

**Talking Governance: *Board-Shareowner  
Communications on Executive Compensation*  
Summary Findings**

**Policy Briefing No. 2**

THE MILLSTEIN CENTER FOR CORPORATE  
GOVERNANCE AND PERFORMANCE



YALE SCHOOL OF MANAGEMENT

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## Background

The Millstein Center's mission is to serve as a vital contributor to the growing architecture of international corporate governance. The Center sponsors research, hosts conferences, generates global databases, designs training and publishes Policy Briefings on emerging corporate governance policy issues. *Talking Governance: Board Shareowner Communications on Executive Compensation* is the second installment in a series of Policy Briefings designed to assist policymaking.

Millstein Center Policy Briefings are framed as think tank reports rather than scholarly research. They include original material and policy analysis in a concise format. Reports serve both as pointers to further detailed empirical research and as a resource for market practitioners.

Re-energized by the proliferation of “say on pay” proposals calling for an advisory vote on executive compensation and guidance from recent regulatory reform, shareowners and boards are actively debating the need for better dialogue on company-specific governance matters. Despite this call for action, there has been very little analysis focused on the practical application of board-shareowner communication models. Through this report the Millstein Center, supported by Deloitte & Touche LLP<sup>1</sup>, sought to explore the constraints, risks, benefits and sustained commitments by investors and boards to engage one another in substantive dialogue.

The findings of this report are principally based on research performed over a six-month period. This research included:

1. In depth reviews of historical research and media reports
2. Individual and group interviews with:
  - a. Directors
  - b. Corporate management
  - c. Institutional investors
  - d. Retail investors
  - e. Professional advisors
  - f. Other governance professionals

The executive summary and initial findings are being released in advance of the full Policy Briefing, which will be published in June 2008. The final publication will include additional information related to international practices, as well as a more detailed analysis of current practices in the United States.

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## **Executive Summary: Findings of the Inquiry**

### **Sustained, two-way dialogue between boards and shareholders is rare in the United States.**

Enthusiasm for better board-shareholder communications displayed by a select group of companies and investors has indicated there is a willingness to engage one another in two-way dialogue. However, anecdotal evidence obtained through a series of interviews conducted by the Millstein Center suggests that current communications are focused on corporate managers regularly conversing with buy-side portfolio managers. There is very little evidence suggesting that boards and shareholders are regularly engaging one another in sustained two-way dialogue on governance matters.

### **There is no insurmountable legal obstacle to boards and shareowners engaging in constructive dialogue on governance matters, including executive pay policies.**

Resistance to two-way dialogue on governance between directors and investors at US corporations has often centered on concern that the Securities and Exchange Commission (SEC)'s Regulation Fair Disclosure ("Reg FD") is a barrier. The argument is that directors risk disclosing matters of material interest to the market to a select group of shareowners rather than the market as a whole. However, guidance reviewed in this report has affirmed to boards that have initiated dialogue that Reg FD is a caution, not a barricade.

Certain companies and investors have proven successful in respecting legal constraints while engaging in constructive communication on a host of topics. The formula involves supplying advice to participating board members and investors, or developing a charter to govern discussions.

### **Regulators would likely find broad support for an initiative to develop a market-wide safe harbor for board-shareowner communications.**

Companies motivated to engage in dialogue with their investors have commissioned in-house or outside counsel to provide bespoke legal advice on the frameworks and constraints affecting such initiatives. Advice often affirmed that neither Reg FD nor other regulatory barriers prevent communication. However, companies have had to shoulder a cost burden to produce custom legal guidance.

Costs could diminish if the SEC were to issue market-wide guidance affirming circumstances under which board dialogue with shareowners on governance issues gain a safe harbor from risks of sanction or litigation under Reg FD. Such a revision would embody the logic of the rule. Regulation FD was created to prevent companies from selectively disclosing non-public, material information in a private setting. It does not appear to have been the intention of the Commission to restrict private meetings with investors to review governance matters. Interpretative guidance could place the SEC in a position of leadership in improving communication between investors and the companies they co-own.

**Investor and corporate officials identify concrete and significant advantages from board-shareowner communications that, they assert, outweigh potential risks and costs of dialogue.**

Companies and investors putting forth the effort of engaging in two-way dialogue and participating in such endeavors have identified concrete value in such exercises. Moreover, they cite practical solutions they developed to mitigate risks and costs. A concern over certain board-shareholder communication efforts is the increase in shareholder influence over the basic business decisions of boards of directors.<sup>2</sup> Companies interviewed by the Millstein Center have taken great measures to ensure the models used in their communication efforts respect the defined role of the board and shareholders and are, therefore, focused more on promoting an alignment of interests rather than a struggle for power.

Additionally, the following advantages commonly resonate among those engaging in dialogue:

- Minimizing the use of shareholder resolutions as means of encouraging dialogue
- Humanizing the board, management and shareholders
- Gaining greater clarity with respect to the company’s long-term objectives
- Creating an understanding of the shareholder’s interests in the long-term objectives
- Garnering goodwill and trust from shareowners

Companies have commented on the benefit of boards acting as a “listening post” even if simply to hear shareholder concerns.

**Constructive director-shareowner dialogue on governance hinges for both investing institutions and corporate boards on three features: high-level commitment, resources and informed strategies.**

Communication between boards and shareowners has been tainted by mirror stereotypes. Companies and boards, for their part, see certain individual investors as gadflies more interested in becoming the center of attention at the annual shareholders meeting rather than raising substantive topics for discussion. They identify others, notably certain hedge funds, as falsely projecting an image of good stewardship in an effort to glean inside information so as to profit in the short term. And they perceive some big conventional institutional investors as fielding substandard representatives in communication exercises. On the other hand, governance professionals at investing institutions often take the view that invitations to corporate road shows represent public relations events staged solely for good publicity and not for the purpose of engaging in substantive two-way dialogue on governance issues.

Whatever the preferred method of communication may be, a common concern cited by companies and investors was the necessity for both parties to make available the appropriate personnel when discussing the issue at hand. Considering the variety of

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<sup>2</sup> Martin Lipton, “Directors Face to Face Meetings with Institutional Investors on Corporate Governance Policies and Practices.” June 28, 2007.

shareholder concerns are diverse, ranging from key governance issues to political disclosure, they require varying degrees of expertise, a well defined strategy and a high-level of commitment to address them appropriately and to the satisfaction of both parties.

**Compulsion, through crisis or other acute events, is the foundation under most current US corporate initiatives to foster governance dialogues with institutional owners.**

Evidence suggests that scandals over executive compensation – whether payouts for failure or backdating stock options – were key contributors in 2007 in motivating certain boards to increase their interaction with shareowners. Exercises in board dialogue on governance have generally not come about in the United States as a product of proactive, long-term strategic outreach by untroubled corporations. This reality has contributed to growing investor conviction that regular dialogue will not spread widely in the absence of compulsion, even where companies are troubled. As a result, many funds back a UK-style annual advisory vote on executive pay policies, a measure that helped open channels of communication between UK boards and their equity owners.

**There are no common best practices for board-shareowner communications on governance and executive pay. Companies and investors continue to experiment with various methods of interaction.**

The Sarbanes-Oxley Act of 2002, SEC proxy amendments, and stock exchanges have all provided guidance focused on the intention of making boards and management more accessible to shareholders.

A 2004 study published by a joint task force between the NACD and Council of Institutional Investors surmised through their research that boards want to be able to communicate with their shareholders.<sup>3</sup> The study also highlighted concerns that clear examples of how to achieve effective dialogue failed to exist. Since 2004, highly-publicized corporate efforts and a series of Millstein Center corporate and shareholder interviews suggest there is an increase in the experimentation on how best to engage one in constructive dialogue.

Pressure for boards to communicate with their shareholders is nothing new. In a 1992 article, Marty Lipton and Harvard Business School Professor Jay Lorsch called for US boards to “meet annually in an informal setting with 5 to 10 of the larger investors in the company.”<sup>4</sup> Recent efforts seen on the behalf of companies and investors engaging in dialogue beyond the annual shareholder meetings have included the following models:

*Open invitation shareholder meetings:*

- In addition to the annual shareholder meeting, this gathering is open to all shareholders for the purpose of providing unfettered access to the board.

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<sup>3</sup> The National Association of Corporate Directors and The Council of Institutional Investors, *Framework and Tolls for Improving Board-Shareowner Communications*, (2004).

<sup>4</sup> *Global Proxy Watch* Vol. XI No.42.

*Invitation only shareholder meetings:*

- A closed meeting, with invitations extended only to the company's largest institutional investors for purpose of discussing a defined agenda of governance topics with select management and board members.

*Formal shareholder advisory groups:*

- A small, select group of shareholders advising the board and management on one set topic. The composition and activities of the group are formalized through a published committee description.

*Informal shareholder advisory groups:*

- A small, informal gathering of select shareholders who regularly communicate with the company on a host of topics. This group is not convened for the purpose of discussing just one topic and is not governed by a published committee description.

*One-off responses to shareholder inquiries:*

- Responses, generally from management, to inquiries received from shareholders filed through the channels outlined in the company's proxy.

“There's been an unprecedented level of engagement between companies and shareholders” this year (referring to the 2007 proxy season), noted Richard Ferlauto, director of corporate governance and pension investment at the American Federation of State, County, and Municipal Employees (AFSCME). “Engagement is now part of the landscape.”<sup>5</sup>

**Without processes for open board-shareowner dialogue, public markets may face unnecessary costs and burdens.**

Entrenched cultural habits in public markets appear to drive owners and companies apart even though enterprise may prosper best when the two parties are fully aligned as they are in private equity arrangements. Some funds, for instance, say they are compelled to file shareowner resolutions as a “knock on the door” at companies which are considered otherwise to ignore an institution's voice on governance. In 2007, investors filed approximately 1,145 resolutions only to withdraw more than 300 of them as of September 15th. This was a significant increase from the prior year in which 189 of the 947 resolutions were withdrawn during the same period.<sup>6</sup> It is not an uncommon practice for investors to file a resolution, making their intention known of withdrawing it if the company will simply engage in dialogue and demonstrate a commitment to addressing the issue in question. These figures would suggest that practice is becoming more prevalent.

Without a further alignment of interests between shareowners, management and boards, hostility between parties can saddle investors and public company boards with

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<sup>5</sup> RiskMetrics 2007 Post Season Report.

<sup>6</sup> Id.

burdensome costs and risks, including the possibility of the share price not reflecting the full value potential of the company over time.

**Companies currently tend to focus board-shareowner communication efforts on larger institutional investors despite developments which suggest the potential rising influence of retail investors.**

Most companies focus on inviting only their largest shareowners into a governance dialogue process with their boards. Reasons corporate executives give for this focus on the top tier include:

- the ease of identifying the largest shareholders
- their willingness to meet with the company
- the likelihood of larger shareholders having the resources and expertise to address the issues
- the likelihood of being more focused on the long-term

However, there is a rising potential in the power of grassroots campaigns launched by retail investors, as has been seen recently at Yahoo and Motorola. In a recent speech Louis Thomson Jr., former head of the US National Investor Relations Institute, discussed the proliferation of the internet giving rise to the influence of the retail investor. He goes on to explain this is particularly evident in mid-cap companies where there is a larger percentage of individual investors.<sup>7</sup> Add the SEC's recent proxy rule amendments<sup>8</sup> which are expected to open avenues for real-time communications among investors and with boards and it may become more crucial to consider all shareowners, not just the largest.

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<sup>7</sup> Louis Thompson, Jr., *Shareholder Communications in an E-Proxy World*", Speech to NIRI Cleveland/Northern Ohio Chapter May 3, 2007.

<sup>8</sup> <http://www.sec.gov/news/press/2007/2007-247.htm>.

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