When it comes to engagement, stay the course

Investor intelligence and insights

As a new administration settles into the White House, many are trying to predict what changes may await the corporate governance landscape. But predictions recently have proven to have little value for national and international political outcomes. Instead, when it comes to engaging with shareholders, boards would be wise to stay the course rather than to digress.

The momentum behind current corporate governance practices is strong and will be difficult to slow. Shareholders aren't changing their tack or their expectations of the board and management. But with the turn of the calendar, it is worth revisiting how we got here and how the board can stay focused in 2017 amid the noise of political turnover and regulatory stagnation.

Shareholder empowerment has morphed from the "Vote No" campaigns of the mid-'90s, kick-started by Stanford University's Joseph Grundfest, into proxy access, withhold votes, and "no" votes on directors and company proxy proposals. Annual disclosure of mutual fund proxy voting records has provided significant transparency and accountability. Additionally, visibility on how and why institutional investors vote proxies is vastly improved, and asset managers, including passive investors, are finding their voice in the boardroom, either directly or by proxy through activist investors.

While investors continue to advocate pro-shareholder regulation, they have also become more comfortable with forcing corporate governance changes without regulatory intervention. After a U.S. appeals court struck down the SEC's rule on proxy access in 2011, we witnessed the success of investor "private ordering" with proxy access. Shareholders used the shareholder proposal process and collective action to get companies to voluntarily implement proxy access.

Hedge funds, both those with a more aggressive, confrontational style and those with a subtler approach to negotiating, have increased in number and have been encouraged by settlement trends. While rising interest rates may slow the growth of new funds for these investors, the regulatory landscape is unlikely to deter them from carrying on business as usual.

Although we may see considerably less support for environmental, social, and governance (ESG) issues in this new administration, the groundwork for continued investor interest has already been laid. Investing along ESG guidelines, first embraced by the world's largest asset owners, has become the bailiwick of asset managers as well. Additionally, the ESG learning curve has flattened. Proxy advisory firms—as well as influential index companies and data providers—have invested heavily in making ESG information more accessible to proxy voters and all walks of investors, regulators, and NGOs. The consideration of ESG issues and long-term sustainability has become firmly rooted in investing strategy.

Simply put, institutional investors and corporations are no longer waiting for laws to compel them to do what is both appropriate and in their best interest. This includes the evaluation of executive compensation which, despite the fresh uncertainty over the implementation of the SEC rules on disclosing CEO pay ratio disclosure, touches on the hot-button issue of income inequality and the wage gap. How is the board going to approach these conversations with investors? What about compensation clawback policies?

In short, shareholder engagement will continue to matter. The following are some practice tips for boards to consider as they forge ahead in 2017:

Pay attention to trends in shareholder proposals, even those that don't receive majority shareholder support. As Grundfest wrote back in 1993, "Symbols…have consequences. The resultant negative publicity can sharply reduce the prestige associated with serving on a target corporation's board, thereby providing an impetus for incumbent directors to improve corporate performance."[1] Does the board understand the implications of opposing proposals from large or influential shareholders?

Preview governance changes with large shareholders. Expected changes in regulation, both federal legislation and SEC rulemaking and enforcement, are likely to put more pressure on large shareholders to engage in private ordering. And ensure that the board understands and is satisfied with the company's investor relations capabilities. Does the company have the appropriate chain of command and protocols in place to ensure that the board receives the critical engagement information it needs?

Have the governance conversation with management. Be proactive. Discuss trends, shareholder-related crisis management, and how management and the board would engage on certain key issues (such as activist approaches, shareholder proposals, and political attacks). Some shareholder issues that boards may have considered resolved may actually still be evolving, including proxy access. And even at some companies that have adopted a form of proxy access, investors in certain cases are pushing for more lenient terms. How would your board approach a second bite of this apple?

Despite the uncertainty that 2017 brings, boards that stay the course and help to ensure that the company clearly communicates its strategic goals and discloses its key risks should find smoother sailing in the New Year.

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[1] Joseph A. Grundfest, "Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates," Stanford Law Review, pp. 857-937 (1993).

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