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The Board's Three 'C's' of Corporate Governance: Composition, Communication and Connection

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U.S. companies face a dizzying array of challenges, including from disruptive technologies and cybersecurity threats; economic and geopolitical uncertainties; climate change and evolving sustainability metrics; and questions about corporate culture, sexual harassment and ethics. Investors continue to look to boards of directors to oversee companies' navigation through these challenges while at the same time producing superior operating results, financial returns and stock price appreciation.

Activist investors remain active, quick to challenge a company's business strategy, management's ability to execute and the board's capabilities. In addition, many long-term institutional investors and large asset managers have become more likely to question whether board members possess the appropriate skills, knowledge and characteristics to oversee the company's business and management to avoid or mitigate risks and ensure long-term value creation.

In light of these dynamics, boards of directors must focus on the three "C's": composition of the board; communication, both regarding items of importance to investors and to convey the board's competence with and command of issues that pose threats to long-term performance; and connection, or building relationships, with investors to establish credibility and confidence, which become essential when a company hits a rough patch.

Board Composition

Recent proxy fights at Procter & Gamble (P&G) by Trian Partners and at Automatic Data Processing by Pershing Square stand as stark reminders that shareholder activism remains a permanent part of the corporate landscape and that mega-cap companies are not immune to activist attack. The Trian campaign at P&G was unique in that the only Trian nominee was Nelson Peltz, and Trian indicated that it would be willing to add back to the P&G board the unseated incumbent director if Trian prevailed. Nevertheless, over the past few years, activist investors have become more sophisticated in forming slates of nominees in proxy contests, typically nominating candidates with relevant industry and other operational experience consistent with the activist's case for a board's shortcomings.

Citing evidence supporting the view that more diverse boards outperform boards lacking diversity, large asset managers such as BlackRock, State Street and Vanguard have been unambiguous in expressing their desire to see greater boardroom diversity — with an emphasis on gender diversity. In addition, in September 2017, the New York City comptroller and New York City pension funds followed up their successful campaign to increase the number of companies with proxy access bylaws with a new campaign dubbed "Boardroom Accountability Project 2.0" to "ratchet up the pressure on some of the biggest companies in the world to make their boards more diverse, independent, and climate-competent, so that they are in a position to deliver better long-term returns for investors."

Recent data on boards of directors of Standard & Poor's 500 index companies indicates that boards are, in fact, becoming more diverse — with Spencer Stuart reporting in its 2017 U.S. Board Index that more than half of incoming directors were women or minorities — although the pace of change may not be as swift as some would prefer. As described in Vanguard's August 31, 2017, open letter to public company directors, Vanguard

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"view[s] the board as one of a company's most critical strategic assets" and believes that "when a company has a great board of directors, good results are more likely to follow." It will remain incumbent on boards and board-nominating committees to be vigilant in analyzing and assessing the composition of the board and its members' skill sets in light of the company's business, strategy and challenges to ensure that investors continue to perceive the board as an important strategic asset.

Communication

One outcome of the adoption of mandatory say-on-pay votes has been the transformation of proxy statements, at least at many large-cap companies. Proxy statements have evolved from "compliance documents" that hew closely to required disclosures to "communications documents" that strive to convey a coherent and continuing story regarding company strategy and performance. In addition, proxy statements go to lengths to explain how the directors standing for election, as well as the executive compensation structure subject to the say-on-pay vote, support that strategy and incentivize that performance. Consistent with this transformation, BlackRock's 2016 annual letter to CEOs requested that they "lay out for shareholders each year a strategic framework for long-term value creation [and] explicitly affirm that their boards have reviewed those plans." BlackRock's 2017 annual letter commended companies for heeding this call, stating that these disclosures "provided shareholders with an opportunity to evaluate a company's long-term strategy and the progress made in executing on it." BlackRock's recently released 2018 annual letter reiterated this call for companies to publicly articulate their strategic framework for long-term value creation and to "demonstrate[] to investors that your board is engaged with the strategic direction of the company."

As companies have expanded and improved their communications regarding strategy, performance and executive compensation, shareholders have called for expanded and improved disclosure on other topics of concern. For example, the New York City comptroller's Boardroom Accountability Project 2.0 goes beyond calling for more diverse boards by seeking better disclosure — in particular a board skills matrix so that investors can more easily assess the skills and diversity represented in the boardroom. Although some companies in recent years have been including a directors skills matrix in their proxy statements, others view matrices as an oversimplification or crude device to convey the complexities of boardroom composition. In any event, the campaign makes it clear that some investors believe there is a lack of communication or transparency regarding board skills and composition. As a result, companies should consider, whether by using a matrix or other forms of disclosure, how to best convey the thought and care that goes into determining the needs of the board in terms of skill sets, and how those determinations are addressed in the board refreshment process.

Another topic on which investors seek greater information is sustainability. Sustainability encompasses a broad range of issues and is not limited to climate change and related environmental topics, although that remains an essential area where investors seek more transparency in how a company is addressing the risks presented and seek better ways to compare the financial impacts of climate change from one company to the next. Sustainability also may include items such as human capital management as well as business practices and corporate culture matters that have the potential to either foster or derail long-term value creation. As stated in BlackRock's 2017 letter to CEOs, "[e]nvironmental, social and governance (ESG) factors relevant to a company's business can provide essential insights into management effectiveness and thus a company's long-term prospects." As companies continue to consider how they communicate business strategy to investors, they also will need to determine how to convey the ways in which relevant sustainability matters are factored into their business strategy and how the boards oversee the associated risks as part of their oversight responsibilities.

Beyond sustainability, BlackRock's 2018 annual letter to CEOs calls on companies to "not only deliver financial performance, but also show how [the company] makes a positive contribution to society." While this call is best understood in light of BlackRock's focus on long-term financial performance, it nevertheless will require additional efforts by companies and boards of directors to consider what and how they communicate with stakeholders and the public regarding a host of issues beyond financial performance.

Connection

For a number of years, the message for boards of directors has been to enhance engagement with shareholders. As a result, companies and directors have expanded their shareholder engagement efforts, often meeting with investor governance teams and increasingly including director involvement in engagement efforts regarding topics such as executive compensation, board leadership and board refreshment practices. Investors may not always feel a need to engage with a particular company or its directors, but periodic check-ins and reminders that directors are available can garner the credibility and goodwill that may be critical when the board is facing an activist challenge or other crisis.

BlackRock made it a point following the 2017 annual meeting at ExxonMobil to explain that it had repeatedly requested meetings with the company's independent directors to better understand the board's oversight of long-term strategy amid major strategic challenges (including but not limited to climate change), and that those requests were denied pursuant to the company's policy of not permitting engagement between independent

directors and shareholders. As a result, BlackRock voted against the company's lead independent director and the chair of the committee responsible for this policy. According to press reports, in December 2017, ExxonMobil announced that the board had changed the policy and would allow directors to engage directly with key shareholders to address areas of interest.

It also is important to remember that communication is a two-way process and that director engagement with shareholders can provide directors with valuable insights into investor perceptions. In some instances, directors may learn that they are already addressing issues of importance to investors, but company disclosures fail to effectively communicate that fact, creating a gap between investor perception and reality. In any event, listening to investor views with an open mind is an important element of director-shareholder engagement.

As boards of directors head into 2018, some of the challenges they face will be familiar and some not yet known. The recent sexual harassment scandals present issues that boards were not contemplating a year ago but are now playing a role in board CEO searches and succession planning. Directors will be better positioned to address these challenges if they pay attention to the three "C's" — they have focused on board composition so that the board has the diverse skills and perspectives to address the challenges that inevitably arise; they have communicated with investors to convey the board's diligent oversight of business strategy and risks, and how the board is a strategic asset for the company; and they have connected and built relationships with investors so that they have the credibility and goodwill with investors that provide the board time to manage through the challenges.