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Changing Board Practices and Culture to Meet Investor Expectations

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2011 was a watershed year for corporate governance practices in the US. The introduction of the advisory vote on executive compensation that year required analysts to assess governance practices in the context of a company's performance. It also provided a context to initiate an annual conversation between long-term institutional investors ("investors") and publicly-listed companies. These conversations traditionally revolved around CEO pay. In our experience however, over the past year, investors are broadening the dialogue to address matters that go beyond executive compensation and cover a range of diverse topics such as long-term business strategy, risk mitigation and board composition.

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Today, in our experience, investors are beginning to develop an integrated view of a company's governance and performance. They are using this integrated view to inform their proxy voting decisions, which range from electing directors to approving capital allocation decisions made by boards. These changing investor expectations are increasing demands on boards and independent directors, necessitating significant changes to current board culture and practices.

In this paper, we highlight the key investor expectations that are driving these changes and identify priorities for the board that will help them meet these expectations.

New Investor Expectations and Their Implications for the Board

The two key changes in investor expectations are related to the role of a board and a desire to engage with non-executive directors. Investors now expect boards to provide active leadership without micro-managing.[1] They hold boards accountable for the performance and governance of a company and expect boards to ultimately hold management responsible for poor performance. This increased accountability necessitates a dialogue with shareholders on a broad range of topics, which in turn allows investors to assess board quality. It also enables boards and long-term shareholders to build trust and strengthen relationships that can be valuable in the face of short-term activism or in challenging circumstances. Conversely, directors who ignore investor feedback may fail to receive shareholder support in their re-election bids.

In order to meet these changing investor expectations, the culture of boards will have to evolve and directors will need to become more open, transparent and accountable to their shareholders. Companies will need to develop shareholder engagement programs that facilitate dialogue between the independent directors and various stakeholders. Finally, boards will need to strengthen director and board evaluation procedures with the desired result of strengthening of the board's composition, its procedures and practices.

Investor Expectation 1: The Broadening Role of the Board

Prior to the 2008 financial crisis, a working assumption of investors such as SSGA was that the primary purpose of a board was to:

- Hire and fire the CEO (who was responsible for setting and executing strategy);
- Be a sounding board for the CEO; and
- Provide strong audit oversight to ensure that the financial reports were accurate.

With increased investor focus on long-term performance and strategy, in our experience investors have begun to expect boards to:

- Help set and challenge current strategy, particularly under uncertain macroeconomic conditions, high market volatility and in a fast changing technological environment;
- Set risk appetite and mitigate or set mitigation standards for reputational and other risks;
- Influence firm culture and set ethical standards for doing business;
- Develop the right incentive structure that focuses management on the long-term strategy;
- Hold management accountable in a timely manner for the execution of strategy and long-term performance;
- Plan for the succession of directors and senior leadership; and
- Provide strong audit oversight to ensure that the financial reports are accurate.

The list of responsibilities now goes beyond financial oversight and light-touch involvement in strategy and governance. It requires boards to play an active role in establishing the tone at the top with regards to a broad range of governance and ethical issues while providing active leadership in setting strategy and mitigating risk. We believe that boards that do not meet these expectations will find themselves increasingly at odds with their shareholders, which could result in a lack of support for key ballot items.

Investor Expectation 2: Increased Engagement with Non-Executive Directors

Interactions between investors and directors have been on the rise over the past two years in the US. In the first half of 2015, 30% of State Street Global Advisor's ("SSGA's") US issuer engagements were with a director of the company, up from 20% for the same period in the prior year.[2] In comparison, over the past two years in the UK due to a well-established engagement culture between shareholders and directors, two-thirds of our engagements have been with a company's director.

Direct engagement with investors propagates a sense of accountability among directors. It also challenges a tradition of insulated board culture that typically delegated shareholder communication responsibilities to senior management. To address the growing demands from issuers for engagement, boards will need to own the shareholder engagement process and become more open to obtaining investor views on key governance and business decisions. For their part, directors will need to be prepared to speak to all aspects of the business and board practices with investors. Consequently, the ability to effectively communicate with investors will be an important skill among independent directors that hold leadership positions on the board such as that of the independent chair, lead director and/or board committee chair(s).

Board Priorities That Can Help Meet the Changing Investor Expecations

Below we have identified actions that board can take to better align their board's culture and practices to meet investor expectations:

Focus on the Development and Oversight of the Long-Term Business Strategy

Strategy should shape aspects of governance such as board composition and pay drivers.

Recognizing the importance of a well-developed and executed strategy, the UK Financial Reporting Council ("FRC") in its revision to the UK Corporate Governance Code published in September 2014, expressly defined the role of a director as having to "constructively challenge and help develop proposals on strategy". In addition, they recommended that companies enhance information on strategy in their annual report to shareholders and that the independent chair discuss governance and strategy with shareholders. Through these suggestions, the FRC hopes to bring investor and director focus on strategy as the key driver that shapes important aspects of a company's governance structure.

At SSGA, we make a concerted effort to broaden governance and proxy voting discussions with our investee companies to focus on the proposed business strategy of the company. As a result, in 2014, we discussed the long-term company strategy[3] in more than 30% of our engagements, up from 6% in 2013.

Once a board has developed a long-term strategy, it is important for the company to clearly communicate this strategy to investors. Short-term and long-term performance goals based on key strategic drivers should be established and boards should evaluate senior executive and company performance against these goals. The board should also periodically evaluate the viability of the strategy based on the changing business environment, competitive landscapes, regulatory requirements and other macroeconomic factors. Any change in strategy should also prompt an assessment of director skills and expertise to ensure that the board collectively has the background and knowledge to oversee the implementation of the strategy.

Evaluate and Refresh Director Skills and Expertise to Ensure Good Board Composition

Boards should have a mix of independent directors with direct industry experience and with experience relevant to the company's long-term business strategy.

With increased responsibility for setting strategy and providing risk oversight, shareholders expect boards to nominate at least one independent director with direct industry experience. This direct industry experience should be complemented through the appointment of directors with broader industry or sector experience. In their paper A New Kind of Board, Mule and Elson call for the appointment of 'industry expert independent directors' as a way to avoid 'management knowledge-captured boards'. Collectively, directors with industry experience can be good sounding boards for the CEO while challenging long-term strategy in a constructive manner. In addition, they can also guide management on possible challenges in implementing strategy and in identifying and mitigating various risks.

Another factor that will drive board composition is the background and skills needed to provide board oversight and direct management implementation of the company's long-term strategy. For example, a company looking to grow their business through an active M&A strategy may look to add a director with experience in operationally integrating acquired businesses, or a director who previously led the M&A practice in an investment bank or strategy consulting firm. Other examples include directors with geographic expertise added to help guide the company through an emerging market growth strategy, or a director with experience in online marketing being added to the board of a company that wishes to strengthen its online presence.

A change in strategy may require some directors to step down to create room to add directors with the skill sets vital to the success of the new strategy.

Promote a Culture of Accountability on the Board

Increased interactions with shareholders and strong board and director evaluation practices instill a culture of accountability among directors.

We believe that direct interaction with investors enhances a director's sense of responsibility and accountability to their shareholders. Through our engagements, we have found that feedback given directly to a director often results in their taking actions that address our concerns in a timely manner. Consequently, we encourage director-shareholder engagement as we believe it facilitates relationship and trust building between the two parties.

Further, we also believe that directors, who are evaluated on their contributions to the board, are more likely to feel accountable to other board members and to shareholders. Therefore, we strongly urge boards to adopt and/or strengthen director and board evaluation practices.

Conclusion

In the US, we are in the midst of a significant shift in investor and board relations as it relates to investor expectations around responsibilities and accountability of their elected representatives — the directors. To address these new expectations, boards need to evolve their practices and foster a culture of openness and accountability among directors. In the future, direct dialogue between investors and directors will be the expected norm and investors will evaluate board quality and governance practices in the context of the long-term business strategy and performance of the company.

Any questions or comments regarding this guidance may be directed to Rakhi Kumar, Managing Director and Head of Corporate Governance, SSGA at Rakhi_Kumar@SSGA.com

[1] Owning Up — The 14 Questions Every Board Member Needs to Ask By Ram Charan.

[2] http://corpgov.law.harvard.edu/2013/10/25/global-trends-in-board-shareholder-engagement/

[3] SSGA's Engagement Database.

Appendix

A Good Shareholder Engagement Program

Identifies a director on the board who is responsible and empowered to engage with investors.

Typically the independent chair or lead director is responsible for general engagements on business, strategy and risk with investors; the chair of the compensation committee would lead pay-related engagements; the chair of the audit committee is responsible for accounting/finance related engagements; and the chair of the nomination/governance committee is responsible for leading governance discussions with shareholders on topics such as by-law amendments and director nominations.

Seeks investor feedback on a broad range of issues.

Directors should welcome investor feedback on a range of topics that could include board governance, pay practices, capital allocation decisions, long-term strategy and environmental/social impact of the business.

Should demonstrate a board's responsiveness to investor feedback.

Boards should engage with their investors well in advance of the final proxy vote on any important voting matter such as an M&A transaction or change in executive compensation. This would allow for boards to build investor support for their decisions and/or obtain investor feedback that could inform the final decision.

Helps boards build strong relationships with their long-term shareholders.

A board that has good relations with its investors that is built on trust and responsiveness to their feedback, will find that it can lean on their long-term shareholders to support the company during difficult times.

A Strong Board Evaluation Process

Identifies a director on the board who is responsible and empowered to lead the evaluation processes.

Typically the independent chair, lead director or the chair of the nomination/governance committee of the board is charged with conducting the evaluations.

Is an annual exercise that evaluates both directors individually and the board collectively.

Sets expectations with directors that they will be evaluated on an annual basis.

As a corollary, performance expectations and the duties and responsibilities for the directors should be set in terms of their individual contribution to the board and also what is expected of members of board committees.

Has an outcome.

This may range from no change being identified, refreshment of the board, additional director training for the full board or for individual directors, developing performance plans for an underperforming director, or director resignations, if necessary.

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