HANK BOERNER

THE GOVERNANCE BUZZWORD FOR 2015: *ENGAGE*

Transparency, privacy, corporate disclosure, accountability, rising expectations of institutional shareholders. In 2015, these are some of the buzzwords for corporate executives and board members to tune in to. And also *engagement* — as in engaging in dialogue with significant shareowners and key stakeholders to discuss critical issues of importance to both parties.

In past years, unhappy shareholders could do "the Wall Street walk," selling their shares in companies in portfolio and seeking other investment opportunities. Since the early 1990s, shareowner activists in the institutional investment community have adopted "engagement" policies, usually under the banner of encouraging more effective corporate governance at firms in which they have significant investment. A leader in this trend has been CalPERS, the large California public employees' pension system, which has actively engaged with corporate managements to discuss governance improvements for a number of years.[1]

The large pension systems of New York, New York City, Wisconsin, Connecticut, and other public sector fiduciaries have engaged in corporate governance campaigns. In recent years, the focus on corporate governance has been expanding to include what are often viewed by finance officers as "nonfinancial" or "intangible" aspects of corporate operations — environmental and energy (E) issues and societal (S) issues. Along with governance, they make up the ESG approach for a growing number of institutional managers.

HANK BOERNER *is chairman of Governance & Accountability Institute, an advisory and research firm with three decades of experience in corporate governance affairs. He was named in the Directorship 100 list by the National Association of Corporate Directors as one of the experts to watch in corporate governance. He's been commenting in this journal since the spring of 2002. He can be reached at* hboerner@ga-institute.com.

The issues that are top-of-mind for institutional owners and managers are the basis for engagement with company executives and, increasingly, requests for meetings with directors. The public arena where the issues play out — and the drama of "shareholders challenging management" becoming headline matter — is the annual corporate proxy voting season. In the U.S., the majority of the annual meetings occur in the first half of the calendar year.

A survey by the compensation consulting firm Veritas reveals that more than 500 U.S. public companies received over 950 shareowner-sponsored resolutions in the first half of 2015 on critical issues to be put before shareowners for a yes/no vote.

In terms of volume, access to the proxy process for board nominations is the number one issue for institutional activists. In the first half of 2015, companies received 84 such proposals on the ballot — four times the number of similar resolutions in 2014. Of those resolutions already voted on, the average approval rate was 55 percent. Some companies have their own proposals on the ballot with terms that are more restrictive.

The second highest issue is the continued call for the establishment of an independent board chair. There were 84 proposals in the first half of 2015; the average shareowner approval rate was 29.5 percent. So far, shareholders have not cast majority votes on the measure for any company.

The number three issue is the perennial "say-on-pay" vote by shareholders on the company's executive compensation proposal. Shareowners have been voting on this issue in prior elections, choosing an annual, biennial, or triennial schedule for future voting on executive compensation. (The votes are advisory, not binding.) Worth noting: Those resolutions for "pay packages" coming to vote in 2015 have averaged more than 90 percent shareowner approval.[2]

E and S added to G issues

Looking at the trends in E and S issues that are at the center of shareowner activism in proxy season 2015, a record number of E and S issues are being added to the range of proxy resolutions that have been filed for the 2015 vote — 433 by one count aggregated by a consortium of proxy activism monitors.

The top issues for investors are political spending and climate change. One-quarter of the early 2015 resolutions deals with corporate political spending before and after elections. Proposals on climate change risk, energy, and related risk accounted for about 40 percent of the early total. Human rights and diversity issues make up the balance.

Proxy Preview, a collaboration of three organizations — As You Sow, Proxy Impact, and Sustainable Investments Institute (SII) — monitors and reports on annual corporate proxy activities. "This year we have once again broken the record on the number of resolutions filed," observed Andrew Behar, As You Sow CEO. "This year's proposals have escalated the connection of critical issues to the boards of directors by demanding that shareowners be enabled to nominate board candidates and to link executive pay with sustainability."[3]

Among the top issues charted by the Proxy Preview initiative are:

- Political spending — About the same number had been filed by the spring of 2015 as filed in the same period in 2014, but Proxy Preview expects the number to continue to grow in later 2015 voting at annual meetings. One author of the Proxy Preview explains that "a broad coalition of investors wants corporations to tell stockholders and the public about 'dark money,' spent in campaigns and on lobbying by groups."
- Climate change and environmental issues — According to the report authors, shareholders are actively looking to manage climate risks. Most 2015 resolutions ask companies to reduce greenhouse gases or to report on the risks of climate change on business operations. Investors in traditional energy companies are especially concerned about how their businesses can succeed in a low-carbon economy. There is growing alarm about stranded assets (that cannot be utilized) and the potential of a carbon bubble.
- Sustainable governance — These proposals ask managements to report on ESG issues; these include board oversight of ESG performance as well as the qualifications of board members with respect to ESG. A new 50/50 Climate Project is organizing to help identify potential board nominees with qualified climate change experience.
- Diversity — With the public dialogue on same-sex marriage and related topics continuing, a number of 2015 resolutions call for "formal" protections for lesbian, gay, bisexual, and transgender employees. Proxy Preview notes that one-half of the targeted companies have already agreed to such policies, including ExxonMobil. The 30 Percent Coalition is campaigning for greater board diversity and lining up support among institutional investors.
- Human/labor rights — Institutions belonging to the Interfaith Center on Corporate Responsibility (ICCR), which has almost 300 member institutions, are joining with labor funds to request corporations in portfolio to conduct human rights risk assessments.

How should corporate managements and boards of directors respond to these expectations of their shareholders?

ONE-QUARTER OF THE EARLY 2015 RESOLUTIONS DEALS WITH CORPORATE POLITICAL SPENDING BEFORE AND AFTER ELECTIONS.

Engage, says the U.S.' largest asset manager

BlackRock, the largest asset manager in the U.S. in terms of assets under management (AUM), joined with Ceres, the not-for-profit coalition of investors, to publish a guide for asset owners, asset managers, and financial analysts to educate and inform them when engaged with corporate managements. The emphasis is on ESG issues and knowing more about what your money is doing in the real world and engaging to help figure that out.

This is the 21st Century Engagement initiative, which involved the contribution of 37 experts on engagement, including the largest public employee pension funds in the U.S. and several of the country's largest asset managers. Guidelines for institutions do not prescribe *what* issues should be in focus; BlackRock and Ceres point to water scarcity, climate change, human rights, and other E and S issues that are part of the ESG construct for discussion with public company boards and C-suite executives.

Michelle Edkins, managing director and head of corporate governance and responsible investment at BlackRock, commented:

> BlackRock believes we have a responsibility to engage with companies on a range of governance matters, including the material environmental and social impacts of their operations. We're encouraged by the efforts leading companies are making in reporting material ESG risks and opportunities....We hope the guide helps broaden and deepen company-investor dialogue on ESG factors that impact value creation...[4]

Mindy Lubber, president of Ceres, explained:

> Every year for the past decade we have seen an increase in corporate engagement by institutional investors on sustainability issues...especially climate change, resource constraints, diversity, and human rights. These create enormous economic risks for companies and investors. The number of shareholder-sponsored resolutions continues to rise. We're seeing upticks in engagement strategies, such as investors meeting with boards, negotiating with executive teams, and asking hard, pointed questions on earnings calls and at annual meetings.[5]

AS THE INSTITUTIONAL OWNERS DEMAND MORE ENGAGEMENT WITH MANAGEMENTS, SOME COMPANIES ARE LOOKING TO BE LESS VISIBLE AND CONDUCT CONVERSATIONS REMOTELY.

Bess Joffe, managing director of corporate governance at TIAA-CREF (T-C), noted, "T-C has a long history of quietly engaging with portfolio companies on ESG risks, and we are energized by the positive trajectory that has developed across the broader landscape over the past several years."[6] T-C is the largest pension complex and financial service company in the U.S. with $866 billion in AUM. CalSTRS director of corporate governance, Anne Sheehan, said, "CalSTRS investment staff reviews not only the financial potential of investments, but also their social, human, and environmental impacts to the ultimate benefit of our members, California teachers."[7] CalSTRS has $193 billion in AUM.

Can companies engage virtually as an element of governance interaction?

As the institutional owners demand more engagement with managements, some companies are looking to be less visible and conduct conversations remotely.

An emerging trend in the U.S. at company annual meetings is virtual interchange. An example from the spring 2015 proxy season is that of Hewlett-Packard (H-P), which in March of 2015 engaged with a prominent activist, the Reverend Jesse Jackson. Over the years, Rev. Jackson often showed up in person at large-cap annual meetings of shareowners. This year he "attended" and had an exchange with CEO Meg Whitman on the issue of diversity among Silicon Valley leadership. The H-P meeting was virtual — no meeting hall, gathering online only, with investors logging in on a remote-access basis. This is the largest corporate enterprise to adopt the policy.

Broadridge Financial Solutions, a service provider to annual gatherings, noted in 2011 that just 21 American companies had a virtual-only meeting. By 2014 the number of companies reached 53. A number of companies have had "hybrid" meetings, in-person with remote access made available as well, including Intel and Microsoft — software companies, naturally.

Procter & Gamble amended its bylaws to be able to have online-only meetings but has not scheduled any to date. Online-only meetings enable shareowners to vote their shares, present proposals, and to ask questions of the board and CEO remotely.

The Council of Institutional Investors (CII), the trade association for U.S. state and labor pension funds, endowments, and other institutions, has a policy supporting online meeting attendance — not substituting the online for the physical presence of the annual meeting where shareowners can participate in person.

Nell Minow, a long-term corporate governance activist who is vice chair of ValuEdge Advisors, opposes online only meetings. There is "demeanor evidence," which means there are things you can only get from being in the same room and looking at them.[8]

Corporate disclosure/reporting on ESG performance

As investors and asset managers increasingly demand that companies disclose more about climate risk and opportunities, environmental performance, and related ESG issues, the largest public companies are leading the way in sustainability and responsibility disclosure and structured reporting.

The 500 companies in the S&P 500 Index managed by S&P 500 Dow Jones Indices is regarded as the best single gauge of large-cap U.S. equities; there is over $7.8 trillion in AUM benchmarked to the index, representing 80 percent of available market capitalization. Each year the Governance & Accountability Institute monitors the sustainability disclosure and reporting activities of the index universe to analyze trends in ESG, sustainability, and corporate responsibility.

In 2014, 76 percent of the companies published reports (often titled "Sustainability," "Corporate Responsibility," or "Citizenship"). This level of reporting demonstrated stability in the trend. In 2013, the level was 72 percent. In 2012, just over one-half of the companies were reporting on sustainability, etc. And in 2011, the first year of monitoring, the level was 20 percent, or one in five companies.[9]

Summary

The first half of 2015 was an active period for corporate executives and boards as the annual meeting and proxy voting took place. A high number of shareholder-sponsored resolutions came to vote by all shareholders at hundreds of U.S. companies. This annual exercise is a form of engagement by institutions with the companies in portfolio.

Two large and influential organizations — BlackRock and Ceres — are guiding and educating fellow investors on the corporate engagement process. Savvy managements are becoming skilled at these types of engagements, but many executives are not yet experienced at shareholder engagement, especially at small and mid-cap companies.

The issues in focus may change from year to year, but certain "mainstays" remain, such as climate change and political contributions. The focus on effective corporate governance for a growing number of investors has broadened to include E and S issues.

Corporate governance is still an important focal point for many asset owners and their managers, but the subject matter is changing, broadening, and becoming more complex. This is demonstrated in the proxy contests of the first half of 2015. ■

NOTES

[1] There is abundant academic research on the growth of institutions choosing activism and engagement with companies in portfolio versus "the Wall Street walk" approach. For an excellent meta study, see: Admati, A.R. and Pfleiderer, P., The Wall Street walk and shareholder activism: Exit as a form of voice, *Review of Financial Studies* 22, no. 7 (2009): 2445–2485.

[2] "Compensation in context: U.S. proxy season halftime report on governance issues," Veritas Executive Compensation Consultants (May 26, 2015). Available at: https://t.e2ma.net/message/upbih/qinrp. The firm's perspective is based on the analysis of ISS Voting Analytics.

[3] "Record number of social and environmental shareholder resolutions filed in 2015," Proxy Preview (March 5, 2015). Available at: http://www.proxypreview.org/. The Proxy Preview Initiative is a collaboration (in its 15th year) of As You Sow, Proxy Impact, and SII.

[4] "BlackRock, Ceres launch investor guide on U.S. corporate engagement," Ceres (May 28, 2015). Available at: http://www.ceres.org/press/press-releases/blackrock-ceres-launch-investor-guide-on-us-corporate-engagement. BlackRock is a leader in investment management, risk management, and advisory services for institutional and retail investors. As of March 31, 2015, the firm had AUM of $4.774 trillion. Ceres is a non-profit organization mobilizing business and investment leadership on climate change, water scarcity, and other challenges. Ceres manages the Investor Network on Climate Change (INCR), a network of institutions with $13 trillion AUM. The Guide can be downloaded at: http://www.ceres.org/EngagementGuide.

[5] *Ibid.*

[6] *Op. cit.* note 4.

[7] *Ibid.*

[8] McGregor, J., More companies are going virtual for their annual shareholder meetings, *The Washington Post* (March 18, 2015). Available at: http://www.washingtonpost.com/blogs/on-leadership/wp/2015/03/17/more-companies-are-going-virtual-for-their-annual-shareholder-meetings/.

[9] Governance & Accountability Institute announces "Flash report: 75 percent of the S&P 500 Index published corporate sustainability reports in 2014," (June 8, 2015). Available at: http://www.ga-institute.com/nc/issue-master-system/news-details/article/flash-report-seventy-five-percent-75-of-the-sp-index-published-corporate-sustainability-rep.html?tx_ttnews[backPid]=254&cHash=a3b30342faf8d876b8ac20da691fe6ac.