EY Center for Board Matters

2016 proxy season preview: a focus on the long term

What investors are saying

Heading into the 2016 proxy season, investors are focused on supporting long-term, sustainable corporate strategies amid concerns about short termism in the market.

As hedge fund activism continues and stock buybacks come under increased scrutiny, many investors are questioning whether boards are sufficiently focused on the long term. At the same time, some investors are increasingly integrating company strategy into their perspectives on governance. Corporate environmental and social practices are also coming into the spotlight, and the push for proxy access and board diversity continues.

The EY Center for Board Matters talked to more than 50 institutional investors, investor associations and advisors about their corporate governance views and priorities for the 2016 proxy season. Participants included asset managers (with more than US$17 trillion in assets under management), labor and public funds, and faith-based and socially responsible investors.[1] This report brings together this broad-based input and draws on our tracking of governance trends through our proprietary corporate governance database.[2] So what have we learned?

- Most investors remain focused on whether the right mix of directors, with a depth of diverse skills and backgrounds, are in place to oversee long-term strategies and risk management.
- For an increasing number of investors, how a company manages — and how the board oversees — the company's environmental and social impacts is integral to whether the company is being run well for the long term.
- Particularly given the surge in stock buybacks and continued hedge fund activism, many investors are focusing on whether companies are investing capital and operating for the long term.
- Many investors are closely watching how companies implement proxy access; companies restricting shareholders' ability to use proxy access may damage relationships with investors.
- Companies should strive to make engagement focused and tailored to the investors with whom they are engaging.

Four areas boards should focus on

We asked investors what topics they would like to see boards focus on in 2016. Among the top answers cited were:

Board composition

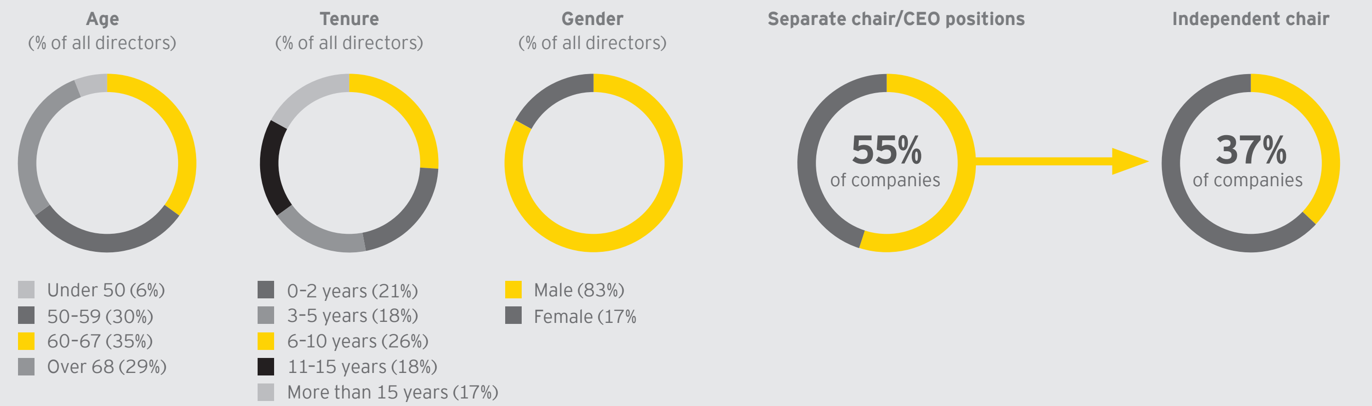
Investors view board composition as a matter of governance risk in their portfolios. To manage that risk, they evaluate and engage with boards on a number of composition-related factors including:

- **Skill set and subject-matter expertise relevant to industry, strategy and risk.** Investors seek assurances that boards have the right portfolio of talents for the company's industry, long-term strategy and risk oversight needs, including the right depth and breadth of complementary skills.
- **Diversity, specifically including gender, race and ethnicity.** For a number of investors, diversity across gender, race and ethnicity is important and speaks to the robustness of the nominating process. Some investors have called for disclosure reform to support their ability to analyze board diversity.
- **Board succession planning/balance of director tenure.** Many investors remain concerned about the slow rate of turnover on boards. Board refreshment is critical to enhancing board diversity and recruiting expertise aligned with the company's evolving strategy and challenges. Some investors are also increasingly focused on whether directors' professional expertise is current, and some investors believe that lengthy tenures may impact board independence.

Investors expect boards to have an independent leadership structure. For some, there is no substitute for an independent chair, but others find lead directors to be sufficient provided that the responsibilities are clearly defined and robust — and provided that other challenges do not raise questions about the strength of independent leadership.

An increasing number of investors are looking at director assessment processes used by boards and considering how to use them as potential indicators of a board's commitment to meaningful review and periodic renewal.

S&P 1500 directors and board leadership by the numbers



Oversight of environmental and social risk and value drivers

Investors want to know how companies manage and how boards oversee environmental and social-related risks and strategic opportunities, particularly as they relate to long-term performance. Many view environmental and social impacts in a broader business context and approach these topics with questions such as:

- **Is the company's business model viable relative to climate change and the transition to a lower carbon economy?** They want to understand how companies are mitigating climate-change-related risks, investing in innovation and considering the impact of new technologies on company strategy and operations.
- **Is the company achieving operational excellence across the supply chain?** They want to understand whether companies are using resources efficiently and how they are overseeing their global supply chain, including environmental and human rights practices.

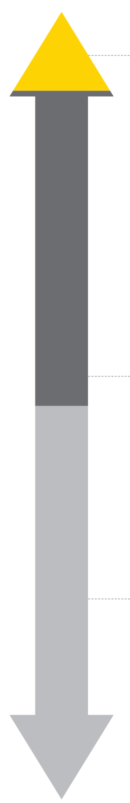
Many investors view how companies address climate change and other environmental and social challenges as a proxy for the strength of the board and management and a metric for measuring governance risk.

Long-term strategy amid activist hedge fund activities and stock buybacks

A number of investors are developing a more holistic approach that combines investment and corporate governance perspectives and that includes strengthened communications between governance teams and portfolio managers. They are evaluating governance decisions through an investment lens and putting engagement conversations about governance in the context of company strategy. Included in this new architecture is the task of evaluating whether hedge fund activist campaigns and corporate capital allocation decisions align with long-term investment goals.

US companies are spending record amounts to buy back their own shares. Many investors question whether buybacks are driving long-term value creation. For many, their focus is on understanding why cash is not better off invested in human capital, innovation and other long-term strategies. For some, their focus extends to the broader economic and societal implications of this use of capital.

Challenges from activist hedge funds persist. For some institutions, activists represent a welcome safeguard against failing managements, provided that corporate targets are well-chosen, the cases made are informed and the intended outcomes contribute to the long-term health of the firm. On the other hand, in an environment of a growing number of settlements between companies and activists, many investors have concerns that this activity is driving capital allocation and board composition decisions with a short-term horizon.



Companies are increasingly reaching settlements with hedge fund activists — often before an official proxy contest is even announced. What are investor views on this trend?

Positive
A minority of the investors we spoke with generally viewed this trend positively because it avoids the costs and distractions involved with proxy contests and represents successful company-shareholder engagement. Many believe that their own regular engagement with companies helps inform these settlements, regardless of whether companies reach out to them about the particular circumstances.

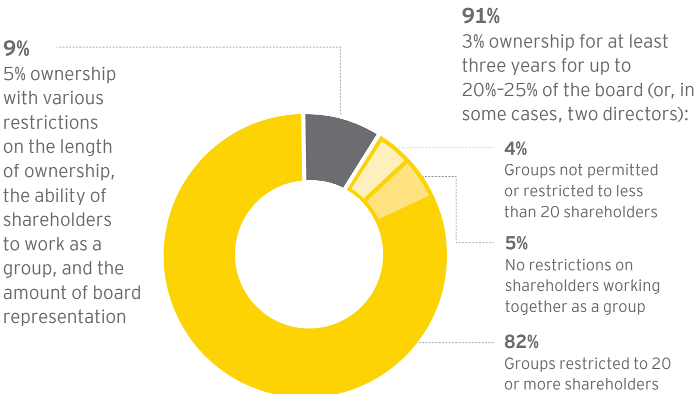
Depends on the circumstances
Just under half stressed that it's a case-by-case situation. For these investors, while settlements are attractive for a number of reasons, they don't want settling to be the default orientation of the company. Some actively managed funds also noted that they buy into companies because they believe in the strategy and in management — not in the hope that an activist will initiate change.

Negative
Around half generally viewed this trend negatively. The cost savings and avoided distraction notwithstanding, these investors have serious concerns that companies are too quick to acquiesce without consulting their other shareholders. Some feel that board seats should not be a bargaining chip, as this practice distorts the board's election process, and some also question whether activists — even if constructive and persuasive — belong in the boardroom.

Proxy access

This will be another big year for proxy access, with close to 200 companies expected to face proxy access shareholder proposals. Many investors are closely watching how boards implement proxy access and tell us that boards acting in bad faith (i.e., adopting overly restrictive terms that prohibit, in practice, shareholders' ability to use a proxy access right) may damage their relationships with investors.[3]

Breakdown of proxy access bylaw terms adopted by more than 180 companies so far



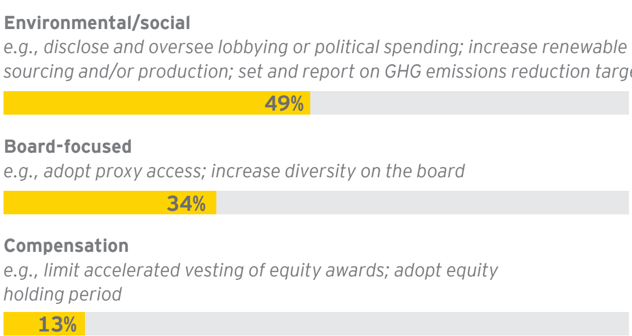
Preview snapshot: 2016 shareholder proposal landscape so far

So far we are tracking more than 600 shareholder proposals submitted for 2016 annual meetings, which is around the same level as this time last year. Around 10% of the proposals have already been withdrawn – in most cases because companies have agreed to implement the proposal in part or full, provide additional disclosure or commit to ongoing dialogue on the topic.

Environmental and social category continues to lead

Proxy access is the most commonly submitted shareholder proposal so far this year. However, when considered by category, environmental and social topics represent the largest proposal category by the overall number of proposals submitted. This year, a growing number of these proposals address climate change. For example, some proposals at energy companies focus on the risk of stranded assets while proposals at utility companies focus on the challenges and opportunities related to distributed generation.

Top three 2016 shareholder proposal categories to date (based on proposal submissions)



Making engagement focused and investor-specific in 2016

The current level of engagement requires some investors to develop prioritization plans and be more targeted in their own engagement approach – in part to keep the attention of directors who are starting to get more involved in engagement. Also recognize that their governance views and approaches vary.

The message for companies is this: Recognize that there is pressure on investors to engage and that they may not have time to talk with you two to three times a year. Companies seeking to engage need to clearly communicate their intent for the meeting and the people who will participate. They should also track what is discussed in meetings and review that record, along with investors' policies and voting practices, in advance of meetings to maximize productivity. Companies should also be prepared to discuss governance in the context of corporate strategy.

When should directors be involved in engagement? It depends on the circumstances – and the investor.

Investor views on director involvement in engagement vary. Some investors want to see directors involved much more often in engagement discussions and may have concerns that their views are filtered and distorted through management. Others say director involvement should be rare. Most fall somewhere between these two views, believing that director involvement should be ongoing and periodic and that it should depend on the circumstances involved. Some specific circumstances in which many investors told us directors should be involved in engagement include:

- When the subject under discussion is directly under the board's purview (e.g., executive compensation, board leadership structure) and when investors seek a view independent from management (e.g., M&A)
- In times of crisis, when the company is in the headlines and facing high-profile challenges (notably, a minority of investors stated the opposite: that directors should not be meeting with investors when there is a crisis at hand)
- When the engagement needs to escalate because discussions with management have stalled and/or shareholders do not believe their views are being shared with the board
- When the company has received a low or failing vote on a management proposal and/or when a shareholder proposal has received majority support
- When there has been or will be a significant governance change or strategic overhaul

Questions for boards to consider

- Is the board prepared to incorporate strategy in engagement conversations with investors on governance matters?
- Are there opportunities to enhance the company's communications around board composition and director succession planning and assessment processes?
- Does the company integrate environmental and social impacts into its strategic thinking — and how is the board communicating that to investors?
- Can shareholder engagement be more focused, productive and investor-specific?

Endnotes:

1 EY's investor outreach conversations included asking specific and consistent questions to a broad spectrum of more than 50 institutional investors, investor associations and advisors. Investor views vary. All respondents are anonymous, and results are presented in aggregate.

2 Data for 2016 is through 24 February.

3 For information on some of the proxy access terms that are of concern to many institutional investors, see the Council of Institutional Investors' Proxy Access: Best Practices, August 2015.