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Rethinking the Annual Meeting

by John C. Wilcox, Chairman, Sodali

"Fasten your seat belts. It's going to be a bumpy ride."

During the past decade the Annual General Meeting has become a forum for confrontation with shareholders as much as an assembly for the conduct of company business. In today's environment, companies planning their AGMs must prepare for an array of potential disruptions that can include organized opposition to agenda items, opportunistic activism and campaigns to unseat or replace directors, often accompanied by negative media coverage and reputational damage.

Opinions vary widely as to whether confrontation at annual meetings is a sign of healthy corporate governance or a distraction from essential business goals. Regardless of its merits, controversy at AGMs has become a fact of life for listed companies around the world. How to avoid being surprised or forced into a defensive posture or losing control of the annual meeting is a serious challenge that corporate boards and managers will face once again in 2013.

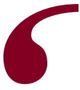
The roots of confrontation

Disruptive annual meeting tactics started in the U.S. as a grass-roots methodology used primarily by small shareholders, labor unions and special interest groups. These gadfly campaigns had little impact until prominent institutional investors joined the corporate governance movement in the mid-1980s. Annual meetings gave these institutions an ideal platform to promote governance reforms, strengthen shareholder rights and call attention to egregious corporate practices. Over time the repeated successful use of these aggressive tactics transformed the annual meeting to the point where it is now viewed as a quintessential corporate governance event.

Against this background of long-term trends, today's activism has been intensified by the macro-economic issues and unstable market conditions that affect companies around the world. These conditions create an unusually difficult global context for companies planning their annual meetings in 2013:

Three decades of successful activism and corporate governance reforms have permanently realigned the rights and powers of shareholders and corporate boards. Institutional investors are expected to oversee and engage with portfolio companies; corporate directors are expected to be fully informed and responsive to shareholder concerns. Global corporate governance standards have eliminated the old "Wall Street Rule": companies can no longer tell dissatisfied shareholders to mind their own business and invest elsewhere.

Changes in shareholder demographics have concentrated voting power in a powerful cadre of global institutional investors. Even hybrid companies in developing markets – those with family ownership, majority control groups, voting agreements, or state-owned "golden shares" – will usually find among their minority shareholders some sophisticated global investors who bring critical perspectives, diverse investment strategies and a wide range of attitudes toward governance and activism.



Proxy advisory firms have become a permanent fixture, facilitating the exercise of shareholder voting rights, highlighting poor corporate governance practices and strengthening support for shareholder initiatives. The prolonged global debate over whether proxy advisors have too much power and whether they should be regulated is beside the point. Whether or not regulators in Europe or the U.S. impose new standards, proxy advisors are here to stay. Companies in all markets must develop effective ways to counter their limitations.

The global spread of Say-on-Pay voting rights (SOP) has done more than any other issue to transform the dynamics of annual meetings. SOP legitimizes shareholder scrutiny of companies' compensation decisions, which have come to be regarded as a reliable gauge of board competence and independence. Shareholders now routinely use their SOP votes as a lever to hold boards accountable on a wide range of governance and performance issues. Directors must be prepared to explain and defend their pay decisions in terms of performance metrics and strategic business goals.

Celebrity CEOs and excessive CEO pay at high-profile companies in developed markets have alienated shareholders, attracted negative media attention and generated widespread public resentment of business leaders. While rooted in broad cultural trends, the problems of overpaid imperial CEOs, high CEO turnover and mistrust of business create serious challenges for corporate boards and fodder for activists.

Inefficient financial markets. Despite the lessons of the financial crisis, stock markets and new trading platforms continue to give precedence to opaque speculative practices and high-frequency equity trading disconnected from listed company fundamentals. These activities erode essential market functions of capital raising, liquidity and equity valuation. In addition, derivative investment strategies give rise to the possibility of "empty voting" – decoupling voting rights from stock ownership and economic interest – which undermines core governance principles. Regardless of these market distortions, companies are still under an obligation to manage investors' expectations and deal with stock price volatility, undervaluation and other market dysfunctions.

Globalization of the investment process has added complexity and inefficiency to the logistics of shareholder meetings. Today's cross-border proxy system is a multi-layered morass of intermediaries, third-party agents, proxy advisory firms, voting platforms and opaque back office operations. It operates with little regulatory oversight. Under these conditions, companies with global ownership have little choice but to dedicate significant time and resources to their annual meetings, even when no controversy is expected.

The advent of Stewardship Codes and Principles of Responsible Investment has turned a spotlight on the governance and conduct of institutional investors. These new and evolving standards for investment managers -- which emphasize transparency, engagement and responsible exercise of voting rights – increase pressure on portfolio companies in the form of closer scrutiny of AGM agendas and higher levels of shareholder participation at annual meetings.

ESG. There is growing interest in the intangible, non-financial aspects of corporate conduct and performance, including sustainability, environmental, social, community and governance policies (ESG). Although ESG issues are important to companies, most analysts and portfolio managers are reluctant to give them equal billing with earnings, stock price and traditional financial metrics. Companies must therefore deal with contradictory messages from institutional investors: governance activists want more attention to ESG, while portfolio managers and analysts continue to focus on earnings and stock price.

Short termism. A persistent and widespread focus on short-term performance has distorted the incentives, metrics and strategic focus of both companies and investment professionals. Companies are told to manage for the long term but are judged on the basis of short-term results. After years of finger-pointing and rhetoric about short-termism, there is a growing consensus that all parties – financial market professionals as well as companies – must take responsibility and modify their practices in ways that will "break the short term cycle." Companies should anticipate that pressure to modify short-term incentives will gain increasing prominence on the activist agenda.

The adversarial and legalistic U.S. governance model - with its detailed and prescriptive rules, strict compliance and systemic reliance on shareholder resolutions and litigation – continues to spread globally. U.S. institutional investors' increasing presence in developing markets brings activism and combative tactics to the shareholder meetings of companies outside the U.S.

This long list of trends and conditions that promote controversy, aggressive conduct and activism at AGMs is tempered by the principles-based corporate governance system that prevails in countries outside the U.S. Principles-based governance and its comply-or-explain methodology encourage board-level dialogue, consensus decision-making and flexible implementation of governance policies. This flexibility can take the edge off of activism and make it easier for companies to avoid confrontation with shareholders. Nevertheless, as the European Commission cautioned in its second Green Paper in 2011, comply-or-explain governance is only as effective as the explanations that companies are willing to provide. The Commission found that in many cases of non-compliance companies have provided little more than "group-think" and boiler-plate instead of meaningful explanations for their decisions. Weak explanations provide fertile ground for confrontation and activism.

Rethinking the AGM

In rethinking their AGMs, companies should question their most basic assumptions and attitudes about shareholders and the purpose of the annual meeting. Their goal should be to initiate and manage the process of change rather than reacting to external pressure.

Development of a new and constructive mindset toward the annual meeting should begin with the following basic do's and don'ts:

• Don't think about shareholders collectively. Analyze your ownership base with a view to understanding shareholders' diverse characteristics, investment goals and track record on activism and governance issues. Understanding your audience is key to preparing an effective message and gaining support at the annual meeting.

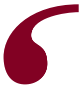
• Don't assume that shareholders want to use the annual meeting to micro-manage your business. In most cases the opposite is true: shareholders want the board and management to run the business, but they also want sufficient information to make an independent judgment that the job is being done well. Their goal is to cast an informed vote on agenda items, particularly the election of directors.

• Don't let activists dominate your thinking about shareholders. Rather than worrying about speculators, hedge funds and activists, companies should focus on attracting and retaining the long-term investors who will generally support the company's annual meeting agenda.

• Benchmark your company's governance policies and practices against peer companies and global standards. Conduct a perception study among your largest institutional investors if a controversial proposal is on the agenda. Understanding your strengths and weaknesses relative to other companies will enable you to anticipate problems, prepare an appropriate proxy solicitation campaign and counter the effects of negative vote recommendations from proxy advisors.

• Be unsparing in your internal analysis of conflicts of interest, related-party transactions, ethical problems, accounting policies, performance shortfalls, whistle-blower initiatives and other sensitive and confidential matters. Be prepared to respond appropriately in case these issues arise at the annual meeting.

• Be sparing in the use of outside advisors for assistance on the board's core governance responsibilities such as compensation, director recruitment, CEO succession planning and accounting policy. Third parties should not be in



the driver's seat on issues for which shareholders hold the board of directors primarily accountable.

• Initiate dialogue with institutional investors and proxy advisors. Listen to their views, but don't look to them for guidance. There is no question that a company's management and board understand the details of their business better than shareholders do, but they often do not understand how the business is perceived externally. Outreach and engagement with shareholders is the most effective means to deal with misperceptions and avoid negative surprises at the AGM.

• Give directors a voice and a defined role at the annual meeting. Traditions of boardroom collegiality and privacy should not prevent directors from engaging with the shareholders who elect them. In addition to the annual report and meeting agenda, boards should consider providing a written report that describes the directors' expertise and competence, explains their decision-making processes and informs shareholders about key governance issues such as compensation, succession planning, related-party transactions, split chair and CEO and other governance hot topics.

• Don't let legal constraints or competitive concerns override transparency in your annual meeting disclosure documents. A principles-based "explanation" that gives confidence to shareholders should (i) provide a clear and detailed articulation of the company's business strategy and goals; (ii) explain how the board's policies and decisions relate to the strategy and goals; and (iii) make a persuasive case that these policies and decisions will benefit shareholders.

• Start AGM preparations early. Don't underestimate the resources and expertise required for an effective cross-border solicitation campaign. Use your web site and all available technology to facilitate information flow and share voting. Coordinate these activities with your Corporate Governance, Investor Relations and Human Resources programs.

This basic advice may sound like "Annual Meetings for Dummies," but in today's unstable, high-pressure environment it has proven remarkably difficult for companies to establish trust and make productive use of their AGMs.

The New Annual Meeting

A simple motto – "Treat shareholders as customers" – is the key to managing a successful annual meeting. Companies rethinking their AGM can often find a useful model in their own market research, marketing and customer relations activities. Planning for the AGM should begin with basic research and benchmarking that can provide answers to critical starting-line questions: who are the company's ultimate beneficial owners; what are their characteristics and investment goals; what are their perceptions about the company; how can their misperceptions and biases be corrected; how does the company's risk profile, governance and performance compare with competitors; how can the company convince shareholders that its policies and decisions serve their interest; what sort of packaging, written materials, outreach, road shows and electronic communications can be used to build loyalty and strengthen relations with shareholders/customers.

Just as companies dedicate executive time, money and resources to conducting market research and surveying customers, they should be equally willing to commit resources and underwrite the costs of identifying, characterizing and analyzing their ownership base and benchmarking their strengths and weaknesses in preparation for the AGM.

Another model for AGM planning can be found in companies' investor relations programs. However, it is wrong to assume that the AGM can piggyback on investor relations contacts and road shows developed for financial communications. A successful IR program is generally not a path to establish relations with investors' policy and voting decision-makers. The opposite is often true. Many institutional investors suffer from the so-called "split-brain" syndrome that creates an unbridgeable gap between their investment decisions and their voting decisions. To deal with this gap companies have two choices: (1) they can develop an expanded form of holistic investor relations that addresses both govern-

ance and non-financial issues (the board perspective) as well as the financial expectations of investors (the management perspective); or (2) they can create a separate institutional investor relations program, independent from IR, that works with the company secretary and the board of directors to engage with shareholders on ESG and other board-level issues. Both holistic IR and institutional investor relations programs require an expanded level of communication from the board of directors that should not duplicate or conflict with communications from management. Both approaches require outreach to an unfamiliar audience that includes governance policy-makers and an array of third-party agents, custodians, proxy advisory firms and other intermediaries who assist them in proxy voting. Many of these players are difficult to identify or reluctant to engage with companies.

For a successful AGM, companies must be willing to simplify, clarify and amplify the information they provide in support of their policies and decisions. The existing comply-or-explain standard does not go far enough. Companies should not limit their explanations to con-compliant policies. Instead they should provide a customized, comply-and-explain narrative that tells a compelling story of how the company is being run, where it stands competitively and how its board-level policies and decisions (executive remuneration is a case in point) are linked to business goals. The board of directors, as the elected representatives of shareholders, should take primary responsibility for producing a narrative that explains the company's culture and values and describes the internal processes by which governance serves business strategy.

The wish list for a successful annual meeting should also include improvements in cross-border logistics that are beyond the reach of individual companies. Some form of global initiative will be needed to achieve a more open and less costly process for cross-border communication and share voting. Long-sought goals – end-to-end vote confirmation, a vote audit trail and identification of beneficial owners – will remain elusive until global standards can be established through harmonized regulation and enforceable standards of best practice.

Conclusion

Theoretically, the annual meeting should be a litmus test that reveals whether shareholders support the company's governance and business strategy. The level of shareholder support at the AGM should measure the degree to which the interests of the company and its shareholders are aligned. In practice, however, this correlation is rarely achieved. Many obstacles stand in the way. Mechanical and systemic complications, inadequate regulation, shareholder apathy, legal and cost concerns, poor communication, a compliant mindset and fear of shareholder activism all contribute to less than optimal results at AGMs regardless of fundamentals. These conditions are likely to worsen as macro-economic conditions, increased regulation and stewardship codes increase pressure on both companies and shareholders.

In the final analysis, responsibility for a successful AGM rests with each company's management and board. They should make certain that the AGM is a platform that informs and educates shareholders, explains the links between governance and business strategy, brings transparency to boardroom processes and eliminates contentious issues before they develop into activism. A successful AGM should be a customized and highly individual event that demonstrates the company's commitment to serving shareholder interests while giving priority to the achievement of business goals.