Defining Engagement: An Update on the Evolving Relationship Between Shareholders, Directors and Executives

A study conducted by Institutional Shareholder Services for the Investor Responsibility Research Center Institute

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Executive Summary

This update to the 2011 first-ever benchmarking study of engagement between investors and public corporations in the United States demonstrates that engagement has become even more important since then. While engagement was already increasing in frequency and importance three years ago, a variety of factors, the most significant of them the advent in the US of universal say-on-pay votes, has deepened the trend.

Compared to the situation three years ago, not only are overall engagement levels higher, but fewer respondents said that they do not engage. Nearly half of issuers, and more than half of investors, initiated more than 10 engagements; compared with around 30 percent of issuers and investors three years ago; while only 22 percent of issuers and 19 percent of investors reported initiating no engagements, compared with 27 percent of issuers and more than 40 percent of investors three years ago. Investors and issuers alike are devoting more staff resources to engagement. And investors and issuers are both reporting greater levels of success in engagement, as they come to appreciate the benefits and learn what works and what doesn't. Furthermore, corporate directors are more likely to take part in engagement with shareholders, although this remains the exception rather than the rule.

Many of the trends and patterns observed three years ago remain in evidence today. For example, issuers are more likely to view engagement as a series of discrete conversations, while investors are more likely to see engagement as an ongoing process. In fact, 61 percent of investors surveyed said that an engagement typically lasts more than a month, while 66 percent of issuers said a typical engagement lasts less than a week; and comments by those who were interviewed revealed an even deeper divide, with issuers indicating that engagements typically last a few days or even a few hours, and investors indicating that engagement may go on for months or years, or even the entire duration of the investment. Issuers are still more likely than investors to define success in engagement in terms of establishing a dialogue, while investors are more likely to define success in terms of concrete actions. Perhaps for this reason, issuers are also more likely to report higher degrees of success, though both issuers and investors are reporting increased levels of success compared with past years, largely because with the experience of more engagement they are getting better at it. As was the case three years ago, engagement is most likely to lead to concrete changes in areas where shareholders are broadly in agreement, such as declassification of the board of directors or the replacement of a plurality vote standard for directors with majority voting, than in areas where shareholders' views diverge, such as the need for an independent board chair. While executive compensation is the subject of much of the engagement that takes place, opinions are divided as to how often that compensation-related engagement leads to change.

Issuers tend to engage most often with their largest shareholders, while investors are likely to engage with large companies, with companies heavily weighted in their portfolios, and with companies facing contentious issues. Lack of time is the biggest impediment to engagement, for both investors (over 60 percent of whom cited lack of time as an obstacle) and issuers (nearly 70 percent of whom flagged a lack

of time. An "unwillingness to talk" was cited as an impediment by a slight majority of investors, and more than a third of issuers. To some extent the perceived unwillingness to talk is likely a function of time limitations, and participants' need to focus on those engagements which will yield the most "bang for the buck." But there are also cases where the philosophical differences between issuers and shareholders are real, and cannot be bridged by dialogue.

Although engagement levels at an individual company will continue to fluctuate from year to year, based on such factors as financial and stock price performance and the issues faced by the company, evidence suggests that overall engagement levels will continue to trend upward, as investors seek to better understand, and mitigate risks at, companies they intend to hold for the long term; while issuers seek to win support for company proposals, ward off activists, and keep shareholders happily invested in the stock.

Introduction

In our initial 2011 study of shareholder-issuer engagement in the United States[1], we observed that engagement had increased in frequency and in importance, due to a variety of factors. Investors, having suffered the effects of the financial crisis and having observed a decade's worth of corporate scandals including accounting fraud, the backdating of stock options and numerous varieties of mortgage-related malfeasance, were more sensitive to risk and less inclined to simply trust corporate boards to protect their interests. They were more apt to raise questions about director and auditor independence, conflicts of interest, and the types of behavior incentivized by compensation programs. For their part, issuers, seeing the greater attention paid to these issues by shareholders, including the increasing levels of support for shareholder proposals aimed at addressing perceived governance defects (and increasing levels of opposition to directors who failed to implement proposals winning majority support), and the ability of activist shareholders to make arguments that appealed to mainstream investors, had ample incentives to be proactive about telling their own stories to shareholders, so as to garner support for company strategies and blunt the appeal of activist campaigns. Engagement also allowed issuers to gain insight into their shareholders' views and concerns and build trust and goodwill. We noted as well that enhanced disclosure requirements and other shareholder-friendly regulatory changes had given investors more visibility into corporate financial results, compensation practices and potential conflicts of interest, and had made it easier for investors to compare companies in their portfolios and determine which were outliers. For the large number of institutional investors who use passive investment strategies, simply selling the shares of such outlier companies, as long as they remain in the benchmark index, is not an option; and shareholders may instead engage with those companies in order to seek changes to their compensation or governance practices.

[1] The State of Engagement Between U.S. Corporations and Shareholders, A Study Conducted by Institutional Shareholder Services for the Investor Responsibility Research Center, 2011. The online survey and interviews for that study were conducted in 2010.

We anticipated that the expansion of mandatory "say-on-pay" votes, from participants in the US Treasury's Troubled Asset Relief Program to nearly all US public corporations, would result in an increase in engagement, as had happened in countries such as the UK and Australia which had previously enacted say-on-pay legislation – and as the drafters of the US say-on-pay rules in fact intended. Although the say-on-pay votes in the US are advisory in nature, and there are no legal ramifications for failure to "win" the vote, most companies and boards are keen to avoid the embarrassment of having to report a low rate of support, as well as the potential consequences if they are seen to be insufficiently responsive to the concerns expressed by shareholders. Those consequences can include votes against the members of the compensation committee, shareholder proposals on compensation-related topics, or activist campaigns in which compensation and board accountability become issues. As predicted, in the three years since our original study – which correspond to the first three years of "universal" say-on-pay in the US – overall engagement levels are up, and in particular, companies are initiating more engagement with shareholders, as they seek to head off potential opposition to the say-on-pay vote or demonstrate responsiveness after receiving a high level of dissent. Moreover, corporate directors – especially lead directors and members of compensation committees – are taking part in more engagements, though this is still far from a common occurrence, especially compared to the situation in some other countries.

Yet while the say-on-pay votes, and compensation concerns in general, are clearly a key driver of the increase in engagement as well as a key topic of conversation, compensation is far from the whole story. Issuers and investors are engaging extensively on merger and acquisition activity; on environmental and social issues; on board structure, director qualifications, and other corporate governance topics; on activism and shareholder proposals – and also on corporate strategy and financial results. There is a tendency for companies to engage with portfolio managers on earnings and strategy, and with corporate governance and proxy voting specialists on governance issues, as well as environmental and social issues. But there are frequent exceptions to this pattern, often because the organizational structures of institutional investors differ.

Even as engagement frequency continues to increase, issuers and investors are both reporting higher degrees of success. Comments from both groups suggest that participants – especially issuers – are getting better at engagement as they do more of it. This entails knowing how to allocate appropriate levels of staff resources, prioritizing the topics of greatest importance, becoming familiar with one's counterparts and their views – and also knowing when *not* to engage.

There is no evidence to suggest that engagement will become less frequent or less important going forward, so it is in everyone's interest to handle it efficiently and productively. The potential rewards from successful engagement are clear: issuers can learn shareholders' views and gain useful insights, avoid failed votes, and keep shareholders happy so that they remain long-term owners of the stock; while investors can learn about companies' strategies and policies, while helping companies take steps to mitigate risks and build sustainable value.

Study Methodology

The study included an online survey, open from September to December 2013, with responses from 133 US-listed companies, with an aggregate market capitalization of over $2.3 trillion, and 82 institutional investors holding shares of US companies, with aggregate assets owned or managed of more than $17 trillion. The survey was followed by in-depth interviews with 20 issuers and 25 investors, conducted from November 2013 to February 2014. In order to facilitate comparisons between the results of our initial study and this follow-up study, the online survey in 2013 included most of the same questions as in 2010, along with several new questions. Participants in the original study were encouraged to take part in the follow-up.

On the investor side, survey respondents included mutual funds, hedge funds, asset management firms, public employee and multi-employer pension funds, and faith-based and other socially responsible investment funds. Investor respondents were asked to characterize themselves as asset owners or asset managers, and asked to categorize the size of their assets owned or assets under management. Issuer respondents were similarly categorized by market capitalization, and included companies in a wide variety of sectors.

The survey defined "engagement" broadly, as “direct contact between a shareowner and an issuer (including a board member),” allowing each respondent some flexibility to define the term as he or she saw fit. Each respondent's engagement activity was assessed in terms of subject matter, frequency, participants, measurements of success, and impediments. In addition, the study evaluated how the volume and the success of engagement have changed over time and are likely to change in the future.

To encourage candid responses, interview participants were promised anonymity. Accordingly, where interviewees are quoted, they are not identified by name or by the name of their organization.

Respondent Profile

Asset size, organization size

Fig. 1: Breakdown of Investor Respondents by Assets Owned/Managed

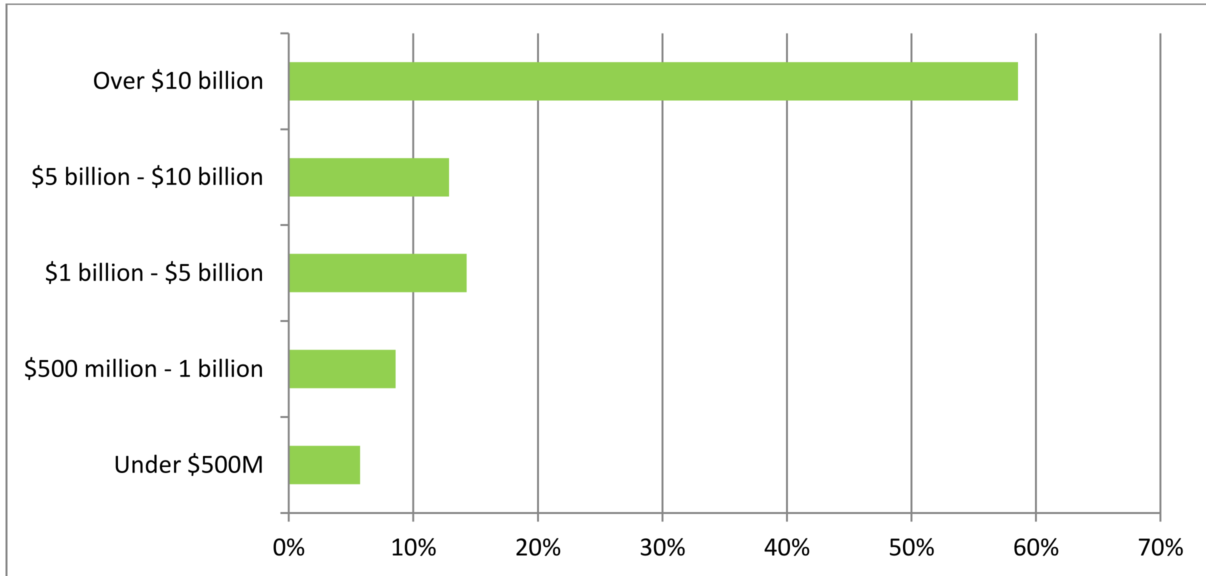
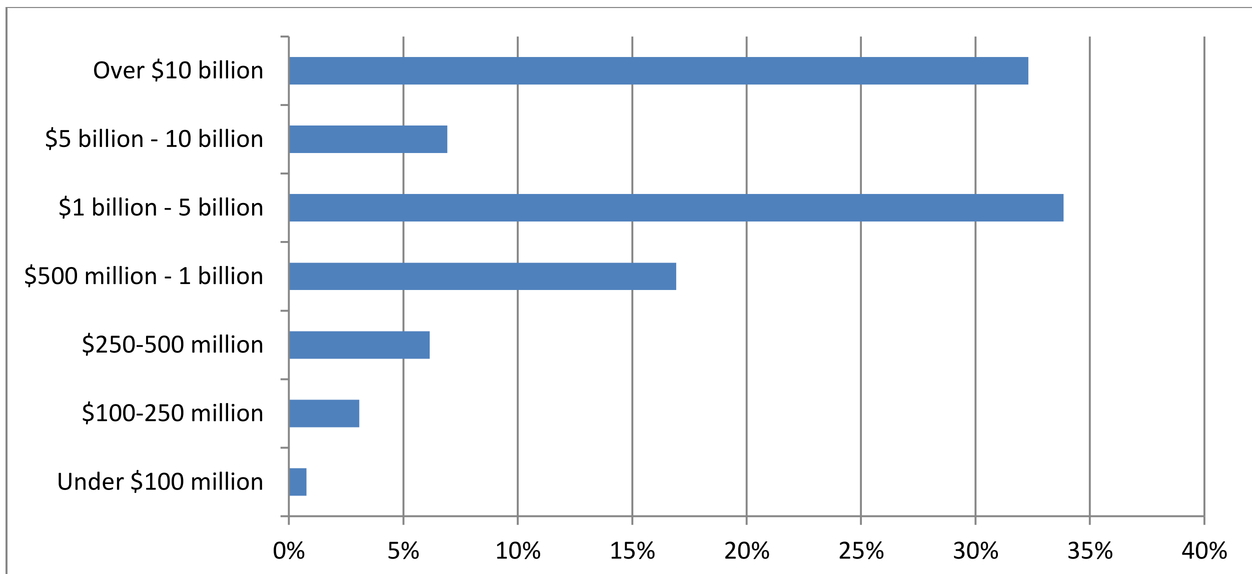


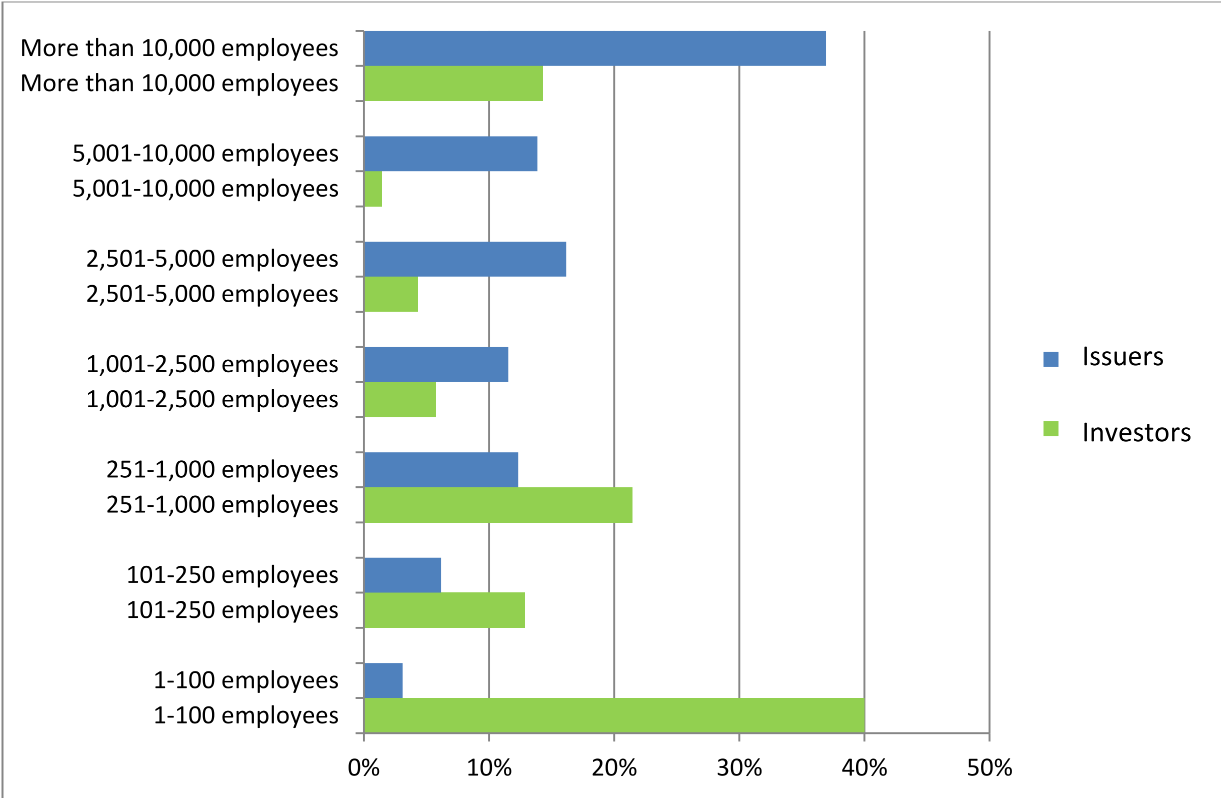
Fig. 2: Breakdown of Issuer Respondents by Market Cap



As detailed in Figures 1 and 2, among investor respondents to the survey, nearly 60 percent had equity assets under management, or assets owned, of over $10 billion. Among issuer respondents, nearly a third had market capitalizations of over $10 billion, while slightly more than a third had market caps of

between $1 billion and $5 billion. Meanwhile, in terms of the number of employees, 39 percent of investor respondents had 100 or fewer employees around the world; while 21 percent had between 251 and 1,000 employees, and 15 percent had more than 10,000 employees. Among issuers, there was a roughly even split between those with more than 10,000 employees, those with between 2,501 and 10,000 employees, and those with fewer than 2,500 employees.

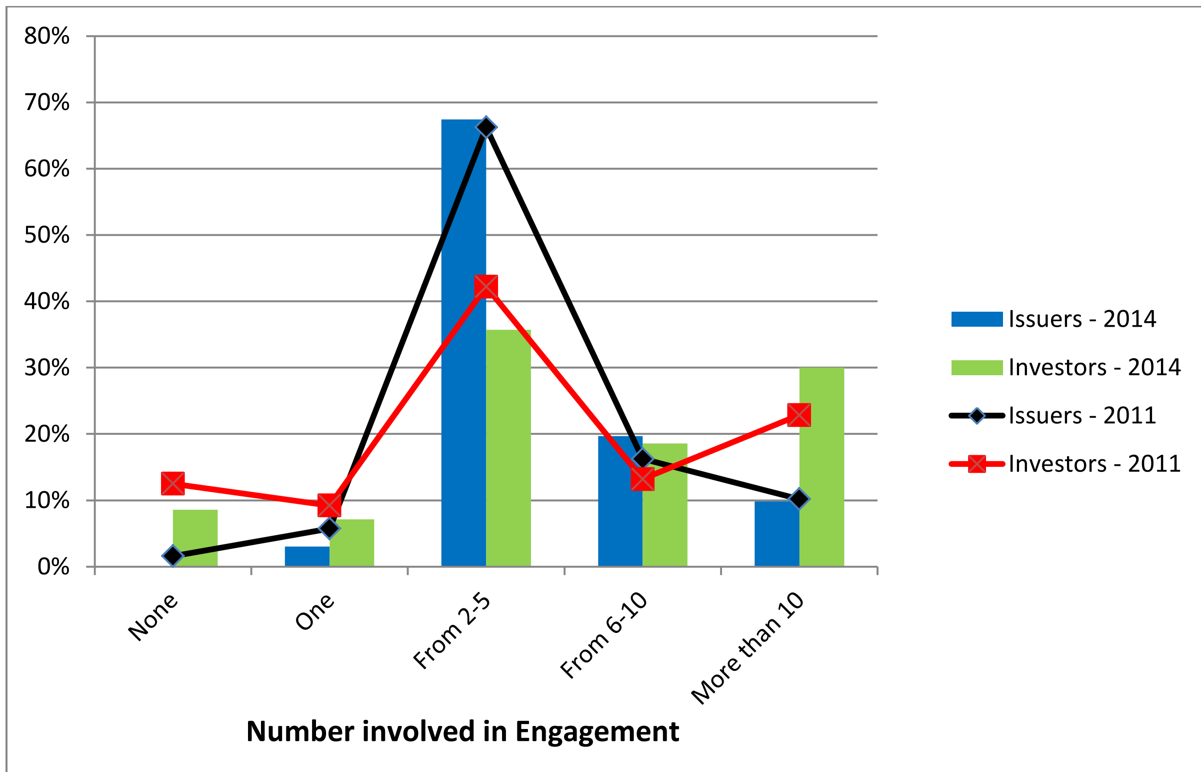
Fig. 3: Size of Workforce



Staff involved in engagement

Among both investors and issuers, the most common answer to the question "How many staff in your organization are typically involved in engagement?" was two to five staffers; chosen by 68 percent of issuer respondents and 36 percent of investors. Around 10 percent of issuers and 30 percent of investors indicated that more than 10 staffers are involved; while only 8 percent of investors (and no issuers) indicated that no staff members are involved in engagement.

Fig. 4: Staff Involved in Engagement



This contrasts with the situation three years earlier, when 1.6 percent of issuers, and 12.5 percent of investors, said that no staff members were involved in engagement; and only the largest issuers and investors (those with market caps or assets of over $10 billion) were likely to report having more than 10 staffers involved. The increase in the number of people involved may partly reflect an improvement in the economic climate, which in the wake of the 2008-09 financial crisis had forced many institutions to operate with smaller staffs and reduced budgets; but is more likely a function of the increased engagement workload, which has forced investors and issuers to dedicate more staff to engagement. The increase is reflected in a slight decline in the percentage of investors citing "staffing considerations" as a common impediment to engagement; as detailed in the section on "Impediments to Engagement" below.

Engagement Frequency

The survey drew a distinction between engagements initiated by the respondent ("proactive engagements"), and those where the respondent took part in an engagement at someone else's initiative ("reactive engagements").

Fig. 5: Engagement Frequency (Investors)

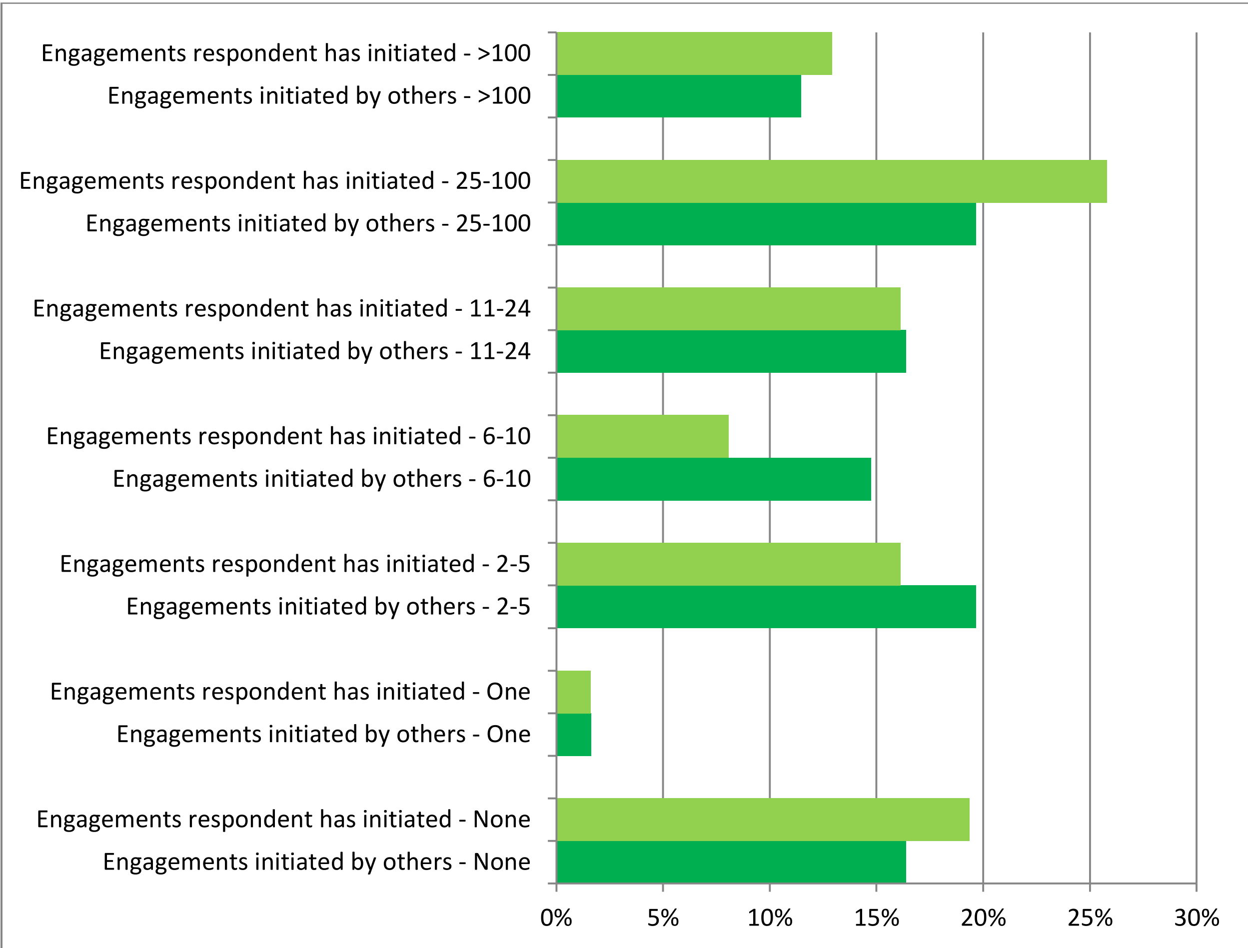
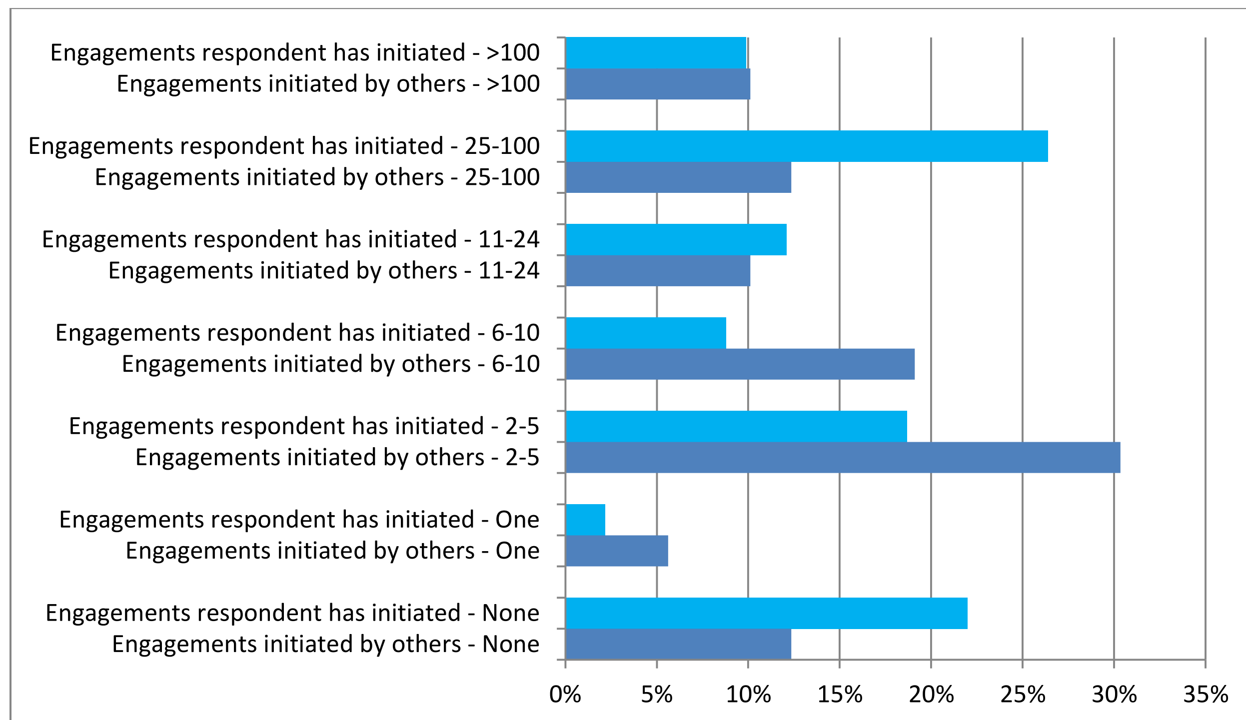


Fig. 6: Engagement Frequency (Issuers)



Among issuers who answered the question, 26 percent had initiated between 25 and 100 engagements the previous year, while 10 percent had initiated over 100 engagements. 22 percent had not initiated any engagement the previous year. Only 12 percent reported that they had not taken part in any engagements at the initiative of investors. However, as a rule companies took part in fewer reactive engagements than proactive engagements: 36 percent of issuers reported engaging between one and five times at investors' initiative, while only 22 percent of issuers reported more than 25 reactive engagements.

Investors typically initiated engagement with issuers often or not at all: 55 percent of investor respondents reported initiating 11 or more engagements in the previous year (including 13 percent who reported more than 100 proactive engagements), while 19 percent of investor respondents – mostly asset managers – reported no proactive engagements. With respect to reactive engagements, however, frequencies were more evenly spread out.

In the survey three years ago, a much higher percentage of respondents reported having experienced no engagements, while a much lower percentage of respondents reported engaging more than 10 times. In the 2010 survey, 27 percent of issuers said they had not initiated any engagement the previous year, while 19 percent reported no reactive engagements. On the investor side, 44 percent had done no proactive engagement, while 41 percent had done no reactive engagement. An equally dramatic shift was seen in the percentage of "super-engagers": in 2010, 30 percent of issuers and 31 percent of investors reported engaging in more than 10 proactive engagements. By contrast, in 2013 47 percent of issuers and 55 percent of investors reported more than 10 proactive engagements.

Timing of Engagement

Survey respondents were asked what percentage of their engagement is tied to quarterly earnings releases, and what percentage is tied to annual shareholder meetings. Among issuer respondents, the percentage tied to quarterly earnings releases varied from zero to 100 percent, with a mean of 46.5 percent and a median of 50 percent; while the percentage tied to annual meetings again varied from zero to 100 percent, but with a mean of 33 percent and a median of 20 percent. (Engagement on governance, environmental and social topics, or on economic transactions, need not be tied either to quarterly earnings or to the annual meeting, but could logically take place at any point during the year.)

A handful of investors stated that all of their engagement is tied to quarterly earnings releases, but the most common answer, by far, was that none of their engagement is tied to quarterly earnings. The average (mean) percentage of engagement tied to quarterly earnings was 15 percent. Meanwhile, the modal answer for investors was that 100 percent of their engagement is tied to the annual meeting, and the mean percentage of engagement related to the AGM is 55 percent.

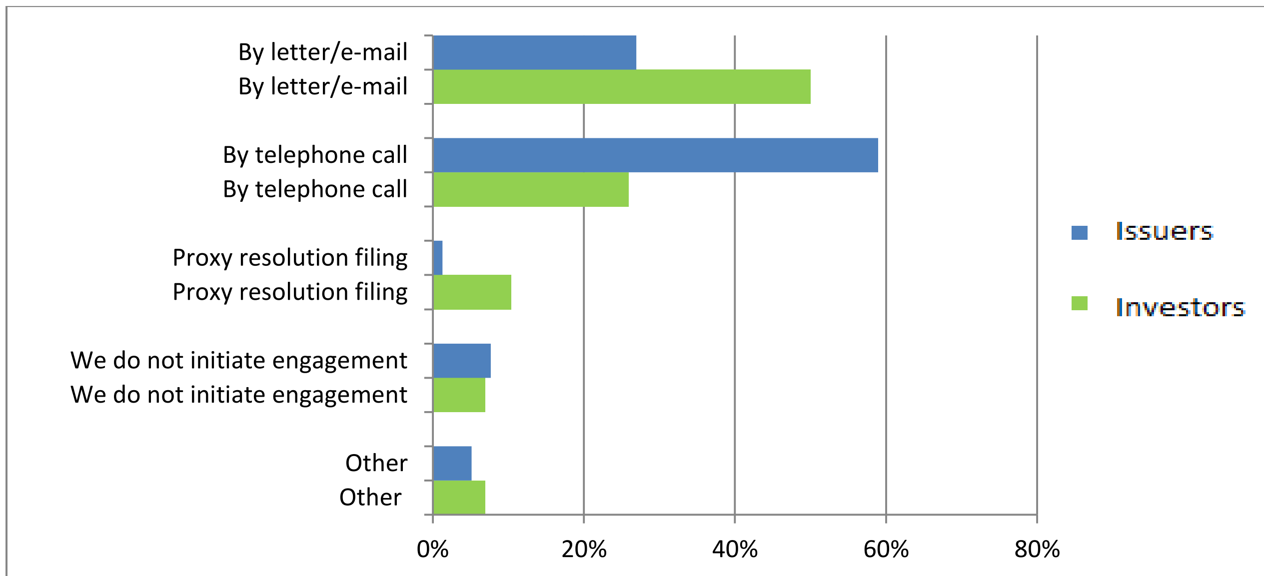
The discrepancy between issuers' and investors' views of the timing of engagement could indicate that issuers are more likely than investors to think of their quarterly earnings calls, and the associated conversations, as "engagement"; while investors are more likely than issuers to think of a query related to a voting item as "engagement." It could also reflect the presence in the survey sample of governance and proxy voting specialists, who are typically more concerned with the items on the meeting agenda than with variations in the financial results from quarter to quarter.

Initiation of Engagement

Survey respondents were asked how they typically initiate engagement, if they do so. Among investor respondents, the most common method is by letter or e-mail, chosen by half of investor respondents -- nearly twice as many as chose "telephone calls." Among issuers, there was a marked preference for initiating engagements by phone – chosen by 59 percent of issuer respondents, compared to 27 percent who generally initiate engagement by letter or e-mail. The percentage of companies who initiate engagement with a phone call was virtually unchanged from three years earlier, but interestingly, letters and e-mails increased in popularity; having been chosen by fewer than 10 percent of issuers in 2010. Three companies commented that at least some of the time, they use outside IR firms or investment banks to arrange meetings with investors, at conferences or on roadshows.

Only four investors and six issuers stated that they don't initiate engagement at all. However, a number of survey respondents skipped this question altogether, and presumably in many cases this was because those respondents do not proactively engage.

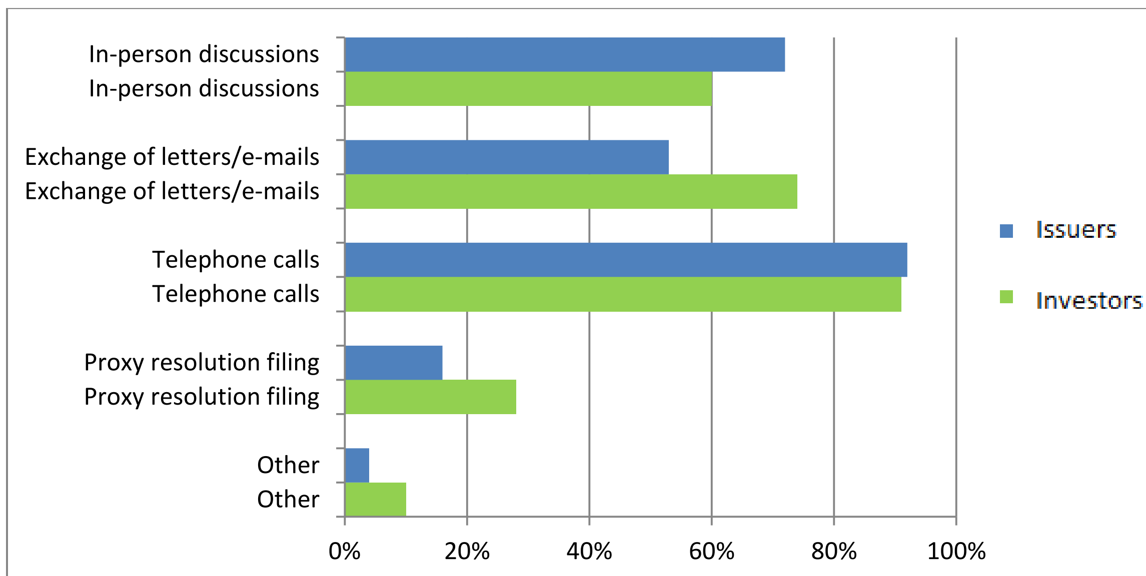
Fig. 7: How Engagement Is Initiated



Methods of Engagement

Once an engagement is underway, 76 percent of investor respondents indicated that the conversation is likely to include one or more telephone calls. A majority of the investors who answered this question indicated that engagements are also likely to include both in-person discussions and exchanges of letters or e-mails. Twenty-seven percent of investors stated that filing of proxy resolutions may be a part of the engagement; but several of those investors commented that they only file a resolution if the discussion has not produced results, and indicated that filing a proposal is generally a last resort. One asset owner indicated that shareholder proposals are a means of getting leverage where the investor has been unable to reach agreement with a company, but that most of the proposals are ultimately withdrawn. As noted above, there are some investors who begin their engagement with the filing of a proxy resolution, but those represent a minority even of the subset of investors willing to consider filing a resolution. Interestingly, three years ago 46 percent of investors indicated that a proxy filing was generally part of an engagement episode; although it is clear that many respondents were not referring to their own filings.

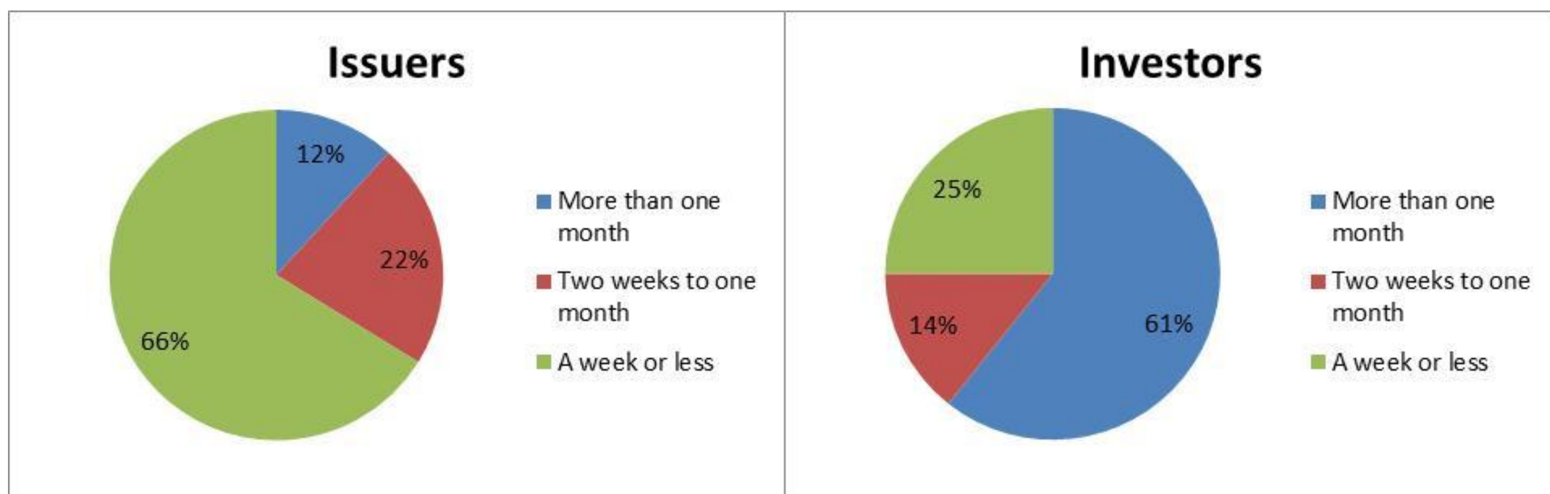
Fig. 8: Methods of Engagement



Among issuers, over 90 percent of respondents indicated that an engagement is likely to entail one or more phone calls. However, while "in-person discussions" and "exchange of letters/e-mails" were each chosen by a majority of issuer respondents, "in-person discussions" was a significantly more popular answer among issuers than "exchange of letters/e-mails". (By contrast, "exchange of letters/e-mails" was more popular among investors.) Sixteen percent of issuer respondents stated that their engagements are likely to include proxy filings; which may refer to resolutions filed by shareholders or to the standard management proposals. In addition, two issuers indicated in the comments that investor conferences are another way in which engagement takes place – and presumably some of the issuers who chose "in-person discussions" were also thinking of discussions which take place at conferences.

Duration of Engagement

Fig. 9: How Long Does an Engagement Typically Last?



When asked how long an engagement typically lasts, two thirds of issuers answered "a week or less," while only 12 percent said that an engagement typically lasts more than one month (the remaining respondents answered "2 weeks to one month"). By contrast, 61 percent of investors said that an engagement typically lasts more than a month, while only 25 percent answered "a week or less." This disparity in perceived duration of engagements was perhaps the biggest difference between investor and issuer responses to any survey question, to the point where it is apparent that the two groups are defining "engagement" differently. This difference mirrors what was found in our 2010-11 study, when 55 percent of issuers and 22 percent of investors answered "a week or less;" and 19 percent of issuers and 54 percent of investors answered "more than one month." Moreover, as was the case three years ago, the comments revealed an even greater disparity, as for many issuers "a week or less" can really mean no more than the duration of a single phone call; while for many investors "more than one month" can actually mean several years. Investors who engage with the goal of bringing about change at portfolio companies – for example, on social or environmental issues – were especially likely to engage for an extended period, with one such investor (an asset manager) commenting that "if an engagement aims for reform, it typically takes a company at least one cycle of board meetings to address the issue." (Though the same investor noted that an engagement aimed at obtaining additional information or clarification may begin and end with one phone call.) In the interviews, several investors pointed out that engagement on environmental and social topics is more of a long-term process than engagement on governance issues. One asset manager, while noting that engagements typically last more than a month, attributed this to resource constraints coupled with a large number of engagements, slowing down the process. Several investors commented that they are long-term shareholders, and that their investment style entails regular contact with management over the duration of their holding period –

but it appears that while such investors often see each meeting or call as part of a single ongoing engagement, issuers are more likely to view each of those calls and meetings as a discrete engagement event. One issuer did, however, comment that it has many long-term shareholders, and that "developing relationships takes more than a week."

Engagement Participants

The survey included a series of questions regarding the points of contact, both when investors initiate the engagement and when issuers do so. When investors wish to engage with company management, they typically reach out to the investor relations department; more than twice as often as to the corporate secretary/general counsel or to C-suite executives. However, a number of investors commented that depending on the subject matter, it could be any or all of the above; while one investor commented that it depends on whether they have an existing relationship with someone at the company. When interviewed, one asset manager commented that while her firm usually speaks with an IR officer first, she has found that "IR is better at addressing questions than addressing concerns," and that "sometimes you get canned speech" from the IR department.

Fig. 10: Points of Contact When Investors Seek to Engage with Management

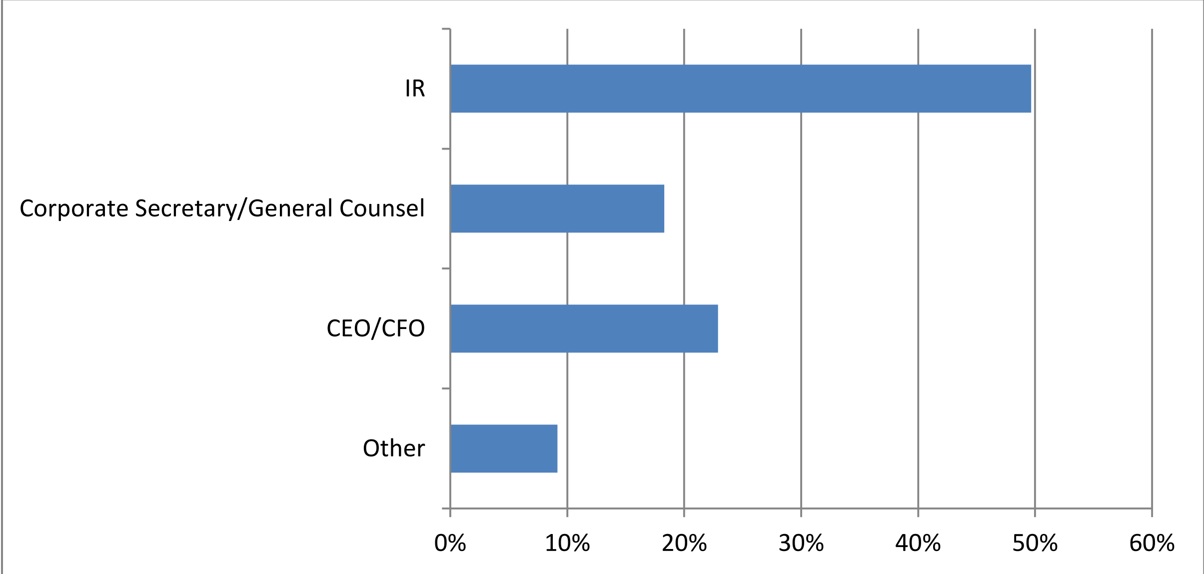
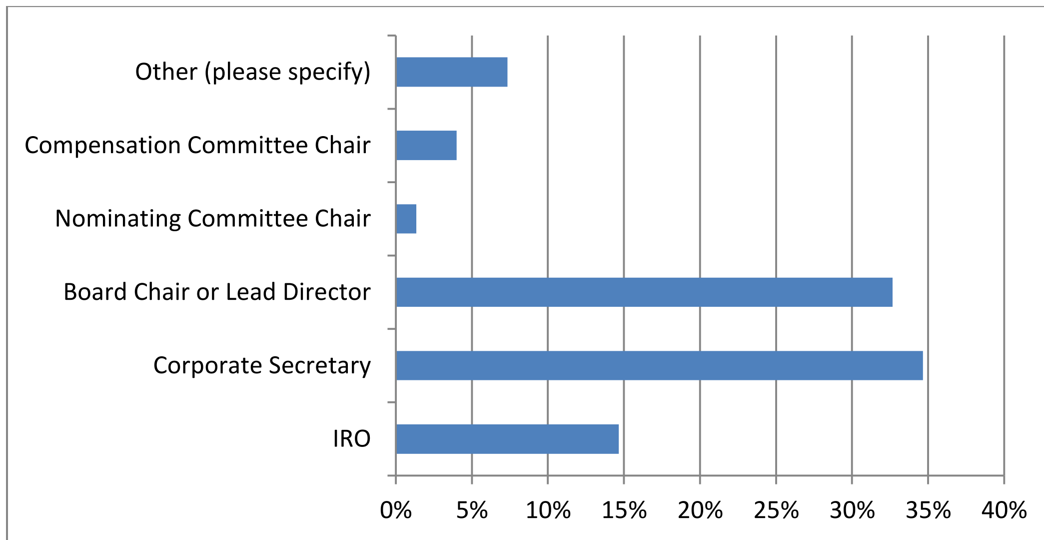
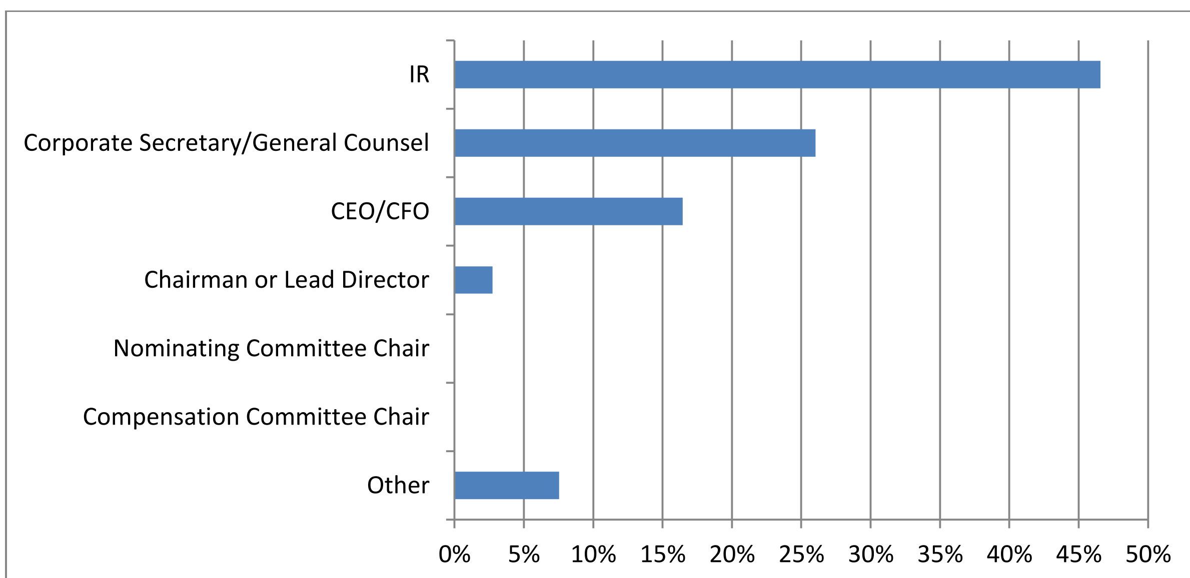


Fig. 11: Points of Contact When Investors Seek to Engage with the Board



When investors seek to engage with members of the board, they most frequently reach out to the corporate secretary, to the board chair or lead director, or to the investor relations office. Few investors go straight to the chair of the compensation or nominating/governance committee. However, many of the investors whose first contact is with the corporate secretary or IR team simply ask those individuals to help arrange a call or meeting with the lead director, chairman, or a member of the relevant committee. Responses three years ago showed much the same pattern: most investors said that their first point of contact for a board engagement was the chairman or the corporate secretary.

Fig. 12: Whom From an Issuer Typically Initiates Contact with Investors?



When it is the company, rather than a shareholder, who seeks to engage, it is most often an investor relations officer or the corporate secretary or general counsel who initiates the contact. Only 3 percent of respondents stated that the chairman or lead director does so, and no respondents indicated that the committee chairs initiate contact with investors. Once again, however, respondents' comments indicated that the person who initiates contact will often depend on the subject matter. For example, the IR department may initiate an engagement on financial or strategic issues, while the general counsel or corporate secretary may do so with respect to governance issues, and a sustainability or CSR officer, or a technical subject matter expert, may do so with respect to environmental or social issues. Two respondents noted that proxy solicitors often make the initial contact with shareholders on behalf of issuers, with one investor commenting that an increasing number of companies are using solicitors for this purpose.

Issuers who were interviewed were asked whether they primarily engage with portfolio managers or with governance and proxy voting specialists; or whether it depends on the topic. Although answers varied, most issuers – unsurprisingly – engage with both groups, depending on the topic. In many cases, the investor relations office engages with portfolio managers about financial results and strategy, while the corporate secretary, general counsel, or compensation or HR department – and sometimes directors – will engage with governance and voting specialists about governance practices or items on the shareholder meeting agenda. However, there are frequent exceptions to this pattern, such as when portfolio managers are involved in the discussion of compensation or other governance issues.

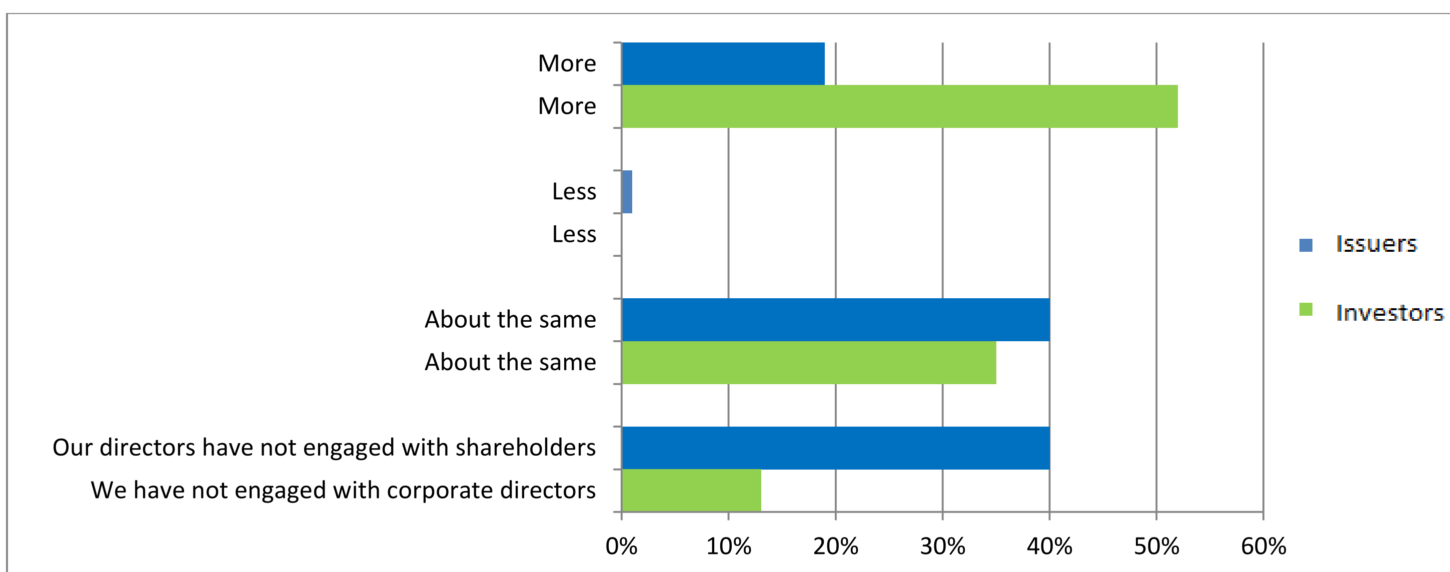
Similarly, investors were asked in the interviews with whom at a company they typically speak first, and who is the final point of contact. Investor Relations was most frequently named as the initial point of contact, while the general counsel or corporate secretary's office was the next most common answer; although some investors begin their outreach with a letter to the CEO. If the issue cannot be resolved through the initial conversation, investors may "escalate" to a subject matter expert at the company, or in rare cases to a member of the board. However, one labor-affiliated fund which engages frequently on governance and social issues said that investor relations is the "worst point of contact" because IR departments are not traditionally used to dealing with corporate governance, and that requests to IR "vanish into outer space."

Participation by Directors in Engagement

On the whole, director involvement in engagement remains the exception rather than the rule. Investors and issuers were both asked what percentage of their engagements have involved a director. For investors, answers ranged from zero to 80 percent. The mean answer was 22 percent, but the median was only 10 percent. For issuers, answers ranged from zero to 50 percent, with a mean of 10 percent and a median of 5 percent.

However, 52 percent of investors said they are engaging more with corporate directors than was the case three years earlier. Thirty-five percent said their level of engagement with directors is unchanged. No investors reported engaging less often with directors than was the case three years ago, but 13 percent of investors have not engaged with directors at all. On the other hand, only 19 percent of issuer respondents said that their directors are engaging more with shareholders than they did three years ago. Thirty-nine percent of issuers said their directors are engaging to the same degree, and 40 percent said their directors had not engaged with shareholders at all. Only one company said that its directors are engaging less than before.

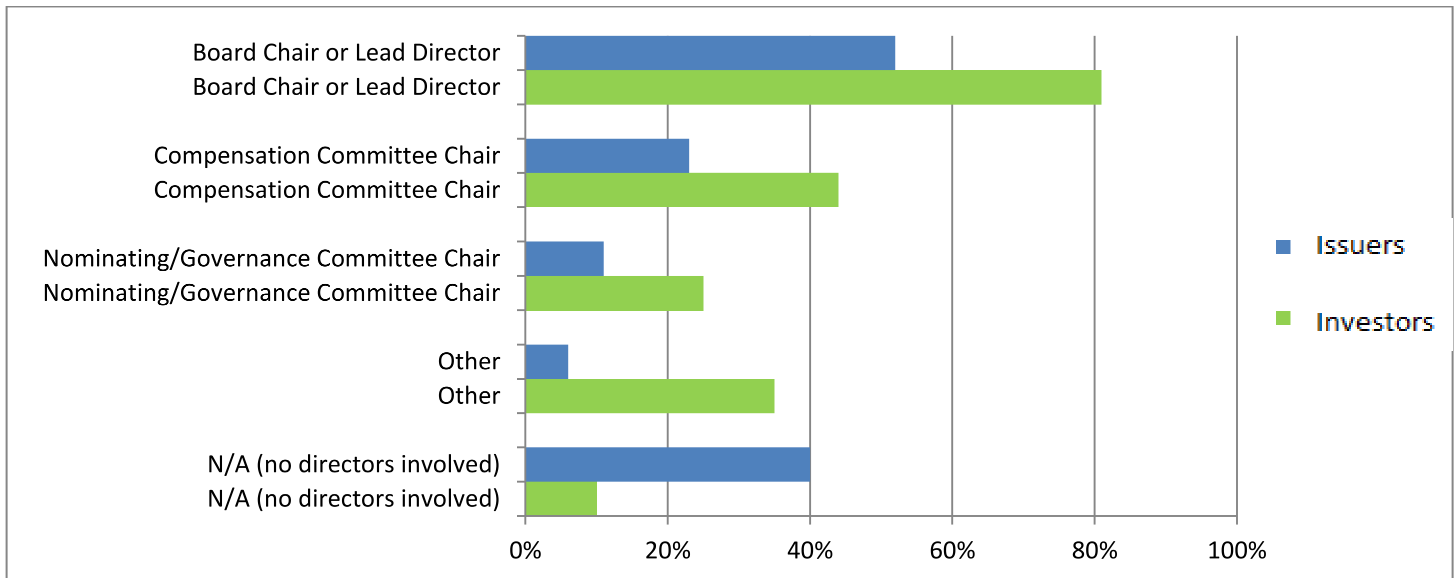
Fig. 13: Are Directors Taking Part in Engagement More Often than Was the Case 3 Years Ago?



The most likely explanation for the discrepancy between investors' experience of engaging more with directors, and most issuers' perception that their directors are not engaging more, is that directors of a relatively small number of companies – such as those that have received low support for their say-on-pay proposals or those which have been targeted in "Vote No" campaigns – are engaging with a relatively large number of shareholders; while directors whose performance and responsiveness to shareholders have not been challenged may feel less of a need to speak to shareholders.

Respondents were also asked *which* directors had been involved in engagement. Eighty-one percent of investor respondents, and 52 percent of issuer respondents, said that a board chairman or lead director was involved. Forty-four percent of investors said that they had engaged with one or more compensation committee chairs, while 23 percent of issuers said their compensation committee chair had taken part in engagement. Ten percent of investors, and 40 percent of issuers, answered "N/A" – meaning that their engagement had not involved directors at all.

Fig. 14: Which Directors Take Part in Engagement?



Investors who were interviewed were asked if they had sought access to board members, and if so, how satisfied they were with their access; and whether this had improved over the past three years. Unsurprisingly, answers varied widely, but many investors did report greater engagement with directors than in past years, especially where the company in question had experienced low support for proxy resolutions. One asset manager stated that more and more companies "get it" that it's normal for shareholders to talk to directors on compensation and governance, but another noted a need to convince some companies that his firm is "active, not activist" in order to get access to directors.

Investors were also asked if they are able to have candid conversations with directors; and again the answers varied widely. One large asset manager called discussions with directors very constructive, stating that "they have deep knowledge of the big picture," while a senior official of a public pension fund said that conversations with directors were often better than discussions with management. But another asset manager said that conversations with directors were not necessarily candid, due to concerns about Regulation FD or due to ignorance of issues on the part of directors; while an asset owner opined that it was conversations with CEOs that were more likely to be candid. Another asset manager complained that conversations with directors tend to be "scripted" and "legalistic," and that directors are "not too comfortable" in such interactions. Yet another asset manager offered that directors should be accessible to shareholders, but should not be the company's spokespersons or "tout the company." The corporate governance director of a labor-affiliated fund said that she had had "great conversations with awesome board members," but that it was sometimes obvious that directors "don't know anything about compensation," and that she sometimes gets further talking to management members who have regular contact with the board, such as corporate secretaries and general counsels.

She also opined that it's best to have conversations with management first, as shareholders will get only limited time with directors. Finally, she noted that non-US investors with whom her fund sometimes works "don't understand why it's so hard to talk to directors in the US." This comment was echoed by a governance specialist at a European asset manager, who stated that "US company directors tend to be less open to investors than [directors of] European companies." However, a US-based but globally active asset manager opined that engagement with directors, while admittedly "very common in Europe," "is becoming more prevalent in the US." This individual also stated that "access to the board . . . correlates with the size of [one's] holding in the company" – which could partially explain the perceptions of European investors that US directors are less open to engagement, as they are likely to hold smaller stakes in US companies than in companies in their home markets. A corporate secretary noted in an interview that while international investors initially seek to engage with directors, they "usually find out they wanted to talk to the comp team and are happy as such."

Issuers were likewise asked in the interviews how often their directors take part in engagement with investors, and whether this is more common than it was three years ago. Most companies indicated that participation by directors is still infrequent (or even nonexistent), but one corporate secretary of an energy company noted that boards are now asking in the boardroom what investors think about governance issues, and said that the trend over the last three years was toward greater participation by directors. The deputy general counsel of a company which recently underwent a CEO succession said that the company's lead director (who also chairs the nominating committee) had been taking part in more engagement, and noted that investors may reach out directly to board members, without necessarily going through the company. (This is another possible reason for the discrepancy between investors' and issuers' experiences of director involvement in engagement.) A deputy general counsel at a bank holding company said that if a shareholder requests access to directors the company will consider it, but the company does not "lead with it;" while other issuers made similar comments. Many companies said that they were open to having the directors take part in engagement, but that shareholders had not requested it. (On the other hand, several investors said that companies are offering access to their directors even when the investors haven't asked.) The assistant corporate secretary of an aerospace company noted that directors are "keenly aware" of the company's discussions with investors, but that it's rare for the directors to get involved themselves, or for investors to request it. And the corporate secretary of a large-cap industrial company stated flatly that his company's directors had never been asked to take part in engagement, and that the company didn't think it would be a good idea. He said that (notwithstanding that the company regularly receives shareholder proposals on governance and social issues) investors want to talk about business and operations, about which senior management is more knowledgeable than the independent directors.

The topic of engagement between shareholders and directors has been attracting increased attention in recent months. In Feb. 2013, the Conference Board established the "Task Force on Corporate/Investor Engagement," which issued its recommendations as well as a set of engagement guidelines in March 2014[2]. The Task Force noted that public confidence in business and financial institutions has not entirely recovered from the effects of the financial crisis, which in turn threatens the legitimacy of the capitalist system and invites new regulations. To address these concerns, the Task Force recommended that directors should take into account investors' viewpoints on the governance and strategy of the corporation, while investors should hold directors accountable through effective engagement and the election process. The report notes further that "direct engagement between directors and institutional investors can be beneficial in special circumstances, but it should not be a routine method of engagement for most US companies and investors."[3] The Task Force's Guidelines for Engagement detail some of the circumstances in which board involvement in engagement may be appropriate. These include "re-establishing company credibility following a period of board or management instability," "resolving significant board composition or succession issues," "coping with significant CEO succession issues," or "dealing with significant policy questions regarding executive compensation."[4] A separate Conference Board Report, published in Oct. 2013[5], noted that "there is a common view in the current governance environment that directors should respond to shareholder questions regarding executive compensation, corporate strategy, financial performance, campaign financing, environmental and social issues, and corporate governance matters." This report highlighted the potential benefits of engagement between shareholders and directors, including giving directors a chance to share their perspectives on a company's long-term strategy (particularly where short-term performance is unfavorable), and enabling shareholders to offer their "unique outside perspective[s] on the company's performance" to the board and management. At the same time, the report flagged some of the pitfalls of shareholder-director engagement, including the possibility of violating Regulation FD through inconsistent disclosure, the possibility that directors could waste time talking to shareholders who are uninterested (or who are not the proxy voting decision makers), and the possibility of embarrassment for directors who are unprepared to answer shareholder questions.

In Feb. 2014, a new group known as the Shareholder-Director Exchange (SDX) announced a 10-point "SDX Protocol" to offer guidance on when direct engagement between shareholders and corporate directors is appropriate, and how to make such engagements "valuable and effective." The Protocol states that appropriate topics for engagement between shareholders and directors are those for which the board has responsibility, including board leadership and composition, management performance and succession, and takeover defenses – but not matters which are more properly within the purview of management, such as financial results. The Protocol also refers to engagement with "long-term institutional investors such as asset managers and public pension funds," and the document makes clear that one purpose of the group is to help ensure that the views of such investors are given greater weight by corporate boards, relative to the views of activist investors; and to blunt the appeal of activist campaigns to mainstream investors by helping to ensure that such investors feel that boards are responsive to their concerns. Whether or not directors and investors formally sign on to the SDX Protocol, it is likely that directors will play a greater role in shareholder engagement going forward.

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[2] Recommendations of the Task Force on Corporate/Investor Engagement, Conference Board Research Report 1539-14-RR, March, 2014 (http://www.conference-board.org/publications/publicationdetail.cfm?publicationid=2712) ("Conference Board Recommendations") and Guidelines for Engagement, Conference Board Research Report 1541-14-RR, March, 2014 ("Conference Board Guidelines")

[3] Conference Board Recommendations, p. 12.

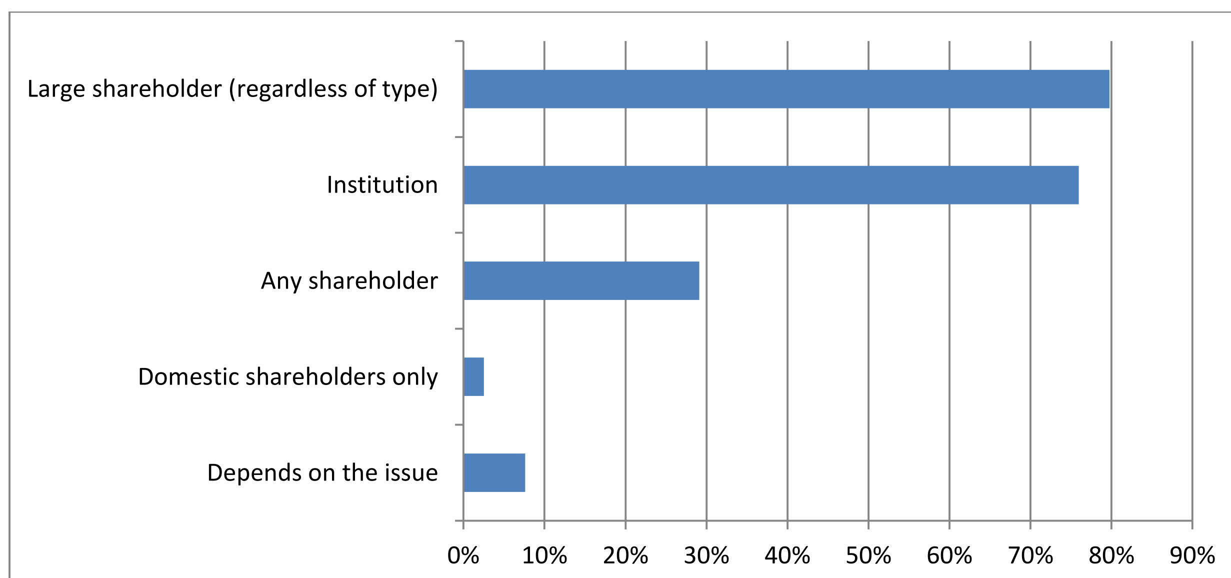
[4] Conference Board Guidelines, p. 19.

[5] Global Trends in Board-Shareholder Engagement, James Kim and Jason D. Schloetzer, Conference Board Director Notes No. DN-V5N20, Oct. 2013. (http://www.conference-board.org/publications/publicationdetail.cfm?publicationid=2618)

Engagement Targets

Issuers were asked with which types of investors they are most likely to engage; with multiple answers allowed. Almost 80 percent of respondents stated that they were likely to engage with large shareholders, regardless of type; while nearly as many responded that they were likely to engage with institutional investors. (At most companies, of course, the largest shareholders *are* primarily institutions.) Thirty percent of issuers said they were likely to engage with any shareholder. Nine percent of issuers said that it depends on the issue, and several commented that they will engage with shareholder proponents – or engage on environmental and social issues with investors who focus on those issues – regardless of their size. One company commented that even though most of its engagement is with large shareholders, it will engage with smaller institutions at their request; while another said simply "we engage with those who engage with us."

Fig. 15: Issuer Engagement Targets

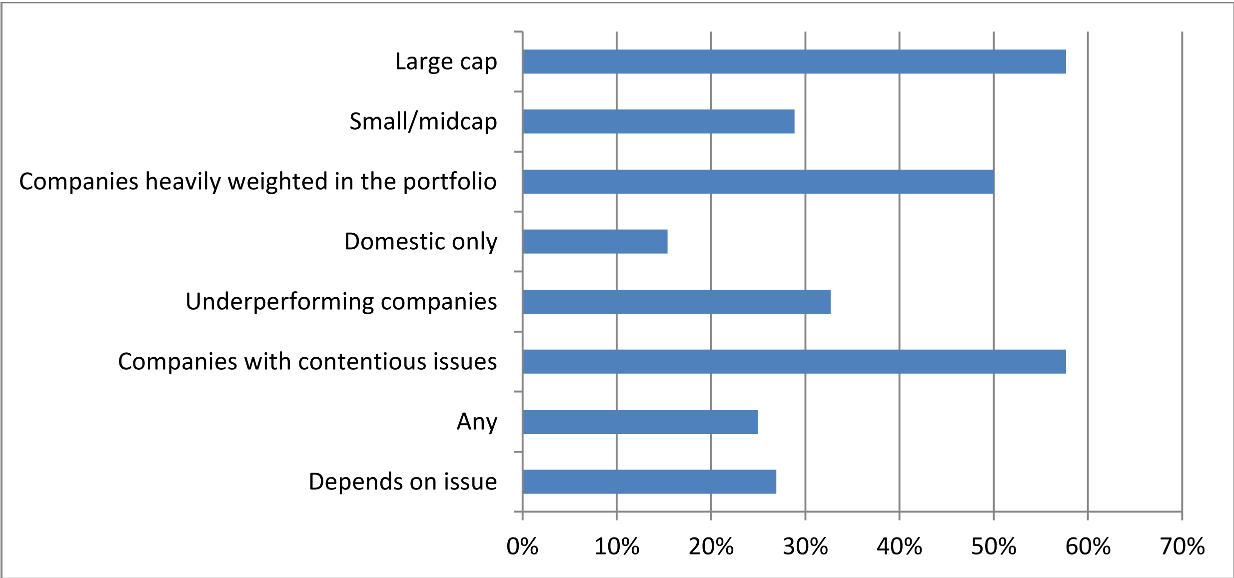


Interestingly, the bias in favor of large shareholders was even more pronounced than three years ago, when 70 percent of issuer respondents said they were likely to engage with large shareholders, and 38 percent of issuers said they were likely to engage with any shareholder. Even though issuers reported engaging more frequently than in the past, it does not appear that they are broadening the scope of engagement to include more small shareholders. The implication is that companies are talking to a higher percentage of their top shareholders, or having more frequent conversations with the same core group of investors.

Investors were likewise asked with which types of companies they are most likely to engage. The most popular answers were "large-cap companies" and "companies with contentious issues," followed closely by "companies heavily weighted in the portfolio". A number of investors said that they are likely to

engage with small and mid-cap companies, but all but two of the respondents who chose this answer also said they are likely to engage with large-cap companies. Only 15 percent of the investor respondents said they are likely to engage only with domestic issuers.

Fig. 16: Investor Engagement Targets



27 percent of the investor respondents said that the type of issuers with which they're most likely to engage depends on the issue being discussed, with one asset manager flagging proxy contests and takeover defenses as topics likely to require engagement, while an asset owner indicated that her firm engages with companies that violate the United Nations Global Compact (UNGC). One asset manager indicated that his firm engages with underperforming companies, but also noted that they will engage on best practices even with companies that are performing well.

The interviews offered respondents a chance to provide more color on this question. Many issuers reiterated that they target their largest shareholders (anywhere from the top five to the top 50 or 75), but an assistant corporate secretary noted that her company will talk to investors that are known to have concerns about particular issues, even when these investors aren't in the top 50; while a deputy general counsel said that he tries to engage with "influential voices" in the investment community (such as public pension funds), and a corporate counsel noted that his company targets investors who have their own voting guidelines. Even retail investors are not entirely shut out of engagement: the Director of Shareholder Services of a transaction processing company noted frequent conversations with retail investors about issues such as dividends and administrative issues related to the shares.

On the investor side, one large asset manager commented that it targets companies for engagement based on the nature of the concerns and whether the investor has something constructive to offer; but noted that it does not engage proactively with controlled companies. Several investors said they choose targets for engagement based on negative recommendations from proxy advisors or low scores on corporate governance ratings (particularly where investors use an indexed strategy and are unable to

sell the shares of companies they see as poorly governed), or that they target companies which have lost a say-on-pay vote; while others commented that they choose target companies either because those companies are perceived as laggards on a particular issue, or because the companies are seen as leaders, whose actions are expected to be influential with other issuers. Investors who frequently file shareholder proposals most often target large companies in order to get the most "bang for the buck," in terms of bringing attention to an issue. But an asset manager who frequently engages on governance as well as environmental and social issues observed that "the small-cap world used to fly below the radar, but not anymore;" and this was more-or-less confirmed by another asset manager who spoke of an effort to get small- and mid-cap companies to better disclose their sustainability initiatives. Now that a majority of large companies have declassified their boards, instituted majority voting and appointed female directors (to name a few examples), investors who focus on these issues are increasingly turning their attention to smaller companies. (At the same time, on the more complex issues, investor expectations may differ according to the company's size, so that what would be considered a meaningful commitment from a small-cap company with limited resources would not necessarily be considered reasonable from a large-cap company with greater resources.) A vice president at a large asset management firm said that issues, rather than market cap or the size of her firm's position, determine who the firm targets for engagement, but that large-cap companies were more likely to reach out to her. And a corporate governance analyst at another asset management firm noted that the firm engages more often with large companies, which have more resources to conduct shareholder outreach, but that engagement with smaller companies is more likely to involve the CEO or CFO than is the case at larger companies.

The survey three years ago had a smaller set of choices for investors; limited to "large-cap," "small/mid-cap," "domestic issuers only," or "any." This makes direct comparisons difficult, but one interesting change is that the percentage of investors who said they engage with domestic issuers only fell from around 25 percent to 15 percent.

Collective Engagement

Investors were asked how often their organizations engage with issuers alone, versus engaging collectively with other like-minded institutions. A slight majority of respondents answered either that they typically engage alone, or that the questions were not applicable – which could mean that collective engagement does not apply to them (i.e. they always engage alone), or that they do not proactively engage at all.

Fig. 17: How Often Do You Coordinate with Other Investors to Choose Engagement Targets or Subjects?

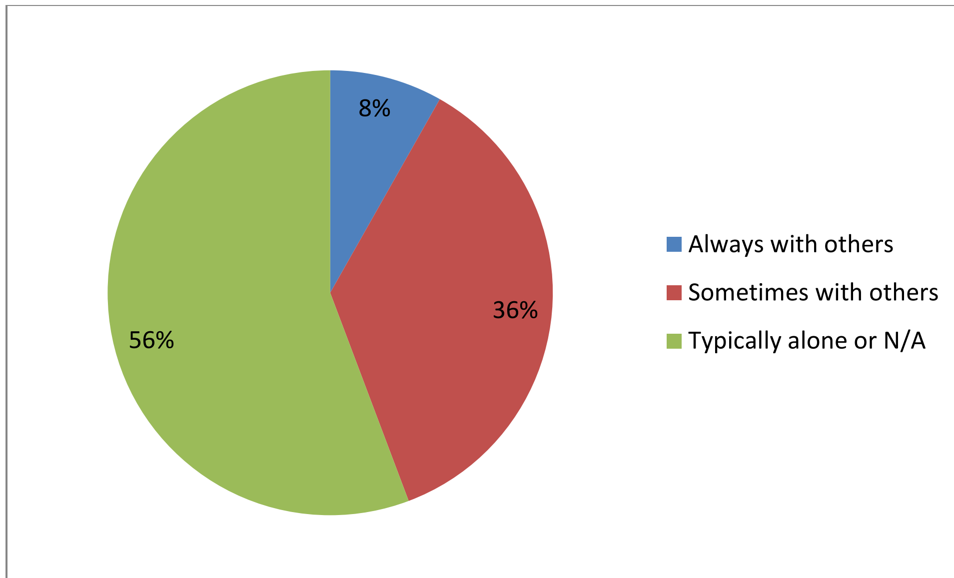
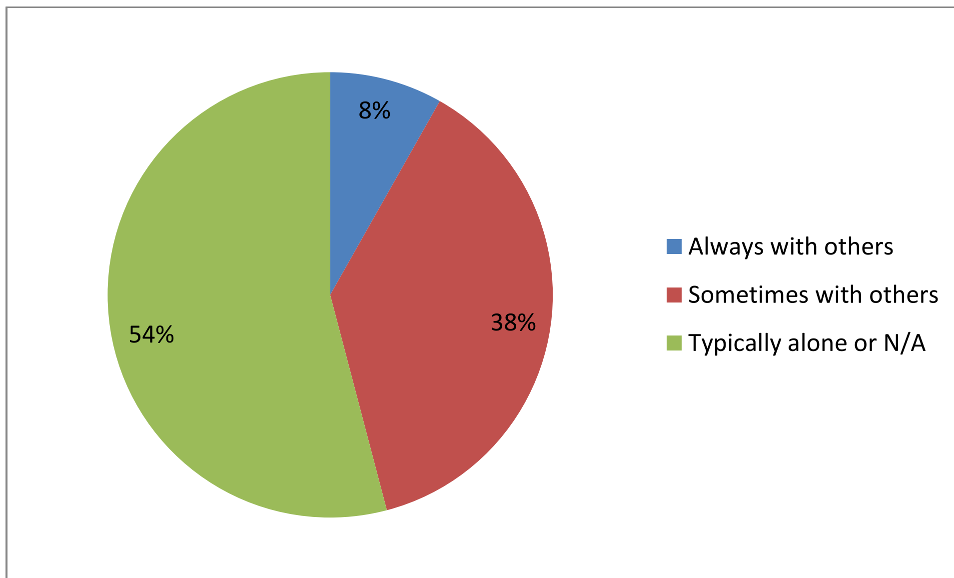


Fig. 18: How Often Do You Involve Other Investors Once an Engagement is Underway?



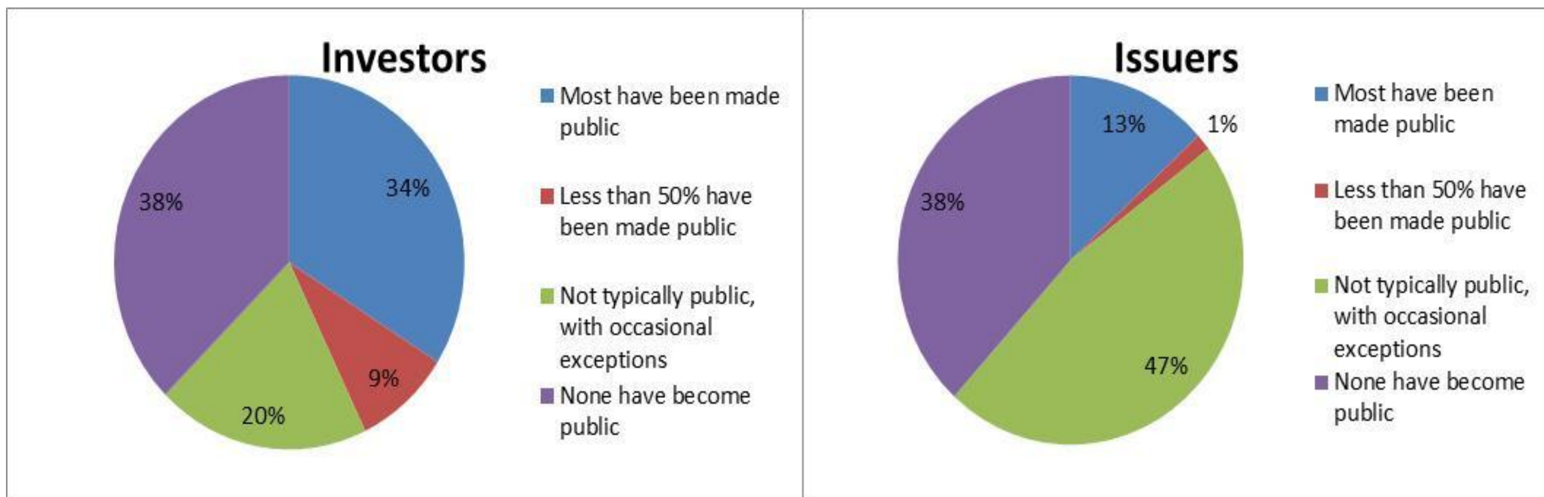
In the comments to this question, one asset owner representative indicated that her organization preferred to engage with a group, but that it almost always leads that group, choosing subjects and target companies largely on its own, and then soliciting the involvement of other funds. One asset manager who typically engages alone commented that collective engagement entails "too much free riding by asset owners who make no substantive contribution," while an asset owner noted simply that

she finds it "generally faster and easier to do it alone." However, in interviews, two SRI-oriented investors and a labor-affiliated pension fund all noted that their engagement was more likely to be successful when conducted as part of a group or coalition of investors, because companies don't feel they're being singled out when approached by an investor coalition formed around a particular issue. Another reason for collaborative engagement may be that companies may be more responsive on environmental and social issues when they see evidence that concerns in these areas are widely shared in the investment community. In addition, collective engagement can be a way for smaller investors to get the kind of access to executives and directors that is usually reserved for their larger counterparts.

Publicizing Engagement

Participants in the study were asked how often their engagements have been made public. Among investors, the most common answers were that most engagements are made public and that none of their engagements are made public. By contrast, only 13 percent of issuer respondents said that most of their engagements are made public.

Fig. 19: Have Your Engagements Been Made Public?



In 2010, only 21 percent of investors and 30 percent of issuers said that none of their engagements had been made public. The increased willingness to keep conversations confidential may reflect the increased focus on compensation – which is inherently more sensitive than financial results or governance topics like board structure and voting procedures – as a topic of engagement.

Once again, the comments provide a somewhat more nuanced picture. For example, one asset manager who indicated that most of his engagements are made public noted that this doesn't necessarily happen until after the fact, while another asset manager stated that on the rare occasions when the firm's

engagements are made public, it is always well after the underlying issue has been resolved. One asset owner said that her organization prefers to engage in "quiet diplomacy," and does not typically discuss settlements with issuers without their consent; but noted that the group sometimes goes public after a shareholder proposal has been filed, and the issue is in the public domain.

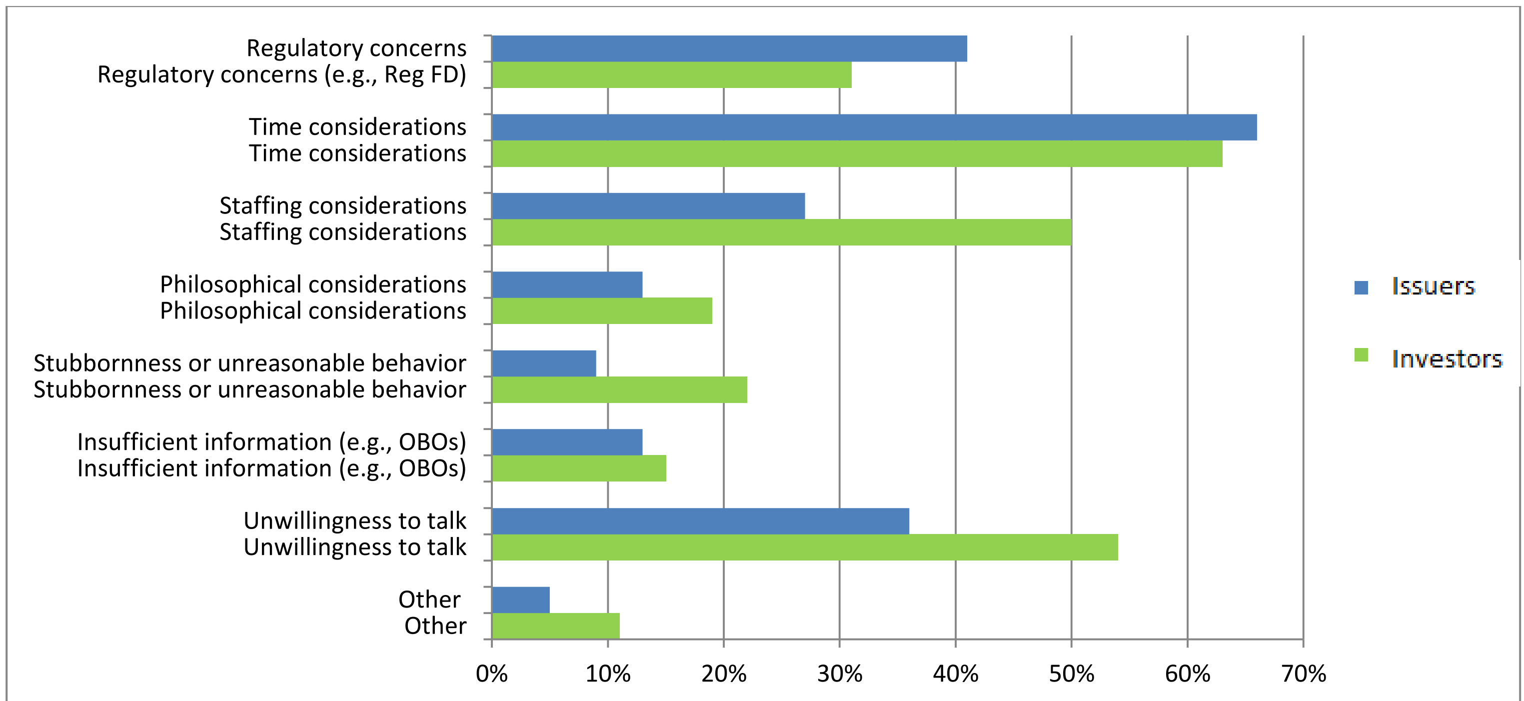
Some investors commented that they disclose the names of the companies with which they engage but not the content of the engagement, while others take the opposite approach and disclose the issues on which they are engaging but not the identities of the companies. Similarly, some issuers discuss the breadth of their engagement with shareholders, and some go on to disclose the feedback they are getting and the changes they are making in response to that feedback, but without identifying the individual shareholders with whom they have spoken. And some issuers, while responding that their engagement is not typically made public, pointed out that their earnings calls (including the questions and answers) are public, or that conference presentations are posted on their website.

The comments from investors indicate that many feel that engagement is more effective if done behind the scenes, in such a way that issuers and their representatives are not publicly singled out or embarrassed. At the same time, investors want their own clients or other constituencies to know that they are in fact engaging, and therefore disclose partial information; or, in the words of an asset manager, provide "reporting on select engagements to create awareness of our engagement activities." Issuers likewise may want to be perceived by investors as responsive to shareholder concerns (particularly if those concerns are widely shared), and as proactive rather than passively waiting for investors to contact them. At the same time, an issuer may not like to disclose that it has been targeted for engagement, as this may imply that it is viewed as a laggard on governance or environmental performance, and may not want to bring publicity to what it may see as a pressure group or special interest whose concerns are not representative of the broader investment community.

Impediments to Engagement

Survey respondents were asked what they view as the most common impediments to engagement. Among investors, the factors most cited as impediments were time considerations and staffing considerations, along with an "unwillingness to talk." Each of these was cited by a majority of investor respondents. Among issuers, time was again the biggest impediment. No other single factor was cited by a majority of issuers, and issuers were significantly less likely than investors to identify unwillingness to talk, philosophical considerations, or stubbornness as impediments to engagement. It is not clear whether this means that investors are genuinely more willing to talk than issuers, or merely that issuers are more diplomatic in expressing their views on this point.

Fig. 20: Impediments to Engagement



Some notable differences with the results of the earlier survey were that issuers were more likely to identify time considerations as an impediment in 2013 (only half of issuers cited time as an impediment in 2010, while some two-thirds of issuers did so in 2013), while they were less likely to identify staffing and insufficient information as impediments than in the earlier survey. Issuers and investors alike were less likely to cite philosophical considerations as a hurdle, but this is most likely because of the newly-added categories of "stubbornness" and "unwillingness to talk."

Although issuers and investors alike often identified regulations (such as Regulation FD) as an impediment to engagement, one asset owner commented that this is a "specious argument" made by companies who simply didn't want to talk (although this asset owner did say that most companies are in fact willing to engage). This echoes similar comments about Reg FD made by an asset manager in the earlier survey. Among investors who are globally active, one commented that US and Asian companies are the least open to engagement, while another stated that "in comparison to other markets in which we operate, US boards do not see the importance of engagement as strongly. We are able to have greater access to directors for greater mutual benefit in other markets." Yet another respondent pointed to "regulatory support for adversarial proceedings" in the US as an impediment to less adversarial engagement. For their part, several issuers noted that a lack of time or resources on the part of investors was an impediment to engagement, although one corporate secretary noted in an interview that he felt investors were dedicating more staff resources to engagement than in earlier years. One company pointed to "uneducated investors" and "misunderstanding of the market." Although relatively few issuers flagged the "Objecting Beneficial Owner" (OBO) system (whereby beneficial owners can opt

to keep their identities secret from portfolio companies) as an impediment, in an interview the assistant general counsel at a resource company opined that the OBO system is "broken," especially after the advent of say-on-pay, the increase in shareholder proposals, and changes to the broker vote rule.

Engagement Subject Matter

Survey respondents typically engage with respect to a broad range of topics, both when they initiate the conversations and when they respond to a request for engagement. For investors, the most common topics on which they sought to engage in the previous year were compensation and other governance topics, which were also the most common topics on which issuers sought to engage with them. Perhaps surprisingly, investors were more likely to request engagement on environmental and social issues than on financial results or transactions and corporate strategy. However, this may reflect that investors are satisfied with existing levels of disclosure on financials and strategy, and do not feel a need to engage further; or it may reflect that some of the survey respondents were corporate governance and proxy voting specialists, who are more likely to engage on governance or environmental and social matters than on financial matters. Nearly twice as many investors reported that they sought to engage on environmental and social/non-financial issues, as stated that issuers sought to engage on such topics with them.

For their part, issuers reported that they most commonly sought to engage on financial results; with transactions/strategy, "other governance," and compensation all roughly equally common, and all significantly less common than financial results. Few issuers sought to engage on social issues, and even fewer on environmental issues. The most common topic on which issuers said that investors sought to engage with them was financial results, followed closely by transactions and strategy. Issuers reported that shareholders sought to engage with them on environmental and social matters less often than compensation or other governance issues, and far less often than on financials or strategy.

Notably, over 70 percent of investor respondents reported engaging proactively on compensation, while only 26 percent of issuer respondents reported engaging reactively on this topic. Meanwhile, 35 percent of investors reported engaging proactively on financial results, while 53 percent of issuers reported engaging reactively on financials. On the other hand, 5 percent of issuers reported engaging proactively on environmental issues; while 28 percent of investors stated that they received requests to engage on such issues. One possible explanation for these apparent discrepancies – apart from the above-mentioned distinction between portfolio managers and governance and proxy voting specialists – is that a small number of companies seek to engage on environmental issues, but do so with a wide range of investors; while a large number of investors seek to engage on compensation (and on environmental and social issues), but each with only a limited number of portfolio companies. Evidence for the latter proposition is found in the voting statistics for "say on pay" proposals. Notwithstanding all the attention paid to the relatively small number of companies with failed votes, say on pay proposals in the US are

passing with average support of 91 percent (based on ISS data for 2013), indicating that most investors are focusing their attention on a small group of perceived outliers.

Fig. 21: Engagement Subject Matter (Investors)

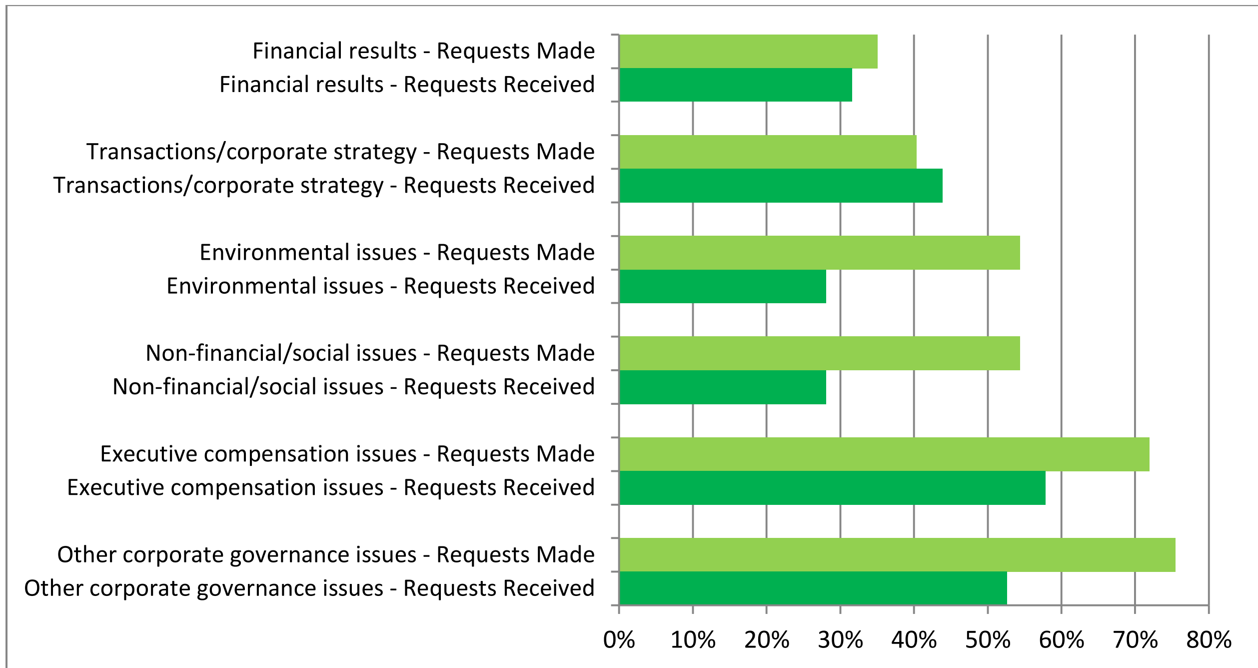
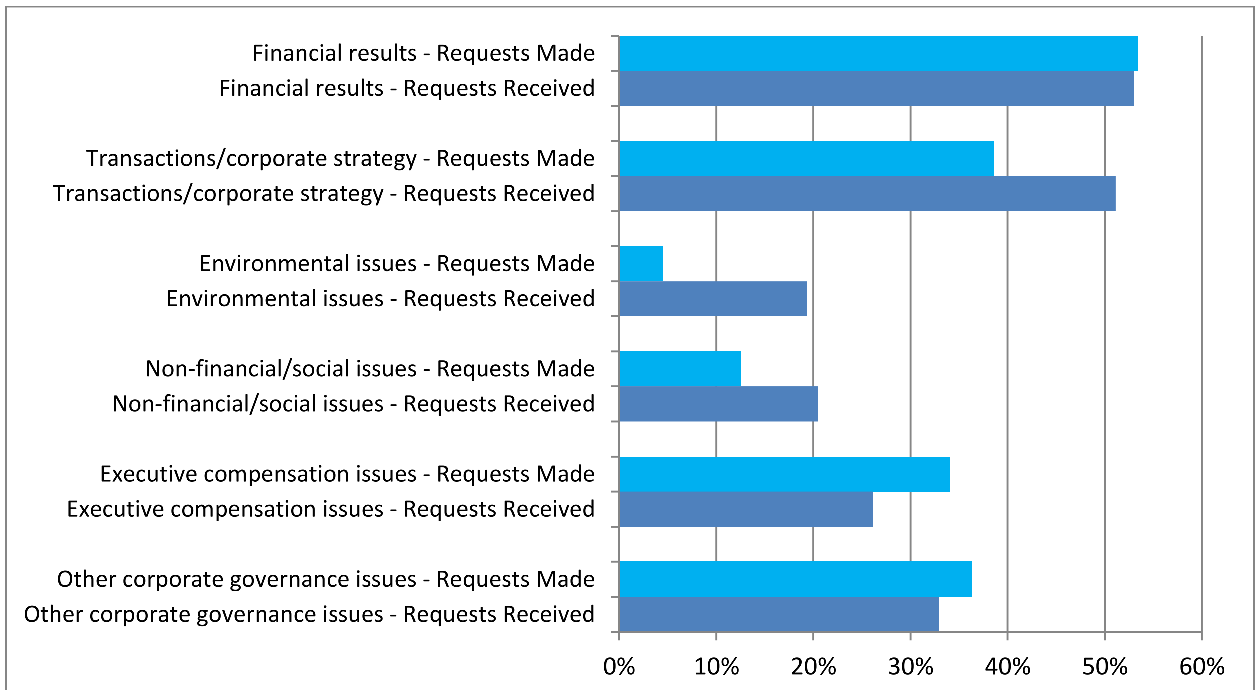


Fig. 22: Engagement Subject Matter (Issuers)



The biggest differences from the results of the 2010 survey are the apparent decrease in the prevalence of financial results and corporate strategy as engagement topics for investors, and the increase in the prevalence of executive compensation. In 2010, 51 percent of investors reported engaging proactively on financials and strategy, while 59 percent of issuers reported engaging reactively on these matters. Meanwhile, in 2010 only 48 percent of investors said that they had engaged proactively on compensation. In addition to the obvious dynamic introduced by widespread "Say on Pay" voting, this could reflect an improvement in economic performance at many companies (meaning that investors feel less need to discuss financial results), or it could mean that engagement on compensation is "crowding out" engagement on financial results and strategy; or it could simply reflect differences in the respondent group.

Investors and issuers who were interviewed were asked what topics require the most proactive engagement, as well as what topics were most frequently raised when others sought to engage with them. Investors frequently identified compensation as both an area requiring proactive engagement, as well as a common topic when issuers seek to engage. Other topics on which investors often seek to engage include board composition and directors' skill sets and performance; succession planning; governance provisions such as majority voting and board declassification, capital allocation and M&A, and political contributions and lobbying expenditures. Investors identified shareholder proposals and shareholder activism as topics that issuers frequently want to discuss with them; along with M&A and corporate actions.

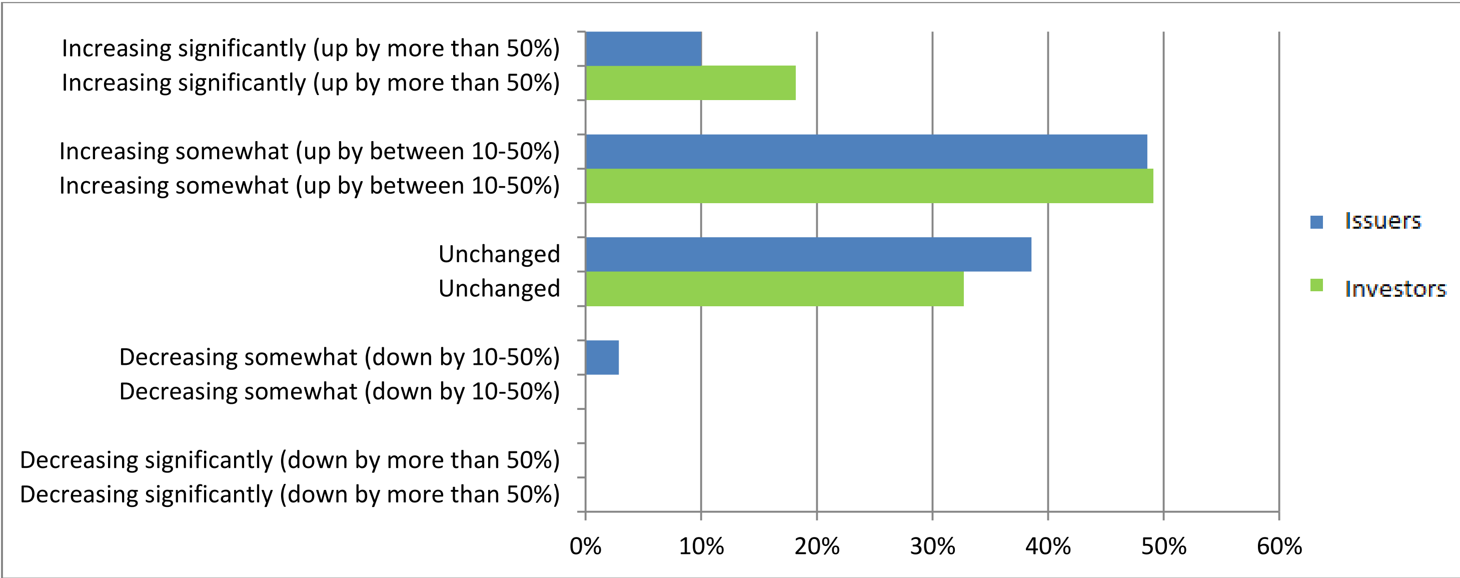
For their part, issuers identified compensation as a topic on which they often engage proactively, along with any shareholder proposals on the ballot in a given year. Several companies also said they engaged frequently on issues such as board tenure/refreshment and director skill sets and diversity, while others pointed to financial performance, growth plans and earnings projections. Issuers' perceptions of the issues on which investors want to engage with them are similarly broad, and included company operations and performance as well as compensation. Although several issuers indicated that they rarely hear from shareholders on governance matters, one company did identify the separation of the chairman and CEO posts as an issue on which investors had sought to engage with it, while another company said this was an issue, but only for overseas investors. Several companies indicated that investors had reached out to engage on the classified board, but that after declassifying they seldom heard from investors on governance issues. One general counsel of a small cap company observed that "most conversations are not about votes, as most investors are pretty predictable in their voting patterns."

Trends in Engagement

A majority of survey participants reported that the number of engagements in which they had participated during the previous year had increased. Among investors, 49 percent reported that the number of engagements had increased somewhat (defined as a 10 to 50 percent increase), while 18

percent said the number of engagements had increased significantly (i.e. by more than 50 percent). The remaining third of investors said the number of engagements had not changed, while not a single investor reported a decrease. Nearly half of issuers also said that the number of engagements had increased somewhat, while 10 percent said it had increased significantly. 2 percent of issuers reported that engagement had decreased somewhat, but no issuers reported a significant decrease.

Fig. 23: Is Engagement Increasing?

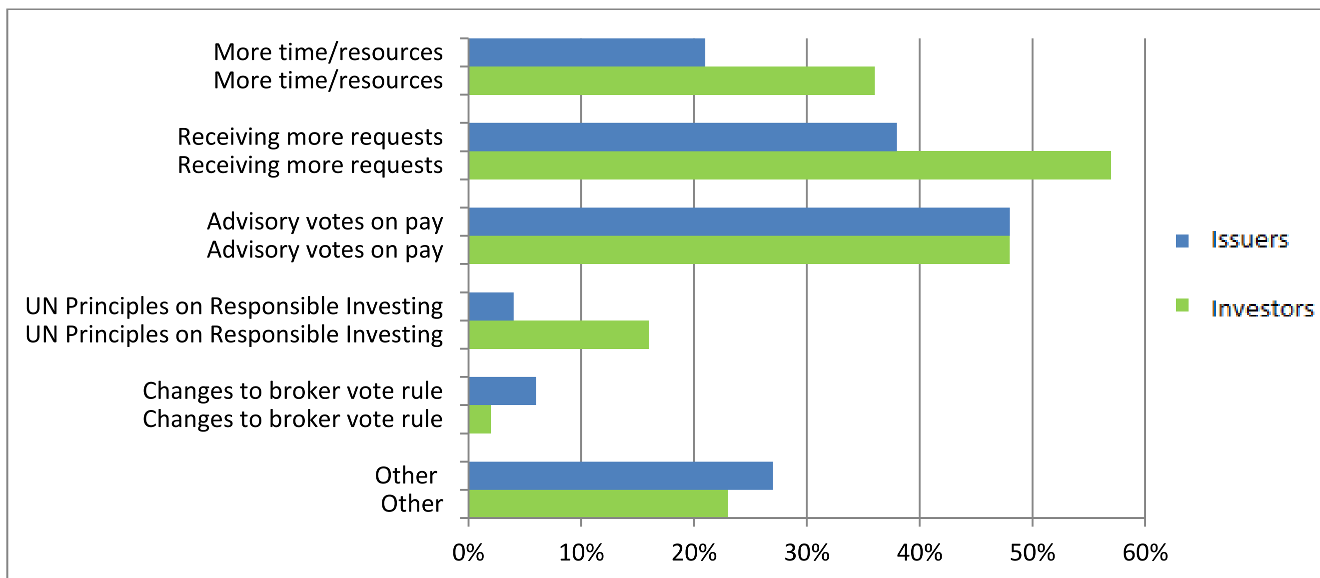


Relatively few comments were received on this question, but one issuer, while responding that its engagement had increased somewhat compared to the previous year, pointed out that engagement levels can fluctuate from year to year depending on whether or not investors feel they have anything to discuss with the company, and that a decrease in the level of engagement would not necessarily "reflect the company's commitment to engagement." Several issuers made similar comments in interviews, with one noting that "engagement goes down during good years" when investors are happy with the company.

Participants who responded that they were engaging more or less than three years ago – the last time this study was conducted – were asked to what factors they attributed the increase or decrease. Among investors who reported an increase in engagement, the most common reasons given were that the investors were receiving more requests to engage (chosen by 57 percent of investor respondents), and the emergence of universal "say on pay" votes (48 percent of investors). 36 percent of investors cited an increase in time/resources; which may mean that as we move further away from the 2008-09 financial crisis, investors have been able to rebuild their staffs, or it could mean that existing staff resources have been shifted to engagement in recognition of its increased importance. 16 percent of investors pointed to the United Nations Principles on Responsible Investing (UNPRI), which existed three years ago but which have picked up additional signatories during this time. Although we had expected the recent

changes to the "broker vote rule," which prohibited brokers from voting uninstructed shares with respect to uncontested director elections, to make it somewhat harder for companies to make their quorums and to therefore result in additional "get out the vote" engagement, only one investor cited the changes to the broker vote rule as a factor in increased engagement.

Fig. 24: If You Are Engaging More, What is Driving the Increase?



In the comments to this question, some investors cited specific reasons for which they regularly engage, such as clarification of independence determinations, and provision of feedback on the reasons for votes against executive pay proposals. One asset manager referred to changes in internal policy, while an asset owner noted that engagement, previously outsourced, had been brought back in house. Other factors cited by investors in the comments included client requirements; participation in investor coalitions on issues such as board gender diversity and lobbying disclosure; and an increase in openness on the part of issuers as they get better at engaging.

Numerous investors who were interviewed indicated that they believed issuers were more proactive than in the past, leading to increased engagement. A governance specialist at a large asset manager specifically mentioned receiving a greater number of requests by issuers to engage on compensation outside of proxy season, but pointed out that such discussions were not necessarily needed or wanted. A governance specialist at a different asset manager identified client requirements as a driver of increased engagement, pointing to an "increase in client interest in how companies are run, and how we look at the way companies are run." This was echoed by an executive director of another asset management firm, who noted pressure on managers "from those whose retirement plans they are holding" to increase returns, by pushing companies harder; as well as a desire to learn the details of the asset managers' engagements with issuers, including the outcome. One asset manager with a socially

responsible orientation pointed to the US Supreme Court's *Citizens United* decision[6], and the ensuing focus on corporate political contributions and lobbying expenditures, as a key driver of increased engagement.

Forty-six percent of issuers cited say-on-pay as a factor driving an increase in engagement, while 38 percent of issuers said they were receiving more engagement requests. 21 percent of issuers cited an increase in time or resources. Only 4 percent of issuers responded that the UNPRI was a factor, while 6 percent pointed to changes in the broker vote rule. Among the other reasons cited by issuers for increased engagement were a "growing company profile," an increase in the number of shareholder proposals received (cited by several companies), an increase in investment in the company by activists and/or hedge funds, and "greater interest on the part of our investors [in] engagement." One company said that it was trying to be more proactive on governance engagement, while another said it had adopted a more systematic approach to engagement on governance and compensation matters twice a year, and on other issues as they may arise throughout the year.

Say-on-pay was the reason most commonly given by issuers for an increase in engagement, and while investors were somewhat more likely to cite an increase in the number of requests to engage, it is likely that a fair number of those requests from issuers to investors were themselves related to say-on-pay. It is safe to say that the advent of say-on-pay in the United States has been a major driver of increased engagement – which indeed was one of the intended consequences of the requirement that companies hold regular advisory votes on compensation. The results of the investor interviews bear out this finding, with a large number of investors pointing to say-on-pay as a driver of increased engagement. While many interviewees opined that say-on-pay had caused an increase in engagement initiated by issuers, an engagement manager at a Canadian asset management firm noted that her firm does more proactive outreach with companies in the US, where say-on-pay is mandatory, than in Canada where it is voluntary. Aside from compensation, several investors pointed to an increase in proxy fights and "Vote No" campaigns, with a corresponding increase in "headline intensity." One director of socially responsible investing, who engages almost exclusively on environmental, social and governance issues, attributed the increase to a realization by companies that "engaging shareholders is an effective tactic and not antagonistic."

Issuers who were interviewed also frequently pointed to say-on-pay as a driver of increased engagement, although many companies cited other factors as well, including a merger, an increase in shareholder activism, or industry-specific issues. The assistant general counsel of a pharmaceutical company attributed the increase in engagement in large part to the Affordable Care Act, and an increase in investor requests to engage on health care issues and on lobbying issues. A number of issuers said their engagement levels had increased because they had more formalized or better-organized engagement programs than was the case in the past; while one corporate counsel noted that "as we get larger, the stakes get higher."

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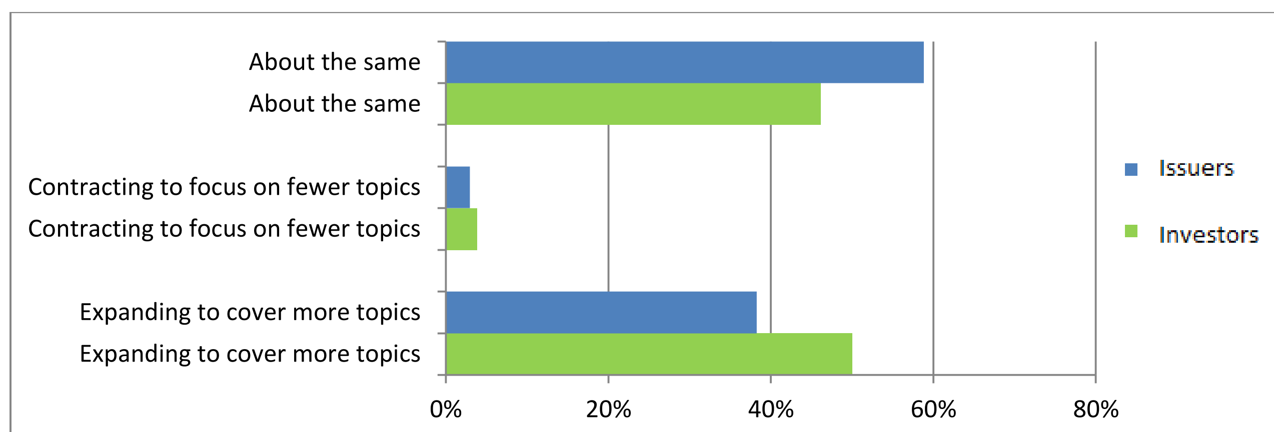
[6] *Citizens United v. Federal Election Commission*, 558 U.S. 310 (2010).

Among the few issuers who reported engaging less than they did three years earlier, the most common reason was that the company was receiving fewer requests to engage. One issuer stated that it had resolved an issue leading to previous engagement. And one issuer that reported its overall engagement level as unchanged cited say-on-pay as the reason for an increase and "less time/fewer resources" as the reason for a decrease.

Fig. 25: What is the 3-Year Trend in Topics Covered?

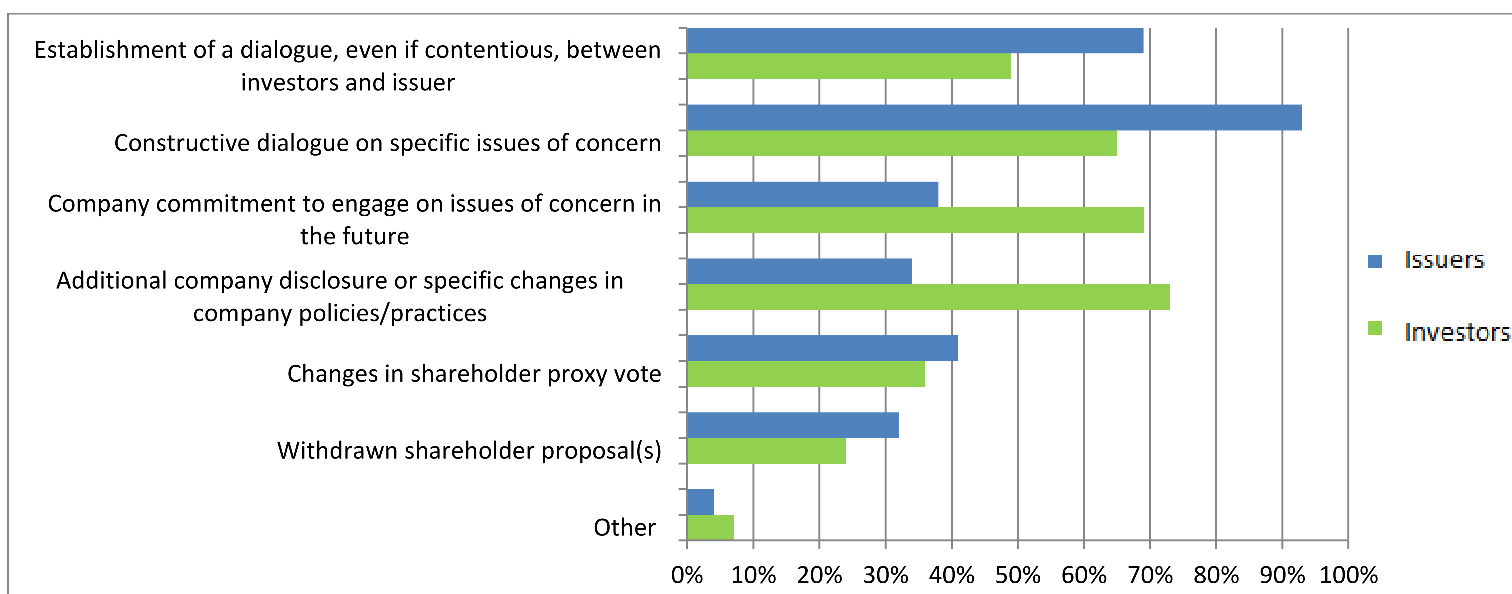


Half of investor respondents reported that the three year trend was for engagement to expand to cover more topics, while 46 percent of investors reported that the number of topics covered was about the same. Only four percent said that their engagement was focusing on fewer topics. Among issuers, 59 percent said the number of topics covered was about the same, while 38 percent reported an expansion and only 3 percent reported a contraction in the number of topics. One asset owner commented that "companies are more willing to talk to their shareholders, leading to an expansion in topics." Several investors noted that they are engaging more on sustainability and environmental and social issues, or on risk factors, including director and management succession as well as industry-specific risks. Another investor noted greater attention being paid to board composition and director qualifications. Surprisingly, only one investor specifically pointed to the say-on-pay vote as being responsible for an expansion in the topics covered in engagement, which suggests that compensation was a concern for investors even before it was a regular voting item. Among issuers, several noted that they are engaging more on governance and compensation (where the engagement had previously focused more on corporate performance and strategy), while others noted that they are engaging on a broader variety of environmental and social issues. Other issuers noted company-specific factors including changes to the senior leadership team, a move from the over-the-counter bulletin board to NASDAQ, and an increase in the number of overseas investors. Finally, one company which reported that its engagement is contracting to focus on fewer topics noted that it was receiving fewer shareholder proposals, and that it had addressed certain governance issues (such as shareholders' right to call special meetings and simple-majority voting) that had previously led to engagement.

What Makes an Engagement Successful?

For issuers, the hallmark of a successful engagement is dialogue: 93 percent of issuer respondents said that a constructive dialogue on specific issues of concern was sufficient to make an engagement successful; while 69 percent of issuers said that the establishment of a dialogue, even if contentious, was sufficient to constitute success. Issuers were less likely to equate "success" with enhanced disclosure or a change in practices or with the withdrawal of a shareholder proposal; although 41 percent of issuers did say that a change in a shareholder's proxy vote would be sufficient to make an engagement successful.

Fig. 26: What Makes an Engagement Successful?



On the other hand, investors were notably less likely than issuers to equate dialogue with success, although nearly two-thirds of investor respondents did say that a constructive dialogue on issues of concern would make an engagement successful. A slightly higher percentage of investors said that a commitment to engage in the future would constitute success, and 73 percent answered that additional disclosure or a change in company policies or practices would suffice to make an engagement successful. While it is hardly surprising that investors are much more likely than issuers to equate success with a change in company practices or disclosure, it is somewhat surprising that investors were nearly as likely as issuers to respond that a withdrawn shareholder proposal or a change in the shareholder's vote is an indication of a successful engagement. This can be taken as evidence that proponents often view shareholder proposals as a negotiating tool, and are often happy to withdraw a proposal in exchange for enhanced disclosure or a change in practices (even where this falls short of what was requested in the proposal); and evidence that many shareholders are open to changing their votes if given a good reason to do so. In an interview, one asset manager whose firm has often filed shareholder proposals stated

explicitly that "any institution who files a resolution is looking for engagement," and "if the resolution is on the ballot, that means the engagement has failed."

Many of these results closely track the responses to the original 2010 survey, which also revealed that issuers were more likely than investors to be satisfied with the establishment of a dialogue, while investors were much more likely than issuers to define success in terms of additional disclosure or a change in corporate practices. And in 2010 as well, a change in the shareholder's proxy vote was seen as a sign of success by investors (in fact, asset managers were more likely than issuers to equate a changed vote with success), as was a withdrawn shareholder proposal (which nearly as high a proportion of asset owners as of issuers defined as "success.")

Comments for this question reinforced the importance for issuers of relationship-building and dialogue as well as the importance for investors of specific concrete action. One issuer stated that the "establishment of a better understanding of each other's priorities and/or fostering a relationship of trust" would constitute success, while another company stated simply that success means "establishing a relationship and trust." Another issuer commented that a "general discussion of strategic direction and opportunity to seek shareholder feedback" would suffice to make an engagement successful. On the other hand, investors' comments on what would constitute success included "actual policy changes at the company," "a reform/change that we have identified as being necessary taking place," and "substantive policy developments, board or senior management changes, [or] improved performance on ESG issues." One investor and shareholder proponent commented that "unless a company has already done something and just hasn't disclosed it (and agrees to disclose it. . .), we only settle when we get an agreement in writing. Otherwise, the issue goes to a vote and the [conversation] continues."

In the interviews, issuers again stressed dialogue and two-way communication, but a number of issuers also defined success in terms of the investor continuing to hold the shares. One company said that its goal was for the stock to be "fairly valued," and that engagement (with portfolio managers and analysts) is a way to "convey the most accurate information on the company" so that it can be properly valued. One general counsel offered that an engagement is successful if the shareholder goes away happy; whether that's the result of additional explanation or disclosure, or a change in practice. For their part, many investors who were interviewed noted that a constructive dialogue would be counted as a success, but others felt that getting "tangible results" was a greater level of success; with one large asset manager noting that "eight years ago, an open dialogue would be a success, but we are past that now. Now, the expectation is that there is some change that actually takes place as a result of the engagement;" or that "at the very least, the company should provide a detailed explanation showing that they pursued your idea, ran it by other shareholders, and are not going to implement it for well-defined reasons." One large asset manager described an engagement "pyramid," meaning that the firm conducts many short ad hoc engagements to seek answers to discrete questions, along with a smaller number of more planned engagements, which may involve formal letters or (at the top of the pyramid) in-person meetings. This firm said that having a chance to share its views might be considered success with companies at the bottom of the pyramid, but for those at the top, success is defined in terms of whether or not the issuer agrees with its suggestions. Echoing the issuers who defined success in terms of continued shareholding, one asset manager said that a successful engagement would mean his firm

continuing to invest in the company for the long term and continuing to make money for its clients – or else promptly "get[ting] out of the company if we think they're not changing." And one executive of a large asset manager, whose engagement is entirely reactive, said that a successful engagement would be one that covers his areas of concern without the need for further engagement, while an unsuccessful engagement is one where he is "hounded" by a company trying to sway his vote, or trying to get him to reveal which way he is leaning.

Fifty-seven percent of investor respondents, and 73 percent of issuer respondents, said that their definition of a successful engagement does not vary by subject area. (For comparison, 74 percent of issuers and 64 percent of investors said in 2010 that their definition of a successful engagement did not vary.) Those who said that their definition of a successful engagement *does* vary were asked to explain. Many investors noted that some issues are inherently more difficult and time-consuming than others; or inherently more contentious and less amenable to compromise. (As an example of the latter, one investor mentioned engagement around replacement of a company's CEO.) One asset manager drew a distinction between engagements aiming for "explicit reforms" such as the adoption of a majority vote standard, and engagements aiming to "identify and encourage best practices, such as supply chain risk mitigation or better disclosure of energy efficiency or compensation practices." Although the investor did not state this explicitly, the clear implication was that in the former case, "success" would mean simply that the subject company adopted the reform sought by the investor; while in the latter case, a broader range of outcomes would constitute success. Along similar lines, another asset manager stated that "for certain issues, a simple commitment to change is sufficient whereas for others an actual change is necessary." One large asset manager commented that "our objectives and thus definition of success vary based on company specific fact patterns, the likelihood of achieving change, and the nature of any concerns we may have;" while an asset owner noted that its definition of success "depends on where a company is before engagement." One ESG-oriented asset manager noted that "when we bring a new issue to a company, we often count it as a success if we are able to continue an engagement with that company or engage others based on the outcome of the first dialogue." Two investors drew a distinction between engagement linked to a shareholder proposal or other voting item, and engagement with the board not related to a specific vote. Finally, a large public pension fund noted that its definition of success may vary depending on whether it is engaging with a domestic or foreign company.

While issuers were more likely to say that their definition of success does not vary, among those who said that it does vary, several drew a distinction between engagement aimed at persuading a shareholder to vote with management, and engagement for the purpose of establishing a dialogue or seeking feedback from shareholders. One issuer noted that "some engagements are intended to inform; others are intended to sway opinion or behavior." Several companies effectively said that their definition of success depends on the shareholder with whom they are engaging. One company commented that "some of our shareholders think we should take all of their advice and engage on their issues of concern -- some not realizing that their issues will create more issues," while another company stated that "the facts and circumstances about the issue at hand and the disposition of the particular shareholder necessarily impact the expectations and definition of success." But one corporate secretary

noted that "even when the conversation is with someone with a very firm policy who is not interested in discussing, you learn something: success of the engagement is incumbent on the listener."

Interviewees were asked what subject areas are of greatest concern in pursuing engagement, and what subject areas are most likely to result in concrete action or change (by an issuer or by an investor) in response to engagement. One large asset manager, while careful to note that its definition of success is determined case by case and not based on whether an action or change takes place, noted that capital allocation (share buybacks or dividend increases) is an area where companies are open to change if shareholders make a good case and apply pressure. Another asset manager, for whom takeover defenses are a key concern, noted that several companies had eliminated their poison pills or put them to a vote as a result of engagement. Still another asset manager identified the election of directors as the hardest area for change and compensation as easier to bring about change (while noting that there is "more bang for the buck" in the election of directors), while yet another asset manager observed that compensation is the area most likely to see change due to engagement, simply because it's relatively easy for companies to make changes or (especially) disclose additional information even after the proxy is out. An asset manager from Canada, with extensive US holdings, identified executive compensation (pay magnitude) as its greatest area of concern, and offered that the higher the level of concern, the easier it is to expect the concern to be addressed. Meanwhile, an asset owner noted that the more controversial a topic, the easier it is for companies to defend their practices. This individual flagged the issue of independent board chairs as an example of an issue where no consensus has emerged. Conversely, numerous investors noted the adoption of majority voting for directors and the declassification of boards as the issues where change was most likely to result from engagement, because institutional investors overwhelmingly favor these changes and companies know that a shareholder proposal on either topic is likely to get majority support. In the words of an asset manager, "vote results or anticipated vote results are the key" for engagement to result in concrete action. Perhaps for this reason, several investors cited changes through engagement on the issues of "overboarded" directors and poor attendance at board meetings, which many investors use as the basis for votes against the directors in question. Within the broad category of compensation, this asset owner said that companies are "willing to listen" on the issues of accelerated vesting of equity awards in a change-in-control and on pay disparity, but that "we get nowhere" on the issue of retention of equity awarded to executives. (An asset manager, meanwhile, put pay disparity in the category of issues on which "no companies are supportive," and an asset owner reported getting "a lot of pushback" on the issue of share pledging.) Another asset manager identified enhanced disclosure of metrics and targets for incentive programs as an area where engagement is likely to lead to success. One Senior Vice President for Sustainable Investment, who frequently engages on environmental and social topics, observed that those topics involve companies' day-to-day business activities, about which companies are "highly sensitive," while an asset manager who also frequently engages on these topics felt that companies are more willing to act if "a business case is being made;" and cited as an example the issue of supply chains after the tragic fire at an apparel factory in Bangladesh in 2012.

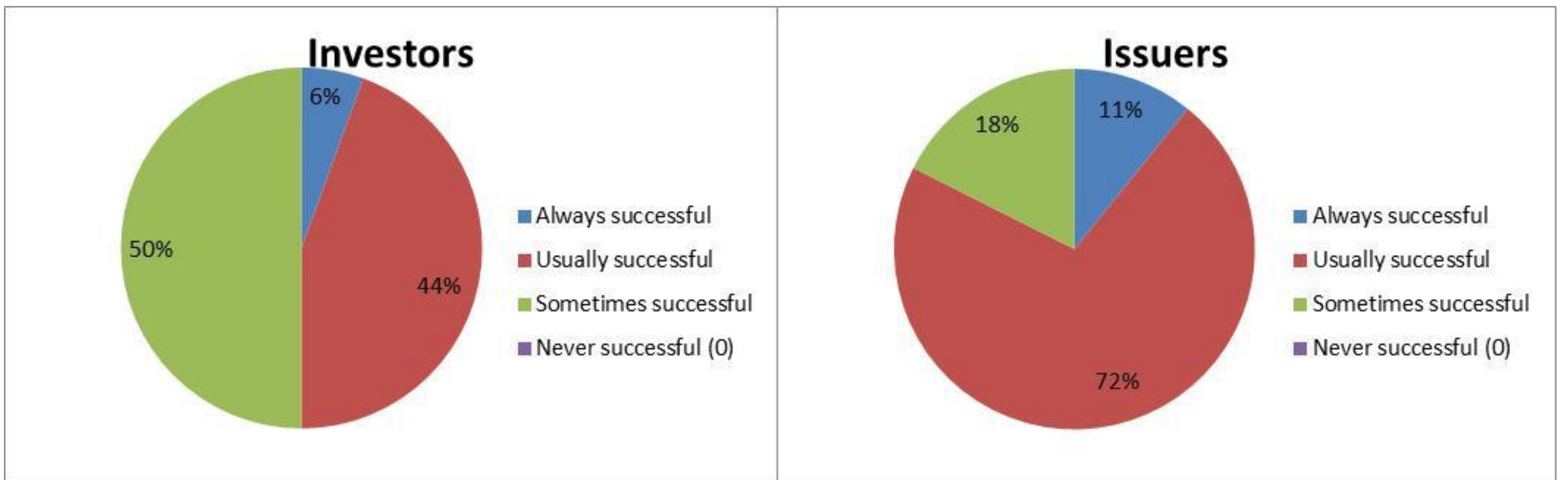
Among issuers, several identified compensation as an area where changes might be made in response to engagement, with one corporate secretary noting that his company "often gets good ideas from

investors, especially input on comp[ensation] metrics." However, other companies commented that "compensation is too complex to make changes just based on engagement," or that it is not advisable to "over-react to one investor's concern." Other issuers identified governance changes such as adoption of majority voting or greater disclosure of political contributions, or capital structure (dividends and share buybacks) as topics on which engagement is likely to result in change. The senior counsel of an insurance company noted that the board had heightened its debate over the issue of board tenure as a result of feedback obtained through engagement. The assistant general counsel of a consumer products company which sells products under different brand names observed that shareholders had asked for more information on results broken down by brand – although he added that this "requires thought" in order to give shareholders more information without revealing too much to competitors. The general counsel of a REIT stated that additional disclosure in his industry is driven by the requests of a particular analyst, whom he described as the "800 pound gorilla of the REIT analyst community," and who asks about governance as well as financial matters. And the deputy general counsel of a technology company said that his company is most likely to make changes as a result of engagement with respect to CSR (corporate social responsibility) issues such as human rights or political contributions, and that shareholders are also likely to make changes after engagement in these areas.

How Often is Engagement Successful?

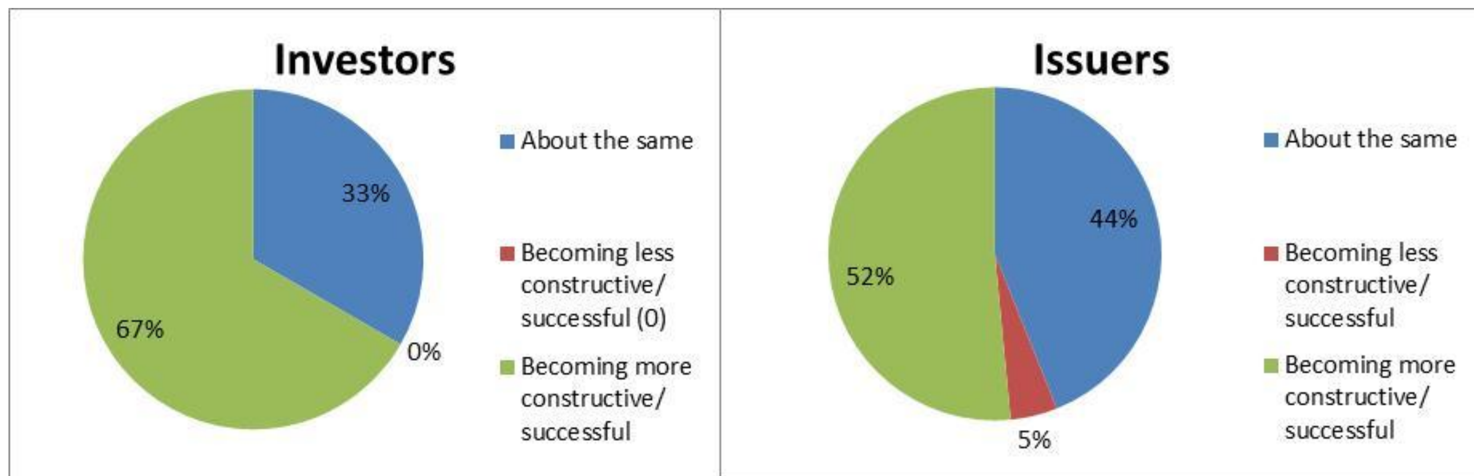
Survey respondents were asked whether their own engagements in the past year were always successful, usually successful, sometimes successful or never successful. Among investors, 50 percent of respondents said that their engagement was sometimes successful, while 44 percent said their engagement was usually successful, and only 6 percent said their engagement was always successful. However, issuers were notably more likely to report greater degrees of success: 72 percent said their engagement in the past year was usually successful, and 11 percent said that it was always successful. Only 18 percent of issuers said their engagement was sometimes successful. No respondents from either category said their engagement in the past year was never successful. These results are consistent with those from the previous survey, in that issuers were again much more likely than investors to report that their engagements were always successful (18 percent of issuers versus 6 percent of investors in 2010) or usually successful (62 percent of issuers versus 36 percent of investors in 2010). The biggest change was that compared to three years ago, fewer investors this time said that their engagement was "sometimes successful" while more said that it was "usually successful."

Fig. 27: How Do You Characterize the Success of Your Engagement Efforts?



Respondents were also asked about the three-year trend in the success of their engagement activities, as they defined success. Two-thirds of investors said that their engagement is becoming more constructive/successful, while one-third said that engagement was about as constructive/successful as it had been three years earlier. No investors responded that their engagement was becoming less constructive or successful. Among issuers, 52 percent reported greater success, while 44 percent reported the same level of success; and 5 percent admitted that their engagement was becoming less successful. In comments, several investors pointed to an increased willingness to engage on the part of executives and directors, and an increased willingness to make changes in response to investor concerns. One issuer noted that investors appreciated its year-round outreach, particularly during the proxy off-season; while two companies pointed to improved understanding and support for their compensation programs. One issuer reporting greater success attributed this to more institutional investment and less retail ownership.

Fig. 28: What is the 3-Year Trend in the Success of Your Engagement Activities?



Issuers and investors alike were more positive about the trend in engagement success in 2013 than was the case three years ago. In 2010, only 36 percent of issuers said that engagement had become more constructive/successful over the previous three years, while just over half of investors at the time said that engagement had become more successful. As in 2013, only a handful of issuers, and no investors, said in 2010 that investment had become less successful.

The simplest, and likeliest, explanation for issuers' greater reported success compared to investors is that issuers were more likely to define success in terms of dialogue and relationship-building, as discussed above; while investors were more likely to define success in terms of concrete actions. However, another contributing factor may be that, as also discussed above, issuer respondents were significantly more likely than investor respondents to engage proactively on financial results, while investors are more likely to engage proactively on thornier topics like executive compensation or environmental issues, which may be less amenable to a successful meeting of the minds.

In the interviews, participants who reported that their engagement was always or usually successful were asked to what they attributed that success; and what lessons they might offer to others about how to improve their success rates. Comments varied widely, but a common theme among many investors was the need to be selective: to focus on a limited number of companies and topics (and in the words of a public pension fund, "not to focus on things that are not directly linked to valuation,") to "prioritize by greatest chance of success," and to not be afraid to decline to take an issuer's call if a conversation is not needed. One asset manager, while conceding that the positive responses she gets from issuers "could be rhetoric," stressed the importance of proactively getting investors' message through to the company. The head of corporate governance at an asset manager which takes large stakes in smaller companies noted that "having a large position helps" because "people listen when you own a large position." A chief compliance officer advised investors to be knowledgeable about the company's business and operations, while a proxy voting manager noted that his firm goes in to an engagement "having done our homework," and that it's "helpful when companies do the same," by reading his firm's publicly available policies. These comments were echoed by a corporate secretary, who said that issuers

"need to read up and understand the issues prior to the conversation;" including the investor's policy as well as the views of proxy advisors and of the industry generally. Meanwhile, an assistant general counsel responded that he had more success with shareholders with a long history, because each side understands where the other is coming from. He offered as lessons the need to focus on discrete issues, and to understand the purpose of the call going in. That was echoed by a director of executive compensation, who said that if you don't have a specific purpose for the engagement, you're just wasting your time and the shareholder's time. He went on to say that "if there's a problem [with compensation], you will be notified," and if there are no problems, there's no need to have a call. An investor relations officer explained that success comes from "telling it like it is," and being straightforward, candid and proactive. In the same vein, a deputy general counsel advised companies to reach out, because investors "may be more receptive . . . than you think." One corporate secretary said that the board holds the key, and that boards should be pulled into shareholder engagement. On the other hand, the assistant secretary for a utility company, while generally emphasizing the value of engagement, said that companies should "stop falling over [them]selves in producing a 130 page proxy statement," but should instead spend time and money in growing the business; and that as long as a company's governance program is adequate, it should focus on performance. Finally, one asset manager offered that "engagement is not hard," and that board members "should pick up the phone."

Final Thoughts on Engagement

Interviewees were asked if they had any "final thoughts" on the subject of engagement. A vice president at a large asset management firm commented that it's important to build relationships, because her firm is a long-term holder, and noted that it doesn't do any good to vote and then not tell companies why. A governance analyst at an asset management firm praised the European model of engagement as "more progressive" than that seen in the US, while an engagement manager at a Canadian asset management company contrasted the situation in Canada, where it is common for investors to have direct access to board members, with that in the US, where management controls access to the board. Meanwhile, the UK-based corporate governance director of a global asset management firm believes that US-based shareholders are more likely to "trust the board to do the right thing" – though he also noted that this is less common now than a few years ago. But the same US governance analyst who praised the European model of engagement also expressed a belief that the "tide has turned" and engagement is more important now in the US as an opportunity for value creation as well as relationship building. But a sustainable investment specialist cautioned that the diffuse ownership of so many companies means that "no one is totally engaged in and overseeing the company," leaving a "void [to] be exploited by activist investors." He noted that for engagement to be effective, "all players in the industry need to define their roles," and better define what is success.

On the issuer side, an HR and compensation executive of a mining company said that his firm was starting to "embrace engagement" and take a more proactive stance after seeing the challenges faced by peer companies in aligning pay and performance in the face of an industry downturn. This executive

noted that engagement on its pay programs and company strategy, and on what factors are out of the company's control, is one way to "help the situation." The corporate secretary of an energy company offered that the engagement process had "transformed the corporate secretary's role," and had also "transformed the boardroom;" while the assistant secretary of an electric utility opined that shareholders "should have access to the board," if not for routine conversations, then at least where there are significant issues related to governance, performance or ethics. And the assistant secretary of an aerospace company described engagement as "surprisingly beneficial" and "interesting and stimulating;" while also noting surprise about how many resources engagement consumes.

Conclusions

Most issuers and investors who responded to the survey are engaging more than they did three years ago; and significantly more than they did five or ten years ago. The requirement that US issuers seek shareholder approval at least every three years for an advisory vote on management compensation is the biggest single reason for the increase, but is far from the only reason. The increase in shareholder activism, manifested in proxy contests, shareholder proposals and "vote no" campaigns, has given shareholders and their portfolio companies more to talk about, not least because activists have been making great efforts to appeal to mainstream investors by highlighting concerns about governance and compensation, as well as growth strategies and returns of capital. Corporate officers and directors are aware that activists' arguments are more likely to win support if mainstream investors feel that a board is out of touch or unresponsive to investors' concerns; and this is leading to more proactive engagement even by companies that have not yet been targeted. Moreover, environmental and social issues, and the long-term sustainability of their portfolio companies, are of concern to a growing number of investors, prodded by initiatives such as the United Nations Principles on Responsible Investment and the growing global push for investors to be good long-term stewards of the assets entrusted to them by clients or beneficiaries. These factors too are contributing to the increase in engagement levels.

But even though overall engagement levels are increasing, and participants generally report greater degrees of success in their engagements, it is worth noting that not all participants are having the same experience. Small shareholders are inevitably not given as much attention by issuers as large shareholders; although small investors can counter this to some extent by engaging in collaboration with larger ones, or through investor organizations or issue-specific coalitions. And while small corporations may have been happy heretofore to avoid some of the attention given to their larger counterparts (particularly in terms of shareholder proposals), to the extent that they engage less often, small companies miss out on opportunities to learn about investors' concerns and pain points before those concerns erupt in the form of a failed say-on-pay vote or a successful activist campaign.

Although the focus of this study was on engagement activity in the United States, in an era in which both issuers and investors have global operations – and in which issuers' activities (including shareholder meeting agendas) are often governed by the laws and listing rules of multiple jurisdictions—governance concepts and practices can spread fairly quickly across borders, as has happened with the practice of "say-on-pay" votes. As issuers and investors alike more closely follow overseas trends, we would expect to see a certain amount of international convergence with respect to engagement as well.

The factors driving increased engagement are varied, but they appear to be largely long-term trends rather than short-term responses to events such as the financial crisis. Accordingly, engagement is likely to remain an important part of the investment landscape for the foreseeable future.

About the IRRC Institute

The IRRC Institute is a not-for-profit organization headquartered in New York, NY that provides thought leadership at the intersection of corporate responsibility and the informational needs of investors. More information is available at www.irrcinstitute.org.

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