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Some Thoughts for Boards of Directors in 2014

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In many respects, the relentless drive to adopt corporate governance mandates seems to have reached a plateau: essentially all of the prescribed "best practices"—including say-on-pay, the dismantling of takeover defenses, majority voting in the election of directors and the declassification of board structures—have been codified in rules and regulations or voluntarily adopted by a majority of S&P 500 companies. Only 11 percent of S&P 500 companies have a classified board, 8 percent have a poison pill and 6 percent have not adopted a majority vote or plurality-vote-plus-resignation standard to elect directors. The activists' "best practices" of yesterday have become the standard practices of today. While proxy advisors and other stakeholders in the corporate governance industry will undoubtedly continue to propose new mandates, we are currently in a period of relative stasis as compared to the sea change that began with the Sarbanes-Oxley Act and unfolded over the last decade.

In other respects, however, the corporate governance landscape continues to evolve in meaningful ways. We may be entering an era of more nuanced corporate governance debates, where the focus has shifted from check-the-box policies to more complex questions such as how to strike the right balance in recruiting directors with complementary skill sets and diverse perspectives, and how to tailor the board's role in overseeing risk management to the specific needs of the company. Shareholder engagement has been an area of particular focus, as both companies and institutional investors have sought to engage in more regular dialogue on corporate governance matters. The evolving trend here is not only the frequency and depth of engagement, but also a more fundamental re-thinking of the nature of relationships with shareholders and the role that these relationships play in facilitating long-term value creation. Importantly, this trend is about more than just expanding shareholder influence in corporate governance matters; instead, there is an emphasis on the roles and responsibilities of both companies and shareholders in facilitating thoughtful conversations instead of reflexive, off-the-

shelf mandates on corporate governance issues, and cultivating long-term relationships that have the potential to curb short-termist pressures in the market.

Shareholder relations are particularly critical in light of the recent uptick in economic activism by hedge funds and other investors seeking increased leverage, large share buybacks, special dividends, spin-offs, divestitures and other corporate transactions. This increase is being precipitated by a convergence of several factors, including the erosion of takeover defenses, as well as governance reforms that have made directors more vulnerable to withhold-the-vote campaigns and proxy contests. The governance activism plateau is serving as a convenient stepping stone for economic activists. While boards should be prepared to defend against such attacks, they should not let the threat of an attack undermine the company's ultimate objective of creating sustainable, long-term value. A carefully crafted strategic plan can carry the day in a proxy fight, as illustrated by the decisive victories of incumbent boards in proxy contests at AOL, Target, Clorox and many other companies.

In recent years, companies have been busy responding to the steady barrage of new best practices, shareholder proposals, ISS policies and incremental disclosure obligations. There has been considerable pressure to adopt reforms for the sake of reform. These challenges on the governance front were compounded by economic and market factors that created a relatively bearish market characterized by uncertainty, where stability rather than growth was often the more realistic objective, and pressures to produce short-term results were acute. In today's environment, boards need to embrace a mindset and tone at the top that is proactive, confident and bold. Boards should reassess their playbook on key priorities, including long-term strategy, CEO succession planning and risk management, with a view to pressure testing it for vulnerabilities in the current environment. They should be proactive not only in reviewing their strategies and plans, but also in communicating these initiatives to shareholders and other market participants.

Highlighted below are a few of the more significant issues and trends that directors should bear in mind as they consider their companies' priorities and objectives and seek to optimize governance structures and procedures.

Board Composition

Boards face a two-fold challenge: they must recruit and retain high quality directors who are willing to shoulder the escalating workload and time commitment required for board service, while at the same time, they face pressure from shareholders and corporate governance advocates to embrace the concept of "board refreshment." This newly popular catchphrase in the corporate

governance lexicon is an amalgamation of several issues relating to board composition—including director independence, and gender and other diversity goals.

For example, in the latest ratcheting-up of director independence standards, director tenure is being added to the litany of potentially disqualifying criteria in assessing independence. ISS focused on director tenure as one of the central themes of its 2013-2014 policy survey, and reported in October that 63 percent of the investors surveyed believed long director tenure is problematic because it can diminish a director's ability to serve as an independent steward. The Council of Institutional Investors has urged boards "to consider carefully whether a seasoned director should no longer be considered independent," and CalPERS's head of corporate governance has urged shareholders to "make the case for director refreshment." It remains to be seen whether there will be pressure to adopt term limits or bright-line rules that presume directors to be non-independent after a specified period of board service. In the U.K., directors with tenure exceeding nine years are considered non-independent unless the company provides clear justification, and many other European countries have drawn the line at 12 years. Currently, ISS's policy is to recommend voting against term limits, but if the average tenure of a board's directors exceeds 15 years, it will consider whether directors are sufficiently independent from management and whether there has been sufficient turnover to ensure fresh perspectives in the boardroom. ISS recently launched a consultation process to consider, among other things, whether it should classify directors with lengthy tenures as non-independent, and whether to consider the mix of director tenures on a board as a key factor in deciding whether to recommend a vote for the re-election of nominating committee members.

Another issue that has been prompting calls for board refreshment is diversity, with director turnover advocated as a means of creating opportunities for women and minorities to join boards. The issue of gender diversity in particular has been gaining momentum and has spurred several new legislative and non-governmental initiatives in the U.S. and abroad. In Europe, several countries have adopted mandatory quotas for gender diversity, and a report recently issued by the European Commission indicates that the percentage of women on public company boards has increased notably as a result. A pending proposal by the European Commission would require large public companies to introduce a new director selection procedure that gives priority to qualified female candidates unless at least 40 percent of their non-executive directors are already women. In Canada, the Ontario Securities Commission has commenced a consultation on disclosure requirements for gender diversity on listed company boards and in senior management, and has suggested a comply-or-explain disclosure model. In the U.S., the California state senate recently approved a resolution that urges every California public company to have, by the end of 2016, one to three women on its board.

To be sure, adding new directors to the board can enhance board performance, and nominating committees should consider whether there are underperforming directors or ways in which boards could be enhanced with new skill sets and perspectives. In a recent survey by PricewaterhouseCoopers, 35 percent of the directors polled suggested that someone on their board should be replaced due to diminished performance because of aging, a lack of required expertise, poor preparation for meetings or other factors. The risk, however, is that director turnover is being advocated as an end in itself, rather than as a means to achieve a well-functioning board. Longevity should not in and of itself be a disqualifying factor. Indeed, long-serving directors with a deep understanding of a company's business and culture, and first-hand knowledge of the ways in which the company has evolved over time to meet new challenges, can be truly irreplaceable. Likewise, the benefits of gender and other diversity should be considered in conjunction with other factors to facilitate a well-rounded composition tailored to the particular needs of each company.

In seeking a balanced board, what is needed is the right mix of industry and financial expertise, objectivity, diversity of perspectives and business backgrounds, integrity, character, commitment, judgment, energy, competence and professionalism, among other qualities. These factors are intrinsically difficult if not impossible to boil down to bright-line regulatory requirements or off-the-shelf mandates. One of the ways in which companies have sought to demonstrate that they are focused on this issue is by enhancing their proxy statement disclosures. In addition to expanding director biographies to comply with the SEC's disclosure requirements of 2009, several companies now include a skills matrix to highlight relevant areas of expertise, which directors are particularly qualified in those areas and how board composition is tailored to the company's needs and strategy. A recent survey by Ernst & Young reported that 13 percent of Fortune 100 companies included such a matrix in their 2013 proxy statements. Such disclosure initiatives can be helpful in pre-empting or responding to pressures for board refreshment.

Regulation Of Proxy Advisory Firms

Over the past few years, there has been an emerging, broad-based consensus that proxy advisory firms enjoy a regulatory loophole that needs to be addressed. In contrast to the detailed disclosure requirements and procedural mandates that apply to solicitations of proxies and investment offers, these firms have basically carte blanche discretion to enact voting policies that influence, and may effectively determine, a substantial portion of the voting decisions of institutional investors. Studies suggest the proxy advisory firms, as a whole, affect as much as a quarter to half of votes cast, and their influence extends to some of the most fundamental decisions made by public companies, such as executive compensation and director elections. Despite the key role they play, their processes have been widely criticized as lacking

transparency, plagued by errors and conflicts of interest, and based on blunt, one-size-fits-all formulas that can undermine shareholder value. A paper recently issued by the Rock Center for Corporate Governance at Stanford University outlined evidence that corporations change their executive compensation programs to obtain a favorable say-on-pay recommendation from proxy advisory firms, and that these changes are value decreasing for shareholders.

Although regulatory changes to address these problems have yet to be adopted, there continued to be several “smoke signals” this past year that suggest that some changes may be on the horizon. In the U.S., the House Subcommittee on Capital Markets and Government Sponsored Enterprises held a hearing in June titled “Examining the Market Power and Impact of Proxy Advisory Firms.” Later in the summer, SEC Commissioner Daniel M. Gallagher criticized the legal linchpin of the proxy advisory firms’ influence—namely, two SEC no-action letters issued in 2003 that suggest mutual fund, pension fund and other investment advisors may discharge their fiduciary duty to clients by voting their shares in accordance with recommendations of proxy advisors. He suggested that the SEC “should fundamentally review the role and regulation of proxy advisory firms and explore possible reforms, including, but not limited to, requiring them to follow a universal code of conduct, ensuring that their recommendations are designed to increase shareholder value, increasing the transparency of their methods, ensuring that conflicts of interest are dealt with appropriately, and increasing their overall accountability.” Echoing the concerns voiced by Commissioner Gallagher, in October, NASDAQ filed a rule-making petition urging the SEC to revise its no-action guidance to promote greater transparency in proxy advisors’ formulas and methods as well as disclosures of conflicts of interest.

In tandem with these developments on the regulatory front, some major investment advisors have been re-thinking the role of proxy advisory firms in their proxy voting processes. In a letter issued to CEOs and/or board chairs of approximately 600 public companies in 2012, BlackRock noted that it makes its proxy voting decisions independently of proxy advisory firms on the basis of internal guidelines that are “pragmatically” applied, and it advised companies to engage with BlackRock to address potential governance issues prior to engaging with proxy advisory firms. T. Rowe Price, Vanguard, CalSTRS and others also have internally developed voting guidelines that they supplement with research from proxy advisory firms.

The changes precipitated by ISS and other proxy advisory firms over the last two or three decades have become firmly entrenched, however, and at this point, there is no going back to first principles. Notwithstanding any future waning of these firms’ influence, best practices such as the majority voting standard and the demise of standing poison pills will continue to shape the voting policies of institutional investors. However, a renewed emphasis on tailored, pragmatic voting decisions would be a much welcomed change from the notoriously inflexible and dogmatic

check-the-box culture of proxy advisory firms. As a case in point, the failure of the highly contested CEO/Chairman split proposal at JPMorgan Chase this year illustrates the ability of a company to persuade shareholders why an off-the-shelf mandate will undermine rather than enhance shareholder value. Despite recommendations of ISS and Glass Lewis in favor of the proposal, it garnered only 32.2 percent of votes present, as compared to 40 percent shareholder support for the same proposal in 2012. Another sign of the potential waning influence of proxy advisory firms: 261 companies received negative say-on-pay vote recommendations from ISS in 2013, yet only 18 percent failed to win majority approval.

Engagement With Shareholders

One of the most fundamental changes in the corporate governance landscape in the last few years is the evolving nature and dynamic of companies' relations with shareholders. Today, shareholders increasingly expect—and directors have been increasingly called on to devote time and attention to—meetings and other dialogue with shareholders about corporate governance and other matters. This trend was accelerated by the enactment of mandatory say-on-pay voting which, for most companies, now occurs on an annual basis and has prompted many companies to engage in substantial outreach efforts to explain their executive compensation policies and solicit shareholder views. A recent survey by Georgeson reported that 58 percent of respondents indicated that management or the board had proactively reached out to the company's large investors and shareholders in 2013, with the most common discussion topics being say on pay and CEO compensation. These efforts can make a difference in voting outcomes; for example, Georgeson reported that almost all of the 39 companies that successfully passed their say-on-pay vote in 2013 after failing to pass muster in 2012 disclosed a shareholder outreach effort in their 2013 proxy statements, and many described the number of top shareholders they contacted and/or the percentage of shareholdings that were covered in their outreach efforts.

The past year has also demonstrated the importance of shareholder relations in dealing with controversial issues or activist attacks. Hewlett-Packard conducted a particularly intensive outreach effort to reassure shareholders following the write-off of the Autonomy Corp. acquisition, and ultimately all of the directors up for re-election received majority support. Directors and key executives at JPMorgan Chase had numerous meetings with shareholders to explain the company's rationale for keeping Jamie Dimon in a combined CEO/Chairman role and to address shareholder concerns about risk management and other governance issues following the "London Whale" losses. Many other companies found themselves immersed in outreach efforts to fend off activist attacks on their board composition, business strategy, executive compensation and other matters. In these kinds of situations, well-established relationships with significant

investors can truly be outcome determinative, and a company's efforts to cultivate these relationships proactively is an essential element of advance preparedness.

The importance of engaging with shareholders on corporate governance matters extends well beyond special situations and has become a regular, ongoing initiative of corporate governance and investor relations teams at public companies. Perhaps more than ever before, it is important for companies to nurture relationships with long-term shareholders and cultivate their understanding of the company's point of view, including with respect to investments that have a long-term horizon. As a result of the adoption of majority voting standards, changes to stock exchange policies regarding discretionary broker votes, board declassification and other changes to best practices, the dynamics of director elections have become increasingly complex with less predictability in voting outcomes. Dialogue with shareholders can help to increase the board's credibility, enhance the transparency of governance decisions, pre-empt shareholder resolutions and proxy fights and otherwise navigate potentially contentious issues with shareholders.

For their part, institutional investors have been enhancing their in-house attention to corporate governance matters at their portfolio companies. For example, the head of Vanguard's corporate governance program recently indicated that, although in the past companies have usually been the ones to initiate any engagement with Vanguard, it has commenced a proactive, targeted outreach program this year with the goal of engaging in a more nuanced conversation than would be possible after a company's proxy statement has been filed. Vanguard has sent letters to approximately 350 companies to identify specific governance practices that Vanguard believes are potentially problematic. As institutional investors reassess the manner in which they fulfill their fiduciary duties to their investors and the nature of their relationships with their portfolio companies, the concept of "stewardship" has been a recurring theme. For example, the Stewardship Code adopted last year in the United Kingdom seeks "to enhance the quality of engagement between institutional investors and companies to improve long-term returns to shareholders and the efficient exercise of governance responsibilities."

As companies and shareholders continue to develop their relationships and seek a more active dialogue, one of the key considerations is determining the appropriate role of directors. PricewaterhouseCoopers' 2013 Annual Corporate Directors Survey reported that over 60 percent of directors communicate directly with institutional investors, representing a nearly 30 percent increase over the prior year. Interestingly, however, the survey also indicated that one-third of directors believed the board "does not and should not" communicate directly with institutional investors. Perhaps this divergence in views is indicative of the complexity of this issue and the need for case-by-case, company-specific tailoring of shareholder outreach programs. While management should generally be the primary caretaker of shareholder relationships, it may be

desirable in certain circumstances for directors, following consultation with management, to accommodate requests from major shareholders for a meeting or other direct communication. A lead director, independent chairman or committee chair can sometimes be a key participant in shareholder meetings to signal, for example, that the board supports management's strategy and the company's executive compensation policies; in other situations, a member of the management team may be the more appropriate representative of the company. In any event, participating directors should be thoroughly briefed on discussion topics as well as the constraints of Regulation FD, and care should be taken to ensure that management and directors speak with a unified, consistent voice to avoid confusion in the company's public posture.

Economic Activism

As the board-centric model of corporate governance was steadily eroded over the last three decades, companies consistently voiced a concern that the mandates of governance activists would make them more vulnerable to short-termist attacks by economic activists, who are seeking not just governance reforms but also major transactions such as takeovers, spin-offs, extraordinary dividends and buybacks, divestitures and other material changes. Regulators, academics and others viewed this concern with skepticism, and objections to proposed reforms were dismissed as biased attempts to entrench and insulate boards from accountability. In the end, the shareholder rights agenda prevailed, on the theory that shareholders, as owners of the company, are best positioned and best incentivized to determine the path that will promote corporate growth and value.

Today, the concern voiced by companies, and their prediction that majority voting standards, declassification of boards and other reforms would create new opportunities for hedge funds and other event-driven or short-term investors, has come true. The number of activist campaigns has increased from 27 in 2000 to more than 200 in 2013, in addition to numerous undisclosed behind-the-scenes situations. Nearly one-sixth of S&P 1500 companies have faced a public activism campaign since 2006. No company is too big to become the target of an activist, as illustrated by campaigns waged against Apple, Microsoft, Sony, Hess, P&G, Transocean, ITW, DuPont, PepsiCo, Kraft and EADS. Even companies that have basically adopted all of the governance activists' prescribed best practices, and/or have outperformed their peers and are widely respected industry leaders, have come under fire from activists seeking to parlay gains into more immediate results for shareholders, such as campaigns by Greenlight Capital and Carl Icahn for dividends and accelerated stock buybacks by Apple. In the U.S., approximately 56 percent of activist campaigns against S&P 1500 companies in 2013 targeted companies whose stock prices had been outperforming the market prior to being attacked.

Activist hedge funds have generated a nearly 20 percent annual return since 2009, as compared to an average annual return of 7.5 percent for hedge funds as a whole. These outsized returns have enabled them to grow their assets under management by over 50 percent in the last year and attract prominent institutional investors as partners in sponsoring activist attacks, such as CalSTRS and Relational in attacking Timken, and Ontario Teachers' Pension Fund and Pershing Square in attacking Canadian Pacific. These returns are also justifying increasingly sophisticated, well-financed attacks, with many activists incurring substantial expenses to conduct multi-faceted campaigns. Major investment banks, law firms, proxy solicitors and public relations advisors have been retained to facilitate detailed analyses and financial presentations, extensive publicity programs, and pre-emptive litigation efforts. When viewed in hindsight, it may be that the primary beneficiary of corporate governance reforms has been activist hedge funds.

Earlier this month, we issued a memorandum that contains a more detailed overview of activist attacks and ways in which companies can prepare in advance to deal with this threat. That memorandum was was discussed previously on this Forum, here.

Risk Management

The financial crisis spurred an evolution of regulatory regimes and an acceleration of trends that continue to have ripple effects across the corporate governance landscape. In retrospect, however, one of the most fundamental lessons of the financial crisis is the importance of the board's role in risk management. Regulators, shareholders, management and directors have been focused on enhancing the effectiveness of risk oversight, at the same time that risk management issues have become increasingly challenging given the rapid pace of technological change and business complexity. While the legal parameters of the board's oversight duties established in the *Caremark* case remain good law, the reputational and economic stakes are at an all-time high.

One area that has become particularly critical for boards to monitor is legal and regulatory compliance risks. There has been a clear change in the attitude and approach of regulators in terms of the size of fines, the intensity of their investigations and their scrutiny of issues ranging from FCPA violations to securities trading and disclosure issues to accounting improprieties. For example, the head of the Department of Justice's FCPA Unit stated earlier this year that it has more prosecutors and agents, as well as a greater caseload, than it has ever had. Meanwhile, the SEC has reconsidered its "neither admit, nor deny" policy and identified certain types of cases where it may seek admissions of wrongdoing as a condition of settlement. In announcing JPMorgan Chase's admission of wrongdoing in connection with the "London Whale" trades, the SEC's Co-Director of Enforcement stated that "JPMorgan's senior management broke a cardinal

rule of corporate governance: inform your board of directors of matters that call into question the truth of what the company is disclosing to investors." Thus far, the SEC has applied this policy to obtain admissions of wrongdoing in two settlements, and it remains to be seen whether such demands will become commonplace.

Another risk management issue that merits attention in the coming year is cybersecurity. Online security breaches, theft of proprietary or commercially sensitive information and damage to IT infrastructure can have a significant financial and reputational impact on companies. The prevalence of these risks has been exacerbated by developments in cloud computing, mobile technology and social media, among others. Despite the attention this issue has garnered, a survey report issued last year by the Carnegie Mellon University CyLab suggested that boards "still are not undertaking key oversight activities related to cyber risks, such as reviewing budgets, security program assessments and top-level policies; assigning roles and responsibilities for privacy and security; and receiving regular reports on breaches and IT risks." In addition, boards should be mindful of potentially enhanced disclosure requirements for cybersecurity risks. Last year, the SEC reviewed public company disclosures relating to cybersecurity risks and issued comment letters to approximately 50 companies, and in May, the Chairman of the U.S. Senate Committee on Commerce, Science and Transportation highlighted this issue in a letter to the SEC urging expanded disclosure requirements for cybersecurity practices and risks.

The focus on risk management is a top governance priority of institutional investors. A PricewaterhouseCoopers survey report issued earlier this year indicated that risk management was the issue most frequently cited by investors as either the most important issue or a very important issue for boards, ranking above strategic planning, executive compensation and succession planning. In exceptional circumstances, this scrutiny can translate into shareholder campaigns and adverse voting recommendations from ISS. ISS will recommend voting "against" or "withhold" in director elections, even in uncontested elections, when the company has experienced certain extraordinary circumstances, including material failures of risk oversight. Last year, ISS clarified that such failures of risk oversight will include, among other things, bribery, large or serial fines or sanctions from regulatory bodies and significant adverse legal judgments or settlements. As a case in point, in connection with the ongoing FCPA investigation at Wal-Mart, ISS recommended voting against the chairman, CEO and audit committee chair "due to the board's failure to adequately communicate material risk factors to shareholders, and to reassure shareholders that the board was exercising proper oversight and stewardship and would hold executives accountable if appropriate."

In sum, the board's role in overseeing risk management should be a clear priority and an area of regular assessment. While each board should tailor its risk oversight functioning to the specific

needs and culture of the company, as a general matter the board cannot and should not be involved in actual day-to-day risk management. Instead, directors should satisfy themselves that the risk management policies and procedures designed and implemented by senior executives are consistent with the company's corporate strategy and risk appetite, that these policies and procedures are functioning as directed, and that necessary steps are taken to foster a culture of risk-aware and risk-adjusted decision-making throughout the organization. In setting a "tone at the top," the board can send a message to the company's management and employees that comprehensive risk management is neither an impediment to the conduct of business nor a mere supplement to a firm's overall compliance program, but is instead an integral component of the firm's corporate strategy, culture and business operations.

In addition, the roles and responsibilities of different board committees in overseeing specific categories of risk should be reviewed to ensure that, taken as a whole, the board's oversight function is coordinated and comprehensive. In that regard, PricewaterhouseCoopers's 2013 Annual Corporate Directors Survey reported that the number of directors who believe there is a clear allocation of risk oversight responsibilities among the board and its committees increased by over 17 percent from the prior year, but half of these directors suggested the clarity of the allocation of these responsibilities could still be improved.

Conclusion

In 2005, Martin Lipton wrote for a symposium commemorating the 25th anniversary of his article attacking financial market short-termism and supporting the legality of corporate management to take actions to defeat hostile takeovers. The conclusion to that piece is as relevant today as it was in 2005:

> In the words of [famous educator and management consultant] Peter Drucker, "the Enterprise can be said to be the one innovation that created the Modern Economy—far more so than any other invention, whether material or conceptual." The American enterprise is the systematic risk-taker and risk-sharer of our economy—the primary means through which wealth and prosperity are generated on a macroeconomic level. Central to this structure is a delicate interrelationship among the enterprise, the CEO (who manages it), the board of directors (which oversees its management) and shareholders and society at large (who benefit from it). If special-interest shareholders and other "activists" [and the academics who support them] prevail in their latest battle—that is, if additional, more demanding governance and "shareholder empowerment" measures and personal liability for directors become integrated into the regulatory and common law landscape—we will have altered the structure of the enterprise and moved

> toward excising the board from its principal role. Not only will the board as an institution suffer from the curtailment of its ability to manage the corporation, but we will not be able to attract competent, responsible people to serve as directors of public companies. Moreover, faced with a punitive regime that could extend to any perceived failure of a director (whether or not intentional and whether or not egregious), the people who do serve on boards will focus on their self-protection, and will be hesitant to take risks that may benefit the corporation. As [then] Treasury Secretary John Snow . . . remarked, "some investments that should have been undertaken, that would have been good for society, good for investors, good for shareholders, and good for the economy's growth, won't be undertaken." In short, director passivity will have triumphed over the entrepreneurialism that has always been at the heart of the business judgment rule. We must all brace ourselves for this next battle. And we must do all we can to ensure that the train does not fly off the tracks.