

## Board-shareholder communication

### Introduction

On June 10, 2008, members of the Audit Committee Leadership Network (ACLN) met in New York for the network's 17th stand-alone meeting. During one session, members discussed board-shareholder communication. Other sessions included discussions on the CEO and the audit committee, and the consequences of the credit crisis.<sup>1</sup> For further information about the network, see "About this document," on page 8.

During the discussion on board-shareholder communication, members focused on:

- **The current context for board-shareholder communication**
- **Board directors' approaches to communicating with shareholders**
- **Guardrails to ensure proper guidance and protection for board directors**

Members were joined by Ms. Peggy Foran, a prominent corporate governance expert. Audit chairs participating in the meeting, who sit on the boards of about 25 large-, mid-, and small-cap public companies between them, included:

- Denny Beresford, Audit Committee Chair, Kimberly-Clark
- Dick Harrington, Audit Committee Chair, Xerox
- Judith Richards Hope, Audit Committee Chair, Union Pacific
- Labe Jackson, Audit Committee Chair, JPMorgan Chase
- Mike Losh, Audit Committee Chair, Cardinal Health
- Sandy Warner, Audit Committee Chair, General Electric Company
- Steve West, Audit Committee Chair, Cisco Systems
- Chris Williams, Audit Committee Chair, Wal-Mart

Members from Ernst & Young participating in the meeting were:

- Steve Almassy, Americas Assurance Leader
- Steve Howe, Americas Managing Partner

*ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made before and during meetings are not attributed to individuals or corporations. However, Ms. Foran has permitted her comments to be attributed. Ms. Foran's comments represent her personal opinions and not the official position of her former or current employers.

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<sup>1</sup> See Audit Committee Leadership Network, "The CEO and the audit committee," *ViewPoints*, July 7, 2008. Available at [http://www.tapestrynetworks.com/documents/Tapestry\\_EY\\_ACLN\\_Jul08\\_View21.pdf](http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Jul08_View21.pdf).

## Executive summary

During their discussion on board–shareholder communication, members focused on the following topics, which are covered in more detail on the following pages:

- **The current context for board–shareholder communication** (Page 2)

Currently, there is little evidence in the United States of sustained, two–way communication between a company’s board and its shareholders. The positive outcomes that have resulted from boards communicating with investors on particular issues and clear regulatory support for communication may lead to a change in that status quo, however, especially given that Regulation Fair Disclosure (“Reg FD”) is no longer regarded as sufficient reason to avoid communication.

- **Board directors’ approaches to communicating with shareholders** (Page 5)

Members agreed that the annual general meeting is not an effective way to engage meaningfully with their largest shareholders. Some members spoke of positive experiences with issues–driven communications with investors, most often through small group meetings that focused on specific investor concerns. Members also discussed some prominent examples of companies that have hosted private forums at which their largest shareholders met with board directors.

- **Guardrails to ensure proper guidance and protection for board directors** (Page 6)

Despite speculation that board–shareholder communication will increase, board members remain concerned about the result. They expressed concern that setting a precedent of meeting with shareholders could increase both the demand for and expectations of such meetings, including scope creep. Members discussed the guardrails they would like to see in place to effectively guide and support board members in such discussions, including the careful selection of investor attendees, clarity around the objectives and a detailed agenda, training on Reg FD, preparation for shareholder questions, and the presence of the general counsel.

## The current context for board–shareholder communication

The Council of Institutional Investors (CII) and the National Association of Corporate Directors (NACD) state that “directors are the elected representatives of shareholders and charged with the significant responsibilities of overseeing management, corporate strategy, and performance.”<sup>2</sup> While relations among management, boards, and investors are based on that notion, current research shows that “sustained, two–way dialogue between boards and shareholders is rare in the United States.”<sup>3</sup>

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<sup>2</sup> Council of Institutional Investors and National Association of Corporate Directors Task Force, *Framework and Tools for Improving Board–Shareowner Communications* (Washington, DC: CII and NACD, 2004), 8. Available at <http://www.nacdonline.org/images/White-CIITaskForce-2004-2-26-04.pdf>.

<sup>3</sup> Stephen Davis and Stephen Alogna, *Talking Governance: Board–Shareowner Communications on Executive Compensation, Summary Findings* (New Haven, CT: Millstein Center for Corporate Governance and Performance, 2008), 3. Available at [http://millstein.som.yale.edu/documents/Communications-Summary\\_Findings.pdf](http://millstein.som.yale.edu/documents/Communications-Summary_Findings.pdf).

Increasing attention to this matter among different capital markets participants may create pressure for more of this type of communication:

- Shareholders are likely to continue to exert more influence because of the success of majority voting and other such campaigns
- Regulators – such as the Securities and Exchange Commission (SEC) – support more communication
- Reg FD is being increasingly interpreted as a “caution, not a barricade”<sup>4</sup> to board communication with investors
- Market observers are starting to recognize that by communicating directly with investors, boards may help alleviate shareholder pressure for unnecessary governance changes.

Each of these pressures is discussed in more detail below.

### **Shareholders are likely to exert more influence**

In recent years, shareholders have gained increased power over their appointed representatives on the board. The volume of shareholder proposals continues to rise, with 1,145 resolutions filed in the 2007 proxy season. The relatively speedy adoption of majority voting standards by many leading U.S. companies (over 350 U.S. companies have adopted some version) is one indicator.

Investors often see say-on-pay as a vehicle for improving board-shareholder communication. During this proxy season, investors have filed 80 say-on-pay proposals, more than double the number filed in 2007.<sup>5</sup> Early reports from the 2008 proxy season showed a decrease in support for these proposals, which would provide shareholders with a non-binding vote on executive compensation plans, at several major financial institutions, but overall, RiskMetrics reports higher median support this year. It notes that “so far this year, ‘say on pay’ has won majority support at six companies.”<sup>6</sup>

Members have also observed the growing impact that withhold-vote campaigns can have on individual board members, the board, and the company as a whole. These campaigns are being strengthened by better coordination among investors and their advisers.

### **Regulators support more communication with shareholders**

The following measures, instituted by the SEC and the New York Stock Exchange (NYSE), aim to strengthen director-shareholder communication and enhance related disclosures:

- **SEC Rule 3235-AI90 (2004)** requires a company to state whether it has a process for shareholders to communicate with the board. If the company has no formalized process, it must explain why not. If

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<sup>4</sup> Ibid.

<sup>5</sup> Stephen Davis and Stephen Alogna, *Talking Governance: Board-Shareowner Communications on Executive Compensation, Working Draft – For Public Comment*. (New Haven, CT: Millstein Center for Corporate Governance and Performance, 2008), 9. Available at <http://millstein.com.yale.edu/2008%2006%2005%20talking%20governance2.pdf>.

<sup>6</sup> L. Reed Walton, “U.S. Midseason Review,” *Risk & Governance Blog* (RiskMetrics Group), May 23, 2008. Available at [http://blog.riskmetrics.com/2008/05/us\\_midseason\\_reviewssubmitted\\_b\\_1.html](http://blog.riskmetrics.com/2008/05/us_midseason_reviewssubmitted_b_1.html).

it does, it must explain how communications from shareholders are transmitted to the board, or, if applicable, to specific board members. If not all shareholder communications are relayed to the board, the company must explain how it determines which communications to send. The company must also explain its policy regarding board member attendance at annual meetings and must record the number of board members who attended the prior year's meeting.

- **NYSE listing requirements (2004)** state that companies must disclose a method for interested parties, including shareholders, to communicate directly with the presiding director of the executive sessions of board meetings or with the non-executive directors as a group.
- **SEC proxy rule amendments (2006 and 2007)** permit increased use of the Internet as a medium for communication with and between shareholders. The 2006 amendment allows companies to furnish proxy materials to shareholders through a “notice and access” model using the Internet. The 2007 amendment facilitates the use of electronic shareholder forums for dialogue between shareholders and with the companies in which they invest.

Additionally, legislation giving shareholders a non-binding say on executive compensation passed the House of Representatives in April, and the Senate bill was sponsored by Democrat presidential nominee Senator Barack Obama (D-Illinois). If such legislation is enacted, directors may feel more obliged to meet with shareholders, particularly if the compensation committee is considering major changes to executive pay. That has been the experience of many UK companies.

### **Reg FD is no longer being seen as a barrier**

In recent years, board directors' objections to meeting with shareholders have centered on Reg FD, a regulation on selective disclosure and insider trading implemented by the SEC in 2000 that prohibits a company from intentionally disclosing material information privately unless it simultaneously discloses the same information publicly. Directors fear they may inadvertently disclose material information in meetings with shareholders. However, Stephen Davis and Stephen Alogna of the Millstein Center for Corporate Governance and Performance at the Yale School of Management believe that fear is overblown. In a 2008 report on board-shareholder communications on executive compensation, they say:

Resistance to two-way dialogue on governance between directors and investors at US corporations has often centered on concern that ... 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 a dialogue that Reg FD is a caution, not a barricade.<sup>7</sup>

Brian Lane, former director of the SEC's Division of Corporate Finance, stated in a recent *Compliance Week* article that although Reg FD causes “some chill on communications, ... it has mostly been on the kind of whispered earnings that the SEC wanted to chill.”<sup>8</sup>

<sup>7</sup> Stephen Davis and Stephen Alogna, *Talking Governance: Board-Shareowner Communications on Executive Compensation, Summary Findings*, 3.

<sup>8</sup> Melissa Klein Aguilar, “Best Practices for Talking Under Reg FD,” *Compliance Week*, February 26, 2008. Available to subscribers at [http://www.complianceweek.com/index.cfm?fuseaction=article.SavedSearchResults&search\\_ID=122](http://www.complianceweek.com/index.cfm?fuseaction=article.SavedSearchResults&search_ID=122).

### Communicating directly with shareholders alleviates pressure

Peggy Foran told members, “Rational investors are voting for say on pay because it worked in the UK and they like the options. But when you drill down, what they really want is communication. If you have [board-shareholder forums], you may not need [to adopt] say on pay.”

Members of Tapestry Network’s Compensation Committee Leadership Network (CCLN)<sup>9</sup> recently met and discussed the benefit of increased communications between boards and shareholders. Most CCLN members reported that they were finding that engaging in a dialogue with shareholders seems to yield positive results. One stated, “We had an interesting situation with our shareholders where they were proposing a large number of resolutions in opposition to the fact that we had [one consulting firm] as both our compensation consultants and working on our benefits. I spent an hour on the phone talking about what we did in terms of our decisions, [walking] them through the whole philosophy, and eventually they dropped it.”<sup>10</sup>

One audit chair shared a recent experience of meeting with an activist investor group to address a no-vote campaign the group was waging against board members: “*After meeting with [several of] us for two hours, they decided to withdraw their opposition [to us.] Having said that, they then turned around and opposed [some] other directors, and when asked if they wanted to talk with those [directors], they said they didn’t have enough time.*” In this case, further communication would have benefited both the board directors and activists involved.

### Board directors’ approaches to communicating with shareholders

Scott Newquist and Max Russell noted in their 2003 book *Putting Investors First: Real Solutions for Better Corporate Governance*, “There is virtually no effective mechanism for communication between shareholders of large public companies and boards of directors.”<sup>11</sup> Conventional wisdom says that the annual general meeting (AGM) is the place for board members to engage with shareholders. However, network members express frustration with the AGM as an occasion for constructive communication with the company’s largest shareholders – many of whom may not even attend the AGM.

Board-shareholder communication outside of the AGM has tended to be driven by specific issues or crises in recent years. In a quick and unscientific survey of all the ACLN members, who between them sit on over 35 public company boards, there were only three examples of members being asked or accepting an invitation to communicate directly with shareholders. During the meeting in New York, one member recounted a discussion held between a small number of board members and a significant representation of the company’s shareowners that helped to “*take the sting out*” of a disagreement with investors. While the

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<sup>9</sup> The Compensation Committee Leadership Network (CCLN) brings together a select group of compensation committee chairs from North America’s leading companies for private discussions about how to improve the performance of their corporations and earn the trust of their shareholders through more effective compensation committee work.

<sup>10</sup> Compensation Committee Leadership Network, “Executive compensation in 2008: Never a dull moment,” *ViewPoints*, May 22–23, 2008. Available at [http://www.tapestrynetworks.com/documents/Tapestry\\_Mercer\\_CCLN\\_View\\_May08.pdf](http://www.tapestrynetworks.com/documents/Tapestry_Mercer_CCLN_View_May08.pdf).

<sup>11</sup> Scott C. Newquist, with Max B. Russell, *Putting Investors First: Real Solutions for Better Corporate Governance* (New York: Bloomberg Press, 2003), 116.

company has not committed to ongoing, regular meetings, the member stated, *“We reserve the right to do it again ... When you put out a human face, it helps.”*

Members also discussed the example of Pfizer, the world’s largest pharmaceutical company and an emerging leader in board-shareholder communications. In the summer of 2007, Pfizer initiated a meeting between its board of directors and its largest institutional shareholders, who in aggregate owned 35% of Pfizer’s stock. The discussion was kept at a relatively high level and focused on governance practices and compensation matters in order to avoid concerns about breaching Reg FD. Matters relating to company strategy and product pipeline were off limits. In a press release prior to the meeting, Constance Horner, lead director for the Pfizer board, stated, *“We believe this meeting with our shareholders ... will give us valuable insights and help us maintain the highest standards in corporate governance.”*<sup>12</sup>

Jeff Kindler, Pfizer’s chairman and CEO, remarked, *“Open and candid dialogue with our shareholders – and, in fact, all of our stakeholders – is very valuable and will help us become a better company ... These meetings reflect the view of both Pfizer’s management and its Board that we must listen to shareholder viewpoints on governance so that we can continue to improve our practices.”*<sup>13</sup> Ms. Foran, who was speaking in a personal capacity, stated that she expects that more companies will conduct these types of meetings: *“There will be situations where the board wants to establish the goodwill.”*

Not all members were convinced that having more meetings with shareholders is the wave of the future, but there was interest in the idea both as an important way to deepen mutual understanding during challenging situations and as a means of preventing such situations from arising.

### **Guardrails to ensure proper guidance and protection for board directors**

Although Ms. Foran noted that companies are increasingly conducting meetings with investors without releasing the information to the press, the examples still seem to be few in number, and it is clear that board directors have significant concerns about communicating with shareholders.

In addition to concerns about breaching Reg FD, ACLN members also expressed concerns about:

- Setting a precedent with shareholders that may increase demand for ongoing meetings and broaden the agenda beyond corporate governance and executive compensation
- The risk of creating a discoverable event
- Inconsistencies with management communication
- Driving a wedge between board members or between the board and management

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<sup>12</sup> “Pfizer Board of Directors to Initiate Face-to-Face Meetings with Company’s Institutional Investors on Corporate Governance Policies and Practices,” press release, June 28, 2007. Available at <http://www.pfizer.be/Media/Press+bulletins/Financial/PFIZER+BOARD+OF+DIRECTORS+TO+INITIATE+FACE-TO-FACE+MEETINGS+WITH+COMPANY’S+INSTITUTIONAL+INVESTORS+O.htm>.

<sup>13</sup> Ibid.

- Having an appropriate contact person. The audit committee chair may not be the right director to engage in direct communication if the agenda is focused on corporate governance and executive compensation. Several members suggested that the contact person should be the lead or presiding director rather than the audit committee chair.

At the session, members discussed with Ms. Foran some appropriate “guardrails” that would enable direct communication with shareholders while offering board members proper guidance and support to alleviate their concerns:

- **Be selective in your invitation list.** Investors are diverse: members are interested in engaging with larger, long-term investors and in avoiding the difficulties posed by activist shareholders with very small shareholdings and by short-term investors. One way to do so is by managing the invitations for the meeting, using clear and defensible criteria. Additionally, members broadly recommended that board representation be limited to the lead director and other committee chairs.
- **Be clear about the objectives and the agenda.** Ms. Foran recommended stating clearly what topics would be addressed in advance of the meeting, eliminating the possibility of an unwanted discussion on corporate strategy, or financial results, that could have Reg FD implications. Additionally, the meeting should not be allowed to run over the time allotted.
- **Know the investors.** Ms. Foran also recommended having company staff research the attending investors’ voting records and reach out to them privately via telephone calls before the meeting to learn what they are interested in gaining from the meeting.
- **Agree upon clear answers to potential questions in advance.** It is important that management and board members are all on the same page regarding any issues that are likely to be raised. Everyone should also agree on who will be responsible for answering each question.
- **Provide training and education on Reg FD.** Gary Brown of the corporate department of Baker, Donelson, Bearman, Caldwell & Berkowitz stated in *Compliance Week* that “the best way to avoid violating Reg FD is to adopt clear, written policies for how to communicate with investors and be sure any executives who speak on the company’s behalf are well-versed in the rule’s requirements.”<sup>14</sup>
- **Ensure the general counsel (GC) is present.** The presence of the GC helps to ensure that all parties respect the guardrails. The GC can also intervene if a conversation appears to be encroaching on Reg FD.

## Conclusion

Shareholder pressure to increase their power in the corporate boardroom shows no signs of abating. Speaking at the ACLN meeting, Ms. Foran stated, “Overall, [corporate America’s] investor relationship isn’t working. I have special insight with my role in the Council of Institutional Investors, and I don’t see it stopping or changing. We need to figure it out.” It remains to be seen whether a constructive, ongoing

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<sup>14</sup> Melissa Klein Aguilar, “Best Practices for Talking Under Reg FD.”



dialogue with shareholders can provide a positive, proactive means of avoiding contentious battles, allowing public companies to focus on their primary goal: creating value for shareholders.

## About this document

The Audit Committee Network is a group of audit committee chairs drawn from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit committee environment.

*ViewPoints* is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* may share it with those in their own network. The more board members, management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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