Some are more equal

The politics of shareholder activism

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Abstract: Shareholder activism is an exercise of power, sometime benign, sometimes threatening to the interests of corporate management, boards and other shareholders. The complexity of these combinations helps to understand how difficult it is for directors to operate in shareholders' interest. What we see, particularly in relation to the growth of hedge-fund activism, is greater dispersion of shareholder interests and growing questions about the legitimacy of how those interests are acted out in the political landscape of corporation governance. This paper offers a framework to examine the stance that shareholders take when exercising - or not exercising - their power. Anticipating the expression of shareholder power involves assessing their intentions along three dimensions: their attitude towards an individual stock (buy-hold-sell), their approach to activism (docile, "walkers", or activist) and their investment horizons (long-term, short-term, or ones it calls "perverse", where the economic interest of the shareholder doesn't coincide with its holdings).

Keywords: Corporate governance, shareholder activism, legitimacy, hedge funds, power, politics

Introduction

Big institutional investors have grown uneasy about their investments in the German carmaker Volkswagen AG. Owing the shares has become too political. More than 30 per cent of the shares are held by Porsche Automobil Holding SE. VW's supervisory board chairman, Ferdinand Piëch, is a member of the family that controls Porsche, which had become something of a corporate governance pariah, having refused to accept the unofficial norm of quarterly financial reporting in Germany. It had also irritated the country's Social Democrats by dropping the Aktiengesellschaft legal form in favour of the new European Union Societas Europaea form, which would allow it to reduce representation of German workers on the Porsche supervisory board. Moreover, Piëch had ousted the VW chief

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executive in 2006 and then entered a court battle with the company's second largest shareholder. The state of Lower Saxony in Germany not only held more than 20 per cent in the company. It benefited from a special law giving it veto power over important managerial and board decisions, a statute recently reinforced by the Germany parliament after the European Court of Justice ruled parts of the old law illegal. The European Commission had said that the new version of what German news media like to call the "VW law" was illegal, and Porsche agreed. But attempts at the VW's annual meeting by other shareholders - including activist institutional investors - to seek to challenge Porsche's creeping control of its rival carmaker fell on deaf ears (Milne 2005; 2006; Milne et al. 2008).

Shareholder activism is fundamentally a battle for power acted out in a political landscape that stretches from the boardroom to the halls of national legislatures and the deliberations of supranational organizations. The exercise of power by shareholders both shapes and is shaped by the political force-fields of corporate governance. When public policy concerning private-sector companies is set, some shareholders make their voices heard as well. Sometimes the object is to ensure that shareholder power is over management is strengthened. Sometimes, it's to avoid the erosion of power to employees or outside lobbies. Often, however, it's to wrest power away from other shareholders.

An obvious fact often overlooked when considering the forces that shape corporate governance is this: deciding what is in the interest of shareholders is often impossible. One shareholder's interests often don't coincide with the interests of others. Most of the time, it doesn't matter: shareholders only rarely vote on matters of corporate policy. But for directors, with their fiduciary responsibility to look after shareholder interests, it does. The competing interests of shareholders arise from different stances that investors take to their investments. It is a complex picture of rivalry for the high ground that shapes not only the way they vote at company annual meetings but how they vie with each other for the attention of directors, and how they seek to influence the public policy debate on a macro-political level about the future of enterprise. The discussion focuses mainly on the approaches that institutional investors take. They dominate the investment landscape, even in the United States, where the private persons we think of as retail investors give a greater sense of "democracy" to shareholder capitalism than in many other countries around the world. Those private persons - unless extremely wealthy and willing to take large risks - are only rarely able to gain a voice in the political debate that sets the policy of individual companies let alone the frameworks of law and regulation in which boards must operate.
Dimensions of shareholder politics

A wide number of factors contribute the interests that a single shareholder might have in the board's decision-making. They might be more interested in receiving dividends than capital gains, or want the board to avoid investments in genetically modified crops. Shareholders from one country may bring with them preconceptions about the best way to organize a business when they invest in a company based in a different country. These factors all contribute to the content of any recommendations they might make to the board. Taking a step back from the content of their interests, however, we can see that their political stance can be assessed across three dimensions: their attitude towards the stock, their approach to engagement and activism, and their investment horizons.

Attitude

At any given time, each shareholder has a simple view of the action it takes on each stock in its portfolio and on its watch-list: they buy, sell or hold. Investment analysts use a wider variety of categories in their research recommendations, to be sure, and these nomenclatures vary somewhat between investment banks. In the wake of the dot-com collapse in 2000-01, however, investment banks and the analysts they employed faced criticism for their use of arcane classifications of the actions they were recommending to their institutional clients, and for making recommendations that weren't really what they words they used meant (Dreman 2000), leading to legislation, litigation and new codes of ethics for research around the world (for an example, see CFA Institute 2005). In recognition of the fact that for many asset managers the investment decision rarely involves massive shifts towards or away from a particular stock, a more nuanced version of the old "buy-sell-hold" mantra emerged, and it is the one we shall use here: investors might accumulate, reduce, or maintain their exposure to a particular security.

Activism

Here, too, there are three stances that investors can take, either as a general inclination towards their investments as a whole, or towards a specific stock. Investors may be docile, passive in their approach to the company, its strategy and its management. It may involve routinely voting with management at shareholder meetings or perhaps not voting at all. This is frequently the stance of index-tracking funds, explicitly designed as low-cost operations. They seek to avoid the cost of voting as well as trading the shares they hold. But
it is an approach adopted by many other investors who can't be bothered to vote. A second approach is what we might call the "walkers", invoking a notion sometimes called the "Wall Street Walk" (Admati and Pfleiderer 2007). If unhappy with the direction of the company, they will sell their shares to avoid future price declines or to seek greater returns in an alternative investment. They can also walk into an investment: seeing a strategic decision they like or a change in the business environment that might be favourable to a particular stock or industry, they buy.

This stance is often adopted by traditional active portfolio managers who seek to outperform the index or benchmarks by intelligent stock selection, based on superior research or a more enlightened gut instinct than other investors. But it is also used by a wide range of investors, whether of the traditional "long-only" asset management firms that buy and sell actively, individual investors looking for a gain, or leveraged investors seeking to turbocharge their holdings by buying stock on margin.

"Walkers" can have an impact corporate policy and therefore governance. If the stock price is depressed by their decisions to sell, it can make it harder for the company to raise capital in equity or even debt markets. The resulting increase in the cost of capital, so the theory goes, makes the company less competitive, putting pressure on profitability and on management to change direction. Some writers find this an inefficient way of monitoring and controlling corporations, arguing that role should fall to certain types of investors, particularly pension funds and closed-end collective investment funds (for an example, see Coffee 1991).

There are funds, however, that fit neither of these categories, taking a different approach with respect to at least some of their investments. Activist shareholders seek to influence the direction of the companies in which they invest. They often use their voting rights to indicate displeasure with strategy or management, while lobbying occasionally with directors and senior management for a change in policy. Activists come in a variety of flavours. Some advocate specific policy changes on what they consider ethical grounds. This approach was commonplace as shareholder activism gained ground in the 1960s and 1970s as individual shareholders, churches and charities used their votes as shareholders to try to force through changes in policy of companies towards investments in munitions and tobacco, or on trade with the apartheid regime in South Africa. Indeed, much of the early efforts in the United States to develop what we now call corporate governance research arose from churches who sought to use their votes at shareholder meetings to express their displeasure with US policy and military actions in Vietnam.
Other activists seek changes in management or shifts in strategy in poor performing companies. Others lobby for actions to give shareholders greater rights, say, to oversee executive pay policy, or to vote on potential acquisitions. Still others may seek to oust the board of directors and impose a new board and new management, or push through a merger or acquisition by another company hostile to the incumbent management and board.

Some, by dint of the size of their holdings, can get private access to senior managers or members of the board to make their opinions known. Others, generally the smaller ones, resort to "megaphone diplomacy" as way to be heard, if not always listened to. A few – notably large pension funds in the US and UK – combine the two, using the latter when attempts with the former have showed few results. What these activists share is their active use of voting rights and often other ways of expressing the voice on policy. But they share another thing as well: all seek to assert what they see as their rights as owners to influence decision-making at the board and in management (Davis et al. 2006).

Horizon

Shareholders intentions towards a stock also vary over time. It is self-evident that they hold today are ones they might be inclined to buy again or sell at some time in the future. Beyond that, however, lies a general inclination towards the process of buying and selling. Index-tracking funds, for example, hold shares for as long as the company is a constituent of the index they track. Their actions are dictated, therefore, by index decisions. Only those on the cusp of the index are every likely to be traded, and so for most of the investments of these manager, the time horizon of the investment is quite long. Pension funds, looking to achieve sufficient yields over the lifetime of their beneficiaries, share a long-term orientation towards the market in general, though some may choose to manage their portfolios more actively. They tend, therefore, to be long-term investors, though their horizon for an individual stock may be short-term at any given point. The investment literature, like the tax code in some jurisdictions, draws a distinction between long- and short-term investing. The latter is more speculative in nature. For tax purposes capital gains and losses might be treated more like earned income for individuals or income from operations for corporate entities, rather than savings. Both academics and the taxman often put an arbitrary threshold to distinguish between them, say, one year. In practice it's hard to know whether an investment of thirteen months is very difficult from an eleven-month one, or indeed similar in any way to an investment that might be held in portfolio for
decades. From a corporate governance, as we shall explore below, long-term investors sometimes expect difference treatments from the companies in which they invest, even if their attitude towards the stock at this time might involve an inclination or intention to sell. There has been a growth of speculative, short-term investing among traditional, long-only funds as institutional investors seek to build their business by outperforming rivals for pension-fund mandates by beating their benchmarks on a quarterly basis. This has in turn put pressure on corporate managements to strive for better short-term performance, often at the expense of strategic decision-making (Tonello 2006).

There is, however, a third stance we might consider under the rubric of horizon – the perverse orientation towards an investment. Here the horizon is often short-term, though it need not be. One version of this stance might involve buying and selling simultaneously, though with differing time horizons for the two actions. It is a stance often taken, for example, by otherwise "long-term" investors seeking to achieve capital gains but avoid dividend income. They will sell the stock on a "cash" basis over the dividend record and/ or payment date, having arranged ahead of time to buy it back "forward" at a predetermined price. These stock "lending" activities have counterparties, of course. Sometimes they come in the form of investors seeking dividends to boost the yield of a portfolio pledging its beneficiaries a regular stream of income. These investors then capture the dividend in exchange for an interest payment to the lender. Depending on their separate tax positions, these approaches can produce benefits for both sides. There are corporate governance implications when these arrangements fall over the time of voting at the company's shareholder meeting. Who is the "real" owner? When both tend to be long-term in orientation, the implications might not be particularly large. Given the broad diversification of assets in many institutional portfolios, the borrower might well be a holder – or even a lender – of the same stock it has borrowed, so the implications for voting and corporate governance are perhaps of greater theoretical than practical concern.

There are, however, other types of borrowers whose intentions are not neutral, one being the "short-seller". These "shorts" borrow the stock so they can deliver it to someone to whom they have sold. The intention in a short-sale is to buy the stock back at some point in the future before the pre-arranged return sale to the original lender. If the stock falls in the meantime, the short-seller makes a gain on the difference less the interest payment for having borrowed it in the first place. As a result, short-sellers can benefit from a fall in the share price and even more from a collapse of the company. For these reasons, various countries ban short-selling and other restrict its use. There has, however, been a trend in the
direction of given short-sellers a freer hand. In the US, for example, the Securities and Exchange Commission experimented with a new rule in 2004 to lift the requirement that a short sale could only take place when the previous transaction in that stock was at a higher price than the one before, called the "uptick" rule (SEC 2004).

Hong Kong, a market with a history of stock trading dating back to 1866, introduced short-selling, subject to an uptick rule, in 1994 and allowed "naked" short sales – when the seller doesn't first borrow the stock – a year later, and then lifted the uptick rule. After a cascading sell-off that Asian markets suffered in 1998, the uptick came back, only to be repealed again in 2007. Michael Mackenzie and Ólan Henry concluded short-selling was broad neutral over time, as heavy selling in one period was reversed in the next (McKenzie and Henry 2007). In the UK, however, the Financial Services Authority broadly backs the practice, though incidents in the early months of 2008 led it adopt a temporary measure to tighten up reporting requirements when companies were in the process of issuing new capital through "rights" issues after a spate of new issues struggled to find buyers (FSA 2008). Australia, which had some curbs on the practice, launched a consultation in 2008 about how it might tighten them (ASX 2008).

In the last several years, the perverse stance has added a layer of complexity. Through the use of derivative instruments, including a device called a contract for difference, an investor may have a large economic interest – whether the share rises or falls – without actually buying or selling the shares themselves. These can pose governance issues for the companies involved as CfDs can be linked with an implicit commitment on the part of the counterparty to hold the equivalent number of shares and even vote them on the instruction of the derivative-holder.

An example of this type of perverse relationship is the case in the US of the 2004 bid by Mylan Laboratories to acquire King Pharmaceutical, an example of what we call "empty voting". The hedge fund Perry was a major shareholder of King and stood to benefit from the transaction. However, shareholders in Mylan needed to approve the transaction, and opposition to the deal arose from some larger ones, including the activist investor Carl Icahn. To push the deal through, Perry bought a stake in Mylan, simultaneously hedging the investment with equity swap with two investment banks; indeed, the swaps more than covered Perry's exposure. That gave Perry 9.9 per cent voting rights at a time when it had a net negative economic interest in Mylan (Hu and Black 2006; Kahan and Rock 2006).
Shareholder politics and markets

It is precisely these differences in approach that makes it possible to make a market in company shares. Buyers need sellers, and even long-term investors sell sometime. Differences of tax positions lead otherwise like-minded investors to take opposite stances towards the same stock. Even short-sellers – the most perverse of the perverse stance – perform a valuable function in providing sellers when others seek to buy. When coupled with an activist stance actions of short-sellers can raise serious governance concerns. There is, however, quite a lot of evidence that short-selling helps the market achieve the best price for corporate equity (for recent examples, see Charoenrook and Daouk 2005; Bris et al. 2007; Chang et al. 2007; McKenzie and Henry 2007; Curtis and Fargher 2008). Indeed, Lauren Cohen and her colleagues show that in markets with poor disclosure regimes, short-selling provides a useful mechanism for the transmission of private information (Cohen et al. 2007). Work by Arturo Bris and his colleagues show a more nuanced picture: by looking at dual-listed shares that trade on markets that both permitted and restricted short-selling, they could control for country effects. They find evidence to support the notion that price discovery was better with short-selling. While short-selling does not cause a crash, it may affect its magnitude (Bris et al. 2007).

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**Figure 1 - Shareholder stance**

Accumulate  
Maintain  
Reduce  
Docile  "Walkers"  Activists  
Perverse  Short-term  Long-term
The variety of possible approaches along these three dimensions is summarized in Figure 1. The complex picture that emerges is one in which it is difficult for anyone to know what constitutes “shareholder value” when shareholder interests can be so fundamentally divergent on this structural grounds, irrespective of differences they might have about the business policies and future cash flows of any individual business.

The balance between their different interests will change over time for individual companies as well as for the market as a whole. The growth of passive investment through index-tracking funds, for example, has led over recent decades to an expansion of funds that seek to maintain their stakes in companies over a long time-horizon. To keep costs down, many of them are docile, voting with management if they vote at all. With their rise has come a relative decline in the strength of traditional long-only, actively managed asset management firms that were the backbone of the “walkers” and activists taking a long-term approach to the horizon.

While the growth of hedge funds in 1990s and the early years of the new century vastly expanded the number of managers taking a short-term view of their investments, hedge funds probably still represent a small proportion of equity ownership. Data concerning the size and shape of hedge fund investing if fragmentary at best. The industry is lightly or unregulated in most jurisdictions. Early versions of hedge fund strategies often involved taking a position in a stock and reversing it within the same day, speculating of intra-day price movements with any risk hedged through the use of derivatives. What created a new governance relationship – and a new set of politics to go with it – was the development of hedge-fund activism: asset managers taking a large, often highly leveraged stake in a company and holding it while agitating for a change in policy.

Perhaps the most celebrated case in the brief history of hedge fund activism was the move by a hedge fund with the cuddly name The Children’s Investment Fund, or TCI, which rocked the tradition-bound world of German equities. When Deutsche Börse, the German stock exchange company, tried to take over the London Stock Exchange in 2004, TCI sensed an opportunity to prevent the merger and generate a higher share price for Deutsche Börse. The share of bidders often fall during an after a takeover, reflecting the premium paid for the acquired company. In cases of contested takeovers, the premium is likely to be even higher. TCI sensed that if it could thwart the merger, Deutsche Börse’s share price would increase. It acquired a substantial stake and agitated for a change in direction through contesting the re-election of directors at the exchange company’s 2005 annual meeting. The move attracted other hedge funds to follow suit, and soon a
substantial minority and perhaps even a majority of shares in this most German of institutions was in the hands of foreigners, mainly UK- and US-based hedge funds. The tactic succeeded to a greater extent than anyone had imagined possible. Deutsche Börse not only abandoned its bid, it dismissed the chairman of its supervisory board as well as its chief executive and chief financial officer (Nordberg 2005). Germany's vice chancellor then famously warned about "locusts" invading the capital markets (Bovensiepen and Blechschmidt 2005), and a new term – hedge-fund activism – entered the corporate governance lexicon (Achleitner and Kaserer 2005).

TCI's intervention in the case of Deutsche Börse was in the spirit of much of the activism of corporate raiders in the 1980s and 1990s, using leverage to invest heavily in a company and then using its voting power and an appeal to reason to persuade other investors to join it in seeking a change in strategic direction. We may never be able to tell whether it ultimately created value, as so many other changes in the company and its competitive landscape have ensured. TCI attracted support from other, traditional, long-term investors more associated with "walking" rather than activism, suggesting that its interest were not what we have called perverse. But its chosen approach – to get its slate of directors elected, rather than the one proposed by the company – shows it engaged is a play for power with the board and management of Deutsche Börse and with the government and their trade union allies that rose up to defend the status quo.

Power and politics between shareholders

The array of potential political stances that shareholders might take shows how the lines of conflict might develop around both company-specific issues and the broader debate about corporate control and law. A few examples can help to illustrate the point.

1. **Entrance versus exit**: A venture capital fund that is normally a long-term investor has a fundamentally different view to company policy in the period shortly after the company has achieved a stock market listing than it had before. The pressure it places on management for short-term performance, so that it can find an opportune time to reduce its exposure, will also be at odds with the interests of the pension fund, another long-term investor, that acquired shares in the initial public offering and it looking for sustainable gains over a long time horizon.

2. **One share, one vote**: The founders maintained supermajority voting rights when their company floated on the stock market 25 years ago, with shares carrying five
times the voting strength of those held by others. With only 10 per cent of the capital at risk, they have 50 per cent of the voting rights. The institutions that bought the shares now argue that the founders have retired and their disproportionate voting rights should be abandoned. The matter cannot be resolved in the boardroom or the annual meeting, so the institutional investors take their case to the government, seeking a new law banning disproportionate rights. Having been rebuffed by government, then turn to a supranational body urging it to propose a new legislative mandate to be imposed all member governments.

3. **One share, more votes:** Aware of the rise of hedge fund activism on what we have called the perverse horizon, pension and insurance funds argue empty voting could lead to decision-making that would damage the economic interests of the company and perhaps even the sustainability of the business. They argue, first with the board, then at the shareholder meeting and then with government for long-term investors to be given superior voting power over "mere" speculators.

4. **Director nominations:** To avoid the practice of a powerful Chairman-CEO creating around him a board of cronies, institutional investors agitate – first with the board, then at the shareholder meeting – for a change in the articles of association giving shareholders a voice in nominating candidates to the board. Unsuccessful, they turn to the securities market regulator for a rule opening the proxy statement. A lobbying organization representing CEOs makes representations about how damaging such a measure would be. Opening the nominations process would make companies throughout the country subject to an assault from single-issue lobbying organizations that would seek to get their own board members elected, who would pursue their own agendas, rather than those of the company. The regulator considers the arguments and proposes that only shareholders representing at least five per cent of the equity should be allowed right to nominate directors.

These are not far-fetched examples; indeed, each is drawn from a real-life example of politics-in-action in corporate governance. Each case involves the assertion by one party that its interests are more important – or even more legitimate – that those of other shareholders. Each actor in this political system seeks to use its power over the others to enforce its view on the board's decision, the shareholders' decision, or the macro-political decision on public policy that is forced when micro-political decision-making fails to reach a solution. In these disputes, each side had a legitimate point, even when those points were sometimes in conflict with each other. Resolving them without resorting to physical force
requires something else: the exercise of power depends crucially on its perception of legitimacy.

**Legitimate power**

The changing nature of shareholder activism has led some to argue that activists should themselves be subject to more rigorous public scrutiny and accountability. Iman Anabtawi and Lynn Stout, for example, argue that the increase in shareholder power should bring with it an additional fiduciary responsibility on activist fund managers, enacted through changes in company law and akin to that imposed by law on directors and officers (Anabtawi and Stout 2008). For its part, the International Corporate Governance Network, a loose association of asset management firms most of which adopt a long-term, traditional investment stance with a bent towards activism, has recognized the problem. Perhaps to head off too much intervention from the government side, it set itself the task of reforming the governance approaches of the firms themselves (Cadbury and Millstein 2005).

Such calls suggest there is at least the perception of an issue with the legitimacy of the power that institutional investors hold. The sociologist Max Weber identified three bases for legitimacy in the exercise of power. Legitimacy arose in a pure way either through tradition, by an appeal to reason and legality, or in the charisma of the leader (Weber 1947). The power of the chairman or CEO in dealing with activist investors arises mainly from the last of these, entrenched with a dose of legality as their board colleagues invoke company law to limit shareholder involvement in the day-to-day affairs and decisions of management. Tradition looms large in persistence of the unequal voting rights we see in many established continental European companies.

But what do we make of the legitimacy of calls by one type of shareholders – long-term, activist asset management firms – that corporate boards and management should ignore the wishes of another type of shareholder – the perverse activist? Let us bear in mind that the long-term activists may often be outnumbered in voting strength by those perverse activists and the long-term, docile investors who might have lent them stock and other long- and short-term investors who have chosen to walk, leaving their stock and voting rights to the perverse activist? Whose rights are more legitimate, and on what basis?

In these circumstances, legitimacy involves an appeal to reason. It just cannot be reasonable, as these investors plead with boards of individual companies and with government, that companies act in the interests of the holders of a majority of the shares
when those interests are perverse. Better – and better under all circumstances they say – to pay heed to the wishes of the long-term investor, even if the short-term and perverse ones have control. The company cannot be for all investors equally, though where exactly the interests of the majority of shares ceased to be identify with the "right" decision is hard to define. Better still, they contend, if more of those docile investors would summon up the will to vote – or pass their proxy-voting mandate on to other long-term investors who will – and not to leave the decision in the hands of either those perverse investors or an unchecked and unaccountable board and management. Failing that, there is another political channel open: to appeal beyond the circle of shareholders, to government or another authority with greater legitimacy, to force accountability on the asset management, say, through mandatory share voting or mandatory reporting of how they voted.

Legitimacy helps. But as the VW case shows, in a crunch it comes back to power and its skilful deployment in the politics of shareholder activism.

In George Orwell’s Animal Farm, a band of schoolboys, stranded on a trip without adults to supervise them, form their own society, which divides into groups named after animals. Through the exercise of their greater might (an English word closer to Weber’s Macht than "power"), one group, the pigs, gains superiority over the others, with vicious consequences. And what of equality?

All animals are equal. Some are more equal.

References


