Tapestry Networks

New ways to govern and lead

A pivotal moment to enhance board-shareholder engagement

Sweeping changes emerging from Congress and the Securities and Exchange Commission (SEC) are affecting boards and institutional investors and focusing attention on the need for better engagement between the two groups.

Tapestry Networks is exploring the idea of bringing together institutional investors and leading large-company non-executive directors to co-develop principles and practices that would form the basis for more productive board-shareholder engagement. Over the past few months, we have held discussions with board directors, subject-matter experts, and individuals from several major pension and mutual funds. (See page 7 for a partial list of discussion participants.) We asked them four key questions, the answers to which are described in more detail on subsequent pages:

- Is this a pivotal moment in which to enhance board-shareholder engagement?
- If there is an appetite to participate in change, which parties should be involved?
- What issues should be addressed?
- Is there a need for a new vehicle to accomplish change?

Discussion revealed there are substantial differences among institutional shareholders' agendas, interests, and approaches to engagement. The same is also true for boards of directors of public companies. A recent study, *"The State of Engagement Between US Corporations and Shareholders,"* commissioned by the IRRC Institute and conducted by Institutional Shareholder Services, revealed "a disconnect between investors and issuers in basic areas such as the time frame of engagement, the definition of a successful engagement and, by implication, what engagement itself means."[1]

Clearly, a new approach is required to make real progress in improving board-shareholder engagement. This memorandum provides more detail on the insights we gained from our interviews and our recommendations for a way forward.

The time is now

As one investor put it, *"This is an important time for shareholders. They cannot afford to veer off course on marginal issues. If, two years from now, the corporate world is able to say, 'You see, we knew you couldn't handle the responsibility. You blew the opportunity and proved you are simply the stooge of special interests,' then we have missed a critical moment in time."* Directors in our networks also view the next few years as critical, in terms of their relationship with shareholders.

[1] IRRC Institute, "First Study Benchmarking US Corporate and Investor Engagement Reveals Consensus, Dissonance, Power Shift," news release, February 22, 2011.

The United States was the central focus for discussion participants, even though other countries also struggle with governance issues and board-shareholder engagement. However, the hurdles to more active US board-shareholder engagement seem much higher, and overcoming those hurdles is that much more important because many investors have their first- or second-largest equity holdings in the United States. The fact that shareholders are gaining new powers, through the Dodd-Frank Act and from the SEC, offers a once-in-a lifetime opportunity to break this impasse.

Discussion participants presented a very broad view on what constitutes engagement:

- **Shareholder communications** (i.e., proxy statements). Existing mechanisms for shareholder communication need improvement to complement face-to-face meetings. Much of the proxy has become boilerplate and gets longer every year. An interviewee explained that one company, to improve communication, included *"a three-page letter to shareholders in the proxy statement telling them what [the board] did last year, put the proxy statement in more plain English, and added a more comprehensive compensation discussion and analysis and an executive summary. You can knock on doors or figure out better ways to communicate."*
- **Major shareholder events** (i.e., annual shareholder meetings, analyst calls). Our discussions revealed that many people participating in shareholder events regard them as futile. Several interviewees suggested that new ways to hold annual meetings, such as virtual meetings, might be highly beneficial. They also raised the idea of a "fifth analyst call" including board members.
- **Shareholder votes** (i.e., director elections, say on pay). Investors noted that recent changes make *"the director vote more valuable"* and increase the need for engagement: *"Directors should know why investors are voting against them."* Thankfully, as another put it, *"directors are now more willing to talk because say on pay and proxy access is on the table."* However, investors often lack resources to make informed decisions, and companies are not fully engaging their investors throughout the year to remove the potential for disastrous vote outcomes.
- **Actual board-shareholder engagement** (i.e., one-on-one meetings, director meetings with a group of major investors). Most agreed, *"There are not enough resources, but [boards and investors] want to engage."* At issue is deciding who attends the meeting. Directors want to meet the investment professionals, but they often end up with corporate governance staff.

This holistic approach to engagement closely resembles that of the UK Stewardship Code, which, along with other such efforts, has placed more pressure on long-term investors to reassess their approach to engagement.

There is an appetite to participate

Investors and directors alike are willing and eager to come together to capitalize on this opportunity to improve engagement. Each expert we spoke with shared their "ideal" list of participants in such an endeavor. While some names differed, core constituents were common across all lists.

Discussion participants agreed directors should be included. Too often, practices for board-shareholder engagement are developed in isolation – by director groups or separately by investors – or are too high-level to be practical. Interviewees agreed that involving top-quality directors from large companies would be a distinct and critical component of this effort, with one clear qualification: they have to be willing to implement change in their companies.

Even though investor groups exist, they were seen as lacking in the breadth of their active engaged members and unable to catalyze change on board-shareholder engagement. Participants proposed a list of investors that extends well beyond the same "cast of characters" seen at governance conferences or trade associations to include a truly international set of large, long-term investors. There were three types of proposed investors:

- **Pension funds.** Major US pension funds (CalPERS, CalSTRS, Florida State Board of Administration, New York City Employee Retirement System, TIAA-CREF, and the State of Wisconsin), as well as their major foreign counterparts (Canadian Pension Plan, ABP in the Netherlands, the Australian superannuation funds, and the UK Universities Superannuation Scheme).
- **Mutual funds.** *"It would help to have them included because they have huge holdings, but they would be difficult to get to the table,"* one participant said. Names mentioned included Fidelity, Legg Mason, Capital Research and Management, State Street, and BlackRock.
- **Sovereign wealth funds.** One participant suggested the inclusion of *"international players, such as sovereign wealth funds, to get their perspective of how it works."* After all, one expert noted, *"Half of the market valuation is sovereign wealth funds."* Norges Bank has been active in some governance activities, but interviewees wanted others at the table as well – for example, the Government of Singapore Investment Corporation and Japan's pension fund.

In the longer term, many also stressed the need to include practitioners and firms that advise companies and investors, such as lawyers and proxy advisors – notably, ISS – or those that support the effective functioning of the so-called "proxy plumbing" – notably, Broadridge. The SEC is also crucial, because of its role in encouraging and facilitating board-shareholder engagement. As SEC Chairman Mary Schapiro said, "Speaking both as a regulator and as a former board member, I believe that it is vital that shareholders and board members move beyond the minimum required communications and become truly engaged in the shared pursuit of high quality governance."[2]

The issue set is still unclear

At the broadest level, there is agreement that more – and more effective – board-shareholder engagement would be beneficial. But, as one might expect, there is a broad spectrum of views on the specific focus of such engagement:

- **Performance or governance?** Several participants said that, ultimately, board-shareholder engagement must touch on issues driving corporate performance, especially the firm's strategy.

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[2] Mary L. Schapiro, "Speech by SEC Chairman: Remarks at the NACD Annual Corporate Governance Conference," *US Securities and Exchange Commission*, October 19, 2010.

One UK participant felt that his relationship with independent board chairmen allowed for candid discussion on these matters, but others said that such discussions are better left to management and boards are better placed to discuss governance matters.

- **Substantive oversight or processes?** Should discussions focus on substantive governance matters (e.g., a dialogue that allows investors to gauge how boards are fulfilling their risk-oversight duties) or on ensuring processes work more effectively (e.g., say on pay, director elections, and proxy access)? Participants were equally interested in both sets of issues.
- **Social issues?** Investors, particularly those from Europe, will increasingly focus on social topics. However, few believed these issues could usefully be discussed early on in any such initiative. As one investor put it, the effort could get *"hijacked"* by those pushing their own agenda, and often these issues mean different things to different people.

Even among agenda items that all interviewees could agree on, there was significant divergence of opinion on the solutions. For example, on the subject of executive pay, one participant noted, *"There are some broad things that all investors agree with. Pay for performance is one of them."* But what, some directors asked, does that mean in practice? Similarly, as another participant asked, *"When is a 'no' vote a no?"* Some would say 50% or above, but one participant said, *"Getting a 10% vote against a director is a really negative mark."* These differences are significant.

We need for a new vehicle to accomplish change

Participants described a number of shortcomings in existing forums:

- **Too one-sided.** Most existing forums include only one or two of the necessary constituents. Most cater to some investors or some directors, but not both, nor with sufficient breadth.
- **Too parochial.** The existing forums *"lack an international aspect,"* one participant said. They are not leveraging the knowledge that can be acquired from markets that have established successful engagement structures, such as the UK and Canada. One industry leader suggested we *"take a look at the Euro model … You will probably see it in the US in a few years."*
- **Not action-oriented.** Even those events or groups that attempt to bridge the gap between investors and directors are typically ad hoc. The goal tends to be educational – to understand one another better – rather than focused on sustained problem solving, and the level of discussion is usually high, with not enough focus on the practical changes that are required. Yet, one participant said, *"Directors need answers to practical issues now."*
- **No commitment to change.** Rarely do participants in these groups come prepared to change their own behavior. By contrast, to be successful, one interviewee said, *"Directors would have to get over distrust. [They] would have to come in with good faith to communicate, not just answer questions. Investors also have to go in with the right spirit. They can be critical without trying to embarrass [directors]."*
- **Little or no candor.** Since many of the members of existing forums are transitory – they don't attend all meetings – there is limited opportunity to build strong trust-based relationships.

This greatly inhibits the level of candor among participants about their own behaviors and challenges; instead, the energy is focused on asserting what others need to change.

- **Not the right people.** One participant noted, *"The problem has been getting the attention of suitably senior-level people."* Several recommended including top executives and portfolio managers from the investors, in addition to corporate governance professionals. After all, the effort should seek to change institutional behavior, not just voting policies. Participants also highlighted specific difficulties in getting top-quality directors involved; existing groups like the National Association of Corporate Directors do not count leading Fortune 100 board members among their active membership.

These shortcomings are significant barriers to change. A new vehicle is needed that draws together the right level and types of individuals and institutions, builds relationships among these constituents, generates insight on the most pressing issues associated with board-shareholder engagement, and inspires participants to have the courage to change. One participant noted, *"We need collaboration … to turn this ship."*

Tapestry Networks is uniquely placed to help in this regard, having years of experience in managing this type of multi-stakeholder, collaborative problem solving. Tapestry Networks specializes in forming working partnerships that include the public and private sector as well as civil society. These partnerships – which we regard as networks because of the way they are constructed and function – typically address complex problems where public and private interests need to be realigned. The network participants are respected leaders from key stakeholders who often find themselves leading in genuinely new ways.

Tapestry Networks is built on the premise that relatively small groups of well-positioned leaders, seeking a goal that transcends their own parochial interests and benefits everyone, can make progress toward that goal – no matter how elusive it might have seemed initially – through the collaborative approaches that Tapestry designs and leads.

A first step forward

There is widespread agreement that we are at a pivotal moment to improve the quality and frequency of board-shareholder engagement in the United States. There is also a unique set of participants who would enthusiastically come together to make a difference on this topic. However, there is work to be done in selecting the specific issues to be addressed and how to address them. The design of the initiative must be crafted carefully; the sequencing of issues and activities, and who to include and when, will be key.

We suggest, therefore, that Tapestry Networks convene a meeting of key players over dinner in New York to discuss the opportunity and design an approach for energizing, steering, and motivating change. To prepare for the meeting, Tapestry would meet with each participant to understand his or her perspectives, priorities, motivations, apprehensions, and aspirations. We would prepare a detailed white paper as a starting point for discussion and an agenda tailored to the expressed objectives of the participants.

A first meeting is the easy part. The hard part will be designing and sustaining a process that leads to the substantial and enduring change in practices required to achieve effective board-shareholder engagement. We want a group that does things, not a group that only talks about things that should be done. We do not underestimate the challenge of overcoming inertia, mistrust, and misunderstanding. Indeed, these are precisely the challenges Tapestry Networks was created to address.

Appendix: Discussion participants

The following institutional investors and advisors participated in discussions:

- Janice Hester Amey, Portfolio Manager, California State Teachers' Retirement System (CalSTRS)
- Brandon Becker, Chief Legal Officer, TIAA-CREF
- George Dallas, Director of Corporate Governance, Foreign & Colonial Investments (F&C)
- Richard Daly, Chief Executive Officer, Broadridge Financial Solutions, Inc.
- Jon Feigelson, General Counsel, TIAA-CREF
- Roger Ferguson, Chief Executive Officer, TIAA-CREF
- Margaret "Peggy" Foran, Chief Governance Officer and Corporate Secretary, Prudential Financial
- Wayne Kozun, Senior Vice President – Public Equities, Ontario Teachers' Pension Plan (OTPP)
- Colin Melvin, Chief Executive Officer, Hermes Equity Ownership Services, Ltd.
- Eileen Mercier, Chairman of the Board, OTPP
- Muir Paterson, Director of Corporate Governance, Wellington Management Company, LLP
- Martin van Rijn, Chief Executive Officer, PGGM Investments
- Carl Rosen, Executive Director, International Corporate Governance Network (ICGN)
- Paul Schneider, Senior Investment Associate – Corporate Governance, OTPP
- Sir David Walker, author of the government-commissioned report, "A review of corporate governance in UK banks and other financial industry entities"
- Simon Wong, Executive Partner and Managing Director, Governance for Owners
- Christy Wood, Chairman of the Board, ICGN

We also spoke, under the Chatham House Rule, to a number of board directors of Fortune 100 companies who are members of corporate governance networks run by Tapestry.