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Succeeding in the New Paradigm for Corporate Governance

Recognizing that the incentive for long-term investment is broken, leading institutional investors are developing a [new paradigm](#) that prioritizes sustainable value over short-termism, integrates long-term corporate strategy with substantive corporate governance and requires transparency as to director involvement. We believe that the new paradigm can reduce or even eliminate the outsourcing of corporate governance and portfolio oversight to ISS and activist hedge funds.

Based on a series of statements by these investors over the past few years, we offer practical options for companies to consider as they adjust to the new paradigm and decide what and how to communicate. For example, the January 23, 2017 [corporate governance letter](#) from Laurence Fink, Chairman and CEO of BlackRock, to the CEO's of the S&P 500 companies contains the following advice with respect to engagement:

BlackRock engages with companies from the perspective of a long-term shareholder. Since many of our clients' holdings result from index-linked investments – which we cannot sell as long as those securities remain in an index – our clients are the definitive long-term investors. As a fiduciary acting on behalf of these clients, BlackRock takes corporate governance particularly seriously and engages with our voice, and with our vote, on matters that can influence the long-term value of firms. With the continued growth of index investing, including the use of ETFs by active managers, advocacy and engagement have become even more important for protecting the long-term interests of investors.

Each company should make its own independent decision as to content, persons, venues and intensity of its communications and what adjustments, if any, to its strategy and operations may be appropriate to meet the expectations of investors who have embraced the new paradigm.

What to Communicate

Lead with the Strategy. In the new paradigm, the company's long-term strategy, its implementation and the company's progress in achieving it take center stage. Check-the-box governance fades into the background. Define the company and its vision, explain key drivers of strategy and business outcomes and articulate how a portfolio of businesses and assets fit together and are reviewed. Discuss key risks and mitigation methods and share how the company evaluates whether the

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strategy remains viable as the business environment, competitive landscape and regulatory dynamic change. Discuss how a business model has transformed, and if the company is in the midst of a strategic transformation or a well-conceived turnaround plan that requires time to execute, explain it.

Confirm Board Involvement in the Strategy. The company should also explicitly describe how the board has actively reviewed long-term plans and that it is committed to doing so regularly. Proactively share with these investors how directors are integrated into strategic planning, exercise robust oversight and test and challenge both strategy and implementation. In the new paradigm, be clear and direct about the board's role in guiding, debating and overseeing strategic choices.

Make the Case for Long-Term Investments, Reinvesting in the Business for Growth and Pursuing R&D and Innovation. The company should clearly explain how such investments are reviewed and articulate why and how they matter to long-term growth and value creation. For investments that will take time to bear fruit, acknowledge that and explain their importance, timing and progress.

Describe Capital Allocation Priorities. This also includes discussing the board's process for reviewing and approving capital allocation policies. Where return of capital is a pillar of the company's value creation framework, demonstrate thoughtfulness about the timing, pacing and quantum of buybacks and/or dividends and an awareness of relative tradeoffs. If maintaining an investment-grade or fortress balance sheet is a priority, clarify why.

Explain Why the Right Mix of Directors Is in the Boardroom. Present the diverse skills, expertise and attributes of the board as a whole and of individual members and link those to the company's needs and risks. Be transparent about director recruitment processes that address future company and board needs. Disclose the policy for ensuring that board composition and practices evolve with the needs of the company, including views on balance, tenure, retaining institutional knowledge, board refreshment and presence or absence of age or term limits. Carefully explain procedures for increasing the diversity of the board and for ensuring that directors possess the skills required to direct the course of the company. Discuss director orientation, tutorials and retreats for in-depth review of key issues. Show that board, committee and director evaluations are substantive exercises that inform board roles, succession planning and refreshment objectives.

Address Sustainability, Citizenship and ESG/CSR. The company should integrate relevant sustainability and ESG matters into strategic and operational planning and communicate these subjects effectively. Sharing sustainability

information, corporate responsibility initiatives and progress publicly on the company's website and bringing them to these investors' attention are significant actions in the new paradigm.

Articulate the Link Between Compensation Design and Corporate Strategy. Describe how compensation practices encourage and reward long-term growth, promote implementation of the strategy and achievement of business goals and protect shareholder value.

Discuss How Board Practices and Board Culture Support Independent Oversight. Clearly articulate the actual practices and responsibilities of the lead director or non-executive chair, independent directors, committee chairs and the board as a whole in providing effective oversight, understanding shareholder perspectives, evaluating CEO performance and organizing themselves to ensure priorities are met.

How to Communicate

Periodic “Letters” to Investors. Periodic “letters” to shareholders on behalf of the management and/or board focusing on the issues deemed important for satisfaction of the new paradigm are valuable. Letters from management can articulate management's vision and plans for the future, explain what the company is trying to achieve and discuss how it plans to win in the market. Letters from the board can convey board-level priorities and involvement. Depending on the circumstances, statements or letters may be separate, jointly signed by the CEO and the lead director or non-executive chair, come from particular committees as to matters within their ambit or be from the full board.

Investor Days. The company should use “Investor Days” to articulate a long-term perspective on company prospects and opportunities and provide “deep dives” into strategy, performance and capital allocation. Challenges should also be candidly addressed and responsive initiatives outlined. Deciding which long-term metrics, goals and targets should be shared is an area in active evolution. All of the company's major long-term investors, including “passive” investors and index funds, should be extended an invitation. Key materials from a completed Investor Day can also be separately circulated to investors, including index funds. The company may also invite directors to attend. In certain cases, it may be useful for a director to participate in an Investor Day to validate and communicate board involvement and priorities.

Quarterly Communications. Quarterly earnings rituals remain, for now, a fact of life in the U.S. Nevertheless, the company can place quarterly results in the context of long-term strategy and objectives, discuss progress towards larger goals and articulate higher priorities, all while eschewing quarterly guidance.

Proxy Statements, Annual Reports, Other Filings and the Company’s Online Presence. Proxy statements, annual reports/10-Ks, SEC filings, presentations and voluntary disclosures provide communication opportunities. For example, the customary proxy section entitled “The Board’s Role in Risk Oversight” will ultimately evolve into section(s) covering “Board Oversight of Strategy and Risk.” The company should present information online in readily accessible, user-friendly and well-organized formats.

Investor Engagement. Disciplined, direct and periodic two-way dialogue with institutional investors is advisable, supported by written communications and tailored presentations. Opening channels of communication in advance of a crisis or activist challenge is extremely important. Communicate engagement procedures and activity. Prepare for director-level interactions with major shareholders and know when and how to involve directors – proactively or upon appropriate request – without encroaching upon management effectiveness. Do not hesitate to reach out to investors, even during proxy season, if there is a matter of importance to discuss. Coordinate internal outreach across the different categories of shareholders and have a superstar corporate governance executive and a superstar investor relations executive.

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