Some Thoughts for Boards of Directors in 2016

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I. Introduction

Over the last two decades, the corporate governance landscape has become increasingly dominated by the view that maximizing the power and influence of shareholders will lead to stronger and better-governed companies. The widespread dismantling of staggered boards and change-of-control defenses, the promulgation of say-on-pay and other governance mandates, and the proliferation of best practices are largely premised on this shareholder rights manifesto. In the aggregate, the changes have been transformative and have precipitated a sea change in the gestalt of Wall Street. Hedge fund activism has exploded as an asset class in its own right, and even the largest and most successful companies are vulnerable to proxy fights and other activist campaigns. In response to short-termist pressures brought by hedge funds and activist shareholders, companies have been fundamentally altering their business strategies to forego long-term investments in favor of stock buybacks, dividends and other near-term capital returns. At this point, theoretical debates about the pros and cons of a shareholder-centric governance model have been superseded by observable, quantifiable trends and behaviors. For example, according to Standard & Poor's, dividends and stock buybacks in the U.S. totaled more than $900 billion in 2014—the highest level on record, and last December, a Conference Board presentation compiled data demonstrating that capital investment by U.S. public companies has decreased and is less than that of private companies.

Against this backdrop, however, there have recently been signs of a growing recognition that the current status quo presents a cognizable, systemic threat to the sustainability and future prosperity of the American economy. Several major institutional investors have gone on the record to criticize—and have voted against—the typical activist playbooks, and have sought to establish and publicize their long-term mindset. Such sentiments have also recently begun to resonate beyond the corporate world and have gained some traction in populist or political agendas. For example, Hillary Clinton has been advocating proposals to combat "quarterly capitalism" and has linked short-termism to broader concerns about the growing income disparity gap. In addition, there is now a critical mass of econometric studies and other academic research discrediting the notion that short-termism, activist attacks and shareholder-centric governance tend to create rather than destroy long-term value.

While it remains to be seen whether the tide is indeed turning on shareholder activism, it is clear that a new opportunity has opened up for significant changes in the relationships between companies and their large institutional shareholders. BlackRock, State Street, Vanguard and a number of other major institutions have been articulating their perspectives and expectations on matters ranging from engagement, board composition, long-term strategy and transparency. In a letter earlier this year to independent board leaders of Vanguard's largest portfolio holdings, F. William McNabb III, Vanguard's Chairman and CEO, remarked, "In the past, some have mistakenly assumed that our predominantly passive management style suggests a passive attitude with respect to corporate governance. Nothing could be further from the truth."

In some respects, the policies of the major institutional shareholders overlap with those of the shareholder activists, insofar as they are inclined to push for more rather than fewer shareholder powers and rights. On the other hand, their publicly stated long-term mindset may

put them at odds with the hedge fund activists for whom "long-term" is measured in months rather than years. And their real world experience and meaningful economic stake gives them a much different perspective than, for example, the proxy advisory firms, the gadfly activists who submit hundreds of shareholder proposals each year to companies in which they barely hold a minimum shareholding amount, and the academics who purport to vindicate governance mandates based on statistical analysis. These major institutions are attuned to the real world costs of special interest agendas and the disproportionate impact such agendas are having on corporate strategies and long-term sustainability. Moreover, they are uniquely positioned to use their heavyweight status to recalibrate the system. If they continue on their current path, the influence of activist hedge funds and ISS and Glass Lewis should diminish.

In the coming year, boards should work with management to reassess their understanding of what constitutes state-of-the-art governance in light of this guidance from the major institutional investors, and to develop and enhance their companies' engagement and relationships with these investors.

II. The Evolving Role of the Major Institutional Investors

In many respects, the largest institutional investors today have no choice but to take a view in the ongoing governance debate. Their influence is at an all-time high as a result of the growth in their percentage of total equity ownership and the expanded ability of shareholders to influence the boards and management of public companies. Investors in Vanguard funds, for example, collectively own about 5% of every publicly traded company in the U.S. and about 1% of nearly every public company outside the U.S. Time and again, the outcome of proxy contests and other significant matters submitted to a shareholder vote has rested in the hands of a relatively small group of hugely influential institutional investors. These institutions must decide whether to vote for or against, and even in situations where doing nothing is ostensibly an option, the size of their stockholding position can make non-action as impactful as taking affirmative action.

Accordingly, BlackRock, State Street, Vanguard and other large institutional investors have been articulating their perspectives on corporate governance matters—and not as an afterthought in the shadow of business and financial matters addressed by their portfolio managers, but rather as a standalone priority in its own right. Corporate governance is not just a means-to-an-end administrative or procedural framework; it is about the basic rules of the game and can be an overarching value driver. Among other things, these institutions have been growing their own in-house teams with expertise in governance matters, publishing voting guidelines that in many respects deviate from the inflexible positions of the leading proxy advisory firms, and issuing letters to CEOs and directors of their portfolio companies.

In embracing the concept of stewardship, some institutional investors have not just been disintermediating the proxy advisory firms and actively voting their shares but, more broadly, have emerged as thought leaders in the debate about short-termism. In the summer of 2015, for example, Legal & General Investment Management, a major European asset manager and global investor with over £700 billion in total assets under management, contacted the boards of the London Stock Exchange's 350 largest companies to support the discontinuation of company quarterly reporting, emphasizing: "[R]eporting which focuses on short-term performance is not

necessarily conducive to building a sustainable business as it may steer management to focus more on short-term goals and away from future business drivers."

Implicit in their perspective is a recognition that shareholders are not a monolithic constituency, and that "shareholder value" is hardly as objective as the daily yardstick of stock price performance would suggest. As Anne Simpson, director of corporate governance and a senior portfolio manager of CalPERS, recently stated, "Generally speaking, investors today fall into three groups: owners, traders, and raiders. The traders and the raiders—the activists—are all about generating short-term returns. We, the big owners, are there for the long term—so long that we're permanent." As institutional investors become more active in forming and articulating their own views, the ways in which their interests diverge from those of other shareholders will come into sharper focus, which may in turn drive more nuanced discussions about shareholder value and even cast traditional concepts of shareholder power and rights in a new light. While corporate governance debates in the last decade or so have largely been framed in terms of board/management versus shareholders, it may be that the next phase in corporate governance evolution features more debates between different types of shareholders—for example, activist hedge funds versus index funds or other large mutual fund groups.

III. Engagement with Shareholders

Against this backdrop, many public companies have made shareholder engagement a top priority and have been spending considerable time and energy to cultivate relationships with their long-term shareholders. Most companies have traditionally had active investor relations programs, including regularly scheduled meetings with shareholders, investor days and/or other outreach activities. The difference today is that such outreach has evolved from being focused mainly on business and financial matters to now also addressing governance issues, sometimes in separate meetings led by in-house governance experts at both companies and institutional investors. In addition, engagement has increasingly become a board-level issue with direct participation by independent directors. Recent statements by major institutional investors clearly outline their expectation that companies should provide access to independent directors, and they have indicated that it will color their attitude toward a company if the company first begins to provide such access only after it has been attacked by an activist.

Companies have been exploring a range of approaches in constructing shareholder relations programs that will facilitate the development of meaningful long-term relationships. One question that merits careful consideration is the extent to which independent directors should be proactively involved in outreach efforts, while at the same time striking an appropriate balance between the roles of management and the board. The policies and arrangements best suited for any given company will depend on, among other things, the preferences of directors, the nature and extent of existing relationships with major shareholders, the expressed preferences of those shareholders, and the structure and staffing of the company's existing shareholder relations program. For example, some institutional investors have suggested that companies should create a board-level shareholder relations committee to receive communications from and meet with investors. As an alternative, some companies have found it useful for the lead director or a committee chair, with or without other independent directors, to be available for meetings with the company's top investors.

Whatever approach is taken, the key is quality rather than quantity. As a practical matter, institutional investors have a finite bandwidth for engagement activities and tend to prioritize their efforts toward companies where they have governance concerns or where engagement is needed to make a more fully informed voting decision. Shareholder relations programs should be realistic about the extent to which they call for one-on-one meetings and individualized feedback from investors. Likewise, preparing for and participating in road shows, investor days, and other outreach efforts require a considerable amount of time and effort from management and directors, and both companies and investors should be pragmatic about balancing the goals of shareholder engagement with the demands of running a business.

A more unilateral—but nonetheless essential—form of engagement is disclosure and transparency. As recently noted by Vanguard's Chairman and CEO, "Sometimes engagement can mean just being crystal clear about your expectations—and about how you think through certain issues." Enhanced disclosures and other communications to investors can be an efficient and effective way for directors to convey their perspectives, priorities and expectations to shareholders. In this regard, companies have increasingly been including disclosures about their engagement efforts in their proxy statements. A report by the EY Center for Board Matters at Ernst & Young LLP suggests that approximately 56% of the S&P 500 companies included such disclosures in 2015, up from approximately 6% five years ago. Other disclosure trends that may be gaining traction are board skills matrices and descriptions about the frequency and process for conducting board self-evaluations. For their part, institutional investors have also been working to be more transparent by, for example, publishing their voting and engagement priorities on key governance topics.

IV. The Board's Role as Strategic Advisor

One of the most important challenges facing directors today is advising with respect to business strategy in an era in which short-termist pressures have thoroughly saturated Wall Street's expectations and the base case against which strategic decisions are evaluated is often measured in quarters rather than years. Short-termist pressures are perhaps most prominent in situations where activist hedge funds have launched an attack. The frequency of public activist attacks as well as behind-the-scenes activist situations has continued to increase. And the influence of activism is altering corporate strategies not only in actual activist situations, but also more pervasively as boards and management teams follow the advice to "think like an activist" and proactively consider stock buybacks and reductions in capital expenditures, research and development, and employee training and headcount. A survey of C-level executives and board members commissioned by McKinsey & Company and the Canadian Pension Plan Investment Board found that nearly two-thirds of respondents felt that pressure on their companies' senior executives to deliver short-term financial performance had increased over the past five years, and 79% said they felt the most pressure to produce results within two years or less. In this environment, the board's role in providing strategic advice and support for management's plans to create long-term value has never been more critical. As Laurence Fink, Chairman and CEO of BlackRock, observed in a 2015 letter issued to CEOs of S&P 500 companies: "[T]he board is management's first line of defense against short-term pressures."

Several trends have converged to tilt the playing field in favor of hedge fund activists and other sources of short-term pressures. According to FactSet's 2015 data through the beginning

of June, the number of proxy fight settlements or withdrawals after the company made material concessions was the highest of any year since FactSet began tracking proxy fights in 2001, and there were 46 non-proxy fight activist campaigns that resulted in a board seat, the most in any comparable period. As a case in point, the challenges faced by all companies dealing with activists is illustrated by the fact that DuPont—a leading American company with a distinguished board and management, a strong track record and a long history of world-class innovation—defeated Trian Partners' proxy fight to replace four DuPont directors only by a very close vote after a long fight. Not long after the proxy fight was won, the DuPont CEO resigned and the new CEO announced that the company would pursue some of the strategies that Trian Partners had urged in the proxy fight.

The challenges faced by boards in navigating short-termist pressures are further exacerbated by the nature of their predicament: a decision to forego prudent investments may jeopardize the long-term viability of the company, but proceeding with such investments risks fueling an activist attack or other backlash from unhappy shareholders focused on quarterly results. Such strategic decisions are tremendously complex and rife with tradeoffs and inherent compromises that test board functioning at its core.

In this environment, boards must reaffirm their commitment to the long-term vitality and competitiveness of their companies, and not be unduly distracted or discouraged by the prevailing short-termist mindset on Wall Street. Now more than ever, directors need to have the courage of their convictions in overseeing the strategic direction and management of companies. Given the recent statements of some major institutional investors, there is hope that boards that resist short-termist pressures, and are able to clearly explain their companies' long-term strategy, may be able to win the support of their largest shareholders in the event they do face an activist attack.

V. Spotlight on Boards

The ever evolving challenges facing boards of public companies prompts an updated snapshot of what is expected of them—not just the legal rules, but also the aspirational best practices that have almost as much influence on board and company behavior. In sum, boards are expected to:

- Establish the appropriate "Tone at the Top" to actively cultivate a corporate culture that gives high priority to ethical standards, principles of fair dealing, professionalism, integrity, full compliance with legal requirements and ethically sound strategic goals.

- Choose the CEO, monitor his or her performance and have a succession plan in case the CEO becomes unavailable or fails to meet performance expectations.

- Maintain a close relationship with the CEO and work with management to encourage entrepreneurship, appropriate risk taking and investment to promote the long-term success of the company (despite the constant pressures for short-term performance) and to navigate the dramatic changes in domestic and world-wide economic, social and political conditions.

- Approve the company's annual operating plan and long-term strategy, monitor performance and provide advice to management as a strategic partner.

- Develop an understanding of shareholder perspectives on the company and foster long-term relationships with shareholders, as well as deal with the requests of shareholders for meetings to discuss governance, the business portfolio, and operating strategy, and for greater transparency into the board's practices and priorities.

- Evaluate the demands of corporate governance activists, make changes that the board believes will improve governance, and resist changes that the board believes will not be constructive.

- Work with management and advisors to review the company's business and strategy, with a view toward minimizing vulnerability to attacks by activist hedge funds.

- Organize the business, and maintain the collegiality, of the board and its committees so that each of the increasingly time-consuming matters that the board and board committees are expected to oversee receive the appropriate attention of the directors.

- Plan for and deal with crises, especially crises where the tenure of the CEO is in question, where there has been a major disaster or a risk management crisis, or where hard-earned reputation is threatened by a product failure or a socio-political issue. Many crises are handled less than optimally because management and the board have not been proactive in planning to deal with crises, and because the board cedes control to outside counsel and consultants.

- Determine executive compensation to achieve the delicate balance of enabling the company to recruit, retain and incentivize the most talented executives, while also avoiding media and populist criticism of "excessive" compensation and taking into account the implications of the "say-on-pay" vote.

- Face the challenge of recruiting and retaining highly qualified directors who are willing to shoulder the escalating work load and time commitment required for board service, while at the same time facing pressure from shareholders and governance advocates to embrace "board refreshment," including issues of age, length of service, independence, expertise, gender and diversity.

- Provide compensation for directors that fairly reflects the significantly increased time and energy that they must now spend in serving as board and board committee members.

- Evaluate, or arrange for the evaluation of, the board's performance and the performance of the board committees and each director.

- Determine the company's reasonable risk appetite (financial, safety, cyber, political, reputation, etc.), oversee the implementation by management of state-of-the-art standards for managing risk, monitor the management of those risks within the parameters of the

company's risk appetite and seek to ensure that necessary steps are taken to foster a culture of risk-aware and risk-adjusted decision-making throughout the organization.

- Oversee the implementation by management of state-of-the-art standards for compliance with legal and regulatory requirements, monitor compliance and respond appropriately to "red flags."

- Take center stage whenever there is a proposed transaction that creates a real or perceived conflict between the interests of shareholders and those of management, including takeovers and attacks by activist hedge funds focused on the CEO.

- Recognize that shareholder litigation against the company and its directors is part of modern corporate life and should not deter the board from approving a significant acquisition or other material transaction, or rejecting a merger proposal or a hostile takeover bid, all of which is within the business judgment of the board.

- Set high standards of social responsibility for the company, including human rights, and monitor performance and compliance with those standards.

- Oversee relations with government, community and other constituents.

- Review corporate governance guidelines and committee charters and tailor them to promote effective board functioning.

To meet these expectations, it is necessary for major public companies to: (1) have a sufficient number of directors to staff the requisite standing and special committees and to meet expectations for diversity; (2) have directors who have knowledge of, and experience with, the company's businesses, even if this results in the board having more than one director who is not "independent"; (3) have directors who are able to devote sufficient time to preparing for and attending board and committee meetings; (4) provide the directors with regular tutorials by internal and external experts as part of expanded director education; and (5) maintain a truly collegial relationship among and between the company's senior executives and the members of the board that enhances the board's role both as strategic partner and as monitor.