ViewPoints: Advancing board-shareholder engagement

Introduction

On April 26, 2012, representatives of four large, North American institutional investors met with five experienced non-executive directors of major, global corporations to explore the important topic of how corporate boards and their members should appropriately engage with shareholders. This topic has attracted great interest in recent years, triggering a fair amount of animated discussion, particularly so in the wake of the 2000–2001 corporate scandals (e.g., Enron and WorldCom) and the 2008 financial crisis.[1] For a complete list of research participants, including attendees of the April 26 meeting, please see the Appendix, on page 11.

Indeed, before and after the financial crisis, Tapestry's corporate governance networks have discussed their responsibility to investors and met with major investing institutions in the United States, Canada, and Europe and experts, advocates, and other participants in the field of board-shareholder engagement in an attempt to determine a way forward that works for all constituencies. Shareholders, lawmakers, board leaders, and corporate governance activists have all expressed views, and they are not always in agreement. Many of the issues are laid out in a Tapestry-prepared white paper, "A Key Moment to Improve Board-shareholder Engagement,"[2] that was shared in advance with meeting participants.

Directors and investors agree the time for enhanced dialogue is at hand. As one director remarked at the April meeting, *"Investor engagement is the new frontier for boards … I have always been frustrated with the lack of communication that directors have with investors. That is changing, and we have begun a journey that will get better with more engagement."* An investor told Tapestry, *"This is an important time for investors. We cannot afford to veer off course on marginal issues. If the corporate world is able to say, '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."*

While this document addresses discussions with large institutional investors, the themes expressed also raise questions of how boards should be engaging with all investors.

[1] For more on this issue, see Tapestry Networks, "The Investor Perspective," 2012.

[2] Tapestry Networks, "A key moment to improve board-shareholder relations," 2012.

Participants at the April 26 meeting discussed the following themes, which are discussed in more detail on the following pages.[3]

- **The current paradigm of board-shareholder engagement fails both boards and shareholders** *(Page 2)*

  Investors elect board directors to represent them. Board directors hire management to run the company. Yet in the United States, rather than interacting with directors, investors generally interact with management. Directors are rarely involved except in a crisis. Policymakers, regulators, and some institutional investors want to see more engagement between investors and boards. Many non-executive directors believe that more engagement with long-term institutional investors in particular is inevitable. While there have been examples of successful engagement, and even collaboration, between boards and investors, both groups increasingly acknowledge that current practice often seems rote and reactive, and recognize that the default relationship between boards and investors is unnecessarily adversarial.

- **Several real and perceived challenges stand in the way of progress** *(Page 5)*

  Among the significant obstacles to board-investor engagement, meeting participants cited resource constraints, worries about director liability under Regulation Fair Disclosure, the potential for regulatory change compelling investors to *"become more activist"* in Europe to translate to the US, and board and management wariness toward greater engagement.

- **Productive engagement requires a new mind-set, new practices, and new protocols** *(Page 6)*

  Participants said board directors and members of management need a new mind-set, one that acknowledges the value of greater engagement between directors and investors. Boards and investors should agree to a set of principles for engagement, including more proactive, direct communication and less reliance on intermediaries, such as proxy advisory firms. Participants also outlined a set of engagement practices including conference calls between directors and investors, a shareholder meeting day, and regular, informal meetings between boards and their major investors. For issues to be tackled through board-shareholder dialogue, see the box on pages 7–8.

The current paradigm of board-shareholder engagement fails both boards and shareholders

Legal and regulatory changes and corporate governance trends have thrust board-shareholder engagement into the spotlight. Leading regulators are calling for more dialogue between boards and investors. Mary Schapiro, the chair of the Securities and Exchange Commission (SEC), said, "Speaking both as a regulator and as a former board member, I believe that it is vital that investors and board members move beyond the minimum required communications and become truly engaged in the shared pursuit of high quality governance."[4]

[3] *ViewPoints* uses a modified version of the Chatham House Rule whereby comments made during conversations are not attributed to individuals or companies. Quotes in italics are drawn directly from conversations with participants during the April 26 dinner and from separate discussions with participants in the field of board-investor engagement prior to the dinner on April 26.

[4] Mary L. Schapiro, Remarks at the NACD Annual Corporate Governance Conference, Washington, DC, October 19, 2010.

A broader range of investors, more coordinated than before, have begun engaging with board directors on an increasing number of corporate governance issues.[5] Money managers are calling on non-executive directors for better engagement;[6] they are also calling on other investors to make themselves heard.[7] Some directors have added their voices to the call for increased engagement: *"In my view,"* said one, *"investors have a right – a right – to speak to directors."*

There are signs of positive change in the air:

- Investors have gained new powers, such as say on pay, through the Dodd-Frank Act and increased disclosure requirements from the SEC.[8]
- The UK Stewardship Code has increased pressure on long-term investors to reassess their approach to engagement.[9]
- Some European investors are now pushing for the same access to American boards that they have in many European countries.[10]
- The influence of intermediaries such as proxy advisory firms is being actively debated by all stakeholders, including the SEC.[11]

However, participants said the current paradigm for engagement between directors and investors leaves significant room for improvement. Participants presented a very broad view on what currently constitutes engagement, including formal channels such as the annual general meeting, proxy voting, and director votes, and informal, direct interaction between boards and investors.

Formal channels through which boards and investors communicate include:

- **Written communications** (i.e., securities filings). A director said, *"We are terrible about telling people how we do our jobs."* Indeed, existing mechanisms for investor communication need improvement to complement any face-to-face meetings. Participants said much of the proxy has become boilerplate and gets longer every year.
- **Regular shareholder events** (i.e., annual shareholder meetings, analyst calls). Our discussions revealed that many institutional investors and board directors regard regular shareholder events as futile. One director said, *"The annual general meetings and analyst calls are generally formulaic exercises."*
- **Investor 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."* One investor said, *"When we vote on a director, we take their other boards into account. So if you were on the board of Enron or WorldCom, you are likely not going to get our vote at another board. I don't think directors*

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[5] See, for example, Ernst & Young, "Proxy Season 2012: Board Priorities for Investor Engagement," *Proxy Perspectives*, February 2012, and Marc Goldstein, *The State of Engagement between U.S. Corporations and Investors*, (New York: IRRC Institute, 2011).

[6] Barry B. Burr, "Money Managers Increasing Activism on Governance – but Quietly," *Pensions & Investments*, March 19, 2012.

[7] Roger W. Ferguson, "Riding Herd on Company Management," *Wall Street Journal,* April 27, 2010.

[8] Marc Goldstein, *The State of Engagement between U.S. Corporations and Investors* (New York: IRRC Institute, 2011), 5.

[9] Peter Bartram, "Activist Investors Raise Their Heads Once Again," *CFO World*, November 29, 2011.

[10] Ernst & Young, "Proxy Season 2012: Board Priorities for Investor Engagement," *Proxy Perspectives,* February 2012.

[11] See Reese Darragh, "SEC Reveals Plan to Regulate Proxy Advisory Firms," *Compliance Week*, December 16, 2011.

understand that." 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 unwelcome vote outcomes.

In addition, participants said their informal discussions usually occur when a corporate crisis unfolds, or there are serious performance issues. As one director remarked, *"I have been involved in a couple of situations where investor engagement has been thrust upon us. I have always been frustrated with the inability to have that communication [more regularly] with investors."* Indeed, participants noted that there is little actual engagement that is not linked to either a performance issue or specifically about executive compensation ahead of a contentious Say on Pay vote. An investor said, *"It really matters in times of crisis if you have gotten to know the company outside times of crisis."*

Several participants acknowledged that the current system of board-shareholder engagement has resulted in an antagonistic relationship between investors and boards. An investor said, *"This whole board engagement process and this whole relationship dynamic between investors and companies has become so adversarial. We are judged on our corporate governance merits on how many times we vote against management."* A director added, *"If we can defuse this adversarial relationship, we could enhance the dialogue with the investors."*

The adversarial relationship has helped obscure each party's decision-making process. Several directors questioned investors' methodologies and justifications for voting against companies. One said, *"I would like to understand the triggers that cause investors to say, 'These are terrible directors.' If you are holding directors accountable, how so?"* An investor commented, *"We trust, but verify. Our process is simple. We read your disclosures. If we are not comfortable with something, we ask to sit down with you. We want to see a process that demonstrates real thought about your plan."* Another investor said, *"If I understand that there is an engaged, knowledgeable, highly fiduciary-oriented board, I am going to place a premium on that company rather than the one I think that is made up of six roommates from college."*

Some companies are attempting to improve information sharing. Roger Ferguson, the chair of TIAA-CREF, commented favorably on the efforts of the biotechnology company Amgen: "Based on discussion with TIAA-CREF and other investors, Amgen … provided investors with the ability to comment on its compensation program directly to the compensation committee of Amgen's board. When investors and companies collaborate cooperatively, we can achieve outcomes that further the long-term interests of all shareholders."[12]

And some do see progress. Vanguard chairman emeritus John Brennan, for example, notes, "One of the most significant changes I've observed over the past two and a half decades has been a great attitudinal shift in boards away from doing what is right for the insiders to doing what is right for the investors. Importantly, this cultural change has been driven by board members themselves."[13]

[12] Roger W. Ferguson, "Riding Herd on Company Management."
[13] John J. Brennan, "Improving Corporate Governance: A Memo to the Board," *Wall Street Journal*, May 10, 2010.

Several real and perceived challenges stand in the way of progress

There are substantial differences among institutional investors' 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 Investors," commissioned by the IRRC Institute and conducted by Institutional Investor 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."[14]

One director said, *"I never considered that sitting across the table from investors would be a bad thing. Even if you disagreed, you gained a mutual respect, and there were a lot of things that we could learn from each other."* However, participants acknowledged that *"there is no one-size fits all approach"* to board-shareholder engagement, and companies and investors may have to overcome some significant practical concerns that prevent directors and investors from communicating more effectively. These include:

- **Lack of resources**. Investors acknowledged that it would be ideal to personally get to know the boards of the companies in which they invest, but resources constraints make that impossible. One investor commented, *"It's a real challenge meeting board members in person. Consider all of the companies that we have significant investments in: it is impossible to meet 50,000 people that sit on all of those boards."* Another said, *"We vote for names on paper. We have a database and some institutional knowledge, but our resources are limited."*
- **Director liability.** Many directors fear violating Regulation Fair Disclosure, which requires that disclosure of material information be made to all shareholders at the same time. But one director said that this is just an excuse: *"Boards use Reg FD as a crutch that prevents directors from talking to investors."* Regulators have made it clear that directors and investors should be talking to one another: SEC chair Mary Schapiro has insisted that "Regulation FD does not restrict communications between companies and their investors" nor does it "prevent companies from seeking out and listening to the views of investors."[15]
- **Regulatory creep.** The UK Stewardship Code, issued in 2010 by the Financial Reporting Council, has prompted some large institutional investors to take a more activist role in their investments. David Paterson, head of corporate governance at the National Association of Pension Funds, said, "The code has focused investors' minds on issues which they were familiar with but which they were perhaps not addressing so directly as they should do … There's pressure on the asset managers, who are responsible for the day-to-day activity to be seen to be doing more."[16] One investor remarked, *"What's happening in Europe is a major problem for governance here in the US. If investors are obligated to become activists in their companies, that could potentially translate over here. We don't want to be activists."*

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

[15] Deborah Gilshan and Elizabeth McGeveran, "The Fifth Analyst Call: Investors Seek Greater Communication with Directors," *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), March 20, 2011.

[16] Peter Bartram, "Activist Investors Raise Their Heads Once Again."

- **Board lack of interest in engagement.** A director said, *"On my boards, I am the Lone Ranger when it comes to board-investor engagement. I am viewed as an outlier [for expressing an interest in more engagement]."*

Productive engagement requires a new mind-set, new practices, and new protocols

Participants at the April meeting outlined three important changes that need to be made to enhance board-investor engagement and ultimately create more long-term value for public companies and their owners: a change in mind-set, a new set of principles to guide engagement, and a set of protocols by which boards and investors engage.

A change in mind-set on the part of the board and management

Directors and investors at the meeting said they care deeply about effective governance, and were in favor of changing their relationship dynamic. They would like to move away from the current confrontational relationship, in which directors feel threatened and investors feel denied a sufficiently clear view into the companies they own, and toward greater collaboration.

One director said that some directors mistrust investors' motives in calling for more direct engagement: *"Some directors think that investors are going to come in and superimpose their judgment on us. If the investors are simply there to understand our processes, that is entirely different from what is believed on some boards."* One research participant described what a change in mind-set would require: *"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]."*

Directors observed that management's aversion to increased board dialogue with investors can also present an obstacle. One director commented, *"If you have an entrenched management, the CEO and GC have enormous power and can be an impediment to engaging with investors."*

A new set of principles

Directors and investors said that boards and investors also need a new set of principles to guide engagement. Participants discussed several suggestions:

- **The board should have a lead role in communication with investors.** One investor said, *"Our philosophy is that we elect directors and directors select management; but the communication is mostly done by the CEO. I don't think directors understand how to talk to investors."* Another investor said, *"In a real sense, we have delegated [shareholder] relations to management. Why? Are we meeting fiduciary duty if we delegate owner relations to management? That's a damning, provocative question."*
- **Engagement should be proactive and frequent.** Directors and investors agreed that their interactions need not be burdensome, but there should be more early, and more open communication. A director said, *"To the extent that I as a board member have a greater understanding of the questions and concerns of investors, I'd be a better board member."* Another director remarked, *"Engagement should be early, and not only around a specific issue.*

Early, open, and proactive." Investors agreed; one said, *"We need to lay the groundwork for the development of a trusting relationship. That starts with early, open communication."*

- **Directors should be fully informed.** Directors and investors acknowledged directors' obligation to understand the concerns of all their shareholders, recognizing the heterogeneity among them. One investor remarked, *"I have a couple of questions for directors: (1) Do you know who your top 10 investors are? (2) Do you know what their proxy policies are? The policies of your major investors won't all be identical, but they rhyme. Directors could go a long way in educating themselves."*
- **There should be less communication through intermediaries.** Directors are interested in speaking directly with owners rather than through intermediaries like proxy advisers. One director said, *"I am very concerned about the intermediaries and the influence they have. I have found it wholly uninformative when I talk to proxy advisory firms, but when I speak with investors, I find it very informative."* Investors are also wary of the influence of proxy advisory firms: *"A lot of investors have blindly outsourced [communication with the board] to proxy advisory firms. Frankly, [proxy advisers] have a very rules-based approach that does not reflect the nuanced approach that investors need to take."*
- **There should be a strong commitment to act in the long-term interests of the institution.** Directors and investors said that the investor community is not homogeneous, and oftentimes short-term and fringe investors have the loudest voices and obscure the interests of long-term investors. As one investor said, *"I'm the long-term investor, but the owner who buys a 5% stake for six months – the guy who is passing by – gets disproportionate attention."* A director remarked, *"It's the fringe that has the loudest voice and drives the public agenda. And that's a problem: look at compensation. Some investors get bent out of shape when they see them, and directors are viewed as enablers of these decisions."*

Issues to tackle in a board-shareholder dialogue

The specific focus of engagement between directors and investors could include traditional corporate governance and executive compensation issues, but could also focus on the major areas where the board plays a critical role: corporate strategy and succession planning, the quality of the board, and risk oversight.

- **Strategy and succession planning.** Several participants said that, ultimately, board-investor engagement must touch on issues driving long-term corporate performance, including the firm's strategy and management succession plan. An investor asked, *"What is the process by which you develop a talent pool? This is very important."* For their part, directors said they can offer investors a better view into the company's strategy and succession plan: *"The most important role that the board plays is to agree on the strategy and ensure that we have the right team … If investors had a question about strategy and talent, directors could share information about that with them."*

Issues to tackle in a board-shareholder dialogue *(continued)*

- **The quality of the board.** An investor remarked, *"We want to know that there is a good governance process in place."* Another said, *"Directors, at the start, get the benefit of the doubt. We then look at (1) is the director engaged? It is a real concern if you miss 60% of meetings, no matter the circumstances. And (2) is the director truly independent? There is no substitute for a truly independent director."*

- **Board oversight of risk management.** Investors also agreed that they would like more insight into specific governance issues, including risk oversight. One said, *"We can vote against the audit committee if the numbers are all out of whack, or against the risk committee if there was an obvious mistake."* More comprehensive, frequent dialogue could allow boards and investors to avoid contentious battles on hot-button issues such as executive compensation, as well.

An emerging set of protocols for engagement

One director said, *"We are marching toward the inevitable – greater communication between boards and investors – and what we need is a new set of protocols by which boards and investors can engage and communicate."* Participants suggested that there is an emerging menu of engagement options that directors and investors can choose from. While these options may not be perfect, participants suggested that experimenting with them would allow directors and investors to identify the challenges and overcome them.

In addition, as one director noted, the increased dialogue may yield unforeseen benefits. One director gave an example: *"In conversations with investors, we mentioned that we are in a director search. The investors gave us five names of potential directors, one of whom we are moving forward in our recruitment process. That's the way engagement should take place. And the board should ask, 'What do you want to know from the board?'"*

Participants' ideas for engagement include the following:

- **Fifth analyst calls.** In April 2011, Occidental Petroleum Corporation won plaudits from investors when it hosted a fifth analyst call – that is, a call, hosted jointly by the company and a large investor, which includes at least one director. Deborah Gilshan, corporate governance counsel for Railpen Investments, a London-based pension fund, said, "The point here is about board accountability. You get a better understanding of the board's oversight approach when the message isn't filtered by management."[17] Observers have noted that fifth analyst calls could be improved through more transparency; Occidental Petroleum's fifth analyst call, for example, was marred by the fact that the company "did not publicly announce the event in a news release, an SEC filing or anywhere on its IR website. And access to the call itself was not made available to the public via a call-in number or webcast."[18]

- **Shareholder board meeting days.** One investor said, *"I'd suggest we have an owners meeting, led by board. If investors don't come, they lose the right to complain. It's not a*

[17] John R. Engen, "Communicating with Shareholders," *Corporate Board Member*, February 28, 2012.
[18] Dominic Jones, "Did OXY's 'Fifth Analyst Call' Violate Reg FD?" *IR Web Report*, April 27, 2011.

perfunctory thing. We want something different – a more substantive investor day." A director agreed: *"Why is there no 'board day' with the investors?"*

- **Board visits to major shareholders.** An investor commented, *"At one company, the entire board traveled around doing a road show and meeting with their top investors."*
- **Informal meetings with key investors.** One investor remarked, *"One major public company hosts a cocktail party with members of the board and major investors every year. It's a good way to get to know the people on the board in a social setting."*
- **Investor meetings with board committees.** One investor reported, *"We met with the entire audit committee at one company to talk about a series of issues. We got value out of the discussion; we saw how they approached certain issues."*
- **Virtual shareholder meetings.** Intel and Best Buy are among US companies that have held virtual shareholder meetings (VSM). Assessing VSMs, *Directorship* magazine notes, "Unlike webcasts, which are available to the public, [the VSM] offers the ability to verify attendance and provides an interactive element that allows for real-time voting in a secure environment. The VSM also enables two-way engagement, allowing investors to ask questions of corporate officers and directors."[19]
- **Shareholder relations committees of the board**. John Brennan, chairman emeritus of Vanguard, wrote, "Similar to the compensation or audit committee, a group of directors should be charged with engaging the company's serious, long-term stockholders on a regular, meaningful and candid basis. Think about it: If you had only one owner of a private company, the board would be in contact constantly. Why not take the same approach, especially with your best investors who have been, and will be, with you through good times and bad."[20]

Conclusion

Non-executive directors and leaders from large investing institutions agree that the time for enhanced engagement between their two constituencies is at hand. Current mechanisms have failed to address the problems of entrenched, adversarial relationships and a lack of clarity regarding how each party makes decisions. Directors and investors at the April meeting were in favor of proactive, regular, and frequent engagement, which they felt would result in win-win scenarios. The challenges are significant: management wariness of such engagement, concerns about Reg FD, and the influence of short-term investors, among others. But directors and investors are interested in *"challenging each other,"* as one director said, with the goal of enhancing board-investor relations. As one director said, *"People will be getting out of their comfort zone … but it is important that the dialogue continues."* An investor commented, *"Owners want more openness from and engagement with the stewards. And, today is just the beginning of investor demands on the board – they will only get more intense."* Investors and directors who participated in the meeting and in the series of dialogues preceding it stressed the need to continue and broaden the dialogue, with an eye toward making real change in their relationship and forging real progress in effective governance.

[19] Judy Warner, "A Virtual Annual Meeting Approach," *NACD Directorship*, February 16, 2012.
[20] John J. Brennan, "Improving Corporate Governance: a Memo to the Board."

About this document

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting investors, board members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* may share it with those in their own network. The more investors, board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

Appendix: Participants

The following board directors and institutional investors participated in the April 26 meeting:

- Les Brun, Director, Automatic Data Processing, Broadridge Financial Solutions, and Merck
- Jon Feigelson, General Counsel, TIAA-CREF
- Bonnie Hill, Director, AK Steel Corporation, California Water Service Group, Home Depot, and Yum! Brands
- Shawn Johnson, Investment Committee Chairman, State Street Global Advisors
- Rich Kushel, Head of Portfolio Management, BlackRock
- Linda Fayne Levinson, Director, Hertz, Ingram Micro, Jacobs Engineering Group, NCR, and Western Union
- Eileen Mercier, Chairman, Ontario Teachers' Pension Plan; Director, CGI Group, Teekay Shipping, Intact Financial, and ING
- Thomas O'Neill, Director, Archer Daniels Midland, Nasdaq, and Misonix
- Richard Roedel, Director, Brightpoint, IHS, Lorillard, Luna, Sealy, and Six Flags

The following institutional investors and advisers participated in discussions that informed the white paper "A Key Moment to improve Board-shareholder Engagement."

- Janice Hester Amey, Portfolio Manager, California State Teachers' Retirement System (CalSTRS)
- Donna Anderson, Global Corporate Governance Analyst, T. Rowe Price Group
- Brandon Becker, Chief Legal Officer, TIAA-CREF
- George Dallas, Director of Corporate Governance, F&C Investments
- Richard Daly, Chief Executive Officer, Broadridge Financial Solutions
- 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
- Muir Paterson, Director of Corporate Governance, Wellington Management Company
- 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.