Lead Director Network
ViewPoints
Issue 14 August 9, 2012

A dialogue with institutional investors

Introduction

On June 19, 2012, the Lead Director Network (LDN) convened in New York City for its 13th meeting, during which members examined the relationship between directors and major shareholders.

Members were joined by representatives of two different types of institutional investor: Richard Breeden, former chairman of the United States Securities and Exchange Commission (SEC), and CEO and chairman of Breeden Capital Management, an asset manager focused on active engagement in a small number of investments;[1] and Shawn Johnson, senior managing director and investment committee chair at State Street Global Advisors, a large and diversified investor with substantial holdings across virtually all public companies.[2] Gary Retelny, president of Institutional Shareholder Services (ISS) and executive committee member of its parent, MSCI, joined members and guests for a dinner discussion concerning proxy advisers.[3]

This issue of *ViewPoints* synthesizes discussions of the LDN members and guests concerning board-shareholder engagement.[4] For further information about this document, see page 12. For a full list of contributing members, see the Appendix on page 13.

Executive summary

Directors, particularly lead directors,[5] face increasing pressure to meet directly with their companies' largest institutional shareholders. Many LDN members have engaged with their shareholders; those who have not are interested in exploring the benefits and risks of such meetings.

- **The upswing in board-shareholder engagement** *(Page 2)*

  According to both directors and investors, demand for direct board-shareholder engagement has increased. Pressure for corporate performance, greater attention to governance, new investor powers, international practices, and frustration with written disclosures are contributing factors. Members and guests expect that board-shareholder engagement will become even more common in years to come.

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[1] Breeden Capital Management specializes in managing concentrated, long-only, small- to mid-cap value equity portfolios with a focus on active engagement. Its stated investment philosophy is to "vigorously and actively engage our portfolio companies to identify and implement opportunities to increase performance and shareholder value on a sustainable basis. By persuading company management and boards to adopt healthy, value-enhancing practices, activists can force positive change and create sustainable shareholder value." (Breeden Capital Management, "Investment Philosophy," 2011.)

[2] Towers Watson ranked the value of State Street Global Advisors' assets under management as the second largest in the world as of yearend 2010. See Towers Watson, *The World's 500 Largest Asset Managers* (New York: Towers Watson, 2011), 20. State Street Global Advisors operates a wide variety of investment vehicles with different investment philosophies and approaches.

[3] For a summary of the session with Mr. Retelny, see Lead Director Network, "Dialogue with ISS President Gary Retelny," *ViewPoints,* August 9, 2012.

[4] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule, whereby names of members and their company affiliations are a matter of public record, but comments made before, during, and after meetings are not attributed to individuals or their companies. Messrs. Breeden and Johnson agreed to speak on the record; their comments are also italicized. Unattributed member comments are shown in italics, and unattributed comments from other subject-matter experts with whom Tapestry has spoken are unitalicized.

[5] Documents for this network use the term "lead director" to refer interchangeably to the titles *lead director, presiding director,* and *non-executive chairman* unless otherwise stated.

- **Topics for board-shareholder discussion** *(Page 4)*

  When they meet, directors and investors tend to discuss issues such as board composition and leadership structure, executive compensation, and CEO performance. Most LDN members suggested that board-shareholder dialogue should not focus on a company's strategy or financial or operational performance, but some shareholders will be focused on those topics rather than governance issues.

- **Benefits and risks of direct engagement** *(Page 6)*

  Direct engagement can help directors better understand the company, its investors, and related issues, and might result in practical advice or better proxy voting outcomes. Engagement may also satisfy investor desire to meet with the directors they elect. However, director-investor dialogue carries risks that must be managed carefully, such as the potential for mixed messages, excluding management from shareholder conversations, and violating Regulation Fair Disclosure (Reg FD).

- **Effective engagement practices** *(Page 9)*

  Members and guests identified a number of practices that improve director-shareholder dialogue, such as having directors learn more about shareholders and their voting preferences before the meeting, carefully selecting investors and company representatives for the specific issues to be discussed, and setting, and following, the right agenda. More broadly, some members felt that regular, proactive engagement with shareholders is preferable to reactive outreach during proxy season. Members suggested that management should generally coordinate and participate in meetings with shareholders unless circumstances require otherwise. There is no one ideal format for investor meetings; one-on-one meetings, teleconferences, and informal group gatherings can all be effective.

The upswing in board-shareholder engagement

Corporate engagement with shareholders, especially among senior executives, investor relations personnel, and large institutional investors, is strong.[6] Historically, there has been little direct dialogue[7] between board members and shareholders, but that is changing. A briefing for directors published by the Canadian Institute of Chartered Accountants notes that "as part of a growing, international trend, many shareholders want to increase their engagement with boards."[8] Money managers are calling on directors for better engagement[9] and for other investors to make themselves heard.[10]

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[6] See, for example, Marc Goldstein, *The State of Engagement between U.S. Corporations and Shareholders* (New York: IRRC Institute, 2011).

[7] As discussed more fully on page 10, there is no standard format for board-shareholder meetings. Dialogues may be formal or more casual, occur in person, by phone, or through a virtual forum, with two or more organizations each represented by one or more people. While individual issuers, investors, and directors may have general preferences, they are not necessarily the same; the common theme is to optimize the format of each meeting based on its purpose.

[8] Andrew J. MacDougall and Robert Adamson, *Directors Briefing – Shareholder Engagement* (Toronto: Canadian Institute of Chartered Accountants 2011), viii.

[9] Barry B. Burr, "Money Managers Increasing Activism on Governance – but Quietly," *Pensions & Investments,* March 19, 2012.

[10] Roger W. Ferguson, "Riding Herd on Company Management," *Wall Street Journal,* April 28, 2010.

Conversations between shareholders and directors are often on issues unique to the company or the investor. Nonetheless, members observed that a number of generally applicable, systemic factors have contributed to the increase in direct discussions:

- **Pressure for corporate performance.** Several members suggested that governance questions are often triggered by performance issues: *"If your company is sailing along with no issues, then perhaps you won't [be asked for an investor meeting]. But not many companies are in that comfortable spot these days."* Mr. Breeden said, *"Directors need to understand how their company has performed in delivering shareholder returns over a multiyear period, and be aware that consistently weak performance compared with peer companies will lead to rising shareholder concern regarding the board's attention to accountability for performance."*
- **More attention to governance issues.** One member said, *"There is an increasing understanding that governance matters."* Mr. Johnson agreed: *"At State Street Global Advisors, we believe that governance matters, and we push companies and boards for what we perceive to be reasonably good governance."* Mr. Breeden also noted that governance concerns include *"the quality of a company's disclosures and overall transparency and the board's attention to major business risks."*
- **Enhanced investor powers.** Investor power has increased markedly, members said. This is in part due to legal and regulatory changes, such as mandated advisory say-on-pay votes and the accretive effects of broker discretionary vote changes. Governance trends, such as declassifying boards and electing directors to a majority vote standard, have also boosted investor power.
- **International governance practices.** In foreign markets, particularly in some European countries, board-shareholder engagement is the norm, by law and practice. In the United Kingdom and other European countries, shareholder stewardship codes have encouraged investors to disclose their engagement practices and activities. These trends are coming stateside, according to directors and investors.
- **Frustration with written disclosures.** Proxy statements and other regulatory filings are often seen as impenetrable "legal and anachronistic" documents.[11] When information is not clear or is hard to interpret, investors want meetings. As one investor told Tapestry, "Our process is simple. We read your disclosures. If we are not comfortable with something, we ask to sit down with you. We want to see a process that demonstrates real thought about your plan."[12]
- **The rise of passive investing.** Indexed investors lack the option to sell their stock position, in some cases, so they believe that they must seek to improve company performance through better governance practices. Mr. Johnson said, *"As a big passive investor, we see a need to really own governance, which is why we have higher standards than others and why we focus on board engagement."* According to the mutual fund adviser Strategic Insight, passively managed funds have become more common and

[11] Andrew J. MacDougall and Robert Adamson, *Directors Briefing – Shareholder Engagement*, 2.
[12] Tapestry Networks, "Advancing Board-shareholder Engagement," *ViewPoints,* May 30, 2012, 4.

important in recent years: from a mere 0.8% of the mutual fund market in 1990, they rose to 8% by 2000 and 19.1% by 2010.[13]

- **Desire to disintermediate proxy advisory firms.** Boards and investors have expressed concern over various elements of the proxy advisory industry.[14] The SEC is considering how to provide guidance on how the federal securities laws should regulate the activities of proxy advisory firms.[15] There are some investors and directors who seek to disintermediate proxy advisory firms from the relationship between the shareholders and the company, particularly the company's board members. One member said, *"Investors seem to want dialogue [with the board] not intermediated by the proxy firms."*

Members expect these systemic issues will result in increasing pressure for direct board-shareholder engagement. One member observed, *"We are now in an environment where investors want to reach out to our boards."* Mr. Johnson agreed, saying, *"If we call you, you already have a problem. If you don't answer, you have a real problem."*

Topics for board-shareholder discussion

Members and guests identified four subjects most likely to arise in these new, more proactive board-shareholder dialogues: corporate governance, the chief executive, strategy, and operational and financial performance.

Corporate governance

LDN Members noted that board members are well positioned to discuss the company's governance structure and process, including three common topics:

- **Quality of board dialogue.** Conversations with directors provide an opportunity for investors to gauge the general quality of the board and its approach to governance. One member said that some meetings with investors *"seem to be for the purpose of confirming if the board, using the lead director as a proxy, really understands the company's situation."* As one investor told Tapestry, "If I understand that there is an engaged, knowledgeable, highly fiduciary-oriented board, I am going to place a premium on that company rather than the one that I think is made up of six roommates from college." Mr. Johnson said, *"I really want to see that there are active, careful debates."* Mr. Breeden agreed, adding, *"When issues of capital allocation or risk management are before the board, for example, many large shareholders want to assess whether directors have carefully thought through the issues."*

- **Separation of the roles of CEO and chair.** One member said the lead director is the only person who can effectively explain *"why combining the roles makes sense."* Several members discussed meetings they have had on this topic – conversations that, in several cases, have led shareholders to drop proposals to separate the roles. In those cases, the conversations have been enough to set investors

[13] Personal communication with Loren Fox, senior research analyst at Strategic Insight, June 27, 2012.
[14] Barry B. Burr, "Money Managers Increasing Activism on Governance – but Quietly."
[15] Reese Darragh, "SEC Reveals Plan to Regulate Proxy Advisory Firms," *Compliance Week,* December 16, 2011.

at ease. Mr. Johnson pointed out, *"We have not seen any statistical data that shows separating the chairman and CEO titles is any better than having a strong lead director."*

- **Executive compensation.** Members believe questions about CEO pay are often best addressed by a director. One member cautioned that although these conversations are appropriate for directors, they are particularly complex: *"How things cascade into compensation and translate into the ultimate, specific [compensation] decision on the board's part – that's a complicated conversation to have."* One investor said that the most useful compensation discussions *"are philosophical – not about a pending proposal, but about how the board thinks about compensation."*

Occasionally unexpected questions broadly related to governance can arise, and these can lead to positive conversations. For example, one member said, *"I had a meeting with a shareholder who wanted to talk about why our directors were not buying more stock – shares in addition to those we received for our board service … [The question was unusual, but] net-net, the discussion was good."*

The chief executive

Members said that in addition to compensation issues, executive performance and succession issues – including *"issues concerning the termination and replacement of the CEO"* – are also appropriate for investor dialogue, as are *"allegations that the executive wasn't receptive to investor concerns."* In a recent Tapestry meeting, some directors and investors suggested that the conversation about development and succession should extend beyond the CEO and the C-suite and to management more broadly.[16]

Strategy

Members generally agreed that management is better suited to discuss strategy than the board. Management *"lives strategy every day"* and has a deeper understanding and command of related issues; directors know that investors want to hear from those closest to strategy.

The board does, however, have an important role overseeing strategy, and investors may want to evaluate and discuss that oversight role. One member said that when a governance issue *"raised a question of strategy, the board needs to articulate the strategy."* Although some thought the line between formulating strategy and oversight was difficult to draw, one member asserted that *"the board understands its part in strategy and can explain it. The line [between oversight and management] is not as gray as you may expect."*

Operational and financial performance

Members also agreed that senior management, not directors, should generally be the company's face on issues concerning financial results and performance. As one member put it, *"The key is to keep conversations targeted and relevant to what directors know and do. We're not the right people to explain why the company is down 6% in Brazil."* Mr. Johnson said that while State Street Global Advisors is

[16] See Tapestry Networks, "Advancing Board-shareholder Engagement," 7.

"focused on performance, when I meet with directors, my job is to make sure the company is well governed."

Mr. Breeden had a slightly different perspective: *"Like most active fund managers, our firm focuses intently on the company's performance record over a multi-year period alongside governance concerns. Discussing strategy or governance may be useful, but it can also be fairly abstract. On the other hand, the results achieved and returns generated compared to other competitors is something that can be more rigorously evaluated. If our analysis indicates specific issues that may be damaging results or valuation, we believe that management and directors should be interested in seeing that analysis so they can factor it into their thinking. We respect management's critical role in making operating decisions, but at the same time if a company is failing to achieve its potential, everyone should be interested in new perspectives on how things can be improved."*

Benefits and risks of direct engagement

One member observed, *"We're not management's representatives; we're the shareholder's representatives. They elect us, they want us to engage with them, and we should."* Some of the benefits and risks associated with direct engagement are discussed below.

Benefits associated with direct engagement

When directors and shareholders interact directly, both sides often gain insight and clarity, particularly in the following areas:

- **A better understanding of the company, investors, and issues.** *"From my perspective, it is very helpful to hear from key shareholders how they view the company's profile and the issues that they are particularly concerned about … in an unfiltered way,"* one member said. Another member said that *"listening across investors gives us all a good sense of whether the company is on the right track."*

  Investors echoed the benefits of listening. Mr. Breeden said, *"Remember that your investors are all too often demonized, but they are pretty thoughtful businesspeople, too. Sometimes they might have a good idea."* Mr. Johnson said, *"We can give you context to make you a better director."*

- **Effective advocacy for beneficial proxy vote outcomes.** If a closely contested proxy vote cannot be avoided, directors can be part of the company's response. Most members said this type of engagement was purely reactive and generally in response to adverse proxy adviser recommendations on governance issues, including say on pay and proposals to separate the chairman and CEO positions.

  Success may not manifest itself immediately, particularly if the outreach on an issue occurs during a busy time like proxy season. But relationships can open the door to discussions. One member said, *"I think it is very important to have relationships that allow you to have discussion with investors."*

Identification of director nominees. One member mentioned a very tangible benefit gained from a shareholder meeting about board composition: a new director. *"As we look for new directors, we look for people with [technology] experience. I asked the investor for any ideas … By time I got back to my office, I had an email that said, 'We talked with our technical staff; here are several people you may want* *to take a look at, to see if they are a fit.' It was not aggressive, but a polite recommendation. We put two of their candidates through the process and found a director who was a great fit."*

When investors seek seats on the board

Members discussed the pressure they've faced from shareholders for seats on their boards. One member said, *"I've taken the position that owning 10% of the company doesn't qualify you to sit on the board. What do you think?"*

In response, Mr. Johnson said, *"Owning 10% doesn't qualify or disqualify you from being on a board … We'll look at the independents [activists] put up. We want someone who knows the business the company is in and can ask the right questions."*

Mr. Breeden said, *"Owning 10% of a company doesn't automatically qualify someone as a director, but the chances are that someone who owns that large a stake has considerable knowledge about the company and its business. Most active fund managers don't want a seat on the board, as it seriously limits their liquidity. However, sometimes the perspectives of a meaningful shareholder with relevant knowledge or experience can help a company grapple with major issues, and that can add significant value. As private equity firms and family companies constantly demonstrate, large owners have a focus and sense of priorities that can often add significant long term value to a company. Particularly if the investor is only seeking one or two seats, this can often be a huge advantage to the company and its board compared to the alternatives of a proxy fight."*

Risks of direct engagement

Members and guests discussed risks associated with increased board-shareholder engagement – risks that have prevented some lead directors from engaging with shareholders.

- **Fear of breaching Reg FD.** Members are concerned with inadvertent selective disclosure of information that would run afoul of Reg FD.[17] *"The slightest mistake can cause a Reg FD problem,"* one member said. The *"danger is higher than ever; one could blunder quite easily in saying something the company has not disclosed,"* another member remarked. For this reason, King & Spalding partner J. Kelley recommended, *"Someone from the general counsel's office should be at board meetings with shareholders to make sure the conversation stays within the guardrails, and if not, [to see that] appropriate corrective measures are taken quickly."* Mr. Johnson said, *"If you need to have a representative from the corporate secretary or general counsel's office on the line with us, so be it. We do not want any Reg FD issues, either."*
- **Risk of mixed messages.** *"It is easy to see a CEO and lead director having conversations that confuse an issue and send mixed signals if the CEO and lead director are not in sync on every issue and*

[17] Reg FD provides that "when an issuer … discloses material non-public information to certain enumerated persons … it must make public disclosure of that information." See US Securities and Exchange Commission, "Final Rule: Selective Disclosure and Insider Trading," August 21, 2000.

every possible question," one member said. Differing messages may be no more than different phrasings or ways of explaining a concept or issue and therefore may not indicate a divergence of opinion, but one member said that *"there is nothing more dangerous than for institutional investors to get different answers from the board than from the CEO."* As business becomes more global and complex the likelihood of an inadvertent discrepancy increases. One member insisted that nevertheless, *"there shouldn't be resistance to talking to board members. We are not dummies collecting fees and having lunch."*

Management's view on board-shareholder engagement

Directors and investors have told Tapestry that senior management is not always eager to have directors engage with shareholders. While chief executives presumably share some of the concerns described above, some members said that management was reluctant for different reasons. One member spoke of a recent conversation with directors who, the member reported, said that *"their CEOs would absolutely flip if [the directors] had any conversations with a shareholder. Sometimes management feels threatened by directors speaking with shareholders. I think the CEO's views on engagement vary significantly board to board."*

There is a perception that some CEOs restrict access to board members:

> A number of investors expressed frustration about an inability to engage with members of the board. There appears to be a widespread perception that issuer staff often acts as gatekeeper and that (in the words of an investment fund partner) "CEOs usually want to keep issues away from their bosses." One asset manager diplomatically referred to board access as a "work in progress," noting that few companies were willing to put their directors in front of shareholders.[18]

Investors are concerned about restricting investor access to board members. Mr. Johnson said, *"If your CEO is uncomfortable with directors speaking with shareholders, I'd urge the board to think carefully about your choice of CEO."*

On a positive note, one member suggested that these restrictions are becoming less common: *"The age of the imperious CEO is over; there's a sense of enlightenment here in having broader board-shareholder engagement."*

- **Diverted time and energy.** Some members were concerned that engaging with investors took time away from more pressing board matters. These members said their time might be more meaningfully spent on other oversight activities than on an activity that is typically and best performed by management. Others suggested that making time for investor engagement simply requires putting a

[18] Marc Goldstein, *The State of Engagement between U.S. Corporations and Shareholders*, 21.

higher priority on having efficient board meetings. For more on this topic, see "Optimize the format of each dialogue," on page 10.

- **Exclusion of management.** *"My big concern [is that] if you have a constant dialogue at [the] board level [with] large institutional investors, you're basically cutting management out of the conversation. You'll train [institutional investors] to come straight to the board or their contact on the board. They'll come to you – that's problematic,"* one member said. Mr. Breeden thought this concern might be overstated, saying, *"I wouldn't dream of going around the CEO. We always go to management first to express our concerns. We ask them to share a document [outlining our concerns] with the board."*

Effective engagement practices

Most members believe that pressure for direct board-shareholder engagement will continue to grow and that more directors will meet with shareholders in the future. Most members said that investor engagements tend to begin in response to a particular exigency, from a close vote on an item in the proxy statement to a major corporate event or crisis, but a trend toward more proactive, pre-crisis engagement is emerging. With that in mind, members and guests described practices that make investor engagement more effective.

Understand the shareholder base

Mr. Johnson asked, *"How many [directors] could name their top 10 shareholders? How many have read their [shareholders'] proxy policies? You have to take those first steps."* Many members devote portions of board and committee meetings to learning more about their investors and investors' concerns. One member said, *"On all boards on which I sit, we have frequent and fulsome reports about discussions with major shareholders."* Boards accomplish this in different ways, with presentations to the full board or to an appropriate board committee.

Decide with which investors to engage

Members differed regarding which investors boards should engage in conversation. While some members see benefit in meeting with any investor, including small shareholders and those focused more on ESG[19] issues than on returns, others have formally or informally restricted engagement to certain types of shareholders.

Regarding hedge funds, one member said, *"I'd respond if a hedge fund with a large position in our stock asked to meet with me, intimating it might otherwise use the proxy process."* Mr. Breeden suggested that was a positive approach: *"If a company has a weak performance record or is in financial jeopardy and directors are unwilling to listen to our concerns, we would certainly consider other alternative actions including a potential proxy contest. Recent history suggests that if a company's performance record is poor, preventing election of shareholder nominees may prove quite difficult. Isn't it better to listen to the concerns of the shareholders the board represents? You may not agree, but the effort shows a responsiveness that may head off larger problems."*

[19] Environmental, social, and governance issues.

Engage regularly – and outside the proxy season

In the majority of member examples, direct engagements with investors have been reactive responses to investor demands or high-profile corporate issues. One member said, *"We've found that shareholders do appreciate it when we are proactive … Being proactive is typically more successful than being defensive."* As Mr. Breeden said, *"If a shareholder of a company with very weak performance is going to mount a challenge for board seats, waiting until the day before the Annual Meeting to open a dialogue is not likely to work."*

Mr. Johnson added, *"Boards should focus their engagement efforts outside of proxy season. Some of your investors are voting 15,000 or more [company] proxies globally; we do not have capacity during the season for that outreach, but will in the other three quarters of the year. But if you do not meet with shareholders in good times, you will regret it in bad times."*

Have management coordinate investor meetings

Having management coordinate meetings helps keep directors better informed about investor concerns and also ensures that management is fully aware of the board's outreach. Most members said that management arranged their meetings with investors. *"All of our companies are required to have in our governance documents how shareholders can contact us, and that is usually through the companies. Investor relations professionals will let us know when [an investor] has an interest in a meeting – directors do not generally initiate the conversations,"* one member said. Another member said that requests *"come through our corporate secretary's office."*

Optimize the format of each dialogue

There are varied opinions as to the right setting for investor conversations. *"Twice a year, we have a dinner – cocktails, a meal, a brief and informal presentation – attended by board members, senior executives, and a group of our largest investors' portfolio managers,"* one member said. Another said, *"When we've responded to problems with investors, we've set up separate, [formal] meetings for each investor – separate 90-minute meetings to discuss the matter."* Some members said that when meeting with a shareholder for the first time, face-to-face meetings may be best, but that may evolve: *"After the first few meetings, we decided to continue the process more informally, conducting meetings by phone with a handful of very large institutional players important to the company."*

One member suggested setting aside a day for investor meetings, *"having the lead director and all committee chairs in the same place, having private meetings with individual investors back-to-back."* Another member said, *"At one board meeting each year, we have an open session where we invite our 10 largest shareholders to come and visit the whole board."*

There are a variety of means of engagement other than direct, personal conversations. For example, Occidental Petroleum hosted a "fifth analyst call" in which two directors, along with the company's general counsel and head of investor relations, spoke with some 50 investment firms to discuss governance matters.[20] Other companies have hosted annual meetings in a virtual environment, events that enable companies to verify attendance, establish a secure voting environment, and promote meaningful two-way communication.[21]

Set a clear agenda for the conversation

Some members said that agendas for meetings with investors should be carefully limited. *"Don't put directors in a meeting with an open agenda,"* one member advised. Another said, *"You need to get a very specific agenda for discussion, as opposed to general insights."* The specificity of the agenda can minimize the likelihood that a director inadvertently shares non-public information or deviates from other corporate messaging.

Get prepared

Members differed on the nature and depth of preparation required to meet with shareholders. One said, *"There needs to be training for directors to understand how to manage interviews and difficult issues."* Another member said that it was essential that directors be briefed on the investor's background – its holdings and its philosophy. One director said that adequate preparation meant *"getting the bullet points – the three to five key points on corporate strategy, the points that we need management and the board to address."*

Carefully choose company representatives

There was a consensus that the board's first representative to shareholders should be the lead director – the director with the strongest grasp of the people, boardroom dynamics, and corporate issues. One member suggested that the lead director is particularly appropriate because *"part of the job is assimilating a wide variety of points of view into a coherent narrative. That's how we report out executive session discussions to the CEO, and the skill is very applicable here."*

Some members said that the default rule should be that the CEO attends with the lead director, unless the reason for the meeting – a discussion of CEO compensation or performance – makes that inappropriate. *"The CEO knows the guardrails, both substantive strategic issues and procedural disclosure rules and requirements,"* one member said. Even if not attending the meeting, the CEO should know that it is occurring. As one member said, *"We are not Lone Rangers. I would never see a major shareholder without the advice and consent of the CEO and general counsel."*

Some members thought that other individuals – such as the compensation committee chair, corporate secretary, head of investor relations, head of human resources, or member of the general counsel's team – were also appropriate attendees, though one member cautioned against having too many people present: *"In my experience, three or four people is the right number to be in any meeting – it keeps things focused, but it preserves candor and interaction."* Members said that meeting attendance should always be tailored to the meeting's purpose.

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[20] John R. Engen, "Communicating with Shareholders," *Corporate Board Member,* February 28, 2012.
[21] Judy Warner, "A Virtual Annual Meeting Approach," *NACD Directorship*, February 16, 2012.

Conclusion

Before the meeting, member views on board-shareholder engagement fell across a spectrum, with some eager to engage with their investors and others not just reluctant, but opposed to the idea. At the end of the meeting, at least one member's reluctance to meet with investors had not changed: *"I do not want to meet with investors – I think the CEO is better positioned. But what I will take away from the meeting is that institutional investors are reaching out, and we have to be prepared."*

However, most members' views had shifted. Several members saw significant benefit in carefully constructed dialogues with their leading shareholders. *"Before the meeting, I was one of the people more cautious about having individual board members meet with investors, but my position changed today. I want to consider it and set an initiative to try it out,"* one member said. Another said, *"My views shifted, too. Before the meeting, I only saw downsides, but now I think it is worth trying."* On this, the investors agree. Mr. Johnson said, *"Trust and get to know your shareholders. You'll be better directors for having done so."*

About this document

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the issues confronting lead directors. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* is encouraged to share it with those in their own companies and their colleagues at other companies. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

The Lead Director Network (LDN) is sponsored by King & Spalding and convened by Tapestry Networks. The LDN is a group of lead independent directors, presiding directors, and non-executive chairmen drawn from America's leading corporations who are committed to improving the performance of their companies and to earning the trust of their shareholders through more effective board leadership. The views expressed in this document do not constitute the advice of network members, their companies, King & Spalding, or Tapestry Networks.

Appendix: Network participants

The following network members participated in the meeting:

- Richard Auchinleck, Presiding Director, ConocoPhillips
- Frank Blount, Former Lead Director, KBR
- Roy Bostock, Former Non-Executive Chairman, Yahoo!
- Daniel Carp, Non-Executive Chairman, Delta Air Lines
- Loren Carroll, Lead Director, KBR
- David Dorman, Non-Executive Chairman, CVS Caremark Corporation; Lead Director, Motorola Solutions
- Eugene Fife, Presiding Director, Caterpillar
- Raymond Gilmartin, Presiding Director, General Mills
- Ann Maynard Gray, Lead Director, Duke Energy
- Ann Fritz Hackett, Lead Director, Capital One Financial Corporation
- Bonnie Hill, Lead Director, The Home Depot
- Phillip Humann, Presiding Director, Coca-Cola Enterprises and Equifax; Non-Executive Chairman, Haverty Furniture Companies
- Edward Kangas, Non-Executive Chairman, Tenet Healthcare
- Linda Fayne Levinson, Lead Director, NCR
- Alex Mandl, Lead Director, Dell; Non-Executive Chairman, Gemalto
- Wesley von Schack, Lead Director, Bank of New York Mellon and Edwards Lifesciences

The following network members took part in pre- or post-meeting discussions:

- Peter Browning, Lead Director, Nucor and Acuity Brands
- Daniel Feehan, Non-Executive Chairman, RadioShack
- Richard Goldstein, Presiding Director, Interpublic Group
- Robert Kidder, Lead Director, Morgan Stanley
- John O'Brien, Lead Director, TJX; Non-Executive Chairman, Cabot

- Stephanie Shern, Presiding Director, GameStop

The following King & Spalding attorneys participated in all or some of the meeting:

- Laura Hewett, Counsel, Corporate Practice Group
- J. Kelley, Partner, Corporate Practice Group
- Richard Marooney, Partner, Business Litigation Practice Group
- William Spalding, Partner, Corporate Practice Group
- Christopher Wray, Partner; Chair, Special Matters and Government Investigations Practice Group

Lead Director Network
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Dialogue with ISS President Gary Retelny

Introduction

During portions of two Tapestry Networks meetings – a June 19, 2012 Lead Director Network (LDN) meeting and July 10, 2012 Compensation Committee Leadership Network (CCLN) meeting – members were joined by Gary Retelny, president of Institutional Shareholder Services, the largest corporate governance and proxy advisory services firm.[1]

The LDN and CCLN networks are each composed of board directors who gather to discuss how to improve the performance of their corporations and earn the trust of their shareholders through more effective board and committee leadership.[2]

At both network meetings, Mr. Retelny addressed directors' questions and criticisms of ISS and the proxy advisory industry. The purpose of engaging with Mr. Retelny was to enable meaningful, candid dialogue on issues related to proxy advice. The following content is a synthesis of the questions and answers from the two meetings.[3]

Q&A with Mr. Retelny

Who is MSCI, ISS's parent?

"MSCI is a leading provider of investment decision support tools to around 6,200 clients worldwide, ranging from large pension plans to boutique hedge funds. MSCI and its family of leading brands, including Barra, RiskMetrics, and ISS, offer a range of products and services – including indices, portfolio risk and performance analytics, and corporate governance solutions.

"Located in 20 countries around the world, and with over 2,400 employees, MSCI is dedicated to supporting the increasingly complex needs of the investment community with new products, high quality data, superior distribution, and dedicated client support.

"Since the MSCI indices were launched over 40 years ago, the company has grown both organically and through acquisition to become one of the world's leading players in the provision of products and services to institutional investors."

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[1] For a summary of the other discussions during the June 19, 2012 Lead Director Network meeting, see Lead Director Network, "A dialogue with institutional investors," *ViewPoints,* August 9, 2012.

[2] See Lead Director Network Fact Sheet and Compensation Committee Leadership Network Fact Sheet for more information about these groups, including current membership. You may also view summaries of other network meetings at the Lead Director Network and Compensation Committee Leadership Network webpages.

[3] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule, whereby names of members and their company affiliations are a matter of record, but comments made before, during, and after meetings are not attributed to individuals or their companies. Member quotes are italicized and unattributed. Mr. Retelny agreed to speak on the record; his comments appear unitalicized in quotation marks throughout the document.

What is ISS?

"ISS is many things to many people: From a business perspective, ISS is the world's leading corporate governance and proxy voting advisory firm, serving about 1,700 institutional clients worldwide, with approximately 600 full-time employees. And, ISS is a registered investment adviser, the only proxy advisory firm that operates under the same regulatory requirements as its clients.

"Overall, there are roughly 40,000 public companies, and we now provide an analysis of approximately 37,000 of them covering all holdings in our clients' portfolios. ISS is also a firm that inspires passion. Directors and others regularly critique ISS, which is fair; in fact, it is this type of feedback that helps us understand that we need to do a better job of engaging with certain constituencies. But investors are similarly passionate and view our services very favorably."

What is ISS's business model?

"ISS has two primary business components – corporate governance and proxy research and voting services, including proxy distribution and vote execution; and ISS Corporate Services or 'ICS.' The lion's share of revenue is from the proxy voting business, which includes proxy voting policy creation, voting recommendations, and vote execution. Most of this is subscription based and serves the fiduciary needs of institutional investors.

"ICS, ISS's corporate services subsidiary, offers data, analytics, and information services to corporations. This work is a mix of non-recurring and subscription based work."

How do you prevent conflicts of interest between your proxy advice and corporate services businesses?

"There is a strong firewall in place between the two businesses. Each company has its own personnel and systems. For example, when the corporate services group is analyzing executive compensation for a client, they use their own system – one that is distinct from the system we use to generate proxy voting recommendations. ICS staff is also physically segregated from ISS staff. Additionally, the identities of ICS' corporate clients are not disclosed to ISS research analysts who make proxy recommendations – so there is no possibility of an ISS analyst favoring an ICS client because they don't know who the ICS clients are. And very importantly, ISS proxy recommendations are policy driven. Because our policies are published, any ISS client could determine if we did not follow our policies and gave favorable treatment to an ICS corporate client. That has never happened. To ensure that ICS's corporate clients do not have a misunderstanding or false expectation, ICS makes clear and emphasizes upfront that ICS clients do not receive and should not expect to receive any preferential treatment by ISS or any guaranteed analysis or recommendation from ISS."

How does ISS develop its governance policies?

"An internal committee oversees our policy development, based on external inputs from clients, corporate issuers and industry experts through our annual policy survey and a variety of roundtables and discussion forums. We also have a separate committee for particularly controversial issues."[4]

Who authors a report on a company?

"Each report is the responsibility of the analyst, named on the front page of the document. In many cases, analysts will draw from the specialty expertise of our compensation team, our environmental and social issues team, or teams with certain sector experience, like energy. The minimum professional level of these individuals is a college degree, although a significant number of our research professionals have additional certifications and/or degrees."

How could ISS improve the quality of its services?

"We are constantly working to improve the quality and integrity of our data, upon which we overlay our policies and generate our analyses. We are also considering how we can more efficiently manage the logistical challenges of proxy season. For example, ISS would like to provide each company report to that company 48 hours before it is published and shared with investor clients, but right now time and delivery commitments allow us to do this only for S&P 500 companies. Without timing constraints, I'd give every company a week to review the report. But I can't."

What about the occasionally "snarky" tone of reports?

"You are right; there is on occasion still too much extraneous and sometimes inflammatory commentary in our reports. I am aggressively, forcefully weeding that out because it takes away from the substance of the report when the reader is focused on the tone rather than the conclusions. I'm confident that you will find the language in our reports more consistently professional and balanced going forward."

How effective is your peer group methodology? How might it change?

"For compensation committee members, this is definitely the hottest-button, most controversial topic. It's also important for many of our clients, especially as they engage with portfolio companies.

"Companies are generally developing peer groups for the purpose of pay benchmarking and executive recruitment and retention, while ISS is analyzing pay against performance through an investor lens. There are likely to always be differences, but either way, the peer groups need to be rational.

"ISS's peer group development is an ongoing issue. We have heard and want to continue to hear director concerns; we've heard a suggestion to publish both an ISS peer group and the peer group used by a company. Our clients, shareholders, also have suggestions, and they are worried about the potential for peer groups to skew the number and contribute to the ratcheting up of pay. It's a complicated balance.

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[4] ISS's 2013 Proxy Policy Survey was released on July 24, 2012 and will close on August 17, 2012. The survey will be followed by topic-specific telephonic roundtables and in-person director roundtables before final policy updates are released in November 2012. For more, see Institutional Shareholder Services, ISS Policy Gateway: ISS Annual Policy Development Process.

We are undertaking a very broad review of our peer group methodology over the next few months. Everything is on the table."

What do you think of using realized pay instead of realizable pay in your analysis?

"Ultimately shareholders care about the linkage between pay for performance. This is often true regardless of the size of an award. When Tim Cook took over at Apple, the widely reported realizable pay figure was very large. But because of Apple's performance, ISS's base proxy recommendation was a 'yes' for say on pay. We took heat from some investors on that, but we stood behind it.

"Regardless of the metric used, I recommend that you provide a basis for your compensation plan and disclose all that you can in order to facilitate informed decision making on the part of your shareholders."

Why isn't ISS more attentive to companies' unique circumstances?

"I think we are attentive, to the extent possible. Remember that we are covering thousands of companies and serving the needs of 1,700 financial institutions in a compressed period of time.

"Again, I would like to be clear that we sometimes hear justifications for corporate action that are not reflected in publicly disclosed documents. If it is not publicly disclosed, we cannot use it. If you want us to rely on something, put it in your proxy."

How might you engage more effectively with the companies you review?

"Keep in mind that ISS is the only corporate governance and proxy adviser that actually does engage with companies. In fact, in 2012, we directly engaged with more than 400 companies in the US alone. That said, we are trying to engage even more both directly and through key industry groups. One recent development is our Feedback Review Board,[5] which I hope each of you will engage with when it matters. We plan to invite directors to panels we have with our shareholder conferences. We are working on additional means to reach out to relevant audiences, including corporate directors."

Have you considered an advisory board of other stakeholders like directors?

"That's a good idea, and one we've heard before. But before we can move forward with an advisory board, there needs to be a mechanism to implement the recommendations of such a group. We hope that the Feedback Review Board helps us hear more from directors, and we will continue to look for other ways to engage with directors and other stakeholders."

Do you have any advice for directors?

"Again, provide the rationale for your decisions in the proxy; if it's not public, we can't use it. If you're not getting an appropriate response from ISS's people, call me personally. And engage directly with your shareholders. ISS plays a role as an intermediary, but I'd encourage your company executives and directors to have direct communications with your shareholders on governance issues."

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[5] For more information, please see the ISS feedback review board.

What is the future of ISS?

"Owned by MSCI since 2010, ISS is making significant investments in technology and in product development to enhance our services.

"ISS serves an important function in helping investors make informed proxy voting decisions. Our role is not to determine how investors vote, but to give investors information to make informed voting decisions. That doesn't mean that we expect or want all of our clients to vote in accordance with our policies or recommendations. In fact, a large number of our clients have custom voting policies and those who use our benchmark policies do not follow all of our recommendations. Our most engaged clients are those who take their voting obligation seriously and engage with us and the companies they are invested in. We are an important research-based input to the voting decisions and processes of our clients. The future of ISS is to continue to develop, improve and expand the types of, and uses for, corporate governance tools and information, so that institutional investors can make more informed investment and investment-related decisions."

Conclusion

Board directors at the two Tapestry Networks meetings appreciated the candid and sincere discussions with Mr. Retelny. One compensation committee chairman remarked, *"A lot of bad [governance] practices have disappeared. If I were ISS, I'd take some credit for those."* Several others said that there is a clear and compelling need for the type of proxy services that ISS provides. The members present also acknowledged that there are significant business challenges associated with the need to provide recommendations on so many companies in such a narrow window of time.

Opening a dialogue with Mr. Retelny and ISS was a positive step, directors said. The dialogue led to some new approaches mentioned by Mr. Retelny and others that would be helpful. But many lead directors and compensation committee chairmen were still critical of ISS's approach to analysis and recommendations. Fundamentally, directors are concerned about *"the substitution of ISS opinion – however it may be formed – for the judgment of very experienced business executives and leaders."*

About this document

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the issues confronting lead directors. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* is encouraged to share it with those in their own companies and their colleagues at other companies. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

The Lead Director Network ("LDN") is sponsored by King & Spalding and convened by Tapestry Networks. The LDN is a group of lead independent directors, presiding directors, and non-executive chairmen drawn from America's leading corporations who are committed to improving the performance of their companies and to earning the trust of their shareholders through more effective board leadership. The views expressed in this document do not constitute the advice of network members, their companies, King & Spalding, or Tapestry Networks.