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Directors Should Communicate With Shareholders

To demonstrate their effectiveness, corporate boards should increase transparency, provide an annual report of boardroom activities and take charge of their relations with shareholders.

by John C. Wilcox, Chairman, Sodali

With shareholders continuing to press for ever-deepening levels of engagement, companies must find a way to answer the most basic question of corporate governance: *"How effective is the board of directors?"* It is a question that can only be answered by the board itself, but it presents directors with a challenge as well as an opportunity. The challenge is to overcome the mindset, habits and perceived risks that have long kept boardroom activities under wraps. The opportunity, on the other hand, is to define governance and strategic issues from the board's perspective, manage shareholder expectations, take the engagement initiative away from shareholders and reduce the likelihood of activism. Directors should give careful consideration to this opportunity. Over the long term, it will be far better for companies to control the process by which board transparency is achieved rather than waiting for yet again another set of governance reforms that could further erode the board's authority.

Despite widespread support for board primacy and the board-centric governance model, boardroom transparency and director-shareholder relations are not a priority at most companies. A recent DealBook column in the New York Times described the situation as follows:

> "What if lawmakers never spoke to their constituents? Oddly enough, that's exactly how corporate America operates. Shareholders vote for directors, but the directors rarely, if ever, communicate with them."

The problem is not limited to corporate America. Opaque boardrooms are a global phenomenon, particularly common in markets where companies are dominated by founding families, control groups, or the state.

The column concludes:

> "...[S]ome form of engagement with shareholders – rather than directors simply taking their cues from management – would go a long way toward helping boards work on behalf of all shareholders..."
> [Andrew Ross Sorkin, The New York Times, July 21, 2014]

Cues from management are not the only concern. In many global markets the board's role is broadly defined, requiring directors to balance the competing demands of insiders, resolve conflicts of interest, deal with related-party transactions and juggle competing business and public policy goals in addition to their basic oversight duties. In these markets the need for transparency is even more compelling than in highly regulated markets, such as the UK, the European Union and the USA, where comprehensive legal, disclosure and accounting standards are well established.

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BOARDS ARE UNDER PRESSURE...

Pressure for greater board transparency and more open communication continues to come from the usual suspects: activist investment funds, hedge funds with a range of long and short-term investment strategies, governance reform professionals, NGOs, shareholder advocacy groups, trade unions, individual shareholder activists, special interest proponents and other adversaries. Proxy advisory firms compound the pressure by providing a global audience for these disputes. When issues of policy are involved, the media and politicians often step in to further amplify the pressure on companies.

Companies have fought defensive rearguard actions against activism, occasionally prevailing in specific campaigns, but ultimately they have had to concede defeat on most policy disputes relating to governance and board accountability. The decade-long evolution of the say-on-pay vote exemplifies this pattern of opposition and retreat.

Despite the chain of losses, the high-volume debate between companies and shareholders about the merits of governance reform continues today: Are corporate governance standards good or bad for companies? Does shareholder activism produce value or destroy value? Should shareholders have more power or less? Are directors sufficiently independent or not? Should corporate governance be director-centric or shareholder-centric? Is chronic short-termism the fault of greedy shareholders, or greedy CEOs, or weak boards, or does it represent the inevitable decline of free-market capitalism, or all of the above? The list of questions goes on and on. The debate has not lessened in intensity, but it has not resolved the questions either. The few answers that have been provided remain largely determined by research methodologies, policy perspectives or the merits of individual cases. The real answer to most of the big questions seems inevitably to be "It depends..."

As 2015 approaches, it remains unclear how much the debate really matters or whether answers to these questions would be helpful to businesses and investors. For individual companies, the answer would seem to be No.

...BUT INSTITUTIONAL INVESTORS ARE UNDER PRESSURE, TOO.

Today's governance and regulatory environment is changing rapidly for shareholders and the investment community as well as for companies. In the extended wake of the financial crisis, institutional investors remain under the regulatory microscope. They can no longer claim privileged status or remain exempt from the governance and accountability standards they impose on portfolio companies.

Stewardship codes and new laws in several major markets now require institutional investors to intensify their oversight of portfolio companies and disclose publicly their governance policies, voting practices and engagement activities. These requirements have further led to the development of new means of collective institutional engagement through organizations such as the UK Investors Forum.

Proxy advisory firms, themselves under regulatory and industry pressure to provide less standardized governance reviews as well as more information about the integrity of their research and vote recommendations, are relying much less on their traditional check lists of governance externalities. In response to client demand, they are digging for more detailed information about board effectiveness at individual companies.

The financial crisis awakened the investment community and the general public to the failures that resulted from overreliance on quantitative analysis to evaluate companies' performance and risk. In response to new rules, institutional investors are now beginning to include intangibles and non-financial performance metrics in their analytical models. This wider lens embraces corporate governance, environmental practices, social policies, ethics, culture, reputation and other non-quantitative elements that are predictive of long-term performance. The terms “ESG” (Environmental, Social, Governance) and “sustainability” have become a form of shorthand for defining this new way of looking holistically at business enterprises. A recently issued Directive on disclosure of non-financial and diversity information by the EU Council puts the legal imprimatur on this broader set of data.

The enlarged analytical framework has important implications for companies -- and specifically for boards of directors. Responsibility for ESG and sustainability falls squarely on the board. The directors, rather than management, are deemed by shareholders to be answerable for ESG and sustainability.

Investor focus on non-financial criteria is producing some interesting results. In the U.S., the Council of Institutional Investors and its members have taken an approach that involves a carrot rather than a stick. CII has begun publishing periodic reports, based on member surveys and feedback, identifying companies whose disclosure practices exemplify best practice. A February 2014 CII report named six U.S. companies -- Coca-Cola, GE, Pfizer, Prudential Financial, Microsoft and Walt Disney -- as examples of excellence in disclosure of director qualifications and skills. In September 2014 CII published an additional report on board evaluation practices, citing GE (USA), Potash, Agrium (both Canadian companies), BHP Billiton (Australia), Dunelm (UK) and Randstad Holdings (Netherlands) as examples of excellence. According to deputy director Amy Borrus, CII plans to continue publishing reports on issues deemed important for its members to evaluate board effectiveness.

Organizations in other jurisdictions have also begun to identify companies with excellence in ESG/Sustainability and board communication. The annual UK ICSA Excellence in Governance Awards are a prominent example.

TRANSPARENCY INSTEAD OF ENGAGEMENT

Companies’ efforts to deal with activists tend to focus heavily on engagement (i.e., letters, meetings and outreach campaigns). However, engagement is reactive and does not establish a long-term basis for preventing activism. Companies seeking to reduce confrontation with shareholders in the future should look for strategies that preempt activists and forestall engagement rather than erecting more defenses.

Board transparency is surely the most effective form of prevention. Providing information about what the board is doing and why its decisions are aligned with business goals is the most direct means to avoid the shareholder misperceptions and discontent that can lead to activism.

Board transparency has long been acknowledged as the essential board accountability mechanism for companies in jurisdictions that rely on voluntary, principles-based, comply-or-explain governance systems. Admittedly, the comply-or-explain process is far from perfect. Explanations are mandated only where companies are non-compliant with governance principles, encouraging a narrative that can be haphazard and unrelated to other disclosures. The European Commission has been aggressively vocal about the poor quality of companies’ explanations and has threatened regulation to compel better results. Even when companies are diligent, a system designed on an exception basis will encourage piecemeal, ad hoc communication rather than a coherent narrative.

Lopsided communication also results from mechanisms such as the say-on-pay vote. Companies are obligated to prepare lengthy and detailed explanations in support of the complex remuneration programs that are now standard around the world. In addition to being burdensome to both companies and investors, this type of excessive regulatory micromanagement can distort board function by shifting directors’ attention to a particular issue of importance to regulators rather than letting the board set its own priorities based on business considerations.

A more coherent and self-directed approach to board transparency would enable companies to avoid these problems.

TRANSPARENCY -- DEFINING THE BOARD'S RESPONSIBILITIES

A board seeking to increase transparency should begin the process by clearly differentiating its role from that of management. The first step is to articulate the board's specific tasks and responsibilities separately from those of the CEO and management. This division of responsibilities is already implicit in today's global corporate governance principles. Essentially, the board of directors is responsible for its statutory duties plus ESG and sustainability, while management is responsible for everything else – day-to-day business operations, financial performance and the execution of strategy. Affirmation by companies of this allocation of responsibilities would by itself go a long way toward defining the scope and limits of board transparency.

Enumerating the board's specific tasks does not mean that one size fits all. Each company needs to carefully review what its board does and compile a list of responsibilities that takes into account the history, culture and characteristics of the enterprise as well as regulatory requirements. Lists will be different for companies in different jurisdictions and with different profiles -- dispersed ownership, family or group control, IPO companies, mature companies, state-owned enterprises, privately held companies, and so forth. But at a minimum, board responsibilities will include the following:

- Long-term strategy, company values, culture and "tone at the top";
- Oversight of management and long-term performance;
- Accounting principles and the audit process;
- Policies relating to ESG and sustainability;
- Director nomination, selection and competence;
- CEO succession planning;
- Board evaluation;
- Executive and board compensation;
- Risk oversight;
- Ethics, conflicts of interest and related-party transactions;
- Non-financial performance goals and metrics;
- Engagement and communication with shareholders and other constituents.

Differentiating the board's role from that of the CEO and management is more than a mechanistic exercise. It establishes an important principle for board transparency: *There are limits to the topics that directors can discuss with shareholders.* By contrast, there are no such limits (other than legal and regulatory) applicable to topics that the CEO and executive management can discuss with shareholders. If companies respect this principle, they will eliminate most of the risks associated with transparency because the dreaded "material, non-public information" will generally not be the subject matter of board communications. Problems related to duplication, leaks, market confusion, selective disclosure and unfairness will be unlikely to arise if directors articulate these limits and require shareholders to respect them.

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TRANSPARENCY -- AN ANNUAL BOARD NARRATIVE

Given the board's acknowledged primacy – its governing position at the top of the business enterprise, its fiduciary duties and its statutory role as the shareholders' elected representative body -- the absence of an annual written report from the board is an anomaly. If the buck stops with the board, shouldn't the directors be obligated to explain their actions? Assuming that "director-centric" is the preferred governance model, why is there no requirement for an annual report from the board? Director-centric does not mean "No questions asked." Even the business judgment rule – the keystone of board authority -- should encourage transparency rather than silence. An annual narrative describing the policies and decisions of the board and its committees should be the sine qua non of director-centric corporate governance.

If an annual board report were to be required, its content and scope should be defined -- but not dictated -- by the board's enumerated responsibilities. The narrative "story" should otherwise be free form. In some cases the board might describe how its committees and governance policies work in the business context. In other cases, the story might focus on an extraordinary business transaction or on the board's strategic vision. The story might give extra attention to controversial issues, such as compensation, where the board wants to explain a divergence from standard practice. The storyboard for directors should be as varied as the business conditions and issues faced by the companies they oversee. The essential point is that the board itself should decide what story it wants to tell.

The quality of a board narrative should be judged by its impact. Is it clear? Does it tell a compelling story about board effectiveness? Does it reveal a commitment to the company's business goals and sustainability? Are the shareholders convinced?

"DIRECTOR RELATIONS" - A PRACTICAL APPROACH TO BOARD ENGAGEMENT WITH SHAREHOLDERS

In addition to providing a written annual report of its activities, the board should have an independent voice and the means to exercise it.

A company planning to have its board meet directly with shareholders or participate in an engagement campaign should ensure that the process is planned, initiated and controlled by the company, not by shareholders. The agenda for meetings should be set by the company, not by shareholders. In most cases the board's purpose in meeting with shareholders should be for the directors to listen and learn rather than to debate.

A company may decide to go further and establish a formal program for conducting periodic board-shareholder engagement. In that case, the first step is to make sure that opening boardroom windows won't reveal internal problems. To ensure a clean house, the board should review the results of its annual evaluation and take steps to implement any meaningful recommendations. If an annual board evaluation process is not already in place, the board should initiate one. Shareholders have come to view regular board evaluation as an important accountability mechanism for the uniquely self-administered powers of corporate boards.

The board should commission independent experts to conduct a governance benchmarking and perception survey that examine the company's governance profile, competitive standing, reputation, risk factors, media coverage and other relevant measures of shareholder satisfaction with the company's board of directors, executive leadership and strategic direction.

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The board should also be given access to the company's information and databases that relate to share ownership, investor profiles and the views of institutional portfolio managers, financial analysts and governance decision makers. Voting results, contacts with activists, feedback from the annual general meeting and other shareholder and media commentary should be summarized for board review.

Armed with these resources and information, the board will then be in a position to determine whether engagement is necessary and, if so, to address the logistical questions of organizing a campaign: What topics should be on the agenda? Who should speak for the board? With whom should the board engage? When should engagement occur? Who from management should participate? The answers to these questions will vary, but they should be worked out in advance by the board in close collaboration with management.

Director relations programs are an aspiration, not a reality. Over time, however, as board transparency increases and companies become more comfortable with dialogue between directors and shareholders, such programs are likely to emerge. A few conceptual models for administration and logistics are worth considering:

1. Holistic Investor Relations. A management-led IR team can incorporate governance, environmental, sustainability and other board issues into an integrated IR program addressed to an expanded institutional investor audience of governance and voting decision-makers as well as analysts and portfolio managers. Directors can participate as needed, but they receive regular IR/ESG/sustainability feedback. Proviso: the effectiveness of this model relies on the willingness of institutional investors to integrate financial and non-financial metrics into their investment decision-making models.

2. Institutional Investor Relations. An expanded office of the Company Secretary, Board Secretary, or Corporate Governance Officer, within the management's budget, can be charged with a mixture of board and management administrative duties that combine board-shareholder communication and engagement together with such related duties as organization of the annual meeting, proxy solicitation, regulatory filings, disclosure and compliance.

3. Director Relations. The company can set up an independent department dedicated exclusively to serving the board. With its own budget and staff, reporting to the board and serving its committees, the Director Relations office would provide administrative support for internal activities such as director selection, board evaluation, compensation policy, D & O insurance and other ad hoc board projects, as well as external communications and engagements with shareholders. It would also organize the retention of independent experts to advise the board as needed.

There can be many variations on these configurations that take into account the unique characteristics of individual companies and the issues facing their boards.

CONCLUSION

Although global corporate governance standards continue to uphold the director-centric model, information about board effectiveness remains fragmentary and inconsistent. Both companies and shareholders would benefit from an annual board narrative and a structured program for directors to communicate and engage with shareholders.