January 2017

The Spotlight on Boards 2017

This past year witnessed a number of new corporate governance initiatives. Among the most significant:

- BlackRock, State Street and Vanguard each issued strong statements supporting long-term investment, criticizing the short-termism afflicting corporate behavior and the national economy and rejecting financial engineering to create short-term profits at the expense of sustainable value.

- The Business Roundtable issued an updated version of its *Principles of Corporate Governance*.

- The International Business Council of the World Economic Forum issued *The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth* and over 100 companies to date signed *The Compact for Responsive and Responsible Leadership: A Roadmap for Sustainable Long-Term Growth and Opportunity*, sponsored by the WEF, which includes the key features of The New Paradigm.

- The January 23, 2017, "must read," 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, "As we seek to build long-term value for our clients through engagement, our aim is not to micromanage a company's operations. Instead, our primary focus is to ensure board accountability for creating long-term value. However, a long-term approach should not be confused with an infinitely patient one. When BlackRock does not see progress despite ongoing engagement, or companies are insufficiently responsive to our efforts to protect our clients' long-term economic interests, we do not hesitate to exercise our right to vote against incumbent directors or misaligned executive compensation."

These and ever-evolving challenges facing corporate boards prompts an updated snapshot of what is expected in 2017 from the board of directors of a major public company – not just the legal rules, but also the aspirational "best practices" that have come to have equivalent influence on board and company behavior.

Boards are expected to:

- Be actively involved with management in the development and oversight of a thoughtful long-term strategy for the company and the communication of this strategy to investors. Understand strategic assumptions, uncertainties, judgments, alternatives and risks.

- Appreciate that a healthy corporate culture is a valuable asset, a source of competitive advantage and vital to the creation and protection of long-term value. Establish the appropriate "Tone at the Top" to actively cultivate a culture that gives high priority to ethical standards, principles of fair dealing, professionalism, integrity, full compliance with legal requirements and ethically sound strategic goals. Understand employee morale and sentiment, including through updates from management.

- 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. Encourage robust succession planning for C-level executives, senior managers and key personnel below the CEO level.

- 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 worldwide 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 shareholder requests for meetings to discuss governance, the business portfolio, capital allocation 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 and securing the support of the company's long-term investors.

- 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 or business 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 encourage and reward executives for accomplishing business goals in furtherance of the company's long-term strategy and seek 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 take into account the implications of the "say-on-pay" vote. Consider whether compensation schemes for employees below the C-suite create appropriate or inappropriate incentives.

- 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.

- Develop and keep fresh a plan for the annual 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 actions taken in response to non-compliance. 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 stockholders 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. Determine which sustainability and ESG matters to integrate into strategic and operational planning and oversee effective communication on these subjects.

- Oversee relations with government, community, stakeholders and other constituents. Be alert to potential breakdowns in these relationships that may create reputational or other harm to the company.

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

To meet these expectations, it will be necessary for major public companies (1) to have a sufficient number of directors to staff the requisite standing and special committees and to meet expectations for diversity; (2) to 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) to have directors who are able to devote sufficient time to preparing for and attending board and committee meetings; (4) to meet investor expectations for director involvement, age, diversity and periodic refreshment; (5) to provide the directors with regular tutorials by internal and external experts as part of expanded director education; and (6) to 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.

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