GOVERNANCE

September 2018 Issue 289

What price climate change?

‘A lack of consistent financial evaluation of the timing and scale of climate change impacts was cited as a barrier by several respondents – and this was linked with another barrier, the perceived gap between the long-term effects of a warming climate and a much shorter-term focus to most boardroom discussions.’

David Archer and Alex Cameron

Shareholder engagement

‘As US-based investors build out their engagement teams in Europe and beyond, and European-based investors grow their presence in the US, a continued cross-pollination of engagement themes and styles is a likely result. Being able to adroitly navigate the shifting landscape will be a defining challenge for companies and boards in the years ahead.’

Bob McCormick and Rob Zivnuska

Content

Essential, Authoritative Analysis and Opinion for Board Directors, Senior Executives, Investment Professionals and Advisers

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Shareholder engagement

Bob McCormick and **Rob Zivnuska** consider how companies can navigate a complex shareholder engagement landscape.

Building successful, long-term relationships with shareholders through engagement is increasingly important as well as increasingly challenging for UK companies, particularly those with large US-based or other international shareholders who follow varied approaches to meeting with companies. Engagement today is a year-round activity that includes ever-larger index investors and covers a broader range of topics and meeting styles. To ensure such engagements are productive in developing strong relationships with a changing investor base, companies must develop a bespoke approach that takes into account the history, priorities and practices that have shaped the rise of global investor stewardship teams.

Differing styles of engagement

One of the most significant differentiating factors between engagement styles in the UK and the US has been the role of directors. Consistent with the Corporate Governance Code, in the UK board Chairs generally lead engagement efforts, often without a representative from the executive team. However, in the US engagements are traditionally led by the executive team, nearly always including the corporate secretary, head of investor relations or equivalent business leader. While director participation in engagements in the US is increasing, directors typically participate in US investor meetings when there are significant concerns on board-centric topics such as CEO performance, executive remuneration, or board composition. Even when discussing these types of topics, some investors prefer not to engage with directors, believing that discussions with executives are more informative.

UK issuers familiar with the long tradition of a detailed corporate governance code in their home country will encounter a more varied approach in the less prescriptive principles in the US. The more uniform approach among companies and investors in the UK is driven by the Stewardship Code[1] as well as the long-standing and recently-updated Corporate Governance Code which now imposes substantial reporting obligations on companies to consult with shareholders when more than 20% of votes are cast against a resolution supported by the board. In the US, such codes have only emerged in the last few years – the Commonsense Principles[2] and those established by the Investor Stewardship Group[3] – and neither is followed with the same allegiance as those in the UK. Among other differences, the UK Code embraces a ‘comply or explain’ approach whereas the US principles are merely advisory and geared toward creating minimum standards that complement America’s multi-faceted federal, state and exchange-based regulatory model.

Another substantial difference between the US and the UK is collective versus individual engagement. In the UK, investors frequently conduct group engagements with companies, allowing issuers to hear the views of several investors at the same time, often with a high level of consensus consistent with the Corporate Governance Code. This process, which can facilitate decisions in the boardroom, is not part of engagement culture in the US due in part to US regulatory standards that make legal or compliance teams uncomfortable with activities that might create an appearance that investors are acting as a ‘group’ (thereby triggering new filing requirements), US investors are accustomed to engaging one-on-one with issuers and differ even about fundamental governance issues such as the appointment of an independent board Chair.

Rise of investment stewardship in the US

The implications of these differences have become increasingly relevant over the past decade as shareholder registers have been transformed by the dramatic shift of assets from active to passive funds. Today, many companies around the globe, including those in the UK, have as their largest investors the US-based asset managers Blackrock, Vanguard and State Street Global Advisors. The broad shakeout of the asset management industry has had widespread impacts ranging from the consolidation of active managers to increasing scrutiny of, and competition among, passive fund managers regarding their attentiveness to investment stewardship activities.

Indeed, in response to both requirements from initiatives such as the PRI[4] as well as client demands, US-based asset managers are now much more proactive about engaging issuers around the globe on issues that they view as risks to or opportunities for long-term value creation. To meet that need, passive managers (and some active managers as well) are building larger, more specialised global governance and voting teams. BlackRock, which has had governance analysts located in the UK for some time, for example, plans[5] to double the size of its global investor stewardship team within the next few years. Vanguard has also grown its stewardship team and relocated[6] to the UK one of its seasoned governance analysts to establish a new, regionally-focused function responsible for direct engagement with boards and executives and proxy voting at European portfolio companies on behalf of Vanguard’s global funds.

Investment style can determine engagement style

A key to successfully navigating engagement with these growing investment stewardship teams is to understand how

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asset managers' investment styles, as well as their personnel, dictate their approach. Engagements with the governance teams at large index funds require a different approach than meetings with an investment analyst steeped in the story of the company and its industry. Company representatives should be prepared to provide index funds' governance analysts some background on the company, its competitive environment, performance history, capital allocation decisions, approach to sustainable business practices and overall strategy.

Among active managers, the governance discussions may include portfolio managers (PMs) and equity analysts who will want to discuss business strategy and performance, as well as specialist investment stewardship teams. Investment stewardship teams at active firms will routinely consult with PMs and analysts around financially significant voting decisions like mergers and acquisitions. While some firms prefer a PM-led voting model, others have investment stewardship teams lead the voting decisions with varying levels of input from the investment team. Regardless of their investment approach, companies should understand the engagement approach taken by each investor and the specific individuals with whom a company will be meeting to facilitate a more efficient and fruitful meeting.

Adding to the complexity of potential variation within a company's investor base is the additional question of where an investor's engagement team is located. Several large US global investors have governance analysts based in London who have deep local market expertise and are available to engage in-person with UK companies, promoting the development of closer relationships between the companies and these investors. However, not all US investment firms have UK offices and, even some that do have investment personnel in the UK, locate their global stewardship teams in the US; therefore engagements with these investors' governance analysts generally take place by telephone. To further underscore the need for a thoughtful approach to engagement, some investors maintain distinct UK (or global) and US entities, meaning that companies may have to engage with different groups of governance analysts from what may initially appear to be the same investment firm.

Governance teams expand the scope of their interests

Greater resources dedicated to investment stewardship means that investors have more capacity to engage in increasingly detailed discussions on a broad range of subjects beyond standard board, governance and remuneration themes. Issuers can expect that a typical governance engagement discussion may also touch on a range of environmental and social (E&S) issues such as human capital management, supply chain integrity, climate risk disclosure and pay equity. Investors may also inquire about the board's role in establishing, maintaining and overseeing corporate culture.

As the benefits of shareholder engagement have become more broadly appreciated by both US issuers and investors, many investors now receive many more engagement requests than they have capacity for. As a result, securing a meeting has become increasingly difficult. Some US-based investors will only allot one call or meeting each year, raising the stakes around the decision to engage either on a preliminary basis to solicit feedback or closer to the AGM to seek support for actions they have taken. Companies that otherwise enjoy strong support from shareholders but that still want to engage may need to provide a compelling reason when requesting a meeting since some investors will decline meetings in the absence of company-specific concerns. Understanding the expectations and needs of each firm with whom issuers seek to engage is more important than ever in securing an engagement opportunity.

Role of proxy advisors and E&S research firms

UK companies should also take into account the role and impact of proxy advisors and environmental and social (E&S) research and ratings firms in their broader engagement plan. Engaging with proxy advisors to ensure open lines of communication regarding investor feedback is considered a best practice. In addition, understanding how investors use proxy advisor data and whether and to what extent investors depend on the advisors for voting recommendations or have their own proxy voting guidelines is a key to having successful engagements and securing investor support.

Issuers should also be aware of how their sustainability policies and practices are being represented in reports generated by E&S research and ratings providers such as MSCI and Sustainalytics. While investors and issuers alike review the reports created by these providers, the data collection processes at such firms are challenged by the lack of standardised disclosure regimes. Companies should engage with investors and ratings firms to ensure that both parties accurately understand the company's E&S practices and risk mitigation structures and initiatives.

Meet investor expectations by knowing your audience

Understanding the priorities and engagement practices of US-based investors, and devising a bespoke approach to approaching and meeting with top shareholders, is a key consideration in building and maintaining successful relationships in a dynamic market. While many global investors may acknowledge and adhere to the traditions of a company's home country in engagement and voting decisions, some employ a more universal approach across borders. As US-based investors build out their engagement teams in Europe and beyond, and European-based investors grow their presence in the US, a continued cross-pollination

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of engagement themes and styles is a likely result. Being able to adroitly navigate the shifting landscape will be a defining challenge for companies and boards in the years ahead.

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1 https://bit.ly/2xdX9Kx
2 https://bit.ly/2MwjOqT
3 https://bit.ly/2QrH38S
4 https://www.unpri.org
5 https://bit.ly/2p26Ql3
6 https://www.vanguard.co.uk/documents/portal/press_releases vanguard-appoints-adrienne-monley.pdf

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