



Creating Value Through Activism: Opportunities and Obstacles

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Creating Value Through Activism: Opportunities and Obstacles

Originally presented by Glenn R. Carlson, CFA, Co-CEO, in July 2001

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“When, in all innocence, I made my first effort as a stockholder in 1926 to persuade a management to do something other than what it was doing, old Wall Street hands regarded me as a crackbrained Don Quixote tilting at a giant windmill.”¹

–Benjamin Graham

Institutional Money Management and Shareholder Activism

When institutional money managers disagree with company management on important, substantive issues, they have three basic options:

1. They can maintain their investment and hope management’s position proves to be the best (the “hold and hope” option).
2. They can sell their shares (the “sell and shrug” option). This is often referred to as the “Wall Street Walk.” It is also sometimes described as “voting with your feet.”
3. They can attempt to change the situation (the “push and prod” option).

Broadly speaking, the first two options are “passive” investment strategies, while the third is loosely referred to as “activism.”

After a brief review of some general background information, this paper offers thoughts on some key issues related to the “activism choice.” The primary goal of this paper is to stimulate discussion regarding the following questions:

- Why is the activist option still infrequently selected by institutional money managers?
- What are the significant risks, obstacles, and opportunities from the manager’s perspective?
- Would it be in the interests of institutional plan sponsors to encourage more activism?
- What could institutional plan sponsors and institutional money managers do to encourage greater consideration of activism as a means for creating long-term shareholder wealth?

Why Activism?

Publicly listed companies around the world are, with some differences in terminology, managed by executive officers under the supervision of a board of directors. In most cases, the owners of a publicly listed company (i.e., the shareholders) are not involved directly in management of the company – instead, they rely upon the directors (who are elected by shareholders) and officers (who are appointed by the directors) to make virtually all key decisions.

¹ Graham, Benjamin. *The Memoirs of the Dean of Wall Street*. New York: McGraw-Hill, 1996. In this chapter of his memoirs, Graham provides a detailed (and humorous) account of one of his early experiences as a shareholder activist.

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Clearly, the issue of activism should not arise where the owners' agents (i.e., the directors and officers) are skillfully and faithfully representing the interests of all shareholders. For the most part, the vast majority of companies have management teams that are both skillful and loyal to shareholder interests. However, over time, nearly all institutional money managers (no matter how expert they are at assessing management quality) will own shares in a company that has a management team that does not have all the skills and/or vision necessary to maximize shareholder value.

In other situations, although the requisite skills may be present, the owners' agents may not give adequate priority to the owners' interests. In running a public company, management is constantly balancing the sometimes competing, sometimes complementary, interests of a variety of constituencies, including:

- Short-term shareholders
- Employees
- Customers / Clients
- Vendors / Suppliers
- Long-term shareholders
- Strategic partners
- Politicians
- Community interest groups

Not to be overlooked are the interests of the agents themselves, which may not *always* be aligned with the best interests of the owners or the businesses they oversee.

Thus, the potential need for owner "activism" ultimately stems from the principal-agent relationship between owners and company managers. While the relationship works just fine in most cases, there are situations in which owners may be best served by taking steps to ensure that their agents are more effectively representing their interests. The answer to the "agency problem," lies "not in 'aligning' the interests of executives with shareholders through extravagant grants of stock options but in having more engaged, or activist, shareholders."²

What Can An Activist Do?

If a shareholder believes that something needs to be done to realign the principal-agent dynamic, there is a broad array of tactics possible within an "active" investment strategy. These range from thoughtful proxy voting at one end of the spectrum, to aggressive legal challenges (i.e., a proxy battle or law suit) at the other end. The most extreme measures are rarely necessary, as it is often possible to effect some change through private discussions with management. However, as Paul Myners, chairman of Gartmore Investment Management, wrote in an extensive report addressing various aspects of institutional investment in the United Kingdom (including shareholder activism): "... merely meeting with senior management and expressing polite reservations about strategy is not sufficient. . . ." Instead, as he notes, successful activism often requires persistence and the willingness to raise "issues repeatedly over a period of time with firmness until concerns are addressed."³

Activism is, in our view, also more likely to succeed when it is focused on high-level corporate governance values, such as accountability, transparency, and the establishment of proper shareholder democracy, rather than on detailed operating issues. This is not to say, of course, that shareholders should not have opinions on "micro" issues. Rather, the point is simply that activism is more likely to garner support among the

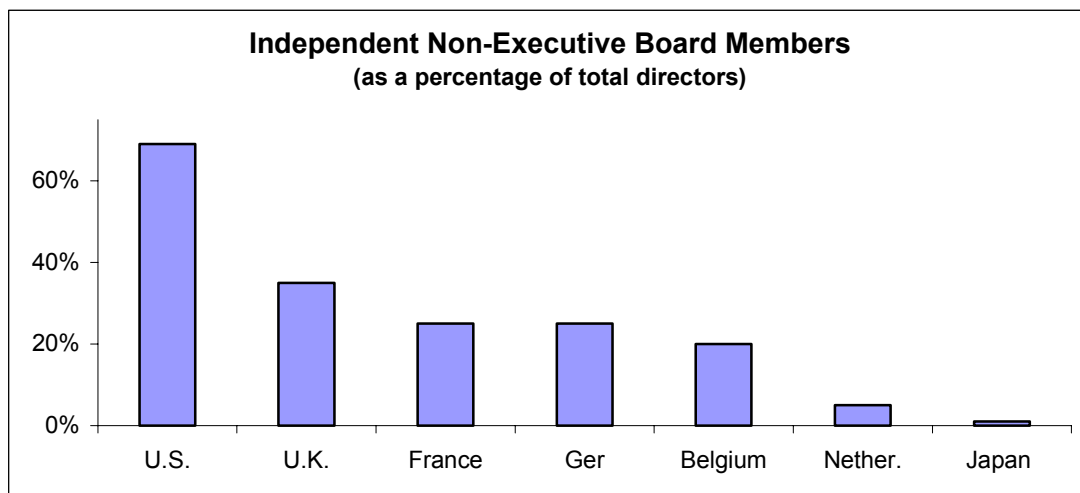
² Chancellor, Edward. "The Inefficient Market: Activists Fight for Better Returns." <<http://www.breakingnews.com/>>. May 15, 2001.

³ Myners, Paul. "Institutional Investment in the United Kingdom: A Review," March 6, 2001, page 92.

board, officers, and other shareholders if it is directed at core governance values, rather than social issues or matters clearly involving business judgment.⁴ Such topics are typically the province of business managers and often provide a more difficult platform for consensus. The most commonly accepted core corporate governance values include the following:

- The board of directors should have a majority of independent, non-executive directors⁵
- The board should have a nomination committee, responsible for nomination of director nominees
- The board should have a compensation committee, responsible for establishing fair and transparent compensation of executive directors
- The board should have an audit committee, responsible for interacting with outside accountants and ensuring integrity of the company’s financial information
- A company should have effective, transparent, and fair procedures for conducting shareholder meetings and for allowing shareholders to exercise their votes

With respect to the critical goal of achieving an independent board, the United States has made substantial progress in recent years, although some believe there are still many companies that have not adopted best practices.⁶ The following graph shows the independent, non-executive board members as a percentage of total directors for certain key developed markets:



Source: Global Proxy Watch, January 2001

⁴ This paper does not analyze or discuss any forms of shareholder activism relating to so-called “socially responsible” investing, such as activism aimed at altering a company’s labor policies, environment impact, or operations in politically disfavored countries. Rather, we confine the scope of this article to activities aimed at improving corporate policies and practices with respect to shareholders’ economic interests in the company.

⁵ In an editorial published by *The Wall Street Journal* on August 12, 2002, David Gale, president of Delta Dividend Group, suggests the following for making boards of directors truly independent: (1) make sure the selection process is taken away from corporate management, (2) mandate more candidates than vacancies so as to give a real choice, and (3) allow any significant group of shareholders to make a nomination to the board in a reasonably simple way.

⁶ For example, CalPERS released a statement on March 21, 2001 announcing that five companies had been placed on its “Focus List” for “poor financial and corporate governance performance.” A lack of majority independent board directors was cited as one reason companies were placed on the list.

Does Activism Produce Meaningful Benefits?

While it seems clear that there are valid theoretical reasons for pursuing activism, is there solid real-world evidence that activist strategies consistently create value? Intuitively, one would expect the answer to this question to be “yes.” However, at this stage, while there are certainly some important supporting studies, it is probably fair to say that the overall evidence presents a somewhat mixed picture.⁷

In a working paper, Stanford law professor Bernard Black notes that in the United States “. . . efforts to find a correlation between a firm’s governance attributes and its value mostly show weak or no results.”⁸ Black cites results from several studies that analyze various elements of corporate governance, including independent directors on a company’s board, and reports “no statistically significant effect on performance.” Studies on overt activism by institutional investors, insider share ownership, ownership by outside shareholders, and a firm’s committee structure yielded similar conclusions – none has demonstrated “a consistent effect on firm value.”

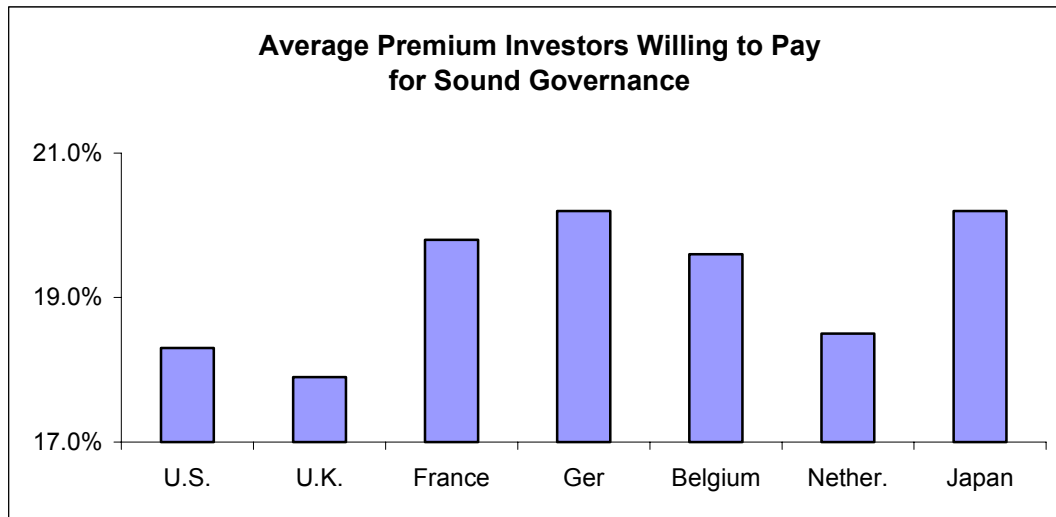
In a June 2000 report, McKinsey & Company failed to find conclusive statistical evidence confirming the link between shareholder activism and improved shareholder returns.⁹ However, the surveys underlying the report did yield some interesting findings:

- 75% of investors said board practices were at least as important to them as financial performance when evaluating companies. In Latin America, almost 50% of respondents considered board practices to be more important than financial performance.
- More than 80% of investors said they would pay more for the shares of a well-governed company than for those of a poorly governed company with comparable financial performance.
- The actual premium investors said they would be willing to pay for a well-governed company differed by country. For example, investors said they would pay 18% more for the shares of a well-governed U.K. company. They would be willing to pay a 19.8% premium for one in France, and a 20.2% premium for one in Japan.

⁷ This section is not intended to be a complete study of the literature, but rather a very brief overview of some recent work to illustrate the debate.

⁸ Black, Bernard. “The Corporate Governance Behavior and Market Value of Russian Firms.” *Emerging Markets Review*, Vol. 2, pp. 89-108, 2001. Notwithstanding his general conclusions, Black did find that in certain “governance-challenged” markets, such as Russia, governance characteristics are statistically correlated with shareholder value.

⁹ McKinsey & Company. “Investor Opinion Survey.” June 2000. This report was undertaken in co-operation with the World Bank and the Institutional Investor’s regional institutes and was based on surveys from over 200 institutional investors, who together manage approximately US\$3.25 trillion in assets. Forty percent of the respondents were based in the United States. The survey was conducted in three regions: Latin America; Europe and the United States; and Asia between September 1999 and April 2000.



Source: McKinsey & Company Investor Opinion Survey, June 2000

The report also suggested that corporate governance is, understandably, a greater concern in regions characterized by less stringent accounting standards. “The size of the premium that institutional investors say they are willing to pay for good governance seems to reflect the extent to which they believe there is room for improvement.”

While a clear statistical connection between investors’ stated preference for well-governed companies and its quantifiable effect on shareholder returns has not been definitively established, there is mounting circumstantial evidence that “good governance pays.” Paul Coombes, Director at McKinsey & Company’s London office, pointed to the majority of investors who take corporate governance issues into consideration when making investment decisions as a “powerful argument in favor of corporate governance reform.” In the survey, Coombes wrote, “If companies could capture but a small proportion of the governance premium that is apparently available, they would create significant shareholder value.”

The success of the California Public Employees’ Retirement System (CalPERS), the largest U.S. public pension plan and an advocate of activist efforts, lends further credence to the benefits of activism. A study in 2001 by Wilshire Associates on CalPERS, updating results from a report released in 1994, confirms that CalPERS has been able to create value through its actions. In a survey of the 95 U.S. companies CalPERS singled out for intervention between 1987 and 2000, Wilshire noted “a dramatic U-turn in performance once subjected to CalPERS pressure.” This pressure included meetings with directors, filing dissident shareowner resolutions, and voting against the board. The firms “underperformed the S&P 500 by an average 96 percentage points in the five years before being targeted. But they outperformed the market by an average 14% over the subsequent five years.”¹⁰

¹⁰ The results of the Wilshire study, titled “The ‘CalPERS Effect’ on Targeted Company Share Prices,” were published in the April 13, 2001 edition of *Global Proxy Watch*, a newsletter prepared and distributed by Davis Global Advisors Inc. According to an article titled “Investor Activism Found to Spark ‘Reversal of Fortune’ at Failing Firms” in the newsletter, the Wilshire study was prepared for a closed CalPERS board retreat in February. The article adds that while the study has been treated as a confidential internal document, CalPERS is “mulling whether to release the full text on its website.”

In April 2001, the Emerging Markets team at Credit Lyonnais Securities (Asia) or CLSA published a report¹¹ that studied 495 companies in 25 emerging markets. CLSA ranked the companies in seven key corporate governance areas: discipline, independence, transparency, accountability, fairness, responsibility, and social awareness. The rankings were based upon 57 separate questions, of which approximately 70% were strictly quantitative (i.e., “Is the chairman of the board an independent, non-executive director?”) and approximately 30% involved subjective judgment by the CLSA analyst (i.e., “Is it true that there have been no controversies or questions raised over whether the board and senior management have made decisions in the past five years that benefit them, at the expense of shareholders?”). CLSA found that, at least for 2000, there was a strong correlation between corporate governance on the one hand and financial performance and share price increases in emerging markets companies on the other.

The level of activism, which has been increasing in recent years, may reflect growing conviction in the notion that action brings results. Activism, as measured by the introduction of shareholder-sponsored resolutions, reached record highs in 2000. The Council of Institutional Investors (CII) reported that in the United States, there were 275 shareholder resolutions filed at 180 companies in 2000, up from 150 resolutions at over 120 companies in 1999.¹² Further, “average support levels increased once again for nearly all types of corporate governance proposals,” CII reported. While activism and support levels may be escalating, the efforts have not consistently translated into the achievement of stated objectives. According to CII, because most resolutions are non-binding, many companies “consistently fail to adopt – sometimes year after year – majority-vote-winning suggested reforms.” This lack of responsiveness has “led some to question the efficacy of traditional, non-binding resolutions.” Given this sentiment, perhaps a more focused, tenacious approach that integrates tactics beyond the introduction of resolutions is necessary to achieve results.¹³ As Bernard Black commented in 1998:

A small number of American institutional investors, mostly public pension plans, spend a trivial amount of money on overt activism efforts. They don't conduct proxy fights, and rarely try to elect their own candidates to the board of directors. Legal rules, agency costs within the institutions, information costs, collective action problems, and limited institutional competence are all plausible partial explanations for this relative lack of activity. The currently available evidence, taken as a whole, is consistent with the proposition that the institutions achieve the effects on firm performance that one might expect from this level of effort – namely, not much.¹⁴

The Institutional Money Manager: Impediments and Incentives

Assuming that there are, or may well be, long-term benefits for shareholders, why is sustained activism not more prominent in today's financial markets? To properly answer this question, it would be necessary to analyze all of the major players and institutions, including: capital providers; regulatory bodies; custodians;

¹¹ CLSA Emerging Markets. *Saints & Sinners: Who's Got Religion?* April 2001.

¹² Council of Institutional Investors. *Council Research Service Extra: 2000 Proxy Season Wrap-Up*. Vol. 5, No. 4, September 26, 2000.

¹³ While shareholder activism has increased, the popularity of index investing, a strategy which embraces passive investment, may be hindering the overall level of activist activity. On April 9, 2001, *The Wall Street Journal* noted that as much as 25% or 30% of pension fund assets in the United States, for instance, sit in indexed portfolios.

¹⁴ Black, Bernard. “Shareholder Activism and Corporate Governance in the United States (*Non-empirical Study*)” published in Peter Newman, ed., *The New Palgrave Dictionary of Economics and the Law*, 1998.

the overall structure of various equity markets; key players in the proxy voting process;¹⁵ and investment managers, who act as agents for capital providers. As the entire topic is beyond the scope of this paper, this section focuses on one key industry group: institutional money managers.

To highlight some of the key issues impacting a manager, let's examine the following hypothetical situation:

- An industrious analyst at ABC Investment Management is responsible for his firm's investment in No Corp. ABC owns, on behalf of clients, 5% of the shares of No Corp. and is the company's largest shareholder.
- No Corp. has a "poison pill," a staggered board, and less than half of its directors are independent, non-executives. The analyst believes that (consistent with recommendations set forth by Institutional Shareholder Services) it would be in the long-term interests of shareholders for No Corp. (including his firm's clients) to remove its poison pill, elect all directors annually, and have a majority of the board consist of independent, non-executives. He has talked to No Corp.'s CEO and CFO over the past few years about these issues, and has even written a letter to the board. No Corp. has, in polite terms, consistently indicated that it is "comfortable" with its current structure and is not interested in the analyst's "fancy" ideas.
- The analyst, however, is not deterred. He puts together a proposal for ABC's CEO, suggesting that ABC submit resolutions (to remove the poison pill, etc.) for consideration at the next shareholders meeting of No Corp.
- Although ABC Investment Management has not previously submitted shareholders' resolutions or otherwise engaged in public shareholder activism, the firm's CEO thinks the analyst has an idea worth considering.

ABC's CEO is always careful when committing significant firm resources or when establishing new policies. Therefore, she begins her analysis with the following list of questions:

- What does our CFO say? What impact will this have on our bottom line?
- What does our General Counsel think? What are the legal issues and impediments?
- What does our Head of Marketing and Client Service say? What impact will this have on our firm's reputation? What will existing and prospective clients think?
- What does our CIO say? Do we have the skills necessary to be successful? What impact will this have on our "bread and butter" activities?
- What will our Board of Directors say? What is the overall cost/benefit conclusion?

¹⁵ Ultimately, a critical aspect of effective shareholder activism is the ability to translate economic interests into votes at shareholder meetings. Although much progress has been made over the past decade, the global proxy voting system is still woefully underdeveloped in many markets. Even if an investment manager is highly organized and motivated, it may not be possible to consistently translate shares into votes due to, among other things, late distribution of proxy information, restrictions contained in client contracts and depositary agreements, and the need to "block" shares in certain markets. Over time, and with a proper commitment of resources by industry participants, it should be possible to make great improvements in this area, so that a very high percentage of shares held by institutional money managers actually get voted at every shareholder meeting. While there is room for improvement, there is evidence suggesting some progress has been made. In the United Kingdom, the National Association of Pension Funds-sponsored Report of the Committee of Inquiry into U.K. vote execution found that pension shares voted had risen to 50% in 1999, from 20% in 1990.

Impact on Firm Economics

At the CEO’s request, ABC’s CFO prepares a quick study of the profitability aspects of the proposal. His analysis ignores “intangible” factors (such as reputation impact) and focuses principally on identifiable, probable cash effects. His spreadsheet includes the following variables:

Costs	Benefits	Other Key Variables
Legal and accounting fees	Increase in management fees	Investment return without activism
Proxy solicitation assistance		Incremental impact of activism – Year 1 (i.e., the “alpha”)
Public relations/ media assistance		Incremental impact of activism – Beyond Year 1
Cost of internal resources		The firm’s weighted average management fee
Amortized cost of “failed” projects ¹⁶		The size of ABC’s stake (i.e., the dollar value of the holding in No Corp.)

The CFO quickly recognizes that the profitability analysis is most sensitive to assumptions regarding total costs, the incremental return due to activism, and the size of ABC’s investment (i.e., the dollar value of the holding).¹⁷ Although costs are difficult to estimate with precision, the CFO believes that total costs per activist project could range from \$250,000 to \$1,000,000 or higher. As a base case, the CFO assumes total costs of \$500,000.¹⁸

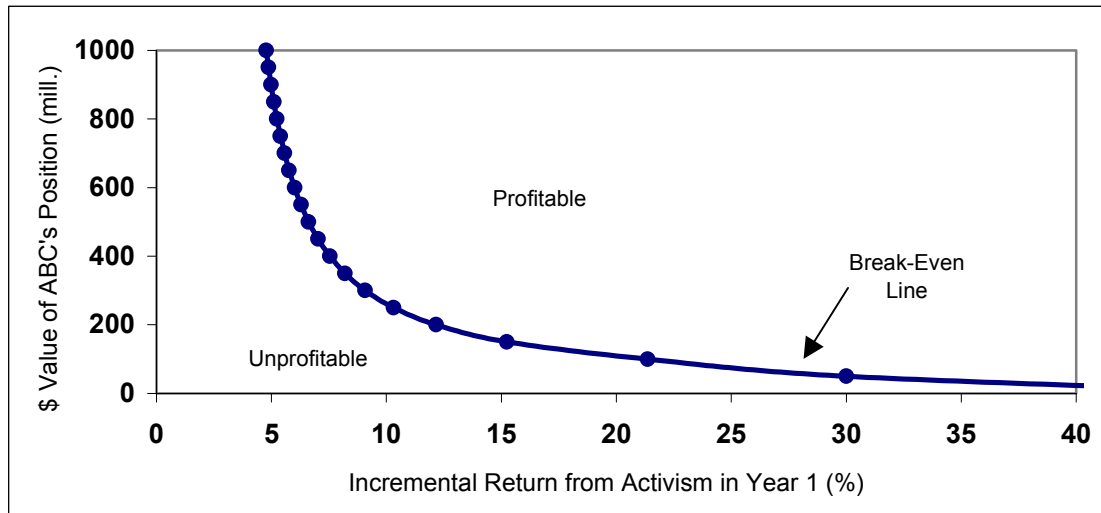
The CFO also estimates that the incremental impact of activism beyond Year 1 will be 3.0% per annum for Years 2 – 7, but nothing beyond Year 7. He then graphs the profitability of activism to isolate the impact of the other two key variables: incremental return from activism in Year 1; and the dollar value of ABC’s stake, as shown below.

¹⁶ The CFO is thinking long-term and recognizes that some activist projects will produce no benefit. Therefore, he estimates the success rate and includes an amortization charge for failed projects.

¹⁷ The analysis is also sensitive to the manager’s weighted average fee assumption. However, the CFO assumes that the firm can’t change its fees in the short-term and simply assumes the firm’s actual weighted average fee.

¹⁸ Consisting of: \$150,000 in legal and accounting fees; \$83,000 in proxy solicitation and public relations assistance fees; a \$100,000 charge for internal resources (time allocated by investment professionals, in-house legal, etc.); and a \$167,000 amortization expense to account for failed projects (assuming a 50% success rate). Based on our experience, we would suggest that the CFO’s base case total cost assumption is far too low for complicated shareholder activism involving a legal dispute.

Shareholder Activism: Break-Even Analysis



Source: Brandes Investment Partners

The CFO's primary advice to the CEO is that activism will probably not make strict economic sense for the firm (i.e., not taking into account "softer" issues such as reputation impact, the firm's strategic positioning, client expectations, etc.) *unless activism produces substantial incremental outperformance and/or the firm's aggregate position in the target company is quite large in absolute dollar terms.* Thus, because the investment manager typically bears all the costs associated with activism, the economic incentives may dissuade the investment manager from undertaking a particular "activist" project (or activism generally), even though it could generate meaningful benefits for clients.

Regulatory Hurdles

During a meeting with the firm's General Counsel, ABC's CEO learns that various securities laws and regulatory issues pose potential hurdles for ABC, should it choose to embark down the path of activism. While not insurmountable, the General Counsel explains that these legal and regulatory impediments may demand a significant investment of time and resources to overcome. Among the factors to consider are the potential for a manager to become an "insider" and face trading restrictions, complex rules governing communication with other shareholders, and complications related to potential appointments to the board of directors. For example, money managers are sometimes asked, based on the size of their holdings, to nominate or make an appointment to a company's board of directors. On occasion, managers try to achieve this through the proxy process. However, such an affiliation would, under many countries' laws, tend to make that manager an insider with respect to the company's stock and thus could complicate sales and purchases of the company's securities.

The General Counsel offers the CEO a thick binder containing a detailed explanation of the legal and regulatory obstacles associated with activist efforts. He adds that, with respect to accounts governed by ERISA, the Department of Labor (DOL) has issued a statement suggesting that some forms of shareholder activism are not inconsistent with ERISA fiduciary principles – although ERISA and the DOL have never articulated any guidelines or standards on the question of whether, when, or if shareholder activism is ever

necessary. We include excerpts from the DOL’s Interpretive Bulletin 94-2, as well as additional items from the General Counsel’s binder in Appendix A.

Impact on Firm Reputation and Market Position

Thumbing through the binder she received from the General Counsel, the CEO walks to the office of the Head of Client Service and Marketing. The CEO realizes some clients may be sensitive to the diversion of time and talent activism entails, or may even view it as an expensive rationalization for poor stock selection. In addition, she knows that members of corporate pension plan committees, upon learning of ABC’s activist efforts, may be reluctant to hire the firm as a manager for its pension plan assets. Any targeted company, at the very least, represents a potential client that likely can be crossed off the firm’s prospecting list.¹⁹

She also understands the potential for press coverage if ABC pursues the proposals and listens intently as her colleague explains that the tone and content of media messages are difficult to control, and that publicity may have adverse effects on how the manager is perceived. ABC has an established reputation for prudence, which could be undermined by the manner in which the financial press often characterizes firms engaged in activism. He tells the CEO that he has been following other managers engaged in activism, paying special attention to how the press regards them and produces a file stuffed with newspaper and magazine clippings. The CEO sees the following phrases circled in red: “rebellious,” “green mailer,” and “quick-buck artist.” The CEO listens to warnings of the potential for inaccuracies and misquotations in published reports. She realizes that these factors may tarnish ABC’s reputation and inhibit business development. After a lengthy discussion of these concerns, her colleague ends their conversation on a note of optimism, explaining that such negative encounters with the media are not universal.

Execution / Impact on Core Functions

With the information she has gathered, the CEO contemplates a course of action. She understands the pursuit of good corporate governance often demands a significant investment of time and unique skills and competencies that her firm may not possess. She recognizes areas of expertise in which the firm may be deficient, such as law, merger & acquisition activity, and public relations – realms outside the firm’s typical roles of security analysis and portfolio management. She weighs the historical precedent for managers – namely, to do the “Wall Street Walk” and sell shares to reflect displeasure. Without sufficient personnel devoted to the time-consuming demands of activist efforts, she realizes the detriments of diverting existing resources from core functions could potentially offset any incremental benefit from activism.

She also contemplates the CIO’s concern regarding the potential for “information chill” – the reluctance of management teams at publicly held firms to share information with activist managers who they feel may pose a threat to their jobs.²⁰

¹⁹ A group focused on improving corporate governance in Hong Kong (see Webb-site.com) has argued that “bottom up” approaches to improving corporate governance are inhibited by conflict of interest issues: “Many fund managers are affiliated to commercial or investment banks, whose profits depend in part on their banking businesses with the same companies in which the funds invest. You don’t win mandates by criticising your clients. This is the same conflict that is at the root of much of today’s broker-led investment research. In addition, even those fund managers independent of banks face difficulties. In a market with inadequate corporate disclosure, they often depend on access to the management of companies for their information. They may make complaints in private to these management teams, but any public criticism of the companies is likely to see them shut out, and scraping around the market for information like everyone else. The ‘company visit’ is often a fund manager’s greatest asset.”

²⁰ To a certain degree, concerns about “information chill” may become less important, especially as global markets move toward full disclosure rules similar to those adopted in the United States. On a related note, for firms actively participating in primary and

Overall Cost-Benefit Analysis

In a meeting with ABC's Board, the CEO shares the analyst's proposal and the information she has gathered about the potential impact of activist strategies on the firm, including profitability issues, regulatory hurdles, reputation and marketing issues, and challenges of execution. The Board discusses whether activism should be a component of the firm's overall business model and long-term competitive strategy. Ultimately, the Board does not make a decision, but sends the CEO back to consider some additional long-term issues, including whether targeted, skillfully executed activism could differentiate ABC from its competition or enable ABC to provide a service to its clients that would assist in overall client retention.

Some Concluding Thoughts

In light of the evidence cited in this paper, including the premium investors are willing to pay for sound corporate governance, CalPERS' efforts and subsequent impact on the performance of targeted companies, and the potential for additional, less-quantifiable advantages, we believe shareholder activism remains an option for institutional money managers and pension plans to consider on a case-by-case basis in seeking to foster long-term wealth creation.

Given the variety of constraints institutional money managers face when considering activism – from regulatory impediments to execution issues to profitability factors – we raise the following questions with the goal of prompting discussions on the roles of pension funds and institutional money managers as they relate to shareholder activism:

- What is your time frame for seeing results from activism?²¹
- How do you monitor manager proxy voting?
- Have you asked managers about their corporate governance activities and policies in this area?
- Have you considered allocating some funds (either individually or as part of an overall industry effort) to supporting corporate governance activities, including the use of specialist managers?
- Have you reviewed contracts and removed any unintended impediments?
- Have you lobbied for best practices at your own corporation?

In closing, we believe that it is worthwhile for pension plans to devote some time and resources to evaluating whether activism is in the long-term interests of their beneficiaries. Assuming that this is the case, some effort should also be devoted to considering how institutional money managers can be encouraged to periodically “tilt at windmills.”

secondary offerings, the reputation as an activist among corporate management teams and investment bankers may negatively affect how these firms are perceived and potentially hurt their future participation in new offerings.

²¹ The Myners Report noted that, from the perspective of the investment manager, “. . . there is little incentive to adopt activist strategies, which do not deliver the quick results which a perceived focus on quarterly figures tends to demand.”

Appendix A

The Institutional Money Manager: Regulatory Hurdles

Insider Trading Restrictions

Most forms of shareholder activism include communications between representatives of the money manager and management of the targeted company. These communications can raise the specter of applicable securities laws that address “insider trading,” the act of fraudulent misappropriation of material, non-public information or “inside information.” As we know, trading or investing by a person who is influenced by inside information, or in some instances merely communicating that information, is a crime in most countries. In entering into discussions with management of a targeted company, a representative of a money manager can become a temporary insider of the company. Many managers are apprehensive about engaging in sustained or contentious talks with company management out of concern for being given, or otherwise obtaining, inside information which could chill the money manager’s buying and selling activities in the stock for an indefinite period.

Solicitation

Another key component of many shareholder activist efforts is communication between or among shareholders of a company. The subject of many of these communications is often whether the company’s management should take particular corporate actions. Communications among shareholders may trigger applicable proxy and solicitation rules. These rules can be quite broad and require a money manager, even under generally benign circumstances, to produce, file, and deliver to shareholders a proxy statement containing extensive disclosures about the money manager, its purpose in the matter at hand, and its purpose with respect to the company’s securities – all of which are subject to various applicable anti-fraud laws and which may be enforced or asserted by the government or through a private right of action by the company itself. Most proxy rules are complicated and rather ambiguous as to their coverage. Thus, a proxy fight is rife with substantial litigation risk, liability, and negative publicity for the money manager. The targeted company has many tools available to it, including litigation, which could mean that the activist process is painful, complicated, and expensive for the money manager.

Indeed, in the United States, a target company can legally exclude a shareholder’s proposal from its proxy statement for a variety of substantive reasons if the proposal relates, for example, to:

- a) personal grievance and/or special interest (if the proposal relates to the redress of a personal claim or grievance against the company or any other person, or if it is designed to result in a benefit to the sponsoring shareholder, or to further a personal interest, which is not shared by the other shareholders at large);*
- b) relevance (if the proposal relates to operations which account for less than five percent of the company’s total assets at the end of its most recent fiscal year, and for less than five percent of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the company’s business); and*
- c) management functions (if the proposal deals with a matter relating to the company’s ordinary business operations). One implication of the foregoing is that share ownership in the United States is ultimately intended to merely entitle the holder to an economic interest in the company (i.e., dividends) rather than any definitive ability to exert control or influence operational details.*

A continuing refrain among shareholder activists is that the foregoing characteristics of the proxy and solicitation rules chill legitimate shareholder initiatives. Managers may also find themselves under some countries’ laws as being a part of a “concert party,” required to make a bid for the entire company as a result of some types of shareholder

communications. We raise these issues to highlight the existence of certain laws that have the effect of making communications among shareholders about corporate governance issues problematic for the activist money manager. In crafting communications on activist issues, a money manager must not only be careful about the substance of its communications, but it must also be careful with whom it communicates.

Board Appointments

Money managers are sometimes asked, based on the size of holdings, to nominate or make an appointment to a company's board of directors. On occasion, managers try to achieve this through the proxy process. However, such an affiliation would, under many countries' laws, tend to make that manager an insider with respect to the company's stock and thus could complicate sales and purchases of the security as addressed above.

Having a board appointment, even if granted to some unaffiliated nominee, will cause the money manager's activity in that company's stock to be plausibly suspect and subject to scrutiny and litigation by other shareholders and regulators because of its association with the board member. This is true regardless of whether the money manager could construct a "Chinese Wall" to insulate it from the actual receipt of inside information from the company. Viewed from a perspective of practicality, many money managers would probably not want to risk the presumption of insider trading and the associated expense of investigation and litigation possible with each sale or purchase of a particular security. Ironically, at some level, the benefit of having a board seat seems completely lost by the need for a Chinese Wall restricting the manager from communicating with the board appointee on confidential matters. In other words, being an active investment manager and having a board representative gives the manager all of the burdens and adverse presumptions associated with being an insider with little opportunity to leverage the connection for the benefit of all shareholders.

Also, insiders such as directors, are, in many countries, under constraints as to when they can sell and buy their company's stock. They may also be subject to reporting requirements with respect to the amounts, timing, and prices associated with any transactions in their company's stock. A money manager appointing people to the board would have to examine local law to determine whether, and to what extent, such reporting obligations and selling restrictions could migrate to the manager as a result of its association with the board appointee. Lastly, if the board member is associated with ineffective, retrograde, unpopular, or illegal activities in his capacity as a board member, the money manager could be tainted by the association. Ultimately, if the company is mismanaged, the money manager may receive part of the blame for having appointed a board member. If that occurs, its ability to manage money could be disparaged by its attempt at managing the business.

These potential developments reflect a few of the legal and regulatory issues faced by a money manager in attempting to actively promote a corporate governance agenda.

Comments on Interpretive Bulletin 94-2

In Interpretive Bulletin 94-2, the Department of Labor (the "Department") stated: "the fiduciary act of managing plan assets that are shares of corporate stock includes the voting of proxies appurtenant to those shares of stock." As a result, the Department noted, the responsibility for voting proxies lies exclusively with the plan trustee except to the extent that either (A) the trustee is subject to the directions of a named fiduciary pursuant to ERISA § 403(a)(1); or (B) the power to manage, acquire or dispose of the relevant assets has been delegated by a named fiduciary to one or more investment managers pursuant to ERISA § 403(a)(2).

The fiduciary duties described at ERISA § 404(a)(1)(A) and (B), require that, in voting proxies, the responsible fiduciary consider those factors that may affect the value of the plan's investment and not subordinate the interests of the participants and beneficiaries in their retirement income to unrelated objectives. Furthermore, the Department has

noted that the fiduciary obligations of prudence and loyalty to plan participants and beneficiaries require the responsible fiduciary to vote proxies on issues that may affect the value of the plan's investment (see, Interpretive Bulletin 94-2)(emphasis added). Although the same principles apply for proxies appurtenant to shares of foreign corporations, the Department recognizes that in voting such proxies, plans may, in some cases, incur additional costs. Thus, the Department has stated, a fiduciary should consider whether the plan's vote, either by itself or together with the votes of other shareholders, is expected to have an effect on the value of the plan's investment that will outweigh the cost of voting. Moreover, a fiduciary, in deciding whether to purchase shares of a foreign corporation, should consider whether the difficulty and expense in voting the shares is reflected in their market price. Nothing in the foregoing has been or should be interpreted as interfering with or otherwise affecting a fiduciary's dispositive powers with respect to plan portfolio holdings.

While by no means mandating shareholder activism by plan fiduciaries, the Department has stated in Interpretive Bulletin 94-2 that a plan's investment policy statement that contemplates activities intended to monitor or influence the management of corporations in which the plan owns stock is not inconsistent with a fiduciary's obligations under ERISA where the responsible fiduciary concludes that there is a reasonable expectation that such monitoring or communication with management, by the plan alone or together with other shareholders, is likely to enhance the value of the plan's investment in the corporation, after taking into account the costs involved (emphasis added). Such a reasonable expectation may exist in various circumstances, for example, where plan investments in corporate stock are held as long-term investments or where a plan may not be able to easily dispose such an investment. Active monitoring and communication activities would generally concern such issues as the independence and expertise of candidates for the corporation's board of directors and assuring that the board has sufficient information to carry out its responsibility to monitor management. Other issues may include such matters as consideration of the appropriateness of executive compensation, the corporation's policy regarding mergers and acquisitions, the extent of debt financing and capitalization, the nature of long-term business plans, the corporation's investment in training to develop its work force, other workplace practices and financial and non-financial measures of corporate performance. Active monitoring and communication may be carried out through a variety of methods including by means of correspondence and meetings with corporate management as well as by exercising the legal rights of a shareholder.

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