Board-shareholder engagement

On March 21–22, 2013, members of the Audit Committee Leadership Networks in North America (ACLN) and Europe (EACLN) met in Washington, DC for their eighth summit meeting. Two guests from the investor community – Michelle Edkins, managing director and global head of corporate governance and responsible investment at BlackRock, and Colin Melvin, CEO of Hermes Equity Ownership Services – joined members for a discussion of board engagement with shareholders. This ViewPoints presents a summary of the key points raised during the discussion, along with background information and selected perspectives that members and experts shared before and after the meeting.

Executive summary

Summit guests and members reviewed the current context for engagement between investors and boards and discussed various aspects of engagement, focusing on three main themes:

- **The “shareholder spring” was exaggerated, but the pressure on companies is real**

  Despite several high-profile shareholder votes in 2012, Ms. Edkins and Mr. Melvin argued that overall shareholder behavior was not substantially different from previous years, partly because companies began responding to shareholder concerns in advance of annual meetings. Executive compensation will continue to be a thorny issue, although Ms. Edkins and Mr. Melvin noted that incentive structures, rather than absolute pay levels, are the chief concern of investors.

- **Investors want to engage proactively, but selectively, with boards**

  Ms. Edkins and Mr. Melvin see engagement between investors and boards as useful for both sides, although, because of the large number of holdings, investors must use proxy advisory firms to identify where direct engagement would be most productive. A beneficial strategy for investors is to build long-term relationships with key companies, while boards should focus on long-term investors and identify the actual decision-makers at investment firms. Ms. Edkins noted that boards are actively reaching out to investors on hot-button issues such as compensation. Mr. Melvin noted that engaging with US board directors was often harder than engaging with their European counterparts.

- **Investors want more information about audit committee–related issues**

  While investors typically have had little interaction with audit committees, they are increasingly interested in information about the audit and the activities of the audit committee. Ms. Edkins and Mr. Melvin proposed that the audit committee report be enhanced to include more information on such issues as the audit process, the audit committee’s interactions with the CFO and internal audit, and its oversight of risk governance.

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1. Two other topics were discussed in main sessions at the summit. See Audit Committee Leadership Summit, “Enhancing audit committee reporting,” ViewPoints, May 2, 2013, and Audit Committee Leadership Summit, “Challenges of the global internal audit function,” ViewPoints, May 2, 2013.
2. ViewPoints reflects the networks’ 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 made before, during, and after meetings are not attributed to individuals or corporations. However, the
The “shareholder spring” was exaggerated, but the pressure on companies is real

Investor discontent has been on the rise in both North America and Europe, and with it the pressure on boards to address investors’ concerns and engage more closely with them. During the 2012 annual meeting season, the activity that took place in Europe - described by some as a “shareholder spring” - included high-profile votes against CEO pay packages and more investor scrutiny on other issues as well. In the UK, the chief executives at AstraZeneca, Aviva, and Trinity Mirror stepped down in the face of pressure from investors, while in France, a large majority of shareholders voted against a departure payment to the Air France-KLM chief executive.

In North America, shareholder proposals involving annual director elections and majority voting standards continued to receive more than 50% support. As in Europe, there were more advisory votes against executive compensation packages as shareholders exercised the say-on-pay rights mandated by the Dodd-Frank Act and implemented in 2011. Though it is rare for shareholders to reject executive pay packages, it happened more in 2012: 2.2% of the time, compared with 1.3% in 2011. These votes led to a few high-profile CEO departures, such as that of Vikram Pandit at Citigroup.

A number of issues emerging or re-emerging in 2013 are maintaining the pressure on boards to engage with shareholders. Compensation will continue to be a lightning rod, and other issues that could draw interest are board composition and leadership, environmental and social responsibility issues, and audit committee oversight of the external auditor. By late February 2013, investor and public outcry forced Novartis to abandon a $78 million payment to its departing chairman, a revolt that came two weeks before the successful Swiss referendum on establishing a binding shareholder vote on executive compensation. In the United States, Hewlett-Packard’s major investors requested a meeting with the board to discuss the company’s recent missteps, including the criticized acquisition of the software firm Autonomy. At the company’s annual meeting in March, several directors received only narrow levels of approval from shareholders, which led to the resignations of the chairman from his post and two directors from the board.

Meanwhile, legislators and regulators are raising corporate governance issues that, in some cases, involve the audit committee and its oversight of the external auditor. Audit policy legislation is slowly advancing through the European Union, and the Public Company Accounting Oversight Board continues to debate audit profession reforms in the United States.

Putting the “shareholder spring” in perspective

While the recent expressions of investor discontent formed a backdrop for the summit discussions of board-shareholder engagement, the guests began by putting the events in perspective. Mr. Melvin said, “The term ‘shareholder spring’ – I’m not happy with it. There were fewer votes against management, and the votes against were concentrated. The pay vote was used to express disagreement about other things.”

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1 Ernst & Young, *Four Key Trends of the 2012 Proxy Season: Engagement Drives Change* (Ernst & Young, 2012), 7.
3 Ernst & Young, *Proxy Season 2013 Preview: Insights on Topics of Investor Focus and Expectations of Engagement* (Ernst & Young, 2013), 2-3.
He went on to note that the votes against management may have been influenced by other factors in addition to shareholder anger: “In the UK, new regulations, the stewardship code, and [British economist] John Kay said fund managers need to try harder, [reflecting] awareness of their responsibility as owners. Fund managers might have used votes against management as a way to show that they were trying harder. Will it happen again? Probably not.”

Ms. Edkins agreed that the idea of a revolt by shareholders was an exaggeration, and she also suggested that proactive engagement by companies was a mitigating factor: “There was a lot of noise, there were a few high-profile cases, but, broadly, shareholder behavior was not that different because companies had made a much greater effort to engage in advance of the meetings to deal with uncertainties.” According to Ernst & Young’s preview of the 2013 proxy season, “The rise in company-shareholder engagement was the defining corporate governance trend of 2012 … Engagement continues to improve, with many management teams and boards showing a greater willingness to have substantive dialogue with shareholders.”

Ms. Edkins predicted continued pressure on companies that are not responsive to shareholder demands: “The companies that got high levels of votes against and made no change will face higher levels of pressure this year. Even the most conservative investors recognize that you must increasingly escalate pressure on boards to respond.” She noted that companies that got low say-on-pay votes last year will have bigger votes against their pay packages if they are not seen to have addressed the issues.

Understanding investor concerns around executive compensation

The issue of executive compensation is undeniably stirring passions among the public and policy-makers. In what ways, however, does this issue actually matter to investors? The guests explained their views regarding two distinct aspects of compensation:

- **Levels of compensation.** The guests and several members agreed that executive compensation has often been excessive. One member said, “Top management is compensated to an extent that is obscene. If one principle of corporate governance is that directors have to represent the interests of the company, it appears that in some cases, CEOs defend their own interests. The justification that they will leave is just an excuse. Compensation committees don’t say anything. If the CEO is doing a fantastic job, it’s OK. But if not …”

Yet the absolute level of compensation is not a concern for investors. Mr. Melvin was very clear: “Although of public and political interest, the amount of pay is not a material consideration for most investors.” In fact, as noted above, he said that when investors voted down pay packages, pay was often not the real issue. Ms. Edkins remarked, “This year, compensation remains a hot-button issue. It’s sad, because it’s very seldom executive pay that causes companies to fail.”

- **Incentive structures.** The bigger concern for investors is incentives. Mr. Melvin noted, “Remuneration committees are more worried about the amount of pay, while investors are concerned about how to align management incentives. We’re more interested in the motivational aspects of pay.” However, investors and boards alike agree that compensation structures may be too complex. Mr. Melvin recounted, “We at Hermes have arranged a series of meetings between remuneration committee chairs from the UK’s largest companies and their pension fund shareholders and we are going to publish some high level principles for executive compensation. We’re hearing from remuneration committee chairs that they would like to see more clarity, less complexity, better alignment around bonuses, and shares held for the longer term.”

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Ernst & Young, Proxy Season 2013 Preview, 1.
Ms. Edkins explained some of the difficulties involved in establishing effective incentive structures, which may be one reason they are of concern to investors: “Before, there was an intent to align incentives with management and shareholders. But share-based compensation failed. Some suggest paying executives in cash and requiring them to buy shares in the market. This will make management into shareholders in a meaningful way. On deferred compensation, the longer you defer receipt of something, the more you discount the value of it. This effect will make executives demand higher levels of deferred compensation.”

Members and guests agreed that compensation issues should not overshadow other issues that investors need to focus on. A member reflected, “Remuneration is a hot topic among investors. Is there a misalignment, in your view? You as investors should go deeper than compensation to the real things that make companies tick.”

Investors want to engage proactively, but selectively, with boards

The investor guests at the summit were very much in favor of direct engagement between shareholders and board directors when circumstances call for it. Both boards and shareholders stand to gain, and both should reach out to the other. Ms. Edkins said, “Boards should engage with shareholders. It’s good to get an unfiltered view from shareholders. Advisors and management will filter their views. Directors should have a channel through which they can hear directly what shareholders are saying.” Mr. Melvin said, “One of our tasks is to build bridges to boards. Talking to investor relations, the legal department, or the corporate social responsibility team doesn’t get change. We need to talk directly to boards.”

Selective engagement

At the same time, investors cannot engage with the boards of all the companies in which they have a stake. Limited resources require investors to rely on intermediaries for research, guidance, and voting services. Both Ms. Edkins and Mr. Melvin acknowledged that proxy advisors such as Institutional Shareholder Services (ISS) and Glass Lewis play an important role. Ms. Edkins explained, “We do depend on ISS to vote because we vote at 15,000 meetings a year and you would be concerned if we didn’t vote. If we tried to do the research ourselves, our corporate governance team would be bigger than our investment teams. So we read their research, we rely on them for basic logistics, and we use them to execute our voting decisions.”

However, Ms. Edkins said, the research from proxy advisors is not always the final word: “We use it to identify meetings that have votes we need to look at closely. The vast majority of companies have few issues, and it’s routine. We focus instead on the 20–30% of companies where ISS has identified issues.” Mr. Melvin described a similar approach but lamented the outsourcing of votes: “We also use ISS and Glass Lewis. We develop templates and focus on key meetings, but a bigger problem is that investors can’t justify spending more time and effort on this. Why can’t the investment industry and its clients see that voting the stock is an important responsibility? To treat this vote as a matter of compliance rather than stewardship seems to be wrong.”

Approaches to improve engagement

An article in the 2012 International Corporate Governance Network (ICGN) yearbook\(^\text{10}\) proposed several key changes to improve board-shareholder engagement, including a shift in mindset from confrontation to collaboration and a new set of principles to guide engagement. These principles emphasize proactive engagement and early, more open communication; non-executive directors should be fully informed and

willing to discuss a broad range of topics, bypassing intermediaries in order to speak directly to long-term investors.

Summit guests and members discussed both board and investor approaches to make engagement more effective:

- **Investors can build relationships with companies.** Mr. Melvin explained, “Our approach is to build strong relationships with companies when they are doing well. For example, I recently met with the senior legal officer of a large bank. We have no concerns now, but we want access to the lead independent director and to develop a positive impression of Hermes. We want to build these relationships so that if there is an issue in the future, there are people we can work with to promote the success of the companies in which our clients invest.”

  Mr. Melvin acknowledged that the process can be challenging: “Our access to board directors varies by market. We have 500 board engagements a year. The US is a difficult market to get access to board members. Our techniques for engaging with boards need to vary by country. We will talk to different levels within a company. Often, we work with investor relations or the legal department, who recognize a problem and help us seek higher access to get change.”

- **Boards can focus on the right investors and decision-makers.** Members and guests discussed the different kinds of investors companies encounter, including investors with very specific agendas or short investment horizons. Of the latter, a member said, “They invest with a purpose that may not be aligned with the long-term strategy of the board.” Mr. Melvin noted, “The issue is the negligence of short-term traders. They are not interested in quality of management, although there is usually no specific intent to disrupt the firm.” Ms. Edkins described how companies can reach long-term investors: “Companies should set out their long-term strategy. The board can put out a roadmap with milestones. They should tell their story well.” A member noted that short-term investors can do little without the support of long-term investors: “They have limited votes, so they have to convince other shareholders.”

  A member asked whom boards should be talking to at investment firms: “We’ve engaged quite actively with investors and sought their input, but when we see different people do the voting – not the people we met with – it’s frustrating when the votes are different. So whom do we engage with, the corporate governance people or the portfolio managers?” Ms. Edkins responded, “At BlackRock, portfolio managers would defer to corporate governance, because pay, for example, gets technical. You need to ask who makes the decisions.”

- **Boards can proactively reach out on hot-button issues.** Ms. Edkins described recent outreach efforts by remuneration committees: “[BlackRock’s] London team has received 150 letters from compensation committee chairs about changes to pay policies and wanting to confirm support in advance. We’ve also had requests to review in advance remuneration reports before they go into the annual reports. Companies are very nervous about pay.”

The ICON article on engagement mentioned a number of potential obstacles to effective engagement, including not only the resource constraints that require selective engagement, but also concerns about liability and opposition from management.11 Ms. Edkins dismissed the legal concerns: “The other thing that is overblown is the legal aspect of directors and shareholders talking. If a company believes its directors are not equipped to manage the boundaries in a discussion with shareholders, it has bigger problems.” Members were more wary: “I am often advised by legal advisors not to engage as much. With a pending legal case, can you engage with shareholders?”

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11 Ibid.
Investors want more information about audit committee–related issues

Though some investors would like to build better bridges to boards, there is little direct engagement between investors and audit committees, except where accounting issues have been identified. Guests and members reported little interaction between the audit committee and investors, especially compared with compensation committee chairs or board chairmen/lead directors. One member remarked, “In seven years as an audit committee chair, I met once with investors. As a new compensation committee chair, I have already had four meetings with investors.” Ms. Edkins offered an explanation: “One reason that we are not engaged with the audit committee is that accounting issues are taken up with management. There’s a strong sense that the external auditor does not see the audit committee as its client, but sees the CFO as the client. People believe that if you want to understand the audit process, talk to the CFO.”

One member questioned whether the low levels of engagement are a problem: “I’m uncomfortable with the idea that there should be more engagement between shareholders and audit committee chairs. It’s different for the compensation committee chair, who has to make decisions and where standards are less specific than in accounting. So it’s appropriate that there are few communications between audit committees and shareholders.” Other members and the guests disagreed, however, noting that it would be “helpful to talk about issues.”

Investor interest in the audit committee

While the level of direct engagement may be low, the guests noted that investors increasingly want more information about the audit and the audit process, including the audit committee’s oversight of the process. Mr. Melvin explained, “We want to trust the numbers produced through the process. We don’t get a lot of information right now. The audit report is very limited. There are proposals to address this, in the UK, for example – should the external auditor report on its audit judgment to the company? For key accounting judgments, the report should tell us about the key issues and the debate between the audit committee and the external auditor. Auditor tenure should be discussed in the report.” Members are less attracted to the idea of the auditors disclosing more information.12

Other elements of the audit committee’s work are also of interest, Mr. Melvin noted: “Since the audit committee has an important role in oversight of risk management, we would like more information about it. We want to understand more about the dialogue and debate on these issues.” While more communication from the audit committee would be helpful, investors are not looking to vote on audit-related issues such as when to retender the audit. Ms. Edkins remarked, “We are wary of mission creep; shareholders are being brought in to more matters that are the responsibility of the board. We do not want to end up in a situation where we are expected to vote to approve every board decision. We already vote on too many issues and we are resourced constrained.”

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Investors’ views on mandatory audit firm rotation are mixed

Investors care about audit quality and the health of the market for audit services, but they disagree on the means for achieving these goals. Last September, a coalition of European investors wrote a letter expressing support for mandatory rotation every 15 years. At the summit, Ms. Edkins and Mr. Melvin expressed a different view. Ms. Edkins said, “We are not in favor of mandatory rotation. It’s not necessarily the solution to the problem. There are other ways to address the issue of professional skepticism and auditor independence.” Mr. Melvin agreed: “We do not favor mandatory rotation. There could be more competition in audit markets, but this isn’t the measure to use.”

Enhancing communication via audit committee reporting

Ms. Edkins and Mr. Melvin noted that the audit committee report could be a vehicle for more communication from the audit committee. Ms. Edkins said, “The audit committee report is very dry – it’s not informative. In Europe, there are good examples of reports. “While protecting commercial sensitivity and the confidentiality of the information known to the committee, the reports give you a flavor of the thoughtfulness and robustness of the discussions of the audit committee with management and the audit partner.”

Ms. Edkins listed some of the elements that investors would be interested in seeing in the report:

- The audit committee’s views on audit policy issues such as mandatory firm rotation
- The audit committee’s process for overseeing the external audit and auditor
- How the audit committee interacts with the CFO and internal audit
- The audit committee’s role in risk governance

Mr. Melvin told the audit committee chairs, “In the context of the increased scrutiny, you’re doing well. We’re looking for a description of what you’re doing, to understand specific issues between you, the company, and the numbers.” Closing the session, Mr. Melvin said, “Better reporting will lead to greater confidence” – an apt segue to the session that followed.
Members’ views on audit committee reporting

In a members-only session, members discussed the rationale for improving the audit committee report, the elements that might be included in such a report, and the potential obstacles to changing it. A number of elements often appear in the more transparent reports:

- A personal statement from the committee chair
- A summary of issues discussed at each committee meeting
- A discussion of how the external auditor was evaluated
- Detail on the committee’s work with internal audit
- A description of how the committee reviewed risk governance and other topics beyond financial reporting and accounting

Members agreed that, wherever permissible in a particular jurisdiction, the report should explain more clearly the work of the audit committee to investors and other stakeholders. They were divided, however, on how much more information an improved report should include. One member said that providing details on accounting estimates and judgments should only happen on an exception basis. Others were wary of a slippery slope leading to excessive disclosures and overly lengthy reports.

Conclusion

Though the overall behavior of investors has not been as dramatically different in recent years as some observers have suggested, investors are seeking greater engagement with boards, and the issue of executive compensation continues to be a focus of attention. Notably, however, investors are less interested in the absolute levels of compensation than in the incentive structures that shape executive behavior. Though investors will continue to use the services of proxy advisory firms, they want the opportunity to develop stronger direct relationships with boards. They also want more detailed information about the work of the audit committee and the audit process, including the audit committee’s oversight of the process. An enhanced audit committee report could be one vehicle for explaining more clearly to investors and others what the audit committee does. More transparency in general, the guests argued, would help investors and boards align their interests and promote the long-term success of their companies.

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13 Audit Committee Leadership Summit, "Enhancing audit committee reporting."
About this document

The European Audit Committee Leadership Network (EACLN) and Audit Committee Leadership Network (ACLN) are groups of audit committee chairs drawn from leading European and North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The networks are organized and led by Tapestry Networks with the support of Ernst & Young as part of its continuing commitment to board effectiveness and good governance.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management and their advisers as they endeavour to fulfil their respective responsibilities to the investing public. The ultimate value of ViewPoints lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive ViewPoints are encouraged to share it with others in their own networks. The more board members, members of management and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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Appendix 1: Guest biographies

Michelle Edkins

Ms. Edkins is a managing director at BlackRock and global head of its corporate governance and responsible investment team, which consists of 20 specialists based in five key regions internationally. In that role, she is responsible for the team’s engagement and proxy voting activities in relation to the companies in which BlackRock invests on behalf of clients. She also serves on the firm’s government relations steering committee.

Ms. Edkins is an active participant in the public corporate governance debate and regularly speaks and writes on the importance of good stewardship for company performance. She was named in the NACD (National Association of Corporate Directors) Directorship 100 Governance Professionals list for 2012. She is also a fellow of the Aspen Institute’s First Movers program and chairman of the board of governors of the International Corporate Governance Network.

Prior to joining BlackRock in 2009, Ms. Edkins was managing director at Governance for Owners, an independent partnership offering products that support responsible long-term share ownership. She started her corporate governance career in 1997 at Hermes Pensions Management, where she spent eight years, initially as the head of the corporate governance team and thereafter as director of institutional relations. An economist by training, Ms. Edkins has also worked for New Zealand’s central bank and the British High Commission in Wellington. She now lives in San Francisco with her husband and two children.

Colin Melvin

As CEO of Hermes Equity Ownership Services, Mr. Melvin helps pension funds to become active owners of public and private companies, advising on responsible investment and corporate governance on £90 billion of assets.

Mr. Melvin is a member of the UK Commission on Ownership and the supervisory board of Eumedion. He has co-founded and led various investor groups and initiatives, such as the United Nations Principles for Responsible Investment, for which he was the first chairman. He currently chairs the Integrated Reporting Investor Network and is non-executive director and remuneration committee chair at Aedas, an architectural firm.

He is an associate member of the Chartered Financial Analysts Institute and holds an MA from Aberdeen University and an MPhil from Cambridge University, both in history, and diplomas in investment analysis and company directorship.
Appendix 2: List of participants

The following ACLN and EACLN members, who collectively sit on the boards of nearly 50 large-, mid-, and small-cap public companies, participated in all or parts of the summit:

- Denny Beresford, Audit Committee Chair, Legg Mason
- Les Brun, Audit Committee Chair, Merck
- Aldo Cardoso, Audit Committee Chair, GDF SUEZ
- Ángel Duránández, Audit Committee Chair, Repsol
- Michele Hooper, Audit Committee Chair, PPG Industries
- Judy Richards Hope, Audit Committee Chair, General Mills and Union Pacific
- Lou Hughes, Audit Committee Chair, ABB
- DeAnne Julius, Audit Committee Chair, Roche Holding
- George Muñoz, Audit Committee Chair, Altria and Marriott International
- Chuck Noski, Audit Committee Chair, Microsoft
- Tom O’Neill, former Audit Committee Chair, Archer Daniels Midland
- Pierre Rodocanachi, Audit Committee Member, Vivendi
- Guylaine Saucier, Audit Committee Chair, Areva
- Tom de Swaan, Audit Committee Chair, Royal Ahold
- Martine Verluyten, Audit Committee Chair, STMicroelectronics and Thomas Cook
- Bernd Voss, Audit Committee Chair, Continental AG
- Chris Williams, Audit Committee Chair, Wal-Mart Stores

Ernst & Young participants included the following:

- Tom Hough, Americas Vice Chair, Assurance Services
- Steve Howe, Managing Partner, Americas
- Christian Mouillon, Global Vice Chair, Assurance Services
- Mark Otty, Managing Partner, EMEIA
- Jim Turley, Global Chairman and CEO
- Mark Weinberger, Global Chairman & CEO-elect
Appendix 3: Discussion questions for audit committees

? What pressures did investors place on your companies and boards in 2012? Do you expect any changes in 2013?

? Are these pressures leading your boards to consider more engagement with investors?

? Are you confident that you have an understanding of all the significant requests coming from investors?

? What benefits do you see from more engagement?

? What risks or obstacles do you see?

? What topics do your boards feel are best handled by management, and which are best handled by board directors? Is there a stated policy?

? What type of investors should the board engage with: larger long-term institutional investors, activists, or others?

? What best practices for board-shareholder engagement have emerged?

? What engagement practices do you think your largest shareholders would prefer? How can different investor preferences and board preferences for engagement be accommodated?

? What topics do your shareholders want to discuss?

? In what ways and how frequently does the audit committee communicate with shareholders? How has your company communicated its stance on audit policy?

? Is the audit committee formally involved in the review of executive compensation metrics and disclosures?