GOVERNANCE CHALLENGES 2018

Board-Shareholder Engagement in the New Investor Environment

A Publication of the National Association of Corporate Directors and Its Strategic Content Partners

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Foreword

It is my pleasure to introduce the National Association of Corporate Directors’ (NACD’s) seventh edition of Governance Challenges.

Each year, NACD collaborates with our five strategic-content partners—Heidrick & Struggles, the KPMG Board Leadership Center, Marsh & McLennan Companies, Pearl Meyer, and Sidley Austin LLP—on the exploration of a timely and important governance topic. This year, our focus is on considerations for directors in a changing investor landscape.

NACD has been a longtime advocate of the importance of the relationship between a company’s board and its major investors. Our Key Agreed Principles emphasize the board’s accountability to shareholders, and calls for transparency in board-shareholder communications and meaningful investor input in director selection.1

Over the past few years we’ve witnessed a number of sea changes in the area of board-shareholder engagement. Many companies have transformed their proxy statements from boilerplate, legalistic documents into essential vehicles for communicating the board’s governance practices, and explaining how decisions in areas such as executive compensation and board composition link back to the firm’s long-term strategic objectives. More boards are incorporating direct meetings with major investors into their overall shareholder-engagement strategies—a majority of respondents to NACD’s most recent public-company governance survey reported that their board met with institutional investors in the prior year.2 NACD has observed a number of trends in board-shareholder engagement, based on our most recent public company governance survey:

- **Engagement With Investors Continues to Grow.** For the first time since 2014, in the 2017–2018 survey a majority of all respondents (50%) had a board representative meet with institutional investors in the prior year. Interestingly, the micro/nano-cap segment had the largest percentage (65%) of respondents indicating that they had met with investors. This focus among micro/nano-cap companies to meet with institutional investors may be driven by their immediate need to attract capital in order to grow.

- **Executive Compensation Is the Top Issue Discussed With Investors.** Overall, 27 percent of respondents discussed their executive-compensation philosophy and pay plans with investors, in addition to discussing oversight of financial matters (21%) and performance metrics and goals for the CEO (19%). There was a large increase in discussing CEO and executive-team succession with investors, from 8 percent of respondents in 2016 to 19 percent this year. See Figure 1 on page 5 for additional topics discussed with investors.

- **Most Meetings With Investors Include the Board Chair.** The board chair (69%) and lead director (24%) are the most common meeting participants overall for those boards meeting with institutional investors, in addition to the investor relations officer (21%) and the compensation committee chair (19%).

- **Fewer Respondents Report Experiencing an Activist Approach Within the Last Year.** This year, 16 percent of respondents reported being approached by an activist in the prior 12 months, versus 22 percent in 2016 and 19 percent in 2015. Micro/nano-cap companies were the most targeted market segment at 28 percent, possibly due to a greater proportion of activist campaigns being launched by smaller funds that acquire greater stakes in smaller companies.

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Most Respondents Have Taken Action to Prepare for an Activist Attack. The methods boards use to prepare for an activist challenge remain largely unchanged from last year: (1) consulting with outside advisors (66%), (2) increasing engagement with the company’s largest shareholders (65%), (3) developing a written response plan (28%), and (4) introducing takeover defenses (27%). (See Figure 2 on page 5.)

Fewer Written Response Plans Include a Predetermined Board Meeting. A large majority (79%) of respondents whose boards have a written response plan for an activist attack indicated their plans include a team of advisors who will be assembled if an attack occurs. Fifty-one percent of respondents have a list of board members that will communicate directly with the activist, an increase from 45 percent of respondents last year. The largest change from last year was the percentage of boards that plan for a special board meeting to occur in a set time frame after the attack, decreasing from 59 percent of respondents last year to 49 percent this year.

There have been changes afoot in the investor world as well. Mainstream asset managers—including major index funds such as Vanguard, BlackRock, and State Street—are speaking out more forcefully on issues like board diversity, company culture, and climate change. Public pension funds such as the Office of the New York City Comptroller have been making their influence felt in areas such as proxy access. And activist investors continue to press for changes to their target companies’ strategies—often by seeking seats on the board.

Governance Challenges 2018 will help directors chart an effective course through this dynamic environment toward the objective they and their investors share: sustainable corporate success and long-term value creation.

Peter Gleason
President and CEO, NACD
FIGURE 1
If a representative from your board has met with institutional investors in the last 12 months, what was discussed in the meeting?

**LARGE-CAP**
- Executive compensation philosophy and pay plan design: 37%
- Board composition: director skill sets, diversity, etc.: 29%
- Board structure and processes: majority voting, annual elections, CEO/Chair split, etc.: 26%

**MID-CAP**
- Executive compensation philosophy and pay-plan design: 30%
- Setting performance metrics and goals for the CEO: 28%
- Board composition: director skill sets, diversity, etc.: 25%

**SMALL-CAP**
- CEO and executive-team succession: 20%
- Oversight of financial matters: external audit, internal audit, financial controls, etc.: 20%
- Executive compensation philosophy and pay-plan design: 18%

**MICRO-CAP**
- Oversight of financial matters: external audit, internal audit, financial controls, etc.: 28%
- Setting performance metrics and goals for the CEO: 23%
- Executive compensation philosophy and pay-plan design: 18%

FIGURE 2
Has your board taken any of the following measures to prepare for an activist-investor challenge?

- Consulted with outside advisors: 66%
- Increased engagement with the company’s largest shareholders: 65%
- Developed a written response plan: 28%
- Introduced takeover defenses: 27%
- Conducted simulations: 6%
- Other: 18%

Which of the following provisions does your response plan include?

- The team of outside advisors that will be assembled: 79%
- A list of board members, if any, will communicate directly with the activist: 51%
- A special board meeting within a predetermined time frame: 49%
- Other: 1%
The Characteristics of Leading-Company Boards Today

By Theodore L. Dysart, Vice Chair–Global CEO & Board Practice, Heidrick & Struggles, and Sara Spiering, Principal, Heidrick & Struggles

Recent research suggests that five key traits distinguish the boards of highly successful companies—traits that can serve them well when activists come calling.

The ideal board—an unchangeable true north to which boards should aspire in all times and places—simply doesn't exist. An exemplary board from the heyday of conglomerates would likely struggle in today's world of spin-offs, pressure from activist investors, and increasing focus on core competencies. Nevertheless, in any given period, an effective board will embody enduring principles of good governance. But it will also exhibit a timely adaptation to its present reality both in its composition and behavior, as our firm found in recent research on today's genuinely outstanding companies.

The challenge of activists provides a particularly good window onto contemporary boards. Few companies are immune to the attentions of activists these days. According to Lazard, activists deployed $45 billion in capital on campaigns through the third quarter of 2017, nearly double the total for all of 2016.1 Inevitably, the boards find themselves squarely in the middle, compelled by their fiduciary responsibility to do what's right for the stockholders. Even boards of companies that have performed well may find themselves in the crosshairs after a subpar quarter. But the more the board of a potential target company possesses the traits of today's leading companies, the better positioned it will be to deal with the challenge.

To identify leading companies, researchers analyzed the financial performance of the world's 500 largest enterprises by market capitalization and arrived at a list of what we call the "superaccelerators."2 These are the companies that have demonstrated the greatest ability to accelerate performance. That is, they are able to reduce time-to-value by building and changing momentum more quickly than competitors and thus profitably grow revenues year after year.

To qualify as a superaccelerator, a company must (1) place in the top 20 percent for revenue growth in both the previous three and seven years, (2) generate no more than 20 percent of its growth inorganically, (3) receive no more than 20 percent of its revenue from its home government, and (4) not see its profit margin reduced by more than 20 percent as a percentage of revenue as the company grows. In 2016, only 23 of the 500 companies we analyzed met all four of these criteria; in 2017, 25 did so.3

This research and our experience indicate that the boards of companies with a marked ability to accelerate performance demonstrate at least five traits—traits grounded in principles and manifested in composition or behavior. These traits include the following:

1. **The board highly values the experience of seasoned veterans.** This doesn't mean that the group always defers to its most senior, distinguished members. But accelerating boards carefully heed the advice of battle-tested business leaders who have lived through multiple business cycles and transformations. In fact, members of superaccelerating boards have longer median tenure than those of nonaccelerating boards—7.6 years versus 4.8 years. These seasoned veterans come with the commensurate gravitas and sophistication to help the board ask the right questions at the right time and tease out of management the real issues at play.

Many people are familiar with the shock that hit McDonald's when CEO James Cantalupo died

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unexpectedly of a heart attack in early 2004 to be succeeded by Charlie Bell, who was claimed by cancer only months later. What is less well known is that the steady hand who helped see the company through this turbulent period belonged to long-time director Andrew McKenna, who joined the board in 1991, became its chair in 2004, and served in that role until 2016. During those 25 years, he served with seven CEOs, and so valued was his advice that upon vacating the chairmanship he remained on the board as chair emeritus.

2. **The board insists on a strong CEO and a deep bench.** The board—no matter who is on it, how often it meets, or what it may collectively know—is not running the company. That’s the job of the CEO. The board’s most important daily requirement is to oversee the performance of the CEO, and it must insist on strength for this role. But the board also knows that it is overseeing an entire management team, so it expects the strong CEO to also be able to act as a conductor, not a dictator. And, increasingly, outstanding boards are taking a far more active approach to their oversight of succession management, making sure that succession needs and risks throughout the top levels of their companies are being systematically managed.

   Consider how the board of a multinational consumer goods company stays abreast of developments among almost 100 senior leaders. At breakfast during the board’s quarterly meetings, each of the 11 independent directors presides over a separate table of nine senior leaders to discuss a wide range of issues—from high-level business philosophy to strategy, operations, and the company's most pressing current concerns. The directors get a feel for the capabilities, motivations, and outlook of these leaders, as well as a feel for the culture of the company—all without intrusive appearances at the leaders’ offices or inquisitorial interviews. Perhaps boards of companies scarred by scandal in recent years might have been able to head off trouble if they had taken a similar approach.

3. **The CEO and the chair/lead independent director enjoy a productive relationship.** If we were to measure only one aspect of performance of a board to determine the board’s projected level of success, we would look at the relationship between the CEO and the board’s lead representative. Do they really know each other? Do they respect each other? Are their perspectives and experiences complementary? Can they honestly debate, disagree, and then move on?

   Behavior that exemplifies this characteristic is rarely visible to outsiders, largely taking place behind closed doors. But even though only the principals and the board can perceive them, there are several signs that indicate the existence of a healthy relationship between the CEO and the chair/lead independent director:

   - The relationship is founded solely on the good of the company and its stakeholders.
   - It is marked by vigorous discussion in private and a unified front in public.
   - The chair/lead director embraces independence of thinking and action but understands that the real test of independence is the ability to work effectively with the CEO.
   - The CEO appreciates the fact that the chair/lead director occupies a demanding intermediary role between the independent directors and management, acting as a conduit—in both directions—for communication, advice, and, sometimes, bad news.

4. **The board overindexes on industry experience.** Businesses today are urged to rethink where they compete (what industry segments and geographies), to consider new business models, and to disrupt their industry or someone else’s. But, while breakthroughs in strategy are still important, they don’t provide the sort of long-term competitive advantage they once did. Strategies are easier to copy in
these fast-moving times, when innovation no longer requires enormous resources. The exceptional success of our superaccelerators is not a case of choosing the right industry sector or geography; the superaccelerators come from all geographies and include companies from sectors often thought of as boring or low-margin.

Consider variation in profits by industry and by geography. We found that the difference between being average in the most and least profitable of 26 major industries is 19 percentage points of margin. Similarly, the difference between being average in the most and least profitable geographies is 16 percentage points. But the differences within industries and within geographies are far greater. The average variation between the best-performing and worst-performing companies within an industry is 34 percentage points, and the average variation between the best-performing and worst-performing companies within a country or region is 38 percentage points. In other words, the greatest opportunities lie within one’s own industry, no matter what it is or where you compete in it, an insight that the composition of the superaccelerators’ boards seems to affirm.

5. **Members of the board are willing to fire themselves.** Superior boards constantly monitor their own performance and refresh their ranks when necessary. They know that the days of “professional directors” are over. When the business grows in scale or changes in focus, rendering a director’s continued presence on the board irrelevant, conscientious directors will be willing to “fire” themselves—leaving the board for the continued good of the company.

The board of a mid-Atlantic financial-services company makes it clear in their offer letters to director candidates that appointment is not open-ended. The letter specifies an initial term of three years and warns that directors can expect to be replaced as the needs of the company evolve. At the same time, the board is careful to retain its most valuable seasoned veterans, who embody institutional memory and timeless wisdom.

This by no means exhausts the desirable attributes of superaccelerating boards, but these five traits notably combine timeless principles of good governance and timely behavior. And should an activist appear, such a board is likely to be up to the challenge. Its seasoned veterans will be able to lead the board’s assessment of the real intentions of the activist and of the wisdom, value, and soundness of the activist’s proposals. A strong relationship between the CEO and chair/lead director will enable the board and management to maintain a unified front in the face of activist demands, which can be particularly challenging when the board and management disagree about whether to resist.

The other traits of superaccelerator boards are likely to discourage activists in the first place. The willingness of board members to fire themselves increases the likelihood that the board has been evolving with the business and will not be seen as vulnerable. The strong CEO and deep management team found in superaccelerator companies are likely to be adept at strategy and at maintaining operational excellence and agility—so much so that activists see little room for significant gains in performance and so take a pass. The board’s depth of industry experience may also discourage activists, who typically insist on installing directors well versed in the company’s industry. But if an activist appears anyway, a company overseen by a board that cultivates the traits of the superaccelerators is likely to come through the encounter in much better shape than would a company overseen by a board lagging in those characteristics.
Engaging With Investors in 2018: What Boards Should Know

By Stephen L. Brown, Senior Advisor, KPMG Board Leadership Center

Along with “disruption,” “engagement” is a frequent topic of conversation among boards and business leaders these days for good reason. To help adequately craft strategic direction, leaders should engage with their key stakeholders: customers, employees, regulators, and shareholders. While managing meaningful relationships with each of these stakeholders is vital, here we will focus on shareholders. Shareholder expectations of directors have changed dramatically—and taking a deeper interest in the shareholder-engagement process is critical for boards in this new environment.

In an era of increased transparency and higher expectations of boards, the importance of demonstrating an understanding of the views of the company’s shareholders shouldn’t be underestimated. Investors who feel boards aren’t responsive to their concerns have increasingly shown a willingness to cast negative votes against directors, and in many cases, to support activists’ slates.

While shareholder communications are the purview of management, carried out through investor relations and other members of management, the board oversees the company’s disclosure policy and shareholder-communications processes. As such, directors should

- be knowledgeable about and have input on the company’s shareholder engagement plan, including consideration of whether/when it makes sense for designated directors to engage directly with shareholders;
- ask questions to help ensure that the company’s governance team is prepared to represent the board’s views; and
- be ready to address key issues that are expected to be top of mind in 2018.

Planning for Engagement

Acknowledge the changed landscape. Directors today face a very different environment than their predecessors did. Over the past two decades, corporate defenses (e.g., plurality voting, classified boards) have been removed. Activist hedge funds have increased in number, size, success, and acceptance by mainstream institutional investors. As institutional investor assets under management have increased, these shareholders have grown more active and assertive. Further, during this time span, the role that the corporation plays with respect to environmental and social issues (e.g., climate change, pay equity, diversity) has evolved to be top of mind for many shareholders.

Consequently, institutional investors are asking more questions aimed at understanding the board’s perspective and position on key strategic, governance, environmental, and social issues. Investors have also become comfortable with generating corporate-governance changes even absent regulatory intervention, as evidenced by the widespread adoption of majority voting and, more recently, proxy access. According to data published by Institutional Shareholder Services, roughly 60 percent of S&P 500 companies had adopted proxy access as of November 2017.

The era of shareholder empowerment has changed what is expected of directors. Boards and management must now act accordingly. The good news is that companies appear to be paying attention to shareholder demands. Data from the 2017–2018 NACD Public Company Governance Survey show that boards are increasing their engagement with shareholders: half of those surveyed indicated that a board representative met with institutional investors in the prior year—up from 48 percent in 2016, and 41 percent in 2015.
What follows are additional steps boards can take to operate optimally in this new landscape.

**Engage management in a conversation about investor-related issues.** Be proactive. Discuss trends, shareholder-related crisis management, and how management and the board would engage on certain key issues (such as activist approaches, shareholder proposals, and political attacks).

**Pay attention to trends in shareholder proposals, even those that don’t receive majority support.** Environmental, social, and governance (ESG) issues continue to constitute a large portion of the shareholder proposals submitted, and while relatively few have received majority support to date, a number of influential institutional investors have made ESG an engagement priority. While shareholder proposals should be considered on a case-by-case basis, they can serve as a bellwether for shareholder sentiment. The board should understand the concern behind the request as well as the implications of opposing proposals, particularly from large or influential shareholders. As Stanford University’s Joseph Grundfest wrote in the 1993 *Stanford Law Review* article, “Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates,” “Symbols . . . have consequences. The resultant negative publicity can sharply reduce the prestige associated with serving on a target corporation’s board, thereby providing an impetus for incumbent directors to improve corporate performance.”

**Getting the Governance Team in Top Shape**

The threat of activism is a fundamental business risk that must be managed. During the first half of 2017, 65 public companies cited “shareholder activism” as a risk factor in US Securities and Exchange Commission filings, according to Bloomberg BNA (“More Companies Cite Activism as a Risk in Financial Disclosures,” July 6, 2017). While many directors may engage directly with shareholders, especially when the company is dealing with a crisis, on a day-to-day basis, directors rely on management to interface with shareholders to explain the company’s and board’s position on issues, as well as the board’s oversight practices. Therefore, it is prudent for boards to ensure that their governance teams have the appropriate talent and a well-developed plan to properly represent the board’s views.

After all, if shareholders are dissatisfied with the management’s engagement, they cannot fire the engagement team; their recourse may come at the annual proxy voting booth against directors.

**Understand and assess the company’s investor relations capabilities.** As part of their assessment of the governance team, boards may want to ask the following questions about the company’s governance team:

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Data from the 2017–2018 NACD Public Company Governance Survey show that boards are increasing their engagement with shareholders: half of those surveyed indicated that a board representative met with institutional investors in the prior year.
1. **Who serves on the team, and are they the right people?** This question aims to help ensure that the governance team has the most current skills, talents, and practices for engaging with investors in today’s environment. Institutional investors have a rather finite length of time to engage with your team. The last thing they want is to leave the discussion with ineffectual responses and unanswered questions.

   - There is no set rule about who should be on the team, but directors should be comfortable that the team includes the necessary subject-matter experts (e.g., legal, corporate governance, investor relations, executive compensation, corporate social responsibility, and communications);
   - has the subject-matter experts routinely coordinate and collaborate with each other;
   - continuously updates their knowledge of all pertinent governance issues; and
   - designates as investor-facing team members those team members who have experience engaging with investors and who are willing and prepared to confidently and adequately respond to investor concerns as appropriate.

2. **How thorough is the team's shareholder engagement and monitoring plan?** Understanding management's annual shareholder-engagement plan is crucial. The plan should detail the team's interaction with the company's top shareholders, as well as those shareholders' questions and requests. This exercise should help determine whether the team satisfactorily manages the dynamic makeup of large institutional investors. Specifically, large institutional investors may have multiple portfolio managers with differing views covering the company. While all of these views should be considered, it is essential that the governance team understands who exercises the investor's voting power on proxy issues. That knowledge may help avoid surprise negative votes against the directors at the annual meeting.

   Additionally, directors should understand how the team stays abreast of the latest governance issues and what issues are top of mind for shareholders. The board should ask whether management

   - has planned meaningful engagements for the proxy “off-season” that provide significant investors time for in-depth discussion with management on how and what they think about key governance issues and company-specific issues;
   - is developing strong relationships with shareholders, which will be important particularly during times of crisis;
   - is interacting with the shareholder and governance communities to gather intelligence on the current investor sentiment and emerging governance demands; and
   - periodically reports shareholder feedback and concerns to the board so directors can be properly informed about what's top of mind for their shareholders.

3. **Can the team talk the “board's book”?** In the absence of an independent director attending the engagement, it is imperative that the governance team be prepared to accurately explain the board's position on issues of investor focus, including board oversight of strategy, risk, ESG, and board composition. The board will want to ensure that the governance team can provide credible and defensible articulation of the board's position, which may be slightly different than defending the company's position on the same issues. An effective response should describe how the board engages management on strategy, risk, and ESG and details board processes related to director refreshment.
Key Issues for 2018

Based on the events of 2017 and conversations with members of the institutional investor community, several high-level themes related to board operations and board leadership on ESG issues are likely to be top of mind for investors this year.

**Board Operations.** Since the financial crisis of 2008, investors have become increasingly attentive to why and how directors come to serve on portfolio company boards and whether directors are carrying out their duties effectively and adding value. Investors continue to scrutinize all aspects of board operations, from the board’s skills matrices, diversity, tenure, and succession processes to the efficacy of the board-evaluation process.

**Board diversity.** The world’s largest money managers have announced plans to focus on board diversity and hold directors—particularly nomination and governance committee chairs—responsible for lack of progress. Boards should expect this focus to intensify. Investors will inquire about diversity and delve into search and succession processes. The “Boardroom Accountability Project 2.0” calls on boards to disclose the race and gender (and, optionally, sexual orientation) of their directors, along with directors’ experience and skills, in a matrix format. Are we prepared to present a convincing and credible argument that the board has the right mix of skills, backgrounds, and personalities?

### Most Important Challenges Companies Face in Adhering to Good Governance*

<table>
<thead>
<tr>
<th>Challenge</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>Aligning company with shareholder interests</td>
<td>39%</td>
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<tr>
<td>Board composition: director skill sets, diversity, etc.</td>
<td>35%</td>
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<tr>
<td>Executive compensation (align pay with performance)</td>
<td>32%</td>
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<tr>
<td>Lack of clarity on what good governance entails</td>
<td>21%</td>
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<tr>
<td>Communications (transparency, engagement)</td>
<td>21%</td>
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<tr>
<td>Dealing with short-termism</td>
<td>17%</td>
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<tr>
<td>Uncertain/changing regulatory landscape</td>
<td>16%</td>
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<tr>
<td>Getting buy-in from management and board</td>
<td>12%</td>
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<tr>
<td>Activism</td>
<td>8%</td>
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<tr>
<td>ESG</td>
<td>7%</td>
</tr>
<tr>
<td>Proxy Access</td>
<td>7%</td>
</tr>
</tbody>
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Source: Rivel Corporate Governance Intelligence Council, “Regulatory Rollback: What If?” Rivel Research Group, June 2017

* Multiple responses.
Board evaluations. Consistent with the desire to understand board performance and dynamics, shareholders are interested in understanding how boards are using the board-evaluation process for self-improvement and board refreshment. What, if anything, should we consider changing to be best-in-class? Do we have a compelling story to tell in proxy disclosures and shareholder discussions about our evaluation process?

Corporate culture. In light of #metoo and other events in 2017, corporate culture and tone at the top remain front and center. Investors will want to understand how the board keeps abreast of company culture. Does the board understand the culture at all levels of the company? What information does the board need to gain adequate insight into human-capital issues?

Board leadership on ESG. Recent surveys have shown that ESG is not necessarily high on the list of board and business priorities, but is indeed top of mind for investors. Management and boards must prepare to bridge this gap.

Environmental. Several large institutional investors have expressed interest in gaining a deeper understanding of how companies are managing risks related to issues such as climate change. The Financial Stability Board’s Task Force on Climate-Related Financial Disclosures has published recommendations for disclosure of climate-related financial risks. Also, major institutional investors have shown a willingness to use their proxy votes when they are not satisfied with the company’s climate-related disclosures. In some cases, they even supported shareholder proposals calling for greater transparency. How are we conveying the board’s role in oversight of climate-related risks? Is the company prepared to answer questions about decisions regarding disclosure frameworks?

Social. From the #metoo campaign and questions around workplace sexual harassment and gender pay equity to CEO pay ratio disclosure, the events of 2017 catapulted human-capital issues to the forefront. Questions about how companies are managing these risks are on investors’ agendas. How do we effectively inform ourselves regarding the treatment of employees? Does the company have the right systems in place to provide these insights?

Governance. While 2018 places a heightened emphasis on environmental and social concerns, governance will also be relevant given the commencement of the first stewardship code in the United States. The Investor Stewardship Group (ISG), formed by several large US-based institutional investors, announced a corporate-governance framework for US institutional investor and boardroom conduct, which became effective in January 2018. The framework details six principles ISG believes are fundamental to good corporate governance. Are we aligned with the ISG principles and do we demonstrate such alignment? If not, can we explain why?
Human Capital Management and Reporting: Key Considerations for Institutional Investors and Directors

Haig R. Nalbantian, Senior Partner, Mercer, Marsh & McLennan Companies

The idea that an organization's workforce is an asset rather than just a business cost is widely accepted by business leaders. Yet in annual reports to shareholders and those routinely shared with directors, meaningful information about the workforce and how it is managed—“Human Capital Management” (HCM)—remains remarkably sparse.

This omission has not gone unnoticed. In recent years, there have been serious efforts to get HCM out of the reporting shadows. Some have emanated from the accounting world, and some from the environmental, social, and corporate governance (ESG) domain. In addition, various investor groups, whether they are government or private pension funds, shareholder activists, or responsible investment (RI) organizations, have been pressing hard to get more meaningful human capital reporting standards put in place.

Many of the recent initiatives are motivated by concerns about corporate social responsibility. For example, pressures from shareholder activists and regulators to promote greater gender diversity and pay equity for women have produced a spate of company disclosures about gender representation and pay, particularly from companies in the technology and financial services sectors.

But the push for increased disclosure increasingly is emphasizing the economic value of greater transparency about HCM for shareholders and the investment community in general. For example, in July 2017, the Human Capital Management Coalition, a group of institutional investors led by the UAW Retiree Medical Benefits Trust, with $2.8 trillion in assets, filed a petition with the US Securities and Exchange Commission (SEC) to “require issuers to disclose information about their human capital management policies, practices, and performance.” Citing and summarizing a wealth of empirical evidence on the business impact of HCM, including its relationship to shareholder value, they argued that deeper and more comprehensive workforce information is required to enable investors to take proper account of HCM in firms when making their investment choices.

Careful attention to HCM is clearly warranted in view of current economic realities. Rapid technological change, increased competitiveness and economic globalization, and generational and cultural shifts are shortening the life cycle of products and business designs for many businesses. Companies are obliged to constantly adapt. It is often human capital that enables effective adaptation to these new realities yet it is at the greatest risk of sudden depreciation in the face of change.

The proliferation of workforce and business data combined with advances in workforce analytics make it possible for organizations to anticipate and address these issues and to manage their human capital in the more disciplined, quantitative way of the kind they bring to other assets. Modern HCM is, in fact, becoming an asset management discipline.

In view of these realities, what do directors need to know about their organization's HCM and what specific information should they be demanding from their executive teams?

1 This article draws on content first published in Haig R. Nalbantian, “When it Comes to Human Capital Reporting, Mum's Still the Word,” Risk & Compliance Magazine. Financier Worldwide Ltd., October-December, 2016.
Why directors should care about HCM

A significant body of scholarly research has demonstrated strong empirical links between HCM and business performance, including shareholder value. Our own research has uncovered an important channel through which HCM can affect shareholder value—workforce productivity.\(^5\) Statistically analyzing 20 years of census data on manufacturing establishments in the United States, our research found that, all else being equal, companies that consistently maintain superior workforce productivity in their plants in comparison to their peers also achieve higher market value (as measured by Tobin’s Q\(^6\)). In effect, sustained premium workforce productivity becomes an intangible asset.

In analyzing the running record of productivity and performance data of client organizations, we find that effective HCM is often a major driver of persistent productivity advantages. To give an example, in a US regional bank, from 10 to more than 40 percent of the variation in branch productivity and performance was attributable to human capital factors depending on the performance measure tracked, as seen in Figure 1:

By far, the biggest predictor of branch success was the tenure of employees in the front-line jobs. We estimated that each additional year of average tenure across the branches was worth $40 million to the bottom line.

Of course, the relative magnitude of HCM’s impact varies across industries and companies. But seldom is the impact negligible. Moreover, even small increases in workforce productivity, if sustained, can generate substantial value to the firm.

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**Regional Retail Bank: Performance Variance Driven by People Factors**

<table>
<thead>
<tr>
<th>Metric</th>
<th>% of explained variance captured by all HR variables*</th>
<th>% of explained variance captured by demographic HR variables*</th>
</tr>
</thead>
<tbody>
<tr>
<td>AGI per FTE</td>
<td>31%</td>
<td>26%</td>
</tr>
<tr>
<td>Pretax income per FTE</td>
<td>42%</td>
<td>32%</td>
</tr>
<tr>
<td>Total customer retention</td>
<td>28%</td>
<td>16%</td>
</tr>
<tr>
<td>Retention of key customers</td>
<td>36%</td>
<td>31%</td>
</tr>
<tr>
<td>Market share</td>
<td>15%</td>
<td>11%</td>
</tr>
<tr>
<td>Average revenue per customer household</td>
<td>13%</td>
<td>11%</td>
</tr>
</tbody>
</table>

Source: Mercer. Disguised case example.


\(^6\) Tobin’s Q Ratio is defined as a company’s market value divided by the replacement value of its assets.
This example also points to significant risks associated with the people side. The research shows that unwanted turnover would be particularly damaging to this business. Valuing productive incumbents would be essential to protecting against the materialization of this risk. Unfortunately, by paying top dollar to recruit new kinds of talent, the organization was inadvertently devaluing their seasoned incumbents. The “return to tenure” for these employees was flattening. Not surprisingly, turnover among higher performing, tenured staff was rising. The very asset that was creating value was starting to walk out the door. Management had to act to address this emerging risk.

This work highlights that directors should have a strong interest in learning more about how companies determine if they have secured the right workforce to achieve their business objectives and whether they are managing that workforce effectively. This is an increasingly urgent question, as rapid technological advances and the infiltration of digitization into all aspects of production and/or service delivery are changing the very nature of work and the kind of human capital companies must access to drive business success. If business transformation is not supported by corresponding workforce transformation, short-term performance will likely decline and shareholder value will be threatened.

The flip side of optimizing workforce management is minimizing and efficiently allocating “human capital risks.” Human capital risks are often among the most serious threats to shareholder value. Directors need to know if and to what extent these risks exist and what is being done to address them.

**Should there be standardized HCM metrics for reporting?**

The quest to produce a standardized set of human capital metrics for public disclosure is problematic. One-size-fits-all, standardized human capital metrics can be dangerously misleading because of the highly contextual nature of human capital management.

For example, streamlined organizational layers and relatively large managerial spans of control may signal operational efficiency in one business, but represent weak supervision and inadequate opportunities for career advancement and learning in another, thereby hurting business performance. Similarly, reliance on incentive compensation plans may signal the application of “pay for performance” in one company but in another may represent an inefficient mechanism to shift business risk from shareholders to employees, upending established principles of effective risk management and actually weakening performance incentives.

Even the most basic human capital metrics can be problematic. For example, high or rising voluntary turnover can be a signal of serious problems in talent management. On the other hand, in times of business transformation, higher turnover may be precisely what’s needed to speed adaptation of the organization’s workforce to new business requirements. Without it, the organization will be unable to deliver on its strategy without exploding its labor costs. Focusing on voluntary turnover without regard to the business context in which it is taking place can be dangerously misleading.

Great care needs to be taken when comparing and interpreting human capital metrics across companies. Human capital reporting requirements that fail to recognize this hazard and permit tailoring and contextualization of published metrics can do more harm than good.

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**A proposed approach**

Human capital reporting must provide information with which directors and investors can gauge whether the organization is securing the right workforce—the right mix of skills, capabilities, and experience—and whether it is managing that workforce in a way that drives productivity. Investors need to have some knowledge about the methods and processes used by company management to ensure human capital is, in fact, being effectively managed as an asset.8

From the standpoint of workforce *optimization*, critical questions include these:

1. Does the organization have in place an explicit workforce strategy that defines the talent requirements necessary to achieve strategic goals and a set of mutually reinforcing management practices to ensure this talent is secured and productively managed?

2. What are the core elements of this workforce strategy?

3. On what is this workforce strategy based? Specifically, what kind of quantitative and qualitative information is management relying on to inform its workforce decisions?

4. What measures are in place to track whether the strategy is being executed effectively and hold executives and line leaders accountable for results?

From the standpoint of human capital *risk*, key questions directors should pose include these:

5. Does the organization have in place a disciplined workforce planning process to identify looming talent gaps and other risks associated with business or technological change?

6. On what data sources and methods does the workforce planning process rely to identify and measure potential talent gaps? Specifically, how does the organization forecast future talent needs? How does it assess the ability of the internal or external talent supply to meet those talent needs?

7. Does the organization have in place a plan to mitigate any risks identified?

Rather than mandate a specific set of metrics to be reported by all, it is preferable to oblige management to provide directors and, ultimately, shareholders, with responses to process questions such as these, backed by hard data to substantiate their answers. This would enable directors to gauge whether management is pursuing a disciplined asset management approach to human capital that can maximize economic value and identify and mitigate human capital risks.

### Basic Descriptive Metrics

Absolute metrics are critical when reporting the demographic composition of the workforce. Given outside pressures and the potential business value of workforce diversity, accurate information on employee demographics, including generational mix, is vital.

A simple, highly useful device for conveying workforce composition is the Internal Labor Market (ILM) Map. The map offers a systems view of the workforce, both how it is distributed across career levels and how talent flows into, through, and out of the organization over time. It provides a summary rendering of the workforce that is easy to understand and potentially revealing of potential talent issues or challenges facing the organization. The ILM Map can be segmented in a variety of ways, for example by gender, as shown in the bipartite map in Figure 2.

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Understanding the Baseline Data
An Internal Labor Market (ILM) Map

<table>
<thead>
<tr>
<th>CAREER LEVEL</th>
<th>TOTAL HIRES</th>
<th>AVERAGE REPRESENTATION AND TOTAL PROMOTIONS</th>
<th>TOTAL EXITS</th>
</tr>
</thead>
<tbody>
<tr>
<td>LEVEL 7</td>
<td>Females 0%</td>
<td>7%</td>
<td>Females 0%</td>
</tr>
<tr>
<td>LEVEL 6</td>
<td>Females 1%</td>
<td>16%</td>
<td>Females 2%</td>
</tr>
<tr>
<td>LEVEL 5</td>
<td>Females 3%</td>
<td>29%</td>
<td>Females 3%</td>
</tr>
<tr>
<td>LEVEL 4</td>
<td>Females 5%</td>
<td>47%</td>
<td>Females 7%</td>
</tr>
<tr>
<td>LEVEL 3</td>
<td>Females 8%</td>
<td>73%</td>
<td>Females 13%</td>
</tr>
<tr>
<td>LEVEL 2</td>
<td>Females 8%</td>
<td>89%</td>
<td>Females 11%</td>
</tr>
<tr>
<td>LEVEL 1</td>
<td>Females 17%</td>
<td>85%</td>
<td>Females 16%</td>
</tr>
</tbody>
</table>

Key characteristics observable in this map include the pyramidal shape of the career hierarchy; the relative emphasis on building over buying talent; higher representation of women in the lower levels, 1–3, declining precipitously from level 4 where the ratio flips; a career “choke point” for women at level 3, where the probability of promotion dips significantly in absolute terms and relative to men; and a spike in turnover for women at level 3, the only level at which female turnover exceeds that of men. The systems view offered by the ILM Map helps connect the dots across data points and assists in drawing hypotheses about root causes of the patterns observed.

Source: Mercer. Disguised case example.
Conclusion

In today’s economy, an organization’s human capital is indeed an asset, often the single largest and most important investment the organization makes. The effectiveness with which that asset is assembled and managed is central to creating value for shareholders and mitigating significant business risks. Careful attention to decisions about HCM therefore becomes a critical part of good board governance.

The information commonly available to directors is often inadequate for them to fulfill this duty. This must change. Advanced workforce analytics and easily accessible workforce data are enabling the flowering of workforce management as an asset management discipline. As such there is no longer an excuse for organizations to keep their directors and investors in the dark about the people side of operations.

Directors can encourage the advancement of this discipline in their own organizations by asking the kind of questions articulated in this article. In doing so, they can lead the way to enhanced transparency about HCM for investors and help their organizations maximize the contribution of HCM to shareholder value.

Communicating Executive Pay in a New Era

By David Swinford, President and CEO, Pearl Meyer, and Jannice Koors, Senior Managing Director and Western Region President, Pearl Meyer

The current business climate—and that of the foreseeable future—points to an increase in organizational transparency and accountability. Stakeholders have found their voice. Major shareholders, institutional investors, activists, employees, pension funds, labor unions, and the general public are all becoming more outspoken about their distinct and sometimes conflicting interests in public companies.

Executive compensation per se is not always a top agenda item for these various stakeholders. That said, they look at disclosures around executive pay and will often infer corporate priorities based on what’s said—and what isn’t. Here, we outline guidance for boards about how to communicate the link between their pay programs and their business strategy and how to do so as clearly and openly as possible. And should companies become embroiled in a situation that calls for a defending response, we suggest how to meet that challenge and how to benefit in the future from lessons learned.

Rely on best practices to guide transparency and communication to all stakeholders.

When thinking about shareholder engagement, official channels of communication such as annual meetings or structured conference calls may come to mind. Directors we’ve spoken with say that, in general, the compensation committee does not regularly or proactively meet with shareholders and instead relies on the important compliance-based communication roles of investor relations (IR) and the general counsel.

Deborah Ellinger, lead independent director at iRobot, confirmed that view, but added, “Shareholders do occasionally request a direct line to the comp committee, especially in proxy season. If there is a very specific request, IR will manage the process. They gather the relevant information and make sure it meets the applicable disclosure standards.”

She also notes that there have been exceptions at times when the compensation committee “wanted to get input from our shareholders on a specific topic and we reached out to invite that conversation.”

While one-on-one conversations and how these interactions are managed may be one component of the strategy, the heart of external communication lies in the annual proxy statement. The Compensation Discussion & Analysis (CD&A) section should encapsulate all information relative to executive-compensation design and its implementation. According to a 2015 survey, “59 percent of institutional investors use proxy information for investment decisions.”

While the CD&A is technically a report to shareholders, as a publicly available document it is also a primary source of information for other interested stakeholders—employees, competitors, customers, suppliers, media, and the local community. We can expect that general awareness of the CD&A is likely to increase in 2018, with the first round of required CEO Pay Ratio disclosures. Given the potential for more interest from more parties, any perceived lack of wanted or needed information, or a narrative that is vague or confusing, could spark an issue.

However, when done well, the CD&A can provide compensation committees with a way to seamlessly deliver full transparency and offer clear rationale for the company’s pay programs. It’s the best vehicle for outlining how performance-based programs work and for explaining how the metrics they are based on drive the business strategy.

The most effective CD&As clearly explain plan design decisions, such as why certain metrics and goals are used in the short-term award program or how the committee determined the balance between time-based and performance-based long-term incentives. The committee might proactively clarify notable differences between realizable pay and the Summary Compensation Table data or discuss the board's views on what constitutes “long-term.” The storyline—in plain English—weaves together all components of pay to reflect a carefully constructed program and provides data to show the pay program's results.

One future subject for compensation committees to bear in mind comes courtesy of tax reform and the removal of the Section 162(m) rule. While many directors agree that there aren't likely to be sweeping changes in plan design immediately for most companies, and many compliance experts believe that it may take time for the proxy advisory firms to clarify and codify their positions, the new law does represent an opportunity for change. As your committee talks through the pros and cons of any structural plan changes, it's critical that they are discussing at the same time, “How would we communicate this?”

Cynthia Jamison, director at Tractor Supply, Office Depot, Darden Restaurants, and Big Lots, notes, “In general, investors don’t want to talk about tax law. They want to talk about business strategy. To that point, with or without 162(m), directors should make sure pay and performance are aligned.”

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**The Four W’s of Engaging with Shareholders on Compensation**

**What** – The most valuable use of any time spent with shareholders is listening. Rather than focusing on promoting an agenda or telling a story, use outreach as an opportunity to learn about the shareholder’s outlook on your programs and allay any concerns before they become larger issues.

**Why** – Consider the value of building important shareholder relationships. Time and effort spent promoting dialogue and building an atmosphere of trust can be a valuable investment in deterring activism. At a minimum, even if no conversations take place, the very act of being available to shareholders signals a willingness to be open and transparent. Practically speaking, it can also guide the company’s compensation disclosure to a wider audience.

**Who** – In the normal course of business, most basic queries from shareholders regarding executive pay can be handled by management, typically by the general counsel and investor relations, and in some cases by senior HR staff and the CFO. These management teams should then provide reports and feedback to the compensation committee. However, if compensation becomes a point of contention, especially concerning the CEO, a board leader (committee chair, lead director, etc.) may need to directly engage with shareholders.

**When** – Proactively reach out to shareholders on an annual basis as a normal course of business. Select a time of the year when both sides are best able to schedule a discussion.
Defend your programs when required, but do so carefully.

Even the best plans can be met with criticism. After a proxy advisor no-vote recommendation, under the glare of the media spotlight, or during an activist assault, you may need to determine how you can defend your compensation program without appearing defensive.

The best first step may be going back to your core communication. Can the issues raised be addressed with information already available in the proxy disclosure? Perhaps expanding on that information by providing additional examples or data, or offering to clarify certain points will suffice. Some boards choose to make their compensation consultant available for specific technical inquiries.

Any deeper investigation of your compensation program by stakeholders likely means both the board and management are fielding complicated questions, possibly from different angles. This is where an explicit board policy on outbound communication, preferably one that outlines how questions are handled based on the constituency, will be helpful. Ensure that the board’s policies complement corporate policies and that the board and management are in lockstep.

When activist investors are in the mix, bear in mind that they are likely to implicate both management and the board, citing a laundry list of alleged failures. Directors and experts agree that while executive compensation is not typically the catalyst for aggressive investor actions, it is frequently used as “proof” of board mismanagement. The assessment of pay and performance may prove to be one of their more antagonistic arguments.

Jamison advises targeted companies to “. . . look to the same things that ISS [(Institutional Shareholder Services)] looks to. If an activist is targeting a company, they will meet with ISS as part of their push to vote their slate. Examine ISS’s definitions of performance, even if they aren’t your definitions, and then do a really good job explaining how your pay and performance are defined and the rationale behind them.”

Ellinger says, based on experience, “You must communicate with activists to understand their perspectives, but there has to be heightened awareness and care when dealing with them. I’m not as concerned when the conversation is with a shareholder with whom you already have an ongoing dialogue, but with an activist there is a higher risk that something could be misconstrued, no matter how careful you are.” She advises, “Try to have more than one person in the room.”

Jamison agrees. “There’s always the risk that directors have the best of intentions in answering questions, but the conversation can quickly and inadvertently veer into territory that is nonpublic.”

The perception of a conflict of interest in the company’s senior management discussing CEO/executive pay programs may necessitate direct board involvement. But that doesn’t mean directors should be “flying solo.” Communications should be coordinated with management, especially the office of the general counsel who will already be integrally involved in any publicly contentious circumstances.
Once you’ve weathered a crisis or witnessed others do so, what lessons can you take away?

Activist investor case studies and high-profile media stories are in abundant supply. Boards can safeguard their executive compensation position with a periodic review of what’s happening in the market. Combine structured Monday-morning-quarterback discussions on sticky issues and how they could have been better managed with a checklist for self-assessment.

✔ Develop complementary board- and committee-level policies for both shareholder engagement and broader stakeholder communication.
✔ Implement a periodic review (an annual review, at least) of these policies at the board and committee levels and update as needed, particularly in light of any recent issues or lessons learned that need to be factored in.
✔ Assess compensation-related risks, perhaps prior to the development of the annual CD&A:
  ● Has the board been selective using discretion when determining payouts and has it clearly communicated its reasoning?
  ● Are any disconnects between payouts and total shareholder return clearly explained?
  ● Has the committee provided a clear explanation for its selection of peers and/or its market-based targets?
  ● Does the compensation program in any way reward behaviors that will be counter to either the business strategy or environmental, social, and governance issues?
✔ Determine if the board itself has any deficiencies that might spark investor attention or provide an add-on issue to a complaint, such as “exorbitant” director pay or significant gender or racial imbalance.
✔ Evaluate relationships with proxy advisors and, where possible, encourage ongoing dialogue.

If deeper analysis is warranted, the committee may choose to reflect on other issues the company faced and what unanticipated questions had to be managed. Were there any concerns that focused elsewhere, but could have had a “dotted line” to your pay programs? For example, Ellinger noted that during a period of activism with one of her boards, “The specific topic of executive compensation didn’t come up during those conversations; that simply wasn’t the hot topic for them. However, we did have some spirited discussions about peer group comparisons, and that can affect compensation.”

Finally, citing a need to strike a balance, Jamison cautions against the reactive impulse to do too much after a crisis. “There is always a risk that the board could ‘over engage.’ You don’t want to appear to be in an ongoing defensive posture and you don’t want to overplay the engagement card.”
Strategic Shareholder Engagement: Practical and Legal Considerations

By Holly J. Gregory, Partner and Cochair, Global Corporate Governance and Executive Compensation Practice, and Rebecca Grapsas, Counsel, Sidley Austin LLP

Boards of directors govern in an environment where large institutional investors expect to actively engage with the companies in which they have invested. Shareholder engagement takes a variety of forms, often in combination. These efforts range from traditional investor relations and earnings calls to meetings with shareholder representatives (a single investor or a group of investors) to surveys of investors to investor-hosted roundtables with participants from several companies. While specific negotiations with shareholder activists and proponents of shareholder proposals are also a type of shareholder engagement, the term is generally used to refer to a more general effort by companies to understand the viewpoints of key shareholders and to seek support for the company’s approach to a particular governance, compensation, or strategic decision.

Over the past decade, boards and management have used shareholder engagement primarily to understand the drivers of a low vote on say on pay, to help craft a response to a majority-supported shareholder proposal, or to obtain support for items on the ballot at the annual meeting. This event-driven shareholder engagement is now evolving into more strategic engagement as companies seek the opportunity to develop enduring relationships with key shareholders and receive unfiltered feedback about the company’s long-term strategy and governance issues, including issues that are not the focus of an annual meeting ballot item. BlackRock’s chair and CEO Larry Fink expressed the need for this new kind of shareholder engagement to CEOs of S&P 500 companies in January 2018:

The time has come for a new model of shareholder engagement—one that strengthens and deepens communication between shareholders and the companies that they own. . . . [S]hareholder engagement has been too focused on annual meetings and proxy votes. If engagement is to be meaningful and productive—if we collectively are going to focus on benefitting shareholders instead of wasting time and money in proxy fights—then engagement needs to be a year-round conversation about improving long-term value. . . . Where activists do offer valuable ideas—which is more often than some detractors suggest—we encourage companies to begin discussions early, to engage with shareholders like BlackRock, and to bring other critical stakeholders to the table. But when a company waits until a proxy proposal to engage or fails to express its long-term strategy in a compelling manner, we believe the opportunity for meaningful dialogue has often already been missed.1

Shareholder engagement efforts at many companies have evolved in recent years to more year-round activity, but engagement still tends to be organized in a cadence in relation to the proxy season and the issues that are likely to be the focus of the annual meeting and shareholder vote. As Larry Fink suggests, more value can be had from shareholder-engagement efforts in strengthening the company’s long-term relations with the captive base of shareholders represented by indexed institutional investors. This requires active ongoing outreach by boards and executives to maintain relationships with and seek feedback from these key shareholders. Strategic engagement can provide a mechanism to get robust feedback and outsider viewpoints on particular matters of strategy and governance that the board may explore, including unfiltered reaction from others with a lot of “skin

in the game,” and in the case of indexed funds a potentially very-long-term interest. There is potential value to gain not only from the substantive views that these shareholders may provide, but in enabling boards to hear directly from shareholders and vice versa, for example by involving one or more independent directors in certain key engagement efforts. (Of course, directors need to be well-prepared about the issues that may be discussed, aware of the company’s position and communications on those issues, able to stick to the board’s consensus view, and well-versed in the rules and limitations that direct conversations with shareholders necessitate.) And such engagement can help improve shareholder understanding of how management and the board approach long-term strategy and corporate decisions.

If key shareholders are knowledgeable and supportive of the company’s strategic direction, governance approach, and management team, the company should be better situated to respond to an activist approach. Shareholder relationships with key individuals on the board and management should be ongoing and developed over time through engagement efforts. In the future we will see the more forward-thinking companies enter into engagement even more strategically to shore up and maintain stable, long-term relationships with the large institutional shareholders that make up the core of the company’s stable shareholder base.

This article provides practical guidance for directors to consider when developing shareholder-engagement policies and when preparing for discussions with shareholders.

### Disclosure is a communication tool and should not become rote.

Benefits of Shareholder Engagement

- Understanding shareholder viewpoints on corporate strategy and governance
- Hearing shareholder concerns in an unfiltered environment and understanding what drives shareholder voting decisions
- Encouraging long-term relationships with shareholders, garnering potential support in the event of a short downturn, a crisis, or an activist situation
- Avoiding—or shoring up company support in the event of—shareholder proposals or “vote no” campaigns
- Achieving greater support for management proposals
- Promoting long-term stock ownership
- Providing opportunities to help shape evolving shareholder viewpoints on emerging issues
- Fostering goodwill and trust

### Practical Considerations

To be effective, engagement should occur on a periodic basis throughout the year—not just during the proxy season. It can be difficult to schedule meetings with the right people from the company’s key shareholders. Large investors face heavy demands and may not be able to accommodate all meeting requests. Advance planning for year-round engagement is critical.

Public disclosure documents, including the proxy statement and financial reports, continue to be important vehicles for engaging with shareholders as shareholders will review them when forming a view about the
company’s strategic direction and governance. Disclosure is a communication tool and should not become rote.

While companies will want to understand shareholder viewpoints about potential ballot items and should take steps to understand any item that indicates significant shareholder opposition, shareholders should be invited to identify topics of interest to them. The company should also be prepared to raise some issues for shareholder reaction that are not of immediate ballot concern. Engagement should be valued as an opportunity to get feedback on a broader set of strategic issues. Strategy is not at the top of the list of issues that shareholders tend to raise in engagement efforts, but company representatives should be prepared to raise these issues.

In most instances, management engages with shareholders under the board’s oversight and direction. Investor relations personnel and the corporate secretary often coordinate and drive engagement efforts. In addition to investor relations regularly communicating with “buy-side” personnel, the company should ensure that engagement efforts also include investor personnel responsible for governance matters, including proxy voting. Engaging with both sets of decision makers can help management and directors better understand the interplay of corporate performance and policy positions with respect to how the investor views the company.

Directors who receive engagement requests from shareholders directly should generally redirect the request to management for appropriate follow up. Individual directors should only engage with shareholders in coordination with the board and as appropriate with management, and only when appropriately prepared

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**Shareholder Engagement—Issues Formally Raised by Shareholders in 2017**

*Source: 2017 Spencer Stuart U.S. Board Index*[^2]

<table>
<thead>
<tr>
<th>Issue</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>ESG/sustainability</td>
<td>18%</td>
</tr>
<tr>
<td>Board refreshment</td>
<td>13%</td>
</tr>
<tr>
<td>Director tenure</td>
<td>9%</td>
</tr>
<tr>
<td>CEO compensation</td>
<td>8%</td>
</tr>
<tr>
<td>Shareholder engagement approach</td>
<td>8%</td>
</tr>
<tr>
<td>Proxy access</td>
<td>7%</td>
</tr>
<tr>
<td>Disclosure of political contributions/activities</td>
<td>7%</td>
</tr>
<tr>
<td>Independent board chair</td>
<td>6%</td>
</tr>
<tr>
<td>Say on pay</td>
<td>6%</td>
</tr>
<tr>
<td>Company strategy</td>
<td>5%</td>
</tr>
<tr>
<td>Director slate</td>
<td>5%</td>
</tr>
<tr>
<td>Strategic alternatives (e.g., M&amp;A, divestiture)</td>
<td>3%</td>
</tr>
<tr>
<td>Director compensation</td>
<td>1%</td>
</tr>
<tr>
<td>Other</td>
<td>4%</td>
</tr>
</tbody>
</table>

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regarding the board’s position on the key issues that may be discussed. Ad hoc, unplanned engagement between directors and shareholders should be strictly avoided. While it is often appropriate and beneficial for independent directors to participate directly, along with management, in engagement meetings with shareholders, this is driven by context and the issues to be discussed. For example, shareholders increasingly expect the lead director to participate regarding board oversight issues, the compensation committee chair to participate in discussions about executive compensation, and the nominating and governance committee chair to participate in discussions about board diversity and refreshment. Consideration should also be given to including inside and/or outside counsel in engagement meetings.

Directors should know with whom they are meeting and understand what their interests and concerns are likely to be:

- What percentage of the company’s stock do these shareholders currently own, and what is their ownership history?
- What are their positions on issues to be discussed, as expressed in proxy-voting policies, voting history, shareholder proposals, support for other shareholders, open letters, and public statements?
- Have they expressed particular concerns about the company’s governance or other practices?
- Which proxy advisory services do they use, and how likely are they to follow proxy advisory firm recommendations when voting?

Before the meeting, management should brief the directors on the topics to be discussed, bearing in mind that engagement discussions are generally at a high level. If necessary, the full board or relevant board committee may wish to meet to discuss a position on a particular topic in advance to ensure that the participating directors are able to accurately represent the board or committee position.

Based on the proposed meeting agenda, management should provide directors with a list of potential questions that might arise and potential talking points that are in line with the board’s positions and prior communications and that are designed to ensure no disclosure of material nonpublic information. Counsel should also review any documents prepared for the meeting, highlight any areas of potential concern, and remind directors about legal considerations and applicable policies. (See “Legal Considerations” on page 29). Legal considerations should not prevent directors from participating in engagement efforts but underscore the need to carefully prepare.

Engagement is most effective when directors and other company representatives are in “active listening” mode during engagement meetings. Shareholders should be given ample opportunity to discuss any areas of concern. Directors need to be particularly mindful that they represent the board and their position must be consistent with the board’s position.

Directors who participate in shareholder engagement meetings should report to the full board or the appropriate board committee on what they have learned. Presumably, investor relations and legal have also participated in the meetings; if not, they should bebriefed as well. If any action items or potential action items have emerged, plans should be made for follow up.
Legal Considerations—Regulation FD (Fair Disclosure)

Engagement efforts between companies and shareholders are required to comply with the prohibition on selective disclosure of material nonpublic information set forth in the US Securities and Exchange Commission (“SEC”) Regulation Fair Disclosure (Regulation FD). Regulation FD prohibits certain representatives of a public company from disclosing material, nonpublic information to analysts or investors unless that information is simultaneously released to the public (e.g., via a Form 8-K or a press release).

The SEC staff clarified in 2010 that Regulation FD does not prohibit directors from speaking privately with a shareholder or groups of shareholders and provided useful guidance for such meetings, including preclearing discussion topics with the shareholder or having company counsel participate in the meeting. (SEC Division of Corporation Finance, Compliance and Disclosure Interpretations, Regulation FD, Question 101.11 (June 4, 2010), available at https://www.sec.gov/divisions/corpfin/guidance/regfd-interp.htm). Some companies adopt a shareholder engagement policy that sets forth protocols for communication and engagement.

Shareholder Engagement “Rules of the Road”

- Agree in advance on the topics to be discussed and ensure they relate to public information or are immaterial.
- Ensure that directors participating in engagement efforts are authorized to speak on behalf of the company and are familiar with Regulation FD and applicable policies.
- Prepare briefing notes and talking points in advance, and have counsel review them to ensure compliance with applicable law (including Regulation FD, insider trading laws, proxy solicitation rules and antitrust laws) and confidentiality agreements.
- Review with participants what information has been publicly disclosed on the topics to be discussed.
- Schedule engagement meetings to take place after public announcements of material information.
- Avoid meeting with shareholders while the board is aware of developments that shareholders could consider important to their voting or investment decisions.
- Debrief with management immediately after the meeting to determine whether any material, nonpublic information was inadvertently disclosed and, if so, whether public disclosure is required (within 24 hours for unintentional disclosures of material, nonpublic information).

Shareholder Engagement Disclosures

Companies are increasingly disclosing their shareholder engagement policies and practices in the proxy statement, although the information disclosed varies.

Companies typically provide more detailed disclosure around engagement efforts in the wake of significant opposition to a say-on-pay vote, or a majority-supported shareholder proposal. Disclosing shareholder engagement efforts relating to such a vote can help bolster a company’s argument that it has adequately
responded to the vote and thereby avoid negative proxy advisory firm recommendations against directors. For example, in a policy change applicable to meetings held on or after February 1, 2018, Institutional Shareholder Services (ISS) clarified the factors it considers when evaluating whether a board has been sufficiently responsive to a previous say-on-pay proposal that received less than 70 percent of votes cast. ISS now takes into account

- the timing and frequency of engagements with major institutional investors to learn their concerns, and whether independent directors participated;
- disclosure of the feedback from dissenting investors that led them to oppose the say-on-pay proposal; and
- whether the company made meaningful changes that were responsive to investor concerns.

Companies should review shareholder engagement disclosures each year, in light of evolving “best practices” and trends, and consider enhancing that disclosure.

**Shareholder Engagement Disclosures—“Best Practices”**

While “best practices” continue to evolve, a 2015 survey by the Council of Institutional Investors (CII) found that “exemplary” disclosures about engagement policies and practices included one or more of the following:

- Detailed information about the processes employed to facilitate engagement
- Instructions and/or email addresses for shareholders wishing to engage with the company
- Emphasis on the board’s role in the engagement process
- Statement that engagement with shareholders is primarily a management responsibility
- Quantification of engagement activities (such as the number of meetings held during the year and the percentage of the company’s shareholder base that the company engaged with)
- Changes to governance practices the company has made in light of shareholder feedback

**Source:** CII, *Best Disclosure: Company-Shareholder Engagement* (December 2015)

**Conclusion**

As engagement efforts become more strategic, engagement topics will continue to evolve to encompass long-term strategy and governance topics that are not the focus of specific ballot items. Boards and management have an opportunity to use engagement efforts to help forge stable relationships with long-term shareholders who understand the company’s strategy and are prepared to support it with patient capital. Engagement efforts should be tailored to the company’s needs and should not be conducted ad hoc. Careful planning and preparation are needed to ensure that communications are aligned with the company’s positions and prior communications.
Appendix: NACD’s Strategic Content Partners

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