SHAREHOLDER ACTIVISM REPORT

2018

CONTENTS

INTRODUCTION

This report looks back at the rapid growth in both Investment Activism (profit-focused activism) and Ideological Activism (purpose-focused activism) over the last 12 months. We'll look at the major events and emerging trends and look forward to the remainder of the year.

Global shareholder activism is at an all-time high. Activist funds have raised record amounts of capital and are looking for opportunities to agitate. An increase in scrutiny on corporate governance from regulators and a highly active global M&A market has created a climate that activists are looking to exploit both domestically and abroad.

With this growing threat of shareholder activism, we have seen a trend for companies to engage more substantially with activists. Having watched the damage of long, drawn-out activist defences, directors and management are increasingly willing to listen to the strategies offered by activists and arriving at a compromise is becoming more common. This is well demonstrated by an increasing proportion of public activist demands that are at least partially satisfied.

In Australia as compared to the US and Europe, shareholder activism is still finding its feet. Nonetheless, the volume and significance of domestic activist campaigns is at unprecedented levels. Motivated activists (both global and domestic) have taken advantage of the legal tools available to shareholders in Australia and turned their attention to ASX-listed companies. Campaigns have become increasingly sophisticated and public (think, Elliott's BHP campaign and Perpetual's Brickworks campaign) and we have experienced our first high profile experience of activist short-sellers with Glaucus Research's recent forays. The growing number of activism-specific funds with global mandates plus the activist-friendly structural framework in Australia, means we can expect more and more activist campaigns in the near term.

Separately, ideological activists have increasingly pressured Australian boards in relation to Environmental, Social and Governance (ESG) issues, with 7 of the ASX 50 having an ESG-related shareholder resolution put forward at their AGM. Although each of these resolutions have failed, we can expect ideological activists to continue their march on corporate Australia.

GLOBAL STATS FOR THE FIRST 6 MONTHS OF CALENDAR YEAR 2018

145 NEW CAMPAIGNS LAUNCHED

against 136 companies (compared with 104 campaigns on 94 companies in H12017).[1]

46.5% OF SHAREHOLDER DEMANDS

were at least partially resolved (compared to 39.3% of demands in H12017).[2]

TIM GORDON
Partner | Corporate Advisory
T +61 2 9263 4251
E tgordon@gtlaw.com.au

What is shareholder activism?

Traditional company theory distinguishes between the shareholders of the company (essentially passive owners with limited rights) and the board / management (the controllers and decision makers). Shareholder activism is an umbrella term that captures active steps taken by shareholders seeking to change the behaviours and actions of the board and management of a company.

Shareholder activism can be broadly divided into two separate categories:

+ Investment Activism – where the end goal is for the shareholder to make money, typically by "unlocking" value / profit; and
+ Ideological Activism – where the end goal is to achieve a non-financial objective, typically ESG-related.

Recently, Australia has seen an increase in both Investment Activism and Ideological Activism. We have a regulatory framework well suited to shareholder activists:

+ continuous disclosure laws give shareholders timely and detailed information;
+ shareholder rights under the Corporations Act are relatively generous by international standards (including prescribing an annual vote on executive remuneration); and
+ large institutional investors (driven by superannuation funds) make up the bulk of most large share registers, concentrating votes and power.

INVESTMENT ACTIVISM

Rationale

The key driver behind Investment Activism is a belief held by the activist shareholder that the current management, strategy or governance of the company is not extracting maximum value from its business or capital structure. In contrast to a complete takeover bid, which is often costly and drawn out, an activist can agitate for change with a minority shareholding, acquired over a short period of time.

Throughout the 2000s, perceptive and agile private equity (PE) buyout funds would identify an opportunity to extract additional value from a publicly-listed company and organise a "take private" transaction (either with the co-operation of the target or via a hostile takeover). Today, these opportunities to extract value are increasingly being seized by activist funds, who can deploy capital and commence an activist campaign at a rapid pace, without the need to arrange the substantial debt + equity funding required by the traditional PE model from a position as a minority shareholder.

With just 5% of a company's shares, a shareholder can requisition a general meeting to put a resolution to shareholders, including to remove director/s, and distribute a statement to shareholders. Access to these legal tools often means that management has little alternative but to meet with and listen to activists. Often the mere threat of shareholder resolution is enough to force change.

Typically, the strategy of Investment Activism focuses on one or more of the following:

1. Income Statement enhancement (improving revenue, EPS etc.);
2. Balance Sheet enhancement (maximisation of net asset value / returning capital etc); and
3. M&A / "event" strategy (focusing on divestments and/or strategic acquisitions intervening in active processes or seizing on crises).

Paired with the above, strategies often also concentrate on director changes and governance issues designed to exert maximum pressure on boards.

The flip-side of Australia's strong minority shareholder rights is that our takeover regime is relatively "target"-friendly (compared to the US), meaning it can be both expensive and difficult to change corporate control.

Short termism?

Critics charge activists with forcing companies to focus on immediate returns, to the detriment of long term value creation. Many have argued that the presence of activists in the market drives short-term behaviour from management of public companies. The general belief is that the "myopic activist" results in:

+ an over-emphasis on maximising distributions to shareholders (through dividends or share buy-backs);
+ distraction of management from more important issues by forcing them to divert resources towards stabilisation efforts; and
+ the sacrifice of any "two steps forward one step back" innovation process for more immediate profits.

Interestingly though, the average shareholding period for activists these days doesn't necessarily support this view. In the US, major activists, on average, now hold positions in target companies for a period of 5-7 years. This is a considerably longer holding period than US mutual funds which, on average, hold shares for 1 year and 9 months. This would suggest that as a result of the evolution of US shareholder activism, the activists, at least currently, tend to have a financial interest in the success of a target company over a much longer period than many institutional investors.

In the US, major activists, on average, now hold positions in target companies for a period of 5-7 years.

Who are they?

Global

The major Investment Activists are fund managers that raise large pools of money with a specific mandate for activist investing. Some of the most high-profile global Investment Activists include:

+ Carl Icahn, Icahn Associates Corporation (notable activist campaigns: Apple, Inc., eBay, Inc. and Dell, Inc.);
+ Bill Ackman, Pershing Square Capital Management (notable activist campaign: Herbalife); and
+ Paul Singer, Elliott Management Corporation (notable activist campaigns: BHP Billiton)

Many of these activist funds have historically only been mandated to engage in activist strategies in the US. However with further high value targets in the US becoming more difficult to identify, funds have turned their attention to Europe and the UK (now accounting for up to 30% of activist targets). Most of these larger funds are also mandated to invest in Australia and, as a result, increasing numbers of foreign activist funds are looking to the ASX. Recent global activist forays into Australia include Spectre Capital's investment in MEC Resources, intervening in a contest over board control.[3]

In the first six months of 2018, US-based fund Elliott has been the 'most active activist'. The New York-based fund has extended its focus beyond merger arbitrage and the technology sector, and more than tripled its number of year-to-date targets over the past four years to 16 companies (year to date), launching 8 new campaigns outside of the US this year.

Globally, these activist players are managing an increasing volume of funds and assets. New assets under management for activists for YTD 2018 is already quickly approaching the total assets under management for the entire calendar year 2017.

BY THE END OF 2018, ASSETS UNDER MANAGEMENT HELD BY ACTIVISTS WILL FAR OUTSTRIP ANYTHING SEEN BEFORE.

Australia

Australia has a relatively low number of pure domestic activist funds. The most prominent local activist player is Sandon Capital, which is currently running activist campaigns in relation to Specialty Fashion Group and Watpac. However, larger institutional investors and entrepreneurs who traditionally have been passive investors are increasingly adopting activist strategies. Examples of local players who have engaged in activist strategies include:

+ Institutional: Perpetual (Brickworks); Wilson Asset Management; UniSuper (Aurizon); Ariadne (Ardent); and
+ Entrepreneurs: Solomon Lew (David Jones, Myer) and Gina Rinehart (Fairfax).

The traditional tactics

1. Initial ownership stake and private engagement

In order to get a seat at the table, activist investors first purchase an initial stake in the company. This can be as low as 0.5% or up to 5% (stakes that are 5% or over require public disclosure), depending on the financial resources and the objectives of the investor. This initial stake allows the activist investor to credibly meet or correspond with the company's board and management to put forward its proposed changes.

The timing of this initial stake can either be event driven (ie, prior to a general meeting to influence a vote on a resolution, or after the announcement of a takeover bid etc.), or can be unrelated to events and have a more long term focus.

2. Increasing ownership stake

Where the company is not responsive to the activist's initial approach, the activist will typically increase its ownership stake and start engaging with like-minded shareholders. However, ASIC draws a line between helpful shareholder input and the inappropriate acquisition of control or illegal association. Shareholders may face penalties if they breach takeover and substantial holding provisions designed to limit collusion between investors. Notwithstanding this, the influence from vocal activists amongst a register can be powerful.

3. Commencing public campaign

Once it is confirmed that the company will not accede to the activist's demands, the new activists will turn up the heat and go public. This can take a variety of forms, including:

+ Publishing research criticising the company's current management and strategy;
+ Creating a professional website housing the campaign's key information;
+ Posting on social media and running a regular media campaign where leaked or unsourced material finds its way to the media; or
+ Engaging in proxy solicitation and an advertising campaign.

CASE STUDY - HIGH PROFILE

Elliott Management and BHP

Activist: Elliott Management (US activist fund run by Paul Singer, over US$34 billion assets under management (AUM)

Target: BHP Billiton

Elliott argued BHP could unlock US$22 billion of value by unifying the dual-listed company to be primarily listed on the ASX, undertaking discounted off-market share buybacks to utilise franking credits and undertaking a demerger of BHP's petroleum business (via sale or ASX listing).

Elliott's approach: Elliott first purchased BHP shares in 2015 and in August 2017 announced that it held 5% of BHP's register. Elliott launched its public campaign in April 2017, which included public press releases, an independent white paper authored by FTI Consulting, a professional website, extensive physical advertisements and a social media effort.

BHP's approach: BHP responded swiftly and comprehensively to Elliott's campaign, addressing the proposed changes. BHP executives met with major global investors soon afterwards to understand the attitudes towards Elliott's suggestions. Importantly, BHP's response to Elliott's proposal weighed the suggested benefits with the risks and costs involved with undertaking the proposed changes, articulating compellingly why the strategy was not in the best interests of the company.

Outcome: BHP is still dual-listed and its conventional Petroleum business remains core to its portfolio. Elliott still holds ~5% of the register. BHP's response is widely considered to be highly professional. In August 2017, BHP's share price was $26. As at July 2018, it had risen to $34 per share..

4. Using legal tools to force change

If the company's response to the public campaign does not satisfy the activist and the activist smells blood in the water, the activist may seek to exercise rights as a shareholder to pressure the board or management. These include:

+ obtaining a copy of the share register;
+ convening or requisitioning a general meeting (shareholders with more than 5% of the votes may requisition a general meeting to be held within 2 months after the request);
+ putting forward a shareholder resolution, including to remove directors at an upcoming meeting (100 shareholders acting together, or shareholders who hold more than 5% of the voting interests, with two months' notice);
+ voting against the remuneration report; and
+ depending on the circumstances, applying to the Courts for a remedy (Brickworks).

Mandatory disclosure of notice to requisition a general meeting

If an ASX-listed company receives a notice from a shareholder to requisition a general meeting, it must within 2 business days disclose the material terms of the notice to the market. The result of this is that the activist shareholder's request becomes public very quickly, increasing the pressure on management and the company.

CASE STUDY - CONTROLLING FINANCIAL DECISION MAKING

Infigen

Activist: Vijay Sethu, Lim Chee Ming (2 major shareholders)

Target: Infigen Energy (renewable energy company)

Context: Infigen had announced plans to refinance its facilities to enhance its capital structure.

In early 2018, 2 major shareholders sent a notice to the company to requisition a general meeting to move a special resolution to amend Infigen's constitution to prohibit the company from entering into debt financing above $500 million without shareholder approval. This resolution was aimed at preventing Infigen from undertaking a previously announced refinancing.

Management successfully engaged with the majority shareholder and the requisition and proposed resolutions were withdrawn by the 2 shareholders 20 days later when it was clear that the required 75% approval would not be obtained.

CASE STUDY - LITIGATION

Brickworks

Activist: Perpetual

Target: Brickworks / Soul Patts

Context: Brickworks and Soul Patts have a cross-shareholding structure where each company owns ~40% of the other company.

Perpetual purchased a 5-10% stake in both Brickworks and Soul Patts. Perpetual held private talks with management of both Brickworks and Soul Patts proposing a series of changes around unwinding the cross-shareholding, including a nil-premium merger and appointing independent directors on both boards. No proposal came to fruition. Perpetual claimed in the Federal Court that the cross-shareholding was being used to entrench the boards of both companies and to unfairly oppress minority shareholder interests by locking up potential value.

The Federal Court dismissed the application, saying that it is the responsibility of the directors, not the court, to determine what is in the best interests of the company as a whole. One of the key takeaways from this case is that activist shareholders will need to adduce strong evidence, essentially rising to the standards required to establish a breach of directors' duties, to be successful in an action for oppression.

CASE STUDY - CHANGES TO THE BOARD

Ardent Leisure

Activist: Ariadne

Target: Ardent Leisure

Context: Dreamworld tragedy occurred in October 2016, leading to a period of public scrutiny and significant impact on financial results.

In early March 2017, Ariadne purchased ~5% of the shares in Ardent Leisure. Ariadne commenced private talks with Ardent Leisure's board to nominate 2 Ariadne directors onto the Ardent Leisure board. Ariadne increased its stake to 10.9%. In June 2017, Ariadne issued a notice of meeting under s 249F to call an extraordinary general meeting to appoint 2 Ariadne directors and 2 independent directors.

Prior to the EGM a compromise was reached and 2 Ariadne directors were appointed to the Ardent Leisure board and 2 existing directors agreed to step down by the end of 2017.

CASE STUDY - BOARD SPILL

Black Prince and Bellamy's

Activist: Black Prince Private Foundation

Target: Bellamy's Australia

In early 2017, Black Prince held ~14.5% of Bellamy's shares. Following a tumultuous period for Bellamy's where its remuneration report received a 'strike' and its share price fell by 40% following an earnings downgrade, Black Prince requisitioned an extraordinary general meeting (EGM) to remove 4 of Bellamy's non-executive directors and replace them with Black Prince nominees.

At the time, it was not initially clear who was behind, or associated with, Black Prince. After Bellamy's issued a tracing notice requiring Black Prince to disclose the holders of relevant interests in its Bellamy's shares, Black Prince revealed its relationship to one of the Black Prince nominations for director.

Prior to the EGM, Delta Partners and Janchor Partners acquired minority holdings in Bellamy's and were reported as being actively involved in discussions with the board and Black Prince. Two of the non-executive directors were removed at the EGM and two of them resigned prior to the meeting. Two nominees of Black Prince were nominated to the Bellamy's board.

Two strikes rule

The two strikes rule effectively allows for a board spill where shareholders vote against a company's remuneration report at two consecutive AGMs. Foreign lawyers and activists marvel at the opportunities for pressure created by this uniquely Australian regime. The process is as follows:

+ at each AGM shareholders vote on the company's remuneration report – if more than 25% of the votes are against the report, the company receives a "first strike". Should they obtain the same result the following year, they will receive a "second strike" and a "board spill" resolution will be put to the shareholders;
+ should the spill resolution be passed by an ordinary resolution (ie, 50% of the votes cast), all the directors (other than the managing director) will be required to stand for re-election (should they nominate to) at a meeting to take place within 90 days. The flip in votes required from 25% to 50% (with KMPs now voting) means spill resolutions, although embarrassing, usually fail.

In 2017, 17 ASX 300 companies had to prepare for a second strike, compared to 15 in 2016 and 14 in 2015. Of those 17 companies, 2 were delisted before the AGM. Out of those companies, only 3 suffered a 25% threshold vote against the second remuneration report, resulting in a successful second strike (Mineral Resources Ltd; Alexium International Group Ltd and Mortgage Choice Ltd). None of these 3 companies exceeded the 50% vote needed to successfully spill the board from the ASX 200, the number of close calls (i.e. votes between 20-24% against the first remuneration report) rose from 5 in 2016 to 8 in 2017.[4]

2016 was the first year an ASX 50 company received a strike. 2017 saw five strikes against ASX 200 companies.

So far in 2018 both QBE and AMP have received a first strike. AMP's first strike came after a round of Royal Commission hearings and was the worst result for an ASX 100 company, with 61% of the votes cast against the remuneration report.

The original purpose of the rule was to hold directors accountable for unsatisfactory salaries or bonuses. However shareholders have used it more as a tool to publicly rebuke companies for a variety of reasons. Where the media reports a first or second strike, the reputational damage may place downward pressure on the share price if the company does not mitigate concerns effectively. As such, even if the outcome does not involve an overhaul of the board, the two strikes rule does play a key role in influencing remuneration practices. It is also a useful weapon for activists, because any shareholder with a meaningful stake publicly declaring that it will vote against a remuneration report resolution greatly increases the likelihood of a strike given the low threshold (25% of those voting, excluding Key Management Personnel). An activist holding 5-10% could have a very high level of confidence that it could significantly impact this vote, particularly at an underperforming company.

Companies also expect activists to be emboldened by the announced proposed changes to the ASX Corporate Governance Principles and Recommendations, which will require further disclosure about corporate values and ESG-related matters.

The short seller – non-traditional tactics

Active short selling is an unorthodox and aggressive type of activism. Notwithstanding controversy and heavy regulation in the Australian market, its proponents argue it is a legitimate mechanism for price discovery and liquidity.

Australia has recently had its first serious dose of activist short sellers in the form of Glaucus Research.

THE TACTICS MOST COMMONLY TAKEN BY SHORT SELLERS ARE AS FOLLOWS:

Diligence

Attempt to discover misrepresentations, inaccurate reporting, accounting irregularities or other falsifications about a company. This typically involves hundreds of hours of monitoring the activity of the company, its board and any associated entities, and is usually focused on the company's financials and announcements.

Take a short position

The activist investor will take a short position by borrowing stock from a broker and selling the stock. The activist's hope is for the share price to drop, to buy the stock back at a lower price and return the stock to the lender – making the difference as profit. Where the stock price does not drop after selling, the short seller will incur a loss.

Release a white paper

The short seller will publish a report online, explaining its position. Increasing usage of social media to disseminate research has seen a broader reach of target audience. Whether the possibility of anonymity will facilitate a rise in the number of short selling activists or simply see a fall in credibility remains to be seen. With the boundaries of Australia's market manipulation and false or misleading statement regimes not yet clearly settled with respect to activist short selling, funds such as Glaucus have taken a cautious approach by releasing reports on Australian targets overseas (although the materials obviously find their way into Australian hands almost immediately).

TOP "SHORTED" ASX COMPANIES

- JB HI-FI LIMITED **(JBH)**
- SYRAH RESOURCES **(SYR)**
- DOMINO'S PIZZA **(DMP)**
- GALAXY RESOURCES **(GXY)**
- OROCOBRE LIMITED **(ORE)**
- INGHAMS GROUP **(ING)**
- MYER HOLDINGS **(MYR)**

As at 30 July 2018

The short seller – trends

Relative to the US, activist short selling is not common in Australia. However in the wake of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, short positions on the major banks increased from 0.6% in January 2018 to 1.1% in April. A downturn in the housing market has also spurred an increase in shorting against building-related companies and mortgage insurers, with average industry players seeing 7-9% total shorted stock.

Australia has few home grown activist short sellers but attracts an increasing amount of foreign activist shorting interest. Soren Aandahl (previously of Glaucus Research Group) has stated that his new short selling group, US-based Blue Orca Capital, will retain the Australian market as a key focus. Counter-intuitively, Aandahl believes shorting is most effective in markets with a strong culture of corporate governance where fraudulent companies are much rarer. This is only going to increase in the post-Royal Commission / APRA Report / BEAR world where scrutiny on, and nervousness amongst, boards around any perception of poor governance will be enormous.

> **“The thing that’s great about Australia is the Australian market cares about corporate governance. It’s counter-intuitive – some people think you’d rather be a short-seller where every company is a fraud, it’s not true.”**
>
> *Soren Aandahl*

Roughly 3.7% of the free float in the ASX 200 is short. This is higher than other comparable global markets, with indexes in the US (S&P 500) at 2.7%, Hong Kong (Hang Seng) at 1.8% and Japan (Nikkei 225 Stock Average) at 2.1%.[5]

Chad Slater, co-founder of Morphic Asset Management has been quoted as saying "Australia is one of the best places in the world to short - hands down.” The primary reason for his view is that Australia doesn't have transaction taxes (unlike the U.K), and it is relatively easy to borrow shares. He said "it ticks every box".

Interestingly, and in contrast to AFSL holders, activist short sellers operate in a grey area of regulation. They are still subject to restrictions on, for example, creating or maintaining an artificial price in the share market and disseminating information which a person knows, or ought reasonably to have known, is false or misleading, and which induces another person to acquire or dispose of financial products.

Common tactics to used to avoid falling foul of such regulations include first claiming the resultant share price is the ‘true’ share price and therefore cannot be the artificial product of market manipulation. Second, attaching a disclaimer to the report which notes that the information it contains is an opinion and is not to be relied on as financial product advice. Thus far, activist short sellers have successfully retained their position in a regulatory limbo.

Critics have suggested that ASIC should escalate its control of activist short sellers. Currently, any controversial report may be released by an activist short seller while the market is trading and before ASIC has viewed a copy. In the case of Blue Sky (see next page), shares had dropped roughly 10% before a trading halt was called. This will continue to raise questions around the fairness of the Australian equity market.

The growth in active short selling in this market will further emphasise the prevelance and relative ease of shorting, raising serious and complicated questions for our regulatory regime.

> **“Australia is one of the best places in the world to short - hands down.”**
>
> *Chad Slater*

Australia's cocktail of strict continuous disclosure rules and an opportunistic class action litigation ecosystem adds further pressure. Activists and litigation funders are part of the same ecosystem and it's no coincidence that activism in Australia is increasing as litigation funding is becoming more established, and all the regulatory action going on will only trigger more class actions (we're already seeing that). Activists short sellers create a negative feedback loop in which bad news causes a share price fall which attracts litigation ... which puts further downward pressure on the share price. This is important for active short sellers given that the downside if they get it wrong is theoretical infinite, whereas the downside for a long holder is limited to 100% of the share price. So, by definition, activist short selling works best when there is an asymmetric risk-return trade-off.

CASE STUDY - ACTIVE SHORT SELLING

Quintis

Activist: Glaucus Research Group

Target: Quintis Ltd (formerly TFS Corporation Ltd) (Sandalwood producer)

Glaucus Research privately undertook due diligence on Quintis and invested more than 600 hours of research. In March 2017 Glaucus published its research report. At the time Quintis was trading at $1.41 per share, Glaucus shockingly claimed that their valuation of the company was $0.00 per share, essentially accusing Quintis of operating under a Ponzi-like structure. They posited that Quintis did not generate as much cash from sales of sandalwood as it claimed, rather it relied on raising capital to plant new crops, cover day-to-day expenses, and pay off its debts. With interest payments reaching 50% of cash EBITDA in FY16 and a further borrowing of $65 million in FY17, Glaucus claimed Quintis could not repay its debts.

After Glaucus published its report, the ASX sent a speeding ticket to Quintis as to why the share price dropped more than 10% in 2 days. Quintis responded in a letter to the ASX and sought a trading halt. Moody's downgraded Quintis' credit rating and Quintis' MD resigned. By May 2017, Quintis' share price had dropped to $0.29 and Quintis was suspended from trading. Quintis entered administration in January 2018 and faces several class action law suits.

Quintis share price, daily ($)

Source: Bloomberg

> *"Australia has a good regulator, it's got solid rule of law, and protections for investors in the market. That's attractive to us. One of the reasons Australia is an attractive market is that Australian investors care about corporate governance. There are markets where if you point out shareholders are being abused, there's no normative condemnation. But Australians care. When you find things that fall short of the standard, you know it's going to matter to people."*

Soren Aandahl (previously of Glaucus Research)

CASE STUDY - ACTIVE SHORT SELLING 2.0

Blue Sky

Activist: Glaucus Research Group

Target: Blue Sky Alternative Investments Ltd

In March 2018 Glaucus claimed that Blue Sky's share price was over- inflated. The claim relied on three main pillars: first that Blue Sky's fee earning (AUM) were grossly over-valued; second, that Blue Sky had misrepresented the performance of its investments; and third that Blue Sky had charged its investors management fees that were disconnected from the success of the actual investments. The Glaucus adjusted share price for Blue Sky was $2.66, 77% below the actual share price of $11.43 (late March 2018). Following Glaucus' report published on its website, Blue Sky responded by holding a teleconference hosted by its MD with investors and analysts, submitting a letter to the ASX, calling on ASIC to intervene and posting on Twitter denying Glaucus' allegations. These, and later, attempts failed to stop the bleeding and the Blue Sky share price currently sits around $1.60, an 86% fall since the attack.

The Glaucus Research Group founders have split post Blue Sky – forming two new activist short selling platforms (Blue Orca Capital and Bonitas Research). Blue Orca targeted high-profile Hong Kong company Samsonite in May 2018 and is poised to attack the European and UK markets. Bonitas recently released an incendiary report on Hong Kong company Hosa International Ltd (11 July). Both new branches of the former Glaucus Research Group are expected to remain active in the Asia-Pacific in the coming years.

IDEOLOGICAL ACTIVISM

Rationale

Ideological activism typically covers non mainstream ESG areas such as climate change (reduced carbon emissions), gender diversity, unethical practices, irresponsible credit lending, supply chain ethics or data security and privacy, but could really encompass any issue of good social governance.

It is argued that such 'ethical' or ESG concerns feed into financial performance mitigating regulatory violations and minimising the risk of litigation.

Trends

Ideological Activism has sky rocketed globally with ESG objectives becoming a staple in a large chunk of activist campaigns.

One of the causes behind this rise is the expanding influence of passive investors who are taking a greater interest in ESG matters. Vanguard, BlackRock, and State Street now own approximately 18% of the S&P 500 up from 14% in 2012. BlackRock's stewardship team specifically aims to "provide specialist insight on ESG considerations to all investment strategies, whether indexed or actively managed." Passive investors typically push companies to serve their communities by being socially responsible and observing good governance principles.

In Australia, activist groups Australasian Centre for Corporate Responsibility (ACCR) and Market Forces have been particularly vocal in pushing ESG concerns. During the 2017 AGM season for the ASX 50, a total of 9 separate ESG driven resolutions were proposed by shareholders at 7 AGMs. 100% of those resolutions were accompanied by corresponding constitutional amendment resolutions.

Further, the ~$350 billion of superannuation money in Australian equities for the most part operates under active stewardship. 70% of the 53 major super funds in Australia in 2018 claim that they oversee general ESG issues at the board level. 60% of those super funds have at least one negative screen across the whole fund (an enterprise in which they refuse to invest). This is an increase from only 34% of funds in 2016. Double the number of funds have screened out tobacco (28 up from 14) in the last two years, 14 funds in 2018 have divested from weapons as opposed to 8 funds in 2017, and 6 funds have negative screens for human rights issues.[6]

Holding these positions might make it easier for activists to recruit these major shareholders to their cause. In the US, shareholder activist Jana Partners recently paired with the California State Teachers' Retirement System (CalSTRS) to lobby Apple to take action to reduce the unintentional negative side-effects of prolonged smartphone screen-time for children and teenagers.

70%
of the 53 major super funds in Australia in 2018 claim that they oversee general ESG issues at the board level

60%
of those super funds have at least one negative screen across the whole fund

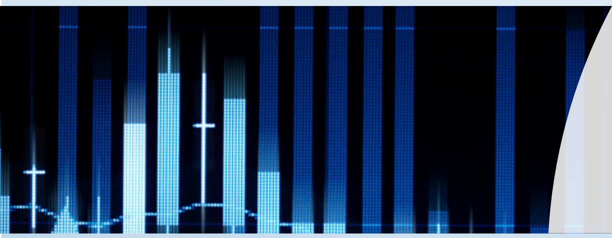
Climate change

The ESG movement gained real momentum in 2015 when a coalition of investors filed shareholder resolutions with BP and Royal Dutch Shell, successfully proposing resolutions at their 2015 AGMs to:

- invest in renewables
- change bonus structures
- test their business models against the target to limit global warming to 2°C.

In Australia, this momentum has continued with 6 of the ASX 50 companies in FY2018 addressing a climate change oriented resolution at the AGM. On average, these resolutions attracted 9.7% of votes. Though all 6 resolutions failed to carry, ACCR and Local Government Super's resolution at Rio Tinto's AGM managed 18% of votes - a substantial amount considering the Board recommendation against the proposal.

Australian law allows for the use of any technology which provides the members with "a reasonable opportunity to participate" in the meeting. This includes conducting "hybrid" meetings which are held in a physical location as well as via an online or remote voting platform. These hybrid meetings have recently begun to be used in Australia and are growing in popularity. Given it is a much simpler task for a member to vote on their mobile or desktop rather than physically attend an AGM, we can expect that increasing flexibility and convenience of online voting platforms may see higher numbers of votes overall and an easier pathway for activists to recruit voters to their causes. We would expect that this will mobilise retail shareholders, reducing the influence of institutional shareholders and proxy advisers.



IN FY2018, 6 OF THE ASX 50 COMPANIES FACED A CLIMATE CHANGE SHAREHOLDER RESOLUTION AT THEIR AGM.

The constitution is the battleground

Australian Centre for Corporate Responsibility v Commonwealth Bank of Australia [2016] FCAFC 80 was a landmark decision for Ideological Activism as it drew the line between matters that are within the remit of shareholders and those reserved for a company's board. The distinction was held by the Full Federal Court to be integral to the effective management and operation of a company, holding that "*shareholders may not control, usurp or exercise the powers of the directors.*" The result is that it is now difficult for shareholders to influence 'board-only' type decisions without first amending the constitution.

Broadly, the case involved the ACCR moving resolutions to:

+ request the directors to report on carbon emissions attributable to CBA's loan portfolio;
+ express dissatisfaction that a carbon emissions report was not already included in the annual directors' report; and
+ amend the constitution to mandate a section on carbon emissions being included in the annual report.

The Full Federal Court confirmed the first instance decision that the first two of these three resolutions were matters reserved for the board alone and the resolutions improperly attempted to usurp the powers vested in the board to manage the company.

The Full Federal Court's ruling has raised the bar but also set ground rules for activists looking to move ESG-type resolutions. In attempting to overcome the strict distinction between board and shareholder matters, Ideological Activists now attempt to first amend a company's constitutions (which requires a special resolution) to allow for 'advisory resolutions', and then subsequently move an advisory resolution. The 2018 Rio Tinto, Woolworths and QBE AGMs all had activists launch unsuccessful attempts with this formula. BHP's notice of its 2017 AGM directly addressed the issue – saying that a proposed activist amendment to allow for advisory resolutions would "*create uncertainty and confusion, whereas the division of responsibility for decision-making as between the Board and shareholders needs to be clear.*"

As a result of the Full Federal Court's ruling, there have been calls from activist investors and corporate governance groups to consider legislative amendment to allow non-binding advisory resolutions to be moved by shareholders at general meetings removing the current hurdle to first amend a company's constitution to give shareholders the right to move advisory resolutions. The response from institutional investors on such a change is divided, with a recent survey conducted by the Governance Institute of Australia suggesting 50% are in favour and 50% consider it unnecessary.

For the time being, we can expect companies and shareholders alike to be cognisant of the findings in ACCR v CBA and ensure that resolutions proposed by activists do not usurp the powers properly vested with the board.

It's worth noting though that proposed changes to Australia's corporate governance principles may give some further ammunition to ideological activists.

Convergence of ideological activism and investment activism

Climate change and business risk

Ideological Activists are at the forefront of promoting the argument that climate change involves material financial risks for companies, rather than standing alone as a purely environmental issue.

There has been a growing mood in Australia for companies and directors to recognise the material financial risks associated with climate change and take action to mitigate this risk and protect the long term value of the company. In 2017, Australia's financial industry regulator APRA, noted that climate change risks were not just foreseeable for companies but also material and actionable now. In this regard Ideological Activists have been successful in changing the agenda. With the overlap between environmental risks and financial risks growing, expect calls from Ideological Activists to be louder and boards and companies to begin listening.

Litigation risk

Climate change litigation is on the rise. There have been several climate change litigation cases recently, most prominently the case filed by the city of New York against Chevron, BP, Exxon Mobil and others. These cases are based on "attribution science" – where a corporation's contribution to climate change is measured by their emissions over time, effectively apportioning responsibility. Attribution science has not been as prevalent in Australia due to a reluctance from the courts to connect climate change to a corporation's greenhouse gas emissions. Even when an environmental claim fails, the fallout for the defendant organisation can include the economic and opportunity costs associated with the distractions involved in challenging the claim, as well as reputational damage.

How to prepare for activism

A proactive strategy is always going to be most successful against an activist.
The following is a check list of key strategies to prepare a company for an Investment or Ideological Activist campaign:

CONSTANTLY MONITOR SENTIMENT	+ Be acutely aware of investor and consumer sentiment and identify any risk areas for activist campaigns; keep up to date on media and social media coverage. + The faster you respond to queries, the less likely the answers will be left in the hands of the media or that shareholders will turn to independent avenues of assistance.
COMMUNICATE YOUR STRATEGY AND PREPARE A DEFENCE	+ Establish a strong strategic vision and communicate it concisely and effectively via the ASX platform and in conference with institutional shareholders and analysts. Proactively address concerns raised by analysts, the media or shareholders. Balance focus on long-term strategies with day-to-day performance. + Express clear justifications for management decisions. Shareholders with a deep understanding of the reasons behind an otherwise controversial change may be more likely to offer support. In the case of a particularly controversial strategy or a performance deficit, work up a solid defence to any potential accusation from activists (in particular, short sellers). Test this defence with advisers where necessary and put it in the top drawer.
MONITOR THE SHARE REGISTER	+ Understand the usual numbers of votes cast and abstentions in order to spot irregular voting patterns. + Keep an eye out for changes in holdings by hedge funds or institutional investors, or signs of new collective associations. + Pay particular attention prior to any "event" (AGM, transaction etc.). Note any significant changes in the size of holdings (particularly 5%+). Consider issuing tracing notices to identify the non-beneficial owners.
PREPARE THE BOARD	+ Consider any potential conflicts of interest and any shareholder board nominees. If appropriate, task an independent director with the role of reviewing activist demands. + Form an ad hoc working group of directors and management to evaluate trends in shareholder activism and potential vulnerabilities of the company.
ROLE PLAY	+ Adopt a comprehensive crisis management plan and engage expert advice to ensure the company is ready to respond. + With the help of advisers, work through the company's response to a mock activist campaign.

FOLLOW UP PROMPTLY AFTER AN AGM

- AGM voting results provide valuable insight about support and sentiment about management. Any unusual or unexpected results should be investigated further.
- If a resolution sees less than 85% of votes aligning with board recommendations, contact major shareholders as soon as possible to find out how and why they voted the way they did.

MONITOR COMPLIANCE WITH GOOD GOVERNANCE PRINCIPLES

- To avoid a “strike” against a remuneration report, engage remuneration experts to evaluate the company’s position relative to market standards. If remuneration doesn’t meet market expectations, ensure shareholders appreciate why the policies are nevertheless necessary.
- Be familiar with ASX Principles and Recommendations and the Australian Shareholder Association Voting Guidelines.
- Consider implementing an LTIP that endures longer than the standard 3 years.

BE MINDFUL OF LEGAL REQUIREMENTS

- Keep on top of accounting policy changes that have the potential to trigger earning shocks.
- Avoid procedural errors when issuing notices of meetings or calling meetings and be sure to consider key continuous disclosure obligations.
- Ensure the company has appropriate resources ready to deal with valid shareholder demands. For example, have drafts and necessary documents on hand in case shareholders requisition a meeting or propose resolutions.

BE WILLING TO LISTEN

- Activists can present good strategies and valuable ideas. Be open and engage constructively with the best interests of the company in mind.
- Engage with institutional investors throughout the year (not just pre-AGM).

COMMUNICATE REGULARLY WITH SHAREHOLDERS AND PROXY ADVISERS

- Regularly reinforce the company's strategic plan and long-term vision, providing frequent updates on long-term projects.

After becoming a target of activism

In the event that the company is the subject of shareholder activism, there are several "mission control" steps to take:

1. Treat it like a takeover, move quickly and methodically.

2. Address and understand the activists' concerns, rolling out prepared communication strategies where appropriate. Engage quickly with shareholders.

3. Check whether the activists are acting in compliance with securities law (eg, where shareholders are acting in concert, consider challenges on the basis of association). Ensure lawful purposes support any requisitioned meeting or proposed resolution, and any proposed notices meet the requirements.

4. Ensure appropriate engagement with regulators.

5. Engage legal, financial and communication advisers that are experienced with responding to activism campaigns.

ASX 50 AGM results for period 1 July 2017 – 30 June 2018

[Note: where the constitutional amendment resolution did not carry, the percentage votes for contingent resolutions represent proxy votes already submitted i.e. this number is an indicator for the likely results if the amending resolution had passed].

	Date of AGM	ASX code	Company name	Type of activism	Subject of activism	Outcome?
1.	Sep 2017	AGL	AGL Energy Ltd	Investment – two strikes	Conditional spill resolution	Withdrawn
2.	Feb 2018	ALL	Aristocrat Leisure	Nil		
3.	Nov 2017	AMC	Amcor Ltd	Nil		
4.	May 2018	AMP	AMP Ltd	Nil		
5.	Dec 2017	ANZ	ANZ Banking Group Ltd	Nil		
6.	Oct 2017	APA	APA Group	Nil		
7.	Sep 2017	ASX	ASX Ltd	Nil		
8.	Oct 2017	AZJ	Aurizon Holdings Ltd	Nil		
9.	Nov 2017	BHP	BHP Billiton Ltd Activist: ACCR	Ideological – climate change	Constitutional amendment	Loss – 7.1%
				Nil	Contingent resolution on climate change disclosure	Loss – 9.1%
10.	Oct 2017	BXB	Brambles Ltd	Nil		
11.	Nov 2017	CBA	Commonwealth Bank Activist: Market Forces	Ideological – climate change	Constitutional amendment to include commitment to preventing climate change as a directors' duty	Loss – 2.9%
				Investment – two strikes	Conditional spill resolution	Not required
12.	Oct 2017	COH	Cochlear Ltd	Nil		
13.	Nov 2017	CPU	Computershare Ltd	Nil		
14.	Oct 2017	CSL	CSL Ltd	Investment - two strikes	Conditional spill resolution	Not required – 3.9%
15.	May 2018	CTX	Caltex Australia	Nil		
16.	Oct 2017	DXS	Dexus Property Group	Investment – two strikes	Conditional spill resolution	Not required
17.	Nov 2017	FMG	Fortescue Metals Group	Nil		
18.	Nov 2017	GMG	Goodman Group	Investment – two strikes	Conditional spill resolution	Not required
19.	May 2018	GPT	GPT Group	Nil		
20.	Oct 2017	IAG	Insurance Australia	Nil		
21.	Jul 2017	JHX	James Hardie Industries Plc	Nil		
22.	Nov 2017	LLC	Lendlease Group	Nil		
23.	Nov 2017	MGR	Mirvac Group	Nil		
24.	Nov 2017	MPL	Medibank Private Ltd	Nil		
25.	Jul 2017	MQG	Macquarie Group Ltd	Nil		
26.	Dec 2017	NAB	National Australia Bank Ltd	Nil		
27.	Nov 2017	NCM	Newcrest Mining Ltd	Nil		

	Date of AGM	ASX code	Company name	Type of activism	Subject of activism	Outcome?
28.	Oct 2017	ORG	Origin Energy Ltd Activist: Market Forces	Ideological – climate change	Constitutional amendment	Loss – 4.7%
				Nil	Contingent resolution on climate risk disclosure	Loss – 13.7%
				Nil	Contingent resolution on transition planning	Loss – 3.4%
				Nil	Contingent resolution on short lived climate pollutants	Loss – 4.8%
29.	Dec 2017	ORI	Orica Ltd	Nil		
30.	May 2018	OSH	Oil Search Limited	Nil		
31.	Oct 2017	QAN	Qantas Airways Limited	Nil		
32.	May 2018	QBE	QBE Insurance Group Ltd Activist: Market Forces and Local Government Super	Ideological – climate change	Constitutional amendment	Loss – 9.1%
				Nil	Contingent resolution on climate risk disclosure	Withdrawn
33.	Nov 2017	RHC	Ramsay Health Care Limited	Nil		
34.	Mar 2018	RIO	Rio Tinto Limited Activist: ACCR and Local Government Super	Ideological – climate change	Constitutional amendment	Loss – 10.7%
				Nil	Contingent resolution on public policy advocacy on climate change and energy	Loss – 18.0%
35.	Nov 2017	S32	South32 Ltd	Nil		
36.	Apr 2018	SCG	Scentre Group	Nil		
37.	Oct 2017	SGP	Stockland Corporation Ltd	Nil		
38.	Nov 2017	SHL	Sonic Healthcare	Nil		
39.	May 2017	STO	Santos Ltd Activist: Market Forces	Ideological – climate change	Constitutional amendment	Loss – 4.0%
				Nil	Contingent resolution on reporting methane gas emissions	Loss – 9.8%
40.	Sep 2017	SUN	Suncorp Group Ltd	Nil		
41.	May 2018	SYD	Sydney Airport Holdings	Nil		
42.	Oct 2017	TCL	Transurban Group	Nil		
43.	Oct 2017	TLS	Telstra Corporation Ltd	Nil		
44.	Oct 2017	TWE	Treasury Wine Estates	Nil		
45.	May 2018	URW	Unibail-Rodamco-Westfield	Nil		
46.	Nov 2017	VCX	Vicinity Centres Ltd	Nil		
47.	Dec 2017	WBC	Westpac Banking Corporation	Nil		
48.	Nov 2017	WES	Wesfarmers Ltd	Nil		
49.	Nov 2017	WOW	Woolworths Group Ltd Activist: ACCR	Ideological – human rights	Constitutional amendment	Withdrawn
				Nil	Contingent resolution on human rights reporting in the Company's supply chain	Withdrawn
50.	Apr 2018	WPL	Woodside Petroleum Limited	Nil		

Endnotes

1. Lazard, 'Quarterly Review of Shareholder Activism' Q2 2018 Report.
2. Activist Insight, 'The Activist Investing Annual Review 2018'.
3. Lazard, 'Quarterly Review of Shareholder Activism' Q1 2018 Report.
4. ASIC, 2017 Annual General Meeting Season Report 564.
5. IHS Markit data, cited in AFR on 23 February 2017.
6. Responsible Investment Association Australasia, 'Super Fund Responsible Investment Benchmark Report 2018'.

Contacts

Sydney

TIM GORDON
Partner | Corporate Advisory
T +61 2 9263 4251
E tgordon@gtlaw.com.au

JOHN WILLIAMSON-NOBLE
Partner | Corporate Advisory
T +61 2 9263 4030
E jwilliamson-noble@gtlaw.com.au

JAMES CAMPISI
Lawyer | Corporate Advisory
T +61 2 9263 4563
E jcampisi@gtlaw.com.au

Perth

JUSTIN MANNOLINI
Partner | Corporate Advisory
T +61 8 9413 8491
E jmannolini@gtlaw.com.au

SARAH TURNER
Partner | Corporate Advisory
T +61 8 9413 8433
E sturner@gtlaw.com.au

Melbourne

NEIL PATHAK
Partner | Corporate Advisory
T +61 3 8656 3344
E npathak@gtlaw.com.au

ALEX KAUYE
Partner | Corporate Advisory
T +61 3 8656 3386
E akauye@gtlaw.com.au

GILBERT + TOBIN

SYDNEY
Level 35 International Towers Sydney
200 Barangaroo Avenue
Barangaroo NSW 2000
Australia
T +61 2 9263 4000
F +61 2 9263 4111

MELBOURNE
Level 22
101 Collins Street
Melbourne VIC 3000
Australia
T +61 3 8656 3300
F +61 3 8656 3400

PERTH
Level 16 Brookfield Place Tower 2
123 St Georges Terrace
Perth WA 6000
Australia
T +61 8 9413 8400
F +61 8 9413 8444

GTLAW.COM.AU