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A New Role for Investor Relations

Convergence of corporate governance with IR will increase the responsibilities of IR practitioners and mandate "holistic" investor relations.

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Does Investor Relations offer companies a better way to manage their corporate governance responsibilities? An affirmative answer to this question seems increasingly likely as companies face an unprecedented array of changes that are radically transforming their relations with shareholders and investors.

Some of these changes are rooted in long-term market trends: the rise of institutional investors and decline in retail owners; the shift from long-term to short-term investment practices; increasing shareholder diversity and dissent; globalization and the proliferation of cross-border investment; growing media attention to business issues and scandals; increased recognition of stakeholders and non-financial constituencies.

Other changes arise directly from the corporate governance reform movement: enhanced board power and accountability; proliferating shareholder activism; growing influence of proxy advisory firms; greater rights for minority shareholders, including voting rights on compensation; increased acceptance of environmental and social concerns.

Finally, new initiatives and regulations in the wake of the financial crisis are fundamentally reshaping the governance landscape: more stringent risk controls; increased transparency; structural reform of the finance industry; upgrades to comply-or-explain governance; formulation of stewardship codes for institutional investors.

A tectonic shift in governance focus

In response to these transformative events, leaders of the corporate governance movement are establishing new priorities. The work of enacting corporate governance rules and promoting best practice standards has been successfully completed, creating a global consensus about how governance should look from outside the company. The most urgent question today is how governance should look inside the company and, most controversially, inside the boardroom. Shareholders recognize that rules, standards and external metrics do not guarantee good governance. Continued reliance solely on systemic reform would over the long term doom governance to a superficial box-ticking exercise.

To avoid this outcome, shareholders are looking for ways to probe more deeply into the inner workings of companies. Targets for activism are being selected based on business fundamentals and financial performance rather than just compliance with governance norms. Shareholders are factoring environmental practices, social responsibility and non-financial performance metrics into the governance agenda. They are pressuring proxy advisory firms to improve the quality of research, increase local market expertise, engage directly with individual companies, make their analytics more transparent and customize their research and vote recommendations.

Ironically, the shift from external to internal governance has also turned a spotlight onto the inner workings of institutional investors. The governance reform movement has come full circle and is now raising questions about the quality of institutional investors' own governance, fiduciary duties, share voting, "stewardship" and oversight of portfolio companies. Although stewardship codes are in the early stages of development, it is clear that over the long term they will accelerate the trend toward deeper scrutiny of companies and boardrooms.

An opportunity for companies

How should companies respond to these new governance pressures? Clearly it is not in their interest to remain on the defensive while shareholders set the governance agenda and push for additional rules. Companies need to bypass the old debates about power, micromanagement, control, entrenchment, shorttermism and governance as a "zero-sum" game. They must capture the initiative, assert their leadership role in governance, define the agenda and recast the governance debate in business terms. For many companies this means a 180-degree change in attitude. They need to unlearn many of the lessons - often rooted in fears about takeover abuses, activists, hedge funds and short-termism - that have been responsible for adversarial relations between companies and shareholders.

The following five principles provide a good starting point for companies to define governance in positive terms and rethink how it can help them run their businesses more successfully:

1. Corporate governance defines the proper relationship of the company's board, management and shareholders. Its objective should be to align their interests.
2. Corporate governance is a framework for running the business. It is not a compliance exercise.
3. Corporate governance is a board responsibility. It requires a voice for directors and transparency in the boardroom.
4. Corporate governance is a means for companies to improve management efficiency, reduce risk, maintain a healthy corporate culture and achieve long-term economic goals. Governance is not an end in itself.
5. Corporate governance is a means for shareholders to become informed about boardroom process, corporate culture and strategic goals. Governance is not about power, control, or micromanagement.

These principles spell out a positive mindset and a governance agenda aligned with business goals that should help companies realize the benefits of constructive dialogue with shareholders modeled on their investor relations programs.

To this end, IR must reinvent itself. It must create a parallel program that integrates corporate governance and board-level issues with the company's business and financial communications. In effect, companies must define their investor relations responsibilities and goals much more broadly in order to develop a holistic relationship with investors that comprises both their buy-hold-sell decisions (IR) and their stewardship responsibilities (corporate governance).

Obstacles to convergence of corporate governance and investor relations

In theory, both investor relations and corporate governance should be solidly aligned in their support of business goals and the creation of long-term economic value. The reality, however, is very different. IR and corporate governance have more differences than similarities. To develop a holistic investor relations program, companies must deal with a wide range of issues that have kept corporate governance and investor relations on separate paths for many decades.

First, IR is a management responsibility, while corporate governance is a board responsibility. IR occupies a well- defined position on the organization chart (usually associated with the CFO). It manages its own budget and runs a structured and continuous program of outreach and communications organized around earnings releases and corporate events. Its sales and marketing functions are well understood and supported within the company.

By contrast, governance is more likely to be treated as a corporate stepchild, without a clear place in the company's organizational structure or a separate budget or resources for implementation. When governance is defined exclusively as a legal/compliance obligation, companies can become overly focused on its risks, costs and liabilities rather than its benefits.

The association of corporate governance with the board of directors can both elevate its importance and reinforce some of these practical problems of implementation and accountability. Boards often lack their own budget and independent resources (except when operating in crisis mode). Boards generally prefer to function collegially and privately behind closed doors – a tradition that discourages external dialogue or disclosures about their internal processes and governance decisions. In some jurisdictions, such as the United States, concerns about liability constrain directors from any form of communication outside legally mandated disclosures. Even in comply-or-explain governance systems, boards have been criticized for failing to take full advantage of the opportunity to "explain" how their governance policies and decisions advance business goals and serve the interests of shareholders. In light of these issues, companies face a challenge in developing new resources and finding new ways for boards to actively participate in the implementation of the governance decisions for which they are responsible and explain how they are doing so.

Second, IR is an internal function, while corporate governance is imposed from outside the company. Governance principles and best practices are the product of shareholder activism, legislation, rule-making and market listing standards – often mandated in the face of strong opposition from companies. The externality of governance is responsible for its characterization as a compliance exercise, imposed on the company by regulators, shareholders and other parties presumed to lack inside knowledge of the business. Governance is also associated with election contests, takeover bids, dissident campaigns and the activities of gadflies and special interest groups that are viewed by boards and managers as an external threat to the welfare of the company.

These characteristics contribute to an attitude of mistrust and a misplaced assumption common among business executives that governance has nothing to do with the "real" work of running a business enterprise. In boardrooms it is common for governance to be perceived as a cover for micromanagement and a threat to directors' exercise of business judgment.

Third, investor relations programs communicate with a well-defined audience, while the governance audience is elusive. The IR audience of securities analysts, portfolio managers, traders and other investment decision-makers are receptive to the IR message and recognize the value of the two-way dialogue, even when they challenge the company's strategy or performance. The discipline of investor relations is widely accepted as an tool for achieving fair valuation and promoting market efficiency.

Unlike IR, companies seeking to communicate about corporate governance often have difficulty identifying who their shareholders are. Complex ownership chains involving trustees, global custodians, subcustodians, asset managers and other agents often intentionally conceal the identity of beneficial owners, purportedly to protect their privacy. Once owners have been identified, it may still be difficult to identify the individuals who make governance decisions. Even when institutional investors disclose their governance policies and voting decisions, they may be unwilling to reveal the identity of the individuals responsible for stewardship duties and share voting.

In addition, governance communication has traditionally been initiated by shareholders rather than by companies, and many institutions prefer a one-way street which allows them to target companies for dialogue rather than being targeted themselves.

Fourth, IR is a continuous program structured around earnings releases and corporate events throughout the year. Governance communication is episodic rather than continuous, usually coming into focus once a year at the time of the annual general meeting. This seasonality creates practical problems for institutional investors. They profess not to have sufficient time and resources to handle dialogue with a large number of portfolio companies during the annual meeting season.

Fifth, investor relations programs communicate directly with the institutional investors, while governance dialogue must also deal with proxy advisory firms. Proxy advisors work on a wholesale basis, establishing standardized governance policies and metrics applicable to many different companies. From the company perspective, this "box-ticking" approach fails to represent an accurate picture of the individual business, establishes a distorted agenda and inhibits dialogue with shareholders.

Sixth, investor relations speaks the language of finance and frames its message using the quantitative and numerical terminology favored by investors. Governance dialogue, however, deals with qualitative issues whose impact may be difficult to quantify or describe in financial terms. However, the financial crisis of 2008 revealed that the tension between quantitative and non-quantitative metrics and values, between short-term and long-term goals and incentives, between tangible and intangible measures of performance, are critical questions that companies, investors and regulators can no longer ignore. The answers to these questions, which define both the rewards of governance excellence and the risks of governance failure, will frame the holistic investor relations dialogue of the future.

Steps toward holistic investor relations

What should the governance side of a holistic IR program look like? What practical steps should companies undertake in order to bring governance and board-level issues into an integrated, holistic program of investor relations and financial communications?

For the near term, investor relations should focus on the company's governance profile and on preparations for corporate events and strategic situations where shareholders have an active role and where governance policies are likely to affect shareholder response. These transactions (which include the annual general meeting, extraordinary general meetings, mergers, acquisitions, takeover bids, capital restructurings, rights offerings, response to activist initiatives and shareholder resolutions) provide useful opportunities to collect data, open lines of communication with shareholders, establish credibility and build relationships with top institutional investors. These transactions, which teach companies and their boards about the practical side of governance, focus on dialogue with investors about business fundamentals rather than governance theory.

In contemplation of this type of corporate event, companies should take the following steps to develop an integrated program of shareholder outreach and investor relations directed at both governance decisionmakers and investment decision-makers.

- Conduct a comprehensive analysis of the company's governance, environmental and social policies and benchmark it against peer companies, global best practices, local rules, proxy advisory firms and other relevant standards. Pay close attention to issues arising from family control, state ownership and related party transactions.
- Prepare an updated shareholder identification and ownership profile, analyzing the implications of recent ownership changes and market activity and the links to the company's financial performance and changes in business strategy.
- Prepare a list of top institutional investors, identify their governance and voting decision-makers and compare them with Investor Relations contacts. Examine their record with respect to activism and support for governance reform.
- Review and update the company's legal and structural defenses with respect to takeover bids or election contests. Evaluate the governance implications of these provisions.
- Compile and review feedback from Investor Relations meetings and road shows during the past year.
- Review and analyze the voting results, shareholder comments, media coverage and other feedback from the most recent shareholder meeting or other recent transactions.
- Review recent private correspondence and communications with top investors, both local and global, including members of controlling groups or families.
- Review analyst reports, media coverage and market commentary about the company and the industry.
- Prepare an objective analysis for the board and senior management outlining the company's risks and vulnerabilities and recommending a plan to deal with them.
- Assemble an internal IR project team, including the General Counsel, Company Secretary and, as appropriate to deal with governance and strategic issues, the CFO, CEO, Board Chairman and other senior executives and board committee chairs.
- Assemble a project team of outside advisors to provide legal and financial counsel, expertise in compensation, media relations, crisis management, cross-border voting, government relations and other skills as needed.
- Determine the appropriate role for the board of directors in engagement with shareholders before, during and after the shareholder meeting or transaction.
- Organize outreach to major shareholders if controversial management proposals or shareholder resolutions are expected to be on the agenda for the annual general meeting or an extraordinary meeting of shareholders.
- On completion of the transaction, conduct a review of the results, analyze findings and make recommendations to improve results in the future.

Conclusion

Holistic investor relations is still an aspirational concept. While primarily a task for companies and boards, the development of integrated governance and financial communications programs ultimately requires both companies and institutional investors to change the way they think and behave towards each other.

Overcoming differences that have long dictated a separation of governance and investor relations within companies will take time, but the effort to establish good corporate governance will unquestionably generate internal benefits companies, whether or not institutional investors are equally responsive.

Institutional investors face a much greater challenge bridging the gap that separates their investment and governance decision-making domains. Companies should take the initiative and push aggressively for governance reform within the financial service industry. Corporate governance standards should apply equally to both companies and the institutional investors who provide their capital.