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Corporate Governance Update: The Changing Dynamics of Governance and Engagement

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As anticipated, the 2015 proxy season has been the "Season of Shareholder Engagement" for U.S. public companies. Activist attacks, high-profile battles for board seats, and shifting alliances of major investors and proxy advisors have created an environment in which shareholder engagement is near the top of every well-advised board's to-do list. There is no shortage of advice as to how, when, and why directors should pursue this agenda item, and there is no doubt that they are highly motivated to do so. Director engagement is a powerful tool if used judiciously by companies in service of their strategic goals. As companies and their advisors study the lessons of the recent proxy season and look ahead, it is worth examining recent shifts in corporate governance dynamics. With an awareness of the general trends, and by taking specific actions as appropriate, boards can prepare and adapt effectively to position themselves as well as possible to achieve their strategic objectives.

Governance Dynamics Trends

Since 2000, the corporate environment has changed in many ways. A thoughtful white paper by The Conference Board discusses five of the most significant legal, social, and market trends during this time period that have contributed to the changing dynamics of corporate governance.[1] These trends have been transformative, and, taken together, they are foundational to shareholder-director engagement today. The first is the increased influence of institutional investors. This is due primarily to the concentration of stock ownership in institutionally-held investment and savings accounts, and to a lesser extent to changes in voting rules and practices and proactive steps by institutional investors to influence corporate governance and direction. The second trend is a shift toward a purely commercial understanding of the purpose of a corporation. Though mid-20th century America generally agreed that a corporation had responsibilities to society as well as to its shareholders, in recent years the prevailing view held by many investors is that public corporations exist primarily to maximize shareholder value. Conflicting interpretations of this goal have produced a further debate as to whether the appropriate timeframe for doing so is the long- or short-term horizon.

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[1] The Conference Board Governance Center White Paper, "What Is the Optimal Balance in the Relative Roles of Management, Directors, and Investors in the Governance of Public Corporations?" 2014, available at conference-board.org (subscription required).

The third trend is declining public trust in business and its leaders. Public confidence in corporate America plummeted with the collapse of Enron and WorldCom and the financial scandals that followed, and it was further undermined by the bankruptcies, bailouts, and stock market losses that accompanied the 2008-2009 financial crisis.

The fourth trend, largely a reaction to the third, is the expansion in federal regulations designed to increase the accountability of directors and senior management and provide shareholders with greater power. Federal regulations over the last decade and a half have, among other things, expanded the range of mandatory company disclosures, provided the U.S. Securities and Exchange Commission (SEC) with authority to introduce proxy access, diminished companies' ability to exclude shareholder proposals from their proxy statements, required regular shareholder advisory votes on executive compensation, and identified shareholder fiduciary duties in certain types of proxy voting by some institutional investors.

This shift in the SEC's focus recently was clearly articulated by SEC Commissioner Dan Gallagher in his last public speech as a Commissioner: "Part of the SEC's tripartite mission is to protect investors. But too often, our concept of 'investor protection' reflects a prejudgment that a corporation is a democracy, where shareholders participate directly in the governance of the corporation."[2] Commissioner Gallagher went on to argue for a more traditional view of federal versus state regulation:

> But, like the United States itself, a corporation can also be a republic, where shareholders elect directors, who in turn govern the corporation. The choice of a shareholder- or director-centric model is properly left to state law. The SEC increasingly has been disrespecting this distinction by interjecting opportunities for shareholder direct democracy into the securities laws. But the director-centric model is at least equally-well suited to the protection of investors, and so the SEC's rules should provide enough flexibility to accommodate either approach.[3]

The fifth trend is the growing influence of proxy advisory firms. Proxy advisors successfully capitalized on the loss of public confidence in business leaders, the rise in share ownership of institutional investors, and the wide array of new regulations and governance requirements. Large investors turned to proxy advisors for guidance, smaller investors followed suit, and the soft power of proxy advisors has become disproportionately strong.[4] Fortunately, over the last year or two, institutions and other large, influential investors have begun to distance themselves from proxy advisors. One factor in this reversal is the SEC's issuance of Staff Legal

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[2] Securities and Exchange Commissioner Daniel M. Gallagher, "Activism, Short-Termism, and the SEC: Remarks at the 21st Annual Stanford Directors' College," June 23, 2015 (footnotes omitted), available at www.sec.gov/news/speech/activism-short-termism-and-the-sec.html.

[3] *Id.*

[4] *See, e.g.*, David A. Katz & Laura A. McIntosh, "Corporate Governance Update: Important Proxy Advisor Developments," Sept. 25, 2014, N.Y.L.J., available at corpgov.law.harvard.edu/2014/09/29/important-proxy-advisor-developments/

Bulletin 20 in 2014.[5] SLB 20 contained a number of elements that together have prompted institutional investors to take responsibility for their proxy votes rather than outsourcing them to advisors such as Institutional Shareholder Services Inc. (ISS). Some large institutional investors have created internal departments to handle much of the work they previously outsourced to proxy advisors. Investment advisors are evaluating and overseeing the work of their retained proxy advisory firms more closely. As Commissioner Gallagher might put it, institutional investors are starting to move from a "compliance mindset" on proxy voting to a "fiduciary mindset."[6]

The 'Active' Investor

As they begin to retake the reins from proxy advisory firms and step into leadership roles in the governance community, institutional investors are becoming more active stockholders than they have ever been. This could be a welcome development for American business, for unlike the "activist" shareholders seeking to enrich themselves through short-term profits, many of the most influential institutional investors are deeply committed to maximizing long-term growth and prosperity. BlackRock chief executive Laurence D. Fink, for example, has made numerous public statements emphasizing the importance of consistent and direct shareholder-company engagement on issues of corporate governance and strategies for long-term growth. He recently noted, in a letter to chief executives, that BlackRock "engage[s] actively with companies on the key governance factors that in our experience support long-term, sustainable, financial performance."[7] In a recent letter to independent directors of portfolio companies, Vanguard Chairman and CEO F. William McNabb III wrote, "We're indifferent as to how a board chooses to engage. What's important to us is *that* it engages. And when they engage, boards should be prepared to enter into a dialogue on appropriate issues of interest to significant, long-term investors."[8]

BlackRock, State Street Global Advisors, Fidelity, Vanguard, and other large asset managers maintain their own proxy voting guidelines; because these investors have a vested interest in the success of the subject companies, these guidelines are far less rigid and agenda-driven than those of leading proxy advisors. State Street's guidelines, for example, are explicitly predicated on the notion that State Street expects to engage with companies on the

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[5] Securities and Exchange Commission Staff Legal Bulletin No. 20, "Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms," June 30, 2014, available at www.sec.gov/interps/legal/cfslb20.htm.

[6] Securities and Exchange Commissioner Daniel M. Gallagher, "Remarks at Society of Corporate Secretaries & Governance Professionals," July 11, 2013, available at www.sec.gov/News/Speech/Detail/Speech/1370539700301.

[7] *See, e.g.*, Laurence Fink, Letter, April 14, 2015, available at www.businessinsider.com/larry-fink-letter-to-ceos-2015-4 ("Fink Letter").

[8] Letter from F. William McNabb III, Chairman and CEO, Vanguard, to the independent leaders of the boards of directors of the Vanguard funds' largest portfolio holdings, Feb. 27, 2015, available at https://about.vanguard.com/vanguard-proxy-voting/CEO_Letter_03_02_ext.pdf.

factors that lead to its voting decisions and to proactively raise concerns with companies in order to resolve them in a manner advantageous to the company and its shareholders.[9]

Over the past several years, there has been a well-documented upswing in the amount and quality of contact between companies and investors.[10] Increased shareholder engagement may initially have been spurred by the requirement of say-on-pay votes every three years,[11] but it has taken on new dimensions as it has grown in scale and deepened in quality. Major institutional investors increasingly expect that companies will provide access to independent directors as well as to other corporate contacts, and not only in times of crisis (*e.g.*, when the company is facing an activist attack or a disappointing earnings release) but on an ongoing basis. An effective shareholder relations program in today's environment will include opportunities for directors and senior management to build substantive relationships with investors over an extended period of time.[12] Corporate secretaries play an important role in coordinating effective director engagement with shareholders.

One lesson to be drawn from the recent attempt by Trian Fund Management, L.P. to obtain four seats on the board of the E.I. du Pont de Nemours & Co. (DuPont) is that the increasingly active role of institutional investors in governance and engagement is good news for companies. In May 2015, DuPont defeated Trian's proxy campaign, thanks to strong support from an unusually large retail shareholder base and, notably, because all three of its largest institutional shareholders—Vanguard, BlackRock, and State Street—declined to follow the recommendations of ISS and Glass, Lewis & Co. to vote in favor of the activist nominees. The independence of its shareholders from the hegemony of the proxy advisors enabled DuPont to continue to pursue its strategic transformation. DuPont effectively communicated its strategic direction by engaging with its investors (including the activists) over a period of years and responding quickly and convincingly to public critiques by Trian. The independent directors, along with the chief executive and members of senior management, were personally involved in DuPont's shareholder engagement efforts and were key elements to DuPont's success.[13]

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[9] *See* State Street Global Advisors, "Proxy Voting and Engagement Guidelines: United States," March 2015, available at www.ssga.com/investment-topics/environmental-social-governance/2015/Proxy-Voting-and-Engagement-Guidelines-United-States.pdf.

[10] *See, e.g.*, Marc Goldstein, IRRC Institute (ISS), "Defining Engagement: An Update on the Evolving Relationship Between Shareholders, Directors and Executives," April 10, 2014, at 4 (finding that, compared to 2011, overall engagement levels are higher, investors and companies are devoting more resources to engagement, and both are reporting greater levels of success in their engagement), available at www.issgovernance.com.

[11] Securities and Exchange Commission Release Nos. 33-9178; 34-63768; File No. S7-31-10 (effective date April 4, 2011), available at www.sec.gov/rules/final/2011/33-9178.pdf.

[12] For a discussion of ways that companies can achieve this, see Martin Lipton & Karessa Cain, "Responding to Institutional Investor Requests for Access to Independent Directors," Wachtell, Lipton, Rosen & Katz Client Memorandum, July 15, 2015, available at corpgov.law.harvard.edu/2015/07/15/responding-to-institutional-investor-requests-for-access-to-independent-directors/#more-71138/. It is important to note that this memorandum outlines a number of different alternatives for shareholder engagement but no company should try to implement all of them; companies must determine the best alternative for that particular company.

[13] For a discussion of additional lessons to be drawn from the DuPont fight, *see* Andrew Brownstein, David Katz, Sabastian Niles and Steven Rosenblum, "Winning a Proxy Fight—Lessons from the DuPont-Trian Vote," Wachtell,

DuPont did exactly what investment community leaders such as Laurence Fink have encouraged corporations to do—"engage with a company's long-term providers of capital; … resist the pressure of short-term shareholders to extract value from the company if it would compromise value creation for long-term owners; and, most importantly, … clearly and effectively articulate their strategy for sustainable long-term growth."[14] In his April 2015 letter to chief executives, Fink promised that "[c]orporate leaders and their companies who follow this model can expect our support."[15] In the DuPont-Trian proxy fight, he and a sufficient number of other institutional shareholders held up their end of the bargain.

Some institutional investors have expressed concerns regarding the rapid increase in director engagement and how they, as large shareholders whose attention is much in demand, will allocate their resources to engage meaningfully. There is some concern that companies with smaller market capitalizations may find it difficult to engage the attention of large shareholders, as these investors are likely to prioritize engagement with companies in which they have more significant investments. Smaller companies may need to seek engagement earlier in the proxy season (or before the proxy season) in order to obtain meaningful access to their institutional investors.

The Corporate Secretary

The preeminence of corporate governance and the rise of shareholder engagement have resulted in a fundamental shift in the role of the corporate secretary. As the Society of Corporate Secretaries and Governance Professionals has observed, "In recent years the Corporate Secretary has emerged as a senior, strategic-level corporate officer who plays a leading role in the company's corporate governance."[16] In addition, many corporate secretaries have become, as one commentator put it, "the primary point of information and influence between the executive management and the board."[17] A 2014 U.K. study concluded that "[t]he role is changing: it is increasingly outward-focused (incorporating investor engagement and corporate communications), and not just about internal administration."[18] A 2014 ISS report found that when investors reach out to engage with boards, they most frequently contact the corporate secretary. The second-most frequent point of initial contact for investor-driven engagement is the board chair (or lead director), with the investor relations office a weak third.[19] When it is the

Lipton, Rosen & Katz Client Memorandum, May 18, 2015, available at corpgov.law.harvard.edu/2015/05/18/winning-a-proxy-fight-lessons-from-the-dupont-trian-vote/.

[14] Fink Letter, supra.

[15] *Id.*

[16] Society of Corporate Secretaries & Governance Professionals, "Role of Secretary," 2015, available at www.governanceprofessionals.org/about/roleofsecretary

[17] *See* Simon Osborne, "Rise of the Company Secretary," Law Society Gazette, July 7, 2014, available at www.lawgazette.co.uk/law/practice-points/rise-of-the-company-secretary/5042026.fullarticle.

[18] Andrew Kakabadse & Nada Korac-Kakabadse, "The Company Secretary: Building Trust Through Governance," Institute of Chartered Secretaries and Administrators/Henley Business School, University of Reading, 2014, at 7.

[19] *See* Goldstein, supra, at 18.

company that initiates engagement, the investor relations office is most often the initial point of contact, with the corporate secretary the second-most frequent point of initial contact.[20]

As a primary liaison with investors who is also close to the board and senior management, the corporate secretary is ideally positioned to help directors and chief executives understand and respond to shareholder concerns. Corporate secretaries are expected to monitor corporate governance developments generally and assist the board in regularly updating and refining the company's governance practices as appropriate.[21] It may be advisable for corporate secretaries to purposefully build relationships with large shareholders, institutional investors, and proxy advisors, in order to be fully up-to-date on the general trends and specific issues that concern both active and activist shareholders, as well as the agendas of key participants in the corporate governance debate.[22]

The 2014 U.K. study found that, for high-performing corporate secretaries, heightened responsibilities may result in complicated reporting structures. Many corporate secretaries report primarily to the non-executive chair of the board or lead independent director, while maintaining close ties to the CEO and senior management; some report primarily to the CEO, while still serving as a significant company contact for the lead independent director or non-executive chair. As a state-law-mandated corporate officer who is appointed by the board but typically hired by senior management, the corporate secretary has a foot in each sphere. Indeed, many corporate secretaries in the U.K. study described themselves as "the third person in the chairman/CEO relationship."[23] Internal direct and indirect reporting lines are best determined in the context of a company's particular structure. The centrality of the role of the corporate secretary will depend in large part on the person occupying that role, on his or her capabilities, and on the quality of his or her relationships with the chairman and the other non-executive directors as well as the CEO and senior management.

When corporate secretaries have taken on significant responsibilities as liaisons between investors and directors, and as the face of the company in outward-focused corporate governance matters, boards and companies may consider splitting the roles of general counsel and corporate secretary, which traditionally have been combined at many companies. The two roles may simply become too large for one person to handle. Moreover, at some companies, the general counsel may be perceived to be more closely aligned with the CEO, while the corporate secretary is perceived to be the board chairman's or lead director's right-hand person, and, in certain situations, it may be simpler and more effective to separate the roles. When the roles are separated, the corporate secretary often reports to the general counsel, while in other situations, the corporate secretary may report to either the CEO or the board chairman, depending upon the particular company and circumstances.

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[20] *See id.*

[21] *See* "Role of Secretary," supra.

[22] *See, e.g.*, Holly Gregory, "The Evolving Role of the Corporate Secretary," Nat'l Ass'n of Corp. Dirs., April 2012, available at www.nacdonline.org/Resources/Article.cfm?ItemNumber=4743.

[23] *See* Kakabadse & Korac-Kakabadse, supra, at 42.

Role of the Board

Corporate governance trends have wrought many significant changes in the management and oversight of U.S. corporations. The priorities and responsibilities of directors, investors, and senior executives have changed to varying degrees as all of the corporate actors adapt to new requirements, societal trends, and the increasingly interconnected corporate environment. Through mechanisms such as majority voting—which is becoming more widespread each year—shareholders are increasing the accountability of directors in annual elections. The hope is that these changing dynamics will have a beneficial effect. As Chief Justice Leo Strine of the Delaware Supreme Court has written:

> [I]t is clear that stockholders have more tools than ever to hold boards accountable and the election process is more vibrant than ever. The election of more accountable boards should come with less tumult, not more. More accountable boards should be given more, not less, leeway to make decisions during their term. This does not mean that corporation law should strip stockholders of their substantive rights to vote on mergers or major asset sales. But it does mean that the costs of further distracting corporate managers from focusing on managing the business to generate profit would outweigh the benefits that come from more corporate referendums.[24]

Perhaps one outcome of increased independent director engagement with shareholders will be a decline in corporate referenda, allowing directors to focus on creating value in the long term. To date, unfortunately, that has not been the case.

Though certain aspects of the role of the board may be changing, the fundamental role and responsibilities of the board hold constant. As a matter of state law, the board is charged with managing, or directing the management of, the affairs of the corporation.[25] No matter how active or activist a company's shareholders may become, their legal responsibilities extend only to the election of directors, votes on certain fundamental matters, and advisory votes on compensation. Some academics and activists argue that state law should be revised to expand the legal rights of shareholders; the merits of this suggestion are debatable, and in any event, it has not been implemented.

Shareholder influence likely will continue to grow, but the legal rights of shareholders remain limited, and the U.S. corporate model remains managerial and director-centric. Directors cannot allow their business judgment to be usurped or overly influenced by investors, advisors, or other board outsiders. Boards are encouraged to interact strategically with investors, to address their concerns, and to reinforce the company's long-term goals, and at the

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[24] Leo E. Strine, Jr. "One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed For The Long Term Unless Their Powerful Electorates Also Act And Think Long Term?" 66 Bus. Law. 1, 23 (November 2010), available at http://www.ecgi.org/tcgd/2011/documents/Strine%20Fundmental%20Corp%20Gov%20Q%202011%20Bus%20L.pdf.

[25] *See, e.g.*, Del. Gen. Corp. L. § 141.

same time to keep in mind that activism, corporate governance, and engagement change nothing about the fundamental fiduciary duties of directors.