1. Achieving Greater Engagement and Transparency

The paradigm of a company's senior management, investor relations team and/or corporate secretary serving as the only points of contact for shareholders, with communications limited to regularly scheduled meetings, conference calls or investor days, or discussions with analysts and portfolio managers at only a few major institutional investors, is fast becoming a relic of the past. Recent high profile proxy fights and activist attacks, the continuing influence of proxy advisory firms, the power and growing advocacy of institutional investors, the SEC's continuing attention to the relationship between directors and shareholders,[1] the impact of social media and the public's wavering confidence in corporations have combined to highlight the need for effective communication throughout the year. BlackRock Chairman and CEO Laurence D. Fink urged this approach in an April 2015 letter to the CEOs of the S&P 500 and the largest companies around the world in which BlackRock invests, calling for "consistent and sustained" engagement – not just during proxy season or at the time of earnings reports.[2]

Some companies are heeding this call and publicly disclosing their programs. Many of these companies are encouraging shareholders to communicate with them at any time of the year through online feedback forms, creating annual engagement calendars, and scheduling regular meetings with their shareholders to hear their concerns and provide meaningful information about the company.[3] Other companies are expressly assigning engagement efforts to existing board committees, such as the nominating and governance committee or, as suggested by Vanguard, to new committees with a sole focus on engagement (*e.g.*, Tempur Sealy International, Inc.'s Stockholder Liaison Committee[4]). Companies such as Allstate, Coca-Cola, EMC, PepsiCo and Prudential Financial have been noted as providing informative disclosure about their engagement programs.[5]

Engagement is not just an issue for large corporations; smaller companies are also facing shareholder pressure to engage. Since 2011, The California State Teachers' Retirement System (CalSTRS) has been targeting and engaging with Russell 2000 companies on majority voting, with an increasing number of companies adopting majority voting in response to a CalSTRS' letter sent in advance of the submission of a shareholder proposal.[6]

Should Directors Engage?

From their vantage point as long-term equity holders of nearly every publicly traded company in the U.S., institutional investors and large asset managers such as BlackRock and Vanguard have advocated that engagement – at least with investors such as themselves – should consist not only of interactions with management but also with the company's lead director or other independent members of the board. In a February 2015 letter to the independent board leaders of 500 of its funds' largest U.S. holdings, Vanguard Chairman and CEO F. William McNabb III encouraged enhanced discussion between directors and shareholders, emphasizing that boards that do this are "more likely to have stronger support of large long-term shareholders."[7] Vanguard's update on its proxy voting and engagement efforts for the 12 months ended June 30, 2015 described the goal of these efforts as providing "constructive input that will better position companies to deliver sustainable value over the long term for all investors."[8] While some boards remain hesitant, proponents of board engagement argue that it can help a board hear directly what shareholders are saying, articulate directly to shareholders the board's commitment to long-term strategy and, in the final analysis, establish a level of confidence in the integrity and independence of the board's stewardship that may help the company weather a future storm.

Transparency goes hand-in-hand with engagement. Just as there is no one mode of engagement, there is no one topic as to which greater transparency will satisfy the expectations of all investors all of the time. Different investors may seek enhanced disclosure regarding the company's business strategy, capital allocation plans, risk tolerance and management, board composition and refreshment, executive compensation, the impact of climate change on short- and long-term corporate performance, or a myriad of other ESG concerns. There are also a variety of vehicles for dissemination of these disclosures. To illustrate, some shareholders want to see social and environmental (sustainability) performance metrics applied and included in periodic reports (primarily the Form 10-K), while others are content with enhanced supplemental disclosure in the form of web-posted sustainability reports. Throughout this Alert, we offer suggestions for increasing transparency about ESG matters. *See Parts 5,6,7,8 and 9 below.*

As investors continue to make their case for engagement, the SEC Staff has made it clear that Regulation FD's ban on selective disclosure of material, non-public company information should not impede constructive engagement between directors and shareholders if desired by all concerned.[9] We provide some guidance in this respect immediately below.

What To Do Now:

- ***Design and Update Shareholder Outreach Programs.*** More and more companies are developing and disclosing formal shareholder engagement programs that extend throughout the year, not only in anticipation of proxy season. In developing such a program, a company should consider its governance profile and potential vulnerabilities, its shareholder base, and its most effective management and board participants. Engagement efforts should be individually tailored to what is of most importance to a specific shareholder. The engagement strategy should be assessed and updated periodically to reflect evolving practice and changes in the company's circumstances.
- ***Use Your Proxy Statement as a Communications Tool—Including about Outreach Itself***. A key opportunity for effective engagement is to use the upcoming proxy statement to put the company's best foot forward on governance. The proxy statement should clearly and concisely discuss matters that shareholders consider important in formulating voting decisions, including the qualifications of the board's nominees, board refreshment policies, oversight activities and the link between corporate performance and executive compensation. This year, if the company has not done so previously, consider highlighting the nature and results of shareholder outreach, including the number of times it took place during the year, who participated on behalf of the company, the total percentage of shares represented at these discussions, a general indication of the topics discussed, how shareholder feedback was conveyed to the board and taken into account (including, importantly, any changes in governance made in response to the feedback) and the channels of communication open to shareholders for engagement in the future. Proxy statement innovations such as the use of charts, figures and images help companies bring to life the story of the company's management, oversight, compensation practices, business practices and shareholder engagement.
- ***Understand Your Shareholder Base and the Positions of Shareholders***. It is critical for companies to understand the sometimes distinct positions of pension funds and other institutional investors on various governance issues. Not every institution follows the position of ISS or Glass Lewis on every issue. In addition, outreach to retail investors (who tend to vote at lower levels and to be less concerned with governance issues than institutions) should not be overlooked.
- ***Ensure Information Flow to the Board***. Particularly where directors do not participate directly in shareholder outreach, it is essential that the board regularly obtain information on any concerns expressed by major shareholders during the company's outreach efforts. A process should be in place to facilitate and organize an unfiltered flow of information from shareholders to directors, giving the board a more direct understanding of how shareholders have responded, or are likely to respond, to their decision-making.
- ***Engage with the Appropriate Contacts at Shareholders.*** Ensure that the person with whom the company is engaging on governance issues is the most appropriate contact to address these issues. The decision-making roles at institutions often are split between voting and investment.
- ***Select and Prepare Directors who will Communicate with Shareholders***. When director involvement is desirable, give thought to selecting the particular director or directors who will communicate with particular shareholders. In some cases, the selection will reflect position (e.g., independent chair or lead independent director); in others, relevant expertise to address the shareholder's key concern (e.g., chair of the compensation or nominating/corporate governance committee). Once identified, these directors should be briefed on the "dos and don'ts" of meeting with shareholders, including Regulation FD. Directors should be cautioned not to "go it alone" and instead to include in the discussion at least one other company representative, such as inside or outside counsel or someone from investor relations, human resources or finance.[10]

- ***Consider Regulation FD and Proxy Rules.*** Be mindful of Regulation FD, but do not use it as a shield or barrier to director-shareholder communication if you otherwise decide that such communication is in the company's best interests. For those companies that opt to authorize one or more directors to meet with shareholders, the SEC Staff recommends consideration of "implementing policies and procedures intended to help avoid Regulation FD violations, such as pre-clearing discussion topics with the shareholder or having company counsel attend the meeting."[11] To give their directors and/or other representatives ample FD protection when meeting with shareholders, whether in person or by telephone or videoconference, companies should provide full and fair disclosure of their key governance practices and any pertinent corporate performance metrics in their proxy statements and/or periodic reports.[12] (In this connection, companies should keep in mind the SEC Chair's recent admonition to ensure that non-GAAP financial measures are used appropriately in both SEC-filed documents and other, less formal communications such as earnings calls and releases.)[13] Equally important, companies should consider the need to file, as proxy materials, any written communications prepared by or on behalf of directors that are provided to shareholders in this context, depending on the timing of these communications and their relationship to any matters to be submitted to a shareholder vote at an annual or other meeting of shareholders.

2. Understanding the Spectrum of Shareholder Views

To understand the increasing shareholder emphasis on engagement and transparency, particularly as these twin objectives come into play in drafting the upcoming annual report and proxy statement and in preparing for the annual meeting, it is important for a company's board and management to recognize the spectrum of views likely to be found within the company's own shareholder base on such issues as corporate objectives, the time horizon for realizing these objectives and a variety of ESG issues. In this connection, it may be helpful to step back and consider how current trends in shareholder activism and recent public stands by major institutions may influence the voting and investment behavior of your shareholders.

Current Trends in Activism

Today the term "activism" encompasses a wide variety of investor priorities and views – from "traditional" governance matters such as separation of the roles of CEO and board chair, elimination of classified boards and now proxy access, to changes in capital allocation policies and the more immediate realization of economic returns, to a host of sustainability issues such as disclosure of corporate political contributions and lobbying expenses, human rights and sustainability reporting. It is becoming increasingly difficult to divide shareholders into the traditional categories of those focused on long-term equity ownership and therefore long-term corporate performance goals; hedge funds and others seeking short-term profitability and a quick exit; single-issue governance activists; and those primarily concerned with environmental/social/human rights issues. For example, a combination of specific ESG concerns prompted the New York City Comptroller to launch an unprecedented proxy access campaign last year and to expand this campaign in 2016.[14] *See Part 3 below*.

Activist hedge funds launched 360 publicly announced campaigns during 2015, compared to 301 during 2014.[15] The actual number of activist campaigns is likely much higher, as it is estimated that less than a third become public.[16] During 2015, activists focused on promoting M&A transactions and strategic corporate alternatives such as spin-offs, split-offs, or divestitures; operational improvements; changes in the board and/or management; and immediate returns of value to shareholders through special dividends or share buybacks. One estimate of the "success rate" of publicly announced campaigns finds 62.5% of such campaigns at least partially successful in achieving their desired outcomes in 2015, up from 59.9% in 2014.[17]

Contributing to that success was support from mutual funds and public pension funds, which, in some cases, even partnered with activist investors in their campaigns. For example, the percentage of dissident proxy cards that BlackRock, T. Rowe Price and Vanguard have voted to support has increased every year since 2011.[18] Mutual funds sided with Starboard in a successful campaign to replace the entire board of Darden Restaurants and in a campaign at General Motors.[19] Furthermore, CalSTRS, the second largest pension fund in the US, is increasingly investing in, or co-investing with, activist funds that targeted individual companies such as DuPont, PepsiCo and Perry Ellis International.

Perhaps the most significant development in shareholder activism during 2015 has been the increase in settlements between activists and target companies. In a recent survey, over 90% of the most prolific activists noted that they found it less difficult to reach a resolution with management than in prior years.[20] In particular, companies increasingly are granting activists board seats as part of a settlement. Recent high-profile settlements include ConAgra Foods agreeing to a board settlement with Jana Partners, and Trian naming an advisor to the board of PepsiCo and gaining two board seats at Sysco and a board seat at BNY Mellon.

In some instances, companies have even welcomed activists as significant investors. In October 2015, Trian Partners (founded by activist Nelson Peltz) announced that it had invested $2.5 billion to become a top ten shareholder of GE, the result of dialogue between Mr. Peltz and members of GE management.[21] Mr. Peltz, who reportedly did not request a board seat for Trian, issued a white paper faulting the stock market for undervaluing GE.[22]

The Institutional View

While the interests of hedge funds and institutional investors may align in certain circumstances, major institutional shareholders and asset managers have taken a public stand on the importance of companies taking a long-term approach to creating value. For example, in his April 2015 letter to CEOs, BlackRock Chairman and CEO Laurence D. Fink strongly advocated this approach despite "the acute pressure, growing with every quarter, to meet short-term financial goals." Mr. Fink acknowledged that returning capital to shareholders can be "a vital part of a responsible capital strategy," and that some activists take a long-term view and foster productive change. However, he expressed deep concern that many companies have undertaken actions such as stock buybacks or increased dividends to deliver immediate returns to shareholders "while underinvesting in innovation, skilled workforces or essential capital expenditures necessary to sustain long-term growth." He indicated that BlackRock's "starting point" is to support management, particularly during difficult periods. Making a compelling case for enhanced transparency, however, Mr. Fink emphasized that this is more likely to occur where management has articulated its strategy for sustainable long-term growth and has offered credible metrics against which to assess performance.[23]

BlackRock and Vanguard have both publicly cautioned that they will actively engage with companies on governance factors that, in their view, detract from long-term, sustainable financial performance." [24] For example, in his February 2015 letter to independent board leaders (also discussed in *Part 1 above*), Vanguard Chairman and CEO McNabb stated that "some have mistakenly assumed that our predominately passive management style suggests a passive attitude with respect to corporate governance. Nothing could be further from the truth." Vanguard espouses six governance principles: (1) a substantially independent board with independent board leadership; (2) accountability of management to the board and of the board to stockholders; (3) shareholder voting rights consistent with economic interests (one share, one vote); (4) annual director elections and minimal anti-takeover devices; (5) executive compensation tied to the creation of long-term shareholder value; and (6) shareholder engagement. The voting record of the Vanguard funds for the 12 months ended June 30, 2015 indicates that the funds largely supported management's nominees and say-on-pay and other proposals. However, there are clear instances in which the funds used their voting power to signal a need for improvement or to effect changes in the board.

Because the pace and pressures of shareholder activism continue to escalate, it is all the more important for a company's management and board to meet the institutional calls for meaningful ongoing engagement and to prepare for activism even during periods of relative calm and corporate profitability. We offer some suggestions below for anticipating and addressing an activist challenge, recognizing that each company must formulate its own approach in light of the relevant facts and circumstances.