InSights
FOR AUDIT COMMITTEE MEMBERS

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Communication between corporate boards and investors

Introduction

The Audit Committee Leadership Network is a group of audit committee chairs drawn from leading companies in North America committed to improving the performance of audit committees and enhancing trust in financial markets. Similar networks have been created in Europe and in regions of the United States. These networks are convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit environment.

Enhancing trust depends in part on establishing deeper relationships among the parties involved, yet clear difficulties arise. Directors have a duty to represent the interests of all investors, but it is not possible to have a dialogue with a myriad of individual investors. Institutional investors hold about 60% of the shares of U.S. companies and about 70% of the shares in the United Kingdom.[1] But even within a particular institution, identifying with whom directors should speak is not easy. Is it the pension fund managers? The analysts? The corporate governance experts?

Because institutional shareholders hold such a high percentage of shares in the largest companies in the United States and globally, this edition of *InSights* focuses on the nature and frequency of interaction between directors of corporate boards and institutional investors. It covers the regulatory context that influences that relationship, reviews current communication practices, and concludes with implications raised by the research. An appendix summarizes best practices proposed by U.S. business and shareholder groups.

Tapestry Networks solicited input from members of the Audit Committee Leadership Network in North America, several regional Audit Committee Networks in the United States, and the European Audit Committee Leadership Network. The audit committee chairs who contributed to this research are:

- Eddie Adair, Tech Data
- Jim Adams, Texas Instruments
- Jim Brady, Constellation Energy
- Jim Broadhurst, National City Corporation
- Per-Olof Eriksson, Volvo
- Sir Anthony Greener, BT
- Judith Richards Hope, Union Pacific
- Bill Jews, MBNA
- Tom Kierans, ManuLife Financial
- Max Lennon, Duke Energy
- Mike Losh, TRW Automotive
- Sir Ian Prosser, BP
- Paula Reynolds, Coca-Cola Enterprises
- Ronaldo Schmitz, GlaxoSmithKline
- Larry Small, Marriott International
- Sandy Warner, General Electric Company
- Doug Yearley, Lockheed Martin

Representing the institutional investor community are leaders of several mutual funds, pension plans, and representative investor organizations:

- Mark Anson, Chief Investment Officer, CalPERS
- Gary Black, President and Chief Investment Officer, Janus Capital Group

[1] Murray Steele, "Time for investors to come in from the cold," *Financial Times,* May 19, 2005, http://news.ft.com/cms/s/ef31f4d8-c86d-11d9-87c9-00000e2511c8,dwp_uuid=1d0ff528-c86c-11d9-87c9-00000e2511c8,ft_acl=,s01=1.html

- Claude Lamoureux, President and CEO, Ontario Teachers' Pension Plan
- Brian Rogers, Chief Investment Officer, T. Rowe Price
- Ann Yerger, Executive Director, Council of Institutional Investors (United States)

This document uses a modified version of the Chatham House Rule whereby names of contributors to the research and their company or organization affiliations are a matter of public record, but comments made privately are not attributable.

Executive summary

Our findings are highlighted below, with more detailed discussion on the following pages:

- **Agency theory and regulatory environment affect director-investor relations** *(page 3)*

  The relationship between management, boards, and investors is based on the fundamental concept of agency theory, which holds that investors elect directors to serve as their representatives in overseeing the performance of management. Directors might therefore be expected to seek input from and report back to shareholders. Regulatory guidelines in recent years have sought to increase shareholders' awareness of how to communicate with directors.

- **Current practice: audit chairs and institutional investors describe limited interaction** *(page 4)*

  Despite their theoretical role as shareholders' agents, most directors responding to our research rarely meet with investors, either as audit committee chairs or in their roles as board directors. Analyst calls are their best source of direct input from investors. Most of the directors we spoke with believe that the traditional channels of quarterly earnings calls, annual shareholder meetings, and correspondence are sufficient, although some engage in additional communication. Many are also reluctant to meet individually with shareholders due to disclosure concerns. Ironically, the Securities and Exchange Commission's (SEC) Regulation Full Disclosure (Reg. FD) [2], which was intended to encourage transparency, may actually deter directors from communicating with their shareholders.

- **Future practice: potential benefits of increased communication** *(page 7)*

  Our research suggests that directors and investors may be missing a valuable opportunity to gain insight from each other's perspectives through additional dialogue, though neither group seeks a marked increase in the level of communication. Board members might benefit from institutional shareholders' views on the company and its management, as well as the sector and competitors. Institutional investors would like to offer their input and expertise on strategic issues and to assess the "tone at the top" from board directors, and their general business philosophy. Investors did not expect to receive preferential information from such discussions. Both parties' comfort with greater interaction might be increased by regulatory guidance on how such discussions should be conducted and by a shift in expectations about the nature of such conversations – away from any notion that directors are there to divulge information and toward the idea that directors' primary objective in meeting is to solicit input from investors.

[2] Securities and Exchange Commission, *Final Rule: Selective Disclosure and Insider Trading,* October, 2000. Full text available at http://www.sec.gov/rules/final/33-7881.htm

Agency theory and regulatory environment affect director-investor relations

Agency theory and the roles of directors and investors

Most institutional shareholders and board directors in the United States would likely agree with their representatives in the Council of Institutional Investors (CII) and the National Association of Corporate Directors that "[d]irectors are the elected representatives of shareholders and charged with the significant responsibilities of overseeing management, corporate strategy, and performance."[3] Indeed, the relationship between management, boards, and investors is based on that notion.

However, directors face a somewhat confusing dilemma. They believe their role is to help create long-term value and represent a long-term shareholder perspective, but they generally perceive institutional investors to be primarily short term in their orientation. This leaves directors representing "shareholders" as a broad concept. One audit chair commented, *"Our shares are controlled by very large institutions that don't represent all shareholders."*[4]

For their part, institutional investors may view themselves as "share*holders*" focused on maximizing the value of a purely financial investment (short-term orientation), or as "share*owners*"[5] with not just a right, but an obligation, to influence management to maximize company performance (long-term orientation). Others have argued it is unrealistic to expect investors to act as anything but a financially interested party.[6] It is also increasingly hard for large institutional investors to "vote with their feet" to exit a poorly performing investment, both because of indexing as well as the potential market impact of unwinding large positions. Therefore, more institutional investors are becoming interested in improving the return on their investment by providing their input through greater engagement with directors and management.

One audit committee chair believes that hedge funds behave more like owners than do other institutional investors, in that many hedge funds actively engage management to effect change. Another audit committee chair described colleagues' general unease at the potential impact of hedge funds. *"Hedge funds are driving a major change. A lot of companies are pretty nervous about how [hedge funds] operate and the effect they might have in the future,"* although he believed they focus more on small companies, where they have a proportionately greater influence on management and directors. *"Hedge funds are a more activist shareholder base and have the largest share of voice, if not of market,"* agreed an institutional investor. Loose coalitions of institutional owners have similarly brought their combined influence to bear when they felt their views were going unheeded, as at Disney in 2004.

If directors serve as investors' representatives in overseeing the performance of management, directors might therefore be expected to seek input from and report back to shareholders. In a recent article, former SEC

[3] Council of Institutional Investors-National Association of Corporate Directors Task Force, *Framework and Tools for Improving Board-Shareowner Communications* (Washington, DC: Council of Institutional Investors and the National Association of Corporate Directors, 2004), 8. Complete pdf file is downloadable at http://www.cii.org/site_files/pdfs/nacd-cii_taskforce-2004-3-12-04.pdf

[4] All quotes in italics are drawn from our discussions with the listed participants.

[5] Shareowner is the preferred term of the Chartered Financial Analyst Institute, which represents more than 70,000 investment practitioners.

[6] Clifton R. Wharton, Jay Lorsch, and Lord Hanson, "Advice and Dissent: Rating the Corporate Governance Compact," *Harvard Business Review* 69, no. 6 (1991).

chairman Harvey Pitt set out a myriad of ways that companies and their directors can interact with their shareholders. He suggests, "It is useful to allow outside directors to meet periodically with large institutional shareholders. Make the lead outside director, or some outside directors, available to meet – let institutions have access to the people who are serving to ensure that your company is well-governed."[7] The Business Roundtable suggests that "[a]lthough communications with shareholders as a group generally are management's responsibility, directors may initiate contact with shareholders when appropriate, generally with notification to management."[8]

Yet the question of whether directors have a right to meet with shareholders surfaces time and again. One investor we spoke to complained, *"There are times when directors have canceled meetings with us because their CEO has asked them to. They don't realize they work for shareholders. They think they work for management."*

Regulatory environment

In recent years, the SEC "has become increasingly aware of investors' desire for a means to communicate with boards of directors."[9] A number of regulatory reforms have taken aim at strengthening director-shareholder communications and enhancing related disclosures:

- **SEC Regulation Full Disclosure (2000)**[10] prohibits a company from intentionally disclosing material nonpublic information unless it simultaneously discloses the same information publicly. If material information has been unintentionally disclosed, the information must be publicly disclosed within 24 hours or the next day's opening of trading.
- **SEC Rule 3235-AI90 (2004)**[11] requires a company to disclose whether it provides: a process for shareholders to communicate with the board, and if not, to explain why they find it unnecessary; a process by which communications are sent to board members and, if applicable, to specified individual directors, or how it is determined which communications are to be relayed; the company's policy regarding board member attendance at annual meetings; and the number of board members who attended the prior year's meeting.
- **New York Stock Exchange (NYSE) listing requirements (2004)**[12] state that companies must disclose a method for interested parties, including shareholders, to communicate directly with the presiding director of the executive sessions, or with the non-executive directors as a group.

[7] Harvey Pitt, "Anticipating the Concerns of Your Institutional Investors," *Compliance Week,* May 31, 2005. The article is available to subscribers at http://www.complianceweek.com/index.cfm?fuseaction=article.viewArticle&article_ID=1792

[8] Business Roundtable, *Guidelines for Shareholder-Director Communications* (Washington, DC: Business Roundtable, 2005), 4. Complete pdf file is downloadable at http://www.businessroundtable.org/pdf/20050527001ShareholderCommunicationsGuidelines-FINAL-5.26.05.pdf

[9] David E. Brown, William Scott Ortwein, Beth R. MacDonald, and Catherine Meeker, *SEC Adopts Final Rules Relating to Director Nomination Process and Shareholder Communications with Directors* (Atlanta, GA: Alston & Bird LLP, 2003), http://library.findlaw.com/2003/Oct/24/133187.html

[10] Securities and Exchange Commission, *Final Rule: Selective Disclosure and Insider Trading,* October, 2000.

[11] Securities and Exchange Commission, *Disclosure Regarding Nominating Committee Functions and Communications Between Security Holders and Boards of Directors,* January 2004, http://www.sec.gov/rules/final/33-8340.htm

[12] A table showing where disclosures must be located is available in pdf format at http://www.nyse.com/pdfs/Apr%2027%202005%20Exhibit%20G.pdf

Current practice: audit chairs and institutional investors describe limited interaction

In their 2003 book *Putting Investors First: Real Solutions for Better Corporate Governance,* consultant Scott Newquist and business writer Max Russell state, "There is virtually no effective mechanism for communication between shareholders of large public companies and boards of directors. Most executives actively discourage or even forbid independent directors from communicating directly with shareholders. Likewise, shareholders have no real way to communicate with directors."[13] Newquist and Russell's finding reflects what we heard from the board directors and institutional investors with whom we spoke.

The audit committee chairs' perspective

In theory, board directors may be their shareholders' agents, yet a number of audit chairs describe an experience similar that of to one director, who told us, *"I'm on four boards and I've never heard of one independent director meeting with a shareholder directly."* Almost all of the 17 audit committee chairs who participated in our research, who between them serve on the boards of over 50 small-, medium-, and large-cap public companies, reported that it was extremely rare for them to meet with an investor outside of the annual shareholders' meeting. However, many directors said they would meet if requested.

The 17 audit committee chairs responding were generally satisfied with their current level of investor interaction, which ranged on a continuum from those who rarely or never meet with shareholders outside of traditional forums, which describes the preponderance of respondents, to several who occasionally did, to the few who regularly did. Of those who rarely met one-to-one with investors, some strongly argued against additional communication, while others were open to the possibility.

One audit committee chair said, *"I would oppose more frequent communication between the audit committee and institutional investors as [it would be] unwise: it will confuse the role of management with that of directors."* Another agreed, saying, *"I do not believe the board should have an active role with investors. Perhaps under certain circumstances, such as a sale, a large acquisition, a CEO change, or a debt or equity offering, but not for normal operations."*

Most audit chairs find quarterly earnings calls the most useful venue for understanding investors' concerns, hearing management's explanations of performance and handling of disclosure, and pinpointing any issues that need follow-up. One audit chair commented, *"I listen for how management handles disclosures and to the Q&A to be sure we haven't overlooked something."*

In many cases, questions that arise on calls prompt board members to pursue the matter further. As one audit committee chair said, *"If something came out of left field that we and management hadn't thought of, if it didn't raise a red flag, it would raise a pink one, and is something we would investigate to be sure we were fully comfortable with the matter and fully informed."*

Among audit committee chairs who were familiar with their boards' specific policies and procedures governing director-shareholder communications, one said that his boards *"generally provide for direct*

[13] Scott C. Newquist, with Max B. Russell, *Putting Investors First: Real Solutions for Better Corporate Governance* (New York: Bloomberg Press, 2003), 116.

communications of hot line items to the audit committee or audit committee chair. Also, anytime a responsible shareholder wants something to go to the board, it does." Another audit committee chair agreed that *"shareholder inquiries are shared with the entire board and discussed at the audit committee, as required. If a board member receives an inquiry [directly], this is shared with legal counsel and management."*

A number of audit committee chairs said they enjoy hearing investors' points of view as a way to compare and contrast what they hear from management. They rely on quarterly earnings calls, annual shareholder meetings, and the opportunity for investors to correspond with management and the board – all relatively safe, controlled channels that do not require face-to-face meetings. Management is often the gatekeeper for communication. One audit chair said, *"Management receives inquiries, which they will respond to, or forward to the appropriate board committee."*

Many directors are reluctant to have private conversations with shareholders over concern that they might unwittingly violate Reg. FD, which appears to have produced an unintended roadblock. Fear of what one director called *"rogue conversations, unrecorded, untranscribed,"* caused a great deal of nervousness. Directors already wary of communicating directly may use Reg. FD as a shield, one director told us. *"There is such a web of full disclosure risks in the environment, directors would be reluctant to engage in direct communications with investors."*

Board directors were also concerned about being perceived as micromanaging or acting as the *"voice of the company"* when *"it's management's place to interact with shareholders."* Time constraints – the fear that they might be overwhelmed by the volume of requests for one-to-one meetings – are another concern. However, another audit committee chair cautioned, *"We should not shrink from speaking publicly regarding a position the audit committee or board as a whole has taken."*

Just two of the 17 responding audit committee chairs described having a formal role at the annual shareholders' meeting, and only one of them makes an audit committee presentation. Nevertheless, all were thoroughly prepared to answer questions addressed to them, and most mingled with shareholders before or following the meeting. One audit committee chair said that at his board meetings, *"no one is queasy about referring questions to audit chairs that are in their area, specifically matters dealing with external audit fees, issues, internal audit matters."* Another audit committee chair added, *"Financial questions regarding internal controls or the financial statements may be addressed by the CEO or CFO, or referred to the audit committee chair."*

Just three audit chairs, including two of the four European respondents, mentioned having a formal program in place to meet with shareholders outside of the typical venues. One European audit chair described his board's policy of having *"regular meetings of the senior independent director with major institutional shareholders. This has proved quite useful."*

The institutional investors' perspective

In practice, many institutional investors said they have more dialogue with the management of the companies they invest in than with the directors whom they elect and who theoretically represent them. They said they had not previously considered contacting directors under normal circumstances, though they

observed that when they have initiated contact, often during a major event or crisis, directors have usually responded. Typically they speak then with the lead or presiding director or the most senior non-executive director, not the audit chair, although the audit committee chair is also of interest as someone *"deeply involved in the strategic side of the business and the finances, and helpful on the question of capital deployment."* Outside of major events and crises, investors said that the *"compensation committee would be interesting to speak with regarding aligning management incentives with shareholder interests."*

One institutional investor said that, as a group, *"[institutional shareholders] are not interested in providing strategic input on any routine basis, but it is important that access, processes, and mechanisms exist. Directors would be surprised at how often it's non-trivial issues investors want to bring to their attention. When there's a problem, they'd be surprised, too, at how much it can help to have that relationship: a long-term owner can be a best friend."*

Another investor commented, *"I don't think there is frequent enough contact. We elect directors, but there is not much interest after that. How many directors call up [investors] and say, 'Hey, what do you think of this company?'"* Investors also believe directors should ask for the analysts' opinion in order to learn about outsiders' perspectives on the industry or company.

One investor felt making the annual meeting more candid and less scripted would also be valuable and encourage attendance: *"Warren Buffett attracts 20,000 investors to the Berkshire Hathaway annual meeting because it's substantive."*

Future practice: potential benefits of increased communication

The Business Roundtable suggests that "meetings with directors should be reserved for shareholders with serious concerns about significant company policies."[14] It may be that quarterly earnings calls, annual shareholder meetings, and various ways for shareholders to correspond with directors suffice.

However, this perspective may not fully take into account benefits that might accrue if communications increased. In the opinion of the CII, "Companies that improve their board-shareowner communications will strengthen their long-term financial performance by not only retaining and attracting investors, but also learning from them."[15]

Hearing investors' concerns may help directors improve performance and deter costly shareholder proposals. Forging relationships in good times and gaining investors' trust may create an ally for boards in more difficult times. A leading corporate governance expert, speaking earlier this month at the annual conference of the International Corporate Governance Network (ICGN) in London, said that taking the director-investor dialogue out of the public domain and media glare improves the conversation.

The status quo may satisfy many, but views expressed here suggest that both directors and investors are missing an opportunity to gain from one another's knowledge and perspectives. In the course of discussions,

[14] Business Roundtable, *Guidelines for Shareholder-Director Communications.*

[15] Council of Institutional Investors-National Association of Corporate Directors Task Force, *Framework and Tools for Improving Board-Shareowner Communications.*

several audit committee chairs began to show interest in additional dialogue. Given a structured, safe way of having a limited number of such conversations, one director conceded, *"Maybe we should be speaking more."*

All the members of the investor community we spoke to were mindful of Reg. FD and did not expect to get "preferential" information from such discussions. They told us that board directors should not feel they are required to disclose sensitive information during such meetings, but can be there mainly to listen. Investors said they would enjoy the opportunity to *"provide [their] input as knowledgeable, savvy investors,"* to share their perspectives on the company, its competitors, and the sector, and to have their own concerns heard. One institutional investor said he would like to *"understand board members as businesspeople – their philosophies and approaches."* Having the "right people" in the director-investor dialogue is critical: a speaker at the ICGN conference said that directors should not "shunt the investor relations responsibilities to investor relations professionals."

Like board directors, institutional investors don't seek excessive interaction, since *"it's not a good use of time to speak with too many companies where everything is fine."* The most efficient use of time might be if a board director, most likely the lead or presiding director, occasionally had a conversation with institutional investors outside of major events or crises. Said one investor, *"If [a board director] scanned their top 15 shareholders or so, and were to call to ask me to lunch, I'd go for it in a second … I would be surprised but pleased if a board member were to contact me proactively."*

If investors and board members are to meet more, both groups expressed an interest in finding an approach that maximizes the benefits and minimizes the risks of one-to-one conversations. They would welcome advice on how to conduct such discussions. Educating directors about how to manage within a *"Reg. FD world,"* providing periodic refreshers, and agreeing to agendas and topics for discussion in advance were some best-practice recommendations (see appendix on page 9). One board director suggested the SEC might be the right body to help formulate some guidelines.

An institutional investor commented, *"Looking back to the 1960s and [the] 'rubber-stamp' crony boards of that era, we have moved toward greater stewardship responsibility. Boards today are certainly more interested in shareholders."*

Conclusion

Directors and institutional and other investors appear to be missing an opportunity to enhance trust through better communication. As directors shift their perception of the director-investor conversation from one in which they fear unintentionally divulging undisclosed information to one in which they invite investor input, both parties may benefit.

Finding the right balance in communication will come about through cautious experimentation and some additional regulatory guidance, and will undoubtedly require more commitment and time. We hope that this document will encourage leaders in business, government, and regulatory groups to further the dialogue between institutional and other investors and the boards they elect to represent them.

Appendix: some recommended best practices from U.S. organizations

A number of organizations representing business leaders and shareholder groups have published best-practice guidelines for director-investor communication (see various footnotes cited earlier). These organizations agree that communication between boards and investors is desirable, and that clear policies and contact information for key management representatives and independent directors should be readily disclosed on websites and in proxy materials. They differ, however, on the degree of communication they recommend and the channels through which they think communication should flow. These practices were not discussed with or endorsed by those who participated in our research.

Common elements of best-practice recommendations

- Directors should attend the annual shareholder meeting and should respond, or ensure management responds, to appropriate shareholder questions concerning the corporation.
- Companies should have effective procedures available to shareholders in proxy materials and on the company website for shareholders to communicate with directors and for directors to respond to shareholders.
- Companies should disclose a method whereby interested parties with concerns can communicate directly with either a designated "presiding" independent director, or with the independent directors as a group.
- The board should designate a member of management, such as corporate secretary, general counsel, or the head of investor relations, to collect, organize and review incoming shareholder communications, unless sent directly to the board. The procedure should be approved and overseen by the independent directors.

Additional best-practice recommendations

- A specific committee of the board, chaired by an independent director, should be actively involved in developing, overseeing, reviewing, and reporting to the full board on shareholder communications programs, policies, and activity.
- The board should be notified of all proposals submitted by shareholders, and the board or governance committee should oversee the corporation's response. Directors should meet with proponents of proposals that receive a large number of votes to hear shareholders' viewpoints.
- Companies should also consider disclosing contact information for the independent chairs of the audit, compensation, and nominating/governance committees. Concerns relating to accounting or auditing matters should be referred to the chair of the audit committee.
- For one-to-one shareholder–director meetings:
  - Set agendas and agree upon topics in advance; distinguish issues appropriate to the board.
  - Train/coach/remind directors about Reg. FD.
  - Decide whether directors should have anyone else present (general counsel, head of investor relations, corporate secretary) or take the meeting alone. At the director and shareholder's discretion, management may be invited to join the meeting.

About this document

InSights is produced by Tapestry Networks to provide assessments of key issues of interest to audit committees. Initially, *InSights* will be distributed to network members who, in turn, will share it with colleagues on audit committees and boards, and their advisers. It will be distributed by Ernst & Young to its partners. Anyone who receives *InSights* may share it with those in their own network. The ultimate value of *InSights* lies in its power to help all constituencies develop their own informed points of view.

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