Broader Stakeholder Concerns Drive Board Engagement

An investment steward and a compensation expert swap insights on ESG, pay for performance, and red flags.

Seven Lessons From Engaged Investors is the title of a recent study by Farient Advisors and its partners in the Global Governance and Executive Compensation Group, a collective of independent advisory firms that represent clients in more than 30 countries. Based on in-depth interviews with 25 of the largest investors around the world, the study finds that these investors place great importance on engagement with boards related to both shareholder and stakeholder issues—especially environmental, social, and governance (ESG). One of those interviewed for the study was Aeisha Mastagni, portfolio manager of the California State Teachers' Retirement System (CalSTRS), the largest public-school educators fund in the world, and the second-largest pension fund in the United States (after the California Public Employees' Retirement System). As of September 30, CalSTRS managed assets of $242.1 billion on behalf of more than 940,000 members and their beneficiaries. CalSTRS owns shares in just about every public company in the United States and in a significant number of issuers abroad. In addition, it has been influential in the sustainability movement: In 1978 and at regular

ILLUSTRATION BY NATHALIE BEAUVOIS

intervals since, CalSTRS has published a policy statement on how it accounts for ESG risks when considering where to invest.

NACD Directorship periodically brings a subject-matter expert together with either a director or, in this instance, an investment steward to explore areas that are of mutual interest and import. Here, Mastagni is joined by Farient Advisors' founder and CEO Robin A. Ferracone for a conversation on topics ranging from the rules of engagement and the need for simplicity in proxy statements, to whether additional compensation for directors who chair board committees discourages rotating new leaders into these roles. In addition to being one of the country's leading executive compensation and performance experts, Ferracone is an independent director of Trupanion and serves on the nonprofit boards of WildAid and Women on Boards 2020.

Robin A. Ferracone: What our survey of investors found is that boards are expected to provide proactive versus passive oversight. That means that they're informed, diverse, independent, and courageous. Boards need to engage with investors, and it's best if the board, and not just management, participates in the engagement process in an open-minded way. It's not enough for boards to pitch the party line. It's much more important for them to have a true dialogue and be open to what the investor has to say. This was a key point that came up universally with all investors regardless of where they worked. We also found that ESG issues—the broader stakeholder issues—really are of paramount importance. With that, let me ask how you in your role at CalSTRS view these key findings.

Aeisha Mastagni: First and foremost, while we do spend a lot of time engaging with individual portfolio companies, we also spend a lot of time in what we're calling corporate and market accountability because we own the whole market. We need to ensure that we're promoting a well-functioning, sustainable market. We spend a lot of time talking to the Securities and Exchange Commission [SEC], the PCAOB [Public Company Accounting Oversight Board], and various policymakers and regulators because we need well-functioning markets in order to manage our portfolio. Without the right tools and protection of shareholder rights, it's almost impossible to engage with individual companies.

Second is what we call board effectiveness. Good governance really begins with an effective board. If you have an effective board that comprises the right skill sets to oversee strategy, that's diverse enough, and that's properly aligning executive compensation with the long-term strategic plan for the company, then all the things fall into place. If you ensure that the board also is properly representing the shareholders, then what I call the governance loop of accountability between themselves, shareholders, and management is ensured.

Last but not least is our low-carbon transition. We're talking to a lot of companies to ensure they have the right disclosures and that they are going to be set up and resilient if policies change, especially in the US. The world is changing rapidly, and there will be companies that are winners and losers if we transition to a low-carbon economy. It's important that companies are focused on these changes and the risks they face as a result.

That's a broad overview of CalSTRS. I have a foot in each one of these areas, and I spend a lot of time on our engagement activity. As we like to say here, we're passive investors, but we're very active owners.

Ferracone: Regarding the regulatory infrastructure you need to back your work, what is it that you would want to see that we don't already have?

Mastagni: More disclosure from companies around how they're managing human capital is one piece. There's a broader consensus now in the market as a whole that we need better disclosures in this area. At the same time, we hear so often from companies that their human capital or employees are their most valuable asset, and yet there's very little disclosure from most companies in terms of how they manage that asset. This is one area, as transparency and disclosures evolve, that we investors are looking for, primarily from the SEC. What areas of CalSTRS's engagement are of interest to you and your clients?

Ferracone: I've started to pay more attention to how votes are cast for board members. I know that CalSTRS withholds about 15 percent of its vote for board members, and it votes against nearly 10 percent of board members. What are the primary reasons for either withholding or voting against board members? Is that part of an escalation policy you have? What would most affect the vote for directors, and how should boards think about that?

Mastagni: One of the reasons we vote against particular directors is because we have very high independence standards—higher than the stock exchanges, higher than, I would say, even the proxy advisors. So there are times that we're voting against board members because they don't meet our standard for independence. Second, executive compensation plans or say on pay are what's driving some of those "against" votes on directors. We've had a long-standing policy that when we're voting against say on pay we're holding the compensation committee members accountable. It would be inconsistent for us to vote against say on pay and then vote for those directors that are actually responsible for that pay program.

Aeisha Mastagni

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Ferracone: Does this happen in the same year, or if a board is not responsive to feedback, does the escalation to vote against a compensation committee member happen in the next year?

Mastagni: The vote against say on pay and the vote against board members happens in the same year. What comes out of that a lot of times is a deeper engagement with that company. Although we own 8,000 securities, we're not engaged in all 8,000 companies, and we're not engaged with all companies whose directors we're voting against. However, that's where we would escalate engagement.

Ferracone: And other reasons you would vote against directors?

Mastagni: We also vote against directors because of our overboarding policy. We have a long-standing policy where if you are a sitting CEO, we believe you should only be serving on one outside company board. You're seeing the market and even some of the proxy advisors and some of the other big asset managers start to implement stricter standards in terms of overboarding. We don't want to waver on this policy because the demands, complexities, and level of engagement with stakeholders and investors continue to increase. We want to make sure that those directors are truly overseeing and helping guide the strategic long-term value of the company.

Ferracone: I'd like to go back to the whole question of engagement. In general, how many or what percentage of your engagements involve the broader issues that are in the ESG realm as opposed to a narrow issue, let's say like say on pay or particular shareholder proposals?

Mastagni: Where we can have the most influence is when companies are really there to listen, to understand what our concerns are, and are open to a dialogue to effectively talk about their long-term strategy, how they're looking to their board to guide that strategy, what the long-term risks are to their business, and how they're thinking about those risks. I'm curious, what are your clients saying about ESG?

Ferracone: What I'm hearing and thinking is that companies are really struggling with how and what to disclose as it relates to ESG. I think what would most benefit investors is if they provided a road map in their proxies. I find that proxies have done a pretty good job on the Compensation Discussion and Analysis, but in terms of talking about how important each element of ESG is, companies are all over the place right now.

Mastagni: I would agree. We're supporters of SASB [Sustainability Accounting Standards Board]. There's still a lot of work to be done, but we think SASB is good because it's so industry focused in terms of what those ESG risks are. It's a good road map for companies and for investors, and can provide some consistency. Certain ESG factors and risks are going to be more pertinent in different industries and companies. That's one piece. The second piece is on the incentive side. As shareholders or investors, we're careful not to tell companies what metrics they should be using in their incentive plans, since that is the compensation committee's responsibility. One last point: Executive compensation plans have gotten way too complicated. I'm more for simplifying some of these plans now instead of adding new metrics.

Ferracone: To the complexity point you raised, my partner, Marc Hodak, just completed a study that looked at companies that do and don't have performance shares. Preliminarily, the study found that S&P 500 companies that rely more on performance shares tend to pay more than those that rely exclusively on time-based incentives. Second, performance is no better for firms with performance shares. If you have a performance incentive, there's no guarantee for better performance. I wonder if we have gone too far with the idea that performance shares are the best of both worlds in terms of linking to financial as well as stock price performance, and whether a heavy reliance on performance shares has created unneeded complexities with no other benefits to investors. Should we keep on the path of trying to get performance shares right? Are they worth the complexity?

Mastagni: You have to be careful what you wish for. The investors have to take some responsibility for the complexity in executive compensation because for years we asked for more performance-linked compensation. It's more complex now because of the various metrics and the different types of equity

awards. And there's been a long-term focus, like you said, on performance shares and the metrics that are used. Companies and their boards have to take a hard look at the equity vehicle they're using in their compensation plan. Companies need to look at what type of equity award is right for them. If your company's growth gears to GDP, stock options probably aren't the right vehicle. If you're a start-up company that doesn't have a lot of cash, maybe stock options are the way to go. Companies need to perhaps wipe the slate clean and start over to say, OK, how could we simplify these plans? What's the right equity vehicle for us to use, and what metrics are we going to use to determine what the payout will be?

Ferracone: Let's talk about red flags as a window into governance and the boardroom. I read a lot of proxies, for better or worse. My radar goes up when I see companies just talking about compensation for the top five executives, for example, which is the statutory requirement, as opposed to the broader executive core and maybe even the workforce as it relates to compensation policy and design. A red flag goes up when I see a real outlier in pay. A red flag goes up when the proxy reads like a public relations puff piece instead of a real discussion of the issues and the strengths and weaknesses of performance.

Mastagni: For my red flags, when I see a CEO whose pay is so much more than the other named executive officers, that reveals a lot about succession planning and how the company and board think about internal pay equity. Lack of refreshment on the board tells us something, too. The world is changing rapidly. Boards need to be constructed so that they have a mix of directors with new blood and those with institutional history as well. When I see a lot of long-tenured directors, my antennae go up.

Ferracone: When I see a proxy that's written in more of a legal format or not in plain English, that's another flag of mine.

Mastagni: I tell companies, especially some of the smaller ones, that your proxy can be an engagement tool, especially if you don't have the resources to go out and talk to a good number of your shareholders or investors. You can communicate well in your proxy. And to your point, it shouldn't be a PR tool, but it should be a good communications vehicle for your investors.

Ferracone: Inherent to what CalSTRS is as a pension fund, your investments are long-term obligations, and a lot of what is being talked about today is about having a long-term perspective and making decisions for the long-term health of the business. To that end, I was thinking about the idea of shareholder versus stakeholder interests. Stakeholder interest is really about higher ideals than generating shareholder value. It's thinking about the way we want our society to work and to make sure our companies behave in socially and environmentally responsible ways so that the planet will support us 50 years from now. It really is about raising our sights to the longer term.

I think about this as the three C's: clarity, consistency, and communication. Clarity is crisply defining values and priorities. Consistency asks whether we are behaving in ways that encourage the long-term sustainability of a company with values that remain constant during good times and bad. Communication speaks to engagement and responsiveness, as well as opening the path for two-way quality communications versus uni-directional high-quantity communications. This is critical because too often disclosures are heavy on boilerplate and quantity, and lighter on substance or quality. These three C's—clarity, consistency, and communication—are critical to the governance feedback loop to ensure that corporations are responding to investor concerns.

Finally, if companies focus on clarity, consistency, and communication, we will create road maps for healthier corporate cultures, which is a hallmark of sustainability and is in a way the fourth C. I just keep coming back to the long-term sustainability of the company as a key theme, especially when we consider how climate is impacting different industries. The importance of moving from financial to ESG issues over time needs to be addressed and managed carefully.

Mastagni: I think the long-term sustainability of our portfolio companies and the increasing impact of ESG on our investments are critically important. We're going to be engaged in the market for as long as there are teachers in California.

Robin A. Ferracone

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