March 7, 2016

The New Paradigm for Corporate Governance

In my February 1, 2016 note, "The New Paradigm for Corporate Governance," I called attention to the growing evidence that the leading institutional investors were developing a new paradigm for corporate governance. In the new paradigm, these institutions would engage with a company and its independent directors to understand its long-term strategy and ascertain that the directors participated in the development of the strategy, were actively monitoring its progress and were overseeing its execution.

In a February 26, 2016 letter to board members, State Street Global advisors said:

> Unless we make independent long-term thinking and leadership the driving force behind a board's mission, no amount of change to management incentives, investor behavior or the like will be sufficient to ensure a focus on the long term. Boards need to look beyond the traditional measures of corporate success such as the quarterly earnings report and accomplishments since the last board meeting. Short-term performance matters, but it should be assessed in the context of a company's long-term goals. Given a company's stated objectives for the next 5, 10 or 20 years, did management execute as well as possible? Did the company meet its milestones and exceed its benchmarks?
>
> We recognize that the role of a board has become more complex and demanding as the challenges companies face in a competitive global economy marked by technological disruption have intensified. Many boards lack the experience and expertise to engage effectively and critically with management with regard to a company's long-term planning. Board recruitment becomes an even more critical function when viewed through the lens of long-term focus. That is all the more reason that boards should continually self-assess the skills and experience of their board members and seek to continually enhance their capabilities by addressing any skill, experience or other gaps.

Martin Lipton

February 1, 2016

The New Paradigm for Corporate Governance

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" use 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.

Martin Lipton

September 18, 2015

A New Paradigm for Corporate Governance

Recently, there have been three important studies by prominent economists and law professors, each of which points out serious flaws in the so-called empirical evidence being put forth to justify short-termism, attacks by activist hedge funds and shareholder-centric corporate governance. These new studies show that the so-called empirical evidence omit important control variables, use improper specifications, contain errors and methodological flaws, suffer from selection bias and lack real evidence of causality. In addition, these new studies show that the so-called empirical evidence ignore real-world practical experience and other significant empirical studies that reach contrary conclusions. These new studies are:

Emiliano Catan and Marcel Kahan, *The Law and Finance of Anti-Takeover Statutes*, October 2014

Yvan Allaire and Francois Dauphin, *The Game of 'Activist' Hedge Funds: Cui bono?* August 31, 2015

John C. Coffee, Jr. and Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, September 4, 2015

For an earlier recognition of these defects in the so-called empirical evidence see, *The Bebchuk Syllogism*.

These new studies provide solid support for the recent recognition by major institutional investors that while an activist attack on a company might produce an increase in the market price of one portfolio investment, the defensive reaction of the other hundreds of companies in the portfolio, that have been advised to "manage like an activist", has the potential of lower future profits and market prices for a large percentage of those companies and a net large decrease in the total value of the portfolio over the long term. *Recognition of the Threat to Shareholders and the Economy from Attacks by Activist Hedge Funds* and *Some Lessons from BlackRock, Vanguard and DuPont—A New Paradigm for Governance*.

Hopefully these new studies will enable and encourage major institutional investors to recognize that they are the last practical hope in reversing short-termism and taming the activist hedge funds. Institutional investors should cease outsourcing oversight of their portfolios to activist hedge funds and bring activism in-house. Short of effective action by institutional investors, it would appear that there is no effective solution short of federal legislation, which runs the risk of the cure being worse than the illness. For an interesting attempt to legislate institutional investor focus on long-term rather than short-term performance see, *European Commission Proposes to Moderate Short-termism and Reduce Activist Attacks*.

Martin Lipton

June 29, 2015

Some Lessons from BlackRock, Vanguard and DuPont—A New Paradigm for Governance

Recent statements by the CEOs of BlackRock and Vanguard rejecting activism and supporting investment for long-term value creation and their support of DuPont in its proxy fight with Trian, prompt the thought that activism is moving in-house at these and other major investors and a new paradigm for corporate governance and portfolio oversight is emerging.

An instructive statement by the investors is that they view a company's directors as their agents; that they want to know the directors and have access to the directors; that they want their opinions heard; and that their relations with the company and their support for its management and board will depend on appropriate discussion of, and response to, their opinions.

The investors want to engage with the directors on a regular basis. They suggest that the company have a program or process for regular engagement. One suggestion is a shareholder relations committee of the board. Other suggestions range from directors accompanying management on investor visits; to directors attending investor day programs and being available to the investors; to the lead director being the liaison for communication. The investors are not wedded to any one form of engagement and are content to leave that to the company and its board.

The investors want independent oversight by a balanced board of effective directors that has appropriate skill sets to properly discharge its responsibilities. They expect the board to arrange meaningful evaluations of its performance and to regularly refresh its membership. They expect "best practices" corporate governance and compensation keyed to performance and shareholder returns.

The investors want the company to proactively communicate its business strategy to its shareholders, and to keep them advised of developments and problems. Vanguard suggests that directors think like activists "in the best sense" and question management's blind spots and the board's own blind spots. To aid in that effort, Vanguard suggests that the board bring in a sell-side analyst who has a sell recommendation. The investors will not accept that there is insufficient time for engagement and discussion of the business or that SEC Reg FD forecloses meaningful discussion.

The investors expect the company to hear out an activist hedge fund that takes a meaningful position in its shares. But Vanguard says, "It doesn't mean that the board should capitulate to things that aren't in the company's long-term interest. Boards must take a principled stand to do the right thing for the long-term and not acquiesce to short-term demands simply to make them go away."

As activism moves in-house at major investors and the new paradigm becomes pervasive, the influence of the activist hedge funds and ISS and Glass-Lewis will shrink and will be replaced by the policies, evaluations and decisions of the major investors. While this will be a welcome relief from the short-termism imposed by the activist hedge funds, it raises a new fundamental question—how will investors use their power? This remains to be seen. It is not likely that activism and short-termism will totally disappear, but I'm comfortable that the influence of major investors will be more favorable to shareholders generally and to the Nation's economy and society, than the self-seeking personal greed of hedge fund activists.

Martin Lipton