EFFECTIVE BOARD ENGAGEMENT WITH SHAREHOLDERS

BY SIMON C.Y. WONG, ADJUNCT PROFESSOR OF LAW AT NORTHWESTERN UNIVERSITY

TRUST AND PRAGMATISM IN MEETINGS WILL BE REWARDED IN THE LONG TERM.

In many countries, corporate boards and institutional shareholders are unhappy about the way they communicate with each other. In the United Kingdom, for example, companies complain that investors tend to tick boxes and that it is an uphill struggle to convince them to accept any deviation from the Combined Code, the country's corporate governance framework. For their part, investors retort that they are too often denied an open and candid dialogue with the senior people at companies and, lacking the requisite trust, they have no option but to insist on strict adherence to form. Shareholders have recently expressed their wider frustrations by voting in unusually large numbers against the remuneration report at a number of recent annual general meetings in Australia, the Netherlands and the UK, and by demanding annual elections of the Chairman and board committee chairs.

To some extent the economic and financial crisis has made things worse but the discontent over poor communication has been simmering for years. If it persists, it could threaten the continuing viability of self-regulation on corporate governance in those regions where engagement between boards and shareholders is integral to the effective functioning of the system.

HUMILITY IS ADVISABLE EVEN FOR HIGHLY SUCCESSFUL COMPANIES – AS WE HAVE WITNESSED IN THE FINANCIAL, MINERAL EXTRACTION, AND OTHER SECTORS OVER THE PAST 18 MONTHS, FORTUNES CAN CHANGE QUICKLY

Directors who respond with openness and understanding can realize substantial benefits, including greater flexibility in structuring their boards, less angst about remuneration, and greater acceptance of other governance-related arrangements (including deviation from established best practices). Better communication will also underpin investor support in turbulent times, not least when activist shareholders agitate for change.

To gain these advantages boards should venture beyond conveying factual information and projecting a positive image of the company, and strive to build a long-term, trust-based relationship with their most significant investors. In doing so they need to conduct meetings in a spirit of candor, providing time for concerns to be addressed and not being afraid to admit to mistakes and differences of opinion.

BUILDING LONG-TERM TRUST

Boards should view – and project – themselves as shareholder stewards. According to a major UK asset manager, "We engage with boards as much to get a sense of whether the board will promote and further our interests as we do to gain information on companies."

Direct interaction between boards and shareholders is commonplace in the UK, where various board members – in particular, the chairman, senior independent director, and remuneration committee chair – routinely meet with key shareholders. But in other markets many boards continue to delegate shareholder engagement activities to the investor relations (IR) function. IR personnel will often not be able to provide the same level of comfort and assurance on governance-related matters as senior board leaders. At one continental European industrial company, the IR officer insisted that a major institutional shareholder meet him first, even though the investor was seeking personal assurances from the CEO that remedial measures undertaken in response to the findings of an internal investigation were progressing well. This lack of access to the CEO contributed to the decision by the institutional shareholder not to support the discharge of the board at the AGM.[1]

Similarly, lack of previous contact with the key individuals of a continental European chemical firm – coupled with the use of the IR function as an intermediary – contributed to the refusal of some shareholders to give the company the benefit of the doubt over a proposal to bundle the election of board members (rather than electing them individually).

In the United States, some companies wheel out legal counsel whenever investors seek to speak to non-management

1 A practice mainly in continental Europe whereby shareholders "sign off" on the activities of the board for the year in question.

board members. By contrast, the Chairman of one European insurer flew directly to London to meet the company's largest shareholder when the latter expressed interest in learning more about the company's atypical corporate governance arrangements.

Perceptions of arrogance or disdain for shareholders can haunt a company a long time. In the UK, a few companies face heightened suspicion and scrutiny from their shareholders due to real and perceived slights that occurred years earlier. Humility is advisable even for highly successful companies – as we have witnessed in the financial, mineral extraction, and other sectors over the past 18 months, fortunes can change quickly.

A MEETING OF MINDS

The focus on building a long-term, trust-based relationship means that regular meetings are important, as relationships and goodwill are built through repeated encounters. Some company chairmen will strive to meet their largest 20-25 shareholders at least once a year, wherever they are located.

Meetings with shareholders do not have to be especially formal. In most situations, casual conversation often works better. The Chairman of a UK retailer, for instance, arranges 30-45 minute "coffee chats" with the company's largest shareholders and will make impromptu calls to them whenever issues arise of which they should be made aware.

The style of meetings is typically influenced by cultural and legal considerations. In Asia, they are often much more formal, including prepared speeches. In the US, due to fears of infringing "fair disclosure" regulations, meetings between boards and shareholders are sometimes highly scripted, with the specific agenda items agreed in advance and legal counsel in attendance to ensure that the discussion does not venture beyond permitted boundaries. Some boards adopt a one-way "listening mode" that involves hearing what shareholders have to say but not offering their own thoughts in return.

Some boards consciously ignore passive shareholders, even when the latter are eager for a dialogue, because they know that their investment approach precludes them from selling the stock. However, the support of passive investors can matter greatly when contentious issues arise, whether on corporate governance or relating to a hostile bid. With the resurgence of interest in passive investing among pension funds – attributed in part to the underperformance of active investment strategies and in part to the low fees of passive funds – companies that continue to neglect this type of investor do so to their potential detriment.

One industrial company only recently met with a passive investor who had, for years, been one of its top five shareholders. With the company now "in play" and amidst calls for the CEO's ouster, the board's earlier failure to develop a relationship with this investor may prove costly.

Boards should always strive to be as candid as possible, bearing in mind insider trading laws and the trustworthiness of the individual shareholder (not always assured given leaks of sensitive information on some high-profile matters in recent years). While boards may be concerned about appearing less than perfect, shareholders do not expect them to be infallible. In fact, owning up to mistakes can help disarm even the angriest investors. At one contentious company meeting with a group of institutional shareholders, the Chairman of a mining firm started the meeting by uttering "I am sorry, I have let you down." His willingness to accept responsibility altered the course of the meeting. Expected to be a confrontation about the company's various problems, the tone became more constructive and discussion focused on measures that would put things right.

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By contrast, Chairmen and CEOs seeking to demonstrate their infallibility – believing this will win over investors – are likely to arouse suspicions and intensify existing concerns. One institutional investor I know always asks "What

worries you?" at the end of a meeting in order to calibrate the degree of candor of the discussion. When the response is the equivalent of "everything is great" or "only unforeseen external developments," that investor will substantially discount the preceding dialogue.

Ideally boards should propose remedial action when they acknowledge any deficiencies. At one technology services firm, the senior independent director told a leading shareholder that the non-executive directors possessed insufficient understanding of the company's business and that, consequently, the board was looking to appoint additional outside directors with international business and telecommunications experience.

Effective board – shareholder communication also requires that shareholders have adequate time to respond. The Chairman of one European retailer called the company's largest shareholders over a weekend to inform them that, on Monday morning, the board would announce that it was combining the Chairman and CEO roles. Unsurprisingly, this tactic provoked a furious response and the board was subsequently forced to engage in extensive consultations over several months to placate angry shareholders.

EFFECTIVE BOARD — SHAREHOLDER COMMUNICATION ALSO REQUIRES THAT SHAREHOLDERS HAVE ADEQUATE TIME TO RESPOND

Quality of discussion, particularly when sensitive topics are on the agenda, is often inversely proportional to the number of people in the room. As a principle, both sides should strive to minimize the number of attendees. Consistency in communication is important because institutional shareholders increasingly speak with each other in informal shareholder groups, including across national boundaries. That said, divergent viewpoints are not necessarily problematic, as long as they do not reflect a dysfunctional board, and they can even provide comfort to investors that the board is rigorous and serious. At one company, investors actually felt reassured when the SID told them there was a healthy debate among board members about how to rebuild the capital base.

In some countries, companies are engaging shareholders in groups. Such meetings require some degree of orchestration – for example, discussing only issues of concern to all investors – and it is therefore important for boards to follow up with individuals to ensure that their key concerns have been disclosed. These include "outlier" issues that might have been omitted from group discussion but could still influence voting decisions.

Linguistic and cultural barriers, meanwhile, need to be addressed when communication takes place across national borders. Where possible, boards should strive to adapt their communication styles to match those of their investors. Similarly, shareholders need to play their part to bridge this gap. One London-based asset manager, for instance, fields an engagement team with fluency in more than 15 languages. In addition, foreign investors can join local shareholder associations to better understand local business and governance practices and collaborate on certain matters.

This article is primarily addressed at companies and their boards of directors. But as the last example illustrates, shareholders must also play their part by gaining a good understanding of the company, acknowledging the challenges involved in running a listed firm, adopting a principled but pragmatic approach to corporate governance, and, most importantly, demonstrating an ability to keep confidences. When one investor told a CEO that he appreciated how difficult it must be to turn around a conglomerate with an entrenched culture, the previously guarded CEO quickly opened up and admitted that "it has been extremely frustrating how few people understand the enormity of the task."

In addition, shareholders should be forthcoming with their own views and be willing to ask direct, contentious questions.

It is in the interest of companies to improve this two-way flow. Those that strive to build relationships based on trust and follow a pragmatic approach to meetings will likely be rewarded in the long term.

Simon C.Y. Wong is an independent advisor and Adjunct Professor of Law at Northwestern University School of Law. Previously, he was Head of Corporate Governance in the London office of Barclays Global Investors and a management consultant at McKinsey & Company.