WHITE PAPER I THE IRO'S ROLE IN PROXY ENGAGEMENT AND MESSAGING

The IRO's Role in Proxy Engagement and Messaging

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Proxies continue to evolve from SEC-focused disclosure documents to investor-focused communications pieces

This important trend started over two decades ago when a few enlightened management teams decided that rather than merely sparring with institutional proxy voters once a year — a process that often left both sides more frustrated than informed — they would reach out to shareholders outside of proxy season in order to get to know them and what drove their voting philosophy and practices. These forward-thinking management teams quickly learned that when it came time to vote on director elections, executive compensation and a range of other issues, investors felt they needed more and different information than what the SEC requires companies to disclose in the proxy (i.e., Form 14A). The trend to include additional "voluntary" information in proxies, such as business context and strategy, as well as the rationale behind board, governance, compensation and other actions requiring shareholder-voting support, has steadily accelerated in both breadth and intensity.

I remember being pleasantly surprised during the 1980s — well before Say on Pay — to see a couple of companies within otherwise dry and often boilerplate proxies clearly articulate the link between their equity plan request and their business model and company strategy, and to observe firsthand the overwhelming support these proposals received.

IROs play a significant role in crafting this voluntary, contextual proxy content.

Investors are asking companies to incorporate business strategy into their proxies

Traditionally, discussion of strategy is contained in the annual report/10-K, whether in the CEO or board chair cover letter, MD&A or elsewhere. However, the "voters" at many institutional investors, who may be distinct from the portfolio managers who know your company and consume your IR disclosures, are time- and resource-constrained, tasked with voting at hundreds or even thousands of portfolio companies. (That's just their U.S. portfolio holdings — many also vote their international portfolios as well.) While they try to vote thoughtfully at each company, they barely have time to review the proxy and often cannot review additional documents, such as the annual report, your IR communications or analyst research reports. For these reasons, they say, "If you want us to take information into account when voting, please put it in the proxy."

Examples of the types of information proxy voters are clamoring for include:

1. How the board skill set aligns with company strategy — focus on board diversity

Investors today are less inclined to rubber-stamp incumbent boards than they were in the past. BlackRock, State Street Global, CalSTRS and others believe that board diversity (gender being a primary component but not the only one) provides companies with a competitive advantage. They also want to know that the board contains the right mix of skills to enable it to provide appropriate oversight of management and its execution of business strategy and to meet the company's current and anticipated needs. The New York City comptroller's office, among others, seeks information on board diversity, including information provided through detailed skills and attributes matrices, but it does not just want to know what the skills are; it also wants to know how each skill fits the company's strategic needs. In response, companies are sharpening these descriptions:

Jacobs Engineering

Keycorp

Prudential Financial

PSEG

Unum

2. How the executive compensation program and incentives align with company strategy

While executive compensation is often complex and multilayered, what traditionally has been missing is clear and credible statements of how the compensation program and the behaviors it incentivizes and rewards tie into and support achievement of the company's business strategy and its efforts to increase shareholder value. Investors have been asking for years, even before Say on Pay and CD&As, "How does pay support strategy?" Recently, more companies are tackling this question head-on.

Amgen Inc.'s CD&A summary

3. Company sustainability in the face of climate change — what are a company's strategies, or risk factors, in the event of climate-related regulatory, competitive, business model and technological change?

Whatever your views on climate change and its causes, it's important to recognize that an increasing range of investors accept the notion that climate change is real. Therefore, climate change, like any other risk factor, poses a risk to company sustainability and thus to long-term shareholder value if not adequately addressed. For this reason, investors increasingly are asking companies to discuss not just their impact on the environment, but the potential impact of environmental change on the company, and they want to find these topics discussed directly in the proxy, as well as in stand-alone CSR or other reports. While the first tier of targets of interest in climate-change disclosures includes energy producers and energy users, this focus will continue to cascade to and include other industries. It is no longer confined to a small but vocal group of climate-sensitive investors. Larger mainstream investors, including BlackRock, Vanguard and others, have recently focused on climate impact as an emerging risk factor.

The growing influence of indexed or "IR-immune" investors

According to Bloomberg, "A little more than a third of all assets in the U.S. are in passive funds, up from about a fifth a decade ago. In the first half of 2017, flows out of active and into passive funds reached nearly $500 billion. The biggest winners have been BlackRock and Vanguard Group Inc., whose founder, John C. Bogle, created the first index fund for retail investors."[1]

Three largely indexed investors, BlackRock, Vanguard and State Street Global, control 20 percent or more of the equity at many publicly traded companies. While these investors do subscribe to the services of ISS, Glass Lewis and other proxy advisers, they make their own voting decisions. That means that these three investors can collectively have a greater impact on the vote than do the proxy adviser recommendations themselves. As "passive" or "IR-immune" investors, they do not typically absorb your company's IR messaging. However, their investment stewardship teams are increasingly active, and their toolkits go beyond voting to include engagement and filing or supporting their own shareholder proposals or those of activists. Indexed investors have become a key voting group with which companies need to engage and build relationships, and so it makes sense to fortify your proxy with the IR and strategic contextual information that otherwise may not factor into these investors' voting processes and decisions.

Company engagement teams are expanding

Attorneys typically retain primary control over the content of the proxy and are involved in investor engagement. That said, to help meet broadening investor informational needs, attorneys are increasingly seeking help from colleagues in investor relations, HR/compensation and benefits, risk management and CSR, so that these skill sets can inform and be incorporated into the proxy drafting process.

As for investor engagement, while some investors may want to hear directly from the board, or at least a particular committee chair, most U.S. investors are satisfied to engage with management, provided that management is well-informed. Companies find that a good, cross-functional team approach capable of handling most areas of inquiry includes representatives from legal, finance investor relations, HR/executive compensation/benefits and CSR.

Where is this contextual information appearing?

- Some companies start the proxy with substantive cover letters, from either management or the board or both. Management letters may focus more on company strategy and performance, with board letters discussing risk oversight and investor engagement.
- Other companies include strategic context within proxy summaries, and within these summaries they weave in a discussion of performance, board/governance and compensation highlights.
- A discussion of the fit between board skills and strategy typically appears in the director nominee section of the proxy, or within a discussion of board committees or corporate governance more generally.
- With respect to how pay supports strategy, this discussion typically appears in the CD&A and its Executive Summary.
- A growing group of companies provide robust context in supplemental proxy filings. We feel that this is fine as a tactic, but urge companies not to refrain from also including this information in the primary 14A filing.

[1] Source: Dec. 4, 2017, 3:55 p.m., Bloomberg QuickTake

- Some companies may want to reserve key information for direct engagement with investors. Such a strategy may prove problematic. Excluding key information from the proxy may create Reg FD issues. What's more, no company can engage with everyone, so incorporating vital contextual information into the proxy itself ensures that this information is available to your full investor/voter base.

For more examples of compelling proxy disclosures on the above and additional topics, please access our **Guide to Effective Proxies**, which contains over 1,000 examples of clear disclosure on over 27 topics, drawn from over 200 proxies.

How can IRO involvement in proxy messaging benefit your company?

Indexed and other voters report that when they understand "the big picture" about a company, whether it's their strategies, competitive environment or key challenges and opportunities, they tend to be more forgiving about company practices that may seem non-standard or may be in less favor with proxy advisers. That's because these practices make more sense when put into company-specific context. And in fact, we have seen evidence of negative proxy adviser recommendations having a lesser impact on the vote at companies that provide clear and credible discussions of how pay supports strategy than at companies that do not include this information.

And what's in it for you?

IROs who request a seat at the proxy tabel, apply their understanding of company strategy to this increasingly important document, and use their skill sets in relationship building and in distilling complex subject matter into clear, digestible language and formats can help build and sustain voting support for their companies, their boards, and executive pay and other actions requiring shareholder support. As investor scrutiny of a range of issues continues to intensify, IRO input is a "must have" and not just a "nice to have," and your contribution should therefore be noticed and appreciated.

About the author

Ron Schneider joined the DFIN Global Capital Markets group as director of corporate governance services in April 2013. Over the past four decades, Ron has advised senior management, the C-suite and boards of public companies of all sizes, industries and stages of growth facing investor activism, as well as challenging and sensitive proxy solicitations involving corporate governance, compensation and control issues. His primary recent focus has been helping companies conduct engagement programs with their top institutional investors with the objective of identifying and addressing investor concerns through best practices in proxy disclosure.