SHAREHOLDER ACTIVISM:

5 WAYS BOARDS CAN PREPARE AND RESPOND

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Transitioning to the New Normal

From Engine No. 1 to Starboard Value's victory over workforce technology provider Box, shareholder activism is nothing new for today's boards. What is new: activist attention on — and action against — individual directors.

Starboard Value attributed much of Box's disappointing results to CEO Aaron Levie, calling the company's decision to accept a $500 million equity investment from KKR "garbage" in a televised interview. Oasis helped lead the ouster of Toshiba's chairman after the Japanese conglomerate announced plans — later revised — to spin out its industrial and tech segments into separate companies. On the other side of the world, the Children's Investment Fund launched a "bareknuckle campaign" to oust the CEO of Canadian National Railway over climate and ESG.

These examples are illustrative of an overarching trend according to recent research by Insightia, a Diligent brand. Across the globe, the number of management director candidates receiving less than 80% support increased from 2020 to 2021: from 1,683 to 1,918 in North America, from 206 to 298 in Europe, and from 535 to 642 in the Asia Pacific region.

> "Institutional investors vote against directors more frequently and for more reasons than they would have in the past."
>
> **- Brian Valerio, Senior Vice President, Alliance Advisors**

While the move to universal proxy voting is one factor behind this heightened focus, it's certainly not the full story. Are outsized shareholder expectations to blame — or is poor director performance?

Another red flag that increases the risk of activism: high levels of dissent against directors. In the words of one activist investor: "Given that our mandate is to catalyze change on behalf of the shareholder base, low vote tallies signal that other shareholders are likely to be supportive of the changes we are driving."

How have businesses been reacting to director-focused activism?

Some corporations have pursued a strategy of engagement, though often away from the limelight.

"We continued to advise numerous activists on behind-the-scenes private engagements. In these cases, companies were willing to engage in a constructive private dialogue to avoid public critique," Greenbrook Communications founder Andrew Honnor said in the report. Other corporations spend a great deal of capital and effort evading and rejecting requests for dialog.

While corporations vary in their responses, they share one common challenge: the growth of shareholder activism has undeniably made a corporate director's role more complicated. The good news is that director-focused activism is neither inexorable nor closed to dialogue. A successful response requires a greater awareness of shareholder interests and a targeted reply about vulnerabilities.

Overboarding and diversity issues are two key reasons for votes against directors, Valerio told Insightia, with climate change, executive compensation, and human capital management also driving recent activist activity.

Read on for Diligent's insights into five problem areas, drawing upon this recent research, and ways that companies and individual directors can respond.

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1. Excessive Outside Commitments

The problem:

To find a new board member, companies look at existing board members — and this trend is escalating according to Insightia research. In 2021, 16.7% of new S&P 500 directors were active CEOs compared to 15.2% in 2020. Moreover, only one out of 3 (33.7%) of S&P 500 boards reported a specific limit on the CEO's outside board membership.

BMO Global Asset Management takes an alternative view. The firm voted against commercial real estate executive Steven Roth's reelection under the rationale that it expects board members to have "sufficient time to discharge their roles properly, particularly during unexpected situations requiring substantial amounts of time."

BMO is not the only investor cautious of overextended directors. In Insightia's 2021 data, 23 of the 68 director nominees failed to receive majority support due to overcommitments. Seven of the 23 actively served as the chairs of outside public boards, and five received opposition due to their roles as CEOs.

The solution:

To prepare for and respond to investor activism on overboarding:

- ☐ Put limits on the number of boards on which a director can serve
- ☐ Track and evaluate directors' hours of service, flagging and addressing overwork when necessary
- ☐ Use modern governance tools like digital D&O questionnaires to collect, consolidate and manage information about a director's board commitments, independence, potential conflicts of interest and insider transactions

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2. Poor Board Diversity

The problem:

Diverse boards are good for business. Insightia research found that FTSE All Share companies and Russell 3000 companies gave female directors more support than male directors: 98.3% vs. 97.7% and 96.3% vs. 94.4%, respectively. This aligns with recent research, including a study published in Harvard Business Review revealing that female board members improve the quality of board deliberations and decision-making. Female board members' different perspectives increase the information available for exploring and resolving complex issues and provide more independent views given the lower influence of "old boy network" connections.

Calls upon boards for more diverse composition have been a long-brewing and escalating constant. The past year brought Institutional Shareholder Services' expectation that all "large companies" in the U.S. should have at least one racially or ethnically diverse director in 2022. Meanwhile, Vanguard's engagement with 290 U.S.-listed companies on the matter was up from 67 in the same period in 2020.

Recently DEI activism — and consequences for a lack of progress — has extended to individual directors. Board diversity was the most frequent reason why BlackRock voted against U.S. directors in the 2021 proxy season. The world's largest asset manager voted against 1,554 directors for "inadequate" diversity reporting according to its proxy season review. Glass Lewis will also recommend voting against nominating committee chairs at FTSE 100 companies that have failed to appoint at least one director from a minority ethnic group.

The solution:

To strengthen diversity on your board:

- ☐ Review board policies and practices in the context of the current business environment — and update as necessary
- ☐ Use resources like the Diligent Director Network to source candidate profiles through a trusted nomination process
- ☐ Use digital D&O questionnaires to collect, consolidate, and manage information about a director's background and experience

3. Lack of Engagement With Key ESG Strategies

> "The themes that will prevail in 2022 are strategic repositioning, operational efficiencies, capital allocation decisions and ESG."
>
> **- Marco Taricco, Co-Founder, Bluebell Capital Partners**

The problem:

While some types of activist actions — like those related to operations or returning cash to shareholders — have been declining in number in recent years, ones related to the environment have been increasing, from 61 in 2020 to 79 in 2021 according to Insightia research. Environmental campaigns have been a particular focus in Europe. After a drop from 2019 to 2020, governance-related campaigns have been increasing as well, from 387 to 391. Governance-related campaigns have been a particular focus in Japan.

"As the notion that ESG factors play an integral role in sustainable value creation continues to gain acceptance and momentum in the capital markets, it naturally follows that more activists will use ESG as a lens to assess company performance," said Alliance Advisors Managing Director Etelvina Martinez, adding that, "Underperforming peers on key areas of ESG that are considered material for your company's particular industry will likely attract activist attention."

Activists are also becoming increasingly aware of ESG's connection to mergers and acquisitions. "The drivers are easy to spot — quantifiable links between ESG and valuation, large ESG-conscious capital flows, and institutional support for activism that successfully links ESG to value creation," said UBS Global Head of Activism and Defense Aneliya Crawford.

About activists, Crawford elaborated, "ESG financial activism empowers M&A on new grounds, not for short-term returns as activists are often accused, but for the long-term sustainability of a business in a world that discounts dirty assets and demands portfolio re-evaluation for the future. Proxy voting advisers and institutional investor scrutiny will reasonably shift along."

When directors aren't engaged in ESG strategies, and when their decisions reflect this lack of engagement, activists are taking notice — and action.

The solution:

To prepare for and respond to investor activism on ESG:

- ☐ Educate board members on an ongoing basis about ESG issues
- ☐ Prioritize ESG issues among relevant committees and roles, like the audit committee and general counsel, and on the full board agenda
- ☐ Use technology to foster collaboration among the organization's ESG stakeholders, monitor ESG risks, and gain clarity on evolving regulations, requirements and liabilities

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4. Excessive Executive Compensation

The problem:

"Say on Pay" gives shareholders an advisory vote on whether they agree with a company's practices for CEO pay. When such votes receive less than 80% support, they become compensation revolts. Over the past year, these revolts have been increasing and impacting director reelections.

In Europe, compensation revolts spiked from 108 in 2020 to 177 in 2021 and impacted nearly 12% of annual meetings. In the U.S., the proportion of pay revolts actually fell from 13% in 2020 to 12% in 2021 — but there were 150 more revolts against director reelections than a year previously, a 10% increase over last year.

In a working environment where the COVID-19 pandemic has heighted and exacerbated scrutiny around a perceived imbalance between high levels of executive compensation and an increase in layoffs and general suffering, it's likely that an increased focus on bonuses is here to stay. Indeed, as Diligent COO and President Lisa Edwards noted, failed pay votes were "potentially the beginning of a trend."

The solution:

To prepare for and respond to investor activism on executive compensation:

- ☐ Use modern governance intelligence tools to benchmark executive compensation practices across peer groups, industries and regions
- ☐ Use digital D&O questionnaires to collect, consolidate, and manage information about a director's compensation, as well as securities ownership and insider transactions and compensation
- ☐ Engage with expert consultants for best practices for your compensation committee

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5. Toxic Management Culture

The problem:

Culture has an impact on company strength and shareholder returns, particularly in a competitive landscape and amid an escalating war for talent, and activists have been amping up the pressure on companies they feel have issues in this area.

Take for example Microsoft's deal to buy Activision Blizzard — a powerful foothold into the gaming world. At the same time, Activision Blizzard was a company with a well-publicized "frat boy" culture and history of ignoring complaints by female employees. This toxic management culture spurred not just a lawsuit but an advisory shareholder resolution; consequently, Microsoft hired an outside law firm for an independent review.

Activists have been shining the spotlight on individuals as well. Alleged racial insensitivity by CEO Dave Lougee fueled much of Standard General's action against media company Tegna, with the activist even hiring a private investigations firm to look into the matter.

The solution:

To strengthen your board's oversight of management culture:

- ☐ Don't be afraid to encourage healthy discussion on difficult topics; face problems head on rather than sweeping them under the carpet
- ☐ Use modern governance solutions, like secure portals and messaging apps, to communicate about issues
- ☐ Enlist an outside specialist, if needed, to "take the reins" in a difficult situation

About Diligent Corporation

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