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The New Paradigm for Corporate Governance

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Wednesday, February 3, 2016

Editor's note: Martin Lipton is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy. This post is based on a Wachtell Lipton memorandum. Related research from the Program on Corporate Governance includes The Long-Term Effects of Hedge Fund Activism by Lucian Bebchuk, Alon Brav, and Wei Jiang (discussed on the Forum here), and The Myth that Insulating Boards Serves Long-Term Value by Lucian Bebchuk (discussed on the Forum here). Critiques of the Bebchuk-Brav-Jiang study by Wachtell Lipton, and responses to these critiques by the authors, are available on the Forum here.

Since I first identified a nascent new paradigm for corporate governance with leading major institutional investors supporting long-term investment and value creation and reducing or eliminating outsourcing to ISS and activist hedge funds, there has been a steady stream of statements by major investors outlining the new paradigm. In addition, a number of these investors are significantly expanding their governance departments so that they have in-house capability to evaluate governance and strategy and there is no need to outsource to ISS and activist hedge funds. The following is a summary consolidation of what these investors are saying in various forums.

Clearly articulated plans are necessary to gain and keep the support of these investors. A company should not leave an opening for an activist with a more attractive long-term plan.

Board participation in the development and approval of strategy should be effectively communicated in letters to these investors, annual reports and proxy statements. The description should include the major issues debated by the board and how they were resolved.

A company should recognize that **ESG and CSR issues and how they are managed are important**to these investors.

A company should develop and communicate its procedures for **engagement by management and directors** with these investors. In addition, a company should **facilitate direct engagement** with directors by these investors who request it.

A company should **support national policies that are designed to achieve long-term value creation**. A company should support major investment by government in infrastructure, a rational tax policy that encourages long-term strategies and other policies that encourage and support long-term growth on both a company and a macro basis.

These investors **do not favor stock repurchases** at the expense of long-term investment.

These investors recognize that there is **no need for quarterly earnings guidance**, if a company has a clearly articulated long-term strategy. These investors also recognize that quarterly guidance is inconsistent with the long-term investment strategies that they are encouraging.

In addition to the statements by, and actions of, these leading institutional investors, similar views are being expressed by The Conference Board, The Brookings Institution, The Aspen Institute, Focusing Capital on the Long Term (an organization formed to promote long-term investment), the chief economist of the Bank of England and numerous others. In addition, recent academic research has revealed the methodological fallacies in the so-called “empirical evidence” used by the academics who have argued that unrestrained attacks by activist hedge funds create long-term value for the targets of their attacks, thereby strengthening the ability of these institutions to refuse to support activist attacks on portfolio companies. A recent article by Professor John Coffee of the Columbia Law School and the February 1, 2016 Letter from Larry Fink of BlackRock to the CEOs of the S&P 500 are must reads.