

PUTTING THE G IN ESG – HOW ACTIVISTS TARGET GOVERNANCE ISSUES



While activists continue to agitate for change on issues such as M&A strategy, operational failings and climate, one area that activists also target under the banner of ESG is governance.

Activists are making increasing use of governance issues when targeting companies, and companies that ignore this risk being caught out. In this short article we look at some reasons behind the focus on governance, the sorts of failures that make companies vulnerable and the steps they can take to protect themselves.

Why are activists targeting governance?

According to Lazards' Q1 2022 Review of Shareholder Activism, governance change accounted for 12% of campaign objectives globally. Further, activists often use governance failures to reinforce a narrative that the board is adrift and not fit for purpose, even where their main objective is something else, such as M&A activity or a change of strategy.

This increasing focus on governance is driven by a number of factors:

- a broader spectrum of investors are looking to drive change and hold investee companies to greater account, partly as a result of rules requiring them to do so, such as the Stewardship Code;
- in recent years, board accountability has increased, as institutional investors, the FRC and proxy advisers monitor companies' compliance with the UK Corporate Governance Code (the "Code") and the quality of explanations provided by boards when they choose not to comply with a provision of the Code;
- shareholders and other stakeholders are demonstrating less tolerance for perceived poor governance, particularly in the wake of the Covid pandemic and where companies accepted government financial support;
- sophisticated activists are highly skilled at making convincing and well-researched

arguments around governance failures and using the media and direct contact to win other shareholders to their side; and

- activists make the campaigns personal, which gets attention and suits the strategy of some activists.

It is also important to note that the UK is a relatively activist-friendly jurisdiction for a number of reasons. Activists do not necessarily need to acquire a significant stake in a company in order to have a significant impact:

- Unlike in some other countries, UK listed companies are not able to embed "poison pills" that deter potential takeover bidders or prevent board change.
- Premium listed companies are required to put directors up for re-election annually under the Code, providing an annual event at which directors can be targeted (without an activist taking any action).
- An activist holding shares in a UK company has relatively generous legal rights that it can lever to agitate for change. Activists are generally only required to make a disclosure of their shareholding upon reaching 3%, or more likely 5%, of the company's share capital so can sometimes stake build under the radar.

How can boards protect themselves from criticisms about governance?

A listed company can limit the scope for an activist to attack its governance by:

- ensuring it maintains high governance standards, particularly in the areas that activists often exploit (see table below);
- complying with the Code and the FRC's Guidance on Board Effectiveness; and
- where it is not complying with a particular provision of the Code, having a clear and convincing explanation for not doing so and communicating this effectively with its shareholders, often directly.

What areas of governance are activists targeting?

| Area | Issues | Examples |
|---|---|---|
| <p>Remuneration</p> | <p>Criticising remuneration is a common point of attack, and one that often resonates with other shareholders and the media. Compensation packages that are alleged to be excessive can indicate that management and shareholders' interests are not aligned, and that the remuneration committee is not working effectively.</p> <p>The Code requires remuneration schemes to promote long-term shareholdings by executive directors that support alignment with long-term shareholder interests.</p> | <p>Foxtons Group plc: After acquiring a 2% stake in Foxtons in 2021, Catalyst Partners demanded the company make operational changes and criticised the remuneration policy, arguing that management pay was disproportionate and not aligned with shareholder value creation. After a 40% shareholder revolt against the remuneration policy at Foxtons' 2021 AGM, the company was forced to announce a review of its remuneration policy. Since then it has also announced a number of board changes, including a change to the chair, and the divestiture of one of its businesses.</p> |
| <p>Succession planning and recruitment</p> | <p>The Code has detailed rules about recruitment and orderly succession planning. It recommends the use of external recruitment consultants for chair and non-executive positions to ensure a diverse pipeline of talent.</p> <p>Recruiting from a limited pool of "insiders" gives the impression that the board is closed to new ideas and is not being refreshed by new talent. A poorly planned succession also gives the impression of disorganised processes.</p> | <p>Allied Minds plc: In March 2022, activist Crystal Amber issued a letter to Allied Mind's shareholders, urging them to vote to remove Harry Rein as the company's chair. Among the criticisms levelled at the standard of governance at Allied Minds, Crystal Amber pointed to non-compliance with the Code, alleging that no external search consultancy was used to identify and recruit the Senior Independent Director and that instead the director had been proposed, and persuaded to join the board, by Harry Rein. Crystal Amber also argued that the director was not independent since he and Harry Rein were connected by virtue of being co-directors of another company.</p> |
| <p>Requisite skills and diversity</p> | <p>It is a principle of the Code that the board and its committees should have a combination of skills, experience and knowledge. Consideration should be given to the length of service of the board as a whole and membership regularly refreshed.</p> <p>Lack of necessary experience on the board has been a common claim in a number of recent high profile campaigns against boards and particular directors.</p> <p>Gender and ethnic diversity arguments may also be increasingly used, particularly where the company falls below the 33% Hampton-Alexander review target for gender diversity, the ethnic diversity targets set by the Parker review, or the recently announced new Listing Rules for listed companies to publicly report on their board diversity.</p> | <p>Arix Bioscience plc: In March 2021, activist shareholder Acacia Research, which held a 19% stake, criticised Arix for a disappointing governance history pointing to the fact that it had had 18 different directors in just five years, a lack of gender diversity on the Board, and a lack of requisite experience and skills. Acacia called for Arix to commence a search for a replacement CEO, restructure the board with individuals with requisite experience and skills, and hire an experienced team of life sciences investment professionals. This led shortly after to the appointment of two Acacia nominees to the board and the replacement of the chair.</p> |

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|---|--|---|
| Board structure | There are a number of potential issues around board structure: no split in the role of Chairman/CEO (though this is relatively rare in the UK these days), the perception of a dominant CEO or of a lack of communication between the executive team and the wider board and lack of perceived independence of the Chair and/or non-executives. | Blue Prism Group plc: In 2021 Coast Capital criticised Jason Kingdon for his “conflicted roles” as chair and CEO of Blue Prism. It also criticised another non-executive director for not being sufficiently independent claiming that his prior links to another company created bias in the context of a takeover battle for Blue Prism. |
| Overboarding | The Code discourages overboarding but while it sets a limit on external appointments held by executive directors, as do institutional investors and proxy advisers, the Code does not set a maximum for non-executive directors. Overboarding makes boards and the relevant director vulnerable to criticism that having too many non-executive roles can make the director unable to devote sufficient time to the company’s business. | A number of institutional investors have said that they will vote against the re-election of overboarded directors. The influential proxy advisory firm ISS has a five-point system for “scoring” whether a director is overboarded when deciding whether to recommend a vote for or against re-election. Glass Lewis and Legal & General operate similar five-point systems. Other institutional investors such as BlackRock and Norges impose their own system of limits. |
| Conflicts of interest and unsuitability | Activists will target a particular director where that individual is perceived as having a conflict of interest or as being unsuitable for the role. Links to other boards or organisations which appear competitive or opaque, or having management who are close friends or family members may also attract increased attention. | SThree plc: In April this year, SThree (a UK listed recruitment company) saw the chair of its audit committee resign from the board. Shareholders had raised concerns about her suitability, having previously served for six years as chair of the audit committee of construction firm Interserve prior to its going into administration amid an investigation into the quality of its auditing. |



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