Shareholder Activism in the UK

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Shareholder activism is on the rise and attracting increasing attention. It has long been a feature of the UK market but for a number of reasons, including the economic environment, policy direction (including the Stewardship Code and the Kay Review) and the development of tactics and approaches first seen in the US, it is set to be an important feature in the UK arena this year.

One of the themes to emerge from the financial crisis is the suggestion that shareholders need to engage more closely with the companies in which they invest. This shareholder engagement is leading to more shareholders taking an active stance where they are not happy with a company's strategy or decisions. At the same time business models amongst funds have evolved, in some cases to focus exclusively on such active involvement.

The rise in activism is reflected in part in the opposition in some quarters to executive pay, particularly in companies where shareholders feel that the board, or a particular director, is open to criticism (evidenced by the so-called Shareholder Spring in 2012).

This chapter considers:

- what shareholder activism is and who are shareholder activists;
- what tools are available to shareholder activists;
- what impact this can have on M&A or other corporate activity;
- what a company can do to strengthen its position; and
- some issues for the shareholder taking an activist stance to consider.

What is Shareholder Activism and Who Are Shareholder Activists?

What is shareholder activism?

Shareholder activism is a generic term used to describe an approach by a shareholder or shareholder group to a company's board, and if necessary to its fellow shareholders, seeking to effect change within a company.

Their aim may be one or more of the following:

- to address management issues, including remuneration and other corporate governance issues;
- to improve business performance;
- to change the company's strategy;
- to seek to unlock value through returns of capital, spin-offs and other divestments;
- to influence corporate activity, in particular the outcome of takeover or other M&A situations; or
- to remove one or more directors or appoint new directors.

The extent of the change that the activist is seeking will depend on the issue being addressed and how receptive and responsive the company is when approached by shareholders about their concerns.

In some instances, activist groups may have a single issue they want to tackle. Alternatively, there are active investors whose business model is to help effect restructurings within companies, sometimes known as "private turnaround in the public space".

Who are shareholder activists?

"Shareholder activist" can cover a wide range of investors. Some activists are investors whose business model is to go into companies and effect change. Others may be existing shareholders who, as a result of a change in circumstances in a company in which they have invested, become activist because they are not happy about how the company is being run or the decisions the board is making. They may act on their own or as part of a group who come together with a common aim.

Hedge funds and other alternative investors, particularly those with event driven strategies or those following models developed in the US, are usually considered to be the principal players in the activist community in the UK. Institutional investors in the UK have traditionally been regarded as being more passive, but in recent years they have shown an increasing willingness to voice their concerns or to lend their support to the more vociferous.

Tools for Activist Shareholders

In the UK, shareholders have a number of tools they can use to effect change in a company.

The UK Stewardship Code, published by the Financial Reporting Council, is a code for institutional investors when engaging with the UK listed companies in which they invest. It applies on a "comply or explain" basis and is principally addressed to firms who manage assets on behalf of institutional shareholders (e.g. pension funds and insurance companies).

The Stewardship Code recommends institutional investors establish clear guidelines on when and how they will escalate their stewardship activities. It says that the process is likely to start with initial discussions on a confidential basis. However, if companies do not respond constructively when institutional investors intervene, then institutional investors should consider whether to escalate their action, for example, by:

- holding additional meetings with management specifically to discuss concerns;
- expressing concerns through the company's advisers;

- meeting with the chairman or other board members;
- intervening jointly with other institutions on particular issues;
- making a public statement in advance of shareholder meetings;
- submitting resolutions and speaking at shareholder meetings; and
- requisitioning a shareholder meeting, in some cases proposing to change board membership.

The Companies Act provides shareholders with a number of tools to assist in their efforts. The box [below] indicates the key rights shareholders have under the Companies Act and the percentage shareholding required in each case.

Shareholder rights under the Companies Act 2006

Shareholder right	Shareholding required	Comment	Companies Act reference
Inspection and copy rights for the register of members and any register of beneficial interests following section 793 request	Any shareholder may request	By getting a copy of the register of members, an activist can find out the identity of other shareholders which can then be used to gain support for the shareholder's cause. The request must be for a "proper purpose". Canvassing support for a meeting should constitute a proper purpose.	Sections 116, 809 and 811
Requisition a meeting	5%	Any resolution is not treated as having been properly requisitioned if it would be ineffective if passed because it is inconsistent with the company's constitution or if it is defamatory or vexatious.	Section 303
Requisition a resolution at AGM	5% or 100 members	The caveats outlined above in connection with the requisition of a meeting apply here too.	Section 338
Have a statement of up to 1,000 words circulated	5% or 100 members		Section 314
Request an independent report on a poll	5% or 100 members		Section 342
Block a special resolution*	25% + 1 vote		Section 283
Block an ordinary resolution*	50%		Section 282
Pass an ordinary resolution *	50% + 1 vote		Section 282
Appoint a director*	50%	This is usually provided for in the company's articles.	
Remove a director*	50% + 1 vote	The right to remove a director by ordinary resolution under this section overrides any contractual provisions. Special notice of 28 days must be given of any such resolution.	Section 168
Pass a special resolution*	75%		Section 283

* these percentages are of those who attend and vote at the meeting in question, so in reality a lower percentage shareholding is likely to be sufficient as not all shareholders in the company will vote at the meeting

The Collective Engagement Working Group, which was established in response to the Kay Review's recommendations on facilitating collective engagement by investors in UK companies, has announced the launch of an "Investor Forum". The Working Group looked at how institutional investors might be able to work together when engaging with listed companies in order to improve long term company performance. The main objective of the Investor Forum, which is expected to be operational by June 2014, will be to provide a new platform for collective engagement by investors. One of its functions will be, when individual and collective engagement with a company in relation to a specific issue is not satisfactory, to establish an "Engagement Action Group" in relation to that company and issue.

What Impact can Activists Have on M&A and Other Corporate Activity?

Private M&A

In some cases, a company that is proposing to acquire or dispose of a company or business will require the prior approval of its shareholders, for example if:

- it is a class 1 or related party transaction or reverse takeover for the purposes of the Listing Rules; or
- shares are to be issued to finance an acquisition and shareholder approval is required for authority to allot shares or disapply pre-emption rights.

Class 1 and related party transactions and reverse takeovers require an ordinary resolution (i.e. the approval of more than 50% of the shareholders who vote). A resolution to disapply pre-emption rights requires a special resolution (i.e. the approval of 75% or more of the shareholders who vote).

This gives shareholders the power to reject a deal after it has been agreed by the board. There is currently some debate in the UK around the extent to which it is appropriate to canvas shareholder support for potential deals ahead of a deal being announced. This is discussed further below.

Alternatively, activists may encourage or put pressure on companies to undertake an acquisition or disposal. If for example an activist believes that a company's business is too diversified or would be more valuable as two distinct businesses, they may encourage the group to split, either through a disposal or a demerger.

Public M&A

On public M&As the views of the target board can to an extent be irrelevant. The bidder simply requires sufficient shareholder acceptances (potentially as few as 50% +1) from the target's shareholders to acquire control. Whilst in reality the target board usually has a critical role to play, as a target board recommendation carries a lot of sway, shareholders are the ones who ultimately make the decision. Even where a target company has not received a formal takeover offer, shareholders can wield influence by either encouraging the target board to negotiate with the bidder or, conversely, by indicating they will not accept an offer price below a certain level and supporting a board's decision not to engage with a bidder unless it is prepared to offer the requisite minimum price.

If arbitrageurs buy into a company in anticipation of a takeover, they will seek to ensure any takeover is successful as their business model will not involve being a long term investor. The drawbacks of short-term investors influencing, or even determining, the outcome of a takeover have been highlighted on a number of occasions (for example by the Takeover Panel in its 2010 review of the Takeover Code and by Professor John Kay in his review of UK equity markets and long–term decision making). However, to date there does not appear to be any real appetite to try and prevent this through changing the regulatory regime for short term investors.

Recent examples of transactions where shareholders have played an important role include Orbis on the Vodafone bid for Cable & Wireless and the Glencore/Xstrata deal where Qatar Holding forced the deal to be restructured in a way that enabled shareholders to block the proposed management incentivisation package but approve the merger.

What Can a Company Do?

The board of a company should be as interested in and aware of the presence of investors from an activist background appearing on its register, as it should for the possibility of a potential bidder. In the same way as companies make preparations so that they are ready in the event of a dawn raid or hostile takeover, they should have a strategy in place for when an activist investor appears on the share register.

Monitor the company register

The starting point is that companies need to monitor their shareholder register for signs of shareholder activists. Although shareholders are required to disclose large stakes to the market (as discussed further below), companies should nonetheless keep an active eye on their registers.

Engage with its shareholders

As discussed above, greater engagement with shareholders is generally recognised as becoming increasingly important. It gives shareholders the ability to air any concerns with the company and gives the company the opportunity to try and address any such concerns. If an activist shareholder then comes into the picture, shareholders with whom the company has regularly engaged may be less willing to support that activist shareholder.

Issue section 793 notices

If a company suspects that shareholders are acting together it can issue a "section 793 notice". Under section 793 of the Act, a UK incorporated public company can serve a notice on a person asking for information about their interests in the company's share capital. The articles of association of listed companies typically include a power for the board to impose certain restrictions on any shares held by a person who fails to comply with a section 793 notice, including suspending the voting rights attaching to the shares. However the power in the articles to disenfranchise shareholders should only be used by the directors for the purpose of obtaining the relevant information.

Sounding out shareholders ahead of a major transaction

Whilst a listed company is required under DTR 2 to announce inside information to the market as soon as possible, in certain circumstances, for example if the transaction is still being negotiated, it may delay disclosure of the information. It is then allowed to selectively to disclose that information if it is for a proper purpose and the recipient owes the company a duty of confidentiality.

A company can therefore speak to its key institutional shareholders ahead of a major transaction to sound out their views. The shareholders are likely only to give their preliminary views and will not be bound by any indication of support (unless they give an irrevocable undertaking to vote in favour of a transaction which would be unusual other than on a takeover).

However there is tension between the benefits of sounding out shareholders ahead of a transaction and the restrictions imposed by the market abuse regime.

The timing and content of any discussion with shareholders will have to be carefully considered as, once the shareholders have received the inside information they will be unable to deal in the company's shares until the information is no longer inside information (generally when it is announced to the market). There is a balance to be struck between allowing the shareholders sufficient time to consider the deal carefully and not restricting them from trading for too long. The company will not want to approach shareholders until it knows it can secure a deal (and there is a greater risk of a leak once they are told).

When approaching shareholders about any sounding out, companies will need to ensure that they do not inadvertently disclose inside information before the shareholder has agreed to receive it. They will also need to ensure that they do not disclose information that goes beyond what will be included in the prospectus or otherwise "cleansed" through being made public. The company's advisers should therefore be consulted and involved in any sounding out (or wall-crossing) process. The series of enforcement cases around Einhorn/Greenlight highlights that wall-crossing is an area of focus for the Financial Conduct Authority (FCA).

Consider the structure of the deal

In the context of M&A, it may be possible to structure a deal to reduce the impact hostile shareholders can have. For example on private M&A, if a special resolution is required, shareholders holding 25% of the company's shares can block a deal. If the deal can be restructured so that only an ordinary resolution is required, the shareholders would have to have 50% of the votes cast at the meeting to block it. However, the advantages of doing this would have to be balanced against the possibility that other shareholders find a different structure unacceptable.

On a takeover offer, where a key or difficult strategic shareholder may present an obstacle, the bidder should likewise consider its offer structure carefully and may want to retain the right to switch from a scheme to an offer, for example.

Be prepared to justify the board's strategy or decision making

As discussed above, in the event of a hostile takeover offer, the target board is powerless to block the bid from being successful. It can only seek to persuade the company's shareholders not to accept the offer. In many cases, the activist will be accused of trying to obtain control without paying a premium. The board will need to persuade shareholders that they will get better value from the existing management. This may involve a promise of a new strategy or a return of cash to shareholders.

In a situation where an activist shareholder is seeking to effect change in the company by, for example, removing the board of directors and appointing new directors that the activist has identified, similar tactics are likely to be required.

Some Issues for the Shareholder Taking an Activist Stance to Consider

Disclosing interests

Under DTR 5, shareholders are required to notify a listed company within two trading days if their interests reach, exceed or fall below certain thresholds. The thresholds are 3% and then every 1% change thereafter. The company must then disclose any notifications to the market.

DTR 5.2.1(a) requires an investor to aggregate, for these purposes, voting rights held by a third party with whom that investor "*has concluded an agreement, which obliges them to adopt, by concerted exercise of the voting rights they hold, a lasting common policy towards the management of the issuer in question*". The FSA (the predecessor to the FCA) commented in August 2009 that: "*This is unlikely to include the kind of ad hoc discussions and understandings which might be reached between institutional shareholders in relation to particular issues or corporate events*". Whilst therefore this is a fairly high threshold, and one that customary investor discussions would not usually reach, investors should keep this in mind and in the event of any doubt discuss the issue with advisers or the FCA.

Acquisitions or disposals which result in a net short position in the shares of a company may also give rise to an obligation to disclose details of that position under the EU-wide disclosure regime established by the EU Short Selling Regulation. Under that Regulation, net short positions of 0.2% or more, and any changes in that position (in 0.1% increments, up to 0.5%), must be privately notified to the relevant competent authority. Net short positions of 0.5% or more, and any changes in that position (in 0.1% increments), must be disclosed to the relevant competent authority, which will make the information public.

The UK Takeover Code is also relevant if the company goes into an offer period. In that situation, holders will have to disclose their interests and dealings when their interest exceeds 1% (Rule 8 of the Takeover Code).

The Takeover Code

As well as the disclosure requirements discussed above, under the Takeover Code where a person or concert party acquires an interest in shares of a UK public company carrying 30% or more of the voting rights, it will trigger an obligation to make a general offer to acquire the remainder of the shares, known as a "mandatory offer" or a "Rule 9 offer". As well as ensuring that they do not personally breach the 30% threshold, a shareholder will also have to take into account any shares held or acquired by anyone with whom it is acting in concert.

Note 2 to Rule 9 sets out the Panel's approach where investors take collective action. Generally, the Panel will not normally regard shareholders voting together on a particular resolution as acting in concert. However, shareholders who requisition or threaten to requisition a board control seeking proposal at a general meeting will be presumed to be acting in concert with each other and with the proposed directors. Panel Practice Statement 26 has provided some helpful clarification of the approach that the Panel will take, but there are still some questions about the exact nature of discussions, and "support" that needs to be offered, to fall within the provisions.

These provisions will be a significant focus for a company in a "shareholder activist situation". For investors, it is important to plan any relevant discussions with these in mind (including script, sticking to script and taking a note of what was discussed). Also, in particularly sensitive situations, a proactive dialogue with the Panel can be important (before, as well as after any issues are raised).

This issue is also being considered at an EU level. In 2013, the European Securities and Markets Authority (ESMA) published a statement regarding shareholder co-operation and acting in concert under the Takeover Bids Directive. The statement is in response to a request for clarity for investors inhibited from co-operating on corporate governance by mandatory bid rules. It includes a "White List" of activities on which shareholders should be able to co-operate without being presumed to be acting in concert.

Market abuse

Dealing in securities on the basis of inside information may constitute market abuse under section 118 of the Financial Services and Markets Act 2000.

Marketwatch 20 sets out the FSA's (now FCA) views on when shareholder activism can constitute market abuse. Importantly, it indicates that an investor's strategy for investing in a listed company can constitute inside information (albeit that investors would not be committing market abuse by carrying out trading on the basis of their own intentions or strategies). As a practical matter, it seems that when the presence of certain "activists" on the share register of companies is known publicly, the share price can often rise (presumably, at least to some extent, on the back of that information).

Marketwatch 20 warns that other investors trading on the basis of such information (if it is not publicly known) can constitute market abuse. Whilst there are no enforcement cases directly on point, there is therefore a risk for a second investor who receives such information and then trades in the shares. The Spector Photo case decision in the European Court of Justice case in 2011 held that if a person deals while in possession of inside information, there will be a rebuttable presumption that the inside information was used.

An investor speaking to another investor in these circumstances should therefore consider what conversations can be held without it getting to the stage of inside information and be careful not to receive inside information about other investors' intentions.

Once the information that constitutes inside information is in the public domain, market abuse is no longer an issue so where an investor wants to be able to have conversations with other investors, they may choose to disclose their investment to the market ahead of any formal disclosure requirement.

An investor will also need to consider whether it has itself received inside information from the company during any discussions with the company. An investor should always be wary of receiving such information, and, generally speaking, the company is very unlikely to want (or to be able) to give such information. Occasionally however inside information may be inadvertently disclosed, for example in discussions about a board seat or the company's intention to implement a strategy that an investor has asked the board to consider.

Related party rules

If an investor holds a stake of 10% or more in a listed company, it will become a related party of that listed company. Where any transaction or arrangement is proposed between the listed company (or any of its subsidiary undertakings) and a related party, the prior approval of the company's shareholders in a general meeting will generally be required. The related party will not be permitted to vote at that meeting. Although there are exemptions for transactions in the ordinary course of business and small transactions, an investor will need to be conscious of this rule when building a stake in a listed company.

Investing in regulated entities

Under the Financial Services and Markets Act 2000, advance clearance is required from the FCA or Prudential Regulation Authority (as appropriate) where there is a change of control of a regulated entity (which would include the acquisition of a 10% stake) or where a person acquires a "significant influence" over a regulated entity (which could include a stake of less than 10%).

The regulatory framework	
Companies Act	The Companies Act provides shareholders with a number of tools that can assist when engaging with a company. See the table above. Equally a company has the power to require shareholders to give them certain information about their shareholdings through its section 793 powers (see above).
DTRs	DTR5 requires shareholders to disclose their interests in a listed company's shares and certain financial instruments such as derivatives.
Takeover Code	The Takeover Code requires shareholders who are interested in more than 1% of a company to disclose their interests and dealings in the company's shares during an offer period. It also requires any person who acquires an interest in shares which (when taken together with shares in which any parties acting in concert with him are interested) carry 30% or more of the voting rights of a company subject to the Code to make a mandatory offer under Rule 9 of the Code.
Market abuse	Dealing in securities on the basis of inside information may constitute market abuse under section 118 of the Financial Services and Markets Act 2000. In certain circumstances, shareholder activism could constitute market abuse.
The Governance Code and Stewardship Code	These Codes published by the Financial Reporting Council encourage, amongst other things, engagement between companies and their share-holders.
Representative bodies	Representative bodies such as the Association of British Insurers (ABI), National Association of Pension Funds (NAPF), Pensions Investment Research Consultants (PIRC) and Hermes have voting guidelines for their members recommending what position to take in various circumstances.

Conclusion

As engagement of all types between boards and active investors has increased, so has experience of both the legal issues that can arise and the strategies that shareholders and companies may use. Both sides will want to be carefully advised around these issues, and in particular around how the discussion is played out in the public domain, both through the formalities of market announcements and through more informal publicity around the situation as it develops, including in social media. It is important both for the investor and for the board to get their approach and strategy right as, particularly in the more high profile situations, reputations can be at stake.

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His client work has included advising EDF on its £12.5 billion cash and CVR takeover of British Energy; a consortium of international banks in providing the equity bridge finance for KKR/Pessina's £11 billion takeover of Alliance Boots; Bradford & Bingley on its capital raisings, including the proposed PIPE investment by TPG; the management and shareholders of Duelguide/Chelsfield on the £585 million consortium takeover by Multiplex, Westfield and Aldersgate; Sherborne Investors on its investments in F&C and Spirent Communications; Freeserve on the £1.6 billion takeover by Wanadoo; De Beers on the US$17.6 billion takeover by a consortium led by Anglo American; and the European administrators of Nortel on its global restructuring and disposals of its international businesses.

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