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ACTIVIST INVESTORS IN UK QUOTED COMPANIES AND THE IMPLICATIONS FOR CORPORATE GOVERNANCE

Bob Wearing and Yuval Millo



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Gillian Knight
Chartered Accountants' Hall
Moorgate Place
London EC2R 6EA
T +44 (0)20 7920 8634
E centre@icaew.com
icaew.com/centre

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ABOUT THE AUTHORS

Bob Wearing

During the period of this research and until September 2011, Bob Wearing was Reader in Accounting in the Essex Business School at Essex University. He is a Fellow of ICAEW and has taught financial reporting and corporate governance at undergraduate and postgraduate level. He has published a number of articles in academic and professional journals. His book, *Cases in Corporate Governance* (Sage Publications) was published in 2005.

Yuval Millo

Yuval Millo is a Lecturer in the Department of Accounting at the London School of Economics. Using a combination of qualitative and quantitative methods, Yuval currently examines several aspects of corporate governance and market structure dynamics. Among his latest publications are *The Usefulness of Inaccurate Models* (with Donald MacKenzie) *Accounting, Organizations and Society* and the book *Market Devices*, co-edited with Michel Callon and Fabian Muniesa.

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Roger Barker
Head of Corporate Governance
Institute of Directors

Rosemary Martin
Group General Counsel and Company Secretary
Vodafone plc

Lesley Brownett
Deputy Secretary
Marks & Spencer plc

Amanda Mellor
Group Secretary and Head of Corporate Governance
Marks & Spencer plc

Peter Butler
Founder Partner and CEO
Governance for Owners

Clifton Melvin
Non-Executive Director
Just Retirement Ltd

Emily Carey
Corporate Governance Manager
BP plc

Peter Montagnon
Senior Investment Adviser
Financial Reporting Council

Frank Curtiss
Head of Corporate Governance
RPMI Railpen

David Richardson
Non-Executive Director

George Dallas
Director, Corporate Governance
F&C Investments

Daniel Summerfield
Co-Head of Responsible Investment
USS

Paul Emerton
Head of Corporate Governance
Schroders

David Trenchard
Vice Chairman
Knight Vinke

Matthew Fell
Director, Competitive Markets
Confederation of British Industry

Andrew Tusa
Managing Director, Corporate Broking Europe
Bank of America Merrill Lynch International

Chris Hodge
Head of Corporate Governance
Financial Reporting Council

Guy Wilson
Non-Executive Director
Fresnillo plc

Eric Hutchinson
Chief Financial Officer
Spirent Communications plc

Sarah Wilson
Chief Executive
Manifest

Mark Hynes
Managing Director
Transparency Matters Ltd

Harlan Zimmerman
Senior Partner
Cevian Capital

Paul Lee
Director
Hermes Equity Ownership Services

EXECUTIVE SUMMARY

The report reviews commonly held views and practices among shareholder activists and related groups of actors. The 25 interviews held covered three categories: investors, functionaries in publicly-listed companies, and representatives of regulatory bodies or non-governmental organisations.

The main findings from the interviews are the following:

- While definitions as to shareholders' activism vary among the different groups, as well as within the groups, our findings indicated that activist investors are seen commonly as shareholders who seek to improve the value of the companies through engagement with managers. This point seems to be the most significant distinction between activist and non-activist investors, more than investment time horizon or overall portfolio composition, which were also mentioned. It was also noted that the level of activism exhibited changed not only across different investors, but also within the different investment avenues of the same investor.
- Most shareholder activists seem to follow a two-fold strategy: (1) research about candidate targets, which culminates in building a shareholding; and (2) direct engagement with management regarding the issues identified by the activists. Although notorious for manipulative use of the media, activists we interviewed stressed that while they did use the media to pressurise management, it was not a preferable course of action and was used only as a last resort. Institutional investors among our interviewees, who, by and large, did not engage in activist investment styles, were supportive of activists as they felt that they too gained from the research conducted by activists and from the impact they had on companies.
- Functionaries in companies tend to see shareholder activists primarily as a useful resource. Interest from activists serves as a warning sign or as a call for action, which are frequently accompanied by insightful analytical comments. Nevertheless, our interviewees also commented on the disproportional share of company resources that activist investors tend to draw from officers and managers.
- Activists rely heavily on communication, information and knowledge exchange and collaboration with other shareholders at all stages of their engagement with the companies. Such networking efforts seem to be most common in situations where strategic changes or high-level personnel changes are demanded, but were also reported at other instances.
- Given the importance attached by the UK Corporate Governance Code (2010) and the UK Stewardship Code (2010) to dialogue and engagement between shareholders and companies, it is appropriate to consider the potential contribution to these processes by activist investors.

1. INTRODUCTION

Shareholder activism in UK quoted companies has been an important and topical issue in recent years. Judging by accounts in the media, activists appear to have played an influential role in both the improvements and the challenges that still face corporate governance. We were keen to examine and understand the sources of this influence and the implications for corporate governance and in the summer of 2010 we began a research project, funded by the ICAEW's charitable trusts, into activist investors in the UK.

The growing importance of activist investors, in general, and institutional activists in particular, motivated research about the interactions between investors and companies and the effects of these interactions. Much of the research defined and measured the success of activist investors by using proxies such as share values or relevant accounting performance measures. This approach yielded mixed results, as causal links between activism and performance were difficult to establish (Becht et al., 2008, Gillan and Starks, 1998, 2000, Klein and Zur, 2009).

Trying to avoid the problem of measuring a phenomenon only according to its possible result, a different line of inquiry focused on the ways in which investors and executives communicate. In the case of the UK corporate governance arena, Barker (1998) studied the importance of information exchange among different stakeholders and Holland (1998) focused on the usefulness and efficacy of inter-personal communication between institutional investors and executives. This line of research explored the establishment and usage of communication modes whereby companies and institutional investors frequently exchange fine-grained information. This research work was supported by evidence on the growing importance that UK firms assigned to the investor relations' function (Marston, 1996, 1998, 1999, Pye, 2001). Companies regard increasingly the connection with large investors as one of the most useful sources for information and insight (Holland and Doran, 1998). Similarly, institutional investors, who have access to the information exchanged during the meetings, also reported an increasing degree of involvement (Hendry et al., 2006, Roberts et al., 2006).

The research so far focused on the strength and potency of the connections between the investor (fund managers, for example) and between the company's board-level executives. Holland (2002), for example, provides evidence of the specific areas of expertise that fund managers use to persuade executives to accept changes. This approach, while providing a basic mechanism for understanding the potential influence of investors, focuses primarily on the investor-firm connection and disregards, in effect, the connections interlinking the different shareholders. In our investigation we expand this framework and examine the broader environment in which activist shareholders operate.

Our goal is to map views, opinions, perceptions and reported practices among actors involved in shareholder activism in the UK. We interviewed 25 representatives of three main categories of bodies: investors (including institutional and activist), publicly-listed companies and non-governmental organisations or regulators.¹

The overall context of our research is essentially the investment scene (UK equities) in the UK. Within this context and over the last two decades it is clear that considerable change has been taking place. One institutional investor referred to the role of the UK financial institutions as follows:

'On the one hand you will have the small investors, the small UK institutions. And the big question mark is really non-UK institutions. Because it warrants remembering that when the Combined Code was first instituted 20 years ago, in the 90s, that's when the group around ABI table would represent over 50% of the UK market cap. Fast forward 20 years that same group is still influential but it is less than 30%. So, the punch that we pack is lessened. We played a strong role but things have changed and other investors have come in to play and, again, the core of long-term institutions are less than 30%. And, again, the smaller institutions might add another 5 or 10% more to that'.

¹ Some of the quotes may seem 'unpolished'. This is because the reported material is based entirely on interviews we conducted with actors and, to maintain the authentic 'voices', we applied minimal editing to the quotes we selected.

This interviewee then contrasted this reduction in the role of UK financial institutions with the increasing importance of overseas investors:

'But then the big gap has to be, and the big question mark in my mind, has to be the overseas investors who, really have not been particularly active here, continental funds as well as some revolving funds. Because the foreign investors that's the big change, they're now about 40% more of the capital – the overseas investors have more under their asset management than the UK listing companies and the leading UK institutions have. And that's often overlooked'.

It could be argued that the old system for disciplining companies via a handful of large institutional investors has been replaced by increasing internationalisation in the market and proliferation of index funds. The danger is that this could lead to a vacuum of engaged ownership.

Over the last four years we have also witnessed the global financial crisis. One institutional investor acknowledged that perhaps the investment community had been too keen in some cases to encourage risk taking and the banking crisis was given as an example where shareholders had up to 2007 urged boards of banks to be less conservative and take on more leverage. Banks needed to have the courage to stand up to such demands.

The report covers a variety of topics, but, aiming to provide an overview of the opinions presented, we start by reporting on the distribution of some of the common negative and positive implications of activism that our respondents identified (see diagrams 1 and 2).² The aggregation of the opinions under these six headings introduces, inevitably, a certain degree of subjective judgement, as the opinions were compiled from the narratives of semi-structured interviews.

To enrich and add nuance to this picture and as a type of a robustness measure, we also present the distribution of negative and positive implications according to actor types (diagram 3). This diagram shows, as expected, that actors perceive the impact of shareholder activism generally in accordance with the roles they play. This way, interviewees from companies, who were on the 'receiving side' of activists' actions tend to portray a more negative picture than investors themselves, while NGOs and regulators present a more balanced set of views. While somewhat crude, this distinction between negative and positive perceived implications of shareholder activism (and the fact that these opinions cross the different actor types) underpins another important distinction about shareholder activism: among investors there is a distinction between those who incorporate the activism into their investment process and between those tend to use activism practices primarily as a response to instances of perceived inappropriate corporate governance conduct.

Diagram 1: Positive implications of activist investors

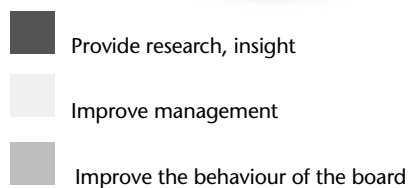
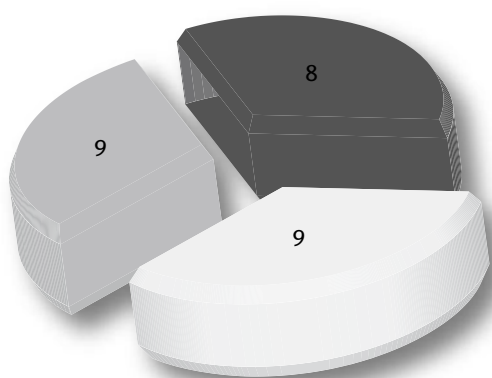
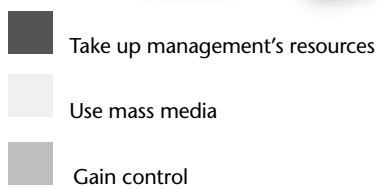
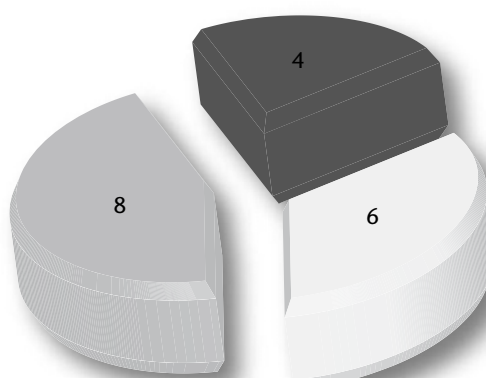
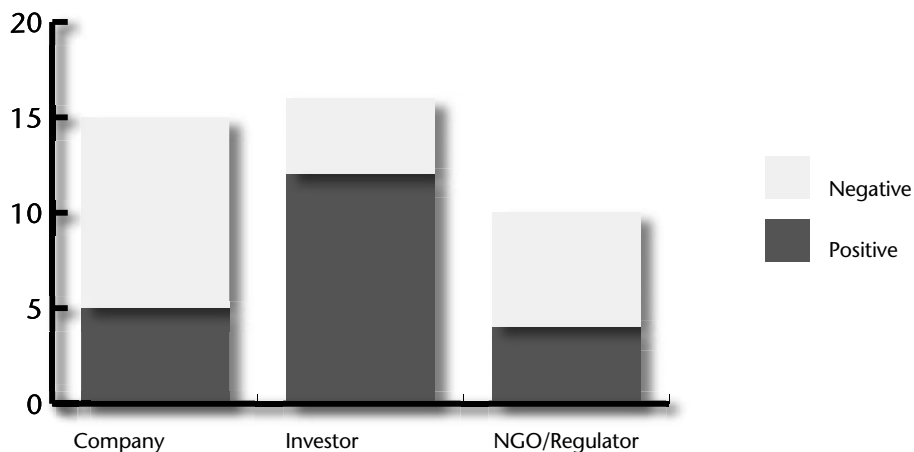


Diagram 2: Negative implications of activist investors



² The diagrams count the instances where an opinion was expressed. Frequently, one interviewee expressed more than one opinion and so the overall count is larger than the total number of interviewees.

Diagram 3: Positive/negative implications of activism, by actor type



Our report proceeds as follows. In section 2 we examine representative views and attempts of definitions offered by the interviewees of shareholder activists and activism. We juxtapose these views with the notions of active and passive investors, which were also proposed by interviewees. In section 3 we examine the variety of reactions by boards of directors to intervention by activists. Related to this topic is the issue of awareness of companies to the composition of their share registers. Regarding this we exhibit interesting views on how companies try to be pro-active in recruiting investors onto the share register. In sections 4 and 5 we refer, respectively, to factors our interviews identified as blocking or hindering companies' performance and how activists may attempt to address such issues and, in effect, unlock value in companies. In section 6 we look at tactics and overall strategies employed by activists. Section 7 explores the links between activists and institutional investors and section 8 refers to views about dialogue and engagement between investors and companies and the differences between public and private communication. In section 8 we also look briefly at some non-traditional activists, which we refer to as corporate social responsibility (CSR) activists. In section 9 we examine shareholder activism in the context of corporate governance in the UK. The report finishes with some concluding comments in section 10.

2. DEFINITION: WHAT IS AN ACTIVIST/ACTIVISM?

In this section we examine how the interviewees defined 'activists' and 'activism' and portray the nature of the related practices. Interviewees expressed a range of opinions on what it meant to be an activist investor and what captured the essence of investor activism. Most frequently, the implied motivation for activist intervention was identified as an eventual gain in value of their shareholding.

An indicative quote defines shareholder activists:

'Somebody who perceives an opportunity for change which will add value, probably over quite a short period, but not necessarily over a very short period, and actually wishes to crystallise that value and take steps through becoming an activist shareholder in that company'.

The above quote implies that activists target specific companies and typically invest for the short to medium term, but not for the very long term. Contrastingly, one institutional investor recognised the different meanings that could be attached to the term 'activism' but saw the term broadly as enhancing long-term value of companies:

'I take it to mean shareholders who are interested, and prepared to get involved with the company in order to sustain long-term value. It's not about micro-managing the company. That's what executives are for. We don't aspire to manage companies. But, we ask that the executives, as stewards, act in the interest of shareholders; long-term shareholders such as us. And, we are a very long-term shareholder. I think activism, according to my definition, is a good thing, because it will help prevent corporate disaster, and to sustain long-term value'.

The idea that activists should not get involved in micro-managing the company was also mentioned by another interviewee:

'I think one of the perils is there needs to be a clear line of management running the business on behalf of the shareholders, and the shareholders not getting into the weeds and micro-managing themselves.'

The view presented above, which separates between 'macro' and 'micro' levels of management, the former being the realm where activists operate and the latter, the realm they avoid, is nuanced by some interviewees, such as the following institutional investor, who regards activists as:

'The kind of guys who come in, they want to take control, change the strategy, put themselves on the board and really do something, fundamental about the company themselves, in a way'.

This view about the level of intervention and the nature of action is also related to the distinction our interviewees made between 'active' and 'activist' investors. While active investors would advise the corporation or other investors, for example, activist investors would not only do that, but also try to bring about the changes they advocate. The same interviewee saw their role as follows:

'Our job as an active investor, is not to overhaul the company as we see it but basically to engage with the company and encourage it to stick with the practices, whether they're strategic or operational governance'.

A similar distinction between typical actions of active and activists investors is implied here:

'Other investors, who aren't so activist, look at their actions, and think, "Well, I'm not going to be vocal about it, but I can understand why they're doing that. And, I don't think it's necessarily a bad thing if someone is putting management on the spot, and making them think about this".'

This distinction, however, is not so clear-cut, as this indicative quote shows:

'Much as we may want to talk about the noted activist names, I actually don't think that it's a hard line between there's this group over here, and then we've got this sort of big break, and then we've got nice traditional long investors over here'.

Since the 'active' notion, refers to engagement with the invested companies, some of our interviewees noted that the notion of 'passive' in its usual sense (ie, long-term holder) is not necessarily inconsistent with being an active investor:

'I think the problem is the term "passive." And, all it means is that they're passive in the selection, in the asset allocation. It doesn't mean that they have to be passive in terms of engagement. Companies say that what they really want are reliable, long-term shareholders. So, a good passive index manager is not passive in terms of engagement and activism, though it's true that some of them are. L&G and BlackRock are examples of the good. But, you can find others that do nothing'.

Another nuance to the active/activist distinction is expressed by interviewees who argued that ways of action are context-dependent. Therefore a company's group of shareholders may 'become activist' if the circumstances call for it, and, crucially, there are catalysts in the form of initial activists who organise the action:

'I think, in their heart everybody can be an activist and that's what the activist model relies on. The shareholder register, if it bonds around a problem that it sees, if it unifies around that problem ... can consolidate around a position which is held by an activist. And if it comes to winning a vote and enforcing accountability, then the activist can create the momentum to get everybody on its side and to get its view across and act as an intermediary'.

One interviewee felt that the activist's agenda was a critical point of differentiation between an activist and an active investor:

'Activists don't put you under any more pressure than regular investors. If anything, regular investors, sometimes, are better at trying to get that information out of you because, of course, they don't have an agenda. But, if you meet with an activist investor, you know in advance they have an agenda that you're going to deal with. And, actually, you can therefore resist that. And, so that's very explicit. Whereas, with regular investors, they start off on a particular line of thinking, and then questions, and then your realise they've come full circle in their thinking to a position where the activist may or may not be'.

'As I understand the term activist is not sector specific. He's just looking for special situations and spotting things that he thinks are undervalued for whatever reason. Whether he thinks that there's a possibility that the sum of the parts of a conglomerate is often worth more than the whole or whatever. He thinks there's a way of making money there'.

This institutional investor saw the amount of research and also 'short-termism' as points of differentiation between 'active' and 'activist':

'The activist investors are often, sometimes they are extremely well informed. The big difference between them and us is we're looking at a large portfolio. They're maybe looking at two or three and maybe having smart people drilling down on an issue for two or three months at a pop. So, in some ways they can be very informed and very bright and raise issues that we might not have raised ourselves. I think that there is a definite role for them in the marketplace, but the concern with short-termism is probably the greatest. Because these guys want to come in, make a change; go in cheap, make a change they think is going to fix it, and sell out and just make a quick buck. And there is probably a role for that in the marketplace. And I think if I was a company's manager I would want to understand what these guys are all about even if I didn't enjoy what they had to say'.

On the other hand, this interviewee thought that in some cases you had to be careful about labelling all activists as necessarily short-term operators:

'One of the interesting things for me, actually, is a lot of the debate at the moment is around so-called "short-termism." And, you find some commentators tend to lump activists in as part of the problem with short-termism, which I think actually is rather both unfair and misleading. Some of them may well have a short-term focus. Others would argue that they've got as long-term focus as the management and other investors'.

Within activism there could be different levels, according to this institutional investor. This quote also brings out the idea of an activist deliberately targeting an underperforming company:

'Where you deliberately invest in an underperforming company on the basis you can make some changes to it which result in better performance, now, that is, if you like, the ultimate activist, and there's only a few people who do that. You know, the Nelson Peltz of the world, Trian, I think it's called; and Ralph Whitworth, Relational Investors, who take a very small portfolio, and with that portfolio they go about trying to change the company so there's a potential for value creation within. But, that's very different from the work that most investors, most equity investors, would pursue. So, there's different levels of activism, I think'.

Finally, one non-executive director believed it important to draw a distinction between an activist shareholder and a control-seeking shareholder:

'An activist is somebody who seeks to influence the board, which is within every shareholder's right to do. I am actually pro-activism. I think shareholders should have a view. They shouldn't attempt to manage or run companies, but they're entitled to have a view and speak their minds. However, a control-seeking shareholder is somebody who seeks to control the board. And, to my mind, that is a totally different concept to activism'.

'Activism is not bad. Secret activism is bad, and secret control-seeking is what's really bad. If you want to buy a company, you make a public offer, you pay say a 30% premium for control, and then shareholders are able to decide with full knowledge of the situation, that's fine. If you can buy enough of the stock, you take over. That's capitalism. However, what if you manage to take control of a company by privately threatening directors, by forcing some of your people onto the board and by threatening shareholder action in the board room? You can take control without paying that control premium and without shareholders knowing what's been happening. You've effectively stolen the company from other shareholders. That is very wrong. And it happens'.

3. BOARDS' PERCEPTION OF, AND REACTION TO, ACTIVIST INTERVENTION

This section firstly considers how boards tend to react in practice to activist intervention and perhaps almost more importantly how they should act. Secondly, we consider the importance of boards understanding exactly who is on the share register and how they might encourage non-investors to take up a holding.

3.1 HOW DO BOARDS PERCEIVE ACTIVISTS?

Board reaction to activist intervention could be hostile. One interviewee said:

'Well, it was a difficult time ... the non-executives were incensed, I would say, that an interloper like this could be criticising, a man who had no industry knowledge, blah, blah, blah. They were portraying him as just someone who made a quick buck and turn on the shares. One of the reasons why the company had lost its way was our board was too big. There were too many non-executives, and they were all classically out for money. They were CEOs and ex-CEOs'.

One interviewee believed that company boards did not welcome the attention of activist investors:

'No company likes having any form of activist investors involved in their story because it creates undue noise, it limits management's ability to actually communicate to investors about its strategy, because it's always trying to address someone else's strategy, and almost always, it's a reflection, in some shape or form, of some inherent criticism of the way the company's being managed'.

One interviewee felt that activists had a right to be heard by management and even influence their behaviour:

'Management doesn't have to listen to what activists are saying. If activists wish to try and influence management behaviour, it's the nature of shareholders. I mean, shareholders should be entitled to do so. They are the bottom of the pile in so many ways, when it comes to a relationship with the company. They've got no creditor rights. They've got total risk versus expected return'.

Companies could put themselves at risk by ignoring the legitimate concerns of their investors:

'I think the point is that the companies which are vulnerable are the ones which persist in not listening to what their active mainstream shareholders are saying, because they think they can ignore them. They are then vulnerable to an activist coming along and saying this isn't right, raising a very clear flag, and everybody falls in behind it, you see. So, the security for the companies come through actually having a sufficient understanding of what a critical mass of long-term or committed owners are thinking, so that they know where the chips are going to fall if anything happens. And sometimes, they will have had to react to things that these, or respond to these, and points that these shareholders may have made, in order to have sort of build up the relationship with trust. Now, all that means is, actually, that I think, the companies want more dialogue than the shareholders do sometimes, because they want to know what the shareholders are thinking'.

One non-executive said:

'I think boards should welcome (activist intervention). Because if someone's out there with a smart idea about your company, I think you'd want to listen to it. Now you might decide actually it's not very smart after you thought about that, but you know, we shouldn't always be so smug and complacent, we don't think we can never learn. I think life is a learning experience and you never stop learning, in my view. And there may be somebody who's got an idea that's really good'.

Speaking some time after an activist had intervened (successfully) in a company and then exited, one executive director felt that money had been wasted at the beginning trying to fight off the activist:

'So, I'm prejudiced. I survived. I'm a shareholder. So, I've personally benefitted. Given that personal interest caveat, would I have done anything differently? I'd try to persuade the existing chairman not to waste money and invite him in.'

One FTSE board member believed that:

'Directors should run the business. Obviously for the best interests of shareholders, but what we shouldn't do is do what shareholders say'.

And in a similar vein this institutional shareholder said:

'Actually, there's an argument to be made (that boards of directors need) to have the strength of their convictions at times and not get distracted by the noise that's often created by shareholders who are leading them down the wrong path sometimes. It takes a very brave board to withstand that pressure and say, "Well, if you don't like what we're doing, this is our strategy, this is what we believe in, if you don't like it sell your shares".'

3.2 MONITORING THE SHARE REGISTER

Monitoring of the share register was seen as an important activity with regular reports going to the monthly board meetings. This was particularly the case when an activist investor took an interest in the company:

'In the case of a special situation, for example, if you're worried when [the activist] puts his hand up and says, "Hey, have you thought about this?" you might actually get an analysis done on your register daily, following all the individual movements to see whether or not his position is actually influencing the trading behaviour of your other shareholders. And, that's also a way of being able to work out who is interested in the issues that the individual is raising, the activist is raising'.

One interviewee believed that monitoring was important even if there was not a perceived immediate threat from activists:

'I think our largest holders have tended to be the traditional fund managers, often with larger index positions, so they have to hold a proportion of us in relation to our size in the FTSE and their portfolio. So, while that's still the case, I think two things we've noticed on our register, firstly we've noticed more non-UK institutions coming onto the register. And that's not just sovereign wealth funds, but actually, again, we've noticed more US institutions come on, and more non-UK. And some interest from Asia, as well. Interestingly there is a lot more stock lending, even amongst the very traditional institutions. And that doesn't necessarily have a link with activism, but there was some concern a couple years ago with people lending stock around the time of AGM and voting rights. There's always churn going on, and, even very traditional UK institutions now are stock lending because it's a good fee revenue for them. You can see things moving around on your register although it's actually not real changes in ownership'.

A number of times, interviewees stated that they aimed to encourage a particular type of investor to take shares in the company, for instance long-term investors and those who understood the companies' long-term objectives:

'I guess I try and encourage a slightly more enlightened view, which is that whether or not hedge funds will invest for the long term, I would much rather they invested because they understood the company's story, than invested because they're trading off what other people are saying, and they don't understand the company's story. They create a lot of liquidity in the market. So, whether it's on a short-term basis, they will influence the day-to-day trading and the share price. And, if by persuading them, or talking to them, or communicating with them, you can demonstrate that there actually isn't much in their strategies to investing in a company. And, that's a good use of time, whether or not they end up being long-term investors or not. You're much better off having better informed investors. The more you can make sure the market is well-informed, the better. And that's the bottom line'.

One FTSE board member believed it was important to make sure the investors understood the company's strategy, since it is not possible to satisfy all types of investor:

'It's not that we're managing the business to satisfy all our shareholders. Because you've got a range of shareholders; you've got a range of people who are interested in you for a variety of reasons. And if you did try through an assessment process to work out what it was they really wanted, you'd get a range of answers. So, you couldn't satisfy them all anyway. But, I believe that the job of management and the job of companies is to determine for ourselves what it is we should do. And then go and explain what it is we're going to do, why we're going to do it. And if the guy says, "I understand exactly what you're doing, but I'm a dividend stock and I don't want you growing market share and investing." You say "that's fine. You go, someone else is coming." If you've got this right, the guy coming in will pay more than the guy going out for the stock, and the share price goes up again. If you got it wrong, the share price goes down over time. So, you have to listen to the shareholders, understand what they're saying and why they're saying it. But you mustn't sway too much in the wind, otherwise you'd find that you were flopping around all the time'.

One interviewee argued as follows:

'Really it's a task for the board of directors to try to attract the sort of shareholder base which makes sense for their company. So, if they are a company which ultimately would benefit from having a long-term approach, the long-term investment strategy, maybe in the pharmaceutical industry or something like that. You need basically, to have support of shareholders. At least some support of shareholders who share that sort of time horizon. The board, in a way, has to encourage that. By being very clear in its communications to the outside world about what its strategy is, what its time-scale is, what are the performance criteria in which the company should be judged. Hopefully short-term shareholders will either not want to, not necessarily become shareholders. Or if they do the

board will be able to say, "Look, this was the deal that you were buying into. You shouldn't be trying to push us towards short-term actions, when we've been very clear all along that we are pursuing a long-term approach."

Relations between companies and shareholders could be improved by giving full information. One non-executive felt that in terms of information provided to investors, companies should be as open as possible and certainly there should be no surprises:

'You just have to make certain that you give (investors) milestones, you know, on a year basis and you report against those milestones and you let them know if, for whatever reason, the milestone is going to be missed and what you're doing about it. Not just investors, but you tell everybody, you know, completely public. So, that if you have a strategy that the investors are brought into, you have the business plan of how you're going to achieve that strategy. You have the KPIs on a regular basis that show you how you're doing against that business plan, which can be measured on a quarterly basis. There shouldn't be any surprises. And the more that you will fulfil as a management what you said you're going to do, the greater the trust the market has in you'.

This interviewee highlighted the importance of being pro-active in ensuring a positive relationship with investors:

'I would also be looking and trying to reach out to people who weren't on my register, who I felt should have been. So, again, some bit of opportunistic marketing. In terms of senior executive time, we've always been quite open here, actually, this being, you know, if we can squeeze you in to a great meeting, I'll squeeze you in. So, that's a very different approach to a number of other companies, and I know some of my peers, if you aren't on the register, they wouldn't see you. Some of my other peers would say, "Hedge funds, we don't see you, because you don't directly own stock, so we're not going to see you." A number of the hedge funds who were big holders of us, would actually declare their positions, because that was the nature of the relationship we had. So, even before the meeting, they would have sent me an email to say, "Just to let you know, that this is the level of CFDs that we are currently holding." So, actually, I would find that a very refreshing sign that says, actually, that you've got a good relationship with these people, that they would ring us up, and they'd say, "We've taken a position in you. This is the size of the position." Which, again, is quite unusual'.

Finally, this interviewee raised the issue of what was likely to bring about shareholder activism in the first place:

'I also think you have to think about what is it that breeds activism anyway? What is it that encourages somebody to take that action? And actually, if you think about it, strength of your board, and the leadership of the chair. How effective is your board? How effective is your chair? How much do you disclose? How much do you communicate? So, again, it's down to the calibre of the boardroom, the behaviour of the boardroom, and the calibre of the chair; the range of skills, feeling that you have the appropriate skill set at the table to take the right decisions for the company. But investors want to know, not only who you are, but how you take the decisions you reach, what skills you've got there. And provided you're answering those questions, and provided you're delivering your performance, then you're not really giving the oxygen for the activists to have cause for concern. So, I think it's where you don't do those things, that gives rise to the activism'.

4. ROLES AND MECHANISMS OF ACTIVIST INVESTORS

Having discussed respondents' experiences and perceptions of the interactions between boards and activist investors, we now turn to a detailed discussion of how investors see their role in relation to the companies in which they are involved. In the first subsection we explore a reoccurring theme in our respondents' descriptions of how they analyse companies' situations and how they perceive their role as what some of them described as 'value blockages': situations where factors such as incumbent management were seen as a hindrance to shareholder value maximisation. In the second subsection we provide evidence about the activist investors' fundamental rationales, which supported and justified their analysis and actions. In particular, we focus on the perceived causal relationship between corporate governance and financial performance and the factors behind good board performance.

4.1 VALUE BLOCKAGES: COMPANY AT FAULT/INEFFICIENT MANAGEMENT

One interviewee provided a review of potential issues:

'I think it's the strategic issues which sometimes are not seen by management and then there's the corporate governance failure in not allowing the information to flow perfectly through all of those. And there may be costs associated with dismantling a business which the market might not understand. And there might be informational or sentimental reasons why that's not happening. So, it's those sorts of blockages which may, then, also feed through to the valuation where the market gets a sense that actually here is a management team, for example, who just can't see the signals.'

Identifying value blockages is only the first step in the operations of activist investors, as this stage is followed by analysis:

'How do the inefficiencies come or rise in the first place? It may be that there is some blockage of the feedback loop so that the accountability which is required by shareholders isn't actually recognised by the whole board. Or the shareholders are feeding back that there is one precise problem and then why do you keep on investing in this business when its low return is going nowhere; no value is ever going to get recognised. Maybe that message is not getting up to board, there is a blockage of that information.'

Among the main issues that our respondents identified as typical 'blockages', which activist investors tackle is the functioning of the board. An executive director we interviewed identified the board as a problem:

'They were also full of very big ideas. I categorise the main problem that they couldn't set priorities. There were too many chiefs, and the CEO wasn't willing or able to drive through what needed to be done.'

Another board-related issue that was mentioned was the UK system of board nominations – candidates selected by a committee made up of the chairman and other board members. This can result in boards populated by directors who are not by nature 'challengers' and who feel an allegiance to the board members who had appointed them. Arguably, such a situation could allow value blockages to persist over time:

'There are many companies in the UK whose boards look good on paper. However, the directors don't have the mindset or incentives to push and challenge the status quo, which is necessary to improve things. They don't really represent shareholders, because at best they've been rubber stamped. They don't feel a threat of being deselected by shareholders – because it basically never happens. And it is extremely difficult in this regulatory environment to get investors together to try to change something'.

This activist also argued that firm performance would actually improve by having shareholder directors:

'An investor who owns, for example, 10% of a company is not considered to be "independent" in the UK. Well, okay, we are not independent from our shareholding, but is that a bad thing? It should be a good thing to have directors who have a real interest in the fortunes of the company. This is common and welcomed in other European jurisdictions and the issues – obligation to represent all parties, not just the 10% owner, addressing connected party dealings, etc – are easily dealt with. In the UK those issues are used as a justification to keep owners off the board and preserve the status quo'.

This institutional investor referred to blockages on the board:

'Generally, what we find is that companies with problems have problems in a number of areas, so typically, a company with a strategic block will often have a blockage on the board, you know. Not surprisingly, you know. If the board is failing to address a major strategic problem, that's probably because there's a problem on the board itself, and typically, you know, if the board is not able to address that sort of issue, it's also failing to address some of the risk issues as well. So, it's quite often the case that we'll see a particular company coming up that's flagged in a number of areas'.

4.2 CAUSAL RELATIONSHIP BETWEEN GOVERNANCE AND PERFORMANCE

Some of the interviewees presented the view that there was an obvious causal relationship between corporate governance and firm performance. For instance, according to one institutional investor:

'I have always regarded corporate governance in its widest sense. It's to do with the managements of company, and it's very closely linked to the performance of the company. So, if there is poor leadership in place or poor leadership structure, it is going to have an effect on the revenue of the company. If there's poor leadership structure, there is greater risk attaching to the company and of course the cost of capital will be higher, so on and so forth'.

Another institutional investor said this:

'It is the only thing that matters, actually, good management and strategy. Everything else, if you've got good management in place and good board checks and balances, things like remuneration just go away. It disappears overnight, because you would expect everything else to just fall into place'.

Following the same rationale presented above, an institutional investor referred to the expected benefits of engaging with companies and improving corporate governance:

'I still feel it's more useful to talk than simply to sit on the sidelines and do nothing, or write an impersonal letter months after the event. We have to be in with the action. So, we think it does help. Although we don't make extravagant claims about it uplifting the value of our portfolio, there is now beginning to emerge a body of quantitative research that suggests that good governance leads to less volatile, more stable returns over the longer term. But, I always thought that intuitively'.

Overall, there appears to be a wide consensus among the interviewees that putting the 'right people' at the highest echelons of the organisation was fundamental to delivering good financial performance. This view is interesting in its own right, as it provides an insight into the rationales prevalent among activist investors, but it is also interesting to note how popular this view is when we compare it with the academic literature in corporate governance. That literature does not find clear correlations between board's functioning and remunerations and between the overall performance of the firm (Bebchuk and Fried, 2004).

5. UNLOCKING VALUE

In section 5 we take a closer look at the concept of 'unlocking value' that many of the interviewees presented as central in their deliberations and actions. We examine this concept, how it motivates actions and present a step-by-step 'script', as it emerged from the interviews, of how activist investors identify areas of potential improvement, how they analyse their findings and how they approach target companies.

Several interviewees regarded unlocking value as a two-stage action plan. Firstly, companies where there was value to be 'unlocked' need to be identified:

'Fundamentally the activist is there because it is a cheap share. You don't see very many activists buying into expensive shares actually to be honest. They buy because there is a value, there's value to be unlocked'.

Secondly, it is crucial to identify a potential mechanism or catalyst as a means of unlocking value. One activist investor explained it as follows:

'So, our starting point is we will invest many, many, many man-hours, I mean hundreds of man-hours in looking at the biggest companies ... and then separately identifying whether there is some kind of catalyst that could help unlock that value, or whether we could be that catalyst, not necessarily the same thing'.

These two stages, some of the interviewees noted, are not performed solely by the activist investor; the perceptions and reactions of other market actors are also important:

'I think you're not just seeing – you're not just recognising a cheap opportunity but you're also seeing a pathway to unlock that value. That's where you would be really interested. You would also be even more interested if you understood that other people also recognise that barrier but that management themselves acted as an obstacle. Because at the end of the day you clearly want other people to appreciate the value of stock by buying and bidding up the shares'.

Following these two stages, an approach is made to the management. Such approaches are indicative, we believe, of the activist investors self-perception: how they perceive their own role in the process of improving the companies affairs and how they justify their intervention. A good example comes from the following activist investor:

'This is what I'm doing. I've got a 15% stake. My money's in the company. I'm not drawing the salary. I'm not gaining on options. I'm like you, Mr Shareholder. My objective is to get this company right, and we'll all make money'.

Such approaches are also accompanied by a rationale that aims to distinguish between the activist investors and others investors and justifies the intended intervention:

'Actually, it's not conventional wisdom, but some of the more activist shareholders who've got 10, 12 portfolio companies have got the luxury of spending more time looking at the companies in their portfolio. And those who do it well, some of them have got very good strategists and analysts, are the ones worth listening to, actually. Some of them have got very interesting things to say. There's so much free consultancy. If someone's prepared to spend a huge amount of time looking at your company and looking at the problems that the company faces and coming forward with an agenda for change, which very few shareholders are prepared to do, then I would argue that it should be worth listening to. Most shareholders just complain. They don't really have a solution in mind when they're approaching companies, from my experience'.

Following such an approach, management would need to decide whether to respond positively or negatively to the activist:

'That particular activist worked very closely behind the scenes with a company locksmith – as he's known. So, either, in the instance where management isn't responding to that activist, then the activist who leaked its interest in the company can talk, begin to talk to others. So, that its interest becomes much more formal and much more public. And then it can be that management has the option of saying we've heard what they're saying. We don't think it makes any sense at all. There's value to be created in this business, you can put your faith in us. Or they can say, "Actually, there's merit in what their proposals are. We can definitely respond to this, we'll do it on our own terms and in our own way"'.
'

Based on the activists' analysis of how value can be unlocked and the management reaction, different ways of actions are followed. We examine some of the ones that appeared commonly in the interviews. Presented here is a situation where an activist believed value could be unlocked by breaking up the company:

'So the value of the parts they felt exceeded the value of the current share price. So, they thought the value would be released by breaking up the company. The more recent issue was about management, executive management's poor money management. So, they felt the company had made a series of expensive acquisitions and hadn't added value on them'.

While activist investors would try to find ways of 'unlocking value', one FTSE board member felt that boards also had a duty to be active in looking for new ways to improve the share price:

'Activists tend to be a little bit more vocal. But I don't think you need to be vocal. A number of times people would say, "well, we like the strategy, we like what you're doing but what we don't see is an event coming which is going to step change the share price". So, your share price will grow but only generally with the market. But particularly the value investors, they're looking for what's going to take it from £10 to £12. Because £10 to £10.80 you can get anywhere in the marketplace. That's just part of the index, you'll get that. But why should we buy you at £10? What's going to take you to £12? And they were looking for that step change. And I think if you're active management, you should be looking for that, as well. We shouldn't be sitting there and saying, well we're doing the right thing, we'll just keep growing it small. You're saying, how can I take this business on to the next level?'

6. TACTICS

In this section we refer to the tactics adopted by activist investors to achieve their aims. One activist investor referred to the considerable resources invested in research:

'We run a very concentrated business in that, the nature of what we do requires, probably hundreds, in some cases thousands, and in a couple of cases tens of thousands of man hours of research. So, we will only ever be invested in probably half a dozen companies at any one time. Which is again very different from most traditional fund managers who might have probably 600 to 1,000 stocks in their portfolio, we might have six. And so, we are doing the sort of analysis in depth in those six companies that no (institutional investor) can do or could be expected to do. But of course we can't do it across the whole waterfront of companies'.

Investing in a company and carrying out research into that company could be carried on in parallel:

'We'll buy a small position. We have a list of what we think are the potential targets at any one time. We'll invest a small amount in something where we think that this has really got some potential. And then we start to do our real forensic analysis and throw the resources at it. And as we get more comfortable with the idea, say we get more comfortable with the valuation, we may get more aggressive. If it gets very cheap we may think that there's a great opportunity here but if the stock's run ahead a little bit, so we'll wait. If you have a three to five year horizon you can be quite disciplined about when you buy and how much you buy. So, we're not traders. We accumulate positions over quite long periods of time. So, we don't wade in and buy the whole thing. Typically, we'll take some months and then we might buy some and then stop, whilst we carry on doing some work'.

One activist described a typical strategy in the following terms:

'They invest in companies where if there was a different change in management or a different strategy, or a different capital structure, or other changes perhaps in their governance, we could see there would be an upside of at least 20%. When we have identified this one (a certain company) that might fit, we then look and have to identify what an engagement programme might be that would change the value from where it is now. Generally, the assumption is when you buy the stuff the market has got it right. You've got to change something to get the value up. We tend not to buy more than 10%. What we aim to do is to be a top 5 or 10 shareholder. Because if you're a top 5 to 10 shareholder then the company is going to give you time. We tend not to go over 10% of the fund. And we don't like being much more than 10% of the company. Because if you're much more than 10% of the company, it's probably going to need a financial transaction to get you out'.

After the stake had been acquired, the next step would be more active engagement with the company:

'And over, perhaps the first year, we will want to meet the chairman, and other non-executive directors. We in part will meet brokers, professional bankers, and we will visit sites. Meet senior operational management, divisional management. And you get involved and spend time on it far more than any other shareholder does. And in that first year you are trying to establish the engagement programme that you had in mind. What we would then do, we would want to make a presentation. Sometimes to the chief executive. Sometimes to the chairman. Sometimes the entire board'.

One interviewee believed that:

'But the key to understanding, for me understanding the activist investor, is that because they are significantly less well-funded than people like insurance companies and pension funds, what they're doing is they're using judo techniques. They're kind of using their own small weight, and getting a situation where they can use the weight of somebody else to achieve their own ends'.

One executive director commented positively as follows on an activist investor who had engaged with a FTSE company over a two-year period:

'He's very good at what he does. The company's been left in good shape. And one other thing he's very good at, he's very good at recognising talent in an organisation'.

One non-executive director referred to the difficulties with 'representative directors' (ie, a director representing one particular shareholder):

'How should a board react to a request for a representative director, and what are the responsibilities of a representative director? There are no rules for a director representing a shareholder ... Advisers will tell a board that if a shareholder has more than about 20 or 25%, and they ask for a representative shareholder, the board should give it. That is custom and practice, but, it's not in the [Corporate Governance] Code. Now that representative person may be totally benign. But in law, any director has to represent all stakeholders, effectively, without fear or favour. So what on earth is a representative director? The individual may actually play it absolutely impeccably, and even be helpful to the board. But, the concept is faulty and difficult, because it's a legal impossibility to be a representative, and to be completely impartial between all stakeholders. It's just not possible. And the Code just pretends that this problem doesn't exist'.

Furthermore:

'You only need one representative director in that boardroom, and the activist, or control-seeking shareholder then knows which director is pliable and who will stand up to him on the board. Who's difficult, and who's not. And, that's what happened in [the company]. Once they had got a representative director, he clearly decided that I was willing to stand up to them. I was trouble. Very quickly afterwards, he privately told me to resign and threatened me. Once you've got an activist shareholder with a representative director inside that boardroom, telling the SID [Senior Independent Director] to resign, what hope is there that the other directors can act independently and impartially?'

Directors have an interest in resigning quietly rather than publicly fight an activist:

'It's very rare for a director to be voted out by shareholders. Corporate governance people tell you this. And, I say, "Yes, that's true. And, what conclusion do you draw from that?" "Well", they say, "it means the system works fine." No. The conclusion I draw is that generally directors fall on their sword quietly, because that's better for their CV than fighting a battle they think they will lose. Let's face it, you'd be barmy to let yourself be voted out publicly, in the full glare of the media. That then looks like a black spot on your CV. Whereas, if you resign quietly, you can give all sorts of reasons why you resigned'.

One interviewee described the activist's tactics as follows:

'Now, what [the activists] will try and do is make sure that they will talk to the CEO, they'll try and build a relationship. They'll try and pass it to the CEO. You know, we had a situation where the CEO was getting calls from [the activist] once a week. And all the time, sort of saying, "What are doing about this? What are you doing about that? Duh duh duh duh duh." And, it wears you down, so, you just ignore it, and you find another way of doing it. And, we actually benefited from having a senior independent director, who then, subsequently became our chairman, who actually put himself in between the activist and the CEO and basically fielded those calls, to make sure that, you know, the CEO was left running the business. And, that was fine, although, in reality, it's the first step of, to an extent, the activist investor achieving his objectives of, you know, making sure that the change is happening within the organisation'.

One interviewee had experience of the lengths to which an activist would go to get information:

'At my previous company the activist investor had gathered a huge amount of information from public sources. A lot of it from public sources just well constructed; so not particularly different from any other institution analyst, about going to a level that's taking analysis from information that isn't quite the same as a normal analyst would do. And, also, certainly seemed to be doing a lot of approaching anybody they can in the company, anywhere, and just engaging them in conversation. So, picking up a lot of gossip, grapevine stuff, from directly from employees in the company.

Furthermore:

'Yes, [the activists] certainly do push against the boundaries. Again, it is a very difficult area because one wants to be as transparent as possible with everybody. But, sometimes it is absolutely not in the company's best interest to talk about issues that are commercially sensitive. And some of the activist investors will push and push and push for information that, in my view, you should not disclose to one investor you couldn't disclose to all investors. And they will push for information that you would not put willingly into the public market because it will commercially damage your commercial interests. So, that's the reality and then you push back and you get accused of being secretive and not talking to them'.

7. RELATIONS BETWEEN ACTIVISTS AND OTHER INVESTORS

In this section we explore the relationship between activists and other institutional investors as well as relationships between institutional investors. In most cases the activists (ie, those of the interviewees who declared themselves to be activist investors) were remarkably frank about the extent to which they would try to achieve co-operation with institutional investors. There seemed to be little friction in general between activists and institutional investors. Some views on relationships between activists and other shareholders (particularly large financial institutions) are reported on here:

'Activists have to be very consensual, they have to bind the other shareholders into what they are doing'.

One interviewee referred to a particular situation:

'I'm aware of one case where an activist investor went along to see a company with a very long major investor, and the company was very concerned to see this raider coming along with some besuited nice guy that he knows very well'.

One activist investor believed that financial institutions were prepared to cooperate with activists in private but were reluctant to be seen to supporting activists in public:

'And one of the institutions said to us, "the problem we have of so publicly agreeing with you, even though we came to a whole series of meetings ... with you in the same room, is that we don't want to necessarily be publicly in the newspapers saying we're agreeing with you. Because we're going to own these companies for the next 100 years and we don't want to lose our access and privileged relationship with the management"'

One interviewee believed that activists had an important role to play, but could generally only do this with the consent of other shareholders:

'So, you can only achieve something as an activist if you can carry the active ones with you. It's fundamental, it's very important, that. And actually, it's also the case that because the active, as opposed to the activists, don't stand far enough back from it. They don't necessarily see the opportunities or the moments when you should do something. And I conclude from this, first of all, that, actually, activist shareholders who are sometimes vilified, especially on the continent, aren't really that dangerous, because they'll never win the argument unless they can carry the mainstream with them. But they are quite useful, because they will make sure that some arguments run which wouldn't otherwise be run. I think that actually means these activists are quite an important part of the overall market architecture. They're the proactive ones. By the way, active shareholders will tend to address problems when they perceive they've arisen, but usually after the event. The activists move in before the event'.

Furthermore, activists can actually assist active shareholders in terms of engaging with the company:

'But if you want shareholders to be engaged and do their job of monitoring and moving companies on, you've got to have the activists in the frame, because they're the people who will, from time to time, initiate, and if nobody's initiating nothing will happen'.

In some cases it was thought that institutional investors were becoming more active and that in certain situations one investor would emerge to take the lead in a special situation:

'I think that the background is such that the fund management world is now much more familiar with acting, not in concert like that, but acting or at least talking about these big issues. And there are various forums whether it's the NAPF or whether it's the ABI, around whose tables these guys will assemble to discuss such issues. And therefore they become aware of each other's thoughts and they're aware that there may be a leader to drive a consensus and then to apply pressure'.

Also it was important to establish exactly what the important issues were in any confrontation between activists and a company:

'We'll want to find out where the, you know, where the balance of power is likely to lie. Who's sympathetic to the activist, what the activist's arguments are? We've gone to the company and said actually what are the points to rebut the activist and we will play an active part in engaging with the institutions as well to try to get them away or to allow them to understand the managers are hearing and that various things are being done'.

This interviewee referred to a situation where the activist contacted the company:

'When they attracted our attention was when that investor contacted us to say, 'I've got a group of investors and together we are concerned about these issues and we want to have a meeting with you, the company, to talk about it.' And, so, it was very clear that they had contacted other shareholders to share their concerns with the other shareholders'.

Nevertheless, although it became apparent that the activist had indeed been in touch with other shareholders, it was not clear that all shareholders were necessarily convinced that the activist's strategy was the correct one:

'My belief is that it was first from them that we heard that they had this group that wanted to come and see us. And what became apparent to us, or what we felt was the case, was that some of that group was there to find out what was being discussed, because they didn't necessarily agree with the position of the lead investor. And there was quite a lot of disagreement between ourselves and the lead investor. The lead investor said that he had all these shareholders behind him, but our individual inquiries of those shareholders indicated that some of them were behind him and agreed with his position, and others didn't. They had gone along to the meeting to find out what was going on and actually hadn't formed a view one way or the other, or had a view that was contrary to his'.

This institutional investor talked about being approached by activists:

'[Activist investors] may try to just rally us to their cause and again, we'll listen. Sometimes they may have a decent amount of data. But you need to be wary about the company and sceptical about the companies you invest in. You also need to be sceptical about the agendas of activist investors too because they are probably working for themselves. And, you know, that interest may be for them and it won't work for the shareholders, and we need to represent the minority shareholder. Again, our modus operandi is not to take over a company and sell off an office division and all that. That's not how we do things, that tends to be what activist investors do. Because there is a role for them in the market but that's not the role we typically fill'.

This institutional investor cited a situation where their course of action could arguably be described as activist:

'There was another case where there were concerns about a company that had made a number of mistakes for some years. We got in contact with all the shareholders. The chairman was somebody who had a fairly robust reputation. So, we wanted the chief executive to change. I got in contact with, well, I got 29% of the share register around the table. And I had arranged for the senior independent director to come in. But got 29% around the table with the senior independent director, and fortunately, the senior independent director recognised it was not worth fighting, he had to concede. There would be a change of chief executive. And there was then some discussion as to when they would change the chief executive. And we gave him some weeks. So, he would go at the results announcements. Then, there was another profit warning at the results announcements. And the senior independent director at that point knew that not only the chief executive, but the chairman would have to go, as well'.

This institutional investor described the positive relationship they had with other institutional investors:

'We talk to other shareholders as part of the desk research. We're in dialogue with other shareholders, on a very regular basis across the whole piece. And there are various, largely informal groupings of shareholders that we're very active participants in, both on a national and international basis. And, we'll talk around general topics and we'll talk around specific companies of concern to one or multiple of the investors'.

One activist investor described an engagement with a company in the following terms:

'So, we phoned the chairman and said, "we think it's time for you to move on". He'd actually had quite a good reputation elsewhere. He just got stuck. But before we did that we contacted five other large shareholders and said, "we believe it's time for a new chairman. He had to really give support to this new chief executive with all these new ideas. Do you agree with us?" And they said, "yes". So, I then phoned up the chairman and said, "we think it's time that you leave thank you very much. Well, I'll think about it and let you know". We then knew he would phone these other five shareholders. And they all told him the same thing. A week later he comes back. "You guys are quite right. You know, I should have done it before. Don't worry. It will be fixed. A new chairman will be in, in the next few months"'.

8. DIALOGUE AND ENGAGEMENT

In this section we explore respondents' views on areas of dialogue and engagement. In the first subsection we look at private engagement. In the second subsection we consider dialogue and engagement that is conducted via the media. In the third subsection we explore dialogue and engagement between activists who have a corporate social responsibility agenda (CSR activists) and companies.

8.1 PRIVATE DIALOGUE AND ENGAGEMENT

This interviewee cited accountability as an important part of the dialogue and engagement process:

'I think the management teams need to be held to account. And the essence of that accountability to shareholders is informed clearly by the actors and by the engagements of the shareholders. So, I think there is some push and pull there as well. So, there is plenty of information which managers will give to the market and then there also needs to be the sense of pull from investors that the strategy is heading the right direction; that the disclosure is right and that the business is running properly and that the capital allocation is proper'.

However, it also had to be recognised that institutions had to tread carefully in sensitive areas, such as remuneration:

'[Institutional investors] have to make a decision, when it comes to a vote, about whether to rock the boat. They have to make a decision about whether a chief executive, who may be pretty assertive and aggressive but good, might walk if he or she was not satisfied with remuneration. And they have to make a decision about what is in the interest of their beneficiaries, as investors. If they actually insist on objecting to the remuneration, they will be possibly avoiding the establishment of a precedent which could be very damaging. But they could also be causing a chief executive to walk, with actually a serious loss of value, because the company would be leaderless. Actually, these are, sometimes, very difficult questions. It's not easy'.

Passive investment or 'investing the index' without actively engaging the management was perfectly acceptable to one interviewee:

'Do we expect that somebody who has bought the shares because they're a member of the index, should engage with the company? Do passive investors have a role in that? Are passive investors set up to engage with the company in the way that an active investor is? The answer to those questions is no, by the way.'

And another interviewee felt there could be dangers in forcing investors to become 'actively engaged':

'I think I'd be nervous if anything came in that sort of said, essentially, "You are required to be active," or, "You're required to engage." Or, indeed, "You are required to vote." Because, I think what you would see then is those people who aren't doing it and don't see the merit in doing so, would simply contract out to voting services agencies or others. And, you'd get a lot more of the box-ticking sort of behaviour that frustrates companies and actively engaged investors alike. So, that would be my concern about trying to make some of this active engagement type of thing mandatory in any way'.

However, for those investors who genuinely wanted to engage with companies, it generally seemed to be the case that activists and institutional investors did not have difficulty getting the boards of companies to engage with them. Thus one activist investor reported that it was not difficult to gain access to a company's senior management:

'We will have an open line, I mean we're well enough known and maybe, feared in some cases, I don't know, but we have enough of a reputation that if we want to speak to the chief executive or the chairman we will almost always have that conversation. And straight away, if we appear on the register we might get a call from the (company) at first saying we notice that you're there would you like to meet the chairman. So it all happens pretty quickly'.

Likewise, institutional investors seemed to experience little difficulty in speaking to companies when they wanted:

'And, they're certainly prepared to talk to their bigger investors. In fact, we don't have any great trouble in speaking to UK companies. There's no unwillingness in principle. Diaries are always a problem. And, the practical logistics can be a problem. Chairmen tend to be busy. My diary's solid. Our chief executive sometimes, we bring him along, and his diary's even more solid than the company chairman's. But, that's just a passing observation. You know, I say that for emphasis just to make it clear that we try to meet or speak to companies, subject to the availability of people on both sides. And, generally, it isn't a problem. We're never refused access'.

One senior independent director was approached by an institutional investor on a particular issue:

'As a director, if the shareholder wants to talk to you, I think you've got no grounds to stand on by refusing to talk to them. You can't talk to every single shareholder. But the major shareholder, the second biggest shareholder ... I think you have to talk to them, otherwise you're not doing your job'.

Another interviewee said:

'By and large, boards do take these things quite seriously and if a letter comes in from any investor saying (to the chairman) I think you should do this or you should do the other. By and large, that will be given reasonable attention'.

But if engagement was not seen to be working, one interviewee thought that it was legitimate for an activist to take matters further:

'If it happens that in the normal course of engagement businesses haven't responded to that accountability or somehow aren't pointing in the right direction. And if it requires an activist investor to get on board and to motivate the shareholders to act as agents for change. If that means the business is broken up or sold, but the capital is reallocated more properly, then I actually think everyone benefits'.

One non-executive director found that institutional investors could make a positive contribution and actually help to have issues raised on the board agenda:

'But, generally I find institutional shareholders very sensible. Quite often you come away from a meeting with an institution thinking, "They're not a 100% right. But, equally, they're not a 100% wrong. We need to think about this again." Sometimes, outsiders see and issue with a clarity that you don't necessarily see when you're close to it. This can be particularly true on personnel issues. They say, "And we really are worried about your chief executive, or your finance director, or your chairman," or something. "He doesn't come across very well." Or, "When are you going to tackle that issue?" Sometimes this helps you. You go back to the boardroom. You know there's an issue. You haven't really wanted to face up to a difficult people issue. Now you're able to go back and say, "I've spoken to our biggest shareholder, and they're worried. They're a bit concerned that we might begin to do this." It can put these issues right back on the agenda. Shareholders are not always right, but sometimes, personally, I find their pressure useful'.

Dialogue within the board could be problematical. One non-executive referred to the problems of 'group think' at board-level discussions:

'Well, there have been times, I think, when the boards I've been on have been guilty of group thinking where you've got the CEO that's pushing something and the people tend to acquiesce a little bit. I mean, I was in a situation where there was a thing the CEO was pushing and I was the sole lone voice saying, "I don't think that's right. I don't think we should do that for all sorts of reasons". And in the end, actually, the board came around to agreeing with me. But it's an uncomfortable position to be in'.

One FTSE company pointed out that the nature of engagement between investors and companies was changing, particularly with regard to US institutional investors:

'What's getting attention, I think, in the US is actually the very fact that investors would have the say on pay. Investors would actually have the ability to have an advisory based on remuneration. Also the thing that we find for US investors is the influence of proxy advisors in the US on the vote. And that's another reason why I think some US institutions are like, "Why would I want to talk to you? I'm just going to be looking at my RiskMetrics recommendation." And I do wonder if that will be the way it will go in the UK. And if people are being seen that they have to vote on all their holdings, and they just simply don't have the resources, they are going to rely more and more on proxy agencies to do that sort of legwork for them'.

Another FTSE company experienced limited dialogue with some US institutional investors:

'Especially the US investors, they will typically vote in line with the RiskMetrics recommendation, and that literally is a computer automated thing'.

And this institutional investor remarked on differences between the approachability of UK versus European companies:

'I have to say that continental European companies are notorious at communication. Most of them are really, really poor. If you're dealing with UK companies, I think it's a lot better. The communication channels are, even if you don't agree with what they're saying, we have no problem at all in meeting management or chairmen or non-executive directors of any listed company in the UK. It's just not an issue'.

But in some cases meaningful engagement with the board was simply not possible and the decision had to be taken to disinvest:

'There's no point staying in the stock and wasting a lot of money and resource trying to change the company when there's no chance of change. You sell. You cut your losses and you sell. That shouldn't be discouraged. We're not in it for the good of society and good of the company, the good of the members. You won't thank us for spending billions of pounds on a failed engagement strategy just because we need to be seen to be doing something'.

This institutional investor was prepared to go to the top of the company in order to voice their concerns:

'Once we have that confidence that we're right, we will then go to the top, and, and for us, the top is not typically the chief exec, it is much more typically the chairman. And, you know, we will see the chair and talk through our concerns and typically it's much more a conversation and a teasing views out of the chair rather than presenting them with our completed assessment of, of an issue, but it's probing and challenging and questioning and over the course of the meeting, making it clear that we have very fundamental concerns'.

Dialogue rather than confrontation was important:

'So you always have to be persuasive. You always have to help people to come around to a different view. So, you hope that, that you never get a brick wall and actually, you work quite hard not to give somebody the opportunity to take that completely contrary stance. Because if you get a brick wall, that actually puts both of you in an awkward position, and it's quite difficult then to move to a different place. Even if the door doesn't get opened wide, at least leaving it ajar and not, not barging in and making sort of making it a head on collision is quite important'.

In addition, stressing that their investment was for the long term helped to reinforce their arguments:

'A long-term perspective gives us actually more authority in the relationship and the dialogue. Our intentions are never going to be misunderstood. We're not going into this conversation in order to get extra information on which we can trade. We're going into the conversation genuinely representing long-term and it's interest, and wanting to deliver change and value for the long run, and we're not going to go away. You know, we can't go away'.

8.2 PUBLIC DIALOGUE AND ENGAGEMENT

In this subsection we examine the views of respondents with regard to relationships with the media.

Referring to dialogue and engagement between financial institutions and companies, one interviewee said that if investors had reached a consensus on an issue then they might have to make sure their position was understood in the media:

'Actually it's quite important that the institutions don't sort of bury their head in the sand, actually that their voice is heard, and that consensus can be very carefully portrayed to the public'.

In the case of activist investors, some interviewees believed that the media could be exploited in some specific situations, but generally activist investors at first tried to avoid the media:

'But, at the end of the day the press is used for marketing purposes by the activists to an extent, but what they are really after is the value uplift. And if the value uplift comes without them having had their moment in the sun then, you know, so be it. But they will have seen the value which, to them is more important from a performance point of view'.

In some cases an activist might have been rebuffed by a board and believe there is no alternative but to involve the media:

'If the activist also believes that by this stage he's got a bit of a consensus with fund managers so he's not just going to die. He's not going to be left out there and hanged to dry. If he believes that he's got that support and wants to gain the support of further investors and then put the pressure back on the board then he engages the press'.

On the other hand, the company might have an incentive also to involve the media:

'But, conversely, the management would also be wanting to paint that investor as being, you know, a pirate or a locust or whatever various descriptor is. And may use the press themselves to be able to turn the tables on the activist'.

One interviewee believed that it could sometimes be counter-productive for an activist to take their campaign to the media:

'It makes it, sometimes, more difficult to get a concession from a company, because the company does not wish to be seen, publically, to have conceded. Because they feel that undermines the authority of the board, if they've been just pushed through the press. So, actually sometimes, if material gets into the press, it kills off the prospect of a satisfactory outcome'.

For one activist investor, approaching the media was not the first priority:

'We're recognised for probably being public in the press, perhaps even being a little strident. That will often be a last resort. We do huge amounts of research, we invest in the company, we invest in companies that we like and that's another important point. We invest in companies where we think there is huge potential'.

But if one-to-one dialogue proves fruitless, then the activist investor will consider using the media (according to this activist investor):

'There's no need for us to go public often. When it becomes clear that private engagement isn't going to achieve what we would like to achieve then we will sometimes take the decision to go more public. And that will often involve talking to other shareholders, but it will often involve also for example financial press, which can be an important advocate in situations like this'.

The above view was echoed by another interviewee:

'Let's suppose you have a situation where there has been ongoing dialogue over a long period of time where shareholders have been trying to communicate their views to the board, and that's just being rejected, and ignored. At the end of that process shareholders may decide to go public and use the media, to take forward the debate. And in those circumstances I think that would be justifiable. I think maybe the specific board might not like it. But I think most directors would accept that, you know, it's not ultimately unreasonable. But I think what they wouldn't appreciate is if that was just used as a first resort. Without actually going through this dialogue or relationship process. If it was just an angle being used by a particular type of activist investor to shall we say, generate support, or stir up a controversy with a company. That wouldn't be appreciated, I don't think'.

One activist investor was clear that successful engagement need not involve a public campaign:

'So, typically if we identify these opportunities, we invest in those companies, we will always then meet the company, we'll meet the board, we'll meet non-executives and the executives. And many times that will become a very cooperative discussion. We will produce the sort of analysis that a private equity firm that was going to acquire them would do, or an M&A partner would do ... and we will engage and if we get the sort of traction that we hope to get then everybody benefits from that. Often we will see the changes being brought about that we hoped to bring about. And that will never become a public campaign and that's the perfect outcome – the share price will go up and everybody's happy and the company benefits from that'.

Although activist investors might consider involving the media, active investors (for example institutional investors) were thought to be unwilling to involve the media:

'Generally speaking, the active long-term holders do not believe that they will get outcomes that suit them by going to the press. And of course it's quite obvious why, because if they go to the press they lose the trust that actually you build up over the years of being on the share register and having contacted the companies. There's quite a lot at stake'.

One interviewee believed that the media should be seen to encompass a broader spectrum of activities compared to the traditional newspapers:

'The media these days goes so well beyond traditional newspapers and magazines and, so we have to think about maybe, for example, should chairmen blog? Should the investor relations team blog? What's the advantage of Twitter? How can Twitter help communicate with investors?'

One activist believed it was important to make sure that their approach was understood in the media:

'There will be some journalists that will take the view that all activists are evil people that come and break up companies and destroy jobs and that's clearly, obviously that's not what we are. Our mission is to try and make sure that the more informed [journalists], the ones who are more influential and the commentators in particular, the people who write things like Lex and Breakingviews and Heard on the Street and so forth, understand who we are, understand our philosophy and therefore, are less likely to write that sort of thing'.

This company found engagement with activists via the media to be a problem:

'In the more recent case [the activists] were using the media as a weapon without any doubt. And the media will just love it because there's meat to the story. And they are just particularly not worried about the validity. It becomes very hard for the management to convince media that there is a different point of view from the point of view being expostulated from the activist shareholder who has their own reason for doing whatever they are doing'.

Furthermore:

'It becomes very difficult to be confident withstanding what may actually be ridiculous noise coming from a very small shareholder because they have a particular thing that they need to do or want to do or sometimes even just to prove they are important, bossy people. And it's time for a rational point of view; it's amazing how much ego is involved in all of this. And I'll say that sometimes some of the noisier activist specimens are all about ego, as well as making money for themselves or for the people they represent. But, sometimes, it's about getting your name in the papers and getting seen to be seen'.

This institutional investor was doubtful about the overall benefits of activists using the media:

'I think if an activist is trying to use the media to, basically, create pressure on a company; maybe there are cases where that's useful but I think probably it's not useful'.

One institutional investor, speaking about their own activities, made this comment:

'We certainly don't like to go public; statements do appear in the press, but only as a last extreme where we've banged our head against the wall enough times and nothing else works. So, we're not activists in that sense. We are not activists in the sense of looking specifically for a troubled company with a definite plan to go and put new directors on the board. It's not quite that active in that sense'.

8.3 DIALOGUE AND ENGAGEMENT WITH CORPORATE SOCIAL RESPONSIBILITY (CSR) ACTIVISTS

We also came across a few situations where CSR activists had engaged with companies.

One FTSE company referred to environmental activists and made an interesting comparison with 'traditional' activists:

'So, this was actually on an environmental issue, as opposed to, activism of, you know, strategic change. But what was interesting there was that they did use the media quite extensively. They also actually, never approached us directly. So, a lot of the materials they were circulating and what they were saying, either we were reading about in the press or investors were sending it to us who had been contacted by [the environmental activist]. And that was a new experience. We haven't had that before'.

In other words, whereas many strategic activists positively shunned the press, or were only willing to use the press as a last resort, the environmental activist appeared to avoid dialogue with the company directly, but instead wanted 'dialogue' via the media. It is interesting to speculate on whether the strategy of environmental activists would be more successful if they more closely mirrored the strategy and tactics of conventional activists.

Again, on the subject of CSR activists, one FTSE company talked about engagement (or the lack of engagement) in the following terms:

'And what gets corporates very angry, and why corporates don't engage with these people [CSR activists], is they're putting out their recommendations without engaging with the company. So, they're going on their agenda, publishing information, which will then tell the people who subscribe to their service how to vote. And they, very often, don't give you the time to respond to that. So, you'll have one of their analysts, usually outside the UK, putting together a report based on what you've said in your annual report'.

9. CORPORATE GOVERNANCE

In this section we refer to comments made by respondents which relate to corporate governance in the UK or refer to the perceived relationship between corporate governance and company performance. The findings in this section add depth to quotes we got from the interviewees and are presented earlier in the report.

On the issue of whether the UK Corporate Governance Code (2010) (the Code) should be modified to take account of activist investors, one non-executive director said:

'I think you can codify too much, really. I think you've got to leave companies to look at it in a sensible way. And if the companies aren't being sensible, that's when the activist become more active. Maybe something gets done about it. No, I don't personally see it to be such a big issue that it needs to be codified. If it does then codify, the problem is that you've then got a machinery turning out corporate governance codes every five minutes'.

At one level the Code can be helpful to boards, according to this FTSE director:

'The [UK Corporate Governance] Code is very helpful in that if you have a problem at board level, a process issue, by far and away, the easiest thing to do is to look up in the Code what you have to do. Now, it's not because you're lame or stupid. It's because it reduces any controversy about the process. If you are doing things that an activist shareholder doesn't like, they may well take umbrage at everything you do. And, if the board has to fight with an activist, the board finds it easier to just follow the Code. [A foreign-based activist investor] attempted to stop the board appointing me as the SID. That wasn't because he didn't like me, because we've never met. He just didn't understand why the board needed a SID, as if UK corporate governance had never happened. He just didn't care. His worry was that a SID would be another block to him exercising extreme influence over the board. But the board felt that it had to appoint a SID, if only to comply with the Code, because we hadn't had one for six months. Suspecting that a crisis was brewing with this shareholder and his friends, the board knew that the corporate governance had to be squeaky clean. However in doing this, it caused the activist shareholder to become even more angry and activist. He then wanted to interfere on almost everything the board did'.

On the other hand, the existing Code does not anticipate potential problems faced by boards and the recommendation for annual election of directors could assist control seeking activists:

'My big criticism of the Code is that it hasn't gone through the what-ifs, and given the board a little bit more protection against control-seeking shareholders. It's gone backwards, because it's put annual election of directors in. I mean, a control-seeking shareholder hearing, "All directors now have to come up for re-election", they'll think, "That's fantastic. That's the best news." You know, it was a complete nonsense, that will do absolutely nothing for governance. But, it's an instant opportunity to a control-seeking shareholder'.

In terms of corporate governance, and certainly as far as the UK is concerned, there was little enthusiasm for a more 'rules-based' approach. The following comment by one institutional investor was typical:

'I recognise that a principle-based approach doesn't work everywhere. And, a rules-based approach would be too narrow and constricting in the UK. We do have this kind of understanding that it's about the intention, and the principle. And, that's accepted by everybody. It's not always easy to transplant that into other cultures. I accept that. But, I think the trouble with an overly prescriptive approach is it just encourages bare compliance. It doesn't encourage compliance with the spirit'.

Another interviewee also preferred 'principles-based' to 'rules-based' corporate governance and said:

'I have to say in some respects, the UK Corporate Governance Code is something of a compromise. Because our view is ultimately much of corporate governance and board behaviour is best determined on a company by company basis. You know, that it's ultimately the individual board of directors that is best placed to determine a corporate governance framework. But if you're going to establish principles of corporate governance which are going to apply to all companies, you know, all listed companies, then better that they be embodied in the form of a code, where there is at least some form of flexibility over the implementation than in regulation. I think there are problems with the code and comply or explain. That can lead to a box-ticking approach. But at least there is the scope for flexibility'.

One company felt that there was a danger that the Stewardship Code could encourage an attitude on the part of investors of simply being seen to engage with companies:

'But I think my perception is, especially with the Stewardship Code out now, that investors really want to, investors feel they have to be seen to be engaging with us. So, I'm not so sure it's the substance of the dialogue, it's just the, almost the optics of the engagement'.

In terms of the particular issue over removing directors, one institutional shareholder believed that annual re-election of directors could encourage short-termism:

'You can remove, shareholders have powers to remove directors if need be. You don't have to wait for the next AGM, or whatever. So, it's less pressing. We have majority voting. So, if a director is defeated in a poll, then he has to go. Whereas, in America, it's a bit different. The board decides whether or not to accept his resignation. They have a different system of voting. The so-called plurality. So, in America, we would favour annual elections, because the board's so remote, and not accountable. In the UK, it's different, and I don't see why we need to import a US solution to what is, effectively, a US problem. The other points I would make are that, we don't expect our politicians to stand for annual election. County, local councillors stand for three years. That's long enough to hold them to account. No one suggests that local authority people should stand every year, that that would make them more accountable'.

According to this respondent the UK Corporate Governance Code was conducive to improving financial performance:

'My perception is the UK model is pretty widely respected and held up around the world the same. So, that is good. And, if you think about it in terms of what's the attraction of the UK as an investment environment, as a place to do business, I think the model of corporate governance, and in many ways they've taken for granted it is part of the building blocks, that makes us a good place to do business'.

One interviewee considered the problems of trying to harmonise corporate governance codes in Europe:

'If the Germans still take the view that all activists are locusts, you could theoretically come up with a German stewardship code that was very different to ours. I mean, that's just hypothesis. And, I think that's, then, difficult for investors who are investing in 20, 30 markets to have lots of different local standards. So, there is probably a case for some form of harmonisation. Whether it's complete harmonisation, given the national and regional variations, or whether it's some form of more sort of mutual recognition. I think it's definitely an issue that needs to be thought through quite carefully fairly quickly. I mean, one version that you could see perhaps working is for there to be some internationally recognised or respectable high-level principles, a bit like the OECD principles of corporate governance for companies. Whether the OECD are the right people to do them or not is another matter'.

Finally, this activist investor considered the issue of how long-term investment could be properly rewarded:

'Now, I think we've moved into a situation where the short-termers have learned how to make super profits. How does the long-term end of the market fight back? And for me, we have to come up with ways of rewarding loyalty and long-term ownership. How do you reward good stewardship? It could be loyalty dividends. It could be some sort of transaction tax. It could be capital gains tax. It could be enhanced voting rights. The principle has to be how do we reward long-term owners?'

Furthermore:

'You make it the responsibility of the directors to ensure that their company has got a reasonable number of good stewards on the register. Because that will give them the opportunity to run the company properly. Now, I don't know the right numbers of good stewards out of the entire population of stockholders, you need is 20%, 30% or 40%. I know it's not one 100%. It might be six'.

10. CONCLUSION

We began our research with the intention of expanding our knowledge about how activist shareholders operate in the UK, and about the effect their activities have on other investors in the UK and on the companies they invest in.

In section 2 we reported on definitions of what it meant to be an activist investor. Although it is difficult to arrive at a precise definition for an activist investor, there are certain characteristics which are important. For example, activists tend to have a specific agenda, they will involve themselves in a small portfolio of companies and be prepared to devote substantial resources in furthering their aims. It was interesting to note that some 'passive' investors could in fact be fairly activist in their engagement with companies. The explanation for this behaviour was that because they were committed to a company by 'investing the index' then trying to secure change by engaging with companies was their best hope of improving the value of their shareholdings.

In section 3 we examined the reaction of boards of directors to activist intervention. Although there was some feeling that in practice boards did not welcome the attentions of activists, because it was an implied criticism of their management, there were a number of company representatives including executive directors and non-executive directors who felt that investors, including activists, had a right to put their views forward. Institutional investors, as might be expected, felt strongly that they should be listened to by management and, indeed, most reported that they had little difficulty in gaining access to senior management. Some institutional investors were actually very supportive of activist investors and felt they did their research conscientiously and were well informed. This may explain why institutional investors seem to be quite receptive when they are approached by activist investors.

In section 4 we refer to 'value blockages' ie, the factors which hinder companies achieving their full potential. It soon became clear that it is not simply a matter of identifying a value blockage. Almost as important is identification of the means of removing a value blockage. Inefficient management was time and again cited as a stumbling block and it is worth repeating the view of one executive director who maintained that 'the key relationship is the chairman and the chief executive and the finance director'.

In section 5 we expand our view into the perceptions underpinning the activists' and institutional investors' analyses and actions and we observe in detail the concept of 'unlocking value' that was introduced by many of our interviewees. We examine this concept and how it motivated actions.

In section 6 we look at the tactics adopted by activists to achieve their goals. What came over particularly was the thoroughness of the initial research and the extent of the commitment to engaging with the company.

In section 7 we consider relations between activists and institutional shareholders. Also, what came through in our research was the extent to which institutional investors will liaise with each other over mutual concerns. The fact that activist investors can effect change in companies on the basis of a relatively small shareholder stake is likely due to the fact that in many cases they have very good relations with some institutional investors.

In section 8 we consider dialogue and engagement. Firstly we consider what we term private dialogue and engagement where this process is not reported in the media. We also look at dialogue and engagement in the public arena. In fact what we found was that the media was often seen as a last resort and some activists were reluctant to contact journalists unless other forms of engagement had failed. We believe that one of the benefits of our research is to reveal the extent of private engagement. In other words, trying to assess the extent of shareholder activism in the UK only via media reports will not give a representative picture of the overall situation.

In section 9 we consider activism and active investment in the context of corporate governance in the UK. Fundamentally the UK Corporate Governance Code was regarded as sound, although some interviewees felt that it could be improved in certain areas. In the context of rules and principles, it was overwhelmingly felt that a principles-based approach was preferable. We cannot recall a single case where anyone expressed a preference for US rules-based corporate governance instead of UK principles based corporate governance.

We believe that the overall conclusion from the data gathered bears important policy implications in terms of understanding the relationship between activists (also active financial institutions) and companies. These policy implications relate to whether, and under what circumstances, shareholder activism should be positively encouraged or discouraged. Also, the extent to which relationships between activists and companies may need to be more formally and explicitly recognised in the UK Corporate Governance Code, 2010 and the UK Stewardship Code, 2010. We hope that this research will provide a useful contribution to this debate.

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Moorgate Place London
EC2R 6EA UK

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