LATHAM&WATKINS LLP

Corporate Governance Commentary

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Rules of Engagement: Building Relationships with Your Shareholders Through Effective Communication

Introduction

In recent years, shareholders of US public companies have increasingly invited dialogue with management, sometimes even demanding personal interaction with directors. This trend is part of a new paradigm in the corporate governance realm. Historically, despite some management engagement with shareholders, companies have seen little in the way of direct dialogue between shareholders and members of the board of directors. For most public companies, governance strategies have seldom included systematic engagement with shareholders beyond quarterly earnings calls, investor conferences and traditional investor relations efforts.

That was then, this is now. More than ever before, institutional shareholders are aggressively exerting their influence in the name of holding companies and management accountable. Emboldened (or pressured) by recent events — high-profile corporate governance and executive compensation controversies, the financial collapse and public criticism of pay disparities — these shareholders increasingly seek to influence board-level decisionmaking, often deploying incendiary buzzwords such as "corporate mismanagement," "excessive risk taking," "pay-for-failure" and the like. All told, the new paradigm represents a significant shift for most public companies.

In this Commentary, we discuss:

- The current state of corporate governance and signposts along the way to the existing state of affairs
- How and when public companies can benefit from shareholder engagement
- The components of an effective shareholder engagement program

These issues are increasingly relevant for many companies today as they consider whether and how to engage in dialogue between company leadership and shareholders.

The Current State of Corporate Governance

Traditionally, public companies have not engaged directly with shareholders in a sustained or ongoing way on matters of shareholder concern. The shareholder vote has served as a primary means of shareholder communication with the company. Voting in director elections has historically served as an effective and sufficient mechanism for expressing shareholder preferences and influencing corporate direction, with a limited number of occasions — such as votes to approve a merger or the sale of all or substantially all assets — when shareholders can provide substantive input.

Over the last four decades, a competing paradigm of shareholder democracy has emerged. Today, shareholders demand increasing input on decisions that, under the old paradigm, unquestionably would have remained in the purview of the board's or management's business judgment.[1]

The world of corporate governance has changed. Large institutional investors place increasing reliance on proxy advisory firms such as Institutional Shareholder Services (ISS) and Glass, Lewis & Co., LLC (Glass Lewis). Management now regularly considers shareholder views and, in some instances, engages directly with shareholders.[2]

Several trends are associated with the shift toward the current state of affairs:

Growth of Institutional Investors

The equity holdings of institutional investors have increased dramatically during the last few decades, with pension funds, mutual funds, insurance companies and foundations holding 50.6% of US public equity securities in 2009.[3]

Interpretations of Investment Managers' Fiduciary Duties

Pension funds and other institutional investors manage employee benefit plans that are subject to the Employee Retirement Income Security Act of 1974 (ERISA), which requires plan fiduciaries to administer assets "solely in the interest" of plan participants and "for the exclusive purpose of providing benefits." The Department of Labor issued interpretations beginning in the late '80s that effectively expanded plan administrators' fiduciary duties to include the voting of proxies.

In 2003, the Securities and Exchange Commission (SEC) promulgated a final rule relating to proxy voting by investment advisers subject to the Investment Advisers Act of 1940 the was based on the position that investment advisers have fiduciary obligations to clients relating to discretionary voting of their clients' proxies.[4] Although the SEC did not conclude that failing to take every opportunity to vote clients' proxies would violate the investment adviser's fiduciary duties, institutional investors today — even those not subject to ERISA — generally take the view that their fiduciary duties require voting proxies to protect the long-term economic value of their investments. Institutional investors may have become further motivated to engage by criticism after the most recent financial crisis that they failed to monitor sufficiently the governance and risk management practices of the companies in which they invested.[5]

Proxy Access, Gone But Not Forgotten

Shareholders can more easily oust company directors and install their own candidates for the board due to an increased focus on the shareholder franchise. This culminated in the adoption of mandatory proxy access under Exchange Act Rule 14a-11 and the ability of shareholders to propose private-ordering proxy access under Exchange Act Rule 14a-8. Even after the judicial invalidation of mandatory proxy access under Rule 14a-11, shareholders are able to include in corporate proxy statements private-ordering proposals for proxy access under Rule 14a-8.

Say-on-Pay

Say-on-pay votes, which in recent years had become the subject of an increasing number of shareholder proposals, were mandated by the Dodd-Frank Act. As a result, most public companies must include in their proxy statements proposals for shareholder advisory votes on executive compensation at least once every three years. Under pressure from proxy advisers and shareholders, most companies have decided to hold annual votes. The implementation of say-on-pay has keenly focused shareholder attention on executive compensation matters. In general, say-on-pay has also obviated the shareholder-initiated pay proposals often seen before mandatory say-on-pay.

Proxy advisory firms, faced with an overwhelming number of say-on-pay proposals and voting results to analyze after the inaugural 2011 season, applied simplistic metrics to evaluate the outcome of the previous year's vote and to make voting recommendations for the 2012 season.[6] ISS has taken the position that a favorable say-on-pay vote of less than 70% indicated substantial shareholder dissatisfaction with a company's compensation policies. If a company does not act to adjust its compensation policies in response to such a vote, ISS will consider recommending that shareholders withhold support for some or all of the company's directors. Furthermore, the SEC's proxy disclosure rules now require that companies disclose whether they have taken their prior say-on-pay vote into account in designing their pay plans and, if so, how. Although the rules do not require companies to in fact consider these votes in governing their actions, most companies in 2012 responded by disclosing that they had taken the votes into account and how they had done so, in many cases detailing pay plan changes and extensive shareholder engagement efforts.

Increase in Shareholder Proposals

In recent years, companies have found it increasingly difficult to exclude from the corporate proxy statement proposals submitted by shareholders. Companies have less ability to exclude a shareholder proposal from the corporate proxy statement under the exclusion in Exchange Act Rule 14a-8(i)(7) for proposals relating to “ordinary business operations.” In responding to no-action requests, the SEC Staff has continued to narrow the category of “ordinary business,” thereby increasing the number of individual shareholder proposals included at shareholder expense in the corporate proxy statement. Many of these proposals relate to executive compensation matters as well as policy controversies, such as net neutrality, and other issues on activist agendas.

Majority Voting

During the 2005 and 2006 proxy seasons, the replacement of plurality voting for directors with majority voting was a focus of activist investors.[7] Under a plurality voting regime, an unopposed director nominee who receives any votes will be elected, provided that a quorum is present. In contrast, a director who receives less than a majority of the votes cast will not be elected under a majority voting regime. Adoption of majority voting or a majority voting policy, under which a director who receives fewer than a majority of votes must submit his or her resignation for consideration by the board, has become increasingly common.

Elimination of Broker Discretionary Voting

With the elimination of broker discretionary voting on director elections and on executive compensation matters, most shares that are held in street name are never voted. This has effectively increased the voting power of institutional shareholders in director elections and in say-on-pay votes. As a result, companies that have adopted majority voting often face significant hurdles in director elections. The combined effect of eliminating broker discretionary voting for these matters and the corresponding increase in institutional investor voting power, together with the adoption of majority voting, has magnified the potential consequences of proxy adviser recommendations. Now, a proxy adviser’s recommendation can have a decisive effect on the reelection of directors of a company that failed its say-on-pay vote (most recently meaning less than 70% approval) during the previous year or that did not comply in all respects with other adviser voting policies.

European Corporate Governance Trends

Corporate governance developments in Europe may have influenced shareholder expectations in the US regarding the desirable level of communication between themselves and the company. For example, in July 2010, the Financial Reporting Council, a UK regulator published the UK Stewardship Code, which outlines the responsibilities of institutional investors.[8] The UK Stewardship Code requires the institutions that adopt it to monitor the companies in which they invest and emphasizes the importance of ongoing, direct dialogue with directors as well as management.

> **“Today, shareholders demand increasing input on decisions that, under the old paradigm, unquestionably would have remained in the purview of the board’s or management’s business judgment.”**

Potential Benefits of Shareholder Engagement

Engagement with key shareholders, as part of a considered strategy, can be an effective adaptation to the changing corporate governance world under appropriate circumstances. The emphasis during the 2012 proxy season on majority voting, compensation matters, proxy access and political spending disclosures indicates that recent trends will likely continue. There are several ways in which companies can experience meaningful benefits from shareholder engagement efforts.

Building Foundational Relationships

Given the influence wielded by large institutional shareholders, building positive relationships can lay the groundwork for future resolution of challenges or conflicts. Engaging with a company’s largest shareholders before a crisis arises potentially builds relationships that are less adversarial than many existing board-investor relationships and may facilitate future communications. When faced with a negative proxy adviser say-on-pay recommendation or an activist shareholder seeking board seats, having ready access to key institutional investors can be vitally important.

Improved Communication

Shareholder voting in director elections may be the primary means for shareholders to register their dissatisfaction, but it is hardly the most precise. Engaging with shareholders can help companies gather information about investor concerns and make educated decisions about whether it is in the company's best interests to act on these concerns. The point at which a company learns that its board has become the subject of a dissatisfied shareholder's "vote no" campaign is too late to develop an informed and considered response to shareholder grievances.

Owning and Telling the Story

Compensation matters have been far and away the most common corporate governance challenge for US public companies since the advent of say-on-pay votes. As a result, companies should develop ongoing narratives about their business goals, incentive performance goals and targets, the responsiveness of their pay plans to business changes and challenges and the alignment between their financial performance and the compensation actually paid to executives. Companies must then communicate those narratives effectively to investors, directly and in plain English.

Although the Compensation Discussion & Analysis (CD&A) disclosure in the proxy statement was thought to offer an opportunity for companies to tell their story, CD&As have become long, dense, and complex legal disclosures built to comply with a still-increasing list of required disclosures, further compounding institutional shareholders' reliance on proxy advisory firms to provide summaries and voting recommendations. Recognizing institutional shareholders' need for effective communication on the compensation matters that are of concern to them, rather than mere legal compliance, companies are increasingly relying on executive summaries to communicate the essential elements of their performance and pay narratives. These summaries are short, succinct, full of graphics and readable and are much appreciated by institutional shareholders who find themselves buried in stacks of ever-growing proxy statement disclosures.

However, proxy advisers' voting recommendations, on compensation in particular, have been based on crude, oversimplified, one-size-fits-all formulae and metrics that cannot take into account all relevant nuances underlying executive compensation decisions. As a result, each year companies must consider the best way to present their unique story in a straightforward and understandable manner.

Better Use of Resources

In light of these considerations, shareholder engagement can allow companies to capture meaningful efficiencies. Although some have argued that shareholder engagement is a misallocation of scarce resources, this concern should be balanced with a consideration of shareholders' willingness in many cases to reward companies that provide direct access to company leadership and to discipline those companies that do not.

An Important Caveat

Shareholder engagement can be effective under the right circumstances, but engagement is not a panacea or an end unto itself. Engagement is a desirable strategy when in the interests of all shareholders. In other circumstances, companies may wish to eschew engagement. For example, shareholders may sometimes advocate an agenda for their own benefit at the expense of other shareholders. As a result, companies should adjust their engagement strategies in light of their particular circumstances.

Designing an Effective Shareholder Engagement Program

The foundation of a shareholder engagement program should be communications between company leadership and shareholders. With respect to certain issues, such as corporate governance and executive compensation matters, some companies have found that some limited and surgical involvement of board members can also be effective.

A comprehensive shareholder engagement strategy should delineate the responsibilities of management and the role of directors and establish paths for shareholders to communicate with each. In general, however, the majority of company interactions shareholders will have will be with management, with director involvement where appropriate.

Elements of a comprehensive shareholder engagement program include:

"When implemented effectively, direct dialogue between the company and shareholders can play an important role in communicating a company's narrative regarding executive compensation and corporate governance choices."

Shareholder Communications with Directors

New York Stock Exchange rules require listed companies to disclose a means by which shareholders may communicate with the presiding director or non-management directors on its website or in its proxy or annual report. In addition, the SEC requires public companies to either disclose and describe in their proxy statement or Form 10-K a process for shareholders to send communications to the board, or to state that no process exists and "state the basis for the view of the board of directors that it is appropriate for the registrant not to have such a process."[9]

Shareholder communication processes range from basic to complex. Some companies may state in the proxy statement that "any interested party may communicate with the presiding director of the board, any of its committees, the non-management directors, or one or more of the individual members of the board by directing correspondence to such group or persons in care of the corporate secretary." Others may permit shareholders to contact directors via mail, email or fax, care of the Secretary, who directs the communication to the appropriate director or committee.

In contrast, some companies have taken a more expansive approach, creating email addresses for shareholders to use in communicating with the whole board, independent directors, non-management directors and individual directors, with the caveat that communications will be reviewed by the company and forwarded to the board only if the communications require a response.

In any case, shareholder communications to the board can provide a valuable source of information about what issues matter most to shareholders and focus a company on which issues ought to be the emphasis of engagement efforts.

Direct Dialogue with Shareholders

Direct communication between companies and shareholders is becoming increasingly common. We believe that a sound shareholder engagement strategy will encompass these principles:

- **Management should represent the company in most interactions with shareholders.** The majority of communications with shareholders should be led by management and other appropriate individuals, such as the general counsel, the corporate secretary and investor relations, with appropriate support from HR and compensation personnel and other professionals.[10]
- **Companies should actively seek out dialogue with large shareholders.** Engaging with shareholders consumes time and other resources, so efforts to engage should focus where they will pay the greatest dividends. We recommend that companies considering implementing a shareholder engagement program seek out their largest institutional shareholders.
- **Begin the dialogue before proxy season.** The optimal time to reach out to large institutional shareholders is shortly after the annual meeting and conclusion of the previous year's proxy season to discuss with investors their concerns, how they voted and why. The beginning of proxy season is too late to begin engagement. At that point, even the investors with the most resources will not have time to

meet with or even have telephone calls with companies. In addition, an initial dialogue ideally would begin when there is no looming controversy with shareholders or anticipated problems with proxy advisory firms.

- **Shareholder engagement by the board, when and if it occurs, should be led by the presiding director.**
  If a company chooses to include board members in its shareholder engagement efforts, the presiding director should lead the discussion, although it may be appropriate for the chair of the board or the chair of the compensation committee to participate in meetings with shareholders, depending on the anticipated substantive discussion.
- **When directors engage with shareholders, discussions should generally focus on executive compensation and corporate governance topics.**
  In general, discussions between board members and shareholders should focus on issues related to executive compensation and governance. The board's involvement in shareholder engagement is not intended to replace companies' traditional investor relations function with respect to business matters.

Regulation FD and Proxy Solicitation Rules

Complying with Regulation FD is a common concern of companies that are considering shareholder engagement, particularly where companies are considering including directors in meetings with shareholders. Although Regulation FD prohibits selective disclosure of material nonpublic information, Regulation FD does not "prohibit directors from speaking privately with a shareholder or group of shareholders."[11]

To facilitate compliance with Regulation FD, shareholder engagement initiatives should:

- Clearly define who is permitted to act as a spokesperson on behalf of the company
- Limit topics discussed with shareholders to corporate governance and executive compensation
- Avoid discussions of operations, corporate strategy or financial results
- Discuss issues at a high level, without getting into specific detail of strategic, operational or financial matters
- Manage shareholder expectations regarding the range of topics that management may discuss
- Brief spokespersons comprehensively regarding their obligations under Regulation FD; and
- Obtain an express confidentiality agreement from a shareholder before communicating any material nonpublic information

During the 2012 proxy season, many companies that received negative proxy adviser say-on-pay recommendations distributed supplemental proxy materials rebutting the proxy advisers' analyses and recommendations.[12] Although institutional shareholders may view supplemental solicitations as a failure by the company to address the tough issues in the proxy statement, there are some instances in which supplemental proxy solicitations can add significant value. In those instances, companies should remember that Exchange Act Rule 14a-6 requires filing of written solicitation materials, which includes scripts, outlines and other written materials used to solicit proxies or distributed to employees or proxy solicitors who are responding to shareholder questions.

Conclusion

Changing features in the world of corporate governance have prompted many companies to take a serious look at the strategic role of dialogue between company leadership and shareholders. Shareholders have welcomed this increased communication with company leadership and, in some cases, even demanded it. When implemented effectively and under the right circumstances, direct dialogue between the company and shareholders can play an important role in communicating a company's narrative regarding executive compensation and corporate governance choices. Moreover, shareholder engagement can help build valuable relationships with institutional investors that will pay dividends in the future, as shareholder engagement takes on increasing importance for US public companies.

Endnotes

1. For a comprehensive discussion of the history of shareholder activism, see Eisenhofer & Barry, "Shareholder Activism Handbook" (2005), Chapter 1.
2. *See* "The State of Engagement between US Corporations and Shareholders," available at http://bit.ly/QgG8n6.
3. *See* Heineman & Davis, "Institutional Investors Part of the Problem or Part of the Solution?" (Oct. 2011), available at http://bit.ly/oMXpn1.
4. *See* Release No. IA-2016 (May 22, 2012).
5. *See* Hawley (ed.), *Corporate Governance Failures: The Role of Institutional Investors in the Financial Crisis* (2011).
6. *See* Nathan, Barrall & Chung, "Say-on-pay 2011: Proxy Advisors on Course for Hegemony," New York Law Journal (Nov. 28, 2011), available at http://bit.ly/R2xR6m.
7. For a discussion of factors that increase the influence of proxy advisers, see "A Call for Change in the Proxy Advisory Industry Status Quo," Center on Executive Compensation (Jan. 2011), at 5; *see also* Latham & Watkins M&A Deal Commentary, "Majority Voting for Directors: The Latest Corporate Governance Initiative," available at http://bit.ly/Prb3jr.
8. Financial Reporting Council, UK Stewardship Code (July 2010), available at http://bit.ly/Ot9FwL.
9. NYSE Listed Company Manual Section 303A.03; Item 407(f)(1) of Regulation S-K.
10. *See* "The Say-on-Pay Solicitation Playbook: Practical Guidance on Strategies and More," The Corporate Counsel (July-August 2010).
11. Question 101.11, Regulation FD Compliance and Disclosure Interpretations.
12. *See* Barrall, "Proxy Season 2012: The Role of Supplemental Proxy Solicitations," Los Angeles and San Francisco Daily Journal (June 18, 2012).

If you have any questions regarding this *Commentary*, please contact any of the attorneys listed below or the Latham attorney with whom you normally consult.

James D. C. Barrall | **Jessica R. Munitz** | **Joel H. Trotter**

Scott C. Herlihy | **Steven B. Stokdyk**

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