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As shareholders become more assertive, directors need to be proactively engaged and start listening. The knowledge gained will support informed decisions on pay and executive performance—and prevent a nasty AGM surprise

By Ken Hugessen with Lisa Oldridge

Boards of directors have long been responsible for taking shareholder interests into consideration as part of their fiduciary duty to the company, but until recently, direct engagement by directors with shareholders has been more of a laudable concept than a practical necessity. Times are changing. Whereas virtual unanimity on director slates and say-on-pay voting used to be the norm (with votes under 95% cause for mild consternation), shareholders, and their advisory groups (such as ISS and Glass-Lewis), are disrupting the status quo much more frequently, sometimes with dramatic results. From worrisome slippage in say-on-pay and director election votes, all the way to activist shareholders forcing changes in board slates, management and corporate strategy, shareholders are becoming much more assertive, pushing directors for greater accountability for company performance. In such a changed environment, it is critical for directors to be proactively involved with their shareholders and advisers before problems arise.

Much has been written on the necessity of a formal policy on shareholder engagement, with careful allocation of responsibilities between board and management. But to date the directors of many sizable public issuers remain "missing in action." While they may be active in the background, today they increasingly need to be directly involved in the engagement with shareholders. Boards gain credibility when they are seen to be listening to shareholders and monitoring opinion (and not just during the weeks leading up to the AGM). Directors who reach out directly and regularly to investors, building relationships before issues surface, will gain a better sense for how their company is seen by the shareholder community.

Rare is the CEO who believes the market is overvaluing his or her company's stock, even when relative performance has lagged. This confidence is understandable, commendable and necessary. However, management's natural predisposition to "drink one's own Kool-Aid" can interfere with a director's ability to objectively assess how the company's management and strategy is perceived by the outside world. Directors should be wary of having management as the sole conduit for shareholder opinion, particularly on matters of company and executive performance—and pay. Directors who regularly monitor third-party research, headlines and public opinion, either through their own analysis or with the support of a board adviser, gain valuable insight into how shareholders perceive an issuer and its future prospects.

How best to leverage research? Look beyond absolute earnings forecasts or target prices in reports, and read the rationale provided. And read widely: the most helpful equity research is often a less-than-glowing equity research report from a less well-known analyst. Look at reports on peer companies—these can provide important clues that help inform decisions about market competitive performance goals. Watch for sector pieces that signal cyclical and secular change. Be aware of fund flows in and out of sectors. Lastly, wherever feasible, seek out industry and company research other than from the sell-side sources. Traditional pay comparator and retrospective relative performance analysis are essential, but are historical by nature. Use third-party research to look forward.

With the growing influence and assertiveness of shareholders and their advisers, boards that communicate with the shareholder community and maintain a fact-based independent view of the company's performance can avoid being blindsided by a poor say-on-pay or director vote. A well-informed view of performance allows directors to make better decisions about the link between strategy, performance and compensation—and how to best disclose any judgment exercised by the committee. Hearing the views and comments of shareholders can enable boards to strategize their executive compensation and governance plans, and related disclosure, over multiple years. Lastly, the act of listening—in and of itself—sends a message to the shareholder community that directors are sensitive to shareholder concerns, thereby strengthening an important relationship.

Management reports to the board on investor relations initiatives are valuable, but directors should be wary of having management as the sole conduit for shareholder opinion, particularly on matters of performance and pay.

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