ART BY NEIL PIETARI

Activist Investors Take On the Board

BY KAREN KANE

ACTIVISTS, THOSE PESKY INVESTORS who buy a small stake with the goal of making big changes to a company, are no longer the short-term players gunning for a quick sale. Now that pensions and large funds hold 70-plus percent of investments in the largest corporations, selling the company's stock is no longer the operative way to correct poor performance or bad management.

A new consensus is emerging that boards of directors are not only accountable to shareholders but must demonstrate their responsiveness to them in meaningful ways. Shareholders, led by activists, are asserting themselves in helping to create more value for the enterprise.

"It's important for directors to understand that many investors hold a stock for five or 10 years, or an indefinite period for index funds," said Peter Michelsen, a partner in Camber-View Partners, a boutique firm that advises public companies and boards on contested and complex governance situations.

"These investors *have* to engage with my companies," said Michelsen. "Fund investors such as pension funds want their managers to engage with the portfolio companies. They want funds to exercise voting rights, which they view to be valuable."

Directors may underestimate the degree to which activists are collaborating with a company's investors, because activists are working on a number of issues for a number of their investments. Clearly, the activists have relationships with large holders, making it incumbent on companies to encourage directors to develop relationships with investors.

With $100 billion in their war chests, activist investors have reshaped investor engagement and the role of the director.

No doubt the number of activist campaigns in 2014 will surpass the 220 in 2013. The success of activist campaigns has caused institutional investors and more traditional long-only investors to moderate their approach, working with directors who have been elected to represent shareholders.

"We may see some traditional investors adopt models similar to funds like Relational or ValueAct, with a less aggressive approach but still putting pressure on companies to consider strategic and governance changes," said Michelsen. "There is a larger universe of investors who may be willing to engage behind the scenes to make changes because it's no longer taboo."

There's no doubt that financial crises and market meltdowns have affected governance practices. A pattern has emerged: crisis followed by regulatory changes, followed by governance adjustments, followed by new crisis. While the Sarbanes-Oxley Act was thought to be the "big kahuna" of regulations for the new rules imposed on the audit committee, a shareholder advisory vote on executive compensation proved to be the real game-changer.

"'Say-on-pay' changed everything," said Mark Borges of Compensia. The compensation consultant watched as the trend transformed investor practices. It turns out that once investors were asked to opine on executive pay, even as a nonbinding advisory vote, they decided to take up other issues with board members. The veil of the boardroom was lifted, and suddenly board directors were talking directly to shareholders about a host of other governance issues.

"Say-on-pay votes were a catalyst for engagement," said Amy Borrus, deputy director of the Council of Institutional Investors, the nonprofit association of pension funds with combined assets that exceed $3 trillion. "Over the years, companies have sharpened their pay practices, and some of the worst practices were winnowed out."

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The rule changes were meant to empower shareholders, and activists have been savvy about using new regulations to their advantage. Yet their biggest success has been engaging other shareholders to bring issues to the attention of the board.

"Very few investors can advocate alone successfully for change at a company," said Michael Levin of TAI, The Activist Investor blog. "A small number have the credibility to propose a strategy, director candidate or balance sheet structure that management knows will resonate with other investors. So ValueAct can gain a board of directors seat at Microsoft seemingly only by its reputation, size of its investment and force of its arguments. Yet, don't underestimate the extent to which even it needed to consult with other investors beforehand.

"Once you have engaged other investors, only then can you say with confidence to the board of directors and management that many others support your view about strategy and tactic," said Levin. "That's a credible threat."

Activist investing has become an accepted strategy as activists have become more sophisticated. "Activists do their homework," Borrus said. "They have to target the right companies carefully, provide insightful perspective, and they present compelling arguments to other shareholders."

Shareholders were very much on the minds of the more than 1,300 directors who gathered for the National Association of Corporate Directors' Board Leadership Conference in National Harbor, Md., in October. The theme, "Beyond Borders," emphasized the challenge of globalization. "Equally important as expanding our thinking beyond geographical borders is the way the conference moved beyond our conventional thought patterns," said Reatha Clark King, chairman of the N.A.C.D.

"Now we are venturing into a different and particularly challenging future," she said. Always the optimist, she spoke of boards of directors facing the future boldly, getting beyond old fears of complex information technology, big data and cybersecurity to embracing them "both as new sources of risk for companies and as transforming tools that will enable us to solve problems."

Few activists today see themselves as short-term players. In fact, directors should embrace activists, said Andrew Shapiro, a portfolio manager at Lawndale Capital with $30 million under management.

"If an activist has an ownership interest—that's really their only interest," said Shapiro. "They want to maximize the value of their shares. If a road to receiving $30 a share can be painted and it's credible, no activist would favor the short-term sale of the company."

Some critics say activism isn't really about good or bad governance. Rather, the skeptics say, it means using the board for the interests of a small group of generally short-term investors—that, in a sense, governance has been monetized for the benefit of minority activists.

Charles Elson, director of the Weinberg Center for Corporate Governance at the University of Delaware, disagrees.

"Activists present to the company some really critical analysis of what you're doing and what you're thinking about," said Elson. "The problem isn't activists but the questions they raise. If someone raises a question, you better have pretty good answer."

Governance experts acknowledge that the activists of 2015 are far different from the days of "Barbarians at the Gate."

"We are seeing a much deeper analysis by activist investors," said Michelsen. "Prior to the financial crisis, a material portion of activism focused on levering up or selling the company. Today, they're asking, 'Can I get a return by making operational improvements? Should we re-evaluate the company's business portfolio, divest divisions or pursue a spinoff to generate value? Are there changes in management that are necessary to implement these changes?'"

Given the current environment, boards need to be armed with a dispassionate evaluation of their vulnerabilities. Poor financial returns are the prime reason activists get involved, but governance issues determine whether they will pursue a campaign.

The big question for directors becomes: "Is the board as it's presently structured willing or capable to take the steps to deliver the returns that an activist has identified?"

Whether it's executive compensation, company strategy or even company structure, directors can take their message directly to shareholders. As directors have increased their direct engagement with shareholders, and as shareholders have developed teams focused on governance issues, the influence of proxy advisory firms has changed. "ISS and Glass Lewis now play an important, but not determinative, role in governance." said Michelsen.

Board composition is the next focal point for governance-oriented investors, according to Michelsen. "Shareholders are looking critically at long-tenured directors," he said.

It doesn't mean that long-serving directors are not smart and well intentioned, but the world and business are changing rapidly. The data breaches at Target and Home Depot demonstrated that the boards needed expertise beyond retail. One illustration of a board refreshing its ranks is Wal-Mart's appointment of the 30-year-old CEO of Instagram, Kevin Systrom, to its board. He joins Yahoo CEO Marissa Mayer, expanding the board's technology expertise to better compete with Web rivals like Amazon.com.

VIEWPOINT

Governance as Engagement

As more than 1,300 corporate directors gathered at the National Association of Corporate Directors for its annual Board Leadership Conference, there were more than a few issues on the attendees' minds. Not only was there a rich offering of impressive speakers and educational sessions, but also the opportunity for directors to meet with peers. It also marked the release of another Blue Ribbon Commission report, this one on strategy development.

N.A.C.D. previewed the report with a session featuring panelists Raymond V. Gilmartin, a Harvard Business School professor who co-chaired the commission with Frontier Communications CEO Maggie Wilderotter, former U.S. Commerce Secretary Barbara Hackman Franklin and Executive Consulting Group president William E. McCracken. Joann Lublin, the *Wall Street Journal* reporter who has covered governance for 23 years, served as moderator.

But even more radical than having a journalist moderator was the commission's recommendation that directors move from a role of reviewing and concurring with management on strategy to much greater engagement in strategy during the formulation process. "As directors we're responsible for creating shareholder value but also, in my view, for the long-term survival of the firm," said Gilmartin. "Failure of strategy is the reason companies fail."

"Boards need to be involved in strategy much earlier," Franklin added. Boards need to understand and test the underlying assumptions, strategic alternatives and risks involved as well as determining how success will be measured. "Then, there needs to be an update on strategy at every meeting," she said.

The panelists agreed that this approach will take some adjustment for some boards and management.

"If you're just reading your board book, you're not prepared," said McCracken. "You have to look at the company as activists do," which means much more independent research and analysis. It prompted Lublin to ask if boards need their own research staff.

McCracken said that management needs to become comfortable with the board asking for more information. At the same time there has to be a high level of trust between the board and management. "Management has to feel that the board is not going to turn on you."

McCracken knows whereof he speaks, having served as independent chairman of CA Technologies, later becoming CEO. Telling the directors that "it looks different from the other side," he said boards have to ask probing questions and hold executive sessions before and after the board meeting.

"It sounds to me like you're saying that the board used to admire the cake," said Lublin. "Now this [commission] is saying, directors need to get in there and stir." *—K.K.*