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Hedge Fund Advisory

Shareholder Activism in the UK

The Armoury and the Minefield



In many UK boardrooms, "activism" remains a dirty word. It is nevertheless an established part of the corporate landscape. As well as some high profile activist situations, there has been much press commentary on the drive for greater shareholder involvement. Anecdotally, shareholder activism is forcing senior management to become more open and better skilled at communicating with their institutional shareholders – which can only be a good thing.

In its softest form, shareholder activism can be no more than the gentle suggestion of strategic direction. Even in these instances, however, there is always the implicit threat of the exercise of statutory powers, and often this is made explicit. Hedge fund investors who acquire a reputation for activism are less likely to be welcomed on a company's register by its board, so there are marked variances as to how much investors are prepared to put their head above the parapet.

There are numerous weapons in the activist armoury, but also a minefield of potential issues to be avoided. These are obviously pertinent to shareholders who are leading an activist agenda, but can be relevant for other long investors who become involved in supporting a potential activist strategy.

There is no "one size fits all", but the following memo is designed to set out some of the key issues to watch out for in any activist agenda.

The Activist Armoury

As referenced above, even "softer" activist agendas must always be looked at in the context of the statutory powers that large shareholders can invoke to drive change:

Voting on resolutions put forward at general meetings

In the UK, as in the US, shareholders typically have a "say on pay" at each annual general meeting. In the UK context, the directors' remuneration report is annually put forward for approval and shareholders have the ability to voice their displeasure by voting such resolution down. However, this has no direct legal effect.

A classic activist weapon at the annual general meeting is instead to vote down the re-election of one or more of directors retiring by rotation – which may or may not be coupled with parallel steps to put forward a substitute. The invitation from the Financial Reporting Council that **all** FTSE 350 directors should put themselves forward for re-election annually could increase further the scope for activism: unpopular directors could be targeted each year instead of every three. Taken to

extremes, the entire board could be removed at one time without invoking any statutory activist powers.

"Bear hug"

The next level of aggression along the activist chain is to stop short of publicly setting the agenda, but instead to make it clear that this will occur if the board does not voluntarily take steps to address shareholders' concerns. There is no set format for such bear hug letters, but they need to be drafted with care and have greater compulsion the higher the level of shareholder support that can be legitimately referenced.

Power to circulate a written statement

Shareholders in a UK PLC holding at least 5% of its voting shares can require the circulation of a statement in relation to a matter put forward for shareholder resolution. In certain circumstances, the cost of the circulation must be borne by the company.

Formal requisition of a general meeting

Shareholders in a UK PLC holding at least 5% of its voting shares can require the directors to call a general meeting. Again, there is no prescribed form of words for a requisition and it may include the text of a resolution that may properly be put to the meeting. The requisition must, however, come from registered holders, rather than holders of beneficial interests or CFDs. Directors in receipt of a formal requisition must call a general meeting within 21 days of receiving a valid request, and a meeting must be held not more than 28 days after the date of the notice convening the meeting. If the requisition is to remove a director, there is also a statutory notice period, but this can run in parallel. Should the directors fail to call a meeting within the requisite time, the requisitioning shareholders may themselves call a meeting at the company's expense.

There are similar powers for shareholders to request that a specific resolution be added to the agenda of an AGM.

Publicity

Tactics vary from case-to-case as to how an activist wishes to gather support. The statutory power to have statements circulated can be invoked, but often the press is brought into play. Overt use of the press does not always go down well with some of the more traditional fund managers, however. If an agenda is taken to shareholders at a meeting, proxy solicitation is an important consideration.

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Litigation

A word on using the courts as a weapon: much was made of the combination of codified directors' duties and the new statutory right for shareholders to take a derivative action against directors for breach of duty. Although this is still a developing area of law, early signs are that the various practical and legal hurdles make this tactic unattractive. Likewise, an alternative action for unfair prejudice is, in practice, hard to pursue.

Negotiating the Minefield

There are a host of hazards for the unwary to be overcome or negotiated before the activist armoury can safely be used – we set out the principal ones below. Any interested shareholder should take advice on each of these areas, as getting it wrong can have liability and credibility consequences – and a defensive board will be motivated to find fault.

Market abuse/insider dealing

The ability to invoke statutory powers, and the success of an activist agenda, are obviously a function of the level of shareholding that can be influenced. There are of course insider dealing/market abuse restrictions on investors dealing if they have some inside information about the relevant company's trading and performance. What if the only relevant non-public information is the proposed activist agenda? An unpublished activist agenda could be inside information in certain circumstances. The UK Financial Services Authority has clarified that it would not generally regard as abusive stakebuilding by a person with an unpublished activist strategy if the relevant information in its possession is confined to knowledge of its own activist intentions. Unlike in a takeover context, it seems implicit in the guidance that activity would not be abusive if made through CFDs, as opposed to trading in the underlying.

The position gets more complicated where investors trade, having been contacted about another's activist intentions (e.g. to sound out support). If the activist intentions meet the test of inside information, trading may be insider dealing and improper disclosure of the plans may constitute market abuse. We are often asked to give guidance on this area, including as to the potential to address this through consortium vehicles.

Takeover Code: mandatory bid provisions

It is often the case that activist agendas realistically require the support of in excess of 30% of the shareholder register. It is also unusual for this to be controlled by a single shareholder, and so it is common for larger shareholders to "come together" to agree on how they would vote through an activist agenda. A key issue to avoid is a 30%+ concert party group forming, and then trading, which has a "board control-seeking proposal" under the UK Takeover Code: the trade may trigger a mandatory cash bid for the company. Typically, the proposed agenda does not amount to a control-seeking proposal, but advice should be sought. Advice should also be taken on when a concert party grouping ceases; it may not necessarily fall away upon completion of board changes. This is an area where we have had numerous discussions with the Takeover Panel.

Limits of a requisition

One area to watch out for is that a requisition resolution may not be proposed if it would be ineffective, defamatory, frivolous or vexatious. This would, for example, enable a board not to have to put forward a vote of no confidence.

Constitutional requirements

In each case, the relevant company's constitution should be examined to see whether there are additional provisions prescribed – for example, as to the details to be filed in respect of any proposed directors.

Companies Act conflicts rules

UK incorporated companies are caught by the Companies Act 2006, which has codified directors' duties. This codification and the existing case law continue to make it clear that directors who are put on a board at the behest of shareholders owe no lesser duty to the company than any other director. Nominated directors should not assume they can always act in accordance with their nominator's wishes; nor that they can freely pass information through about the company.

One new area to be addressed is the additional requirement for "situational" conflicts to be approved. These do not have to be manifest at the time of appointment and a director can be in breach of the Companies Act if he allows a potential conflict to exist without board approval. Advice should be sought as to how to address this situation, particularly where any company board is unlikely to readily authorise the potential existence of a situational conflict.

Board balance: Corporate governance, Takeover Code jurisdiction and tax residency

A shift in the balance of board management may have some unintended consequences. This can be particularly pertinent for offshore investment vehicles. Appointing additional or replacement directors who are UK-resident may prejudice the tax status of the relevant company; conversely, for an AIM company, the change could take the company outside of the Takeover Code's jurisdiction. These issues aside, one also has to consider whether any proposed board changes will change the number of independent directors on the board and whether this runs counter to the UK Corporate Governance Code. Finally, although a rare problem, it is worth checking that a change in board control does not trigger any change of control provisions in key contracts.

Nomad status for AIM companies

If the relevant company adopts a defensive strategy against an activist agenda, there is a risk that a successful strategy could give rise to the Nomad resigning. This automatically causes a suspension in the company's stock until an alternative Nomad is in place.

FSA controller regime for regulated entities

In addition to the Takeover Code concert party rules, there is also a concert party concept in the context of controllers of FSA regulated entities. In essence, a concert party group (for FSA

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purposes) directly or indirectly controlling more than 10% of a regulated entity would have to seek FSA approval. As part of a current consultation process, the FSA has recently indicated that it does not consider shareholders who engage in a concerted exercise of voting power on a single issue to be acting in concert for the purposes of the controller regime.

Concert party disclosure under the DTRs

Aggregated disclosure under the UK Disclosure and Transparency Rules (typically triggered at 3%) may be required where a shareholder has an agreement with another shareholder which obliges them to adopt a lasting common voting policy. A typical activist strategy would have no such

ongoing obligation, but it is a trap to watch out for.

Additional issues can arise if a shareholder grouping is artificially arranged to avoid the disclosure regime.

Libel

Finally, when using the press or producing circulars to shareholders, an area to watch out for is UK libel law: advice should be taken on the scope for qualified privilege and the best tack is always to be sure of your ground on any public statements made.

For more guidance on these issues, please feel free to contact any of the following specialists or your usual Travers Smith relationship partner:



Richard Spedding
richard.spedding@traverssmith.com
+44 (0) 20 7295 3284



Aaron Stocks
aaron.stocks@traverssmith.com
+44 (0) 20 7295 3319



Spencer Summerfield
spencer.summerfield@traverssmith.com
+44 (0) 20 7295 3229



Jane Tuckley
jane.tuckley@traverssmith.com
+44 (0) 20 7295 3238

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Travers Smith advises over 60 hedge fund managers on UK legal issues and is an acknowledged specialist in this field. Our clients' strategies span the industry, and our advice ranges from formation through to regulatory and corporate advisory. We advise managers on activist agendas they wish to pursue (with varying degree of publicity) – and many others on how they should handle requests to support such agendas.