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Corporate Governance, Investor Stewardship and Engagement

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The New Paradigm of Corporate Governance is an implicit and voluntary corporate governance and stewardship partnership among corporations, shareholders and other stakeholders working together to achieve long-term value and resist the short-termism that impedes long-term economic prosperity. At the request of the World Economic Forum, members of Wachtell, Lipton, Rosen & Katz prepared a paper titled, *The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth*, which was issued in September 2016 and have subsequently updated and refined these principles to take into account feedback from key stakeholders, including major corporations, institutional investors, and third-party initiatives.

The below is an updated outline of synthesised principles intended to promote the common goal of facilitating sustainable long-term value creation through the governance roles of the board of directors and senior management, the role of investors in impacting corporate strategy and governance decisions within a framework of stewardship, and engagement between companies and investors to forge relationships built on transparency, trust and credibility. Companies and investors would tailor the application of these principles to their specific facts and circumstances. With respect to stakeholder governance, boards of directors and senior management have a pivotal role in harmonising the interests of shareholders and other stakeholders, and it is worth recognising that shareholders and other stakeholders have more shared objectives than differences – namely, they have the same basic interest in facilitating sustainable, long-term value creation.

Guiding Principles

Governance:

1. *Purpose and Strategy*. The board of directors and senior management should jointly articulate the company's purpose and oversee its long-term strategy, ensuring that the company pursues sustainable long-term value creation.
2. *Management and Oversight*. The board of directors is responsible for monitoring company performance and for senior management succession.
3. *Quality and Composition of Board of Directors*. Directors should have integrity, competence and collegiality, devote the significant time and attention necessary to fulfil their duties, and represent the interests of all shareholders and other stakeholders. The board of directors as a whole should feature backgrounds, experiences and expertise that are relevant to the company's needs.
4. *Compensation*. Executive and director compensation should be designed to align with the long-term strategy of the company and incentivise the generation of long-term value, while dis-incentivising the pursuit of short-term results at the expense of long-term results.
5. *Corporate Citizenship*. Consideration should be given to the company's purpose and its stakeholders, including shareholders as well as employees, customers, suppliers, creditors, and the community in which the company does business, in a manner that contributes to long-term sustainability and value creation.

Stewardship:

1. *Beneficial Owners*. Institutional investors are accountable to the ultimate beneficial owners whose money they invest. They should use their power as shareholders to foster sustainable, long-term value creation for their investors and for the companies in which they invest.
2. *Voting*. Investors should actively vote on an informed basis consistent with the interests of their clients, which aligns with the long-term success of the companies in which they invest.
3. *Investor Citizenship*. Investors should consider value-relevant sustainability, citizenship and ESG factors when developing investment strategies.

Engagement:

1. *By the Company*. The board of directors and senior management should engage with major investors on issues and concerns that affect the company's long-term value and be responsive to those issues and concerns.
2. *By Investors*. Investors should be proactive in engaging in dialogue with a company as part of a long-term relationship and should communicate their preferences and expectations.
3. *Shareholder Proposals and Votes*. Boards of directors should consider shareholder proposals and key shareholder concerns but investors should seek to engage privately before submitting a shareholder proposal.
4. *Interaction and Access*. Companies and investors should each provide the access necessary to cultivate engagement and long-term relationships.

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Governance

Purpose and Strategy. **The board of directors and senior management should jointly articulate the company's purpose and oversee its long-term strategy, ensuring that the company pursues sustainable long-term value creation.**

- The board of directors should oversee the company's business strategies to achieve long-term value creation, including by having meaningful input over the company's capital allocation process and strategy.
- The board of directors should help the company articulate its purpose and the ways in which it aims to make a positive contribution to society, recognising that there are various stakeholders, including employees, customers, communities and the economy and society as a whole.
- The board of directors should go beyond a "review and concur" role to ensure that it understands the strategic assumptions, uncertainties, judgments and alternatives that underpin the company's long-term strategy.

Management and Oversight. **The board of directors is responsible for overseeing the management of the company, monitoring company performance and preparing for senior management succession.**

- The board of directors sets the "tone at the top" to cultivate an ethical culture and demonstrate the company's commitment to integrity and legal compliance. In setting the right tone, transparency, consistency and communication are key – the board's vision for the company should be communicated effectively throughout the organisation and to the investing public. Companies should have in place mechanisms for employees to seek guidance and alert management and the board of directors about potential or actual misconduct without fear of retribution.
- The board of directors should periodically review the company's bylaws, governance guidelines and committee charters and tailor them to promote effective board functioning. The board of directors should be aware of the governance expectations of its shareholders who hold a meaningful stake in the company and take those expectations into account in periodic reviews of the company's governance principles, being mindful of the stage of the company's development and all other relevant factors. The board of directors has two key roles with respect to management: oversight of management and partnership with management. The board of directors should work to foster open, ongoing dialogue between members of the board and management. This dialogue requires directors to have access to senior management outside of board meetings. Management has an obligation to provide information to directors, and directors should seek clarification and amplification where necessary. The board of directors and CEO should together determine the information the board should receive and periodically reassess the board's information needs. The key is to provide useful and timely information without overloading the board. Deep understanding of a company's business cannot be gained or maintained solely in regularly scheduled board meetings. At the core, every director should understand how the company makes a profit and fulfils its purpose, and the threats and opportunities it faces.
- The board of directors and senior management should jointly determine the company's reasonable risk appetite, oversee implementation of standards for managing risk and foster a culture of risk-aware decision-making. In fulfilling its risk management function, the board's role is one of informed oversight rather than direct management of risk. The board of directors should consider significant risks to the company, including technological disruption, cybersecurity and reputational risks. The board should not be reflexively risk averse; the board should seek appropriate calibration of risk to benefit the long-term interests of the company.
- Even with effective risk management, crises will emerge and test the board of directors, with potential situations ranging from the unexpected departure of the CEO to risk management failures and major disasters. Each crisis is different, but in most instances when a crisis arises, directors are best advised to manage through it as a collegial body working in unison with the CEO and senior management team (unless the crisis relates directly to the CEO and/or management team). Once a crisis starts to unfold, the board of directors needs to be proactive and provide careful guidance and leadership in steering the company through the crisis. If there is credible evidence of a violation of law or corporate policy, the allegation should be investigated and appropriate responsive actions should be taken. The board of directors, however, should be mindful not to overreact, including by reflexively displacing management or ceding control to outside lawyers, accountants and other outside consultants.
- The board of directors should maintain a close, truly collegial relationship with the CEO and senior management that facilitates frank and vigorous discussion and enhances the board's role as strategic partner and evaluator. The board of directors should monitor the performance of the CEO and senior management.
- The board of directors and senior management should maintain a succession plan for the CEO and other key members of management and oversee the cultivation and development of talent. The board of directors should prioritise succession planning by addressing it on a regular rather than reactive basis, including having an emergency plan in the event of an unexpected CEO departure or disability. Direct exposure to employees is critical to the evaluation of the company's senior management. This is especially important in the current environment in which it is typical for the CEO to be the only management person with a seat at the board table.
- Companies should frame required quarterly reporting in the broader context of their long-term strategy and use interim results and reporting to address progress toward long-term plans. Companies should not feel obligated to provide earnings guidance.
- The board of directors should carefully consider extraordinary transactions and receive the information and take the time necessary to make an informed and reasoned decision. The board of directors should take centre stage in a transaction that creates a real or perceived conflict of interest between shareholders and management, including activist situations. It may be desirable for the board of directors to retain experienced outside advisors to assist with major transactions, particularly where there are important or complicated financial, legal, integration, culture or other issues or where it is useful for the board of directors to obtain independent objective outside guidance. However, the board should be careful not to create unnecessary divisions through the use of special committees with their own separate advisors when there is no legal requirement for a special committee.

Quality and Composition of Board of Directors. **Directors should have integrity, competence and collegiality, devote the significant time and attention necessary to fulfil their duties and represent the interests of all shareholders and other stakeholders. The board of directors as a whole should include diverse backgrounds, experiences and expertise tailored to the company's needs.**

- Every director should have integrity, strong character, sound judgment, an objective mind, collegiality, competence and the ability to represent the interests of all shareholders and other stakeholders. After competency and integrity, the next most important (yet often underemphasised) consideration is collegiality as part of an effective board culture.

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- When filling vacancies, directors should take a long-term strategic view focused not merely on filling immediate vacancies on an *ad hoc* basis, but on constructing a well-rounded board that works well together and is bonded together by mutual trust and respect. The quality of team dynamics may have a significantly greater impact on firm performance than the sum of individual director contributions.
- The composition of a board should reflect a complementary diversity of thought, background, skills, experiences, and tenures. The board of directors should develop a system for identifying diverse candidates, including women and minority candidates, and for effectively integrating new members into the board dynamic.
- A substantial majority of the board of directors should be independent. The board of directors should consider all relevant facts and circumstances when evaluating independence. Long-standing board service should not, by itself, disqualify a director from being considered independent.
- The board of directors should decide, based on the circumstances, whether to have separate or combined chair and CEO roles alongside an independent board leader. The board of directors should explain its decision to shareholders, and, if the roles are combined, should appoint a strong lead independent director. The lead independent director should serve as a liaison between the chairman of the board and the independent directors, preside over executive sessions, call meetings of the independent directors when necessary, guide the board's self-assessment or evaluation process, and guide consideration of CEO and senior management compensation and succession within the context of relevant board committees.
- The size of the board of directors will depend on the nature, size and complexity of the company and its state of development. In general, the board of directors should be large enough to include a diversity of perspectives and as small as practicable to promote open dialogue.
- Companies should consider limitations on the number of other boards of directors on which a director sits to ensure a director's ability to dedicate sufficient time to the increasingly complex and time-consuming matters that the board of directors and committees are expected to oversee.
- The composition of a board of directors should reflect a range of tenures. The board of directors should consider whether policies such a mandatory retirement age or term limits are appropriate, but board refreshment should be tempered with the understanding that age and experience can bring wisdom, judgment and knowledge. Substantive director evaluation and re-nomination decisions will serve better than arbitrary policies.
- Directors should spend the time needed and meet as frequently as necessary to discharge their responsibilities and should endeavour to attend all board and committee meetings, as well as the annual meeting of shareholders. The full board of directors should have input into the board agenda.
- Time for an executive session without the CEO or other members of management should be on the agenda for each regular board meeting.
- Confidentiality is essential for an effective board process and for the protection of the company, and director confidentiality is not inconsistent with engagement pursuant to The New Paradigm. Directors should respect the confidentiality of all discussions that take place in the boardroom. Moreover, directors generally owe a broad legal duty of confidentiality to the company with respect to information they learn about the company in the course of their duties.
- The board of directors should have a well-developed committee structure with clearly understood responsibilities. Decisions about committee membership should be made by the full board based on recommendations from the nominating and governance committee, and committees should meet all applicable independence and other requirements. Committees should keep the full board of directors and management apprised of significant actions.
- Companies should conduct a robust orientation for new directors and all directors should be continually educated on the company and its industry. New board members should receive extensive education about the company's business, purpose and strategy. That process should include sessions with the CEO, other directors, members of senior management and, in appropriate cases, major shareholders.
- Companies may find it useful to have an annual two- to three-day board retreat with senior executives to conduct a full review of strategy and long-range plans. Companies should also provide directors with regular tutorials and site visits as part of expanded director education, and external experts, such as expert counsel or other consultants, in appropriate circumstances to assure that, in overseeing complicated, multi-industry and new-technology businesses and strategies, the directors have the information and expertise they need. Companies and boards may also find it useful for directors to have access to the workforce.
- The board of directors should evaluate the performance of individual directors, the full board of directors, and board committees on a continuing basis. Evaluations should be substantive exercises. Evaluations should be led by the non-executive chair, lead independent director, or appropriate committee chair, and externally facilitated evaluations may be appropriate from time to time.

Compensation. **Executive and director compensation should be designed to align with the long-term strategy of the company and incentivise the generation of long-term value, while dis-incentivising the pursuit of short-term results at the expense of long-term results.**

- The board of directors should develop management compensation structures that are aligned with the long-term strategy and risk compliance policies of the company. The board of directors should carefully consider whether management compensation structures promote risk-taking that is not consistent with the company's overall risk appetite. A change in the company's long-term strategy or risk compliance policies should trigger a re-evaluation of management compensation structures.
- Executive compensation should have a current component and a long-term component. A substantial portion should be in the form of stock or other equity, with a vesting schedule designed to ensure economic alignment with investors. In general, executives should be required to hold a meaningful amount of company stock during their tenure and beyond.
- The board of directors or its compensation committee should understand the costs of compensation packages and the maximum amount payable in different scenarios. In setting executive compensation, the compensation committee should take into account the position of the company relative to other companies, but use such comparison with caution, in view of the risk of an upward ratchet in compensation with no corresponding improvement in performance.
- In considering executive compensation, companies should be sensitive to the pay and employment conditions elsewhere in the company and take into account the pay ratios within the company. The board of directors should also consider the views of shareholders, including as expressed in "say-on-pay" votes, but should not abdicate its role in deciding what is best for the company.

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- Companies should monitor, restrict or prohibit executives' ability to hedge the company's stock and oversee the adoption of policies to mitigate risks, such as compensation recoupment or clawbacks.
- Directors should receive compensation that fairly reflects the time commitment and exposure to public scrutiny and potential liability of public company board service, with appropriate benchmarking against peer companies. Independent directors should be equally compensated, although lead independent directors and committee chairs may receive additional compensation and committee fees may vary.
- If directors receive additional compensation not related to service as a director, such compensation should be disclosed and explained to shareholders.

Corporate Citizenship. **Consideration should be given to the company's purpose and its stakeholders, including shareholders as well as employees, customers, suppliers, creditors, and the community in which the company does business, in a manner that contributes to long-term sustainability and value creation.**

- Companies should be good citizens of the communities in which they do business and produce value and solutions for stakeholders, with consideration of relevant sustainability and societal issues in operating their businesses. Good stakeholder relationships are good business and are good for business.
- Companies should identify and articulate their purposes – i.e., their objectives and contributions to societal and public interests. Profits are not the *raison d'être* of a company, but rather are a product of its pursuit of its corporate purposes.
- The board of directors and senior management should integrate relevant ESG matters into strategic and operational planning, budgeting, resource allocation and compensation structures. The company should communicate its policies on these subjects to shareholders.
- Companies have an important perspective to contribute to public policy dialogue on issues related to the company's business or purpose. If a company engages in political activities, the board of directors should oversee such activities and consider whether to adopt a policy of disclosure of the activities.

Stewardship

Beneficial Owners. **Asset managers are accountable to their client investors – the beneficial owners whose money they invest and those clients are accountable to the ultimate beneficiaries of the invested assets. Investors should use their power as shareholders to foster sustainable, long-term value creation for their investors and for the companies in which they invest.**

- Investors should provide steadfast support for the pursuit of reasonable strategies for long-term growth and speak out against conflicting short-term demands. An asset manager's support should be expressed through constructive engagement, public expressions of support, and voting in favour of company-sponsored proposals. The support of institutional investors, and the vocal endorsement from respected and influential asset managers to act as a "champion" for a company, can be decisive in curbing short-termist pressure.
- Asset managers and investors who have policies supporting ESG and sustainable long-term investment strategies should not invest in activist hedge funds whose tactics promote short-termism.
- Investors should establish a firm-wide culture of long-term thinking and patient capital that persists through cycles of short-term turbulence, including through the design of employee compensation structures that discourage the sacrifice of long-term value for short-term gains.
- Investors should adopt and disclose guidelines and practices that help them oversee the corporate governance practices of investee companies. Disclosure should include investors' long-term investment policies, evaluation metrics, governance procedures, views on quarterly reports and earnings guidance, and guidelines for relations with and policies towards short-term activists. Investors should also disclose whether they use consultants to evaluate strategy, performance and transactions and how a company can engage with those consultants.
- Investors should evaluate the performance of boards of directors, including director knowledge of governance and other key investor concerns, as well as the board of directors' understanding of the company's long-term strategic plan. That evaluation may be shared with the board of directors and/or senior management through the lead independent director or independent chair or CEO, with candid feedback expected in return.

Voting. **Investors should actively vote on an informed basis consistent with the interests of their clients, which aligns with the long-term success of the companies in which they invest.**

- Investors should devote sufficient time and resources to the evaluation of matters for shareholder voting in the context of long-term value creation. Investors should consider increasing their in-house staffing and capabilities to the extent appropriate to dedicate sufficient time and attention to understanding a company's business plan and long-term strategy, getting to know its management and engaging effectively with the companies in which they invest.
- Investor votes should not abdicate decision-making to proxy advisory firms; rather, votes should be based on the independent application of internal policies and guidelines, and the assessment of individual companies and their boards and management. Investors may rely on a variety of information sources to support their evaluation. Third-party analyses and recommendations, including those of proxy advisory firms, should assist but not be a substitute for individualised decision-making that considers the facts and circumstances of each company.
- Investors should disclose their proxy voting and engagement guidelines and report periodically on stewardship and voting activities.
- Asset managers and investors who have announced their adoption of, and adherence to The New Paradigm or who have policies supporting ESG and sustainable long-term investment strategies should explain any vote in favour of a proposal by an activist hedge fund that is opposed by the company.
- Investors should have clear procedures that help identify and manage potential conflicts of interest in their proxy voting and engagement and disclose such procedures.

Investor Citizenship. **Investors should consider value-relevant sustainability, citizenship and ESG factors when developing investment strategies.**

- Investors should consider the ways in which ESG factors are relevant to sustainable growth and integrate material ESG factors into their investment analysis and investment decisions.
- Investors should disclose their positions on societal purpose, social and other ESG matters.

Engagement

By the Company. **The board of directors and senior management should engage with major investors on issues and concerns that affect the company's long-term value and be responsive to those issues and concerns.**

- Companies should disclose their adoption of and adherence to The New Paradigm.

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- The board of directors and senior management should establish communication channels with investors and be open to dialogue. Boards should be responsive to shareholders and be proactive in order to understand their perspectives.
- Companies should clearly articulate for investors the company's vision, purpose and strategy, including key drivers of performance, risk and evolution of business model. The company should explicitly describe how the board of directors in particular has actively reviewed long-term plans and that it is committed to doing so regularly.
- Companies should explain and make the financial case for long-term investments, including capital projects, investments in equipment and technology, employee education, workforce training, out-of-the-ordinary increases in wages and benefits, research and development, innovation and other significant initiatives.
- Companies should make adequate disclosures on a variety of topics, including: how compensation practices encourage and reward long-term growth; the director recruitment and refreshment process; succession planning; consideration of relevant sustainability, citizenship, and ESG matters; climate risks; political risks; corporate governance and board practices; anti-takeover measures; material mergers and acquisitions; and major capital commitments and capital allocation priorities. Companies should explain the bases for their recommendations on the matters that are submitted to a shareholder vote.
- Companies should disclose their approach to human capital management, including employee development, diversity and a commitment to equal employment opportunity and advancement opportunity, health and safety, labour relations, and supply chain labour standards.

***By Investors*. Investors should be proactive in engaging in dialogue with a company as part of a long-term relationship and should communicate their preferences and expectations.**

- Investors should disclose their adoption of, and adherence to, The New Paradigm.
- Investors should actively listen to companies, participate in meetings or other bilateral communications and communicate their preferences, expectations and policies with respect to engaging with and evaluating companies. Investors should accept their responsibility to understand the purpose and strategy of companies in which they invest, and to eschew ideological positions not tailored to each company's position and needs. Investors should clearly state their expectations for a company and provide candid and constructive feedback.
- Investors should address and attempt to resolve differences with companies promptly, by first engaging in a constructive and pragmatic manner that is intended to build trust and a common understanding, and should give due consideration to the company's rationale.
- Investors should acknowledge their role in supporting the long-term interest of the company and its stakeholders as a whole, provide companies with candid and direct feedback and give companies prompt notice of any concerns. To the extent that an asset manager's or investor's expectations for any given company evolve over time, the asset manager or investor should proactively communicate those changes to the company.
- Investors should invite companies to privately engage and should work collaboratively with boards of directors and management teams to correct subpar strategies and operations, but this does not mean that investors need to abandon its support for companies in resisting the short-termism advocated by activists. Asset managers and institutional investors should make it clear that activists do not speak for them. Investors should provide an opportunity for a company to engage privately on an issue or concern before publicly disclosing a negative opinion about the company.
- Investors should disclose to the companies in which they invest their preferred procedures and contacts for engagement and establish (and disclose) clear guidelines regarding what further actions they may take in the event they are dissatisfied with the outcome of their engagement efforts. Those procedures and policies may differ on a company-by-company basis depending on the relative stakes involved and the shareholders' views about the value of differing levels of engagement with particular companies.

***Shareholder Proposals and Votes*. Boards of directors should consider shareholder proposals and key shareholder concerns but investors should seek to engage privately before submitting a shareholder proposal.**

- Boards of directors should respond to shareholder proposals that receive significant support by implementing the proposed change if the board of directors believes it will improve governance, or by engaging with shareholders and providing an explanation as to why the change is not in the best long-term interest of the company if the board of directors believes it will not be constructive.
- Investors should raise critical issues to companies as early as possible in a constructive and proactive way, and seek to engage in a dialogue before submitting a shareholder proposal. Public battles and proxy contests have real costs and should be viewed as a last resort where constructive engagement has failed.
- Long-term investors should recommend potential directors to the companies in which they invest if they know the individuals well, believe they would be additive to the board and are prepared to discuss with the company the range of skillsets the investor believes should be included in the board.
- Shareholders have the right to elect representatives and receive information material to investment and voting decisions. Indeed, it is an essential element of correcting shareholder-corporate relationships that key shareholders be informed on a company-specific basis and accept the responsibility that comes with their role in The New Paradigm. It is reasonable for shareholders to oppose re-election of directors who have persistently failed to respond to their feedback after efforts to engage constructively.
- Boards of directors should communicate drivers of management incentive awards and demonstrate the link to long-term strategy and sustainable economic value creation. If the company clearly explains its rationale regarding compensation plans, shareholders should give the company latitude in connection with individual compensation decisions. The board of directors should nevertheless take into account "say-on-pay" votes.

***Interaction and Access*. Companies, investors and other key stakeholders should provide each other with the access necessary to cultivate engagement and long-term relationships.**

- Engagement through disclosure is often the most practical means of engagement, though in other cases, in-person meetings or interactive communications may be more effective. Opportunities to engage with shareholders include periodic letters – both from management to articulate management's vision and plans for the future, and from the board of directors to convey board-level priorities and involvement – as well as investor days, proxy statements, annual reports, other filings and the company's online presence.
- Independent directors should be available to engage in dialogue with major investors in appropriate circumstances, recognising that such engagement can be achieved without undermining the effectiveness of management to speak for and on behalf of the company.

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- The ultimate decision-makers of a company's key stakeholders should have access to the company and the appropriate representatives and likewise the company should have access to stakeholders' ultimate decision-makers.
- Boards of directors and senior management should cultivate relationships with the government, the community and other stakeholders.
- Companies and investors should cooperate to develop appropriate metrics to measure the value of ESG and sustainable investments, such as those advanced by the Embankment Project of the Coalition for Inclusive Capitalism.

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Sabastian V. Niles is a Partner at Wachtell, Lipton, Rosen & Katz where he focuses on rapid response shareholder activism, engagement and preparedness, takeover defence and corporate governance; risk oversight, including as to cybersecurity and crisis situations; U.S. and cross-border M&A and strategic partnerships; and other corporate and securities law matters and special situations.

Sabastian advises boards of directors and management teams worldwide and across industries, including technology, financial institutions, media, energy and natural resources, healthcare and pharmaceuticals, construction and manufacturing, real estate/REITs and consumer goods and retail.

In addition to serving as Consulting Editor for the New York Stock Exchange's Corporate Governance Guide, Sabastian writes frequently on corporate law matters and has been a featured speaker at corporate strategy and investor forums. His speaking engagements have addressed topics such as Shareholder Activism; The New Paradigm of Corporate Governance; Hostile Takeovers; Strategic Transactions and Governance; M&A Trends; Board-Shareholder Engagement; Confidentiality Agreements in M&A Transactions; Negotiating Strategic Alliances with U.S. Companies; Current Issues in Technology M&A; Corporate Governance: Ethics, Transparency and Accountability; and Developments in Cross-Border Deals.

Sabastian received his *juris doctorate* from Harvard Law School, where he co-founded the Harvard Association of Law and Business (and continues to serve on the Advisory Board) and won the U.S. National ABA Negotiation Championship representing the Harvard Program on Negotiation.

Wachtell, Lipton, Rosen & Katz

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