The Changing Role of the Director Outside the Boardroom

September 3, 2015 | Houston, TX

Panel: Barbara Duganier, Gentry Lee, Sarah Teslik, Apache

KEY TAKEAWAY CONSIDERATIONS

Moderator | Barbara Duganier

Director, Buckeye Partners (NYSE: BPL), MRC Global (NYSE: MRC), HCC Insurance Holdings (NYSE: HCC), Genesys Works, NACD Texas TriCities Chapter

"Boards should work in concert with management to build trust, relationships and communicate with shareholders proactively rather than only reactively when no votes, criticisms or activist threats occur."
-Barbara Duganier

These days, companies that face shareholder inquiries or various forms of shareholder activism are not just those with sub-par performance, corporate waste or improper corporate governance. Increasingly, shareholders are approaching boards of even the highest performing companies with their ideas and concerns. Shareholders invest in companies they believe in, and that includes having confidence in the board of directors.

The Board should ask management the right questions to understand the depth of shareholder communications that management is having, and the key issues that are arising in those conversations. Some of these topics will involve issues that are best addressed by the Board, rather than management. Boards should work in concert with management to build trust, relationships and communicate with shareholders proactively rather than only reactively when no votes, criticisms or activist threats occur. There is certainly not a "one size fits all solution" for board communications with shareholders; it is dependent on many factors that should be discussed openly by the board and management, always being mindful to honor the different roles of the board and management.

By meeting with shareholders, listening and communicating consistently, credibly and transparently, boards can better understand shareholder concerns and address them before they become contested. Conversely, by meeting with board members, shareholders can better understand the people and thinking behind the decisions and the governance process that helps the board make informed decisions.

Believing that increased shareholder interaction is a short-term "trend" or "problem" that will go away is a missed opportunity for enhancing shareholder value.

Panelist | William "Gentry" Lee, President, Fayez Sarofim & Co.
Director – The Sarofim Group, UT Health Development, St. John's School, The Carruth Foundation

- The focus on corporate governance practices at publicly-traded corporations has consistently risen in importance for the past fifteen years. While originally driven by market volatility and notable examples of poor practices, the current dynamic of greater investor activism promises to keep the topic growing in importance for the foreseeable future.

- Given the economic environment is characterized by slower growth and, therefore, a lower margin for error, investors care greatly about the Board's oversight of a company's capital allocation practices. Understanding the Board's commitment to positive policies can be critical for long-term investment in a company.

- With the increased focus on corporate governance, communication between Boards and shareholders are becoming more frequent as opposed to the past practice of haphazard, one-off issues. As a result, Boards should consider how to anticipate investor concerns and possibly make changes to their communication practices.

- Activist investors have found effective ways of magnifying their influence by convincing other shareholders that the activist's views had merit. In general, this trend seems to have served an important purpose by shining light on areas where improvements could be made.

The overhead presentation and resources on topics referenced in the program can be found at:
https://texastricities.nacdonline.org/Resources/meeting.cfm

Additional Reasons to Consider Director Shareholder Engagement….

- Cost of installing and removing directors is dropping
  - *Majority voting enables removing directors without running alternate slates, a huge change, under-estimated at the time; 89% of S&P 200 companies have majority voting*
  - Some activists are considering binding majority voting as next big campaign
  - *Change in mainstream shareholder habit of always voting with management means activists no longer need to buy shares to have power, they only need to know shareholders who have big voting stakes: a huge change*
    - 10 years ago most mainstream holders automatically voted for management, so activists had to buy shares to get power—15% was considered a standard threshold
    - Rise of executive comp as an issue began to change this
      - High pay irritated analysts and they considered it a performance-related issue, unlike other issues gadflies raised
      - Occidental twice provided fact patterns that changed habits
    - Mainstream holders surprised how easy it was to affect companies they held
      - Directors were removed at almost no cost
      - Sneak previews were obtained from active holders
        - Leading hedge funds now shop their ideas to mainstream shareholders
        - And leading shareholders now also shop their concerns to activists ("RFAs" or requests for activism)
  - New pressure on active managers to stem the massive flows of money out of their funds to passive managers has increased the pressure they feel to enhance returns, which encourages them to work more with activists, further reducing the cost of activism

  - This same pressure on mainstream active funds to enhance returns to stem outflows to passive managers is increasing their direct investments in active funds and their creation of active options within their own fund families
  - The regulatory changes that disallowed broker non-votes and allowed short slates of directors reduced the cost of targeting directors
- Borrowing shares on record date reduces cost of acquiring votes, small uptick in its use
- Shareholders are increasing using shareholder proposals (which are inexpensive) to push M&A deals and director deals, reducing costs and odds of success
  - Relational Investors was first to do this as Timken (successfully)
  - SEC reversed itself in March 2015, allowing a proposal to be put on Bank of America's ballot proposing a break up
- Technology reduces cost of coordinating or soliciting votes
- Say on Pay being permanently on ballots provides an easy way to test vulnerable companies; no one has to file a shareholder proposal to use this vehicle and it is seen as a general referendum on management—reducing the cost of putting a company in play
- Increased press coverage of governance actions (owing to the public's interest in executive compensation) provides free solicitation that reaches individual investors
- Use of supplemental proxy filings as solicitation materials is a new invention that enables essentially free solicitation
- Demand for rolling tallies enables activists to target their use of time and money better
- Adoption of a universal proxy would drop activism costs further
- The steady shift from a paper-based to a paperless governance world will significantly reduce activism costs and success rate
- If annual meetings become online interactive events the pressure on directors will increase at reduced costs to activists
- Cumulative impact of 30 years' effort to take down corporate defenses is now increasing the odds of activists' success at lower costs
- *Use of wolf packs by active shareholders reduces the cost of traditional proxy contests and evades corporate defenses, increases odds of success*
  - Conscious parallelism almost impossible to regulate
  - Wolf pack action is speedy—no negotiations required
  - Analysts gather at industry conferences making campaigning easy:
    - Voters come to activists
    - 13D Monitor event a bellwether
  - Lawsuits and proposals over how abstentions are counted may make it easier for shareholders' actions to succeed and reduce activism costs

- Shareholders are seeking greater involvement in director selection and nomination
  - Focus on directors comparatively recent: Enron was first company whose directors' names were printed in the WSJ, implying responsibility
  - The major proxy access campaign is a shift by public funds away from policy issues captured in shareholder proposals to director-based issues
  - More mainstream shareholders are providing companies with candidate names or director criteria—a change in habit rather than regulation
  - Blackrock's 2015 guidelines ask companies to disclose whether they used sources outside of the incumbent directors' networks to identify new directors

- The UK government is debating requiring board openings to be advertised
    - More governments legislate/regulate who is eligible for certain seats (e.g., 30% women)
    - ISS and the Council linking boards' failure to adopt proposals that succeed to voting against those boards' members in subsequent years enhanced focus on directors
    - In 2015, the combining of proxy access proposals with threats to use votes against directors <u>in the same year</u> as the proposal appeared on the ballot was a key change

- Companies themselves are more willing to work with activists to take on other companies
    - Valeant works with Ackman to take on Allergan 2013/14
    - Fiat courts hedge funds to take on GM in 2015
    - Nissan Renault used Kirk Kerkorian to pursue GM alliance

- PMs/analysts now use director vote for other issues too (increasing "background radiation")
    - State Street votes against directors based on grid analysis and tenure
    - Dimensional votes against directors based on anti-takeover profile
    - Pioneer maintains list of 162 toxic directors it votes against everywhere
    - Glass Lewis may vote against oldest directors
    - Data shows shareholders more willing to vote against boards and their compensation decisions

- Cross-border coordination on the increase
    - Steady decrease of in-country concentration of ownership of institutional investors has had unexpected effect of increasing global governance coordination
    - European practices (from board nominations to 9 year tenure limits to binding votes) more likely to be imported than in the past and many of these focus on boards and expect in-person engagement

- Director-shareholder engagement is inexpensive and surprisingly effective when done right
    - Shareholders tend not to consider boards to be very effective oversight providers; demonstrating otherwise has significant upside potential
    - Discussions with board members, because they avoid management-level topics and Reg FD matters, open the door to big-picture discussions that can demonstrate leadership in ways that IR- and CEO-mediated conversations cannot
    - Because boards have many members, it is possible to match board members to shareholders to produce good results
    - If focus of engagement is listening, potential exists to gain important information for both boards and managements

- As more companies use director-shareholder engagement, however, problems will arise
    - Shareholders don't have time for thousands of meetings
    - Many of these meetings provide too little content
    - Some big shareholders are already adopting rules to limit or ban in-person engagement