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FOR CORPORATE GOVERNANCE AND PERFORMANCE

**WORKING DRAFT – FOR PUBLIC COMMENT**

POLICY BRIEFING NO. 2

# Talking Governance

## Board-Shareowner Communications on Executive Compensation

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This draft policy briefing is being released for public comment

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## EXECUTIVE SUMMARY

Advantages stemming from board-shareowner communications on governance and executive pay outweigh the potential risks and costs of such dialogue. Regulation FD in the US should be seen as a caution rather than a barrier to such communication. Prompted by universal adoption of advisory 'say on pay' resolutions, UK companies have moved to integrate regular engagement with domestic investors into the annual process of framing corporate remuneration policies. Most US companies have not fully endeavored to engage their shareowners in the same manner, but some—motivated sometimes by crises—are experimenting with various models of dialogue. Companies can best manage effective engagement when they provide shareowners with access to appropriate board directors and other governance personnel. Likewise, institutional investors need to develop internal coherence between their fund managers and governance professionals to enhance their capacity to engage with corporate boards and executives on governance and executive compensation. Companies that are successful credit communication programs with improvements in investor loyalty as demonstrated by fewer instances of confrontation.

## 1. INTRODUCTION

The Millstein Center's mission is to serve as a vital contributor to the growing architecture of international corporate governance. The Center sponsors research, hosts conferences, generates global databases, designs training and publishes Policy Briefings on emerging corporate governance policy issues. *Talking Governance: Board Shareowner Communications on Executive Compensation* is the second installment in a series of Policy Briefings designed to assist policymaking.

Millstein Center Policy Briefings are framed as think tank reports rather than scholarly research. They include original material and policy analysis in a concise format. Reports serve both as pointers to further detailed empirical research and as a resource for market practitioners.

Re-energized by the proliferation of "say on pay" proposals calling for an advisory vote on executive compensation and guidance from recent regulatory reform, shareowners and boards are actively debating the need for better dialogue on company-specific governance matters. Despite this call for action, there has been very little analysis focused on the practical application of board-shareowner communication models. Through this report the Millstein Center, supported by Deloitte & Touche LLP[1], sought to explore the constraints, risks, benefits and sustained commitments by investors and boards to engage one another in substantive dialogue.

The findings of this report are principally based on research performed over a six-month period. This research included:

1. In depth reviews of historical research and media reports
2. Individual and group interviews with:
    a. Directors
    b. Corporate management
    c. Institutional investors
    d. Retail investors
    e. Professional advisors
    f. Other governance professionals

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## 2. FINDINGS OF THE INQUIRY

**Sustained, two-way dialogue between boards and shareholders is rare in the United States.**

Enthusiasm for better board-shareholder communications displayed by a select group of companies and investors has indicated there is a willingness to engage one another in two-way dialogue. However, anecdotal evidence obtained through a series of interviews conducted by the Millstein Center suggests that current communications are focused on corporate managers regularly conversing with buy-side portfolio managers. There is very little evidence suggesting that boards and shareholders are regularly engaging one another in sustained two-way dialogue on governance matters.

**There is no insurmountable legal obstacle to boards and shareowners engaging in constructive dialogue on governance matters, including executive pay policies.**

Resistance to two-way dialogue on governance between directors and investors at US corporations has often centered on concern that the Securities and Exchange Commission (SEC)'s Regulation Fair Disclosure ("Reg FD") is a barrier. The argument is that directors risk disclosing matters of material interest to the market to a select group of shareowners rather than the market as a whole. However, guidance reviewed in this report has affirmed to boards that have initiated dialogue that Reg FD is a caution, not a barricade.

Certain companies and investors have proven successful in respecting legal constraints while engaging in constructive communication on a host of topics. The formula involves supplying advice to participating board members and investors, or developing a charter to govern discussions.

**Regulators would likely find broad support for an initiative to develop a market-wide safe harbor for board-shareowner communications.**

Companies motivated to engage in dialogue with their investors have commissioned in-house or outside counsel to provide bespoke legal advice on the frameworks and constraints affecting such initiatives. Advice often affirmed that neither Reg FD nor other regulatory barriers prevent communication. However, companies have had to shoulder a cost burden to produce custom legal guidance.

Costs could diminish if the SEC were to issue market-wide guidance affirming circumstances under which board dialogue with shareowners on governance issues gain a safe harbor from risks of sanction or litigation under Reg FD. Such a revision would embody the logic of the rule. Regulation FD was created to prevent companies from selectively disclosing non-public, material information in a private setting. It does not appear to have been the intention of the Commission to restrict private meetings with investors to review governance matters. Interpretative guidance could place the SEC in a position of leadership in improving communication between investors and the companies they co-own.

**Investor and corporate officials identify concrete and significant advantages from board-shareowner communications that, they assert, outweigh potential risks and costs of dialogue.**

Companies and investors putting forth the effort of engaging in two-way dialogue and participating in such endeavors have identified concrete value in such exercises. Moreover, they cite practical solutions they developed to mitigate risks and costs. A concern over certain board-shareholder communication efforts is the increase in shareholder influence over the basic business decisions of boards of directors.[2] Companies interviewed by the Millstein Center have taken great measures to ensure the models used in their communication efforts respect the defined role of the board and shareholders and are, therefore, focused more on promoting an alignment of interests rather than a struggle for power.

Additionally, the following advantages commonly resonate among those engaging in dialogue:

- Minimizing the use of shareholder resolutions as means of encouraging dialogue
- Humanizing the board, management and shareholders
- Gaining greater clarity with respect to the company's long-term objectives
- Creating an understanding of the shareholder's interests in the long-term objectives
- Garnering goodwill and trust from shareowners

Companies have commented on the benefit of boards acting as a "listening post" even if simply to hear shareholder concerns.

**Constructive director-shareowner dialogue on governance hinges for both investing institutions and corporate boards on three features: high-level commitment, resources and informed strategies.**

Communication between boards and shareowners has been tainted by mirror stereotypes. Companies and boards, for their part, see certain individual investors as gadflies more interested in becoming the center of attention at the annual shareholders meeting rather than raising substantive topics for discussion. They identify others, notably certain hedge funds, as falsely projecting an image of good stewardship in an effort to glean inside information so as to profit in the short term. And they perceive some big conventional institutional investors as fielding substandard representatives in communication exercises. On the other hand, governance professionals at investing institutions often take the view that invitations to corporate road shows represent public relations events staged solely for good publicity and not for the purpose of engaging in substantive two-way dialogue on governance issues.

Whatever the preferred method of communication may be, a common concern cited by companies and investors was the necessity for both parties to make available the appropriate personnel when discussing the issue at hand. Considering the variety of shareholder concerns are diverse, ranging from key governance issues to political disclosure, they require varying degrees of expertise, a well defined strategy and a high-level of commitment to address them appropriately and to the satisfaction of both parties.

**Compulsion, through crisis or other acute events, is the foundation under most current US corporate initiatives to foster governance dialogues with institutional owners.**

Evidence suggests that scandals over executive compensation3 – whether payouts for failure or backdating stock options – were key contributors in 2007 in motivating certain boards to increase their interaction with shareowners. Exercises in board dialogue on governance have generally not come about in the United States as a product of proactive, long-term strategic outreach by untroubled corporations. This reality has contributed to growing investor conviction that regular dialogue will not spread widely in the absence of compulsion, even where companies are troubled. As a result, many funds

2 Martin Lipton, "Directors Face to Face Meetings with Institutional Investors on Corporate Governance Policies and Practices." June 28, 2007.

3 See, for instance, USA Today, *Home Depot shareholders blast CEO over pay; Nardelli cuts criticism short*, May 25, 2006.

back a UK-style annual advisory vote on executive pay policies, a measure that helped open channels of communication between UK boards and their equity owners.

**There are no common best practices for board-shareowner communications on governance and executive pay. Companies and investors continue to experiment with various methods of interaction.**

The Sarbanes-Oxley Act of 2002, SEC proxy amendments, and stock exchanges have all provided guidance focused on the intention of making boards and management more accessible to shareholders.

A 2004 study published by a joint task force between the NACD and Council of Institutional Investors surmised through their research that boards want to be able to communicate with their shareholders.[4] The study also highlighted concerns that clear examples of how to achieve effective dialogue failed to exist. Since 2004, highly-publicized corporate efforts and a series of Millstein Center corporate and shareholder interviews suggest there is an increase in the experimentation on how best to engage one in constructive dialogue.

Pressure for boards to communicate with their shareholders is nothing new. In a 1992 article, Marty Lipton and Harvard Business School Professor Jay Lorsch called for US boards to "meet annually in an informal setting with 5 to 10 of the larger investors in the company."[5] Recent efforts seen on the behalf of companies and investors engaging in dialogue beyond the annual shareholder meetings have included the following models:

*Open invitation shareholder meetings:*

- In addition to the annual shareholder meeting, this gathering is open to all shareholders for the purpose of providing unfettered access to the board.

*Invitation only shareholder meetings:*

- A closed meeting, with invitations extended only to the company's largest institutional investors for purpose of discussing a defined agenda of governance topics with select management and board members.

*Formal shareholder advisory groups:*

- A small, select group of shareholders advising the board and management on one set topic. The composition and activities of the group are formalized through a published committee description.

*Informal shareholder advisory groups:*

- A small, informal gathering of select shareholders who regularly communicate with the company on a host of topics. This group is not convened for the purpose of discussing just one topic and is not governed by a published committee description.

*One-off responses to shareholder inquiries:*

- Responses, generally from management, to inquiries received from shareholders filed through the channels outlined in the company's proxy.

"There's been an unprecedented level of engagement between companies and shareholders" this year (referring to the 2007 proxy season), noted Richard Ferlauto, director of corporate governance and pension investment at the American Federation of State, County, and Municipal Employees (AFSCME). "Engagement is now part of the landscape."[6]

**Without processes for open board-shareowner dialogue, public markets may face unnecessary costs and burdens.**

Entrenched cultural habits in public markets appear to drive owners and companies apart even though enterprise may prosper best when the two parties are fully aligned as they are in private equity arrangements. Some funds, for instance, say they are compelled to file shareowner resolutions as a "knock on the door" at companies which are considered otherwise to ignore an institution's voice on governance. In 2007, investors filed approximately 1,145 resolutions only to withdraw more than 300 of them as of September 15th. This was a significant increase from the prior year in which 189 of the 947 resolutions were withdrawn during the same period.[7] It is not an uncommon practice for investors to file a resolution, making their intention known of withdrawing it if the company will simply engage in dialogue and demonstrate a commitment to addressing the issue in question. These figures would suggest that practice is becoming more prevalent.

Without a further alignment of interests between shareown-

4 The National Association of Corporate Directors and The Council of Institutional Investors, *Framework and Tolls for Improving Board-Shareowner Communications,* (2004).

5 *Global Proxy Watch* Vol. XI No.42.

6 RiskMetrics 2007 Post Season Report.

7 Id.

ers, management and boards, hostility between parties can saddle investors and public company boards with burdensome costs and risks, including the possibility of the share price not reflecting the full value potential of the company over time.

**Companies currently tend to focus board-shareowner communication efforts on larger institutional investors despite developments which suggest the potential rising influence of retail investors.**

Based on Millstein Center interviews, most companies focus on inviting only their largest shareowners into a governance dialogue process with their boards. Reasons corporate executives give for this focus on the top tier include:

- the ease of identifying the largest shareholders
- their willingness to meet with the company
- the likelihood of larger shareholders having the resources and expertise to address the issues
- the likelihood of being more focused on the long-term

However, there is a rising potential in the power of grassroots campaigns launched by retail investors, as has been seen recently at Yahoo and Motorola. In a recent speech Louis Thomson Jr., former head of the US National Investor Relations Institute, discussed the proliferation of the internet giving rise to the influence of the retail investor. He goes on to explain this is particularly evident in mid-cap companies where there is a larger percentage of individual investors.[8] Add the SEC's recent proxy rule amendments[9] which are expected to open avenues for real-time communications among investors and with boards and it may become more crucial to consider all shareowners, not just the largest.

**An institutional investor may be best equipped to assume the role of effective interlocutor when there is coherence between the portfolio management and governance functions of the organization.**

The benefits of dialogue are realized when it occurs among qualified representatives that display a mutual understanding of the subject matter and, on the investor side, when there is a healthy interchange between analysts and governance professionals in the fund organization. Many investment firms divide the two disciplines into silos with little inter-relationship, prompting companies to complain of hearing mixed messages. Either portfolio managers fail to raise governance concerns in dialogue with corporate executives, or governance professionals enter into discussions with insufficient standing relative to money managers within their own institutions. Some institutional investors are at work on ways to build greater synergy between work done by portfolio analysts and governance professionals to most effectively engage companies in dialogue.

Refer to FAQ #4 for a series of tests that may be helpful in determining the capacity of a fund to be an effective partner in dialogue on corporate governance.

**UK companies see the advisory vote on pay as having catalyzed dialogue with shareowners. Boards commonly integrate such dialogue into an annual process framed to produce corporate remuneration policy and the board compensation report. Nascent US practice, by contrast, is based on 'vote first, consult later.'**

UK corporations typically choose between several dialogue models, including a combination of individual shareowner outreach efforts and annual invitation-only gatherings with large institutional investors. Whichever the preferred approach, the process of outreach to shareowners is ingrained in the board's drafting of the executive remuneration report, so much so that UK companies often coordinate their shareowner dialogue with the development of the report. This consultative process appears to be very different from the expected US approach of vote first, consult later.

UK board-shareowner dialogue is not without its challenges both unique to and shared with those faced by US boards and shareowners.

- The shareowner base of UK companies is geographically diverse, often including a significant portion of international ownership. According to a study conducted by the UK's Office of National Statistics[10], 40% of all shares were held internationally as of December 31, 2006, an increase of more than 11% from 2004. Foreign ownership can be far

8 Louis Thompson, Jr., *Shareholder Communications in an E-Proxy World"*, Speech to NIRI Cleveland/Northern Ohio Chapter May 3, 2007.

9 http://www.sec.gov/news/press/2007/2007-247.htm
http://www.sec.gov/rules/final/2008/34-57172.pdf

10 www.statistics.gov.uk/cci/nugget.asp?id=107

higher at specific companies. Yet typical board-shareowner dialogue on governance tends to be limited almost exclusively to domestic investors. This challenges companies on not only how to reach their shareowners, but also on how to address cultural and legal differences unique to the shareowner's country of residence.

- Resource constraints continue to be a common obstacle to board-shareowner communications. Companies often adopt a communications model relative to their available resources. A lack of devoted resources may result in inconsistency or singular point-in-time communications rather than ongoing dialogue that may be more beneficial in addressing issues in real-time.
- Communication gaps exist within investor organizations. Institutions risk conveying mixed messages in dialogue with boards, so some are addressing models of integrating governance and investment analysis. Refer to FAQ #4 for further detail.

## 3. FREQUENTLY ASKED QUESTIONS ABOUT BOARD-SHAREOWNER COMMUNICATIONS

*1. Has there been a notable increase in board-shareowner communications on governance and executive compensation in the United States?*

- Not really. Millstein Center interviews, regulatory changes, recent studies on board and investor activities, media reports and corporate responses to shareowner proposals all point to enthusiasm and mutual interest for dialogue between boards and shareowners. But there is so far little empirical evidence suggesting sustained engagement between boards and shareowners on governance topics. Rather, communications more often take place between corporate managers and buy-side portfolio analysts, who may or may not be familiar with governance topics.
- Anecdotal data gathered in Millstein Center interviews hint at sporadic progress in developing channels of dialogue. Several institutional investors, for instance, indicated that they are progressively experiencing a higher rate of success in convening meetings with companies on governance matters compared to prior years.
- Investors are demonstrating rising appetite for dialogue, judging by the upward trend in the volume of shareholder resolutions they have submitted to corporations.
    - There were 1,145 resolutions filed in the 2007 proxy season, an increase of 198 over the 947 filed in the previous year.[11]
    - CalPERS alone doubled its proposals from 2006 to 2007.[12]

  However, US funds may initiate proposals for the express purpose of triggering discussion with the board regarding a particular topic. This is evidenced by a marked increase in withdrawn resolutions – 189 in 2006 to more than 300 in 2007.[13] An amicable agreement between petitioners and companies may be an increasingly common result of shareholder proposals.
- Institutional investors are showing sustained interest in having a role in executive compensation. Some 80 shar-

11 RiskMetrics 2007 Post Season Report.

12 August 13, 2007 Press Release, CalPERS Steps Up Pace of Shareowner Activism, http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-2007/aug/steps-up-shareowner-activism.xml

13 RiskMetrics 2007 Post Season Report.

eowner proposals advocating 'Say on Pay' have been submitted in the 2008 proxy season.[14] This is more than double of those filed in the previous year. So far vote results point to steady support in the 40-50% range. A handful of companies have voluntarily adopted the practice.

- Recent regulatory changes, particularly the SEC's February 25, 2008 proxy rule amendments removing legal ambiguity for shareowners and companies engaging in electronic communications, may open doors for constructive dialogue.
- Companies, labor organizations, institutional investors and corporate governance advocates have endorsed market-based initiatives that advocate dialogue. For instance, many signed on to the Aspen Principles, which favor effective communications between boards and shareholders.[15] The Principles also call for an alignment of long-term interests between investors and boards on executive compensation. The Committee on Capital Markets Regulation, chaired by Hal Scott, drew broad support behind its recommendation that boards consult with shareowners on governance matters, including executive compensation. The National Association of Corporate Directors has also launched a blue ribbon commission to explore ways of promoting board-shareowner communication.
- A recent study (Eritimur, Ferri & Stubben) finds a dramatic increase in companies adopting shareholder proposals that received a majority vote. [16] The study implies that this increase is not due to new or changing shareholder proposals or increased activism, but rather a shift in the governance environment made manifest by increasing willingness of boards to address shareowner concerns. We are clearly in an era of experimentation as boards and shareholders continue to practice and express interest in dialoguing with one another.

2. *Do companies and boards face a risk of breaching the SEC's Regulation FD if they engage in governance communications with investors?*

- While not without risk, boards and investors have devised practical methods to engage one another in dialogue on executive compensation and other governance matters without breaching Reg FD. Companies are of course, encouraged to seek legal counsel to devise appropriate controls and address specific facts and circumstances associated with Reg FD.
- According to the SEC's Written Statement, "Reg FD does not apply to ordinary course business communications"[17], which may reasonably include corporate governance matters.
- Reg FD was not intended to prohibit boards and investors from engaging in private dialogue, rather it was created to promote fair and balanced communications to all shareholders. "[Reg FD] was an end to quiet whispers about earnings that helped large investors, but left individual investors on the curb", stated Brian Lane, former director of the SEC's Division of Corporate Finance.[18]
- Noted by one company during an interview with the Millstein Center, "Our discussions with shareholders concerning corporate governance do not touch on financial or earnings metrics. We simply do not discuss any material non-public information during such communications, and we generally comment to that effect at the outset of our discussions. We also typically have counsel present during the discussions." Investors made similar statements, establishing the understanding that they will only discuss publicly available information and will not trade on the basis of the discussion. Some investors who communicate on governance issues will take the added precaution of establishing policy of not communicating with their trade desk.
- Gary Brown, head of the corporate department at the law firm Baker, Donelson, Bearman, Caldwell & Berkowitz comments, "executives…have to make sure they don't say anything that could move the stock…"[19]
- Reg FD is enforceable only by the SEC, furthermore, a Reg FD violation and a subsequent failure to publicly disclose by the issuer does not breach the general antifraud rule and

14 http://blog.riskmetrics.com/2008/05/, U.S. Midseason Review

15 The Aspen Institute, *Long-Term Value Creation: Guiding Principles for Corporations and Investors*, June 2007. Principle #2 states: "Focus Corporate-Investor Communication Around Long-Term Metrics."

16 Ertimur, Ferri and Stubben, "*Board of Directors' Responsiveness to Shareholders: Evidence from Shareholder Proposals,* 2007

17 Securities and Exchange Commission, *Written Statement Concerning Regulation Fair Disclosure*, May 17, 2001. http://www.sec.gov/news/testimony/051701wssec.htm

18 Compliance Week, *Best Practices for Talking Under Reg FD*, February 26, 2008

19 Id.

therefore, does not create a private right of action.[20] Thus, plaintiffs cannot use a Reg FD violation as a basis for private securities fraud suits.

- Historical analysis by Reinhart Boerner Van Deuren S.C. shows that there have only been six enforcement actions pursued by the SEC since the rule's inception.[21] Two resulted in cease-and-desist orders by the SEC, three were settled, and the last was dismissed in September 2005 by the Southern District of New York, which stated that Reg FD was intended to promote dissemination of information and "overly aggressive" enforcement would undermine its purpose. As of the publication of this briefing, there is no public evidence to indicate any SEC enforcement or investigation related to companies that have explored progressive shareowner dialogue on executive compensation and other governance matters. In November 2008, Pfizer's directors and management met in a closed meeting with a select group of institutional investors to discuss corporate governance issues, including executive compensation.[22] There has been no hint from regulators that this initiative amounted to a breach in any securities regulation.

- Guidance prepared by corporations and reviewed for this report has sought to respect legal constraints while offering an effective framework for constructive dialogue between shareowners and boards on a host of corporate governance topics. Methods commonly practiced include:

  *Training*
  - Corporate counsel should provide training on the treatment of Reg FD to personnel and board members involved in communicating with investors.

  *Plan and supervise*
  - Consider having counsel present during communications with shareholders to advise on potential Reg FD issues.
  - Establish the understanding at the outset of the meeting that the discussion will stay within the bounds of allowable issues.
  - Set the agenda in advance of the meeting and if possible circulate it to the attending shareowners. This not only sets boundaries on allowable topics, but also may prompt attendees to better prepare for the dialogue.

  *Comprehensive policy*
  - Develop a sound Reg FD and communications policy. Continuously review, update and communicate it to company personnel, specifically those charged with taking the lead on external communications. Develop tailored guidelines that suit the specifics of a private meeting. See Appendix A for an example of policy used in practice.

  *Listening mode only*
  - Reg FD governs selective disclosure of undisclosed material information. It does not prohibit the act of listening and learning from shareowners.

3. *Are shareowners and companies ideally configured to engage in meaningful dialogue on governance and executive compensation? Are the right people talking to each other?*

- Companies are best equipped for dialogue if they are willing to field the appropriate board directors and other governance personnel capable of "hearing" and responding to shareowner concerns. Likewise, shareowners are best able to assess whether to support a company's change in strategy or governance if they are informed about and understand the company's plan.[23] This creates a unique challenge for shareowners and boards wishing to engage in constructive dialogue while achieving a unity of purpose between governance and value. Too often mismatches lead to breakdown or failed starts.

- To avoid mismatch, parties should pair the appropriate shareowner with the board representative(s) most responsible for the topic of discussion. In the same manner investor relations and/or the CEO would engage portfolio analysts in topics involving financial and operational performance, the compensation committee should engage investor governance professionals on topics involving executive compensation. A misalignment of these parties with topics may yield lackluster results for both. Example: during one meeting cited during research a company fielded their outside compensation consultants along with the investor relations team and various members of management. However, according to the investor interviewed, when presented with governance focused questions the company had difficulty responding.

- Constructive communication is not only contingent upon the right parties conversing with one another, but also

20 Reinhart Boerner Van Deuren S.C., *Information Memorandum Regulation Fair Disclosure No Bar to Shareholder-Director Communication,* December 2007

21 Reinhart Boerner Van Deuren S.C., *Information Memorandum Regulation Fair Disclosure No Bar to Shareholder-Director Communication,* December 2007

22 The Wall Street Journal, *Talk Therapy,* January 14, 2008

23 Ira Millstein in remarks to ALI-ABA, *Shareholders, Directors, and Management in Dialogue*, February 2008.

upon who at the company is driving outreach on executive compensation and why. In a chronic example of mismatching, one company interviewed for this briefing described a proactive attempt by its investor relations staff to reach out to shareowners on both earnings and governance related topics. Portfolio managers within fund institutions responded but governance professionals within the same organizations expressed little interest. The company used this as evidence that governance professionals are often unresponsive. However, Center interviews found that investor experts on governance assume that the company's investor relations unit primarily represents management rather than the board, and that it embodies an interest in promotion for stock trading purposes rather than a desire to test shareowner views on governance.

- Taking the time in advance to clarify the topics, define the purpose and identify the attendees of the meeting may go a long way in ensuring the appropriate parties are present to engage in constructive dialogue. "When we initiate dialogue," Said one investor, "it is incumbent upon us to be clear on the topics we wish to discuss. If all you want is an audience, you may end up with the wrong people".

4. *What should shareowners do to get the most out of dialogue with corporate boards?*

- US boards may now have powerful reasons to enter into productive dialogue with their shareowners. The default standard for most director elections is shifting from plurality to majority rule, at least for the largest public companies. As a result, shareowners are gaining the ability to oust underperforming directors. In addition, the New York Stock Exchange has proposed to abolish broker discretionary voting (NYSE Rule 452[24],) for the purpose of director elections. If ratified by the SEC, the change would eliminate a significant block of pro-management votes from election totals—amplifying investors' influence over director ballots. While this emerging electoral vulnerability may be one of the many inspirations behind board outreach to shareowners, the question remains, with whom should the board communicate?
- The investment and governance functions of investor organizations have historically served two separate and distinct purposes, the first to drive the investment decisions and the latter to exercise votes and perform other stewardship responsibilities on behalf of the beneficial owners, among others. Until recently, companies would most commonly communicate with fund managers on financial and operational performance to influence buy, hold or sell decisions. Neither managers nor boards had much practice in engagement with governance professionals who cast their votes on issues often outside the scope of trading decisions. According to interviews and roundtables conducted by the Millstein Center in conjunction with this briefing, companies often seemed unaware that such a split exists in investing institutions.
- It was not uncommon to hear during the Millstein Center interviews that a company that thought it was communicating effectively on a specific topic would subsequently receive a shareholder resolution from the very institutional investor with whom they had engaged in dialogue. This occurrence was seemingly a result of the company speaking with the investment manager rather than the governance professional who presumably initiated the resolution.
- Some US and UK based institutional investors who see corporate governance as a value to their financial interests have acknowledged the risk of internal incoherence that can result from bifurcated duties. These firms have taken measures to coordinate their investment and governance functions in efforts to marry the financial expertise of the fund managers with the risk knowledge of governance professionals. This integration is seen to enhance their capacity to effectively engage with corporate boards and executives on a wide spectrum of topics, including governance and executive remuneration. They can speak with one voice. Corporate boards, for their part, benefit from this coherence by communicating with one team.
- Paul Myners, Chairman of the UK Personal Accounts Delivery Authority and Guardian Media Group and author of principles of fund governance, worked with the Millstein Center in April 2008 to frame a series of original questions designed to benchmark the capacity of an institutional investor to undertake communication with boards on governance with maximum coherence. [25]

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24 NYSE Rule 452 allows brokers to vote on certain "routine" proposals if voting instructions have not been provided by the beneficial owner of the stock to the broker at least 10 days prior to a scheduled meeting.

25 Questions posed by Paul Myners, Chairman, Personal Accounts Delivery Authority and Guardian Media Group, during a roundtable workshop held in London and conducted by the Millstein Center in April 2008

**MYNERS TESTS FOR FUND STEWARDSHIP COHERENCE**

- Do governance professionals participate in meetings that determine the institution's key investment decisions?
- Do analyses addressing governance risk form an important factor in determining the outcome of the institution's investment decisions?
- Do governance professionals and fund managers within the same institution advise each other of all contacts with portfolio companies and afford each other the opportunity either to advise colleagues on issues or to participate in the meetings?
- Is there a high degree of confidence that fund managers, having been advised of governance risks at a portfolio company, will pursue the matter as an integral part of meetings with portfolio companies?
- Do both fund managers and governance professionals have unfettered and reasonable access to the investing institution's chief investment officer and chief executive?
- Is governance a featured element in the way the investment company describes itself to the market?

5. *When boards engage in dialogue with shareowners over governance, do they cede power to current investors over decisions properly the responsibility of directors?*

- According to the Organisation for Economic Co-operation and Development, corporate governance is a system of checks and balances or a set of relationships between the board, management and its shareowners that produces an efficiently functioning organization.
- Boards that have sought the advice of shareholders on governance topics indicated in Millstein interviews that the process enhanced board authority and credibility. However, to protect against any perception of delegation of power to investors, some took steps to underscore the informational nature of the meetings with shareowners. For example, in designing its nominating advisory committee for nominating directors, UnitedHealth devised a committee description clearly stating that service on this committee does not establish a fiduciary relationship to the company or shareholders. It goes on to further explain that:
    - "All viewpoints expressed in the advisory committee are advisory in nature only and the nominating committee and board…are under no obligation to follow any such viewpoints".[26]

6. *What are advantages and disadvantages for boards and shareowners when they talk to each other?*

- Boards and investors have identified common advantages from engaging in constructive dialogue. The most common benefit cited in Millstein interviews was, the opportunity to gain greater understanding and clarity on each other's positions on corporate governance practices, executive compensation, shareholder resolutions or investor voting decisions. In-person, in-depth discussions appear to yield insights as to motives, behavior and strategy not typically available in exchanges of public statements.
- Boards cite the potential to tap the latest investor thinking on governance and executive pay, and to gather ideas companies can consider. For instance, shareowners participating in one US corporation's advisory group on director selection have provided input on the characteristics ideally suited for board service in the company's industry. "We're listening more, and we want to be attuned to what our shareholders have in mind," explained a corporate official.[27]
- Other advantages commonly cited by companies and shareholders during the Millstein Center interviews included:
    - Minimizing the use of shareholder resolutions as a means of encouraging dialogue. US institutional investors may use challenge resolutions as means to provoke the company into dialogue related to a specific topic. These resolutions are often withdrawn if dialogue is achieved. Advocates of board-shareowner communication contend that proactive dialogue can reduce friction and, in particular, lower the risk of shareowners resorting to filing proposals.
    - Enhancing the prospect that shareowners will exercise independent judgment when deciding how to cast their votes at a company's annual meeting. Absent substantive reason to vote otherwise, investors often rely on the

26 UnitedHealth Group Nominating Advisory Committee Description, http://www.unitedhealthgroup.com/about/Advisory_Committee_Description.pdf

27 The Wall Street Journal, *Talk Therapy*, January 14, 2008

- recommendation of one or more proxy advisory services when making ballot decisions. One institutional investor stated during a recent Millstein Center roundtable, that on average they rely on proxy advisor recommendations for approximately 75% of their voting. Sustained communications may allow constructive dialogue on an issue that would otherwise be systematically determined based on a set of parameters. An informed investor, in other words, might vote 'yes' even when their proxy advisor counsels 'no.'
    - Building a base of investor goodwill and trust that in certain circumstances, namely crisis, a hostile takeover bid and hedge fund pressure, could be translated into crucial and timely support from shareowners. The adage 'cultivate friends for you never know when you might need then' comes into play.

- The most significant downside cited by companies and investors is the expenditure of resources required to engage in constructive dialogue. For companies, amounts hinge primarily on the degree of legal and other staff and director time allocated; the frequency of communication events; and the breadth of outreach. For investors, amounts depend on how many portfolio companies they agree to communicate with; how much research they require; and degree of staff engagement required.

7. *Should boards involve retail investors, not just institutional shareowners, when engaging in governance dialogue?*

- Boards have tended to focus on their institutional owners when entering into dialogue on governance matters. Reasons most commonly cited for this focus included:
    - The relative ease of identifying owners who are institutional investors, such as large mutual and public pension funds. Even this process is complex as changing capital markets bring in new and harder-to-identify investors. A 2007 study by McKinsey Global Institute suggests there is a shift in capital ownership from familiar domestic institutions to petrodollar investors, Asian banks, hedge funds and private equity.[28] By contrast, it is often far more difficult and expensive to contact retail owners.
    - The largest investors tend to have the resources and expertise to engage in substantive dialogue. An institutional investor who regularly participates in dialogue with the board commented, for instance, on the need for thorough preparation before each meeting. Individual investors are not always so well resourced.
    - An ability to discern the investment needs of institutions. Many large institutional investors have track records and publicly-known investment strategies including on matters of financial performance and corporate governance. Similar information is normally not available on retail investors.

- However, regulation, recent US SEC encouragement of online forums, coupled with the proliferation of social networking media, provide retail shareowners with new tools to exercise their voice. As such investors gain clout over time, the future of board-shareowner dialogue may have to address means to more regularly involve grassroots savers.

Recent history provides examples in which retail investors with minor holdings rallied enough support to affect significant change. Most notably was the movement against Yahoo started by Florida-based individual shareowner Eric Jackson. Through the use of social media such as Internet blogs, wiki tools and online polling. Jackson was able to garner enough support among other retail and institutional investors to trigger the eventual resignation of Yahoo's CEO.[29] Mr. Jackson owned 96 shares of Yahoo.

- Some companies are now exploring creative methods to reach their retail shareholders. In a recent initiative, Jeffrey Immelt, GE Chairman and CEO, took part in a webcast answering questions submitted by retail investors. The objective: to reach some two million shareowners not generally invited to meet with the company's management or board.

## 4. BOARD-SHAREOWNER DIALOGUE MODELS

US and UK companies and boards continue to experiment with various shareowner outreach methods, employing one or a combination of several aspects of the various dialogue models currently in use. No single model has emerged as the ideal or most advantageous, and each carries its own unique benefits in promoting and accomplishing effective board-shareowner dialogue. One consistent feature among the current models is the ability to position the company as a 'listening post' in an effort to hear shareowner concerns with the added potential for companies to leverage participants as a

28 McKinsey Global Institute, *The New Power Brokers: How Oil, Asia, Hedge Funds and Private Equity Are Shaping Global Capital Markets,* October 2007.

29 In a February 2008 interview, Eric Jackson claimed to have received 2.1 million shares pledged by other retail investors to support his initiative.
http://breakoutperformance.blogspot.com/2008/02/pbs-mediashift-gadfly-20-how-one.html

sounding board. Certain methods allow for a more focused discussion on a set of pre-defined topics while others promote an open format providing the opportunity for shareowners to table any topic of interest. Each also carries certain challenges, including the cost to implement and achieving representative selection of owners. Furthermore, there are features or motives that may serve to undermine the company's efforts. This happens when a company's program, for one reason or another, is interpreted as a public relations activity, or if the board creates an expectation for action and fails to follow through.

Finally, the underlying motive for dialogue is integral in setting the tone. It was clear from interviews conducted for this project that the model employed is not necessarily as important as demonstrating credible motivation for better communication with shareowners. Provided those efforts are evident, each of the models, even those born from an acute event, appear to have merit in accomplishing effective dialogue. As boards and shareowners continue to explore communication techniques on executive compensation and governance topics, methods will continue to evolve relative to the unique characteristics and available resources of companies wishing to converse with their shareowners.

The following matrix displays the models observed by the Millstein Center during interviews with companies and shareowners. Each model demands a different concentration of resources and many companies employ a combination of models that capture the unique characteristics of the various methods. The matrix was not meant to be all encompassing, but rather to serve in highlighting the models' predominant features, opportunities, risks and challenges.

| | Invitation only shareholder Meeting | Formal Shareholder Advisory Group | Informal Shareholder Advisory Group | Open invitation Shareholder Meeting | Individual Outreach and Responses | UK – Annual Integrated Approach |
|---|---|---|---|---|---|---|
| **Predominant Features** | | | | | | |
| Exclusive to the largest shareowners/institutional investors | • | • | • | | | • |
| Open to all shareowners | | | | • | • | |
| Attended by board, management & counsel | • | • | | • | | |
| Attended by management and/or counsel only | | | • | | • | • |
| Limited regularity of meetings | • | | | • | • | |
| Sustained regularity of meetings | | • | • | | | • |
| Communications are aligned with the drafting of the annual report | | | | | | • |
| Highly structured meeting with predetermined agenda | • | • | • | | | • |
| Primary focus on singular topic | | • | | | | • |
| Governed by a public charter or formal group description | | • | | | | |
| Open forum – no predetermined agenda or topics | | | | • | | |
| Unrestricted access to directors, management and counsel | | | | • | | |
| One-on-one dialogue | | | | | • | |
| Response to a specific inquiry or shareholder proposal | | | | | • | |
| **Opportunities** | | | | | | |
| Hearing concerns directly from a larger group of shareholders | • | | | • | | • |
| Focused dialogue with influential shareholders and investors | • | • | • | | • | • |
| Constructive two-way dialogue as predetermined topics allow for advanced preparation | • | • | • | | • | • |
| Depth of expertise (board, management and counsel) capable of fielding a diverse range of questions | • | • | | • | | |
| Goals are predefined | | • | | | | • |
| Tangible results due to focus on a single pre-determined topic | | • | | | | • |
| Minimal resource requirement | | | • | | • | |
| Flexibility to focus on real-time issues impacting the company | • | | • | | • | |
| Management is often more available than board members allowing for frequent in-depth exploration of issues | | | • | | • | |
| Greater opportunity for informal dialogue without board presence | | | • | | • | |
| Hear concerns from a diverse group of shareholders | • | | | • | | • |
| Display willingness and sophistication of the board by addressing all shareholders in an open format | | | | • | | |
| Candid interaction with a smaller group of investors | | • | • | | • | |
| **Challenges & Risks** | | | | | | |
| Significant resource requirement and preparation | • | • | | • | | • |
| Inviting the "right" mix of shareholders | • | • | • | | | • |
| "Missing" the concerns of shareholders not included | • | • | • | | | • |
| Balancing topics with allotted time – not addressing predetermined topics may cause shareowner concern | • | | | | | • |
| Identifying shareholders with the resources and capacity to participate | • | • | | | | • |
| Coordinating multiple meetings involving board members, management, counsel and shareholder participants | | • | | | | • |
| Addressing potential legal issues impacting shareholder participants – involvement of outside counsel | | • | | | | |
| Limited board involvement may be viewed negatively | | | • | | • | • |
| Perceived expectation of being available any time for any topic? | | | • | | | |
| Company representatives must be prepared to address a wide variety of topics | | | • | • | • | |
| Inability to spend a substantive amount of time on any one issue | | | | • | | |
| Certain shareholders may avoid larger meetings out of preference for a smaller setting to focus more time on predetermined issues | | | | • | | |
| Perception of being viewed as a public relations event | • | | | • | | |
| Outspoken individuals may monopolize the time with issues that may not pertain to the larger group | | | | • | | |
| Lack of board involvement may cause shareholders to question if their issues are being escalated to the board | | | • | | • | |
| Reaches only a very select group of investors that may not be representative of the full shareholder base | • | • | • | | • | • |
| Difficulty in addressing governance only topics | | | • | • | | |
| Follow through on action items | • | • | • | • | • | • |

## 5. APPENDIX A

**Sample Guidelines for Private Meetings with Investors: Supplied by an anonymous US Corporation**

*Prohibition Against Selective Disclosure:* SEC Regulation FD and Company Corporate Policy prohibit the selective disclosure of material nonpublic information to investors, among others. As a result, in private meetings with investors such as the reception, colleagues must be mindful of this prohibition and take special care in what they say.

*Materiality:* Unfortunately, there are no objective standards of materiality. It's often a judgment call. A matter is considered material if a reasonable investor would consider it important in deciding whether to buy, sell or hold a security. Any information, whether positive or negative, that could reasonably be expected to affect the price of a security should be considered material.

*What You Can Discuss:* You may discuss any matters that we have disclosed publicly, whether in a press release, SEC filing or webcast presentation. This would include, among other things, previously disclosed financial results, operational performance, product and product candidate developments, overall company strategy, etc. It's also permissible to discuss matters that have not been disclosed publicly if they are not material (i.e., not likely to affect our stock price).

*What You Can't Discuss:* You must not discuss significant matters that have not been disclosed publicly – for example, financial and operational performance to date in the current quarter, internal financial projections, internal strategic plans, significant undisclosed developments or projections regarding in-line products and product candidates (including significant clinical trial results and anticipated regulatory filing dates and launch dates), specific business development opportunities, plans/expectations about future dividend increases and stock repurchases, etc. If you are asked about any such matters, simply say that you are prohibited by company policy from discussing such matters.

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