Some Thoughts for Boards of Directors in 2017

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I. Introduction

The evolution of corporate governance over the last three decades has produced meaningful changes in the expectations of shareholders and the business policies adopted to meet those expectations. Decision-making power has shifted away from industrialists, entrepreneurs and builders of businesses, toward greater empowerment of institutional investors, hedge funds and other financial managers. As part of this shift, there has been an overriding emphasis on measures of shareholder value, with the success or failure of businesses judged based on earnings per share, total shareholder return and similar financial metrics. Only secondary importance is given to factors such as customer satisfaction, technological innovations and whether the business has cultivated a skilled and loyal workforce. In this environment, actions that boost short-term shareholder value—such as dividends, stock buybacks and reductions in employee headcount, capital expenditures and R&D—are rewarded. On the other hand, actions that are essential for strengthening the business in the long-term, but that may have a more attenuated impact on short-term shareholder value, are de-prioritized or even penalized.

This pervasive short-termism is eroding the overall economy and putting our nation at a major competitive disadvantage to countries, like China, that are not infected with short-termism. It is critical that corporations continuously adapt to developments in information technology, digitalization, artificial intelligence and other disruptive innovations that are creating new markets and transforming the business landscape. Dealing with these disruptions requires significant investments in research and development, capital assets and employee training, in addition to the normal investments required to maintain the business. All of these investments weigh on short-term earnings and are capable of being second-guessed by hedge fund activists and other investors who have a primarily financial rather than business perspective. Yet such investments are essential to the long-term viability of the business, and bending to pressure for short-term performance at the expense of such investments will doom the business to decline. We have already suffered this effect in a number of industries.

In this environment, a critical task for boards of directors in 2017 and beyond is to assist management in developing and implementing strategies to balance short-term and long-term objectives. It is clear that short-termism and its impact on economic growth is not only a broad-based economic issue, but also a governance issue that is becoming a key priority for boards and, increasingly, for large institutional investors. Much as risk management morphed after the financial crisis from being not just an operational issue but also a governance issue, so too are short-termism and related socioeconomic and sustainability issues becoming increasingly core challenges for boards of directors.

At the same time, however, the ability of boards by themselves to combat short-termism and a myopic focus on "maximizing" shareholder value is subject to limitations. While boards have a critical role to play in this effort, there is a growing recognition that a larger, systemic recalibration is also needed to turn the tide against short-termism and reinvigorate the willingness and ability of corporations to make long-term capital investments that benefit shareholders as well as other constituencies. It is beyond dispute that the surge in activism over the last several years has greatly exacerbated the challenges boards face in resisting short-termist pressures. The past decade has seen a remarkable increase in the amount of funds managed by activist hedge funds and a concomitant uptick in the prevalence and sophistication of their attacks on corporations. Today, even companies with credible strategies, innovative businesses and engaged boards face an uphill battle in defending against an activist attack and are under constant pressure to deliver short-term results. A recent *McKinsey Quarterly* survey of over a thousand C-level executives and board members indicates most believe short-term pressures are continuing to grow, with 87% feeling pressured to demonstrate financial results within two years or less, and 29% feeling pressured over a period of less than six months.

II. The Emerging New Paradigm of Corporate Governance

One of the most promising initiatives to address activism and short-termism is the emergence of a new paradigm of corporate governance that seeks to recalibrate the relationship between corporations and major institutional investors in order to restore a long-term perspective. In essence, this new paradigm conceives of corporate governance as a collaboration among corporations, shareholders and other stakeholders working together to achieve long-term value and resist short-termism.

A core component of this new paradigm is the idea that well-run corporations should be protected by their major shareholders from activist attacks, thereby giving these corporations the breathing room needed to make strategic investments and pursue long-term strategies. In order to qualify for this protection, a corporation must embrace principles of good governance and demonstrate that it has an engaged, thoughtful board and a management team that is diligently pursuing a credible, long-term business strategy. A corporation that meets these standards should be given the benefit of the doubt by institutional investors, and its stock price movements and quarterly results should be considered in the context of its long-term objectives. The new paradigm contemplates that investors will provide the support and patience needed to permit the realization of long-term value, engage in constructive dialogue as the primary means for addressing issues, embrace stewardship principles, and develop an understanding of the corporation's governance and business strategy.

A number of groups have recently issued corporate governance principles and guidelines that outline the respective roles and responsibilities of boards and other stakeholders in the new paradigm. The *Commonsense Principles of Corporate Governance* was issued earlier this year by a group of large companies and investors led by Jamie Dimon of JPMorgan Chase, and an updated *Principles of Corporate Governance 2016* was issued by the Business Roundtable. *The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth* was prepared by Martin Lipton and issued by the International Business Council of the World Economic Forum. Each of these corporate governance frameworks is a synthesis of prevailing best practices for boards with an amplified emphasis on shareholder engagement, rather than an articulation of new ways to structure and manage the board's oversight role. In effect, they provide a roadmap for how boards can build credibility with shareholders and how shareholders can support such boards in the event of an activist attack focusing on short-term goals or proposals.

To be clear, the new paradigm does not foreclose activism or prevent institutional investors from supporting an activist initiative where warranted. Underperforming companies may be able to benefit from better board oversight, fresh perspectives in the boardroom, new management expertise and/or a change in strategic direction. Responsible and selective activism can be a useful tool to hold such companies accountable and propel changes to enhance firm value, and institutional investors can benefit from the budget and appetite of activists who drive such reforms. However, the new paradigm seeks to restore a balanced playing field, so that activism is focused on improving companies that are truly mismanaged and underperforming, rather than on using financial engineering indiscriminately against all companies in an effort to boost short-term stock prices.

III. <u>Support for the New Paradigm</u>

There have been a number of recent developments that suggest this new paradigm of corporate governance may be gaining real traction and that, although it is a non-binding framework susceptible to diverging interpretations, it can make a tangible difference in the outcomes of activist attacks and the long-term strategies adopted by corporations. Indeed, the effectiveness of a private ordering approach to reform is clearly demonstrated by the widespread adoption of standardized governance practices by most public companies. For example, only 10% of S&P 500 companies now have a classified board structure, and approximately 43% have recently adopted a proxy access bylaw. A key driver of the impact of this private ordering exercise is the remarkable concentration of power over virtually all major corporations in the hands of a relatively small number of institutional investors. As these major institutions have pushed for such governance practices, and as large public companies have adopted them, it is reasonable to look to the institutional investors to use their additional power to promote the long-term sustainable success of the companies in which they invest.

Thus, it is encouraging that several leading institutional investors have expressed grave concern that short-termism and attacks by short-term financial activists are significantly eroding long-term economic prosperity. BlackRock, State Street and Vanguard have 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. In his annual letter to CEOs, BlackRock's Larry Fink emphasized that reducing short-termist pressures and "working instead to invest in long-term growth remains an issue of paramount importance for BlackRock's clients, most of whom are saving for retirement and other long-term goals, as well as for the entire global economy." State Street Global Advisors recently issued a statement acknowledging the "inherent tension between short-term and long-term investors," and expressed concern that settlements with activists may promote short-term priorities at the expense of long-term shareholder interests.

In addition, FCLT Global (formerly Focusing Capital on the Long Term), which started as an initiative in 2013 by Canada Pension Plan Investment Board and McKinsey & Company, recently grew into an independent organization with BlackRock, The Dow Chemical Company and Tata Sons added as founding members in addition to a number of leading asset managers, asset owners, corporations and professional service firms who are also members. The organization's mission is to develop practical tools and approaches that encourage long-term behaviors in business and investment decision-making. In the U.K., leading British institutional investors, acting through The Investment Association, have issued a Productivity Action Plan that "seeks to deliver ambitious and achievable remedies to the ills of some of the most serious causes of short-term thinking in the British economy."

In academic circles, the concerns expressed by institutional investors about activism and short-termism have been echoed in a growing body of research. The notion that activist attacks increase, rather than undermine, long-term value creation has now been discredited by a number of studies. Furthermore, after decades of academic thinking animated by agency cost theory and a conviction that expanding shareholder rights will reduce such costs and thereby increase firm value, a new study suggests an important counterweight—namely, "principal costs," which have been largely overlooked by academics. In *Principal Costs: A New Theory for Corporate Law and Governance*, Professors Zohar Goshen and Richard Squire posit that there is an unavoidable tradeoff between principal costs and agent costs, and that the optimal balance and governance structure for any given company will depend on firm-specific factors, such as industry, business strategy and personal characteristics of investors and managers. This principal cost theory casts doubt on the core assumptions that have been used by academics to justify activism and a one-sided embrace of increasing shareholder power.

Finally, there have been a number of initiatives brewing in the political and regulatory arena which suggest that, in the absence of an effective private sector solution, legislative reforms are on the horizon. For example, this past spring, the Brokaw Act was introduced in the Senate to call for amendments to Section 13(d) reporting rules that would require greater transparency from activist hedge funds who accumulate large stealth positions in public company securities. Co-sponsoring Senator Jeff Merkley remarked, "Hollowing out longstanding companies so that a small group of the wealthy and well-connected can reap a short-term profit is not the path to a strong and sustainable economy for our nation." Shortly thereafter, the Corporate Governance Reform and Transparency Act of 2016 was introduced in the House of Representatives to propose an oversight framework for ISS and Glass Lewis.

In addition, a variety of other ideas are being actively considered in a number of jurisdictions, including tax reforms to encourage long-term investment and discourage short-term trading; prohibiting quarterly reports and quarterly guidance; regulating executive compensation to discourage managing and risk taking in pursuit of short-term objectives; imposing enhanced disclosure obligations on both corporations and institutional investors; and imposing fiduciary duties on institutional investors and asset managers to take into account the long-term objectives of the ultimate beneficiaries of the funds they manage.

In short, there is growing recognition by corporations, investors, academics, policymakers and other stakeholders that short-termism is a profound threat to the long-term health of the economy, and that activism has been a significant source and accelerant of short-termist pressures.

IV. Conclusion

We conclude our Thoughts for 2017 as we began, by noting that the most important issue that boards confront today is to work with management to convince investors and asset managers to support investments for sustainable long-term growth and profitability and to deny support to activist hedge funds seeking short-term profits at the expense of well-conceived, long-term strategies. We urge boards of directors to approve *The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth*, issued by the International Business Council of the World Economic Forum, and to authorize their corporations to endorse it, to work with management to obtain its acceptance and endorsement by the investors and asset managers who are invested in their corporations, and to support the efforts of the World Economic Forum and others, in order to combat short-termism and promote investment for long-term sustainable growth.