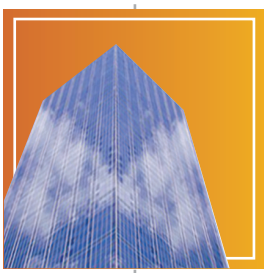
- Investors are seeking more input into board decisions than ever before
- Board should limit communications with shareholders to governance issues
- Policies should be made public through proxy statements and websites
- Information learned from listening to shareholders can be invaluable

By Peter Firestein

Should directors engage investors directly?

Large investors are expressing interest in talking to corporate boards with an intensity that has seldom, if ever, been seen before. At the same time, there is little precedent to prepare directors to address such challenges.

The emerging prominence of boards presents a stark departure from the traditional corporate culture in which boards were often seen to be part of the CEO's team rather than the body that held him or her accountable. And it has always been the CEO and other members of the executive team who have provided investors with perspective on the company, not the board. Now, an evolution of the relationship between directors and investors is under way. And it is appropriate: if one of the board's fundamental purposes is to represent the interests of shareholders, it would appear that part of its obligation is to be transparent to those shareholders.



This new level of interchange is equally appropriate from the shareholder side. As John Wilcox, chairman of international consultancy Sodali, observes: 'When the shareholders elect directors, they're supposed to be making an informed decision – but how can they if there's no communication? Investors' own commitment to act responsibly requires this dialogue.'

The trend toward greater communication between boards and investors is, in part, being fostered by new regulation. Dodd-Frank rules now enable non-binding say-on-pay votes, forcing boards to consider investors' opinions on executive compensation. In the past, there was no reason for those views to enter the boardroom.

The notion of shared responsibility for good governance among boards and investors has taken shape in the UK with an investors' Stewardship Code. It constitutes an agreement among investors to promote good governance in direct interaction with companies, particularly in areas too subtle for regulation, such as corporate culture, risk assessment and allocation of resources.

The reasons behind these changes are not hard to discern. It is no coincidence that investors' interest in engaging board members has followed the financial meltdown. The 2008 crisis raised enormous questions about governance, not only among financial institutions but throughout the entire corporate sector. Over the last decade, increased interest in corporate impact on the environment and workers' rights has attracted additional attention to the principles that underlie corporate strategy and action.

For these and other reasons, governance has grown in investors' minds as a risk factor. As part of this evolution, the points of interaction investment companies present to corporations are no longer confined to portfolio managers and equity analysts. Increasingly, they include governance professionals who make decisions on investors' proxy voting. This can have far-reaching ramifications for any company.

But why would any director want to submit himself

or herself to the scrutiny of investors? Is it a path to anything but increased criticism and liability? In fact, directors can find success in addressing the demand for greater engagement by coming to understand why investors find such conversations of interest – and the contexts in which they are appropriate.

Rules of engagement

There is no reason for a board to engage with investors other than to address subjects that lie in the board's domain rather than the executives'. Conversations with investors should therefore be restricted to the process of governance. While this may seem limiting, there is in fact little of interest to investors that the process of governance does not touch.

Perhaps most obvious is the subject of executive compensation. Investors know, for example, that many CEOs have been incentivized to assume outsized risks – a factor that may become evident only after the boss has departed. Is a CEO's pay calibrated to earnings per share growth (a short-term measure) or to return on capital (considered to have a longer-term orientation)? You can't really talk to the CEO about this; it has to be the board. And it is an issue that has everything to do with the company's sustainability.

'Shareholders are supposed to make an informed decision, but how can they if there's no communication?'

Nor can you speak to the CEO about a plan for his or her successor. That is a subject for the board, and even then, it is a matter of considerable delicacy. Directors are not obliged to discuss likely names, particularly in view of the possible effect on individuals in the company who consider themselves contenders. But directors are in a position to reassure investors that there is a rigorous process in place that will access the right talent at the right time.

The relevance of any subject to the governance process is the primary determinant of whether it is appropriate for discussion. Confining the discussion to process offers directors their primary source of protection in conversations with investors. Comprehensive training is therefore essential.

Yet preparing directors for such engagement has less to do with 'coaching' (though that's a must) than it does with the ways in which governance is carried out at the company generally. This means the company must have processes of good governance in place and must adequately describe its policies through proxy materials and its website. 'This creates an umbrella of publicly available information,' says Catherine Dixon, a partner at law firm Weil Gotshal & Manges. 'It enables you to talk about anything already fully and fairly disclosed.'

Disclosure matters

Many board members' biggest concern lies in the fear of violating Regulation Fair Disclosure (Reg FD) rules by inadvertently revealing information to parties present in a meeting that, under SEC rules, should be disclosed to the entire market at once. Sticking to process – rather than strategy, or even the most innocuous references to future performance – will generally protect directors against Reg FD vulnerabilities.

Another protection is the presence of corporate counsel who can guide the conversation when necessary and, in the worst case, issue a press release containing any mistakenly disclosed information to bring the company back into compliance with Reg FD.

Common sense in approaching an investor meeting means requiring investors to submit their agenda ahead of time, along with the names and functions of the individuals who will be present. Are they from the proxy side of the institution, the investment side, or both? Requiring submission of the agenda also enables the board to prepare content and to decide which of its members are most appropriate for the meeting.

Helping investors understand the company's governance processes represents no more than half the value the board can derive from the meeting. Listening to investors constitutes the rest. Investors are under no disclosure restrictions with regard to saying how they feel about the company, how they value it and even how they regard it personally. What the board can learn from listening to such opinions is unpredictable, but often invaluable.

There are other invaluable benefits from such personal interaction. 'Engaging with investors may be one of the best ways to soften situations that might otherwise end up as undesired proxy proposals or lawsuits,' says Carolyn Brancato of the Conference Board. CS

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