SULLIVAN & CROMWELL LLP

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State Street Becomes Latest Large Asset Manager to Outline Concerns Over Board Responses to Activist Short-Termism

Focuses on Rapid Settlements of Activist Demands That May Not Protect Interests of Long-Term Investors; Urges Companies to Consult With Long-Term Shareholders on Activist Response

SUMMARY

Over the past year or so, a number of the world's largest institutional investors have expressed concern over the potential negative long-term effects of board responses to shareholder activism, particularly the risk that, under pressure from activists, companies may take actions that favor short-term interests at the expense of longer-term results. Last week, State Street Global Advisors (SSGA) issued a market commentary that pointedly raises this concern in the context of settlement agreements between public companies and activists seeking board seats. SSGA sets out the following concerns and observations:

- Settlement agreements that are entered into quickly and without appropriate consultation with other shareholders deprive long-term shareholders of the opportunity to express their views.
- SSGA's review of the actions of the largest activists identified several red flags that raise questions about the long-term effects of activism, including increases in CEO pay and tying CEO pay to earnings per share, as well as undue focus on share buybacks, spin-offs and other financial engineering.
- Settlement agreements should include terms that protect the interests of long-term investors, which could include requirements that activists meet share ownership thresholds and hold shares for a defined period, and restrictions on share pledges by the activist.

SSGA also announced a policy of engaging with companies that pursue previously unplanned financial engineering transactions within a year of a settlement, to better understand the reason behind the strategic change.

The environment today is far different from a decade ago, when activist demands were commonly viewed by companies as hostile acts to be resisted. This evolution has been due in large part to the willingness of traditionally passive institutional investors to support activist agendas in appropriate cases, which has spurred companies to become more responsive to, and aware of, investor concerns. To some extent, the recent concerns over short-termism, including SSGA's concerns over settlement agreements, represent a cautionary reminder by institutional investors that engagement and responses to activist campaigns should be balanced and informed, and that a quick capitulation to an activist agenda may be just as damaging to long-term value as an overly defensive stance.

DISCUSSION

In the past two years, a number of large institutional investors have indicated, both through public statements and through direct communications with companies, that they are concerned about certain effects of board responses to shareholder activism on long-term value. For example, in 2015, Larry Fink, Chairman and CEO of BlackRock, sent letters to CEOs of large-cap companies urging them not to take short-term actions, such as buybacks and increased dividends, that may satisfy the demands of short-term activists, but that impair long-term value. In 2016, Mr. Fink sent similar letters, urging companies to articulate a strategic framework for long-term value creation to serve as a counterpoint to activist demands for actions with short-term benefits. In addition, William McNabb, Chairman and CEO of Vanguard, has sent letters to companies emphasizing the importance of engaging with long-term investors, and some of the largest institutional investors have joined industry initiatives to combat an overemphasis on short-term results, including as signatories to the CommonSense Corporate Governance Principles[1] and as members of Focusing Capital on the Long Term.[2]

The recent SSGA market commentary was issued on October 10, 2016,[3] and raised concerns over one manifestation of short-termism—a trend toward rapid settlement of activist demands without sufficient consultation with other shareholders. SSGA raised concerns over both the process by which these agreements are often reached as well as their substance. From a process standpoint, SSGA notes that settlement agreements reached rapidly or without broad shareholder input have the effect of denying long-term shareholders the benefit of public airing of the activists' views on strategy, compensation, share buyback programs and other factors, especially as compared to proxy contests.

1 The Principles were issued in July 2016 by representatives of a number of large corporations and institutional investors, including SSGA, BlackRock, Vanguard, Capital Group, CPPIB and T. Rowe Price.

2 FCLT is dedicated to developing practical tools and approaches that encourage long-term behaviors in business and investment decision-making. The list of its members is available at: http://www.fcltglobal.org/members/members.

3 SSGA's market commentary and related press release are available on its website.

From a substance standpoint, SSGA identifies specific terms that should be considered for inclusion in settlement agreements to help align with long-term investor interests, including the following:

- ***Longer Duration.*** SSGA suggests that the typical settlement agreement duration of six to 18 months may not be long enough to incentivize the company and activist to be sensitive to long-term factors.
- ***Long-term Shareholding Commitment.*** SSGA would like agreements to specify minimum ownership levels of activists and/or nominees for long periods in exchange for any board representation, and to require directors who are affiliated with an activist to tender their resignation if the activist's ownership in the company falls below the minimum threshold. Requiring activists or their director nominees to continue owning shares for a significant period after receiving board seats can align their interests with those of long-term shareholders.
- ***Restrictions on Pledging.*** SSGA notes that activist investors often pledge a significant portion of their stake in margin accounts, and suggests that boards should evaluate carefully the pledging practices of activists and develop robust mechanisms to oversee and mitigate any potential risk from the pledge positions to the stock price.

SSGA notes that it conducted a review of the actions of large activists over the past three years, and identified several "red flags" for long-term investors that "raise questions about the motivations behind the actions and potential implications for sustainable value creation." These include:

- ***Increasing CEO Pay.*** Significantly increasing CEO pay without explanation;
- ***Tying CEO Compensation to EPS.*** Incorporating earnings per share as the primary determinant of CEO compensation, which can overly focus management on short-term stock performance and often favors activities such as share buybacks over allocating capital for optimal long-term returns; and
- ***Financial Engineering.*** Focusing on financial engineering such as share buybacks, leveraged dividends, spin-offs and M&A, which could add value in the short term but may also undermine long-term value. In situations where a company engages in unplanned financial engineering within one year of a settlement agreement, SSGA will now, as a policy matter, engage with the company to understand the reason for the strategic change.

Finally, SSGA emphasizes broadly that companies and boards should view passive investors as long-term partners, and should ensure that strategic decisions, including business strategy as well as strategy in responding to an activist demand, are understood by, and reflect the input of, the company's long-term investors.

The continued focus of large institutions on corporate governance and long-term value is an important aspect of the ongoing development and maturation of the relationship between public companies and shareholders. While practice has moved away from the "traditional" approach of assuming that an activist is always wrong, neither should companies adopt the view that an activist is always right. Companies that engage effectively with their long-term shareholders in the ordinary course, and in response to an activist demand, will be best equipped to develop an informed and balanced response that is well received by long-term investors.

For a more detailed discussion of considerations on addressing activism in the changing environment, please see our publication, dated March 10, 2015, entitled "The Evolving Landscape of Shareholder Activism."

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