The State of Engagement between U.S. Corporations and Shareholders

A Study Conducted by Institutional Shareholder Services for the Investor Responsibility Research Center Institute

Report Author

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Executive Summary

At a time when engagement is front and center in the public debate about corporate America, this study provides the first-ever benchmarking of the level of engagement between investors and public corporations (issuers) in the United States. As evidenced by the provisions of the Dodd Frank legislation, various SEC rule-makings and the lawsuits contesting them, engagement has emerged as a central governance process for public companies in America. Despite that fact, there has never been a comprehensive picture of investor/corporate engagement and thus no consensus definition of engagement. This study attempts to rectify that lack. It surveyed 335 issuers of stock and 161 investors, including both asset owners (e.g. pension funds, trusts, etc.) and asset managers.

The study reveals both consensus and dissonance. There is broad consensus that engagement between issuers and investors is common and increasing both in terms of frequency and subject areas; that engagement is expanding beyond financial and strategic issues and "traditional" governance topics to include more environmental and social issues; that issues related to executive compensation remain atop the agenda; and that engagement is evolving as increasingly-sophisticated investors demand more detailed information on all of these topics. Yet engagement also means different things to different people: While some use the term to refer to a campaign to persuade a company to change its behavior, others (particularly issuers themselves) classify routine conversations with investors about financial results as engagement as well. The study also reveals some distinct differences between investors and issuers in terms of the time frame of engagements and the definition of a successful engagement,

Highlights of the study include:

- The level of engagement between issuers and investors is high. Approximately 87% of issuers, 70% of asset managers and 62% of asset owners reported at least one engagement in the past year.

- The level of engagement is increasing. 53 percent of asset owners, 64 percent of asset managers, and 50 percent of issuers said they are engaging more. Virtually none of the investors and only 6 percent of issuers responded that engagement is decreasing.

- Amongst investors, engagement is either a priority or a non-event. A biomodal (or“barbell”) distribution was evident, with 28% of asset owners and 34% of asset managers reporting engagements with more than 10 companies. On the other hand, about 45% of asset owners and 43% of asset managers indicated they did not initiate any engagement activity whatsoever.

- Despite the headlines that result from high-profile conflicts between issuers and investors, the vast majority of engagements between issuers and investors are never made public. About 80% of issuers said most engagements remain private, as did 72% of asset owners and 62% of asset managers.

- Asset owners, asset investors, and issuers do not always agree on what constitutes “successful” engagement. While all three groups believed constructive dialogue on a specific issue was a success, issuers were materially more likely than investors to think that establishment of a contentious dialogue was a success. An even more dramatic difference was that about three quarters of both asset managers and asset owners defined either additional corporate disclosures and/or changes in policies as a “success” while only about a third of issuers agreed.

- Engagement is most likely to lead to concrete change by issuers in areas where shareholders are broadly in agreement, such as declassification of the board of directors or the elimination of poor pay practices, than in areas where shareholders’ views diverge, such as the need for an independent board chair.

The study also revealed that issuers' greater willingness to be satisfied with the mere establishment of a dialogue has led them to report greater levels of success. While a majority of investors (approximately 56 percent) report that their engagement efforts in the past year were "sometimes successful," and only about 40% of investors claimed that such efforts were "always” or “usually” successful, roughly 80 percent of issuers responded that their efforts were "always successful" or "usually successful." A majority of asset managers say that the three-year trend is toward their engagement activities becoming more constructive or successful, while majorities of both asset owners and issuers reported that the success of their engagements was about the same as three years earlier.

There is a marked discrepancy in the perceived duration of engagements. Both investors and issuers report that the length of an engagement can certainly vary depending on the nature of the issue. However, a majority of both asset owners and managers indicated that an engagement typically lasts more than a month. In stark contrast, a majority of the issuer respondents indicated that engagements typically last a week or less.

The most common impediments to engagement appear to be resource-related: around half of issuers and three-fourths of institutions report that time is the most common impediment to engagement, while staffing considerations rank second for investors. In addition, nearly 30 percent of issuers and 26 percent of institutions report that philosophical considerations are impediments.

Introduction

The past several years have witnessed a significant increase in the frequency and scope of engagement between investors and issuers. Previously, "routine" communication generally referred to quarterly discussions about earnings and corporate strategy which occurred in company-designed forums such as conference calls and analyst meetings. Today, for many investors and issuers, it has become a year-round exercise involving dialogue on topics such as executive compensation, boardroom independence, and sustainability which take place in a variety of media, from conference calls and meetings to e-mails, public announcements, telephone calls and regulatory filings.

The growing tendency of issuers and investors to engage has been fueled by a number of developments. Investors, burned by scandals at companies such as Enron and WorldCom and more recently by the collapse of major financial services firms, are more sensitive to risks at their portfolio companies and less willing simply to trust boards to oversee managementand leave it at that. Investors are demanding higher levels of independence and accountability in the boardroom, and remuneration programs that better align the interests of executives with those of shareholders. Shareholder proposals calling for greater accountability, such as those seeking annually-elected boards and majority voting standards in director elections, typically receive strong levels of support from institutional investors, and now receive majority support on average, even counting the votes of retail investors. Directors who are perceived to act in a manner contrary to shareholders' best interests can expect to receive higher levels of opposition at the ballot box. Issuers, keenly aware of these trends, have greater incentives to engage proactively with investors.

A more investor-friendly regulatory environment has also fueled increasing levels of engagement. Enhanced disclosure requirements have provided shareholders with greater visibility into company financials, potential conflicts of interest involving officers and directors, and compensation practices. This has facilitated peer comparisons and prompted shareholders to pursue additional information where they have questions or to push for change when they view the status quo to be unacceptable. Additionally, the Wall Street Reform and Consumer Protection Act, more commonly known as Dodd-Frank, has directed the Securities and Exchange Commission to require public companies to allow shareholders a non-binding vote on executive compensation (extending a mandate already applicable to companies participating in the U.S. Treasury's Troubled Asset Relief Program). Out of more than 700 “say on pay” votes through mid-February 2011, five U.S. issuers failed to receive majority support for such resolutions, resulting at the very least in unwanted publicity. Experience in other markets that have "say on pay" votes, such as the U.K. and Australia, suggests that issuers likely will reach out to shareholders to discuss their compensation practices prior to such votes rather than face the embarrassment of significant shareholder opposition. Lastly, the New York Stock Exchange's amendment of Rule 452 to prohibit discretionary broker voting in uncontested director elections ended a practice that likely helped to inflate support for management nominees. This change has had the effect of making shareholder votes more consequential.

Issuers, too, are realizing the benefits of engaging with shareholders. Those who keep a finger on the pulse of shareholders can identify potential concerns early and address them before they reach a boiling point, thereby minimizing the prospect of contentious activity. When confronted with a contentious situation, an informed issuer can frame the debate and reach its investor base more effectively. Further, issuers that work constructively with investors can build trust and goodwill and gain advocates in the investor community. Finally, investors have different points of view about issues facing companies; some focus on capital structure, others on sustainability, etc. Some companies have found that listening to those points of view occasionally serves as an early warning system for corporate managements.

It should be understood that issuer-investor engagement is a continuously evolving process and that the level and results of engagement vary across firms and investors. The interests of issuers and investors can and do differ from time to time and conflict is inevitable. Moreover, neither all investors nor all issuers are of a single mind on most issues, so a scenario in which all parties will successfully achieve their objectives is unlikely. However, engagement can be a powerful tool for investors and issuers alike in addressing the intrinsic conflicts between the two, potentially enhancing long-term value at less cost. This study illuminates the current landscape of U.S. engagement and how it is evolving, including the extent of engagement, issues involved, and measures of success.

Study Methodology

The study included an online survey of approximately 161 institutional investors and 335 issuers based in the United States, open from March to May, 2010, and in-depth follow-up telephone interviews with 21 investors and 22 issuers, conducted in August and September, 2010. Investors were asked to categorize themselves as either asset owners or asset managers, in order to see if the two groups differ in their approach to engagement; for example because many pension funds and other asset owners entrust engagement to their outside fund managers, or because collaboration is more difficult among asset managers, who compete with their fellow managers, than among asset owners, who generally do not compete with fellow asset owners.

On the investor side, survey respondents included mutual funds, hedge funds, asset management firms, public employee and multi-employer pension funds, and faith-based and other socially responsible investment funds. Respondents were asked to categorize the size of their assets owned or assets under management. Issuer respondents were similarly categorized by market capitalization,

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The number of responses to any particular question may be materially fewer, due to the number of respondents who either do not engage at all or for whom the question was not relevant.

and included companies in a wide variety of sectors. The number of respondents in the various categories is detailed in Table 1.

Table 1: Survey Respondents by Category

	Under $500 Million	$500 Million - $1 Billion	$1 Billion - $5 Billion	$5 Billion - $10 Billion	Over $10 Billion	Unspecified
Issuers	66	34	98	36	80	21
Asset Owners	8	5	12	3	23	4
Asset Managers	14	10	20	8	45	9

Note: Size for issuers represents market capitalization. Size for asset owners and managers represents assets owned and assets managed, respectively.

For each respondent, the level of engagement was assessed in terms of subject matter, frequency, participants, measurements of success, and impediments. In addition, the study evaluated how the volume and the success of engagement have changed over time and are likely to change in the future. The survey defined "engagement" broadly, as “direct contact between a shareowner and an issuer (including a board member),” allowing each respondent some flexibility to define the term as he or she saw fit.

To encourage candid responses, interview participants were promised anonymity. Accordingly, even where interviewees are quoted directly, they are not identified by name or by the name of their organization.

Engagement Logistics

Engagement Resources

A review of the survey data shows a correlation between the size of an issuer or institutional investor (measured by market capitalization or assets, respectively) and the number of people involved in engagement activities. However, a majority of all respondents answered that they had between two and five people involved in engagement. The only category of respondents for whom "2 to 5" was not the most common response was large asset managers (more than $10 billion in assets under management (AUM)), who were more likely to say that they had more than 10 staffers working on engagement. Only 5 percent of respondents (12.5 percent of investors) stated that they had no employees working on engagement. This could mean either that these respondents don't engage; or that they interpreted the question to refer to staff members *solely* dedicated to engagement. Asset owners were the group most likely to say that they have no staff involved in engagement, which

suggests that some asset owners effectively outsource engagement, along with portfolio management and proxy voting, to outside fund managers.

Table 2: How Many Staff Members in Your Organization Are or May Be Involved in Engagement?

	0	1	2-5	6-10	>10	Total # of Responses
Issuers						
Mkt Cap <$1b	3.0%	10.0%	78.0%	8.0%	1.0%	100
Mkt Cap $1b-$10b	1.5%	6.0%	68.7%	17.2%	6.7%	134
Mkt Cap >$10b	0.0%	0.0%	47.5%	25.0%	27.5%	80
Asset Owners						
Assets <$1b	15.4%	15.4%	61.5%	7.7%	0.0%	13
Assets $1b-$10b	26.7%	20.0%	40.0%	13.3%	0.0%	15
Assets >$10b	17.4%	13.0%	34.8%	17.4%	21.7%	23
Asset Managers						
AUM <$1b	12.5%	8.3%	70.8%	4.2%	4.2%	24
AUM $1b-$10b	10.7%	10.7%	39.3%	25.0%	14.3%	28
AUM >$10b	4.9%	2.4%	26.8%	9.8%	56.1%	41

Although the survey captured the current engagement landscape, the economic downturn may have forced many institutions to operate with smaller staffs and reduced budgets; as discussed below in the section on "Impediments to Engagement," 65 percent of asset owners and 51 percent of asset managers listed staffing considerations as a significant obstacle to engagement.

Collaboration in Engagement

Investors were also asked in the survey how often their organization engages alone, versus collectively with other institutions. Asset managers were somewhat more likely to say that they typically engage alone: 19 asset managers said they sometimes or always involve others in the engagement process, while 24 said they typically engage alone. Eighteen asset managers said they sometimes or always coordinate engagement with others, while 21 replied "typically alone." Asset owners, however, were more likely to engage collectively: 19 asset owners said they sometimes or always involve others in the engagement process, while only 10 typically engage alone. Likewise, 19 asset owners said they sometimes or always coordinate engagement with others, while seven replied "typically alone." Part of this discrepancy between owners and managers may simply be a matter of asset managers competing with each other in a way that pension funds or other asset owners seldom do. Another explanation may be that asset managers, who are more likely to show up on a company's shareholder register than beneficial owners, are wary of triggering restrictions on "acting in concert".

On a related matter, we found some variation among investors on the matter of how often engagements were made public, though large majorities of owners and managers agreed that most engagements remain private. Issuers were even less likely to make their engagements public.

Table 3: Have Your Engagements Been Made Public?

Respondent	None Have Become Public	Not Typically Public	Less than 50 percent Made Public	Most are Made Public	Total # of Responses
Asset Owners	13.8%	41.4%	17.2%	27.6%	29
Asset Mgrs.	26.2%	19.0%	16.7%	38.1%	42
Issuers	30.2%	42.8%	6.9%	20.1%	159

One public employee pension fund reported that its typical engagement is governed by state law, and requires regular reporting to the legislature. On the other hand, another such fund noted that public document disclosure had caused some engagement to become public, but stressed that their preference was for "quiet diplomacy," which they felt was also appreciated by the issuers with which they engage. Among issuers, answers varied in part depending on how the respondent defined the terms. One company which responded that none of its engagements with specific investors had become public admitted that its analyst conferences were webcast; either it did not consider such webcasts to be "public," or perhaps did not consider them to be "engagement." Other issuers cited such conferences, and earnings calls, as examples of public disclosure. No issuer volunteered a preference for "quiet diplomacy" over public engagement, but during the interviews several companies did express frustration over the fact that shareholders will sometimes file a proxy proposal without first picking up the telephone.

Investors with an "activist" orientation – whether socially responsible investment funds, labor-affiliated groups or hedge funds – may sometimes have incentives to publicize their engagement with issuers, either to bring attention to a cause (and be able to take credit for any changes that companies make), or to help persuade other investors to support a shareholder proposal or a dissident candidate for the board. Conversely, many investors shun the spotlight, either to avoid criticism of their own influence, or because they think that private engagement is more effective. Issuers, for their part, may be willing to publicize engagement on financial results or M&A transactions, but often stand to lose, from a public relations perspective, from disclosure of engagement over perceived defects in their governance or their labor or environmental record. In some cases, issuers may want to publicize their corporate governance reforms, but prefer to have investors think these were undertaken at the board's initiative, rather than under pressure from activist shareholders.

Engagement Frequency

As shown in Table 4 below, the most common answers to the question "How much engagement activity have you experienced in the past year?" were either "none" or "more than 10".

Table 4: How Much Engagement Activity Have You Experienced in the Past Year?

	None	1	2-5	6-10	>10
Issuers					
Initiated by us	27.3%	8.7%	20.9%	9.5%	30.0%
Initiated by others	19.4%	9.1%	27.7%	8.7%	30.0%
Asset Owners					
Initiated by us	44.7%	6.4%	17.0%	2.1%	27.7%
Initiated by others	46.8%	4.3%	8.5%	6.4%	27.7%
Asset Managers					
Initiated by us	42.9%	2.6%	9.1%	5.2%	33.8%
Initiated by others	35.1%	5.2%	16.9%	6.5%	33.8%

The percentages in each row do not add up to 100 percent because some respondents only answered with respect to engagement initiated by the respondent, or only with respect to engagement initiated by others.

Thirty-four issuers (out of the 253 who answered this survey question), 18 asset owners (out of 47), and 23 asset managers (out of 77) replied "none" in both categories, indicating they had neither initiated engagement themselves in the past year, nor engaged in response to outreach by others. Some do not engage as a matter of policy: An administrator of a small public employee retirement fund noted in an interview that her fund's board does not believe the fund should be "on the bandwagon" for corporate governance or social issues, and said that the activities of her fund's more activist peers were not necessarily fulfilling their fiduciary duties to fund beneficiaries. Other asset owners, while not denying the value of engagement, prefer to outsource it to their asset managers, along with portfolio management.

Fifty-three percent of asset owners and 64 percent of asset managers reported that their engagement activity had increased in the previous year. Almost all of those who did not report an increase stated that the number had been unchanged, while only one asset owner and one asset manager reported a decrease. Reasons offered for the increase varied widely, with some investors citing the emergence of advisory votes on executive compensation ("say on pay" votes) , and others pointing to the United Nations Principles for Responsible Investment (UNPRI), which commit signatories to engage. The director of social responsibility for a faith-based asset owner cited the "mainstreaming of sustainability issues" as one factor behind increased engagement. Other investors cited an inability to simply walk away from an investment – the so-called "Wall Street Walk" does not apply to an indexed investment, or even to an active manager whose stake in a company is so large as to not be

readily marketable. The poor performance of many companies over the past several years has put many managers "on the hot seat" (in the words of an investment fund principal), and forced them to justify themselves to owners who are unable or unwilling to sell out at current share prices. Several investors commented during the interview phase of the study that issuers "have been humbled by the market" or are "uncertain in this environment," and are therefore more willing to talk to shareholders.

Finally, another factor behind the increase in engagement is that the stakes have increased significantly. The number of proxy contests has reached record highs, and mergers are increasingly being challenged by shareholders even when agreed to by management of both parties. The widespread adoption – at least among large companies – of majority voting for directors, coupled with changes to the NYSE broker vote rule for 2010 that prevent brokers from voting uninstructed shares in favor of director nominees, has put the outcome of some director votes in doubt even in uncontested elections. The eventual implementation of "proxy access" – assuming it survives the legal challenge brought by the U.S. Chamber of Commerce and Business Roundtable or is imposed on a company-by-company basis through proxy campaigns – is likely to bring further increases in engagement. These developments led the head of corporate governance of a large asset manager to remark in an interview that "law firms are encouraging companies to reach out proactively."

Among issuers, 50 percent reported an increase in engagements in the past year, while 6 percent noted a decrease and 44 percent said the number had been unchanged. As with investors, issuers offered a variety of reasons for the increase, including heightened concern about corporate governance on the part of investors, the economic downturn and its impact on portfolios, regulatory changes, and company-specific factors such as participation in TARP.

Engagement Duration

Survey respondents were asked how long an engagement typically lasts, and the answers showed a pronounced disparity between investors, who most frequently answered that engagements typically last more than a month, and issuers, who most commonly answered that engagements last a week or less.

Table 5: How Long Does an Engagement Typically Last?

Respondent	A Week or Less	Two Weeks to One Month	More Than One Month	It Depends	Total # of Responses
Asset Owners	14.3%	28.6%	57.1%	0.0%	28
Asset Mgrs.	27.5%	20.0%	52.5%	0.0%	40
Issuers	55.0%	21.3%	19.4%	4.4%	160

If anything, the comments related to this question revealed an even wider gap, as six asset managers noted that engagement could last for several years, while six issuers commented that engage-

ment was typically in the form of a phone call, which might only last an hour. This discrepancy may be due to a difference in definitions, with issuers perhaps more likely to consider a series of phone conversations as several discrete engagements, while investors may see the same set of phone calls as part of one ongoing engagement. It also appears that issuers were considering phone calls to address specific issues (related to an earnings release, for example) to be "typical" engagements; while investors – or at least those who answered the survey – were more likely to have in mind an ongoing effort to persuade a company to take concrete action. This gap in perceptions is somewhat ironic, given issuers' frequently expressed concerns about short-termism on the part of investors. Yet it reflects the fact that where investors do hold their shares for the long-term (especially those with passive investment strategies for whom exit may not be an option), engagement is also viewed from a long-term perspective.

Form of Engagement

As shown in Table 6, when initiating engagement, issuers are most likely to begin by picking up the telephone. Investors were divided among those who typically begin with a phone call and those who begin with a written communication – with asset owners more likely to write and asset managers more likely to call. Only one asset owner and one asset manager said they begin engagement by filing a proxy resolution. Fourteen issuers also said that engagement begins by filing a proxy resolution, although in those cases this may refer to the company's filing of its own proxy statement.

Table 6: How Do You Usually Initiate Engagement?

Respondent	By Letter	By Telephone Call	By E-Mail	By Filing a Proxy Resolution	Other/Multiple Answers	NA or Do Not Initiate Engagement
Asset Owners	53.8%	10.3%	2.6%	2.6%	5.1%	25.6%
Asset Mgrs.	26.1%	39.1%	4.3%	2.2%	8.7%	19.6%
Issuers	7.9%	60.8%	1.1%	7.4%	7.4%	15.3%

Once an engagement is underway, most respondents indicated that it may take several forms.

Table 7: What Types of Communication Are Generally Involved in the Engagement Episode?

Respondent	Exchange of Letters	Telephone Calls	E-Mails	In-Person Discussions	Proxy Resolution Filing	Number of Respondents to this Question
Asset Owners	76.7%	70.0%	10.0%	73.3%	50.0%	30
Asset Mgrs.	73.8%	88.1%	9.5%	71.4%	42.9%	42
Issuers	43.5%	89.3%	6.2%	57.1%	23.2%	177

Percentages exceed 100% because multiple answers were allowed. Number of respondents excludes three asset owners who answered "NA".

E-mail was not one of the suggested answers to these two survey questions, but was chosen by some respondents in the "Other (please specify)" category. It is likely that some of the respondents who chose "By Letter" or "Exchange of Letters" were also referring to electronic communication rather than letters sent through the post office. Other answers given by respondents include "13-D filing" (offered by an asset manager), "filings with the SEC under Regulation FD" (an issuer), and "hiring proxy solicitors" (an issuer). Many investors use different methods of communication depending on the subject matter. In particular, some investors use more formal written communication when reaching out to issuers to explain their reasons for voting against directors.

Engagement Targets

As noted above, most investors find their ability to engage limited by time and staffing constraints, and the study found discernible differences in engagement targeting between asset owners and managers. In choosing companies with which to engage, most asset managers indicated that they focus on the composition of their own portfolio, and are more likely to engage with their larger holdings. This does not always correlate with overall market capitalization, and in fact many asset managers are more likely to hold a larger stake in a small-cap or mid-cap company. There is also a perception that small-cap companies tend to have poorer disclosure and poorer governance than large-cap issuers, which may result in more engagement to glean information not disclosed in the proxy, and to persuade companies to improve problematic practices. On the other hand, some respondents said that the size of the company was not especially important, and that their engagement was driven primarily by particular issues of concern.

By contrast, asset owners were far more likely to say that they engage with large-cap issuers than with small or mid-cap companies. One likely reason for the disparity between asset owners and managers is that the former category includes more multi-employer union funds, faith-based inves-

tors, and other activists, who are generally more likely to sponsor shareholder proposals and "vote no" campaigns than asset managers (who are more likely to avoid such controversies). Activists seeking publicity for a cause will generally target a larger, better-known company (though, as the survey indicates, most engagements remain private). Finally, asset owners will own shares in companies at all capitalization levels, while some asset managers, such as small capitalization managers or concentrated hedge funds, may only own shares in small or mid-cap companies.

Table 8: With What Type of Companies Are You Most Likely to Engage?

Respondent	Large-Cap (S&P 500)	Small/Mid-Cap	Domestic Issuers Only	Any
Asset Owners	60.0%	16.0%	24.0%	32.0%
Asset Mgrs.	45.2%	40.5%	26.2%	42.9%

Note: Multiple answers were allowed.

Among survey respondents who provided answers to this question, 11 of 42 asset managers and six of 25 asset owners stated that they engage with domestic issuers only. Interviewees indicated that this was largely a function of their portfolios, which tend to be dominated by domestic companies. However, several public employee pension funds noted that state laws mandating divestment from companies with ties to Iran or Sudan have required them to engage with overseas issuers, even when the size of the holdings is very small, to verify that those companies have no such ties.

The contact points for engagement vary considerably. When asset managers initiate engagement with a company's management, they are most likely to reach out to the IR department (cited by 22 of 53 respondents to this survey question) or the corporate secretary (cited by 15 respondents). In addition, 15 respondents indicated the CEO, CFO, or "senior executives" more broadly. Several asset managers noted that while they often initiate engagement by writing to the CEO, they end up speaking with the IR department, corporate secretary, or a staffer in the appropriate area. Other asset managers noted that while they start with the IR department, they will "move up the ladder" as necessary. Asset managers with an ESG (environmental, social, and governance) or SRI (socially responsible investment) orientation often contact an issuer's CSR (corporate social responsibility) or sustainability office, and one such asset manager noted that "the most effective engagements tend to be with the people actually working on the issue."

When asset managers want to engage with a company's board, they most commonly reach out to the board chair (cited by 13 of 51 respondents to this question), the lead director (cited by eight respondents), or the corporate secretary (13 respondents). However, several asset managers stated that the answer depends on the subject of the engagement, and that they might reach out to members of the relevant board committee.

Asset owners were equally likely to reach out to the IR department or the corporate secretary when initiating engagement with management – each response was chosen by 13 of 37 respondents to

this survey question. Six respondents indicated that they start with the CEO. When asset owners seek to engage with the board, they primarily reach out to the chair (cited by 12 of 35 respondents) or the corporate secretary (10 respondents). Only three asset owners stated that they reach out to the lead director.

Notably, very few asset owners or managers seek to engage with the legal department or general counsel's office, which are often perceived as gatekeepers. The head of proxy voting for a large mutual fund complex felt that general counsels didn't always appreciate her questions, while the director of SRI for a faith-based asset manager said simply "Avoid the corporate lawyers."

For their part, issuers overwhelmingly tend to communicate with their largest holders: In response to a survey question asking issuers what type of investors they are most likely to engage with, 129 of 185 respondents answered "large shareholders (regardless of type)", and interview feedback was consistent with this answer. Once again, multiple answers were allowed for this question, and 123 respondents stated that they engaged with "Institutions," while only 71 claimed to engage with "all shareholders." Yet while there was a noticeable bias in favor of engagement with large shareholders, many issuers did say in the interviews that they also reach out to smaller shareholders who have contacted them in the past. Some noted that they will contact different types of shareholders depending on the issue. Several issuers cited length of holding as a factor as well, and while most of those expressed a preference for engagement with long-term owners, one food company stated that it specifically tries to reach out to its new shareholders.

When issuers initiate the engagement, it is most commonly the IR department that reaches out to investors. Of the 231 issuers that responded to this question, 150 indicated that the IR department plays this role. Thirty-six companies said the corporate secretary initiates engagement (including several who answered that either IR or the secretary would reach out, depending on the issue). Other common answers included the chairman or lead director (chosen by 13 respondents), the CFO (chosen by 21 issuers), and CEO (15 responses). However, few companies indicated that it is always the CEO or always the CFO who initiates engagement. More common answers were along the lines of "CEO, CFO or IR," or "General Counsel and/or CEO". Only three issuers said that a corporate governance specialist (in the general counsel's office) was the one to initiate engagement with shareholders.

During the interviews, a number of issuers drew a distinction between engaging with portfolio managers and engaging with corporate governance or proxy voting specialists. These issuers tend to prefer speaking with the "front office" – the portfolio managers – who are seen as more familiar with the companies in their portfolios; and more willing to make exceptions to their firms' proxy voting policies. One small bank holding company, however, stated that portfolio managers are willing to override such policies in order to vote with management, but that they will "hide behind the proxy department" when they want to oppose management without a confrontation. The same

company noted that it finds engagement on business performance or strategy to be constructive, but that engagement on governance matters is not. No other issuers expressed that view, though the general counsel for a large consumer products company did agree that engagement was more likely to be successful, from his perspective, when the "investment side" is involved in proxy voting.

Only 11 of the issuer survey respondents said that they engage with "domestic shareholders only." However, during the interviews, several issuers cited impediments to engaging with overseas shareholders, including a lack of responsiveness to their requests for engagement, and a lack of familiarity with the companies, particularly on the part of indexed investors. No issuers specifically cited language or cultural barriers as an obstacle to engaging with overseas shareholders.

Subject Matter of Engagements

The survey revealed that investors and issuers are discussing a broad range of topics; and that these conversations are being initiated by both sides. Responses to a question about the subject matter of engagements during the previous year were received from 52 asset managers, 31 asset owners, and 215 issuers. The results are presented in the table below.

Table 9: Subject Matter of Engagement Requests

	Financial/ Strategic	Compen-sation	Environ-mental Issues	Social Issues	"Other Gover-nance"
Asset Mgrs – Requests Made	53.8%	46.2%	28.8%	30.8%	51.9%
Asset Mgrs – Requests Rec'd	36.5%	46.2%	23.1%	26.9%	51.9%
Asset Owners – Requests Made	45.2%	51.6%	48.4%	48.4%	61.3%
Asset Owners – Requests Rec'd	32.3%	35.5%	25.8%	22.6%	35.5%
Issuers – Requests Made	49.3%	23.7%	6.5%	7.0%	29.3%
Issuers – Requests Received	58.6%	35.8%	21.4%	21.9%	44.7%

Multiple answers were allowed. Data represent percentage of respondents who reported at least one engagement request concerning the topic in question. Examples of "other governance" issues would be those relating to directors or takeover defenses.

While asset owners and especially asset managers reported receiving nearly as many requests for engagement as they made, issuers reported receiving many more requests for engagement than they initiated. Survey participants were asked whether the three-year trend was for their engagement to expand to cover more topics, contract to focus on fewer topics, or remain the same. Among asset managers, 22 answered "expanding" and only two answered "contracting," while 17 answered that the number of topics covered had remained about the same. Among asset owners, the numbers were 12, two, and 17, respectively. Among issuers, 66 reported that the number of topics was expanding, nine reported a contraction, and 104 reported that the number of topics had remained about the same. In short, virtually all participants indicated that the range of topics covered in engagement was either static or expanding.

Respondents were also asked to comment on why they believed the number of topics was expanding or contracting. One asset management firm noted that its engagement "used to just revolve around the proxy," but had expanded to cover "new topics and industry trends." Another asset manager noted that it was now "spending more time on fixing poor corporate governance practices than on financial/strategic issues (e.g., M&A)." The director of CSR for an asset owner noted that the issues of concern to her constituents had become more specific – for example, moving from "sustainability" generally, to issues such as hydraulic fracturing – requiring her to have more engagement with issuers on specific topics. One large asset management firm noted that its engagement had shifted "from issue-based or proposal-based engagement to principles-based engagement." Among issuers, several respondents noted that they were now discussing corporate governance and sustainability issues with investors, whereas previously engagement may have been limited to discussions of strategy or financial results. Several companies tied this trend to changes in the regulatory environment. Among the new discussion topics cited by issuers were environmental and social issues such as political contributions and climate change; but especially issues related to executive compensation. As "say on pay" votes become mandatory at U.S. companies, it is safe to assume that engagement on compensation topics will only increase further.

The interviews shed additional light on the topics around which engagement is taking place. The most common answer to the question "Which governance topics require the most engagement?", from both asset owners and asset managers, was executive compensation. Respondents indicated that they are talking to issuers about the forms of compensation, as well as the particular metrics employed in incentive programs and the relationship between pay and CEO performance. One large asset manager cited the need for more information to understand why a particular compensation program is the right one for the company in question. Another set of topics identified by numerous investors as requiring the most engagement are issues related to shareholder rights and takeover defenses: majority voting for directors, board declassification, and poison pills. Other issues flagged by investors as requiring substantial engagement include board composition and diversity; sustainability; capital structures and capital-raising; and M&A and proxy contests.

Most issuers answered this question in much the same way, with “compensation” again the most common answer; as issuers acknowledge that “shareholders have strong feelings” on this subject. One corporate secretary said that supermajority vote requirements, board declassification, and written consent had required extensive discussions, particularly with two shareholders (a major mutual fund group and a large public employee pension fund), and that she expected “say on pay” to require substantial engagement going forward. On the other hand, the CFO of a bank holding company that had already introduced "say on pay" said that he had expected feedback on this issue, but hadn’t received any. With "say on pay" appearing on virtually all annual meeting agendas in 2011, shareholders are likely to have to focus their attention and their engagement on this issue either on their largest holdings, or on companies identified as having problematic pay practices or a disconnect between pay and performance.

Another corporate secretary observed that shareholders are willing to “hear the company out” on director elections and compensation, but that most shareholders oppose classified boards and are not interested in discussing companies’ reasons for having one. Several issuers said that they either seldom or never engage with shareholders on governance topics; and that the inquiries they receive from shareholders generally relate to financial performance and strategy. However, such companies were in a distinct minority.

To the related question "What subject areas are of highest concern in defining a successful engagement?", most investors flagged the same issues that they had identified as those requiring the most engagement; including compensation, director independence and board diversity, majority voting and board declassification, and environmental and social issues. The principal of an investment fund commented that “any governance provision that isn’t in shareholders’ best interests is of concern.” Among issuers, one CFO indicated that his highest concern was getting shareholders to “understand the rationale behind management decisions; understand that there is thought behind them and they’re not just motivated by entrenchment.” A corporate secretary said that he wants to know how shareholders view emerging “hot topic” governance issues, as well as what shareholders find helpful in the Compensation Discussion & Analysis (CD&A), and what they see as “red flags” in the CD&A. Respondents did not appear to believe that their level of concern about a topic impacted their definition of success of the engagement.

In answering the question "What subject areas are most likely to result in concrete action or change in response to engagement?” both investors and issuers tended to be quite specific in their responses. Some of the concrete actions seen by investors in the area of compensation included the elimination of excise tax gross-ups in change-in-control situations; changes to deferred compensation; and enhanced disclosure. However, the issue of deferred compensation was characterized by one respondent as “low-hanging fruit,” and the proxy voting manager for a large mutual fund company expressed frustration with a lack of issuer responsiveness on thornier compensation issues such as guaranteed bonuses or a disconnect between pay and performance. Two respondents noted

that engagement on compensation matters does not necessarily yield immediate results – compensation plans tend to have a multi-year duration – but that it was important to help issuers understand how investors think about these issues; with one respondent offering that the concrete changes may come the next time a comp plan is replaced.

Other concrete actions were seen in the environmental and social arenas: for example, enhanced sustainability reporting; the expansion of non-discrimination policies to cover discrimination by sexual orientation; and divestment, where a public pension fund was engaging on issues covered by a state statute. Several investors said that engagement on M&A and strategic matters brought concrete results – although "engagement" here includes the filing of 13D statements, a step that not all investors are willing to take. With regard to boards of directors, two investors identified the appointment of an independent chairman as an issue where engagement did NOT often bring about concrete change. However, annual election of directors was cited as an area where engagement IS fruitful, because "boards know that shareholder proposals will pass." The representative of one large asset management firm noted that engagement on what she called "classic corporate governance red flags" – such as the implementation of a poison pill without a shareholder vote or the failure to implement a majority-supported shareholder proposal – was successful, because companies were willing to take action after her firm opposed the reelection of directors. These answers suggest that there has been somewhat of a power shift in the relationship between issuers and investors – an issue explored in more detail in the Conclusion – but that this is more likely to be manifested on issues where shareholders are broadly in agreement, such as board declassification, and less likely on topics where shareholders (at least in the U.S.) are less united, such as the appointment of independent chairs; or on certain fundamental compensation issues where companies resist compromise.

When issuers were asked about the areas where engagement was most likely bring about change, interviewees cited both changes they had made in response to shareholder requests – including the introduction of stock ownership guidelines for executives, the implementation of a compensation clawback policy, and enhancements to disclosure regarding compensation, political contributions and supply-chain monitoring – and successes they had had in convincing shareholders to change their votes, or withdraw shareholder proposals. (Only one investor volunteered that issuer engagement sometimes caused her firm to change its votes.) One corporate secretary noted that her company had made changes in the governance area in response to engagement, but that when shareholders want to address operational issues, including safety and environmental disclosure, the company is less likely to agree because it views these as management decisions and thus beyond the realm of shareholder concerns.

Impediments to Engagement

For both asset owners and asset managers, the most significant obstacles to engagement are related to resources. As noted above, among survey respondents 65 percent of asset owners and 51 percent of asset managers listed staffing considerations as a significant impediment to engagement. Sixty-eight percent of asset owners and 79 percent of asset managers listed "time considerations" – which obviously correlate with staff levels – as a major impediment. Public employee pension funds have been under particular pressure recently, as their budgets are set by often cash-strapped states, counties, and cities.

One asset owner noted that travel was the largest concern when engaging overseas companies. As with issuers , no investor specifically pointed to language or cultural barriers, a result which the interview responses suggest is due to two factors. First, smaller investors are simply less likely to engage with overseas issuers; second, larger asset management firms – whose overseas holdings are more extensive – engage those companies through their overseas offices, or with the assistance of brokers who provide interpreters and other logistical support.

Table 10: What in Your View Are the Most Common Impediments to Engagement?

Respondent	Regulatory Concerns	Staffing Considerations	Time Considerations	Philosophical Considerations	Insufficient Info (e.g., OBOs)
Asset Owners	23%	65%	68%	32%	16%
Asset Mgrs.	35%	51%	79%	26%	23%
Issuers	43%	34%	50%	29%	21%

Note: Multiple answers were allowed.

Time is the largest impediment for all respondents. But while 50 percent of issuers cited that obstacle, they indicated staffing considerations less often than regulatory concerns (such as Regulation FD), which were flagged as a hurdle to engagement by 43 percent of issuer respondents. However, one asset manager asserted that Reg. FD concerns were more of an excuse cited by issuers than an actual obstacle; and one issuer noted that Reg. FD isn't an obstacle to engagement on governance matters. In June 2010, after the survey had closed, the SEC issued guidance on this topic, explicitly stating that Reg. FD does not prohibit directors from speaking privately with a shareholder or group of shareholders, and suggesting steps that companies can take to avoid violations of Reg. FD's prohibition on selective disclosure, such as pre-clearing discussion topics with the shareholder, having company counsel participate in the meeting, or getting the shareholder to expressly agree to maintain the disclosed information in confidence.

The SEC, as part of its recent concept release on "proxy plumbing" issues, has suggested it may reexamine the distinction between "objecting" and "non-objecting" beneficial owners – largely in response to issuer complaints about the difficulty of communicating with objecting beneficial owners (OBOs). However, only 21 percent of issuers responding to the survey cited "insufficient information (e.g., OBOs)" as an obstacle to engagement. This suggests that the SEC may want to exercise caution before making radical changes to the current system.

"Philosophical considerations" were cited as an impediment by 29 percent of issuers – and by 32 percent of asset owners. During the interviews, some issuers expressed frustration at shareholder proponents who submit proposals without first contacting the company, or who submit the same proposal to numerous companies regardless of differences among them. Other respondents offered reasons that could easily be classified as "philosophical," such as "unreasonable stockholder demands" and "entrenched management." However, only a small number of issuers or investors were willing to go so far as to accuse their counterparts of being generally unwilling to engage.

In the comments to the survey responses, four issuers and two asset managers noted that simply finding the right point of contact was sometimes an obstacle to engagement. Other hurdles include SEC rules governing the right to file a shareholder proposal (noted by two asset managers); the travel needed to engage overseas companies (raised by an asset owner); lack of clarity on a shareholder's ultimate objective (mentioned by an issuer); and a "lack of fundamental analysis on the issues by [shareholder] proponents" (cited by an issuer).

Aside from these general impediments to engagement, a number of investors expressed frustration about an inability to engage with members of the board. There appears to be a widespread perception that issuer staff often acts as gatekeeper and that (in the words of an investment fund partner) "CEOs usually want to keep issues away from their bosses." One asset manager diplomatically referred to board access as a "work in progress," noting that few companies were willing to put their directors in front of shareholders. Another asset manager complained that companies seem to feel they've done enough merely by making directors available, even if nothing concrete comes out of the meeting. Yet these frustrations were not universally shared, and some investors – particularly large ones – are satisfied with their access to boards. One large asset manager noted that it "picks [its] spots" – generally seeking board access only where it holds a large stake that it plans to maintain for some time. A large public employee fund noted that its engagement with directors is facilitated by the fact that it has the resources to travel to visit those directors. On the other hand, a small asset management firm said it, too, was satisfied with board access, because if it gets no response initially, it will threaten a proxy contest. Meanwhile, a number of issuers indicated during the interview process that they seldom or never received requests from shareholders to engage with directors.

Keys to Success

The survey showed a significant disparity between the views of issuers and investors as to what makes for a successful engagement. While respondents from all three groups agreed that "constructive dialogue on specific issues" would make an engagement successful, issuers were much more likely than investors to be satisfied with the establishment of a dialogue, even if contentious, while investors were far more likely than issuers to specify "additional company disclosure or specific changes in company policies/practices." Simply put, issuers are happy to talk, but investors want to see concrete action.

Table 11: What Outcomes of an Engagement Process are Sufficient to Make an Engagement "Successful"?

Respondent	Establishment of a Dialogue, Even if Contentious	Constructive Dialogue on Specific Issues	Company Commitment to Engage in Future	Additional Disclosure or Change in Practices	Change in Shareholder Proxy Vote	Withdrawn Shareholder Proposal(s)	Other
Asset Owners	44%	85%	59%	78%	30%	41%	4%
Asset Mgrs.	50%	68%	60%	73%	40%	28%	8%
Issuers	57%	87%	34%	33%	37%	42%	4%

Note: Multiple answers were allowed. 27 asset owners, 40 asset managers, and 175 issuers gave valid responses to this question.

Interestingly, almost as many asset owners as issuers saw a withdrawn shareholder proposal as a sign of success, confirming the long-held view that withdrawn proposals signify as much (and in some cases more) accomplishment as high support votes, and that many proponents are happy to withdraw proposals if they can get some or all of what they want through negotiations. Surprisingly, asset managers were even more likely than issuers to see a changed vote as a sign of success, suggesting that they are changing their votes as a result of some action or commitment by the issuer.

Among the "other" responses to this question, one asset manager offered "an immediate change in policy or direction," while another asset manager suggested "changed board composition and practices." On the other hand, issuer responses included "build trust, goodwill, and reduce misinformation on both sides;" "increasing shareholder position" in the stock; and "investor understanding of

business model [and] strategy." One issuer candidly noted that a successful engagement was one limited to the investor and the issuer's management, with "no board member" involved.

Substantial majorities of respondents in all three categories said that their definition of a "successful" engagement did not vary by subject area.

Table 12: Does Your Definition of a Successful Engagement Vary by Subject Area?

Respondent	Yes	No	Total # of Responses
Asset Owners	34.5%	65.5%	29
Asset Mgrs.	36.6%	63.4%	41
Issuers	25.7%	74.3%	171

One asset owner who did say that its definition of success varies by subject area noted that "success is usually a longer process for social and environmental issues" than for an effort (for example) to gain the right to an advisory vote on compensation, where success or failure is quickly apparent. Another asset owner felt that additional disclosure might be sufficient to make an engagement successful in the environmental or social arena (or regarding Iran or Sudan ties), but that engagement on governance issues is not considered successful until the company makes actual changes. Several asset managers answered with variants of "each engagement is unique and we set clear goals for each." Several issuers indicated that the definition of success is a function of the shareholder with whom they are engaging, and whether that shareholder is looking for dialogue, or concrete action, or merely making a suggestion. One company responded that success "may depend on [the] level of hostility in [the] original correspondence from [the] stakeholder," while another commented that "some issues are not subject to compromise." On the other hand, one issuer noted that "engagement in areas that are complex and evolving will have different goals and desired outcomes than engagement about more settled issues, so there may be a broader range of acceptable positive outcomes."

Having been asked to define success in engagement, survey respondents were next asked whether they believed that their own engagement activities in the past year were generally successful; and whether they thought that the trend was toward greater or less success as defined by the respondent.

Table 13: How Would You Generally Characterize Your Engagement Efforts?

Respondent	Always Successful	Usually Successful	Sometimes Successful	Never Successful
Asset Owners	8%	32%	60%	0%
Asset Mgrs.	5%	38%	54%	3%
Issuers	18%	62%	20%	0%

As shown in Table 13, the vast majority of all investors indicated that their engagement is at least sometimes successful, while a majority of issuers said their engagement efforts are usually successful and 18 percent (significantly more than either asset owners or asset managers) characterized their engagement efforts as "always successful." By contrast, only 8 percent of asset owners and 5 percent of asset managers described their engagement as "always successful." One asset manager went so far as to describe his firm's engagement as "never successful," despite having defined success as "constructive dialogue on specific issues of concern," rather than the presumably higher hurdle of "additional company disclosure or specific changes in company policies/practices." (This individual did indicate that all his engagement was initiated by issuers, rather than by his own firm; but he not respond to a request for a follow-up interview to explain why he said that none of the conversations were worthwhile.)

On the other hand, asset owners and especially asset managers were significantly more likely than issuers to say that the three-year trend was toward engagement becoming more constructive or successful. Notably, no investors felt that engagement was becoming less constructive or successful, although 2 percent of issuers did express that view. Two issuers who did see an improvement attributed it to personnel changes: either a new IR officer, or a new board and management team. Another company volunteered that it had "matured in its ability to engage constructively." This was echoed by an asset owner, who commented that "the more we engage with companies, the more we become proficient at doing so," and noted that "some of our engagements have lasted more than three years, so these companies realize we intend to continue engaging with them until we see results."

Table 14: What is the Three-Year Trend in the Success of Your Engagement Activities, as You Define it?

Respondent	Becoming More Constructive/Successful	Becoming Less Constructive/ Successful	About the Same
Asset Owners	43%	0%	57%
Asset Mgrs.	56%	0%	44%
Issuers	36%	2%	62%

Interviewees were asked to elaborate on how they defined "constructive" engagement. Once again, the responses of issuers tended to differ from those of investors. While investors and issuers alike cited factors such as "willingness to listen" and "two-way dialogue," investors were more likely to

equate "constructive" with "effect[ing] some change." One asset manager argued that "agree[ing] to disagree is not a measure of success;" while another said, "Companies need to be open to acting on our suggestions," and that "we need to be talking to the right people, and they need to be willing to listen to new ideas, and communicate them back to the ultimate decision makers." On the other hand, several issuers replied that agreeing to disagree could in fact be considered a success, while another said that "getting candid feedback" is useful even when the two sides disagree. The comments of a number of issuers implied that they were viewed with suspicion or distrust by at least some of their shareholders; other companies complained of shareholders who were not willing to talk even when the company reached out. Either of these factors could explain why companies were more willing to view the mere establishment of a dialogue or building of trust as a success. Another explanation might be that in most engagements, particularly on governance topics, issuers are interested in justifying or maintaining the status quo, while shareholders are more likely to want something changed; thus, both sides may see dialogue as a substitute – whether good or bad – for action. One CFO stated explicitly that "engagement is constructive when it's related to business performance and strategy, but not when it's focused on governance."

It would be a mistake, however, to conclude that issuers are only interested in engaging as a way of avoiding or delaying concrete action. Among the factors cited by issuers as making engagement constructive were gaining a better understanding of how shareholders use the Compensation Discussion & Analysis (CD&A) section of the proxy, and what kinds of disclosure they are looking for; and "getting an educated view of how shareholders view transactions." One corporate secretary said that engagement is constructive if "the company learns something and applies it to doing something." Nor do issuers always see dialogue per se as worthwhile: The director of investor communications for a large company noted that to be constructive, the engagement should be focused on an "issue of genuine interest to investors," and not too short-term focused or "too deep in the weeds" on financial issues. A corporate secretary questioned whether having the same conversation with a shareholder over and over again was a good use of the company's time. (In contrast, as noted above, one asset owner commented that its engagement was becoming more constructive precisely because issuers realized that it would continue to engage on the same issues until it saw results.)

Interviewees were also asked why they believed their engagement was generally successful (or why it was unsuccessful), and what lessons others might learn from their experiences. Not surprisingly, many of the “keys to success” cited by both issuers and investors overlapped with the factors said to make for “constructive” engagement:

- doing one’s homework prior to the engagement;
- making sure “the right people” are taking part;
- being open-minded and willing to listen to the other side; and
- building relationships through transparency and credibility.

One large public employee fund said its passive investment strategy was a success factor, because issuers know that as long as their shares remain in the relevant index, the fund "won't go away" and would engage over a period of months or years if necessary. On the other hand, a smaller public employee fund had the opposite view, i.e., that its indexed approach was an obstacle to success, because the fact that issuers knew it couldn't sell its shares meant the fund had one less bargaining chip to use. Part of this discrepancy may be explained by the difference in size between those two funds: several large asset owners and managers acknowledged that their size was a success factor, because issuers could not easily ignore their opinions. Another large asset manager answered that "success results from shareholders banding together and expressing the same concerns," while another asset manager offered the flip-side of that argument, suggesting that apathy on the part of fellow shareholders allowed issuers to argue that the firm was only representing itself and its concerns were not shared by other investors. Two large pension funds attributed their success to their willingness to use "quiet diplomacy" and keep their engagement out of the media. This was echoed by a large asset management firm, who said it was important to "allow management to save face." (In this connection, it is worthy of note that the board of the California Public Employee Retirement System (CalPERS), which has long employed a "name and shame" strategy through the release of its annual "Focus List," recently voted to discontinue the use of a focus list after a study by Wilshire Consulting found that the companies engaged privately by CalPERS had significantly outperformed those named to the list.) On the other hand, a well-known SRI-oriented asset manager, while stating that "success is not zero-sum," said that shareholders should not be afraid to "go public and make an example of a company" where appropriate. Finally, a public employee fund noted that it had found that "using empirical support yields success" – meaning that the more successful arguments are those that have a financial or economic justification.

For their part, several issuers said that being proactive was a key to success in engagement, with one such company noting that its CEO and lead director (not just the IR department or corporate secretary) "actively engage with the shareholder base." While one issuer emphasized the importance of "mak[ing] sure you have a clear story," that need not be equated with rigidity, and several companies stressed the need to be open to compromise. On the other hand, the CEO of one small-cap company defined success as "satisfying shareholders that the company's course of action is reasonable" -- wording which would seem to suggest that the persuasion goes in only one direction. As noted above, one corporate secretary argued that engagement is more likely to be successful when the "investment side" is involved in proxy voting, as portfolio managers know the company better than proxy voting specialists and are more likely to give management the benefit of the doubt. He went on to say that he believes many shareholders don't want to go against their stated policies, and offered as an example of an "unsuccessful" engagement a situation where an investor supports a shareholder proposal even when asked not to do so. A corporate counsel added that lack of success comes when investors "don't understand the issues or have their minds made up going in" -- or when they don't even return her calls.

Measuring Engagement Success

The director of corporate governance for one large company offered "tracking/benchmarking topics of interest with shareholders" as one way to improve success. The proxy voting manager of a large mutual fund similarly suggested "tracking the engagement process from beginning to end." Yet while keeping records of whom one has talked to and which topics were discussed is relatively straightforward, developing a "cost-benefit analysis" to determine when engagement adds value is far trickier. Not surprisingly, few interviewees seem to have precise metrics for judging the success of their engagement efforts. Some likely reasons for this were suggested by interviewees, whose comments made clear that even for a single investor or issuer, engagements differ widely in terms of the desired result, the time horizon, and the size or importance of the party with whom one is engaging. For a shareholder, it is not immediately apparent how one would compare the "success" of a simple request for information, which might be quickly resolved with a single phone call, to the success of a multi-year campaign to reform a company's board structure. Likewise, for an issuer, partial success in changing the mind of one's largest shareholder may be more valuable than complete success in convincing a much smaller owner.

Conclusions

A majority of the survey respondents reported that their engagement activity has been increasing, if not compared to the immediately previous year, then certainly compared to earlier years. Reasons for the increase include the financial crisis and its impact on portfolios, regulatory developments, and corporate governance reforms, such as the adoption of majority voting for directors, which have raised the stakes for what were formerly viewed as routine shareholder votes. A majority of respondents – particularly among investors – cite time and staffing constraints as impediments to engagement, implying that a recovery in the financial markets and the broader economy, which would enable institutions to increase their staffs, could lead to a further increase in engagement, rather than simply a return to pre-crisis levels. Notwithstanding the obstacles and frustrations discussed above, retrenching on engagement does not seem to be an option for most respondents.

The comments of both issuers and investors indicate that there has been a shift in power in the relationship between the two groups, due to: new rules (such as mandatory "say on pay" votes and proxy access) explicitly designed to give shareholders more of a voice; the efforts of shareholders to push companies to enhance accountability through majority voting, declassified boards, and shareholder approval of takeover defenses (all of which are now regarded by investors as "best practices"); and widespread skepticism that boards have done an adequate job of managing risks and ensuring that executive pay is appropriately linked to performance. As a result of this power shift, issuers appear more willing to engage, both in response to shareholder requests and proactively at their own initiative. Investors, likewise, may have more to gain from engagement because the im-

pact of their votes has increased. Notwithstanding the recent challenge from the issuer community to the SEC's proxy access rule, which has succeeded in delaying the implementation of this mechanism, it is difficult to imagine a significant reversal of this power shift in the near future.

At the same time, the shift in power should not be overstated. Smaller asset owners and managers continue to experience some frustration, particularly when seeking to engage with directors. And even for large investors, the fact that issuers are more eager to talk does not always equate to an eagerness to make the changes sought by shareholders. The attitude of some issuers that engagement should preferably be limited to financial results and strategic talking points, rather than issues like board structure or executive compensation, has not entirely disappeared. Moreover, it appears that some shareholders lack either the resources or the desire to engage more than they are already doing, even where their portfolio companies would like to do so.

That said, a significant finding of this study is surely the fact that virtually all respondents view their engagement activity as being either the same as or more successful than in the past. It is worth reiterating the keys to success cited by participants:

- doing one's homework prior to the engagement;
- making sure "the right people" are taking part;
- being open-minded and willing to listen to the other side; and
- building relationships through transparency and credibility.

While a strict definition of engagement "success" remains elusive, more hard data on engagement practices and outcomes will continue to shed light on a topic that is clearly growing in importance for all market participants.

Suggested Topics for Further Research

Many survey and interview respondents – issuers and investors alike – anticipate that various provisions of the Dodd-Frank legislation will lead to an increase in engagement in coming years. With respect to "say on pay," for example, issuers are expected to solicit feedback from shareholders as they seek to craft compensation packages and Compensation Discussion & Analysis disclosures that meet with shareholder approval. Shareholders, meanwhile, are likely to have numerous questions for issuers as they seek to make effective use of the new right to weigh in on executive compensation. It will be useful to reevaluate the landscape after "say on pay" has been mandatory for a few years, to see if in fact it does lead to more engagement on an ongoing basis; and if the nature of that engagement varies in years when an advisory vote is on the ballot, compared to years in which it is not. If, as expected, many investors choose to use the "say on pay" vote (when available), rather than opposing compensation committee members, as their primary means of expressing discontent on pay-related matters, it may be useful to study how engagement frequency and subject matter, as well as voting behavior, differ among companies that provide an annual vote and those that do so

biennially or triennially. Such information could be helpful to shareholders and issuers as they decide (through the mechanism of the "say on pay frequency" votes also mandated by the Dodd-Frank Act) how often advisory votes should be held. It also appears that many issuers are increasing their engagement efforts in anticipation of these frequency votes, which will be required in 2011 and at least every six years thereafter.

Assuming that the SEC's proxy access rule (Rule 14a-11) eventually does take effect, some potential topics for further research include: the extent to which shareholders engage with issuers prior to nominating "access candidates" to the board; whether issuers reach out proactively to try to forestall the use of access or engage only after candidates are nominated; the extent to which shareholders are persuaded to refrain from nominating candidates; and whether the ability of investors to nominate candidates impacts engagement on other topics. It may also be useful to compare engagement in cases where proxy access is used, to engagement in cases where shareholders seek board representation using the "traditional" proxy contest mechanism. While proxy access would enable shareholders to nominate candidates without incurring the printing and mailing costs of a proxy contest, the nominating shareholders still would need to persuade other investors to support the "access nominees." At the same time, issuers would presumably reach out to shareholders to persuade them to support the incumbent board, just as they do in a proxy contest. Both issuers and investors would benefit from a study of how engagement differs in the two scenarios; for example, whether the "burden of proof" – the evidence necessary to persuade neutral shareholders to support one side over the other – differs between proxy contests and proxy access situations.

Given that many asset owners appear to be delegating responsibility for engagement to their fund managers, it could be helpful to study whether those asset owners have criteria for measuring the performance of those managers when it comes to engagement, and to what extent engagement is used as a factor in selecting which managers will get an asset owner's mandate. At the same time, some investors are not so much outsourcing their engagement, as free riding on the efforts of larger, better-staffed institutions. As noted above, one asset manager expressed frustration at this; complaining that passivity on the part of fellow shareholders allowed issuers to dismiss this manager's concerns as unrepresentative of the broader investor base. An additional topic for further research would be the steps (if any) that investors are taking to persuade their fellow shareholders to become more active.

Finally, given that a number of issuers drew distinctions between engagement with portfolio managers and engagement with corporate governance or proxy voting specialists, it could be fruitful to further investigate this distinction. For example, one could ask asset owners and managers how they divide engagement responsibilities between the front office and the middle or back office; how each group's conversations with a particular issuer are shared within the organization; how they handle conflicting opinions between the two groups; and under what circumstances they are willing to override voting guidelines after engagement.

About IRRC Institute

The IRRC Institute is a not-for-profit organization established in 2006 to provide thought leadership at the intersection of corporate responsibility and the informational needs of investors. Headquartered in New York City, the organization funds environmental, social and corporate governance research.

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