University of Virginia
Darden School of Business

Institute for Business in Society

Views from the C-Suite:

CFOs Discuss the Economy, Constructive Engagement with Proxy Advisory Firms and Shareholder Activism

BY

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The University of Virginia Darden School of Business held Strategic CFO Roundtables on September 10, 2015 and January 7, 2016 in Arlington, Virginia.

Since 2008, these Roundtables have provided a confidential forum for corporate financial leaders representing the varied industries of the Washington DC region to discuss and debate the global and U.S. economies, as well as corporate financial strategies and performance. In addition, each Roundtable focuses on a Top of Mind (ToM) Topic, a specific topic of immediate interest to the Members.

For the two most recent Roundtables, the ToM Topic was *Constructive Engagement with Proxy Advisory Firms* and *Shareholder Activism*, and the discussions were led by invited experts:

- John Roe, Executive Director and Head of Advisory and Client Service at ISS Corporate Solutions (ICS)
- Elizabeth (Beth) Ising, Partner and Co-Chair, Securities Regulation and Corporate Governance Practice and member of Hostile M&A and Shareholder Activism team
- Steve Glover, Partner, Co-Chair - Mergers and Acquisitions Practice, and member of Corporate Transactions Practice and Capital Markets Practice Groups at Gibson Dunn LLP in Washington, DC

THE ECONOMIC DISCUSSION

As of the morning of the September Roundtable, the Dow stood at 16,254, down 8.8 percent for the calendar year. By the time the January Roundtable convened, the Dow was in the midst of a nosedive that by week's end had fallen by 6.2 percent since the close of trading in 2015.

The first trading week for 2016 was the Dow's worst start in more than a century. With continued news of an economic slowdown in China, the global markets became riddled with volatility and stock prices trended downwards around the world. Some economists were predicting that the final growth numbers for China in 2015 would be lower than levels seen in more than 20 years. Terrorist attacks in the U.S. and around the globe were frequently in the news headlines as well as North Korea's claim of detonating a hydrogen bomb.

On the positive side, unemployment had fallen to 5.0 percent by year end, and U.S. energy costs remained low. Not surprisingly, the preponderance of bad news had imparted a noticeable reduction in the CFO's optimism for both the U.S. economy and their own companies.

Darden Regional Business Outlook Survey

Before each Roundtable, the Members participate in a survey designed to elicit insights into their business views relative to national counterparts. We compare Members' responses with those of the Duke University/CFO Magazine Global Business Outlook Survey which has polled senior finance executives nationwide over the past 78 quarters. The comparison of results serves to generate conversation regarding Member expectations of the financial condition and outlook for the U.S. and global economies and their own companies.

Economic Outlook

Although the September 2015 Darden Strategic CFO Roundtable Survey showed a continued level of optimism regarding the U.S. economy, the January results were noticeably less optimistic. Figure 1 depicts how CFOs rated their optimism about the U.S. economy on a scale of 0 – 100%. Both the national Global Business Outlook Survey and the Darden Strategic CFO Roundtable Survey reported optimism levels of 60% or greater for September, but by year end 2015, the national survey (solid line) had fallen from 60% to 46% and the Roundtable Survey (dashed line) had fallen from 68% to 64%.

Figure 1: Optimism for the U.S. Economy
(Scale of 0 – 100%)

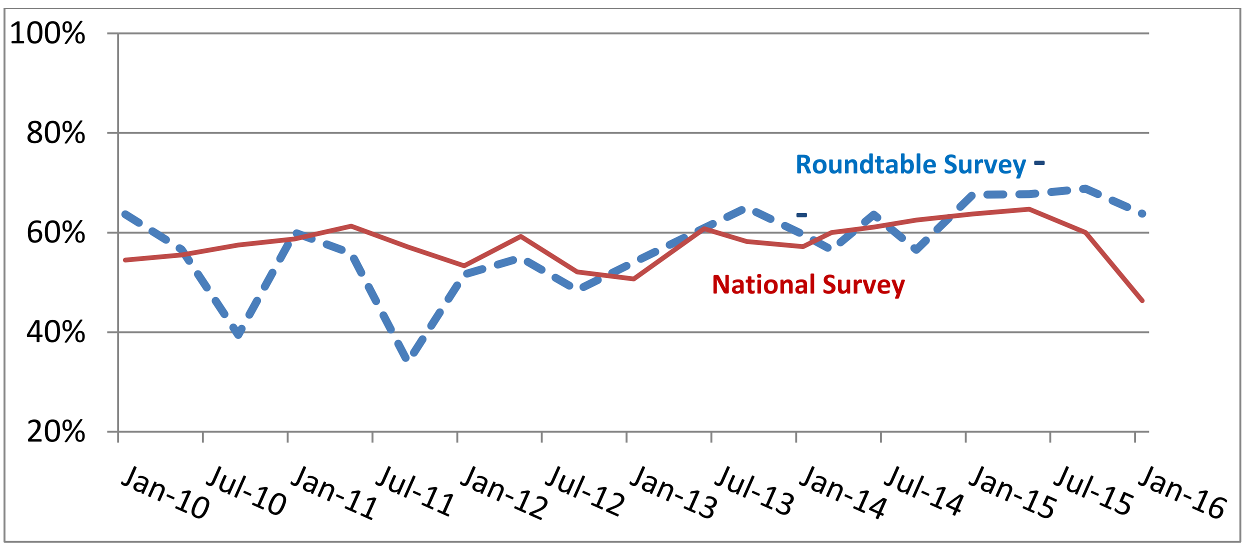
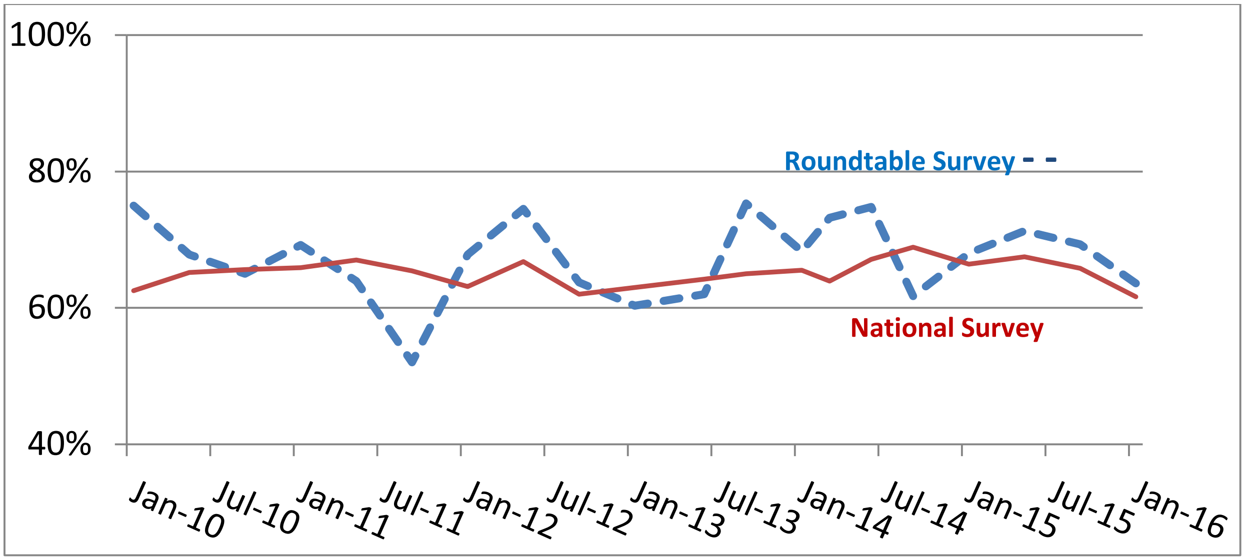


Figure 2 compares the CFO Roundtable group with the national survey regarding optimism about their own companies. For the January survey, the optimism levels for both the Roundtable CFOs (dashed line) and the national survey (solid line) declined, but remained above 60%.

Historically both surveys have reported higher levels of optimism for respondents' own companies relative to the U.S. economy. January, however, represents the first survey for which the Roundtable CFOs reported a slightly higher level of optimism for the U.S. economy (63.8%) than their own companies (63.6%). Conversely, the national survey recorded an optimism level for "own company" that exceeded the U.S. economy level by 15.3%, the highest difference since the founding of the Roundtable in 2008.

Figure 2: Optimism for their Own Company
(Scale of 0 – 100%)



The primary story behind these results is that January appears to be a clear break in the economic outlook of CFOs. Both the national and roundtable surveys reveal marked reductions in optimism. By far the largest drop was for the CFOs responding to the national survey regarding their views of the U.S. economy. In fact, this is first time since the founding of the Strategic CFO Roundtable that we have seen an optimism level lower than 50% reported by either survey. Before seeing the national 4Q2015 results, our focus of discussions was on the level of optimism, but now we have to ask whether the Roundtable CFOs will follow the national trend by falling into the pessimistic region; i.e., below the 50% level.

Regarding the turndown in the level of optimism, one CFO commented:

> I do feel like the election and all the craziness and uncertainty around that is driving a lot of angst. Certainly the international situation is driving a lot of angst. It feels like it's not getting better… Also, there are industries that since the recession have not seen any sort of really strong resurgence of their core business.

Another CFO added:

> I think what we're seeing here is that there are more reasons to be pessimistic than optimistic. All the news flow points to a potential pessimistic outcome, whether it's the Chinese economy, the global terrorism or the fact that our economic engine just can't quite turn and get going. There just aren't any obvious catalysts to be optimistic going forward and that serves to dial back folks' feelings about our direction from here.

TOP of MIND TOPIC

The Darden Strategic CFO Roundtable hosted two experts to lead the Top of Mind (ToM) Topic: Constructive Engagement with Proxy Advisory Firms and Shareholder Activists.

The September ToM discussion focused on Proxy Advisory Firms, led by John Roe, Executive Director and Head of Advisory and Client Service at ISS Corporate Solutions (ICS) and Elizabeth Ising, Partner, Co-Chair - Securities Regulation and Corporate Governance Practice, member of Hostile M&A and Shareholder Activism team and Financial Institutions practice group at Gibson Dunn in Washington, DC.[1] Beth Ising returned to lead the January ToM discussion on Shareholder Activism with her colleague, Steve Glover, Partner, Co-Chair-Mergers and Acquisitions Practice, and member of Corporate Transactions Practice and Capital Markets Practice Groups.

Throughout both discussions, Roundtable members shared their experiences with proxy advisors and activist investors. In general, they expressed a desire to better understand how best to prepare for interactions with these important players. Our guests welcomed the candid comments and fielded some very direct questions.

Proxy Advisory Firms

Immediately, one Roundtable member called out the "elephant in the room:"

> We have hired [proxy advisors] to assist us in ensuring that the recommendations are appropriate which I know is not supposed to be a quid pro quo but [that] feeling exists.

Roe elaborated on how ISS established conflict protections that separate the business side that issues the proxy advisories and the side that consults to corporations:

> . . . there are two sides of the business. There's ISS Research and there's ISS Corporate Solutions which is the side of the business that works with directors and executives to figure out what exactly is going on.
>
> . . . ICS is a separate group from ISS . . . a separate legal entity . . . in a physically separated space . . . electronically separated. There are only two people from the corporate side of the business that are permitted to go and speak to the research side of the business about any policy matters. So anything that ISS is doing from a policy perspective has to go through me or one other person and then it goes to the research side of the business. And we do that to carefully control what information is flowing across the two sides.

[1] Biographical background on the guests speakers may be found at: http://www.pli.edu/Content/Faculty/John_Roe/_/N-4oZ1z11mtd?t=THF5_ANDD5&ID=PE1363945 and http://www.gibsondunn.com/Lawyers/eising

> [When ICS works with ISS Research,] we will have informed conversations . . . we work closely with compliance . . . we never talk about a situation [where a client is named] . . . we never advocate on behalf of a client . . . [the conversations] are always policy-based.

Trends, for instance, are topics for "informed conversations." Recently ICS advised several companies allowing contractors to buy into a corporate stock purchase plan similar to an employee stock purchase plan. ICS provided a heads-up to the research side to expect more companies that use contractors instead full-time employees to seek ways for their contractors to buy into their stock plans.

Roe provided examples of information regarding retirement age and compensation trends for board directors. The trend has been for corporations to raise mandatory retirement ages, with most hovering between 72 and 80 years. For compensation:

> The norms are all over the place . . . largely based on industry and market cap for the company. A normal non-executive director . . . sitting on one committee . . . [and] chairing another committee, could be making $150,000 a year. If you're talking S&P 500 in a tech space, the same director doing the same job might be making $350,000 a year.

The ISS approach has evolved as evidenced by the approach to Board tenure. In the past two years, ISS launched an assessment of companies to determine the percentage of directors who have served for more than nine years on the same Board.

> [The assessment] was about whether you are exposing your company to more governance risks by having directors for more than nine years.
>
> . . . Enough institutional investors have come back to ISS and said, "That might not make complete sense. Why don't we tackle the core issue which is really refreshment, not excessive tenure? Let's make sure that we're bringing enough new views onto the board with enough regularity that the board is constantly kept up to date [so that] you're bringing in the right expertise that you need."
>
> So I think what we're going to see this year is [recognition] that some [long-term board members] have got incredible institutional knowledge and a lot of them are the most willing directors to challenge management…So, ISS is going to change to look at refreshment.

A surprise to most of the CFOs was how ISS provided customized screening on various proxy issues. Roe explained this trend:

> A big part of the business now for ISS is allowing companies to custom define how they want to vote issues. Now it's still policy based, but they come to ISS and say, I want to vote against equity compensation plans with a voting power dilution

> of greater than 15 percent or I want to vote against an executive compensation plan that has an excise tax of X. They can put all those custom tweaks in. To give you some numbers around that, there are more than 400 custom policies that ISS is currently running for its clients and 80 percent of the shares voted by ISS this proxy season were affected somewhere on the ballot by a custom policy.

Roundtable members wanted to better understand the degree of influence that institutional investors wield with ISS and vice versa, to which Roe responded:

> ISS confers frequently, weekly, maybe more frequently . . . looking for what the hot button issues are for institutional investor clients. . . [the feedback] sometimes culminates in policy . . . sometimes it turns into a policy survey question. . .[The 2015 survey included 11 different issues] that ISS is considering making policy on. There's draft policy that companies can comment on. And there's final policy that's released in the middle of the fall.
>
> There's also a perception that all these mutual funds and pension funds and labor funds just vote and lock up with ISS. They don't have a governance group. They don't think on their own. They just get the ISS research report and they cast their ballot and they're done. And I think if you went to Black Rock or if you went to Alliance or State Street or CalPERS or CalSTRS in New York State or any institution that probably have invested in your companies, and you found their governance group, and you made that accusation, they'd just about throw you out of their office.

Both guests suggested that CFOs could achieve more constructive relationships with institutional investors by developing relationships with the governance side of the institutions in addition to the portfolio managers because the two sides do not communicate with each other. And those relationships need to be cultivated with more than just the company's IR head, it must also be with the appropriate Board members (head of compensation for say on pay issues, for example).

Both guests acknowledged that the worst corporate governance policy to have is "one you don't follow." So whatever the governance policy requires, be it retirement at 72 or 80 or any other parameter, it must be strictly followed and enforced. Otherwise, it may be a flag for proxy advisors and a cracked door to shareholder activists.

Shareholder Activism

As the discussion on ICS wrapped up, the focus shifted to shareholder activism as a precursor to a longer conversation on the subject at the January session. By way of introduction to the topic, Beth Ising shared her amazement that a "little provision in the [Securities Exchange Act of 1934] can open the door to so much activism."

> I have dealt with a lot of shareholder proposals. If a shareholder owns $2,000 of stock for one year, they can submit a shareholder proposal. They're usually non-binding but that's how a board can be de-classified . . . and then ISS will recommend votes against your board if you're not implementing it. So it's an amazing stick that is out there for a relatively low investment in the company on major governance issues.

The Roundtable members noted that their Boards range from being "highly, highly sensitive about it but probably a little too much" to spending "zero time thinking about activism." Still another Roundtable member shared that:

> . . . the management team has taken a view point that we should act like activist investors because if we don't, someone will come in and do it for us. And so we have done several things which we've never done in the history of our company . . . and I think that could possibly be one of the reasons why no one has come in.

As a cautionary example of why every public company CFO needs to be prepared for shareholder activism, Ising shared a recent situation with a Fortune 100 company:

> A tweet was sent out saying an activist had taken a large stake of this company. And all of a sudden it's all over Twitter. It's the Wall Street Journal calling. It's every single major financial publication. It just caught on fire. It looks like it's starting to affect the stock price. And the number one question the CEO asked the CFO was "is it true?" And this large company could not answer the question. It took 48 hours to answer the question because they did not have a stock watch program in effect. And it's the CFO who caught the question and who couldn't answer the question.

The January Roundtable ToM discussion continued the focus on Shareholder Activism with an added perspective of transactional impact. The discussion began with members asking about the common attributes of companies targeted by shareholder activists. Through the course of the conversation, these common attributes came to light and include cash on the balance sheet, over or under-performance against guidance, outperformance of peers, management team dysfunction or poor performance, holding assets that could be sold (i.e., "stranded assets," real estate), businesses/business lines that might perform better if spun-off, and Board entrenchment.

Ising and Glover discussed the trends of today's activism and how activists leverage many strategies including publicity (adept at using press and improving with social media), proxy fights (where battles are fought and won at the institutional investor level and most common outcomes are settlements), litigation (seldom given the expense), and negotiated settlements (increasingly common and often in conjunction with Board and/or C-Suite shakeup).

In the realm of corporate governance related activism, one focus is on proxy access. While the SEC provides for shareholders putting proposals in proxy statements, there is no rule that permits shareholders from adding their nominees to the proxy statement.

> They are now going company by company by company and asking companies to amend their bylaws to allow certain shareholders to put their nominees in. . . . If you've held 3% of outstanding shares for three years, you can come together and submit nominees that will go in the company's proxy materials.
>
> Three years ago we had less than 20 companies that adopted. We're at 130 right now, including most of the Dow 30 companies. It has dramatically changed what's happening.

To prepare for activism and unsolicited bids, Ising and Glover recommended that a company ensure Board awareness and define its involvement (i.e., General Counsel briefing); maintain a dialogue with stockholders and media; monitor for signs of stock accumulation; and identify and coordinate a response team.

The Roundtable guests also offered best practices for long-term growth companies to employ as protection against short-term oriented activists. For public companies, retaining a monitoring agency to track shareholder activity at the minimum is required. In addition, subscribing to the adage that a good offense is the best defense, understanding how activists implement their strategies can help with early detection and stronger defenses. For example, a standard tactic is for activists to start by calling the company IR department requesting information – and often on a fairly frequent basis. Making sure IR notices the patterns can lead to early detection.

The group concluded the Roundtable with a few related observations on emerging issues for strategic CFOs and their C-Suite colleagues:

- Given the lame duck status of the SEC, Congress is the new federal securities regulator, addressing disclosure of everything from CEO pay to climate change.
- Granting of universal proxy rights; giving the same ballots to shareholders regardless of whether they attend or do not attend the shareholder meeting.
- Increasing momentum behind virtual annual meetings and corporate town halls.

The Darden Strategic CFO Roundtable will re-convene Thursday, May 19, 2016 when the ToM Topic will be The Strategic CFO's Role in Cyber Risk Management.

About the Authors

Kenneth M. Eades, Professor of Business Administration, is the Chairman of the Darden Finance Department and serves as Interim Academic Director for Darden's Richard A. Mayo Center for Asset Management, as well as Associated Faculty with the Darden Institute for Business in Society. The author of numerous academic articles, more than 70 Darden cases and three books, Eades has received both research and teaching awards.

Jane-Scott Cantus, Managing Principal and General Counsel, The ILEX Group, has worked with and advised Board and C-Suite members on strategy, culture, organizational design, leadership and talent for over 20 years. She co-founded the Strategic CFO Roundtable with Professor Eades and is a Fellow with Institute for Business in Society at Darden.

About the Darden Strategic CFO Roundtable

The Darden Strategic CFO Roundtable is an invitation only peer-to-peer forum for leading chief financial officers in the Washington D.C. Metropolitan Area. The Roundtable members discuss, debate and share best practices surrounding the strategic role of the CFO. Representing a collective 300+ years of strategic, financial and leadership experience, the Roundtable members share their views on the challenges and opportunities facing their companies and themselves. They discuss the lessons learned from triumphs and trials that led to their becoming recognized as strategic CFOs. Founded in 2008 by Darden Professor Kenneth M. Eades and Jane-Scott Cantus of The ILEX Group, the Strategic CFO Roundtable became a branded initiative of the Institute for Business in Society at the Darden School of Business of the University of Virginia in 2013.

About the Darden Institute for Business in Society

The Institute for Business in Society, established at the Darden School in 2011, prepares leaders to positively impact society through business. The institute advances thought leadership and innovative practices through research, teaching, programs and convening events.

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Darden IBiS Strategic CFO Roundtable Survey Results

January 2016

	N = 8 CFO RT Jan 2016		N = 6 CFO RT Sept 2015		N = 4 CFO RT May 2015		N = 7 CFO RT Jan 2015		N= 250 Duke Q4_15		N= 507 Duke Q3_15		N= 513 Duke Q2_15	
	Average	Median	Average	Median	Average	Median	Average	Median	Average	Median	Average	Median	Average	Median
1. Compared to last quarter, are you more or less optimistic regarding:-**U.S. economy** (Less =1, More = 3)	**1.9**	**2.0**	**2.2**	**2.0**	**2.5**	**2.5**	**2.3**	**2.0**	1.4	1.0	1.8	2.0	2.2	2.0
1. Compared to last quarter, are you more or less optimistic regarding:-Financial prospects for **your own company** (Less =1, More = 3)	**1.9**	**2.0**	**2.0**	**2.0**	**2.0**	**2.0**	**2.0**	**2.0**	1.9	2.0	2.1	2.0	2.2	2.0
2. Rate your optimism regarding: (Drag the slider to assign a number.)- **U.S. economy**	**63.8**	**68.5**	**68.8**	**70.0**	**67.7**	**62.0**	**67.6**	**70.0**	46.3	50.0	60.0	60.0	62.9	65.0
2. Rate your optimism regarding: (Drag the slider to assign a number.)-Financial prospects for **your own company**	**63.6**	**62.5**	**69.3**	**72.5**	**71.3**	**75.0**	**68.0**	**68.0**	61.6	60.0	65.8	70.0	67.5	70.0
5. How would you rate...-Your **employees' morale level**? (Poor =1, Satisfactory =3, Excellent = 5)	**3.5**	**3.5**	**3.2**	**3.0**	**3.8**	**4.0**	**3.7**	**4.0**						

Darden IBiS Strategic CFO Roundtable Survey Results

January 2016 (Continued)

	N = 8		N = 6		N = 4		N = 7	
	CFO RT Jan 2016		CFO RT Sept 2015		CFO RT May 2015		CFO RT Jan 2015	
(Weaker =1, No change = 2 Stronger = 3)	Average	Median	Average	Median	Average	Median	Average	Median
6. Recent quarter's financial results **vs. previous quarter: -Income Statement**	2.0	2.0	2.0	2.0	2.0	2.0	2.3	2.0
6. Recent quarter's financial results vs. previous quarter: - **Balance Sheet**	2.1	2.0	2.5	2.5	2.0	2.0	2.3	2.0
6. Recent quarter's financial results vs. previous quarter: - **Cash Balance**	2.1	2.0	2.3	2.5	1.5	1.5	2.0	2.0
8. **Expected change** over the next 4 quarters vs. last 4 quarters: **-Income Statement**	2.1	2.0	2.3	2.5	2.3	2.0	2.7	3.0
8. Expected change over the next 4 quarters vs. last 4 quarters: - **Balance Sheet**	2.0	2.0	2.3	2.0	2.0	2.0	2.0	2.0
8. Expected change over the next 4 quarters vs. last 4 quarters: - **Cash**	2.1	2.0	2.0	2.0	2.0	2.0	2.1	2.0
(Reduced =1, No change = 2, Higher = 3)								
9. **Expected change** over the next 4 quarters vs. last 4 quarters: - **Headcount**	2.4	2.0	1.7	1.5	2.3	2.5	2.3	2.0
9. Expected change over the next 4 quarters vs. last 4 quarters: - **Capital Spending**	2.3	2.0	2.2	2.0	2.3	2.0	2.1	2.0
9. Expected change over the next 4 quarters vs. last 4 quarters: - **Compensation**	2.3	2.0	2.0	2.0	2.0	2.0	2.3	2.0
9. Expected change over the next 4 quarters vs. last 4 quarters: - **Pro develop/training**	2.3	2.0	2.3	2.0	2.3	2.0	2.1	2.0
9. Expected change over the next 4 quarters vs. last 4 quarters: - **Prob (new mkt/product)**	2.5	2.5	2.2	2.0	2.3	2.0	2.0	2.0
9. Expected change over the next 4 quarters vs. last 4 quarters: - **Prob (Acquisition)**	2.0	2.0	1.7	2.0	1.5	1.5	1.7	2.0