Addressing ESG and Activism Challenges

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In American politics there has been a long tradition of candidates for elected office running on a campaign platform defined solely by one issue. These politicians often have a view that simply by running for election it will drive attention to the issue, thus forcing change. This concept, has also influenced how businesses are fronted by issues and activists, and being demanded for changes in the recent years. Traditionally, US has always been the biggest market for activists, with 460-559 companies publicly subjected to activist demands in 2020-2022, according to Activist Insight. Yet, Japan, despite the short history of activism activities, ranked 2nd in the list, with over 65 companies targeted in each of the last three years, surpassed UK and any of the European countries. Activism is no longer western countries kind of thing, but a key upcoming trend not to be overlooked in Asia, in particular, Japan.

Environmental and Social Candidates Likely to Come First And to Target Individual Directors

Demands by activists of Asian companies, mainly Japanese companies, used to, and currently still are mainly on personnel changes - appointments and removals and governance issues. These demands occur much higher than M&A agendas or other business agendas. However, there is also sign of trends shifting as any individual could be an activist (not necessary the traditional activist funds). Pension funds and large global index funds, such as Blackrock, own almost every stock in the world, and are holding almost indefinitely, have also been pressured intensively by NGOs, social groups, and advocates to leverage their position and power to make influence on their holding companies. This left no choice to the investors but to engage companies aggressively to encourage them reduce their vulnerability to climate change, inclusion and diversity, supply change distribution and the quality and sustainability in labour force, and other issues related to any aspect of ESG, in order to reduce companies' exposure to market risks.

Historically, investors in contested elections were forced to vote on either the management card or the dissident card, essentially leaving them with only two options to pick between. Now, all nominees (whether incumbent or dissident) will appear on one slate – even when multiple activists put forth dissident nominees at the same annual general meeting (AGM). This change is significant because now, investors will be able to hand-pick their own combination of directors they would like to elect.

Now that it is cheaper and easier to run a proxy campaign, it is expected that the first funds to pursue this new method of engagement will be ESG-focused funds or responsible investment funds. If these funds believe a company is an ESG-laggard, they may not simply file a shareholder proposal, but aim to replace (or simply add) directors instead.

An ESG or responsible investment-based proxy campaign would draw significant attention to the company's oversight of the topic and force larger institutional funds to closely examine the issues. Further, the notion of changing a single director will be easier to sell to other shareholders given the relative influence on the board would remain intact.

The goal is not necessarily voting success, rather, the bottom-line value impact is that the fight would almost certainly force change even if it fell short of voting success.

What Can Be Done to Minimize Risks?

The potential creation of single-issue director candidates in a proxy fight changes how activists will approach companies, and thus the companies' executive office, corporate strategy, investor relations and legal teams would need to work closely with the boards for activism preparedness. They should advise the boards proactively to conduct ongoing assessment on the following aspects to limit activism risk heading into 2023 proxy season:

- **Focus on individual director relevance** – To combat the potential of dispersed votes, activists will have significantly more incentive to spotlight which incumbent nominees should be replaced. This will result in an increase in direct public attacks on individual directors. To mitigate this challenge, boards should focus on strengthening the public narrative on each director's strengths and expertise, and how the board approaches regular refreshment of leadership and perspective.
- **Evaluate director skills against ESG materiality** – Most boards have implemented formal governance oversight of its ESG program, however, many have not evaluated director skills and alignment to the company's stated material ESG issues. Boards should understand and disclose how directors and their relevant committees include pertinent backgrounds on material ESG risks.
- **Engage investors on directors' skills.** While it should be part of regular board-level engagement with investors, these regulatory changes are a good prompt to gauge investors' perspectives on board skills. Engaging investors can provide insight into what investors consider to be priorities and is an opportunity to ensure investors know the board is continually seeking to improve and enhance directors' skills.
- **Know your ESG gaps** – A single issue campaign is likely to start with criticism of a discerned weakness in a company's ESG program. Boards should understand how outsiders evaluate their ESG program, how criticisms could resonate with investors and what, if any, deficiencies connect to board oversight concerns. Company should also constantly check on its latest business and operational strategies, governance and practices are in line with not only investors' but the wider community's expectation.
- **Enhance your proxy statement to strengthen governance** – Best-in-class companies now disclose ample information on the operations of their board in its proxy statement, including details on the board refreshment process, constantly evolving director skills matrices and even attention on the highly sensitive board self-evaluation process. All of this disclosure is designed to meet investor expectations as institutional investors now want to understand in great detail how a board can demonstrate it is a

highly effective body acting on their behalf. The demands for more information have shown no signs of easing.

- **Refresh activism preparation planning –** Most companies have some form of an activism defense plan on the shelf. However, these plans primarily contemplate campaigns from hedge funds seeking to challenge company strategy through board oversight. Boards should update these plans to account for nuances of the universal proxy and how to manage single-issue campaigns.
- -constantly check on Company's latest strategy, governance, practices are in line with the latest happenings across the wider community's expectations and are addressing social issues and concerns.
- **Coordinate shareholder proposals and activism defense –** Shareholder proposals are often treated as a functional legal aspect of the board and proxy statement. That's still primarily true. However, in light of the expanded capabilities of these shareholders to potentially challenge for board seats, it is important that engagement with these investors is coordinated with the broader activism defense planning teams.

ESG is a reflection of stakeholder capitalism movement–a movement to hold company accountable for measures beyond just financials. In a lot of way, it is kind of a conservative right to fight over the proper role of the company and viewing the proxy as a way to put forward their own agenda. In parallel, shareholder engagement has unquestionably changed in the time of the Universal Proxy. It can be expected that single-issue candidates will continue to grow and take a strong foothold in setting the strategy for how boards engage with investors. Companies also needs to be aware of this shift to adequately and meaningfully prepare for this new type of campaign strategy.

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