will often use the Rule 14a-8 process as a way to introduce proposals calling for governance reforms to a shareholder vote
- Evolving governance regime is derived from federal legislation, SEC rulemaking, state corporate legislation, stock exchange rules, shareholder proposals, “best-practice” standards and judicial decisions, principally those of the Delaware Court of Chancery

What is “social issue activism”?

- Key topics:
  - Political contributions and activity
  - Environmental issues (including climate change, energy, other) and sustainability
  - Human rights
  - Board diversity
  - Animal welfare
  - Sexual orientation nondiscrimination/EEO reporting
- Corporate social responsibility is a major concern for companies and boards

What is "financial activism"?

- Generally, financial activists do not seek to take over a company but advocate "value maximizing" activity, often short-term oriented (for example, share repurchases, spin-offs, balance sheet and business strategy adjustments)
- For any specific company, financial activism is not random
  - Activists (other than pre-existing investors) screen companies and invest only after due diligence
- Financial activism is made more effective by governance activism, which eliminates structural defenses
- Financial activists tend not to use the Rule 14a-8 process, preferring instead to take their message directly to shareholders

What usually happens with financial activists?

Build Stake	Apply Pressure	Take Action
• Accumulate initial stake (may include “hidden” economic ownership through derivatives) • Make HSR filing • Continue to build stake • File 13D (once 5% is acquired) or go public even if below 5% • Team up with other like-minded shareholders • Aggressive use of derivatives (“riskless voting”)	• Request meetings with management or the board • Send private letters threatening public action • Issue open letter to the board • Become aggressive with management on analyst calls • Aggressive 13D disclosure • Threaten to agitate against the Board’s preferred strategic alternatives or to vote against board-approved M&A activity • Seek to stir up third party interest and rally other investors (“wolf pack” phenomenon) • Launch litigation to access board materials	• Threaten “withhold vote” campaign • Demand Board seats • Enlist potential director nominees • Submit “non-binding” proposals for shareholder action • Launch short- or full-slate proxy contest • Call a special meeting (if available) • Take action by written consent (if available) • Make public bear hug • Commence tender offer

What is important for a successful financial activism campaign?

- Identification of viable theses for value creation that are substantial in scope and not being pursued with urgency
- How various constituencies—investors, proxy advisory services, media, others—view the issues, including value creation and business strategies
- Lack of responsiveness by the company to growing evidence of investor concerns
  - Concerns can be economic (for example, investors believe the company should return more capital to shareholders, better control costs or sell itself), governance (for example, concerns with "excessive" executive compensation) or both
- Investor frustration on a scale that leads institutions to embrace the activist as a necessary change agent
  - Are major stockholders expressing the same concerns as the activist, or have they in the past?

Do financial activists target newly public companies?

- Yes: Financial activists increasingly are willing to take positions in companies that experience challenges following their IPO, even if insiders hold a dominant position and the company has strong takeover defenses
- Sophisticated financial activists understand that these companies typically explore all avenues to reignite shareholder value creation
- A financial activist may seek to galvanize a sale, even if the company's takeover defenses are strong
  - Even a dual class structure does not insulate a company from financial activism

Is there a way to prepare for financial activism?

- A company must have rigorous oversight of, and accountability for, its strategic plan, corporate performance and value creation alternatives
- The most formidable activists invest substantial time and money, and engage advisers and consultants, to assist in developing their investment ideas
- To counteract this, a similar investment by the company is required, together with a willingness to confront complex business and management issues
- This does not mean managing for the short term: It requires developing the strongest case for the long-term plan—and executing
- Increasingly, directors—with appropriate support from management—need to be directly engaged with investors

Thank you!

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