COMPENSATION COMMITTEE LEADERSHIP NETWORK
ViewPoints

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Shareholder relations and the confident compensation committee

Compensation Committee Leadership Network (CCLN) members devoted most of the March 11 and 12 meeting to discussing shareholder relations issues, particularly shareholder-director engagement and dealing with activist shareholders. Members were joined by Chris Wightman, Principal, CamberView Partners, and Cliff Robbins, CEO, Blue Harbour Group, for separate portions of the meeting. Members also discussed trends they observed in compensation and ways of empowering the compensation committee. This *ViewPoints* synthesizes the discussion.[1]

Shareholder–director engagement

Directors are receiving more requests to engage directly with the shareholders of their companies. CCLN members expressed a range of views on when and how executives and independent directors should engage with equity holders. Members also discussed the new Shareholder-Director Exchange (SDX™) Protocol[2] and the SDX working group's conclusion that developing direct channels of communication between shareholders and board members can help avoid or mitigate activist interventions and lead to better overall relationships between companies and investors.

Benefits of engagement

CCLN members who have directly engaged with investors in their role as directors have noted a variety of benefits:

- **Better-educated directors.** According to one member, there are *"two kinds of meetings with investors: meetings in proxy season to make a request and meetings out of proxy season to develop a relationship."* Members with experience engaging "out of season" have found it beneficial. *"It is like a preemptive strike. We get lots of feedback and can incorporate that feedback into our plans*," one member said. Another said there is real value listening to what is on investor's minds, because it helps directors *"get [investor] concerns without some of the filters."*
- **Greater investor satisfaction.** Many members believe that board engagement should be reserved for addressing investor concerns, such as in response to a substantial decline in a company's say-on-pay vote. One member described a successful engagement that occurred after investors raised concerns: *"We said, 'Here is what we heard, and this is what we did in response.' It was very powerful for [the investors] to know we heard their opinions."* According to Mr. Wightman, in some situations, *"board engagement has made all the difference. Investors want to know you understand the situation and have things under control."*

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[1] *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 are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

[2] Over the last two years Tapestry Networks has been asked for guidance on why, how, and when US board directors and investors should engage directly with each other. In response to these questions, Tapestry led an effort to create an engagement protocol for directors and shareholders. The result was the 10-point SDX Protocol, which provides guidance to public company boards and institutional investors on when direct engagement is appropriate and how to make it valuable and effective. For more information, please see http://www.sdxprotocol.com.

But engagement need not be only reactive. Boards can get in front of potentially *"radical or risky change,"* one member said, noting that *"investor input would make us more confident in taking on ISS."*

- **Creation of a pathway for future discussions.** Members noted that if relationships can be developed when things are going well, investors may be more likely to trust a board during a crisis. Open channels to investors are particularly helpful when an activist approaches, because as Mr. Wightman explained, *"Activists are already doing this – by the time they make an investment, most activists know the leading institutional investors in the company by name."* One member likened this relationship building to *"a more subtle poison pill or an activist foothold."*
- **A better-informed investor base.** It is not surprising that engagement works best when directors are prepared in advance. Mr. Wightman said, *"A big part of the engagement is education. You want [investors] to understand what you are doing."* Members noted that if they are going to engage without management present, it is important to meet with management beforehand to make sure the company is sending a consistent message. Preparation should include having an agenda, understanding the audience, and ensuring that the right directors participate in any engagement.

Dealing with unconventional requests to engage

While investors generally initiate engagement with a board through standard channels, such as the investor relations function or the company secretary, members noted that they sometimes try unconventional approaches. One member said, *"At one company, investors started reaching out to directors at the golf course or the bank."* Members generally viewed these routes as inappropriate. They agreed that when a board member receives such an approach, he or she should notify the rest of the board both to make them aware that they may be approached and to formulate a broader plan for responding.

They also noted that such an approach may mean the board has a larger issue on its hands – namely, activism. *"Activists use non-traditional channels to reach directors,"* one member said.

Opposition to engagement

Some members thought that directors should only engage in crisis situations. These members felt that absent a crisis, the CEO and management team should speak for the company. Further, these members advised that if directors must get involved, the first meeting should take place with a representative of management present – usually the CEO. One member said, *"The CEO will be there first – and then we can decide if we need to follow up without the CEO."* Those who opposed director engagement with investors outside of crisis situations warned that *"if you engage shareholders in the absence of a problem, [investors] might think there is a problem."*

These members favored more passive means of gaining shareholders' perspectives, such as participating in quarterly calls and other investor events. They noted that board members can "*listen to earnings calls to hear* *things that need follow-up – things that the presenters might not hear because they are focused on presenting."* Another member said that these alternatives provide a good way to learn what investors think, while still letting management speak for the company: *"It is hard for me to go into a meeting and commit not to say anything."*

Compensation as a topic for engagement

In many cases, compensation issues are the most obvious topics for board-shareholder engagement. *"Compensation is the one thing the board actually decides, rather than advises,"* one member said. The board is therefore responsible for justifying compensation decisions to shareholders just as management is responsible for justifying operational decisions. A member noted that *"no matter how good the proxy is, it cannot capture it all. Engagement is a way to fill the gaps."* Another member said that particularly in companies with annual say-on-pay votes, the board is already receiving regular feedback from shareholders on its actions and suggested that direct engagement could turn that into a *"two-way street."*

Members noted the awkwardness of having senior managers defending their own compensation packages: *"[It is] hard for the CEO to speak up for himself [on compensation],"* one said. To avoid that situation, some members suggested having the compensation chair and a representative from management other than the CEO meet with investors to discuss compensation. Mr. Wightman said that *"investors realize that someone from management may be the subject matter expert, and the director is there as a leader and a big-picture person."*

Investor activism

Regarding shareholder activism, Mr. Wightman noted, *"The rise in activism is not being exaggerated, and activism is not going away."* The term "shareholder activist" means different things to different people. CamberView Partners has identified five types of investors that use some degree of activism to achieve change at public companies:

- asset owners, such as pension funds and unions
- asset managers, such as mutual funds
- governance, compensation, environmental, and social "gadflies"
- traditional activist hedge funds that seek to gain control of the company to deliver shareholder value
- constructivist hedge funds that work with the board and management to change financial or operational strategies

Even within these five groups, there is a range of opinion on the best ways to achieve their goals. During the meeting, members focused on activists whose goal is to increase shareholder value, whether through adversarial or constructive approaches, holding for another time a discussion on environmental, social, and governance activism from institutional investors and gadflies.

Trends in shareholder activism

Activism that focuses on shareholder value is not new, but it is changing in ways that are relevant to CCLN members:

- **Activists have more money.** Around the world, the number of asset managers with a stated activist strategy has more than doubled over the last decade.[3] Experts estimate that between $10 and $12 billion in new assets were invested in activist hedge funds in 2013, and these funds now have more than $100 billion under management.[4] A big reason for that, Mr. Robbins explained, is that *"returns have been high – activists have done well."*

- **Activists are targeting larger companies.** In 2009, there were only seven activist campaigns at companies whose market capitalization exceeded $10 billion.[5] That number increased to 23 in 2012 and 42 in 2013.[6] Part of the reason is that even small activist stakes – such as ValueAct's 0.8% position in Microsoft and Pershing Square's 1% position in Procter & Gamble – garnered substantial media, and therefore investor, attention.[7]

  Activist investments in megacap companies are still somewhat rare. Given the inflows of capital to funds with a stated activist agenda, Mr. Robbins predicted that more activist interventions at these companies are coming.

- **Activists have new partners.** One member observed, *"There is more of a trend for investors who were not activists to back activists."* For example, one of the world's large asset managers, T. Rowe Price, recently supported Carl Icahn's attempt to block the leveraged buyout of Dell.[8] In addition, institutional investors including pension funds are themselves investing in activist funds as an alternative asset class.[9] One member also noted that in addition to investors with a stated activist agenda, there are a growing number of *"copycat hedge funds that follow activist investments."*

- **Activists are taking new approaches.** Historically, activists have been known for blunt criticism of companies and their managers. Although that still occurs,[10] the *Financial Times* noted that activists have toned down their rhetoric and are "working harder to present credible plans and to propose serious board candidates."[11] In addition, a wider range of investors are being labeled as activists. Mr. Robbins, for example, noted that Blue Harbour Group, *"resisted the word 'activist,' but had to agree we could be*

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[3] Linklaters, "Activist Investors Turn up the Heat in Global Boardrooms," news release, November 11, 2013.

[4] Alexandra Stevenson, "No Barbarians at the Gate; Instead, a Force for Change," *DealBook* (blog), *New York Times*, January 6, 2014.

[5] Ed Hammond, "Advisers Play at Activism to Pre-empt the Next Icahn," *Financial Times,* December 12, 2013.

[6] Activist Insight, "Activists Target Bigger Stocks," *Activist Investing: An Annual Review of Trends in Shareholder Activism,* January 2014, 24.

[7] James Woolery, "Introduction to the SDX Protocol," *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), February 5, 2014, and Dana Mattioli, "Activist Pushes for Split of Darden Restaurants," *Wall Street Journal,* October 9, 2013.

[8] David Gelles and Michael J. de la Merced, "New Alliances in Battle for Corporate Control," *DealBook* (blog), *New York Times*, March 18, 2014.

[9] Stephen F. Arcano and Richard J. Grossman, "Activist Shareholders in the US: A Changing Landscape," *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), June 28, 2013.

[10] For example, during a July 2013 interview, Carl Icahn noted, "I've been through a lot of these fights. Most of these boards are pretty dysfunctional, but I've never seen a board as bad as Dell's." (CNBC with Reuters, "Carl Icahn: I've Never Seen a Board as Bad as Dell's," *CNBC,* July 17, 2013).

[11] Stephen Foley, "Activist Hedge Fund Managers Get Board Welcome," *Financial Times,* December 23, 2013.

called a friendly activist." The result, one member said, is that *"you can't just put activists in a bubble; you have to get to know them."*

Preparing for an activist

Some members noted that their companies are assessing their vulnerability to an activist intervention. *"When we heard activists were sniffing around, we brought in an expert to do an analysis of why we came up on [the activists'] radar. Now we can self-analyze,"* one member said. Companies are particularly vulnerable when despite having a great product or service, they continue to underperform relative to peers.

Mr. Robbins said that he looks for companies that are *"trading at a discount to intrinsic value,"* then *"thinks about ways to unlock that value."* One member said that even without an activist, it is *"exciting to think about the company that way."* Another member, however, noted that with all the pressing issues that boards face, investor activism *"may be relevant in a crisis,"* but is not something that should take up a lot of the board's time.

Mr. Wightman said that an often overlooked part of the preparation is *"mak[ing] sure you address executive compensation or corporate governance issues."* He explained that while those may not be the reasons an activist invests in a company, *"activists comb through the proxy votes to find vulnerable targets, and poor compensation and governance practices can indicate vulnerability."*

Negotiating with an activist

When an activist approaches, the question is not about whether the company should engage, but how. Sometimes engagement can dissuade an activist from pursuing an aggressive agenda. One member met with an activist, *"explained what we were doing, and [the activist] walked away. To me, that was a fair game."*

In other situations, companies and boards have embraced activists' ideas. Mr. Wightman said, *"Constructive activists will bring a business plan. By the end of a conversation, you may want this person on your board."* For Mr. Robbins, cooperation with company leadership is a prerequisite: *"If we come to you and you are interested in our investment, we will invest; if not, we won't."*

Members commented that an activist investor, however noisy, may not reflect the views of other shareholders. For example, some activists focus entirely on short-term benefits and virtually ignore long-term value creation. One member said, *"Any board can put the company up for sale and get a 20% or 30% control premium. How do you balance what is good for all shareholders against what is good for an immediate pop? The activist needs to propose a change that is fundamental and sustainable."*

Executive compensation and activism

One member noted, *"There are some egregious pay packages out there, but I have not heard of an activist who starts out talking about compensation."* According to Mr. Wightman, compensation is more likely to be a secondary issue that an activist uses to demonstrate that the board is not acting responsibly: *"A company can have a great executive compensation plan, then give a departing CEO a large discretionary 'good-bye kiss' that investors will view as breaking the link between pay and performance. Activists will notice."*

Mr. Robbins explained that when he invests in a company, he wants to make sure that *"the management team has equity upside in the company so they are incented to unlock and create shareholder value."* In addition, he explained that the board and its compensation committee must provide the right incentive tools to be able to attract and retain the right people. Mr. Robbins noted that this approach to compensation is also helpful when discussing Blue Harbour's recommendations for value creation with management: *"The alignment of management and shareholder interests is very important, particularly when management is asked to consider strategic and financial alternatives for value creation, including asset sales, acquisitions, balance sheet optimizations, or the sale of the company."*

Trends from "a challenging period for compensation committees"

Members discussed marketwide compensation trends and how these trends can help to shape committee best practices. John Anderson of Meridian Compensation Partners noted that

> This has been a challenging period for compensation committees as they finalize incentive payouts for 2013 and approve pay actions for 2014. Overall compensation adjustments are generally modest for 2014, and there is a clear movement away from traditional annual 'merit' increases in salary for senior officers. At the same time, committees are asking more questions and requesting more information about proposed incentive goals and ranges. This has resulted in some difficult discussions as management at many companies believe that there is some level of scrutiny the committee should stay out of. We have even observed recent situations where CEOs are asking whether the committee trusts how they set appropriate goals for the company. [12]

Members also noted that turnover on the compensation committee leads to new perspectives and questions.

Despite pushback from management, members believe that committees are feeling more empowered than they have in many years. While committees still care about Institutional Shareholder Services (ISS) recommendations and say-on-pay votes, they act in the best interest of the shareholders regardless. One member said, *"After three years of say on pay, there is a better understanding of what [committees] can do."*

CCLN members also discussed the compressed time frames in which committees now find themselves making compensation decisions. They said they often receive information from management only shortly before committee meetings. One member said that with so little lead time, *"it is impossible to feel you have done [the compensation discussion] justice – we need adequate time to prepare."* Another member observed that the lack of adequate time for pre-meeting discussions makes *"meetings a little more confrontational."*

Additional trends related to compensation that members observed or discussed include:

- Increased use of performance-contingent long-term incentive compensation
- Continued use of a portfolio approach to CEO compensation and the compensation of other named executive officers
- Increased consideration of analyst data for judging performance versus analyst consensus
- Pay adjustments made on a periodic rather than annual basis

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[12] Because Mr. Anderson participated as a compensation expert, his remarks are attributed.

The benefits of pre-meeting outreach

One way to manage the compressed time frames for compensation committee decisions is to hold pre-meeting calls with some subset of the board's compensation consultant, management, compensation committee members, and the compensation committee chair. One member said, *"At least one week before our committee meeting, I schedule pre-calls for each committee member with the compensation people [at the company] and the compensation consultant."* Another member described a similar procedure: *"Three weeks before the committee meeting, I have a call with the comp consultant and management. Then I have a call with each member of the committee."* Management must provide information to committee members in advance of these calls.

The individual pre-meeting calls lead both to better committee meetings and better outputs. One member said that as a result of the calls, *"the committee meeting is much more interesting – it is focused on the right issues."* Another said, *"It allows each member to have their voice heard."*

Empowering compensation committees

As compensation committees continue to gain confidence, members are thinking about the potential for larger changes in the way senior executives are paid. Members were concerned about the current *"formulaic"* compensation plans. One member said, *"The current system has taken discretion and intelligence away from the board."* Another noted that boards often set goals 18 months before they are achieved and should be more focused on *"judging true performance after the fact."*

One member asked, *"If you were starting with a clean sheet, how would you look at large public company CEO pay differently?"* Another identified the goal as *"better aligning company performance and executive pay for the future growth of the economy."* Members discussed ways to propose changes to this system, including a potential dialogue with leaders of large institutional investors.

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As recently as 18 months ago, the dialogue at CCLN meetings focused on the external forces constraining the committee's action: proxy advisers, large institutional investors, conventional practices. In this meeting, we heard higher levels of resolve and confidence. Activists can be dealt with, if a committee is prepared to do some homework; proxy advisers are not entirely irrelevant, but certainly not in the driving role they once held.

Toward the end of the meeting, members spoke of using the voice of the CCLN to influence the way the system itself operates. We look forward to exploring this possibility in future meetings.

About this document

Appendix: Contributing Members

The following members participated in the discussion:

- John Anderson, Meridian Compensation Partners
- Karen N. Horn, Eli Lilly and Company
- Tom Johnson, Coca-Cola Enterprises
- Annette Leckie, Meridian Compensation Partners
- Mel Lagomasino, Avon Products and The Coca-Cola Company
- Marjorie M. Magner, Accenture
- Mary McDowell, AutoDesk
- Steven S. Reinemund, Marriott International
- Laurie Siegel, CenturyLink
- Richard Slater, KBR

The following members took part in pre-meeting or post-meeting discussions:

- Bill Kerr, Interpublic Group
- Marshall O. Larsen, Lowe's Companies