American College of Governance Counsel
Second Annual Colloquium
Report of Proceedings[1]

On November 1, 2016, forty-five Fellows of the American College of Governance Counsel ("College") met at the New York Office of Gibson, Dunn & Crutcher to discuss and debate the current state of corporate governance. This Report builds on that discussion. Part I is based on the Panel Discussion and Guest Interview. It outlines key governance themes, trends, and priorities for Boards in 2017. Part II is based on the Keynote Address by Martin Lipton. It summarizes a New Paradigm for corporate governance.

I. Governance Snapshot 2017: Themes, Trends, and Board Priorities

Themes

- *Shareholder-Centric Governance.* Shareholders have more clout than ever. Boards' defensive measures have eroded. Only ten percent of the S&P 500 have staggered boards, and almost none have poison pills. At the same time, shareholders have gained unprecedented access to the boardroom. Over fifty percent of the S&P 500 (and over seventy percent of the S&P 100) have adopted proxy access, and over ninety percent have adopted majority voting for board nominees. This increased clout has been accompanied by robust shareholder activism.

- *Short-Termism.* Boards and management feel pressured to show short-term gains even at the expense of long-term value. Potential drivers of short-termism include: the activist shareholder looking for a "pop" in the stock price without regard to subsequent performance; quarterly reporting and guidance which benchmark performance in three-month increments; compensation of many executives and asset managers based on short-term performance; and the 24x7 news cycle which amplifies short-term developments (especially negative developments).

    - Subject to debate: Whether to counter short-termism by (i) modifying or abolishing quarterly reporting requirements or guidance practices, and/or (ii) reinstating staggered boards.

- *Spotlight on Directors.* Directors face intense scrutiny from shareholders, regulators, and courts. More is expected of directors than ever before (*see* Board Priorities, *infra*). Drivers of this increased scrutiny and heightened expectation include: emphasis on compliance and best practices; mounting disclosure obligations; unprecedented shareholder access to the boardroom; erosion of defensive measures; shareholder activism targeting director competence, tenure, independence, or commitment; say on pay; and judicial scrutiny of "contextual" director independence.

[1] This Report was prepared by Larry Sonsini and Aaron Benjamin. A complete list of those who presented at the Colloquium is appended to this Report.

- *One-Size-Fits-All Regulation.* SOX, Dodd-Frank, SEC rules, stock exchange listing standards, Delaware law, and emphasis on "best practices" combine to create largely uniform standards for governance. This can create pressure for companies (or even whole industries) with differing needs or circumstances.

- *Ownership Dominated by Institutions, some with Divergent Interests.* Ownership continues to shift from retail investors to institutions, and continues to concentrate among the four largest asset managers (BlackRock, Fidelity, State Street, and Vanguard). But not all institutions share the same investment goals, strategies, or time horizons. Many activist hedge funds patrol for short-term opportunities. In contrast, large asset managers have called for renewed focus on long-term value.

- *Voting Divorced from Economics.* Despite the "one share, one vote" norm, in practice voting and ownership are not always aligned. Examples include: derivative and synthetic securities, hedging transactions, securities lending, empty voting, over-voting, dual- and multi-class stock, and third party proxy advisors who determine votes without ownership.

- *Proxy Advisors hold Significant Influence.* In a proxy contest, ISS and Glass Lewis can account for 20-40 percent of the vote. Their influence can be even stronger among small-cap companies. Some data suggest their influence may be weakening (*see* Trends, *infra*).

- *For-Profit Stock Exchanges.* Once self-regulatory organizations that attracted patient capital, stock exchanges are now for-profit companies that increasingly resemble trading platforms with diminishing holding periods.
    - <u>Subject to debate</u>: Whether a for-profit exchange should continue to wield regulatory authority through its listing standards.

<u>Trends</u>

- *Less Short-Termism.* We believe the pendulum is swinging away from short-termism. Large institutional investors have begun publicly advocating management for the long term. The increasing involvement by index funds in governance gives voice to long-term interests. Rising interest rates and stock prices will relieve some investor pressure to extract short-term yields. The growth of dual- and multi-class capital structures means that a growing portion of the market is somewhat insulated from shareholder short-termism.

- *Robust Shareholder Activism.* Recent years have witnessed steady growth of shareholder activism. Activism has become more frequent, more potent, and more widespread. However, preliminary data suggests a recent slowdown with respect to U.S. activist hedge fund campaigns, assets under management, performance, and formation of new funds. Still, other data shows significant growth in the number of public activist demands globally. The impact of the SEC's October proposal to require companies to use universal proxy cards in contested elections remains to be seen. Other trends follow:
    - Increase in activity by newer activists, usually targeting smaller companies

- Increasingly sophisticated and diverse tactics
  - Target governance reform to achieve economic goals
    - Focus on board composition, executive compensation
  - Public pronouncements, shareholder proposals, private engagement
- Increasingly wide range of objectives
- Increasing engagement by institutional investors
- Settlements occurring faster and more often
- Passive investors can quickly turn active
- Company's size, historical performance no guarantee
- Small stake sufficient for effective activism, especially with allies
- Avoidance of disclosure thresholds by resort to "wolf-pack" tactics, derivatives
- Unwillingness to sign confidentiality agreements
- Exploitation of negative public relations optics with accusations and rhetoric designed to embarrass, while company's response is hamstrung by disclosure regulations
  - However, some data indicate a decrease in the percentage of publicity campaigns and an increase in private engagement
- Proxy advisors nearly always support dissident directors; usually support entire slate put forward by activist

- *Growing Governance Role of Passive Institutional Investors.* Shares continue to shift from active institutions to passive funds. Such investors are increasingly engaging on governance, with both companies and activists. Some have developed internal proxy advisory functions rather than outsource to ISS. Such functions may include multi-year studies of individual activist interventions to inform case-by-case decision-making. Despite these developments, such investors continue to align substantially with ISS recommendations. However, data suggest ISS's influence may be weakening.

  - <u>Subject to debate</u>: The degree to which passive index funds care about governance. Some argue that such investors are motivated only to exceed benchmark returns. Others maintain that such investors' refusal to sell motivates them to care about good governance and absolute performance even more than active investors.

- *Spotlight on ETFs.* Assets invested in exchange traded funds (ETFs) have more than doubled since 2011 and total approximately $2.5 trillion. The rise of ETFs – long-term holders which do not sell – could lead to heightened focus on long-term value. Companies considering time-based voting structures should anticipate that significant voting power may eventually be held by ETFs. However, ETFs themselves are traded frequently (by some estimates, the average holding period in the largest ETFs is less than one month). ETFs may play an increasing role in governance by investing only in companies that meet a specified governance profile (*i.e.*, excluding companies with dual-class stock structures).

- *"One Share, One Vote" Remains the Default Capital Structure.* There has been growth in the number of companies going public with dual-class structures. However, we are not convinced that such growth will continue. There is a growing sense that dual-class structures are appropriate only in limited circumstances, and should be accompanied with meaningful limits such as sunset provisions and transfer restrictions. Many institutional shareholders, as well as regulatory bodies, continue to strongly support "one share, one vote" as the standard. Alternatives such as nonvoting stock have drawn intense and prolonged litigation. The market may not be ready for time-based voting structures.

- *Growing Demand for Private Ordering.* At the same time, we see growing demand from companies for a market approach that would provide flexibility in crafting unique capital structures to meet companies' needs and circumstances. This is part of a broader backlash against the one-size-fits-all governance regulation regime. Anticipated de-regulation by the incoming Trump administration may tilt the balance toward a market approach. However, the degree and imminence of any shift remains unclear.

    - <u>Subject to debate</u>: Whether the market can accurately price alternative capital structures. Some point to the fact that the IPO market does not reflect index fund participation, as well as information asymmetry, as prohibitive distortions. Others point to the fact that Alphabet's nonvoting stock trades at a discount to its voting stock to show that ultimately, the market can price voting rights and, presumably, other alternatives to "one share, one vote."

    - <u>Subject to debate</u>: Whether capital structure restrictions deter companies from going public. There is some concern that private companies (especially those backed by venture capital) accustomed to disparate shares which reward insiders and early investors with outsize voting rights, are putting off plans to go public where comparable control is difficult to maintain under current stock exchange listing standards. Others argue that companies will continue going public because only public markets can provide the level of liquidity sought by significant private investors (*i.e.,* Fidelity).

- *Spotlight on Compensation.* "Say on pay" has made executive compensation the purview of shareholders. Compensation is an area in which executives are vulnerable. As a result, it has become a frequent target of shareholder activists seeking a lever for broader reforms. Regulators have also focused on compensation. We perceive continued trends toward independent compensation committees, enhanced compensation disclosure, and clawback provisions.

- *Continued Emphasis on Compliance and Best Practices.* The increasing homogeneity of the stockholder base may increase the herd mentality by which investors are quick to echo support for governance "best practices" put forward by others. On the other hand, the trend among some institutional investors to "think for themselves" with respect to governance may cut the other way.

- *Technological Change.* 2016 witnessed the first-ever public company issuance of digital securities using blockchain technology. Such technology may have the potential to revolutionize capital market infrastructure by providing accurate and near-instantaneous clearing and settlement processes. Governance implications could include: no separation between record and beneficial ownership; alignment of voting rights and ownership; simplified and accurate corporate voting; ability to track holding periods for proxy access and time-based voting; and prevention of stealth stock purchases (implications for activism) and equity grants (implications for compensation). However, the technology is still relatively nascent and faces numerous obstacles to widespread adoption.

<u>Board Priorities</u>

- *Shareholder Engagement.* Given shareholders' increased clout, it is imperative that Boards engage with the shareholder base. This includes increased transparency of Board decisions as well as direct communication with shareholders. The goal of such engagement is twofold. The primary goal is to proactively explain how the company's (actual and contemplated) actions fit within a business plan focused on creating long-term shareholder value. A secondary goal is to monitor shareholder sentiment. By anticipating or detecting shareholder concern early on, the Board can move quickly and quietly to respond before a damaging or distracting public campaign is mounted.

    - <u>Focus on large institutional shareholders, including index funds and ETFs</u>. Such investors are becoming increasingly active in governance. Many have developed internal proxy advisory functions. Continued concentration of ownership in institutional investors, and particularly in the four largest asset managers, may make shareholder engagement easier for Boards: there are fewer people to talk to, they are easier to find, and may have predictably similar positions.

    - <u>Balance transparency and secrecy</u>: Transparency may promote harmful short-termism. A Board might be more receptive to pursue beneficial long-term objectives at the expense of short-term profits when such pursuit is concealed from short-term shareholders. Further, undue transparency can erode a company's competitive edge. The right balance would explain the company's long-term plan and how periodic results fit within that plan, without disclosing competitive information.

- *Activism Readiness.* The growth in shareholder activism means that no business plan is safe. The speed of activism campaigns means that Boards must be prepared in advance. Steps the Board can take to prepare include: develop, continually refine, and explain a coherent strategic long-term value proposition for the company; review internally for characteristics sought by activists (*i.e.*, excess cash, low margins), and, if any, take remedial action; engage with financial, legal, and public relations advisors to conduct thorough analysis of chosen and alternative business plans, comparisons with peers, structural defenses, and corporate bylaws; engage with institutional investors; and monitor for unusual stock trades.

- *Risk Management.* Implement systems to assess and manage risk and noncompliance. Implement controls to (i) detect risk and noncompliance and (ii) bring to the Board's attention. Monitor to ensure systems and controls are adequate. Respond to red flags. Note that risk oversight is the responsibility of the full board, notwithstanding delegation to committee.

- Spotlight on cybersecurity risk. Frequency of and widespread harm from cyberattacks should put Boards on notice, requiring heightened vigilance and advance preparation. Some advocate for heightened legal duties for directors in the cybersecurity context.

- Stay out of day-to-day management. Satisfying the duty to monitor and manage risk should not require embroilment in day-to-day management.

- Subject to debate. The importance of understanding how to price and compensate for risk.

- *Board Composition.* Build a board that is diverse but collegial. Be wary of directors serving on too many boards or for too long. Seek directors who have the ability, time, and motivation to be "active directors" as required in the modern landscape.

- *Don't Just "Check The Box."* In an age where there is much emphasis on compliance and "best practices," Boards must remember to stay focused on strategy. Never compliance for the sake of compliance. Likewise, despite the "one-size-fits-all" regulatory regime, Boards must not lose sight of the particular needs and circumstances of the company under their charge.

- *Compensation.* Calibrate compensation that will (i) attract and retain management; (ii) be well-received by a shareholder base comprising divergent time horizons and investment models; while (iii) remaining faithful to the company's long-term plan. For many companies, 2017 will be the first opportunity to recommend changes to the frequency of their say-on-pay vote.[2] Recommending that the vote occur less frequently is one way Boards can act to relieve some of the shareholder pressure around compensation. But Boards should be informed of shareholder views—and even better, engaged with shareholders—before making a recommendation.

- *Relationship with Management.* Establish constructive tension with management to foster objectivity and candor. Evaluate management and develop a succession plan. Involve management in developing compensation models, risk management, and establishing "tone at the top" of transparency, trust, and integrity. Reach agreement on oversight and strategy, and then respect and support management's decisions regarding day-to-day affairs.

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[2] 15 U.S.C. § 78n-1(a)(2) ("Not less frequently than once every 6 years," companies must include in their proxy statements "a separate resolution subject to shareholder vote to determine whether [the say-on-pay vote] will occur every 1, 2, or 3 years."). 2017 marks 6 years from 2011, the first year in which say-on-pay votes were required. *See* Thoughtful Pay Alert, Compensia.com (October 31, 2016); Final Rule, *Shareholder Approval of Executive Compensation and Golden Parachute Compensation*, SEC Release Nos. 33-9178, 34-63768, at II.B.3.a - c (April 4, 2011).

- *Embrace some Risk*. The law is still designed to protect, and does not second-guess, the Board's reasonable business judgment. Decisions should be made on an informed basis, in good faith, and with the honest belief that such decisions are in the best interest of the company and its shareholders.

II. Keynote Address

Martin Lipton delivered the Keynote Address, entitled "A New Paradigm for Corporate Governance."[3] Mr. Lipton outlined a framework that recalibrates the relationship between companies and their shareholders as a collaborative effort to achieve long-term value.

In this New Paradigm, the roles of the company and its shareholders are as follows:

<u>Company</u>

- Prioritize long-term strategy and performance;
  - develop, implement, oversee, and communicate long-term strategy
  - frame quarterly reporting in the context of long-term plans
  - take into account relevant sustainability, ESG, and CSR factors
  - design executive compensation to incentivize long-term results
- engage, communicate, and foster meaningful long-term relationships with investors;
  - communicate the right things: describe the strategy and the board's involvement in the strategy; make the case for long-term investment; describe capital allocation priorities; address sustainability, citizenship, and ESG/CSR matters; articulate the link between compensation design and corporate strategy; explain why the right mix of directors is in the boardroom; discuss how board practices and culture support independent oversight
  - use the right methods of engagement: periodic letters to investors, investor days, quarterly communications, proxy statements and annual reports
  - determine appropriate director involvement in engagement activities
- oversee and partner with the CEO and management team;
  - prioritize CEO selection and succession planning
  - establish appropriate tone at the top
  - balance role of board as monitor and partner
- organize the business of the board; and
  - continually educate directors
  - conduct candid and constructive self-assessments
  - manage risk effectively
  - manage crises carefully and proactively
  - carefully consider extraordinary transactions on an informed basis
  - periodically review governance

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[3] This Part II is adapted from Martin Lipton, *The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth*, International Business Council of the World Economic Forum (Sep. 2, 2016), http://www.amgovcollege.org/uploads/7/8/4/7/78472964/international-business-council-of-the-world-economic-forum-the-new-paradigm.pdf.

- thoughtfully consider shareholder proposals
  - fairly compensate directors
  - protect confidentiality of boardroom discussions
  - determine appropriate frequency and agenda of executive sessions
  - use committees appropriately
- get the right mix of directors in the boardroom.
  - factors include: independence, diversity, age and tenure, competence and integrity, collegiality, and commitment to board responsibilities

<u>Shareholders</u>

- Engage and communicate with the company;
  - be clear about expectations for the company
  - provide the company with candid and constructive feedback
  - make informed and active voting decisions
  - institutional investors should:
    - disclose their policy on how they will discharge their stewardship responsibilities
    - maintain and disclose a robust policy on managing conflicts of interest
    - monitor their investee companies
    - establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value
    - be willing to act collectively with other investors where appropriate
    - have a clear policy on voting and disclosure of voting activity
    - report periodically on their stewardship and voting activities
- support long-term strategies;
  - stand by company during downturn
  - support company against short-term demands
  - encourage company to move away from providing quarterly guidance
- help company correct long-term strategies or failures to execute on long-term strategies;
- adopt an integrated long-term investment approach;
  - compensation should reward investment professionals for creating long-term value
- integrate relevant sustainability, citizenship, and ESG/CSR matters into investment strategy; and
- disclose their policies and preferences.
  - preferred procedures and primary contacts for engagement with companies
  - investment policies
  - expectations and evaluation metrics
  - position on ESG and CSR matters
  - use of consultants and how a corporation can engage with those consultants
  - governance procedures it considers significant
  - views on quarterly reporting and guidance
  - degree of involvement with short-term activists
  - voting policies and procedures

Appendix of Presenters at the Colloquium

Colloquium Co-Chairs:
- Larry W. Sonsini, Wilson Sonsini Goodrich & Rosati; Trustee of the College
- John W. White, Cravath, Swaine & Moore

Annual Report on the College:
- John F. Olson, Gibson Dunn & Crutcher; Chair of the College Board of Trustees
- Frank M. Placenti, Squire Patton Boggs; President of the College

Panelists:
- Glenn Booraem, Vanguard Group, Inc.
- Roy J. Katzovicz, Saddle Point Group LLC
- Anne Sheehan, California State Teachers' Retirement System (CalSTRS)
- Steven Davidoff Solomon, UC Berkeley School of Law
  Moderator: Larry Sonsini

Guest:
- Robert Greifeld, then-CEO, Nasdaq, Inc.
  Interviewer: John White

Keynote:
- Martin Lipton, Wachtell, Lipton, Rosen & Katz; Honorary Founding Chair of the College

Closing Remarks:
- Larry Sonsini
- Frank Placenti

Table Reporters:
- Aaron J. Benjamin, Wilson Sonsini Goodrich & Rosati
- Kimberley S. Drexler, Cravath, Swaine & Moore
- Frédéric Duguay, Hansell LLP
- Julia Lapitskaya, Gibson, Dunn & Crutcher
- Aaron A. Seamon, Squire Patton Boggs