COMPENSATION COMMITTEE LEADERSHIP NETWORK
ViewPoints

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# Improving investor relations

The Compensation Committee Leadership Network (CCLN) met in New York on March 24 and 25 to discuss the board's role in investor relations. In one session, members were joined by Don Duffy, president of the financial communications consultancy ICR, and Kathryn Harmon, head of investor relations at the financial platform OnDeck. Another session brought members together with Dennis Friedman and Eduardo Gallardo, partners at Gibson Dunn, to discuss shareholder activism. This *ViewPoints* summarizes those discussions.[1]

## The board's relationship with investor relations officers

As investors seek more information about all aspects of company performance, many companies have made it a priority to hire and empower skilled investor relations officers (IROs). CCLN members discussed the evolution of the role, the qualities of a successful IRO, and the priorities for their IR departments.

### The importance of the IRO

According to Bloomberg, "Historically, [IROs] were primarily asked to communicate with investors and analysts about the events that could potentially affect the organization's stock value. Today, they are involved in wider company initiatives, including assessing competitive threats and measuring strategic initiatives."[2] While the days of an IRO serving as nothing more than a messenger appear to be behind us, members believe that IRO skills and importance still vary widely by company and industry.

A growing number of IROs at Fortune 500 companies (91% in 2014, compared with 82% in 2012) report directly to the CEO (4%) or CFO (87%), reflecting the growing importance of the role.[3] According to CCLN members, a strong IRO can free the CEO and CFO to focus more on running the business. Ms. Harmon said that the IRO should complement the management team: *"The right IR person is dependent on the strengths and weaknesses of your executive team. In some cases, the IRO prepares other executives to succeed with investors; in others, the IRO plays a much more high-profile role."*

IROs are also spending more time working directly with boards. In many cases, members said that their IROs regularly attend and present at board or committee meetings. Several members said it was important for the IRO, and not just the CEO or CFO, to report directly to the board about investor issues. One said, *"The challenge is ensuring an honest discussion. Investor relations may be more willing to tell it like it is rather than presenting an unduly optimistic picture."* Compensation committee chairs also said that since the beginning of say on pay, they have requested regular updates at the compensation committee level. One said, *"We decided we needed more of a dialogue, so the IRO presents quarterly to the committee and I report out to the full board."*

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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] Bloomberg, "Meeting the Needs of the Increasingly Sophisticated Role of the Investor Relations Professional," news release, June 18, 2013.

[3] Korn Ferry Institute, *Investor Relations Officers: The 2014/15 Survey of IR Leaders in the Fortune 500* (Los Angeles: Korn Ferry, 2015), 1, 5.

Ms. Harmon added that informal, out-of-cycle conversations between a board member and IRO are invaluable to both. She recalled her own prior role: *"The lead director would stop by my office every four to six weeks to check in. It helped keep both of us informed."* In a separate session, Mr. Friedman said that an open line of communication between the IRO and the board is essential: *"A lot of the issues that come back to bite you have been told to your IR people but don't get to the board."*

Additionally, directors rely heavily on the IRO when they engage with investors directly, either to help them prepare for investor meetings or to join them when they speak with investors. Before the meeting one member said, *"We are doing extensive outreach to get feedback on our compensation plan directly from investors. The head of IR is with us on every call and at every meeting. We have basically been glued at the hip."* Members explained that it is important to define roles when the IRO and a director meet with investors together. One member explained a successful division of labor: *"In the meeting, I handle the governance questions and the IR person handles questions about finance."*

**Qualities of successful IROs**

Members debated whether the best IRO is a career IR professional or someone rotating through the role on their journey through the ranks of the company. Most Fortune 500 companies treat their IRO as a specialist rather than someone filling a rotational role, similar to legal counsel or a research scientist; however, only about half of the people in the role consider themselves career IROs.[4] One member asserted, *"IR can be such a great training ground for a future CFO or even CEO."* Another countered, *"You need someone who builds trusting relationships. A rotating role would make that difficult."*

In the past, many IROs had communications backgrounds, but in recent years the role has more commonly been filled by people with finance experience, such as former buy- and sell-side analysts.[5] Mr. Duffy explained that former analysts bring the ability to pick up on important signs when listening to what current analysts are saying about the company. Regardless of an IRO's specialized background, members stressed that a winning IRO must build trust inside and outside the company. One said, *"The IR person needs to be a great facilitator who can anticipate investors' questions and bring the right people together to answer them."*

Others opined that the most important skill for an IRO is the ability to coax issues out of shareholders early or even to spot issues before shareholders raise them. When an activist investor starts examining a company or an institutional investor raises a new concern, the IRO is usually the first one to hear about it. In that vein, Mr. Duffy advised members to pay close attention to concerns that their IROs uncover: *"Make sure someone is asking the right questions about company performance. You don't want to miss an early sign."* In a separate session, Mr. Gallardo said that IROs should maintain an accurate list of investors who are known to agitate for change: *"They should have a list of the 50 investors you would not like to see in your stock and have a plan for alerting others if they hear from someone on the list."*

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[4] Ibid., 4.
[5] Ibid., 1.

**Adjusting compensation**

Faced with increased investor scrutiny on executive compensation, members discussed the role adjustments should play in their pay programs. One member asked, *"How can we set our goals in a way that allows us to look after the fact and make sure pay lines up with performance?"* They said that it is important to retain discretion to make adjustments while finding a balance between providing management with strong incentives and protecting shareholder interests. One member said, *"We try to strike a balance by weighing different factors to create an adjustment factor. Then, the factor can change the short-term incentives by up to one-third in either direction."*

Some members suggested that the key to making discretionary adjustments is to reserve the right ahead of time. One said, *"We have found that our investors are OK with discretion as long as we are clear up front about what we are going to look at."* Even if a company creates the perfect adjustment factor, there are risks to implementing it. One member said, *"We created a formula that would compensate management based only on what they could control, but nobody could understand the plan."*

**Investor relations priorities**

Increased engagement requires IROs and their teams to focus on the critical issues for their companies. Members discussed areas where their IR teams can add the most value for their boards and compensation committees:

- **Assessing vulnerabilities.** Members said that they rely on their IROs to identify elements of a company's profile that might make it vulnerable to activists, proxy challenges, or other investor issues. This often entails working with third parties such as an investment bank or communications firm to conduct a formal assessment that surveys large shareholders on key issues. Mr. Duffy explained, *"It is important to get independent feedback on things like corporate performance and executive leadership. The assessment should also track for other vulnerabilities, such as negative media coverage."*

- **Monitoring governance practices.** Some members were concerned that IROs do not spend enough time focusing on governance questions or developments in governance practice. Mr. Duffy said that the best IROs know when to get the board or governance experts involved: *"IR needs to be aware of the difference, in an institutional investor, between the portfolio managers [PMs] and proxy-voting team. If a topic is beyond the purview of the PMs, IR must make sure the right people are having the conversation."* Members explained that the best IROs coordinate with others in the organization to integrate the conversations about financial returns with those about governance topics. This often means developing a close relationship with the corporate secretary or general counsel and perhaps joining them in meetings with investors. One member said, *"Our board pushed the IR team to get out there and seek out issues about governance. They were reluctant at first, but we got them to do it and create a cross-functional team to addresses these issues."*

- **Becoming fluent in executive compensation.** Compensation committee chairs rely on their IR teams to identify concerns or questions about proposed pay plans. One member said, *"When our IR team started asking about compensation, we were surprised by how specific and detailed the investors' questions were."* IROs must not only listen for concerns but also be able to explain the intricacies of pay plans to investors. Ms. Harmon said, *"Your pay-for-performance program only gets you credit if your investors understand it. Investors want to be able to model and track the plan for themselves."*

## Trends in shareholder activism

Members discussed new approaches that activist shareholders are using to influence corporate strategy and generate value for investors. In 2014, interventions were up as activist funds made public investments at 343 US companies, 27% more than the previous year.[6] Assets under management at activist hedge funds continue to increase dramatically; a recent survey of the top 50 funds found that they manage $196 billion in equity assets.[7] In this environment, Mr. Friedman advised directors to *"look at what activists are doing at other companies and start to think like the activist within the company."*

### Campaigns at larger companies

Activists have increasingly turned their attention to large companies. A 2014 survey found that they initiated public campaigns at 14 companies with market capitalizations in excess of $20 billion.[8] Mr. Friedman predicted that this number would increase substantially in 2015 as activists put their growing war chests to work. He said, *"More of the big funds are focusing on fewer targets but taking bigger positions. It's not hard for a growing number of firms to put together a $2 billion position for an investment. Whatever percentage ownership, that's enough money to get the company's attention."*

One reason for this trend is that activists have achieved success at large companies even when they owned relatively minor percentages of the common equity. Of the 64 activist campaigns covered by the above-mentioned survey, 39% began before an activist had amassed the 5% equity stake that would trigger the filing of a Schedule 13D or 13G.[9] At eBay, Carl Icahn held just 0.8% of the common equity, yet his campaign led to the appointment of a new independent director and the planned spinoff of its PayPal business.[10] Starboard Value likewise held just 0.8% of Yahoo! when it started a campaign that led the company to spin off its stake in Alibaba.[11] Activists also pushed for major changes at Amgen, DuPont, EMC, PepsiCo, and Walgreen, despite holding less than 3% equity in each firm.[12]

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[6] Dennis K. Berman, "A Radical Idea for Activist Investors," *Wall Street Journal*, January 27, 2015.

[7] "Top Activist Hedge Funds Close In on $200 Billion Mark; ValueAct Capital, Elliott Management & JANA Partners Lead the Way," *HedgeTracker* (blog), January 19, 2015.

[8] Gibson Dunn & Crutcher, *Gibson Dunn Activism Update: 2014 Year in Review* (Los Angeles: Gibson Dunn & Crutcher, January 27, 2015), 3.

[9] Ibid.

[10] Ibid., 16–18.

[11] Ibid., 14.

[12] Ibid., 5–15.

### Cooperation with other investors

As activists launch more campaigns with smaller percentages of a company's common equity, it is essential for them to obtain the support of their fellow investors. Mr. Gallardo said, *"Ultimately, an activist is only as successful as his appeal to large institutional investors."* One member agreed: *"It turns out that the things activists try to do are things that appeal to a broad group of investors. They are not likely to pursue radical ideas."*

Mr. Gallardo added that part of the usual activist campaign includes outreach to other stakeholders that influence proxy voting. For example, he said, *"Lots of activists are working the press year-round. They know these people really well and can get their slant on a story before the company has a chance to respond."* Members were concerned that activists take advantage of opportunities to engage that are not available to companies. One said, *"There is a certain asymmetry when activists communicate in ways companies can't because of legal requirements."* Mr. Friedman explained, however, that in many cases companies are starting to do more. He said, *"More companies are getting in front of their shareholders year-round before the activist arrives. And once an activist goes public, management can respond in kind."*

Activists not only lobby institutional investors to gain support for their proposals, but also front proposals that originate with passive investors. Mr. Friedman said, *"A substantial number of the ideas that activists present come from the institutional investors in the first place. They are always talking to each other."* Members said that this trend has caused their boards and management teams to focus harder on the interests of their institutional investors. One said, *"It would be a good idea to have an institutional investor with a big stake present to the board and talk about what they think about the business. We should hear those ideas directly."*

It has also become common for more than one activist fund to invest in the same company at the same time, either because the activists intentionally collaborate or because they reach a similar decision separately. In 2014, three major firms each faced simultaneous campaigns from two activist funds: Darden Restaurants (Barrington Capital and Starboard Value), Juniper Networks (Elliott Management and Jana Partners), and Sotheby's (Marcato Capital and Third Point). Emulex and Compuware each had three different activist investors at the same time.[13] Mr. Gallardo said that as more funds pursue an activist strategy, it is more common for multiple funds to reach the same conclusion about a company. He said, *"Sometimes they approach a board together, but usually the larger hedge funds don't like sharing their ideas. It is becoming more common for funds to focus on the same company at the same time because they run the same screens."*

### Common vulnerabilities

Activists look for certain key characteristics before choosing to invest in a particular company. Mr. Friedman explained that they identify companies using a series of screens and *"when the stock price drops, they move in."* He added that once activists choose to invest, they *"do detailed research and prepare thoughtful white papers about the benefits of their proposal for the company."* Members said activists often identify changes that boards were likely to make, but at a different pace. One member shared a recent example: *"We were*

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[13] Soyoung Kim and Olivia Oran, "Activist Investors Bump into Each Other in Campaigns," *Reuters*, March 17, 2014.

*going about things at our leisurely pace and [the activist] showed up. We ended up doing what we were likely to do, just much sooner."*

Members discussed three common vulnerabilities that could trigger an activist investment:

- **Potential for a transaction.** The number of cases where activists pushed for mergers, acquisitions, spinoffs, or other strategic transactions increased substantially in 2014.[14] Mr. Friedman said that in recent years activists have been particularly interested in exploring spinoffs as opposed to pushing for a sale of the whole company, pointing to examples at Hewlett-Packard, eBay, and Hess. He explained, *"In the past, most activists used to be in it for the short term and pushed for the sale of the company. Institutional investors aren't as interested in supporting a proposal to sell the company. So the activists today tend to focus on other ways to create value."*
- **Capital allocation.** Activists also focus heavily on available capital. Mr. Duffy said, *"They run screens for things like cash on the balance sheet and free cash flow yield to identify potential targets."* Mr. Friedman explained, *"Activists want to prevent companies wasting that cash and making bad acquisitions. They say that when companies have excess cash, they usually do bad things with it."* He explained that as a result, activists invest in cash-rich companies and encourage them to return capital to shareholders either through a special dividend or share buyback.
- **Governance challenges.** Mr. Gallardo said that criticism of a board or of specific directors can *"drive an activist's decision to target a company."* One member agreed: *"More and more, they go after your board. We have been advised to have more information available about why we are a great functioning board to respond."* Members identified long-tenured directors, boards that waive age or term limits, non-diverse boards, and disfavored pay practices as particular characteristics that create activist interest.

Some members said that the fear of an activist intervention caused their boards to address vulnerabilities quickly and decisively. Mr. Gallardo said, *"It is a lot easier if you take proactive steps – like adding new directors or considering a special dividend – to address issues before an activist arrives."*

### Limits for legal defenses

Members recognized that legal defenses are unlikely to prevent an activist intervention, and in some cases they may actually encourage one. Mr. Gallardo said, *"Traditional takeover defenses are often useless with an activist because activists rarely seek to remove all directors and take over the company. Traditional defenses can also offend institutional investors."* He discussed a case in which the board used *"all imaginable defenses, which had the effect of telling shareholders the board did not value their input. That mobilized those who would ordinarily support management to remove the entire board with almost unheard-of levels of support."*

Mr. Gallardo and Mr. Friedman noted, however, that companies should regularly review key corporate documents. Mr. Friedman advised, *"Have counsel make sure that your governance documents are consistent. It is common to find a disconnect. It is easier to amend bylaws than charters. Be aware of what these say before an activist arrives."* He also recommended having a shareholder rights plan on the shelf:

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[14] Gibson Dunn & Crutcher, *Gibson Dunn Activism Update: 2014 Year in Review*, 2.

*"There is no need to publicly disclose it, but it is a good idea to have one drafted that can be put in place when there is a true hostile bidder or an activist acquiring a substantial stake."*

**Negotiated settlements**

Members acknowledged that settlements are the most common outcome of an activist intervention and discussed when to engage in negotiation. One member asked, *"If negotiated settlements are the new norm, how quickly should a company engage in negotiations?"* Mr. Friedman advised, *"Sooner is always better,"* extolling the benefits of focusing on the business rather than engaging in a drawn-out proxy fight.

Members were interested in knowing which concessions to seek as part of a negotiated settlement. Mr. Friedman suggested that, before negotiating, companies should look at other settlements the activist has made: *"This helps you get a sense of what you are dealing with. For example, you might be able to see that they are willing to take two board seats instead of the four they seek."* Most negotiated settlements include activist representation on the board. On average, companies grant 2.4 board seats, representing 21.3% of the entire board, as part of a public settlement with an activist.[15]

Another important agreement that Mr. Friedman suggested companies seek is a standstill (usually at least 18 months) that requires the activist to vote with the board and not attack management through any medium. Mr. Gallardo added that when faced with multiple activists, companies have a tougher decision: *"The best approach is to settle with the strongest activist and hope others back off. But there are some cases where after a settlement another activist starts making noise."*

Members discussed the importance of ensuring ahead of time that activists or their nominees become productive board members. Not all of the directors appointed as part of most recent settlements work for or formally represent the activist fund.[16] Mr. Friedman said that activists often prefer to place truly independent directors on boards to avoid both the effort of being a director and the share-trading restrictions. Mr. Friedman advised, *"Most of these independent nominees have been on other boards. Ask around and find out what happens when the door closes."* Putting all board nominees through the same evaluation process is important. One member described a situation where the company provided an activist with specifications from its nominating committee: *"We were surprised. The overlap between [the activist's] list and our list was quite high."* Other members cautioned that activist nominees might seek a larger role in tasks that traditionally fall on management. One said, *"I have seen people who want the board to own the strategy and make the CEO a COO. That can cause a lot of friction if the new directors want to call the shots."*

[15] Gibson Dunn & Crutcher, *Gibson Dunn Activism Update: 2014 Year in Review*, 25.
[16] Ibid., 26-31.

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Active and activist investors are doing more to make sure that management teams and board directors hear their perspectives on how to deliver value to all shareholders. Companies must make sure that their teams are not only listening to what each investor says, but also responding in a way that satisfies many disparate groups. We look forward to picking up on this theme at our next meeting by focusing on ways to select the right goals for management and the company as a whole.

## About this document

## Appendix: Contributing members

**The following members participated in the meeting:**

- John Anderson, Meridian Compensation Partners
- Errol Davis, Union Pacific
- Karen Horn, Eli Lilly
- Bill Kerr, Interpublic Group
- Mel Lagomasino, The Cola-Cola Company and Avon Products
- Mary McDowell, AutoDesk
- Steve Reinemund, Marriott International
- Laurie Siegel, CenturyLink
- Samme Thompson, American Tower
- Marc Ullman, Meridian Compensation Partners
- Linda Wolf, Wal-Mart
- John Wulff, Moody's

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

- Lloyd Dean, Wells Fargo
- Fig Newton, Torchmark
- Richard Slater, KBR