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As Institutional Investor Influence Grows: Is Now the Time For Shareholder Engagement?

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As institutional investors have become holders of an ever increasing percentage of public company shares, so has their influence increased with respect to corporate governance matters. This increasing influence clearly reflects the fact that shares representing more than 75 percent of the equity invested in publicly traded corporations are now held by institutional shareholders.[1] Because institutional shareholders hold their shares on behalf of millions of individuals or other entities, they owe a fiduciary duty to such beneficiaries and shareholders to ensure the financial security of these investments. As a result, institutional shareholders have a duty not only to monitor the financial performance of the corporations in which they have invested, but also to understand how such corporations are managed.[2]

Some institutional investors go beyond mere due diligence, which results in their taking an activist approach to investing by trying to influence the corporate governance matters of such corporations.[3] Such institutional shareholders are commonly referred to as ''activist shareholders.''

Increasing Shareholder Activism

Many of the prominent activist shareholders have emerged from the economic downturn well positioned, and are increasingly targeting larger capitalization companies. Moreover, with some companies still trading below all-time highs and the availability of derivatives, which allow for ''stealth'' accumulations, the costs are lower for activists to take a meaningful economic position in a company.

Once an activist shareholder builds a significant stake in a company, the activist may apply pressure on the company, whether through private and public means, by writing letters to management, submitting shareholder proposals, and launching public relations initiatives to change the board and/or management or in a number of other ways. The activist may then seek to acquire control, either by demanding seat(s) on the board, publicly recommending that the company hire an advisor and commence a sale process, or even by putting in a ''stalking horse bid'' for the company. In addition, continuing pressure to declassify boards and redeem shareholder rights plans, so-called poison pills, makes companies increasingly vulnerable to activist approaches, especially as proxy advisory services are often inclined to support activist agendas.

Proxy advisory firms have expanded and grown more influential—largely due to the growth of institutional shareholders and shareholder activism.[4] With the increasingly important role they play in the proxy voting system, criticisms of proxy advisory firms have emerged, ranging from (i) the methodology used by such firms to determine whether a certain corporate governance practice is cause for concern, to (ii) the ap-

[1] Joseph E. Bachelder III, *Institutional Shareholders and Their ''Oversight'' of Executive Compensation* (July 23, 2012, 9:31 AM), http://blogs.law.harvard.edu/corpgov/2012/07/23/institutional-shareholders-and-their-oversight-of-executive-compensation.

[2] Joseph E. Bachelder III, *Say on Pay: Who Is Watching the Watchmen?* (Apr. 11, 2012, 9:37 AM), http://blogs.law.harvard.edu/corpgov/2012/04/11/say-on-pay-who-is-watching-the-watchmen/#more-27402.

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[3] *Four Key Trends of the 2012 Proxy Season*, Ernst & Young, 7, http://www.ey.com/Publication/vwLUAssets/Four_key_trends_of_the_2012_proxy_season/$FILE/1207-1372854_ProxyGovernance_CF0035_071612.pdf.

[4] Tapestry Networks, Inc., *A Dialogue with Institutional Shareholder Services*, ViewPoints, no. 39, 1 (Nov. 7, 2012), http://www.ey.com/Publication/vwLUAssets/Proxy_advisory_firms/$FILE/ViewPoints_39_November_2012_Dialogue_with_ISS.pdf.

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parent conflicts of interests in providing advice on how to vote to shareholders of some of the same companies to which such firms provide consulting advice, to (iii) the ability of activists to leverage their own agendas by encouraging proxy firms to support the opinions of such activists.[5] Proxy advisory firms such as Institutional Shareholder Services Inc. (''ISS''), RiskMetrics, and Glass, Lewis & Co. (''Glass Lewis'') generally support the shareholder proposals initiated by activist shareholders, and many more traditional institutional shareholders follow their recommendations. The most frequently voiced criticism is that proxy advisory firms have too much influence on shareholders, who allegedly follow recommendations without independent analysis.[6] ISS has more than 1,200 clients, including non-activist institutional investors, mutual funds, corporate and public pension funds, hedge funds, and college endowments, many of whom strictly follow ISS recommendations. As a result, ISS can often influence approximately 25 percent of the vote in a proxy contest. Similarly, Glass Lewis, whose subscribers include eight of the ten largest mutual funds and the top five public pension funds in the U.S., can influence 10 percent or more of the vote in a proxy contest.

Many believe that proxy advisory firms ''have a very rules-based approach that does not reflect the nuanced approach that investors need to take.'' [7] One way corporations can lessen the potentially overwhelming influence of proxy advisory firms is for the board of directors to remove the proxy advisory firms from the role of intermediary and take opportunities to meet and hold conversations directly with the shareholders. The current approach to board-shareholder engagement has frequently led to an often hostile and adversarial relationship between investors and boards.[8]

Over the course of a year, boards of directors often only meet or hold conversations with their shareholders directly during regularly scheduled shareholder events, such as the annual shareholder meeting or analyst calls, which are described by some directors and investors as being largely ''formulaic'' and ''futile.'' [9] Outside of the traditional forms of communication, board-shareholder communication is more or less limited to times of crisis or when performance issues arise.[10]

Benefits of Shareholder Engagement

Several benefits flow from regular, ongoing board-shareholder engagement. First and foremost, direct and ongoing engagement can foster better understanding of the company, on one hand, and the institutional shareholders, on the other hand, as well as of any issues that the company is facing.[11] Board-shareholder engagement can lead to mutual agreements on various corporate governance matters. According to a recent Ernst & Young report, in the 2012 proxy season at least 15 percent of more than 800 shareholder proposals were withdrawn by shareholders following discussions with the board, with proposals submitted by public pension funds among those most commonly withdrawn following such dialogue.[12] Similarly, during a meeting of the Lead Director Network—a group of lead independent directors, presiding directors and non-executive chairmen from leading American corporations—held on June 19, 2012, representatives from several institutional shareholders recalled that after discussions during which board members explained their reasoning for combining the roles of CEO and chairman of the board, the shareholders decided to drop proposals to separate the roles.[13]

Continuing and regular conversations between a company's board of directors and its shareholders can also function as an effective form of advocacy for the company if and when challenging situations, such as a hostile bid or proxy contest, arise.[14] Institutional shareholders are much more likely to support current board members if they have been given an opportunity to evaluate the general quality of the board and become comfortable with the board's approach to corporate governance.[15] A board's efforts to reach out to its shareholders may not always garner immediate results, but ongoing dialogue can help establish and develop relationships of trust with the company's largest shareholders,[16] who may then be more willing to show confidence in the board of directors.

Another potential, if unexpected, benefit from board-shareholder engagement can be the identification of potential director nominees.[17] At the June 2012 meeting of the Lead Director Network, one director recalled that during a conversation with an institutional shareholder of the company, he had mentioned that the board was looking for a new director with technology experience.[18] The institutional shareholder representative then recommended several qualified candidates, one of whom ended up serving on the board.[19] Dialogue with shareholders can not only provide helpful insight into their concerns and perception of the company, but also provide tangible improvements to management and/or the board.

Risks of Shareholder Engagement

On the other hand, there are also unique challenges and risks which accompany increased board-shareholder engagement. Boards may face even greater difficulty in balancing responsiveness to shareholders and doing what is best for the company in terms of governance practices.[20] Likewise, boards may find themselves under pressure to continue and/or enhance any

[5] Bachelder, *supra* note 2.
[6] *A Dialogue with Institutional Shareholder Services*, *supra* note 4, at 1.
[7] Tapestry Networks, Inc., *ViewPoints: Advancing Board-Shareholder Engagement*, 7 (2012), http://www.tapestrynetworks.com/issues/corporate-governance/upload/Tapestry-ViewPoints-Advancing-board_shareholder-engagment-30-May-2012.PDF.
[8] *Id.* at 4.
[9] *Id.* at 3-4.
[10] *Id.* at 4.
[11] Tapestry Networks, Inc., *A Dialogue with Institutional Investors*, ViewPoints, no. 14, 6 (Aug. 9, 2012), http://www.tapestrynetworks.com/initiatives/corporate-governance/upload/Tapestry_KS_LDN_View14_Aug12.pdf.
[12] *Four Key Trends of the 2012 Proxy Season*, *supra* note 3, at 4.
[13] *A Dialogue with Institutional Investors*, *supra* note 11, at 4.
[14] *Id.* at 6.
[15] *Id.* at 4.
[16] *Id.* at 6.
[17] *Id.* at 6.
[18] *Id.* at 6-7.
[19] *Id.* at 6-7.
[20] *Four Key Trends of the 2012 Proxy Season*, *supra* note 3, at 9.

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such increased board-shareholder engagement,[21] which in turn may contribute to considerable time and energy being diverted from other, arguably more pressing board matters.[22]

In addition, increased frequency of board-shareholder communication may lead to increased risk of violating Regulation FD.[23] Adopted by the Securities and Exchange Commission in 2000, Regulation FD prohibits the selective disclosure of information by companies and requires companies to publicly disclose any material nonpublic information which has been disclosed to certain individuals or entities (the concern being that such material nonpublic information may otherwise be available only to market professionals and large shareholders).[24] Similarly, there is also the risk of the company sending mixed messages to its shareholders, if the board and management do not answer questions in exactly the same way, even if they are aligned in terms of their opinions on a certain issue.[25] Such inconsistencies in message, whether actual or perceived, can lead to confusion and uncertainty among shareholders.

Tips for Effective Shareholder Engagement

Despite some cause for concern, on the whole, maintaining ongoing board-shareholder communication can have potential benefits, particularly if certain guidelines are established and followed. The most effective way to reap the benefits from board-shareholder engagement is to think of it as an ongoing process, as opposed to an isolated event or in response to specific shareholder demands or in anticipation of challenges to the company.[26] Shareholders are likely to appreciate early and proactive efforts by the board to communicate with them directly, and thus may be more responsive to and willing to work with the board if and when such challenges to the company do arise.[27] Similarly, in order to maximize potential for effective, meaningful conversations, boards should think about concentrating such board-shareholder dialogue outside of the proxy season, as large institutional shareholders may not have the time to pay particular attention to any one individual company during that busy time.[28] In addition, a board should come to the meeting prepared with knowledge about its shareholder base and the concerns of such shareholders.[29] Demonstrating that the board has taken the time and effort to learn more about its shareholders prior to the meeting is a way to inspire goodwill and show institutional shareholders that the board is serious about its engagement efforts.

It may also be helpful to have management, as opposed to the board, coordinate any board-shareholder meetings to ensure that directors are informed about any specific shareholder concerns and that management is also aware of the board's engagement with such shareholders.[30] The agendas for any such board-shareholder meetings should also be prepared in advance, and limited to those specific topics of discussion.[31] This will not only limit the possibility of sending mixed messages, but also lessen the risk of violating Regulation FD. Similarly, having the general counsel of the company and the Chief Executive Officer (''CEO'') or a representative from management could also help to alleviate the risks related to mixed messages and Regulation FD. The CEO or management representative's knowledge of strategic issues from a business standpoint could also add useful insight to the discussion (unless the meeting agenda includes a discussion of CEO and/or management compensation or performance, in which case, such persons should not be present).[32]

In addition, having the entire board present at the meeting may not be as productive as having a few carefully chosen representatives of the board, such as the lead director—who arguably would have the best knowledge of the board members, boardroom dynamics and corporate issues—and chairs of certain key committees of the board (such as the compensation committee and/or the audit committee).[33] Having too many individuals in attendance could inhibit meaningful interaction between the board and the company's shareholders and increases the likelihood of detracting from the topics of discussion during the meeting.[34]

Several viable options for cultivating engagement outside of or in addition to the formal channels of board-shareholder communication have also emerged. For example, on top of holding quarterly analyst calls, the board could organize a fifth such call, announced publicly and in advance and made accessible to the general public.[35] Similarly, in addition to the annual shareholder meeting, boards could organize a regularly scheduled meeting with a focus on interaction between the board and/or board committees and the company's shareholders.[36] Such interactions could take place in person, or, for convenience, through virtual shareholder meetings.[37]

Moreover, boards and investors do not necessarily have to interact solely in a formal, official capacity at all times—informal meetings in social settings can also help to develop and encourage relationships between boards and investors.[38] Boards may also want to consider creating a board committee specifically charged with the maintenance and further development of board-shareholder engagement,[39] as ''one size does not fit all'' and each individual board may want to tailor its approach to communications with investors according

[21] *Id.*

[22] *A Dialogue with Institutional Investors*, *supra* note 11, at 8.

[23] *Id.* at 7.

[24] U.S. Securities and Exchange Commission, ''Final Rule: Selective Disclosure and Insider Trading'', Aug. 21, 2000, http://www.sec.gov/rules/final/33-7881.htm.

[25] *A Dialogue with Institutional Investors*, *supra* note 11, at 7-8.

[26] *See* Holly J. Gregory, *Shareholder Engagement: Looking Back and Planning Ahead*, Practical Law Publishing Limited and Practical Law Company, Inc., 25-26 (Oct. 1, 2012), http://www.weil.com/files/upload/October2012_Opinion.pdf; *see also A Dialogue with Institutional Investors*, *supra* note 11, at 10.

[27] *A Dialogue with Institutional Investors*, *supra* note 11, at 10.

[28] *Id.* at 10.

[29] *Id.* at 9.

[30] *Id.* at 10-11.

[31] *Id.*

[32] *Id.*

[33] *Id.*

[34] *Id.*

[35] *ViewPoints: Advancing Board-Shareholder Engagement*, *supra* note 7, at 8-9.

[36] *Id.*

[37] *Id.*

[38] *Id.*

[39] *Id.*

to board dynamics or particular circumstances surrounding the company.

Ultimately, the decision on whether to engage with shareholders, and to what extent, rests with each individual board of directors and depends on their analysis of the benefits and risks of such engagement. If the board does decide that the benefits outweigh the risks, it should carefully establish rules to guide communications between the board and shareholders and craft a plan for how and when such conversations should take place. Doing so will ensure that such communications are productive and mutually beneficial to all parties.

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