Activist shareholders pose new challenge for boards of directors

Interview with Barbara Heller, Managing Partner of SWIPRA

Board members are increasingly being expected to cultivate an awareness of their stakeholders' various demands and to engage in active dialog on topics like sustainability and corporate social responsibility. Success comes to those who can credibly demonstrate the connection between the company's strategy and these issues. The Coronavirus will only make this situation more obvious. Barbara Heller is Managing Partner at SWIPRA Services, a service provider that advises companies on all aspects of corporate governance. In this interview with Prof. Reto Eberle, Partner at KPMG Switzerland, she discusses how well companies are succeeding in this.

Reto Eberle: *You pay extremely close attention to the topic of corporate governance in Switzerland. Which aspects of corporate governance will be of particular concern to us this year?*
Barbara Heller: Sustainability in corporate governance is undoubtedly this year's most dominant issue. Regardless of whether you call it ESG (environment, social, governance) or CSR (corporate social responsibility), at their core, these concepts always revolve around the question of how to run a company and how to operate the business successfully in the long term. The answers to these questions determine the composition of the board of directors and the executive board, among other things. We are currently seeing a great deal of pressure from investors, especially activist shareholders, who demand clear answers and transparency.

Do you think there is any truth to the belief that companies are failing to provide enough clear, transparent information about the sustainability of their activities? And if so, why?
Sustainable reporting is a multifaceted issue and the insight that responsible, sustainable conduct will bring long-term success and contribute toward social welfare is nothing new. That's one of the fundamental economic principles proposed by Adam Smith in his magnum opus "The Wealth of Nations". What's not quite as easy to explain, however, is how this principle should be implemented. In the past, the focus has clearly been on backward-looking (financial) reporting. Today, it's more about "how" a business is run and embraces a forward-looking approach. The purely financial view is giving way to a process-based view that incorporates every aspect of socially responsible action and encompasses employees, the environment, the value chain, supplier relationships and so on. There is even more focus on this topic in a crisis, such as the one the Coronavirus brought forth. Using simple tools and words to describe the opportunities and risks this opens up is an enormous challenge and one aspect of the support we provide to companies in our day-to-day work.

Barbara Heller
Managing Partner of SWIPRA

Acting responsibly and sustainably over the long term is a fundamental economic principle

You mentioned activist shareholders In Switzerland, we're observing a growing trend in the number of shareholders taking an activist approach. Why?
We need to differentiate between the various types of activism. There are traditional activists, who also act as active investors and who want to leverage their financial engagement as a means of effecting change and reaching a goal. They may be hedge funds, for example, and address strategic issues with a short to medium-term horizon or they could be trying to prevent or influence current M&A transactions to turn a quick profit. This type of activist shareholders doesn't shy away from using the public spotlight as a way of exerting pressure and promoting his or her interests. A newer type of activism, often referred to as "active ownership", has emerged from the ever-growing camp of passive institutional investors.

At least with respect to equities, these are investors who don't engage in stock picking but compile indices and define thematic investment strategies instead. These include large international fund managers, asset owners such as pension funds and even larger banks with their asset management businesses.
They often advocate issues related to the governance and sustainability agenda and try to exert their influence in the run-up to annual general meetings to shift agendas or the officer elections in their favor.

Is going public always their first choice?
No. Normally, shareholders with an activist approach – independent of the form of activism – first request a meeting with the board of directors. If the formal route takes too long or doesn't move in the right direction, they may use publicity as a way of putting pressure on the company. Since dialog with active owners with a long-term focus (something we refer to as "engagements") is much less likely to take place in public and rarely happens directly at annual general meetings, it's less visible from the outside, even though dealing with these stakeholders is just as important, if not more so, for the company and the board of directors. Our corporate governance survey, which we've been conducting for eight years now, has shown us that companies make more adjustments in their governance structures based on engagements than on the basis of AGM results. We find that this holds even more true in a year where most AGMs take place under the exclusion of the public in view of the Coronavirus.

Are activist shareholders only important in terms of their media impact or is the role they play actually important in real terms? Or in other words: Isn't it possible that the importance of activist shareholders might be overestimated due to their enormous media coverage?
I can assure you that the discussion conducted in public is only the tip of the iceberg. Dialog takes place between institutional investors and the companies throughout the year; it's an ongoing exchange that happens far away from the media spotlight. Activists that fall into the first category I mentioned are much more opportunistic, however, and their actions make a bigger impact in the media.

What do activist shareholders typically criticize about Swiss companies?

While known activists opportunistically target companies that are going through difficult strategic phases or involved in a transaction like a takeover, institutional investors who manage pension fund assets, for example, are different because they have a long-term horizon. The big challenge – both for the company and investors – is to understand how the strategy, governance, CSR, risk management and incentive systems should be integrated into a business model geared toward long-term success. Because the way these factors interplay has a crucial impact on the opportunities and risks associated with an investment. When it comes to new topics and approaches like ESG, however, even investors are still trying to work out how to implement these correctly, both within the scope of their investment process and with an eye to an upcoming AGM. Plus, since institutional investors often don't have enough in-house resources to evaluate the topics on their own, they consult ESG ratings like MSCI[2] and Sustainalytics[3] and draw on the recommendations of proxy advisors. This can be problematic, however, because – from the company's perspective – topics like these can't be examined using a standardized approach. Our survey revealed that only around 25% of businesses feel that their CSR efforts have been sufficiently factored into these ratings. The stock market is already exhibiting valuation-distorting trends that can be attributed to ESG ratings.

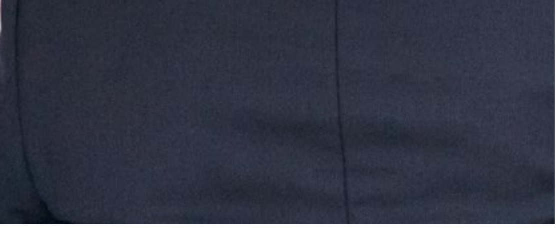
When it comes to engaging in dialog with activist shareholders, what role does the board of directors play?

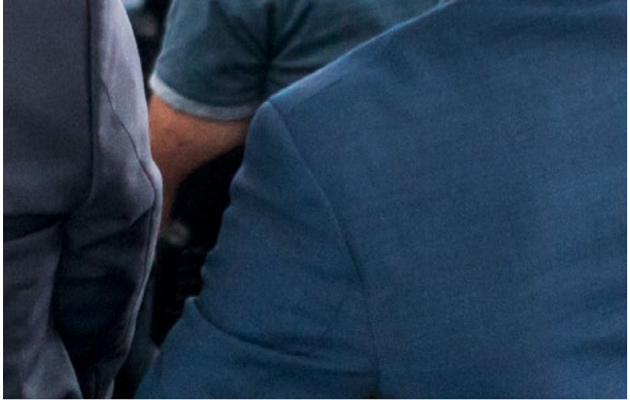
The board of directors is responsible for defining and monitoring this integrated view of the various aspects of corporate governance. Here, we're not just talking about monitoring and controlling financial processes, but also about non-financial topics and, consequently, about reputation management as well. Nowadays, the board of directors has a bigger responsibility to protect its company and to understand all the opportunities and risks associated with its business activities.

Is there any way for boards of directors to shield their companies from this type of activism?

Active owners can't be prevented from taking action. That's not bad per se, because what activist shareholders want is to have active dialog taking place between the company and its stakeholders. That means that one of the board of director's main responsibilities is to maintain an ongoing dialog with its most important shareholders on the topics I mentioned earlier. This isn't a task that can be delegated to the management board, either. Here, too, our survey has shown over and over again that investors clearly consider this to be the board of director's responsibility. While the chairman plays a key role in this, individual specialists – including the chairs of the audit and remuneration committees – are also expected to address certain questions and concerns that fall within their area of responsibility.

[2] www.msci.com
[3] www.sustainalytics.com





So are you saying that the actions of activist shareholders can also be positive?
Companies should be communicating openly and transparently on their own initiative and gearing their actions toward the principles of sustainable corporate governance as a matter of principle. That way, they move into the "driver's seat" without investors forcing them to adopt a specific approach. Listening carefully to professional investors is usually a good idea. They have a wealth of valuable information and also compare you with your competitors. If you want, you can consider it free "intelligence" for the Board of Directors I still think it's important for each company to make its own decision as to what and how to communicate. People talk a lot about so-called "best practices". In the area of governance and CSR, however, no best practice exists – each and every company is different. You can do better or worse, but differences and special situations have to be explained, and that's not always easy.

Are company-specific characteristics like that even noticed when many of the major governance analysts are based abroad?
Yes, definitely. My experience has been that the work done by major international fund and asset managers' governance and CSR specialists is extremely professional. They use external analyses only as a basis. In fact, we're much more likely to find that Swiss institutions still have a few shortcomings and some catching up to do.

In that context, which skills are needed on boards of directors?
Of course, not every board member needs to meet the same requirements and have extraordinary communication or mediation skills, but the key individuals I mentioned earlier and definitely the lead independent director really need to have a profile that includes an aptitude for media and investor relations. They have to be strong communicators and leaders, able to withstand a certain amount of headwind and criticism, and be capable of coping with a crisis.

What role do proxy advisors play?
Many institutional investors, like pension funds in Switzerland, work with a proxy advisor whom they trust and follow almost blindly. Proxy advisors frequently use checklists to evaluate individual issues when preparing for an annual general meeting. What they lack, however, is an integrated or even a dynamic perspective of a longer period of time, because all they can do is issue a recommendation for the upcoming AGM. Last but not least, many asset managers lack the resources they require to manage the process themselves with the desired level of diligence and active engagement. Market players on the investors' side are fiercely fighting to boost margins and market share, which is manifesting itself in mounting pressure to consolidate. That's not necessarily conducive to increasingly complex analyses of individual investments, however.

Sustainability is a hot topic at the moment. In that context, many companies are publishing separate sustainability reports to document their commitment to ESG. Is there still any need to take further action in this regard?
Separate sustainability reports probably will lose their relevance going forward. In the early years – and to this day in some cases – these reports were well written yet had and still have a penchant for philanthropic reporting. While sustainability reports generally weren't prepared with a limited intent of establishing a link to a company's corporate strategy, that's precisely what's expected today. That's why there needs to be greater correlation between the individual components of corporate reporting in the annual report.

Do we need new standards to ensure the comparability of companies' efforts?
For once, it's Europeans who want to define concrete standards as guidelines, while the US – otherwise known as being sticklers when it comes to compliance – have developed a more open sustainability reporting framework in line with the instructions issued by the Sustainability Accounting Standards Board (SASB). This is one instance where I prefer the US approach because it gives companies greater leeway to portray their special characteristics accordingly.

Now SIX – in keeping with Swiss tradition – is leaving it up to the companies themselves to choose one of four recognized standards; they're not actually even required to produce any sustainability report at all. Is that the right approach?
I like Switzerland's liberal approach. I'm of the opinion that companies are under enough pressure from stakeholders to voluntarily and independently pursue a path toward sustainability and, above all, to communicate this accordingly. To an ever greater extent, the realization that long-term success is only possible through the sustainable use of resources and responsible interactions with all stakeholders involved will become part and parcel of the DNA of each and every business activity. Nevertheless, at this time of the Coronavirus crisis, the discussion focuses very much on how and whether a company should bear the implications of these actions.

This raises one last question from an audit firm's perspective: Shouldn't compliance with the standards applied be verified?
I'm not sure if broadening the scope of traditional audits would be helpful. Of course everybody would love more assurance in every aspect of corporate governance, but only around a quarter of the investors who took part in our 2019 corporate governance survey stated that they expected a CSR audit to really be beneficial. Many people are actually relatively unaware of the fact that quite a number of non-financial aspects are already being examined in connection with the audit of the annual financial statements. That's probably something that needs to be explained a better.

About Barbara A. Heller
In addition to her post as Managing Partner of SWIPRA Services, Barbara Heller, lic. oec. publ., is also a member of the board of directors of Bank Cler and chair of the audit committee, a member of the investment committee of the Sammelstiftung Transparenta für berufliche Vorsorge (Transparenta Collective Foundation for Occupational Pensions) and Of Counsel at Lemongrass Communications. She additionally serves as Vice-Chairwoman of the Swiss CFO Forum and chairwoman of the jury for the CFO of the Year award while also holding other positions on supervisory bodies in the non-profit and sports sectors. She has earned an MBA from the University of Zurich with special qualifications in the areas of financial market economics, empirical financial research and banking.

About SWIPRA Services
SWIPRA provides corporate governance and CSR services for listed companies and their boards of directors as well as advice on responsible investing to institutional investors. Further, SWIPRA Services publishes the „SWIPRA Swiss AGM Analysis" and the „SWIPRA Corporate Governance survey" on an annual basis. The current results can be found at www.swipra.ch.

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