

GOVERNANCE CHALLENGES 2018

# Board-Shareholder Engagement in the New Investor Environment



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# Strategic Shareholder Engagement: Practical and Legal Considerations

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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.<sup>1</sup>*

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

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<sup>1</sup> <https://www.blackrock.com/corporate/en-no/investor-relations/larry-fink-ceo-letter>

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Disclosure is a communication tool and should not become rote.

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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.

#### **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

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

Source: 2017 Spencer Stuart U.S. Board Index<sup>2</sup>

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

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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<sup>2</sup> <https://www.spencerstuart.com/research-and-insight/ssbi-2017>

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 be briefed 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.

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