

Shareholder Activism & Engagement

Contributing editors

Arthur F Golden, Thomas J Reid, Laura C Turano
and Thomas D Malinowsky



2017

GETTING THE
DEAL THROUGH

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CONTENTS

Introduction	5	Israel	47
Arthur F Golden, Thomas J Reid, Laura C Turano and Thomas D Malinowsky Davis Polk & Wardwell LLP		Clifford MJ Felig, Yael Weiss and Jonathan M Nathan Meitar Liquornik Geva Leshem Tal	
Australia	7	Italy	52
John Elliott, Raymond Lou and Lana Tian Norton Rose Fulbright Australia		Enrico Giordano and Gabriele Lo Monaco Chiomenti Studio Legale	
Brazil	14	Japan	57
Fernando Zorzo Pinheiro Neto Advogados		Masakazu Iwakura, Yo Ota, Ryutaro Nakayama and Shigeru Sasaki Nishimura & Asahi	
Canada	18	Korea	62
William J Braithwaite, John Ciardullo and Mike Devereux Stikeman Elliott LLP		Chang Hyeon Ko and Gene-Oh (Gene) Kim Kim & Chang	
China	23	Sweden	67
Chen Bao Fangda Partners		Björn Kristiansson and Sanna Böris Hannes Snellman Attorneys Ltd	
Finland	27	Switzerland	71
Johan Aalto and Jesse Collin Hannes Snellman Attorneys Ltd		Mariel Hoch Bär & Karrer AG	
France	31	United Kingdom	76
Jacques Naquet-Radiguet, Juliette Loget and Ferdinand Barbé Davis Polk & Wardwell LLP		Will Pearce and Allison Kramer Davis Polk & Wardwell LLP	
Germany	36	United States	82
Martin Schockenhoff, Gabriele Roßkopf and Martin Hitzer Gleiss Lutz		Arthur F Golden, Thomas J Reid, Laura C Turano and Thomas D Malinowsky Davis Polk & Wardwell LLP	
India	42		
Vandana Shroff and Paridhi Adani Cyril Amarchand Mangaldas			

Preface

Shareholder Activism & Engagement 2017

Second edition

Getting the Deal Through is delighted to publish the second edition of *Shareholder Activism & Engagement*, which is available in print, as an e-book, and online at www.gettingthedealthrough.com.

Getting the Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique **Getting the Deal Through** format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes new chapters on Brazil and Korea.

Getting the Deal Through titles are published annually in print. Please ensure you are referring to the latest edition or to the online version at www.gettingthedealthrough.com.

Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Getting the Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editors, Arthur F Golden, Thomas J Reid, Laura C Turano and Thomas D Malinowsky of Davis Polk & Wardwell LLP, for their continued assistance with this volume.

GETTING THE
DEAL THROUGH 

London
January 2017

Introduction

Arthur F Golden, Thomas J Reid, Laura C Turano and Thomas D Malinowsky

Davis Polk & Wardwell LLP

While in recent years the story surrounding shareholder activism has been its rapid growth, much of 2016 has been characterised by tales of shareholder activism headwinds. Examples include activist mainstay Pershing Square realising public losses in its investment in Valeant Pharmaceuticals (among other investments) and suffering public defeat in connection with the attempted bid by Canadian Pacific for Norfolk Southern, ValueAct facing litigation and agreeing to a concessionary settlement over its investment in connection with the terminated merger between Baker Hughes and Halliburton (in addition to ValueAct's own substantial losses on its investment in Valeant) and well-known activist Carl Icahn's investment fund falling 18 per cent in just the first half of the year. In our inaugural edition of *Shareholder Activism & Engagement*, we predicted that shareholder activism was here to stay. Despite the headwinds experienced by shareholder activists in 2016, we continue to believe that this is clearly the case. 2016 has also strengthened our belief that as shareholder activists experience losses and reduced – even if still positive – performance levels, there will be sharper focus on the low investment diversification, liquidity challenges and personality-dependent strategies that feature prominently in the shareholder activism asset class.

The chapters of this second edition of *Shareholder Activism & Engagement* are again a product of the efforts of esteemed practitioners throughout the world, including some of the foremost experts in the expanding field of shareholder activism. This introduction identifies some of the trends and topics that we have seen as 2016 comes to a close, and we look forward to providing readers with in-depth, country-by-country coverage in the chapters that follow.

Mid-cap companies increasingly in the crosshairs of shareholder activists

In 2016, we continued to see examples of large-cap companies with household names being targeted by shareholder activists (for example, United Continental, Viacom and Yahoo). However, a trend has emerged in which shareholder activists are increasingly retreating to the relative safety of smaller targets, often with high success. Market-wide, a total of 58 per cent of the companies targeted by shareholder activists in 2016 have market caps below US\$2 billion, compared with 49 per cent in the three-year period prior; and only 7 per cent of companies targeted by activists in 2016 have market caps above US\$20 billion, compared with 12 per cent in the three-year period prior. This trend appears to be, in large part, a combined product of seasoned veterans seeking novel opportunities and new firms entering the activist space. Activist firms Jana Partners, Land and Buildings, Marcato and ValueAct, among others, have each targeted companies with average market caps of less than 50 per cent of their targets in the three-year period prior, and in fact, of the top 10 activist funds (measured by campaigns initiated in 2016), only Elliott Management and GAMCO Investors targeted companies with higher average market caps than they did in the three-year period prior. These activist titans are, however, being joined in the market by an expanding group of peers. Large firms with more traditional investment portfolios and new, smaller firms entering the activist space have each found room in the market. Campaigns by 'occasional' activists have ballooned in recent years, and by some metrics there has been more than double the volume of such campaigns in 2016 as compared with 2014. As this growing pool of activist shareholders looks for opportunities, companies outside of the United States may also find themselves

to be increasingly in the crosshairs of investors. In 2016 approximately 33 per cent of all activist campaigns were levied against non-US companies. As a result, the market for shareholder activism in 2016 is very much one where activists are everywhere and anyone can be an activist. It is also a market in which no company is too big or small to be a target.

A related trend we are following is what changes shareholder activists are actually pursuing in the companies they target. In years past, many noteworthy firms' primary strategy for generating returns was to identify and pursue companies with salient capital structure or management weaknesses, taking a short-term view to generate immediate returns by encouraging leverage where appropriate or forcing change at the top. This has decreased in 2016, with only 23 per cent of shareholder activists indicating an interest in modifying their target's capital structure (down from an average of 47 per cent in the three-year period prior) and only 13 per cent leading with an open intention to change management (down from 16 per cent in the same time frame). Instead, shareholder activists are more often seeking a seat at the table and pushing for board representation and governance changes in 49 per cent of target situations (up from 41 per cent in the same time frame) as well as strategic changes in 50 per cent of targets (up from 46 per cent in the same time frame). We see this trend as linked to the broadening of the activist population. As shareholder militancy for change becomes more and more common, we expect the population of activists to continue to expand and include more and more traditional large investors.

Increased role of institutional investors in the activist landscape

As the population of activist investors expands and broadens we are paying close attention to the evolving role of institutional investors in the activist marketplace. Previously resigned to maintaining passive, long-sighted investments, index, mutual and pension funds are among the market constituents most rapidly shifting to add activist investments to their portfolio. As early as the first quarter of 2015, institutional investors Vanguard and BlackRock indicated their increasing willingness to engage in opportunistic activism, and true to form, in April 2016, BlackRock launched its first activist campaign, targeting the G-Resources Group based out of Hong Kong, while in June 2016, Vanguard issued a summary of its activist efforts, indicating a 19 per cent increase in engagement over the 12-month period prior and a 67 per cent increase over the three-year period prior.

This uptick in engagement efforts is even more revealing when one considers the breadth and scale of investments within these institutional investor portfolios. In the 11-year period prior to June 2016, Vanguard alone went from holding a greater-than-5 per cent stake in less than 1 per cent of all S&P 500 companies to holding such stake in more than 90 per cent of S&P 500 companies today. Clearly, these institutional investors are forces to be reckoned with now and going forward, but their strategy is not without challenges. In April 2016, the US Department of Justice brought a civil action against ValueAct in connection with its purchase of shares of Halliburton and Baker Hughes, alleging a plan to 'take steps to influence the business decisions of both companies.' As the line between shareholder activists such as ValueAct and institutional investors begins to blur, institutional investors will need to be mindful of potential additional limitations and compliance requirements as they plan their interactions with the companies they invest in and what a portfolio with mixed strategies looks like in practice.

Proxy access by-laws gain further support

Proxy access has quickly evolved from uncharted territory to inevitable. Rule 14a-8 shareholder activists made nearly 200 proposals to enact proxy access at 2016 annual shareholder meetings. (Rule 14a-8 refers to US Securities Exchange Act Rule 14a-8, which requires a company to include a shareholder proposal in its proxy materials if certain minimum requirements are met, including the shareholder owning at least US\$2,000 or 1 per cent of the securities entitled to vote on the proposal.) At this point, it is widely expected that a majority of S&P 500 companies will have adopted proxy access by the end of 2016. This increase is put into greater perspective when we consider that merely a dozen companies had made a similar adoption prior to 2015. However, the explosion of proxy access by-laws has not yet been accompanied by a similar increase in proxy contests and we do not expect that to happen. Many boards seem to have a similar view and have approached proxy access with relative equanimity. In addition, in many ways, this rapid shift is not unexpected. At a time when proxy advisory firms hold great sway and institutional investors have detailed 'no exception' in-house voting guidelines, one-size-fits-all governance is an increasingly powerful force.

On 10 November 2016, activist fund GAMCO Investors filed the first proxy access director nomination, proposing a candidate for the board of National Fuel Gas Company (NFG). GAMCO ultimately withdrew the nomination after NFG declared the nomination to be invalid on the basis that GAMCO did not satisfy NFG's proxy access by-law's 'passive investment' requirement (which required a nominating shareholder (i) to have acquired shares 'in the ordinary course of business and not with the intent to change or influence control of [NFG]' and (ii) to 'not presently have such intent'). Even though the GAMCO nomination was withdrawn, we believe that it is important to note for two reasons. First, it illustrates the importance of proxy access eligibility requirements – both for companies as they design and enforce such requirements, and for potential nominating shareholders as they plan their interactions with the companies they invest in (similar to our point above regarding the Hard-Scott-Rodino 'passive investment' exemption). Second, it is further evidence that shareholder activists may attempt to use whatever tools are at their disposal (even tools, such as proxy access, that were not originally intended as an activism tool for those seeking to change or influence control). While many believed that the holding period requirements and other proxy access by-law restrictions (including limitations on solicitation) would make proxy access unattractive to traditional shareholder activists, we do not think that GAMCO will be the last traditional shareholder activist to attempt to use proxy access. Especially in cases where a shareholder activist has not had to file a Schedule 13D (for example, because the target company

is a mega cap company and the activist has not crossed the 13D filing threshold), we may see traditional shareholder activists calibrating or delaying their contacts with target company management to avoid leaving a trail of breadcrumbs regarding their intentions that could later be used by the target company to reject their proxy access nomination.

Settlements become mainstream

As we predicted last year, shareholder activists have increasingly been able to effect change without instigating a full-scale proxy fight. Companies are settling with activists early and often, viewing the threat of a costly fight as more harmful than the certainty of negotiating and accommodating demands up front. In the first three quarters of 2016, there were 107 board seats awarded to shareholder activists – already a higher total than was awarded to such investors in 2015 – only seven of which derived from an actual proxy contest. We have also seen increasing scrutiny of boards quickly acquiescing to shareholder activist demands, with State Street even issuing a report on settlements. We will continue to monitor developments in this area, including in how settlement practices in the United States influence such practices in other jurisdictions. We continue to believe, as some investors have said, that boards may now be too quick to raise the flag of surrender in many cases.

Universal ballot

In October 2016, the US Securities Exchange Commission proposed changes to proxy rules to require the use of universal proxy cards in contested proxy elections. The proposal is designed to address the current inability of shareholders of US public companies to vote for the combination of board nominees of their choice in an election involving a proxy contest. We believe this is an important development to monitor, especially because of its potential interaction with proxy access developments (despite the differences between proxy access and universal proxy) and the potential impact of the US presidential election.

Final note

We are excited to add Brazil and Korea to this second edition of *Shareholder Activism & Engagement* and are eager to share the updates that we and our fellow contributors have prepared regarding jurisdictions covered in last year's inaugural edition. Our aim in this second edition is to provide an updated analysis of the global shareholder activism and engagement landscape and to identify key changes over the past year to help our readers understand and evaluate the evolving marketplace. We look forward to following future developments as shareholder activist and engagement strategies continue to mature.

Getting the Deal Through

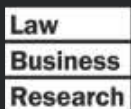
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