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GENERAL COUNSEL CORPORATE GOVERNANCE SUMMIT BRIEFING PAPER

Report from the General Counsel Summit on Short-Termism and Public Trust

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About the Report

This summary report was prepared for participants in the General Counsel Corporate Governance Summit and presents some of the key discussion topics and views of participants at the summit. It is not intended to provide a complete summary or represent a unanimous consensus of the summit's proceedings.

Views or positions presented in this briefing do not necessarily reflect the position of the Millstein Center, the Law School, Columbia University, The Conference Board, or any supporters or particular participants.

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Finally, we would like to thank Chief Justice Norman Veasey, Ira Millstein, Bill McCracken, and Bill Ide for their leadership in this important area and for their active participation in the proceedings.

About the Millstein Center for Global Markets and Corporate Ownership

The Millstein Center's mission is to drive change in boardrooms, so that directors can resume using their business judgment to address the challenges companies face, through active engagement in strategy, capital allocation, and culture shift for the long-term future.

For more information, please visit www.law.columbia.edu/millsteincenter.

About The Conference Board Governance Center

Founded in 1993, The Conference Board Governance Center draws upon authoritative research from The Conference Board. Its mission is to work in the public interest to provide knowledge and thought leadership on global corporate governance issues for boards and c-suite leaders, investors and other leading organizations.

The Governance Center is:

- A resource for robust research, analytics and insights on high-priority governance issues.
- A platform for private, constructive engagement with corporate board members, executives, investors and other business leaders.
- A network for peer-to-peer exchanges of governance intelligence, and practice experience.
- An investment in promoting "good governance" that supports long-term corporate performance and trust.
- "Eyes and ears" on the ground to keep members on top and in front of important governance policy developments.

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Genesis of the Summit

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“Corporations are the best means we’ve invented to provide value to everyone...Not only do corporations provide such value now, they hold our future welfare in their share capital—the wealth we will rely on to sustain us. It is not hyperbole to say everything is a stake here. I think corporations protect us, so we have to protect them. The mechanism of governance offers the best protection for us all—employees, consumers, investors and government.”ⁱ

The following summary tracks the introductory comments of Messrs. Millstein and Ide and the three sessions that followed.

Public corporations have been the engine of growth and prosperity in advanced economies since the beginning of the 20th century, creating innovative products and services and leading to unprecedented improvements in the standard of living. The question now is whether changing capital markets and governance practices have caused public companies to limit future growth by becoming overly focused on extracting value in the near term instead of investing for the creation of long-term value. There is a growing concern that the forces affecting corporate governance are jeopardizing capitalism as society’s engine of long-term, durable growth and creating public mistrust in public companies and the capital markets.

Some contend that boards of directors, management and self-described long-term shareholders are not adequately responding to the decline in long-term growth, and that their roles and responsibilities should be the focus for reform. Others point to the rise of activist hedge funds and structural changes to the capital markets as increasing short-term demands. Through proxy contests and related negative media campaigns, companies and the financial markets have raised many different arguments on governance and short-termism. One result has been increased loss of trust in business. While the issues and causes are complex and interwoven, the need for thoughtful analysis and dialogue on the solutions has become urgent.

The Millstein Center at Columbia Law School and The Conference Board have been researching and producing written reports on these questions and their potential solutions. With the philosophy that the long-term financing of innovative and durable public corporations is a critical function and goal of the capital markets, and with the recognition that society depends on the long-term health and success of the private sector, it is our concern that short-termism is having a

profound negative effect on society, impacting gross domestic product (GDP) and public trust in business².

At the public company level, two trends, in particular, are in line with the expected impact of short-termism—a reduction in business investment and an increase in payouts to shareholders³. Governance experts, economists, and shareholders themselves are raising concerns with these trends, saying many companies are jeopardizing future prosperity for higher (and likely unsustainable) returns today.

Throughout the history of the corporation as a recognized entity in society, the board of directors has occupied a unique and exalted role. Boards of directors are recognized under state law as the fiduciary overseers of the company’s well-being and their duties have been well-defined by the courts through the business judgment rule. Shareholders, too, occupy a vital position in the capitalist system as the providers of capital and a vital link to society as one of the principle mechanisms of wealth creation and distribution.

Corporate governance—the system of rules, practices, and processes by which a company is directed and controlled—is complex and nuanced. The legal intricacies that direct the activities of the board and the corporation and their relationships to the company’s stakeholders are many, requiring skilled legal analysis and counseling. This necessitates an engaged and proactive role for general counsels, as they fulfill their fiduciary duties to their companies while counseling their boards. Indeed, general counsels have a critical role, in advising and supporting their companies and their boards, to play in solving this serious problem.

It is our view that boards must become proactive in assuring long-term decision-making and, as a trusted advisor to the board, it falls to the general counsel to guide directors through

ⁱ Interview of Ira Millstein for Listed Magazine, October 30, 2014 available at <http://listedmag.com/2014/10/ira-millstein-why-governance-is-our-best-defence/>

the complexity of laws, policies, and conflicting interests at play. Lawyers have long been the leaders in times of crisis, particularly when it comes to resolving complex issues with multiple causes and impacts, bringing diverse participants together to find a solution.

It was under these circumstances that The Conference Board Governance Center and the Millstein Center for Global Markets and Corporate Ownership at Columbia Law School convened a summit of leading public company general counsels to consider solutions for the right balance of short- and long-term considerations in board decision-making, the restoring of public trust in business, and the appropriate role for the general counsel in this process. This report summarizes the discussions at this meeting.

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- ¹ For a discussion of the impact of short-termism on economic growth, see for example, Andrew G. Haldane, Growing, Fast and Slow, Speech given 17 February, 2015 at the University of East Anglia, Norwich, available at <https://thenextrecession.files.wordpress.com/2015/03/haldane-on-growth.pdf>
- ² For a discussion on the broader effects of short-termism, and specifically on public trust in business, see The Aspen Business and Society Program, “SHORT-TERMISM AND U.S. CAPITAL MARKETS: A Compelling Case for Change”, available at https://assets.aspeninstitute.org/content/uploads/files/content/images/Compelling%20Case%20for%20Change_August2010.pdf
- ³ Thomas B. King and Timothy Larach, Corporate cash flow and its uses, The Federal Reserve Bank of Chicago Essays on Issues 2016 Number 368

Session One: The Short-Termism Debate and The New Drivers of Corporate Governance: The Market at Work, Abusive Capital, or Both?

Ira M. Millstein, *Founding Chair, Millstein Center, Columbia Law School; Senior Partner, Weil, Gotshal & Manges LLP*ⁱⁱ

Chief Justice E. Norman Veasey, *Former Chief Justice, Supreme Court of Delaware; Special Counsel, Gordon, Fournaris & Mammarella, P.A.*ⁱⁱⁱ

Capital markets have evolved dramatically over a generation from individual stockholders and relatively simple organizations to enormously complex institutions with many layers of intermediation, and these institutions now control an overwhelming percentage of the shares of public companies. While the ultimate shareholders in the system tend to have a long-term view of investing as they save for retirement or their children's education, this viewpoint is sometimes lost in the complex capital market system. Due to the size and complexity of the portfolios they oversee, some intermediaries find it difficult, if not impossible, to think of corporate governance through the lens of the individual company. Institutional investors, in general, are not well-positioned legally or operationally to manage the daily affairs of the companies in which they invest. Adding to the complexity is the rise of trading and speculation in the financial markets, which creates volatility and pressures by certain types of shareholders for short-termism decisions by boards.

Our corporate legal system advocates a board-centric approach to corporate governance. Boards are entrusted with the authority to manage the affairs of the company, and with that authority, the fiduciary duty to act in the long-term interest of the company. Recent Delaware case law reaffirms this authority; e.g., *Air Products & Chemicals, Inc. v. Airgas, Inc.*, 16 A.3d 48 (Del. Ch. 2011), which confirmed that boards can, so long as certain tests are met, ignore a short-term sale in favor of a long-term strategy, and *In re Trados, Inc. Shareholder Litigation* (2016), which supports broad board discretion. In addition, there are extrajudicial writings, such as those of the current Chief Justice of Delaware, Leo Strine, that support the proposition that creating long-term shareholder value is the standard to which directors should aspire⁴.

As a result of their close relationship with the board, general counsel are in a unique and key position to educate boards regarding their authority and duty to act in the company's long-term interest.

In addition, other than the directors themselves, general counsels are in the best position to ensure that directors have effective governance processes in place, which both support the board's fiduciary duty of due care and help to build trust with major institutional investors.

⁴ See for example, 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, *Business Lawyer*, footnotes 30 and 32 (2010).

ⁱⁱ Mr. Millstein is the author of *"The Activist Director: Lessons from the Boardroom and the Future of the Corporation,"* to be published in December, detailing his first-hand experiences advising boards of directors in an effort to offer pragmatic suggestions for recruiting activist directors to the boardroom to secure the future of the corporation.

ⁱⁱⁱ Mr. Veasey is co-author with Christine T. Di Guglielmo of *"Indispensable Counsel: The Chief Legal Officer in the New Reality"* (2012). The Wall Street Journal called it "a field manual to aid [chief legal officers] with their new tasks." (March 9, 2012).

Session Two: The Path Forward for Corporations and their Boards

William E. McCracken, *Chair, Millstein Center, Columbia Law School; Former Chairman and CEO, CA Technologies; Director, MDU Resources Group, National Association of Corporate Directors*^{iv}

Stephen M. Cutler, *Vice Chairman, JP Morgan Chase & Co.*^v

Peter R. Gleason, *President, National Association of Corporate Directors*

We are at an inflection point, not just a transition, in corporate governance. General counsel can play a key role in re-establishing the board's central role in:

- establishing good governance practices and culture;
- ensuring that the company's long-term strategy is effectively communicated to its shareholders and other stakeholders;
- setting the board agenda so that adequate time is devoted to long-term strategy, including a continual review of assumptions underlying that strategy;
- confirming that executive compensation incentives support the long-term strategy;
- ensuring that capital allocation decisions are made in the context of a long-term strategy and that decisions regarding dividends and stock buybacks are made within the context of the strategic goals of the company;
- allocating adequate time to key risk management issues, including a robust compliance system; and
- facilitating a strong succession planning and evaluation process for management and directors.

General counsel are often expected to do everything and in the past have not always been on point for the company in governance, but in the context of today's serious issues affecting the continued viability of public corporations, these corporate governance issues have never been more critical and the leadership of the general counsel as a trusted advisor to the board has never been more urgently needed.

A copy of the Commonsense Principles of Corporate Governance is attached as an addendum to this report. The underlying concept in creating the Principles was "*if we owned the company, how would we govern it?*" The Principles are the consensus of a group of CEOs of major public corporations, asset managers and a major hedge fund, focused on creating long-term shareholder value through corporate governance practices.

The Principles were developed jointly by public corporations and major institutional investors who understand the negative effects short-termism may have on their overall

portfolios and the economy. Although the Principles are a good model for best practices, perhaps the most important aspect of the Principles is its proponents. The group, convened by JPMorgan Chase CEO Jamie Dimon, includes Berkshire Hathaway Chair and CEO Warren Buffett as well as lead executives from BlackRock, State Street Global Advisors, Vanguard Group, T. Rowe Price Group, Canada Pension Plan Investment Board, ValueAct Capital, General Electric, General Motors, and Verizon Communications.

^{iv} Mr. McCracken served as co-chair of the 2015 NACD Blue Ribbon Commission on The Board and Long Term Value Creation

^v Mr. Cutler served as reporter for The Commonsense Principles of Corporate Governance.

Session Three: The Path Forward For the Summit Initiative to Further Long-Termism and Rebuild Public Trust in Business

Laura Stein, *Executive Vice President, General Counsel and Public Affairs, The Clorox Company*

R. William Ide, *Chair, Advisory Board, The Conference Board Governance Center; Partner, Dentons*

There is a growing concern that public corporations are overly focused on the short term and that it is having a negative effect on economic growth. That has spawned a number of recent initiatives and reports in addition to the Commonsense Governance Principles, including:

- The “*New Paradigm*,” prepared for the International Business Council of the World Economic Forum by Wachtell, Lipton, Rosen & Katz Partner Marty Lipton, a comprehensive roadmap for corporations and investors to achieve long-term investment and growth, making the proposition that corporations adopting the New Paradigm should receive the support of their shareholders when confronted with short-term pressures;
- Focusing Capital on the Long Term, an organization that develops tools and approaches to encourage long-term behaviors in business and investment decision-making;
- Statements by major long-term institutional investors such as Vanguard, BlackRock and State Street urging the companies in which they invest to engage in longer-term thinking—signaling that the largest shareholders of many public companies expect their boards to engage in longer-term thinking and behavior;
- Numerous academic and other studies, which were shared with the attendees.

These are useful resources for general counsel, but most have not been developed to promote specific actions to make needed reforms. The purpose of the General Counsel Summit and other meetings being planned by the Millstein Center and The Conference Board Governance Center is to focus on the key efforts needed to counteract harmful short-term pressures on management and boards, and to develop practical tools that general counsel can use in advising management and boards on making the needed changes.

There was consensus of the attendees that the Millstein Center and The Conference Board Governance Center should move forward with specific focus on the following:

1. Short-termism is an issue that boards should address and a priority for directors is approving a long-term strategy specifically addressing the company’s approach to the key issues raised in short-termism debates that can be effectively communicated to stakeholders.

2. From a fiduciary standpoint, boards should feel empowered to exercise far greater control and judgment when responding to activist pressures to boost payouts or augment short-term profits. Boards should act in the long-term interest of the company and all of its shareholders.
3. Setting high governance standards is essential to carrying out a board’s fiduciary duties, to earning public trust and to building strong relationships with major long-term investors. Interactions with them can then be based on strategic, rather than governance issues, which should enhance a company’s ability to withstand activist attacks.
4. Boards should consider buyback programs and dividend policies in the overall context of the long-term strategic plan. In general, strategic capital allocation decisions should not be based on the funds left over after payouts to shareholders.
5. Executive compensation should effectively incentivize thinking beyond current stock price movements and align with the long-term plan for value creation.
6. Companies should not feel obligated to provide quarterly earnings guidance, and should only do so if they believe that the benefits of providing quarterly guidance outweigh the costs.
7. There was little support for considering extra dividends or enhanced voting rights to reward long-term investors, although it is permissible to do so under Delaware law.
8. The general counsel should continually keep the board of directors informed of the foregoing and other relevant governance issues to assure the company is in a proactive mode with its significant shareholders and other key stakeholders.

Much of the discussion centered on this last point.

General Counsel Interaction with Directors

The Commonsense *Principles of Corporate Governance* encourage the board to expect unfettered access to management at all levels, although this principle does not appear to be the norm in today’s public corporations. How much contact should a general counsel expect to have with the directors? It was generally agreed that general counsel should expect to have direct individual contact with directors, and they should expect to be

involved in the agenda setting process for board and committee meetings, which can offer an opportunity for discussion of long-term issues with the lead director, non-executive chair or committee chairs. The general counsel may also find an annual review of corporate governance to be an appropriate time to raise short-termism as an issue with the full board, or in the context of an enterprise risk management discussion. It was agreed that it is a good practice for the general counsel to inform the CEO of when he or she communicates with a director and the general nature of the discussion.

Long-Term Strategy and Capital Management

While those at the Summit agreed that most corporations have well thought-out long-term strategies, the real issue is the lack of good communication on those strategies. This is where the general counsel's input on shareholder communications is key, including SEC filings, press releases and quarterly analyst calls. The short-term question also gives the general counsel a unique opportunity to meet with the CEO and CFO on long-term strategy and to educate the board on their duties to the corporation and all its shareholders. The duty of the board is beyond short-term profit maximization, a fact which CEOs and CFOs, including those on the board, may not fully appreciate. Finally, another key role for general counsel is ensuring that board agendas calling for capital management decisions are made in the context of a long-term strategic plan.

Quarterly Guidance

It was agreed that there is intense pressure on quarterly performance, but the pressure to give quarterly guidance may have lessened. Some companies do not do so because of the long-term nature of the business. Other companies that have ended quarterly guidance have not experienced a negative long-term effect on their stock price. One participant said that in the end, the past quarter's performance is not necessarily relevant to the long-term prospects of a firm. Most participants agreed that the CFO or IR staff tend to have dominion over the issue of giving quarterly guidance, but that general counsels have a role to play as the chief corporate governance advisor to the board and as a member of the senior management team—keeping in mind that the CFO and IR staff may not be communicating with investors' governance staff.

Director Compensation and "Golden Leashes"

The Commonsense *Principles of Corporate Governance* prohibits special payments to public company directors by a shareholder in addition to company compensation for the director, also known as "golden leashes." Such payments are common in private equity and increasingly being sought in settlement agreements with activists in which a public company agrees to name one or more activist nominated directors to the board to

avoid a proxy contest. There was general agreement that activists should not directly pay a supplement to what the company offers because directors should only act on behalf of the company, not on behalf of any particular shareholder. It was also agreed that it would be helpful to have balanced research into the legal arguments for and against golden leashes.

Conclusion

In his 2010 essay, "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," Chief Justice Strine wrote: "It is jejune to demand that CEOs and boards manage for the long term when the stockholders who can replace them buy and sell based on short-term stock price movements, rather than the long-term prospects of firms."⁹

There is something to the Chief Justice's observation. And yet, the call for boards to remain, or return to, a long-term focus has remained strong and even grown in recent years. As discussed in the sessions and in related writings and research, institutional investors are not well-positioned to affect the governance behaviors at individual companies in line with the needs of those individual firms.

And so, that leaves only the boards, who have the legal duty to manage or direct the affairs of the corporation. General counsels are uniquely positioned to advise their boards, in their role as counsel, to their duty to focus on the long-term value creation of the company.

This starts by:

- encouraging the development of a sound long-term strategy,
- working closely with the board and colleagues in management from various functions on effective communication techniques to investors and other key stakeholders,
- building out strong and sound governance practices at the organization, and
- ensuring that there is a trust and understanding between the company and its institutional investors on where the company is going and how it plans to get there, over the short and long term.

"A long-term oriented, well-functioning and responsible private sector is the country's core engine for economic growth, national competitiveness, real innovation and sustained employment... [However,] it is beyond dispute that U.S. public companies today are under tremendous pressure to deliver near-term results, and that this pressure is having a real impact on corporate strategies and investments."¹⁰

The long-term success of the private sector, and the companies that comprise it, is an issue of national import. Leadership of and by boards, with the support and advice of their general counsel, to focus on the long-term success of their companies is critical to address this issue. The Conference Board Governance Center and the Millstein Center at Columbia Law

School will support general counsel and boards as they begin to address this through convenings, research, and advocacy.

Building on the initial gathering summarized above, The Conference Board and the Millstein Center plan to:

- undertake an education and outreach program for general counsel and their boards through a series of general counsel regional and industry summits;
- develop practical tools for general counsel to use in advising boards and CEOs;
- work with long-term investors and boards to reach alignment on the best ways to assure longer-term thinking;
- conduct educational sessions for policy makers and companies to discuss regulatory or legislative actions relating to short-termism and the restoration of public trust in business; and
- serve as a voice for general counsel on short-termism issues, as may be needed.

⁵ 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," 60 *Business Lawyer* (2010), 10-12.

⁶ Wachtell, Lipton, Rosen & Katz "Some Thoughts for Boards of Directors in 2015" December 2014.

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GENERAL COUNSEL CORPORATE GOVERNANCE SUMMIT BRIEFING PAPER

New Drivers of Capital Markets and the Short-Termism Debate: Is the Future of Market Capitalism as Society's Growth Engine in Jeopardy?

New Drivers of Capital Markets and the Short-Termism Debate

*Is the Future of Market Capitalism as Society's Growth Engine in Jeopardy?**

This paper presents the perspectives of several key studies on the short-termism debate as it relates to the governance of public corporations. The focus of these studies is on corporate governance changes as a driver of short-term thinking. The effects of technology, demographic shifts and globalization are not addressed in this paper.

Significant changes in capital markets have sparked a debate as to whether the stewards of public companies are emphasizing the extraction of value in the short term over long term investment in their businesses—or whether the entire system is geared toward a short-term view of capital. The conclusions drawn from this debate provide a starting point for those seeking to achieve a better balance of incentives and governance structures to ensure the continuing prosperity of market capitalism.

Changes in the Capital Markets

Capital markets have experienced major transformations since the mid-1980s. Each development has generated its own circle of proponents and detractors.

Trading vs. Investing: Changes in the manner and volume in which stocks are traded on public exchanges have been among the most visible developments, and the totals now stand in stark contrast to the level of investment. Equity underwritings during 2015 were \$256 billion while the volume of stock trading totaled \$48.6 trillion. Trading by speculators and investors, therefore, represented 99.5% of the total activity on Wall Street last year.¹ This trend, from investing to trading, has been present for many years prior to the rise of high frequency trading.²

Proponents tout the new efficiencies brought about by these technological innovations. Critics of the “more and more often” dynamic of trading activities contend that the exchanges have now become platforms that no longer direct investment capital to listed companies but rather emphasize trading between and among other traders.³

Time Horizons in Corporate Management and Financial Markets: A seismic shift in capital markets has involved an increased focus on briefer time horizons.⁴ The debate in the U.S. has largely focused on management's provision of quarterly bottom line earnings guidance to analysts, which provides a strong incentive to meet or exceed the guidance each quarter, sometimes at the expense of R&D efficiency or long-term capital investments.⁵

Proponents have stressed that increased information flow allows companies to reduce their cost of equity since shareholders are willing to take on more risk with more information in their possession.

Detractors are legion. One oft-cited survey of CFOs revealed that the vast majority would forgo spending on long-term projects if such spending would jeopardize a miss in earnings estimates for the quarter.⁶ The term “quarterly capitalism” has been coined to describe the actions of some companies to employ gimmicks that provide short-term stock gains at the expense of long-term health.⁷ BlackRock CEO Larry Fink has criticized quarterly capitalism in his much-touted annual Corporate Governance Letters to CEOs. And recently, a group of prominent CEOs⁸ have recommended that companies stop giving earnings guidance as part of their “Common Sense Governance Principles.”⁹

Few have recommended ending quarterly reporting altogether in the U.S. Quarterly filings and earnings calls allow companies to communicate regularly with their investors and the reports provide for internal oversight by boards of directors and regulatory oversight by the Securities and Exchange Commission.

The Shareholder Revolution and the Rise of Activist Shareholders: Another powerful shift from management to shareholders began with the takeover wave of the 1980s and gained momentum in recent years with the rise of activist hedge funds. Prior to this shift, management within a public corporation typically sought to balance the interests of multiple stakeholders, including employees, customers, suppliers and regulators. Over the past generation, however, the notion that shareholders are the primary stakeholders in public corporations has gained acceptance and that creating value for shareholders is the categorical imperative for management.¹⁰

Critics have dubbed this shift a move from “retain[ing] and invest[ing]” to “downsiz[ing] and distribut[ing]” the profits of public corporations,¹¹ and they contend that “The interest of some shareholders in immediate payouts [should] not trump the interest of society at large in a productive corporate sector and in a rising standard of living over time.”¹² Yet the pressure on institutional investors to increase returns to meet pension and other obligations can result in some investors supporting gains today over investments for tomorrow.

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Shift from Investing to Paying Out Profits to Shareholders: Perhaps the most dramatic change in capital markets is the approach public companies now take toward capital allocation. Evidence of the shift by corporations returning capital to shareholders vs. retaining it to invest in initiatives over the long haul is startling. “From 2003 to 2012, the 449 companies in the S&P 500 Index that were publicly listed during that time used 54% of their earnings to buy back their own stock, almost all through purchases in the open market, and dividends absorbed an additional 37% of earnings leaving just 9% for reinvestment in the business.”¹³ In the 12-month period ending March 2016, S&P 500 companies spent a record \$589.4 billion on share repurchases, surpassing the previous record set in 2007.¹⁴

Short-Termism Alarm

Changes in capital markets have triggered an alarm over “*short-termism*”—i.e. the notion that various constituencies in today’s markets have “allowed short-term considerations to overwhelm the desirable long-term growth and sustainable profit objectives of the corporation.”¹⁵ Those who are concerned about short-termism believe corporate boards and managers are overly influenced by the pernicious effects of maximizing shareholder value over short time horizons. However, short-termism is not limited to boards and management or the behavior of a few investors or intermediaries. Rather “it is system-wide, with contributions by and interdependency among corporate managers, boards, investment advisors, providers of capital and government.”¹⁶ Nevertheless, two factors are worth mentioning as influencing the movement toward shorter-term behaviors: the rise of activist hedge funds and changes in executive compensation design.

Activist Hedge Funds as a New Sphere of Influence: Activist hedge funds are a significant new sphere of influence in the short-termism debate. Assets under management by such funds have increased five-fold over the past decade, and activists pursue growth strategies at the companies they target only 1–2% of the time.¹⁷ Most frequently, they seek to obtain board seats to stimulate a spin-off or sale of a company to effect a stock price premium, but they also regularly pursue increased distributions to shareholders.¹⁸ “The primary criticism of share buybacks is that they have become so pervasive that necessary investments in the business are not being made—the emphasis instead is on paying out profits to shareholders over all other uses of funds.”¹⁹

Executive Compensation Design: Short-termism isn’t driven solely by hedge fund activists and other intermediaries in the financial system. Managers of publicly held companies play their own prominent role in the trend. The design of executive compensation has shifted such that larger proportions of total compensation are weighted toward equity awards linked to a company’s financial performance. This

design was intended from a governance standpoint to better align the interests of management and shareholders. However, an unintended consequence is that it frequently places emphasis on increasing total short-term shareholder returns since “[p]erformance triggers that are tied to near-term indicators, such as one-year share price increases, encourage executives to focus more on short-term share price and accounting measures than on long-term performance.”²⁰

But Does Short-Termism Really Exist?

Despite all the noise, many have argued that short-termism doesn’t exist or isn’t the issue many make it out to be.²¹ In their minds “[b]ad short-termism is when boards and managers forgo good long-term business opportunities simply to meet quarterly earnings targets” while “[b]ad long-termism... is when they invest in businesses that have no future... [with] an increasingly fine line between the two.”²²

Short-Termism Isn’t Real: Business are Investing for the Long-Term: Those refuting the idea of short-termism argue that traders with short holding periods represent a portion of the market whose influence is overblown. Major institutional investors such as Fidelity and Vanguard have much longer holding periods for their investments than many realize,²³ and businesses on the whole are actually investing for the long haul as evidenced by the success of companies like Apple, Amazon and Google that have invested huge sums in R&D as they grew to maturity.²⁴

The counterargument is that investment growth is at its slowest level no matter how investment is defined. Moreover, weak investment is occurring in what should be an exceptionally favorable environment of cheap credit and record corporate profits.²⁵ So where are those profits going? To institutional and activist shareholders, argue the short-termists.

Reasons Why Short-Termism Doesn’t Exist or Isn’t a Problem Assuming It Exists: Professor Mark Roe of Harvard Law School has offered perhaps the most detailed refutation of the notion that short-termism exists or is a problem to be reckoned with. His counterarguments include the following:

- i. **Offsets:** “Even if the stock market is excessively short-run focused and even if there are transmission mechanisms that bring financial markets’ time horizon into corporate decision making, policymakers need to see the American economic system as a whole, where there are [built-in] countermeasures.”²⁶ In other words, there are offsets in the markets—often substantial—such as private equity investors with lengthier time horizons.
- ii. **Long-Termism Evidence:** There is considerable evidence of stock market long-termism, including indications that public firms frequently over-invest when compared to their private counterparts.²⁷

- iii. **Insider Issue:** Substantial, albeit unheralded, sources of excessive short-termism come from inside the corporation. For example, contrary to the typical short-termist view, studies show that CEOs actually increase their firms' R&D spending during their first year as CEO and reduce it in their final years.²⁸
- iv. **Appropriate Reaction:** The new short-termism, to the extent it even exists, may be an appropriate reaction to changes in the economic environment such as more rapid technological change, increased globalization and excessively influential government short-term policies.²⁹

One Factor at Most, But Not a Major Factor: In the eyes of detractors, "system-wide short-termism in public firms is something to watch for carefully, but not something that today should affect corporate lawmaking."³⁰ Put another way, the threat isn't real, or certainly isn't substantial enough to deviate from a laissez-fair approach to the operation and regulation of capital markets in advanced economies.

Conclusions of Previous Studies

If short-termism exists as a matter of potential concern, what can be done beyond simple monitoring? These are some of the solutions proposed in previous studies.

Financial Reporting: One proposal is for public companies to abandon quarterly bottom line earnings guidance in favor of guidance and information that is material to a company's long-term prospects and progress against a company's strategic objectives. In other words, adopt a balanced scorecard approach which The Conference Board refers to as "integrated reporting and guidance" (encompassing a combination of financial and environmental, social and governance performance in a single report or document).³¹ Support for a shift away from short-term earnings guidance has been buttressed in the past by a 2006 McKinsey study reviewing approximately 4,000 companies with annual revenues over \$500 million that revealed no negative effects from ending such guidance.³² At the end of the day, the study concludes, "[t]here appears to be no significant relationship between guidance and valuation—regardless of the year [when guidance commenced or ceased], the industry, or the size of the company in question."³³ More recently, a number of public companies have moved away from quarterly bottom-line earnings guidance for the same reasons highlighted by the McKinsey study without suffering adverse results.³⁴

Transparency: At the other end of the regulatory spectrum, advocates have proposed increased transparency in the form of revised disclosures for investors. This would involve changes to current disclosure rules that permit hedge fund activists to become formal shareholders of a public corporation with voting power while simultaneously "shorting" the

corporation's shares (a/k/a "empty voting") or entering into a derivatives contract to hedge away the fund's economic interest to an investor who owns shares of one company and uses that position to increase the value of its holdings in another company.³⁵

Other suggested changes include shortening the reporting windows for certain SEC filings. Proposed legislation recently introduced in the U.S. Senate known as the "Brokaw Act" (S. 2720) would reduce the 13D reporting window from 10 days to two business days, expand the definition of "Beneficial Ownership" to include derivative instruments, expand the definition of "Person" to include hedge funds and require investors acquiring direct or indirect short interests of a registered security greater than five percent to report such interests within two business days of such acquisition.³⁶ Previously, the NYSE and corporate governance and investor relations groups petitioned the SEC to reduce the 13F reporting window for investment advisers and other investors with at least \$100 million in equity assets under management to just two days after the quarter ends instead of the current 45 days.³⁷

Fiduciary Duty: The Aspen Institute and others have argued that many 529 college savings, 401(k) and related retirement funds pursue strategies that are inconsistent with their investors' goals as they turn over portfolios, pay their managers and engage in activism in pursuit of short-term financial objectives at the expense of long-term performance. Advocates claim that these funds should be "subject to clearer and more rigorously enforced enhanced fiduciary duties to address the disconnect between the interests of intermediaries and ultimate investor/beneficiaries."³⁸

As the CFA Institute and the Business Roundtable Institute for Corporate Ethics note, "When asset managers are evaluated and compensated primarily on the basis of quarterly metrics, they may pressure companies into the same short-term thinking or increase volatility by regularly trading in and out of company securities in an effort to capture short-term profit." They recommend that "a significant portion of asset managers' incentive pay be measured by long-term metrics (three to five years), similar to those used at the companies in which they invest."³⁹

Patient Capital: Market incentives to encourage what proponents refer to as "patient capital" include the following:

- i. **Tax Reform:** At the simplest level, this would involve re-setting capital gains rates. BlackRock's Fink argues that long-term capital gains treatment be granted only after three years with a decreasing tax rate for each year of ownership beyond that, potentially dropping to zero after 10 years,⁴⁰ while the Aspen Institute suggests a similar approach.⁴¹ The Institute further supports implementation of an excise tax on trading designed to discourage excessive turnover and encourage longer-term

share ownership.⁴² Such a financial transaction tax isn't a new concept. It's already in place in some form in 15 of the G20 countries.⁴³

- ii. **Capital Loss Deductibility:** Elimination of the capital loss deductibility limitations for long-term holdings, currently capped at a relatively low \$3,000/yr. for losses related to holdings of any duration, is yet another recommendation from the Aspen Institute.⁴⁴
- iii. **Holding Periods:** Some advocates have suggested the adoption of minimum holding periods or time-based vesting in exchange for enhanced shareholder participation rights. Limiting proxy access, in particular to propose director nominees, to shareholders of a specified minimum duration is perhaps the most notable proposal (the most common recommendation is to grant access for holders of three percent of the company's outstanding common stock for at least three consecutive years).⁴⁵
- iv. **Share-Related Solutions:** Several bodies have recommended a movement toward share-related incentives such as offering extra dividends or enhanced voting rights to reward long-term investors. Incentives along this line have been adopted by companies in Europe and Asia in the form of so-called loyalty or "L-Shares" whereby, for example, an investor who buys and holds L-Shares for at least three years will be awarded two votes per each share held.⁴⁶

Ending the More is Better Approach to Corporate Governance: If corporate governance reform is to play a critical role in addressing short-term thinking by key players in the capital markets, reformists must be careful to avoid the "more is better" approach. Matching proper levels of stewardship with responsible ownership will always be part of the debate.⁴⁷ But adding more mandates in the wake of each headline worthy governance crisis is not the panacea for this matching exercise, especially from the perspective of corporate boards and managers who are already hard-pressed to carry out their current duties.

Some have gone so far as to suggest that shareholders and society as a whole would be best served if boards focus primarily on areas vital to a corporation's health as opposed to mandatory checklists and historical reports. "Most fundamentally, that means ensuring that boards have adequate time to focus on whether the corporation has the right strategy, whether that strategy is being implemented effectively and by the right management team, whether the corporation is taking prudent steps within the law and whether the corporation is operating with a prudent level of financial leverage."⁴⁸ This kind of approach requires discipline by managers and directors and assistance from the agenda setters of corporate governance discussions—that is, general counsels and corporate secretaries—so that boards and executives can focus more on strategy and long-term investment considerations and less on quarterly performance.

Conclusion

If short-termism is mainly a mindset of key players in the capital markets it nevertheless remains a mindset that has shifted the priorities of such players out of balance in the eyes of many critics. The impulsive focus on extracting value now instead of patiently investing to create value down the road, whether at the behest of activist and institutional investors or simply by managers and directors who believe their fiduciary obligations lie solely to shareholders as opposed to other constituencies, is the end result. Shifting the mindsets remains a challenge for the future, but there remains room for optimism.

Policy and governance recommendations such as those put forth by the Aspen Institute and The Conference Board may provide a starting point for corporate executives, board members and investors to "review their governance structures to determine whether they adequately promote long-term thinking and to consider whether any changes could better serve their long-term interests as they move forward in the current environment."⁴⁹ Coupled with potential regulatory reforms, a return to a long-range view of value creation for public companies may ensure the future of market capitalism as society's growth engine.

Endnotes

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Is Short-Term Behavior Jeopardizing the Future Prosperity of Business?

EXECUTIVE SUMMARY



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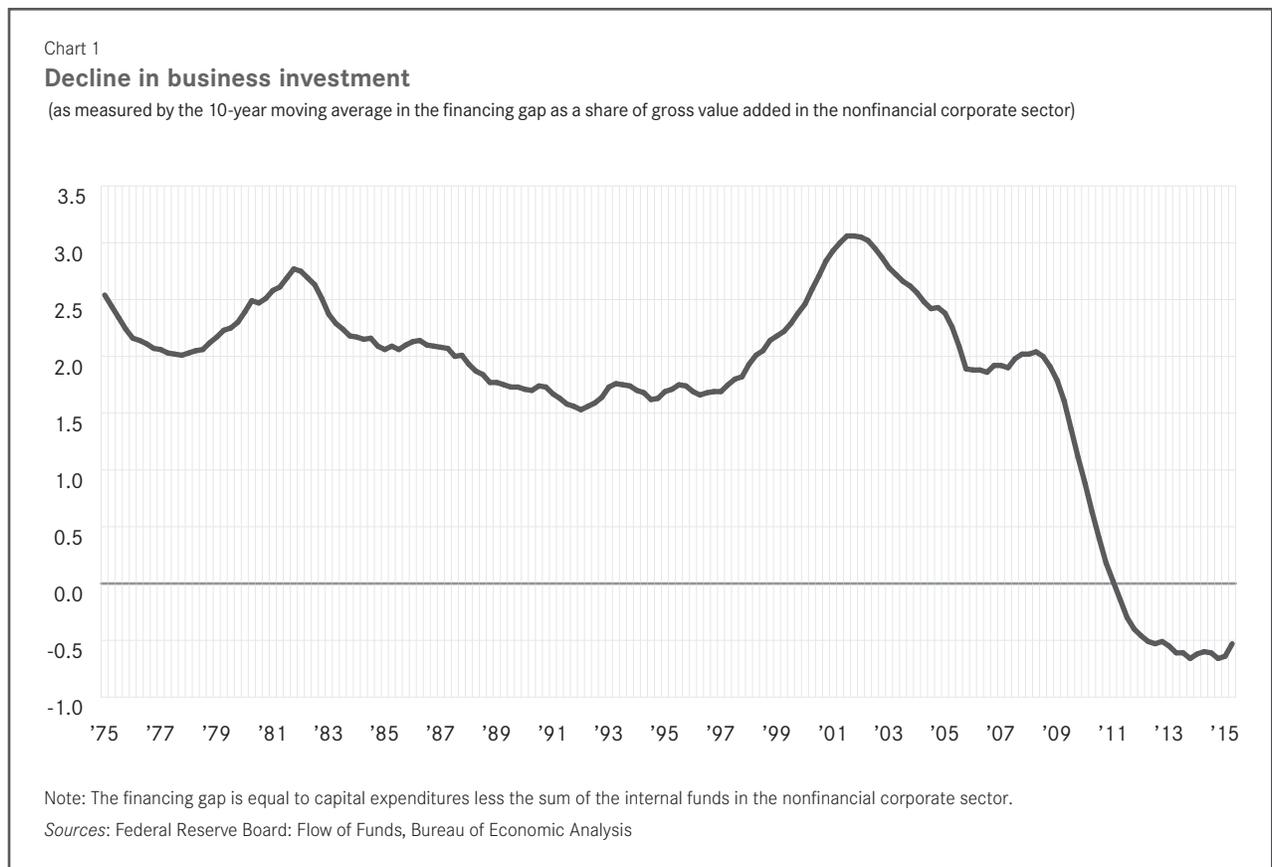
Executive Summary

Sustainable capitalism calls for using the capital available to a business in a way that creates value and profit today while preserving value for the future. In short, it calls for a balance of short-term and long-term focus. In this report, we look at trends putting sustainable capitalism at public companies under pressure and conclude that the current state of business is out of balance, resulting in a focus that is too short term. We examine the key drivers of a short-term focus and note that the pressures to maximize profits at the expense of future profitability are likely to be stronger in the future as downward pressures on corporate profitability increase. Nevertheless, we believe that public companies can engage in longer-term behavior

in the current environment, bringing back a more balanced focus, and we provide some recommendations for moving in that direction.

Why Is Short-Termism a Concern Now?

Business investment has declined substantially in the last decade as measured by the 10-year moving average in the financing gap as a share of gross value added in the nonfinancial corporate sector.¹ Typically, investment has been around 1.5 to 3 percentage points of gross value added larger than internal funds, but in the past 10 years it has steeply declined into negative territory.



So what have companies been doing with their cash?

Public companies have been spending on stock buybacks and dividends. From 2003 to 2012, the 449 companies in the S&P 500 index that were publicly listed during that time used 54 percent of their earnings to buy back their own stock, almost all through purchases on the open market, and dividends absorbed an additional 37 percent of earnings, leaving just 9 percent for reinvestment in the business.² Noting that companies were on track to spend over 100 percent of their corporate earnings in 2015 on total payouts to shareholders, Commissioner Kara Stein of the US Securities and Exchange Commission stated, “It’s worth thinking about what effect this uptick in stock buybacks may be having on innovation and capital formation.”³

Key Drivers of Short-Term Behavior

- Activist hedge funds
- Executive compensation design
- Quarterly capitalism
- Changes in capital markets: from investing to trading

ACTIVIST HEDGE FUNDS

Activist investors are gaining ground in the governance of public companies. In 2014, activists gained board seats at 107 companies, according to FactSet, an all-time record that is likely to be broken this year.⁴ And when companies resisted putting activists on their boards, the activists won proxy contests 73 percent of the time last year. Activist hedge funds’ assets under management have increased fivefold over the past decade.⁵ While some activist interventions promote the long-term prospects of targeted businesses, many do not. Studies have found that activists pursue growth strategies at target companies only 1 percent to 2 percent of the time.⁶ Increasing payouts to shareholders is one of the most frequent demands of activist hedge funds, after obtaining board seats and M&A campaigns such as sale of the company or spin-off of part of the company. From October 2008 through August 15, 2015, there were more than 220 public campaigns by hedge fund activists against

US companies to increase payouts to shareholders, the vast majority of which were to increase stock buybacks.⁷

EXECUTIVE COMPENSATION DESIGN

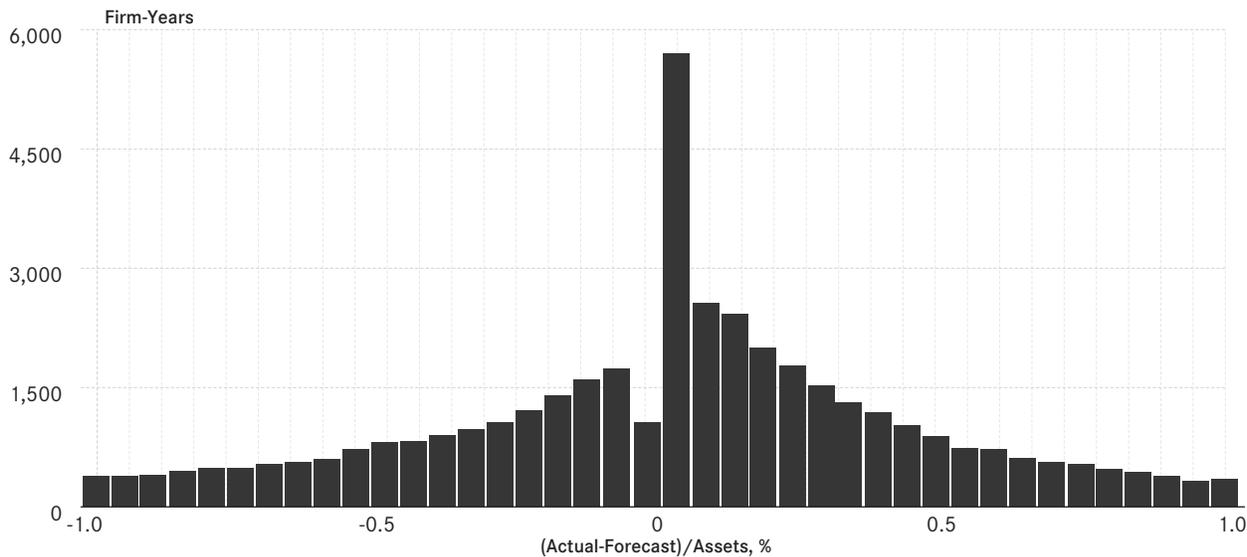
Of course, short-term behavior is not solely driven by activists. Executive compensation is a key factor as well, both in the design of compensation that may not adequately support longer-term strategic goals and as a factor in driving a surge in stock buybacks to offset dilution from stock awards.⁸ Compensation should be linked to drivers of long-term value, and capital allocation policies should ensure that stock buyback decisions take into account the other investment needs of the corporation. The timing of buybacks to offset stock awards should also be considered in capital allocation decisions. Whether buybacks add or destroy value depends upon the price paid relative to intrinsic value. If a company pays less than intrinsic value (i.e., shares are cheap), a buyback will add value. If the company pays more than intrinsic value (i.e., shares are expensive), a buyback will destroy value, since wealth is transferred from those who hold to those who sold.⁹

QUARTERLY CAPITALISM

Management’s role Management of many public companies is keenly focused on quarterly earnings, which, if they falter, can make the company the target of an activist intervention designed to improve performance. When asked how much of their companies’ quarterly earnings or revenue targets could be put at risk to pursue an investment with a positive net present value that would boost profits by 10 percent over the next three years, a majority of more than 1,000 C-level executives and directors surveyed by McKinsey & Company and Canada Pension Plan Investment Board responded that their companies would not be willing to accept significantly lower quarterly earnings for this kind of investment, and nearly half said short-term pressures reduce their companies’ willingness to pursue investments with less certain returns. The vast majority felt the most pressure to deliver financial results in two years or less, despite the fact that 86 percent said using a longer time horizon to make business decisions would positively affect financial returns and innovation.¹⁰

Chart 2

Earning forecast errors for large US firms and realized profits (1982-2010)



Note: Chart 2 displays the annual distribution of the difference between realized and forecast earnings (forecast errors), scaled by firm assets for a panel of US public firms. Earnings forecast errors are Street earnings minus median analyst forecasts from a 2-quarter horizon, scaled by firm assets and expressed as a percentage. The histogram represents a panel of 43,688 firm years, covering 1982-2010 for 7,215 firms.

Source: Stephen J. Terry, "The Macro Impact of Short-Termism," Stanford Institute for Economic Policy Research discussion paper no.15-022, April 14, 2015, p. 42.

Economist Stephen Terry, the first to try to quantify the macroeconomic impact of short-termism, observed: "A disproportionately high number of firm profit realizations just meet or beat analyst expectations, while the distribution is hollowed out just below zero with relatively few firms reporting profits failing to meet earnings targets."¹¹ (See Chart 2.) He concludes that research and development spending is one item that is being adjusted to enable companies to just meet or exceed analysts' expectations for quarterly earnings results. While overall R&D spending has not been substantially reduced by such activity, the efficiency of such spending is adversely affected, which he says has negative implications for overall economic growth.

Investors' role Other research shows that public company management prefers investment projects with shorter time horizons in the belief that investors fail to properly value long-term projects. Studies and surveys have confirmed that investors penalize long-term corporate investments by using discount rates that are 5 percent to 10 percent higher than risk and actual returns justify.¹² In addition, many institutional investors focus on quarterly investment results in the evaluation and compensation of their portfolio managers.

Analysts' role Recent studies have concluded that greater analyst coverage of quarterly earnings results in more pressure on firms to perform in the short term and biases firms against making longer-term capital investments.¹³

**CHANGES IN CAPITAL MARKETS:
FROM INVESTING TO TRADING**

Changes in the stock market itself are also a factor contributing to short-termism. Based on NYSE index data, the mean duration of the holding period for US investors was around seven years in 1940 and remained at that level for 35 years. However, by the turn of the century, it had dropped to less than one year.¹⁴ Technological and regulatory changes have reduced the costs of trading stocks, giving rise to high-frequency traders and more frequent trading by many other market participants.¹⁵ Granted, not all stock market participants engage in frequent trading. For some major institutional shareholders, in fact, the duration of holding has not changed.¹⁶ For example, the holding periods for two major shareholders, Fidelity and Vanguard, have not changed since 1985, and the duration for mutual funds and pension funds actually increased during the quarter century from 1985 to 2010.¹⁷

But high-frequency trading increases stock price volatility, which can foster general market instability as opposed to useful liquidity, undermining the efforts to manage for long-term value creation.¹⁸ Trading does not provide capital for investment in the business; it simply flows capital between shareholders. Stock markets, which used to provide business investment capital, have now largely become trading platforms in which capital is directed not to business but to traders.

Changes in the tax code to encourage longer-term holding over frequent trading and mechanisms to reward longer-term shareholders merit consideration to help restore a balance between trading and investment. Laurence Fink, chairman of BlackRock, a long-term investor, identifies the tax code as contributing to our “gambling culture” in stock markets. He points to the one-year favorable capital gains treatment as encouraging a short-term perspective: “Who really believes a one-year commitment is long term?”¹⁹

Another frequently mentioned solution is to impose a small transaction tax to discourage frequent trading. European markets are already adopting this concept. Others have focused on rewarding longer-term investors to shift the balance from frequent trading in shares to longer-term investment in public companies, and a number of companies are experimenting with this concept (Toyota, for example, recently issued special shares to longer-term investors for the purpose of using the proceeds to invest in R&D projects).

A Look at the Macroeconomic Impact of Short-Termism

A growing number of commentators have blamed the slowdown in the economy since the financial crisis on short-termism.²⁰ While a review of the data on macroeconomic effects shows that economists differ on whether short-termism is a significant factor in the economic slowdown, a number of economists have concluded that short-term focus is taking a toll on the overall economy: William Lazonick (the rise in stock buybacks affects income inequality, with implications for the economy),²¹ Andrew Smithers (decline in business investment affects trend growth of GDP),²² and Andrew Haldane, chief economist of the Bank of England, who was recently quoted as saying shareholder power is “holding back economic growth.”²³

We believe the data on macroeconomic effects clearly support a conclusion that short-termism is one factor in the economic slowdown, but the data are not sufficient to conclude that it is a major factor.

Short-Term Pressures Are Likely to Increase in the Near Future

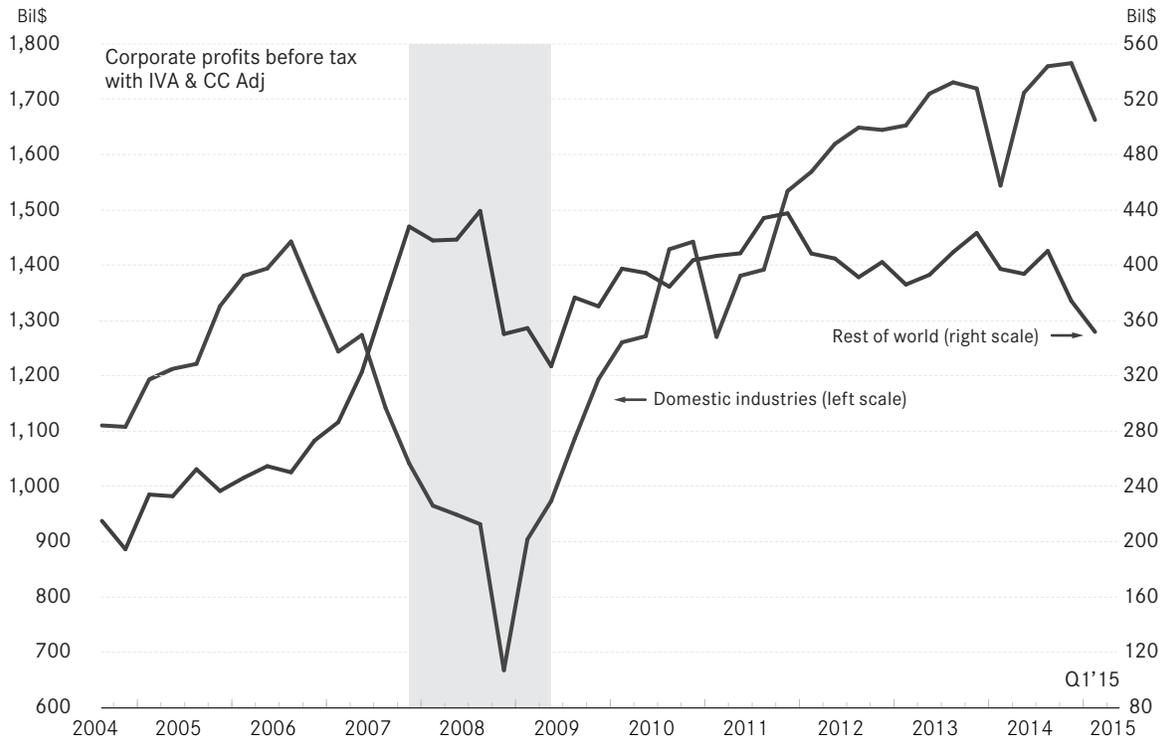
Short-termism is likely to grow in importance in the coming years as performance pressures mount. Corporate profits as a share of GDP in the past decade were unusually high, mostly due to very low labor costs during and after the Great Recession, leaving businesses with an unusually large amount of spare cash. But higher labor costs triggered by a growing shortage of workers are likely to lead to stagnating or even declining corporate profits in the next decade. In fact, corporate profits may have already reached a peak in this business cycle (see Chart 3, p. 7). In the United States and elsewhere, unemployment has already or soon will reach its “natural rate,” meaning labor costs have already begun to rise and will continue to do so over the next 15 to 20 years as baby boomers exit the workforce in record numbers.²⁴ As labor costs rise, there will likely be increasing pressure to cut costs in other areas, such as longer-term investments.

Moving toward a Balanced Focus

The Conference Board Governance Center, which has been studying this issue for more than a decade, believes the future strength of business rests on a return to a more balanced approach between long-term and short-term horizons and arresting what many of our members view as the overrepresentation of short-term interests today. The policy recommendations summarized here provide a starting point for corporate executives, board members, and investors to review their governance structures to determine whether they adequately promote long-term thinking and to consider whether any changes could better serve their long-term interests as they move forward in the current environment. Detailed recommendations are included in the report.

Chart 3

Corporate profits before tax with inventory valuation adjustment and capital consumption adjustment (US corporations)



Note: Inventory valuation adjustment (IVA) is an adjustment in national income to corporate profits to remove inventory profits. Capital consumption adjustment (CCA) consists of tax-return-based depreciation charges for corporations.
 Source: Bureau of Economic Analysis

Governance changes public companies, with support of their investors, can make

- Abandon quarterly bottom-line earnings guidance and replace it with longer-term guidance and information that is material to the company’s long-term prospects
- Revamp executive compensation to reward long-term thinking
 - Require executives to hold shares for a longer term
 - Establish metrics in compensation plans that measure longer-term performance
- Consider the benefits of offering extra dividends or enhanced voting rights to reward long-term investors
- Adopt capital allocation policies with respect to share buybacks to ensure that the long-term interests of the company are not sacrificed to the pressures of daily business activity

Governance changes investors can make

- Move away from quarterly portfolio manager compensation and evaluation
- Do not overly discount longer-term corporate investments

Tax changes the government can make

- Adjust the capital gains tax rate to reward longer-term investments
- Impose a transaction tax on frequent trading

Endnotes

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General Counsel Corporate Governance Summit

Columbia Law School | September 27, 2016

Remarks of R. William Ide III

A General Counsel observed to me, that five years ago, General Counsels would not have been meeting on this subject. I agree, but this critical national problem has now appeared and lawyers are essential to the needed solutions.

Throughout our country's history, lawyers have played a daunting, but critical role in shaping how we treat each other and act together as a society. From John Adams representing the vilified British soldier to Abraham Lincoln in his second inaugural address calling for North and South to forgive, forget and reunify, there has been the lawyer at work for the greater good. It is an unassailable truth that the Magna Carta's promise of rule of law could not be achieved without an independent legal profession assuring the rights promised by our Constitution are delivered.

In our popular culture, we tend to focus on our advocacy system as the delivery mechanism for maintaining a functioning society where competing interests are reconciled without tearing apart the fabric of our society. In many ways that is right. However, it is the lawyer functioning as the counselor, the architect of accepted solutions to complex conflicting interests which enables our society to stay united and function for the greater good of its members.

Today we gather in that spirit to address a critically important situation which has great complexity and strong competing forces. There is great need for thoughtful analysis of the issues and identification of the potential solutions given in the spirit of seeking to pursue the greater good. This is what lawyers do best.

Time after time over the years, Ira Millstein through outstanding lawyering has turned complex business problems into constructive solutions. There is a reason that where we are today is named the Millstein Center.

Throughout the years Norm Veasey from the bench and now as a counselor has also created thoughtful solutions that others with competing interests could not see. Those of you in attendance have been selected as the lead lawyers for very significant enterprises because of your skills in also solving big problems. And do we have a large and complicated problem to discuss, which we label "short termism."

In their book "Crisis Point", former Senators Tom Daschle and Trent Lott discuss dealing with daunting issues as follows:

"Whatever the difficulty in enacting ...changes, their need can't be ignored.... Classifying these as impossible is actually misguided, because putting ideas on the table and discussing and debating them is a start. If enough people in power can talk about the impossible, then it ceases to become so."

In that spirit, we propose that working together, General Counsels, their companies and their boards identify the key "short termism" issues, craft and implement solutions within their power to control and start the needed dialogue for needed actions by third parties. We are fortunate to have Bill McCracken with us today. Bill is a former CEO and proactive business leader who is dedicated to building strong bridges between boards and shareholders.

Concerning solutions within the control of boards, best governance practices are essential for a board's credibility and trust with shareholders and all stakeholders. We will fully discuss today the standards that boards must consider adopting to have the needed trust when making critical decisions in the atmosphere of pressure from competing interests. We will also identify the criteria that boards should assess when asked by certain shareholders to take immediate actions such as buying back stock, reducing G&A and other actions that might increase the stock price in the short term, but have negative consequences in the longer term.

It is our premise that well informed boards on the "short termism" issues will build trust that allows them to make the best decisions for the long term health of their companies. We also know, however, that shareholders and other stakeholders are a critical part of the equation and must be part of the process. We will work to arm boards with the data and thoughtful perspectives to be used in the needed dialogue with investors. Those materials will also be designed to be utilized by business trade associations and corporate government affairs offices to inform opinion leaders and policy makers of potential reforms.

The Conference Board Governance Center and the Millstein Center are dedicated to convening investors and companies for constructive dialogue that will lead to common understandings of the "short termism" issues and alignment on solutions to assure our public companies and financial markets regain the needed earnings, job and wage growths that our society rightfully expects. "If enough people in power can talk about the impossible, it ceases to be so". Thank you for your commitment to assure the needed conversations to resolve this critical issue facing our country.

COMMONSENSE PRINCIPLES OF CORPORATE GOVERNANCE

The following is a series of corporate governance principles for public companies, their board of directors and their shareholders. These principles are intended to provide a basic framework for sound, long-term-oriented governance. But given the differences among our many public companies – including their size, their products and services, their history and their leadership – not every principle (or every part of every principle) will work for every company, and not every principle will be applied in the same fashion by all companies.

I. Board of Directors – Composition and Internal Governance

a. Composition

- Directors' loyalty should be to the shareholders and the company. A board must not be beholden to the CEO or management. A significant majority of the board should be independent under the New York Stock Exchange rules or similar standards.
- All directors must have high integrity and the appropriate competence to represent the interests of all shareholders in achieving the long-term success of their company. Ideally, in order to facilitate engaged and informed oversight of the company and the performance of its management, a subset of directors will have professional experiences directly related to the company's business. At the same time, however, it is important to recognize that some of the best ideas, insights and contributions can come from directors whose professional experiences are not directly related to the company's business.
- Directors should be strong and steadfast, independent of mind and willing to challenge constructively but not be divisive or self-serving. Collaboration and collegiality also are critical for a healthy, functioning board.
- Directors should be business savvy, be shareholder oriented and have a genuine passion for their company.
- Directors should have complementary and diverse skill sets, backgrounds and experiences. Diversity along multiple dimensions is critical to a high-functioning board. Director candidates should be drawn from a rigorously diverse pool.
- While no one size fits all – boards need to be large enough to allow for a variety of perspectives, as well as to manage required board processes – they generally should be as small as practicable so as to promote an open dialogue among directors.
- Directors need to commit substantial time and energy to the role. Therefore, a board should assess the ability of its members to maintain appropriate focus and not be distracted by competing responsibilities. In so doing, the board should carefully consider a director's service on multiple boards and other commitments.

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b. Election of directors

- Directors should be elected by a majority of the votes cast “for” and “against/withhold” (i.e., abstentions and non-votes should not be counted for this purpose).

c. Nominating directors

- Long-term shareholders should recommend potential directors if they know the individuals well and believe they would be additive to the board.
- A company is more likely to attract and retain strong directors if the board focuses on big-picture issues and can delegate other matters to management (see below at II.b., “Board of Directors’ Responsibilities/Critical activities of the board; setting the agenda”).

d. Director compensation and stock ownership

- A company’s independent directors should be fairly and equally compensated for board service, although (i) lead independent directors and committee chairs may receive additional compensation and (ii) committee service fees may vary. If directors receive any additional compensation from the company that is not related to their service as a board member, such activity should be disclosed and explained.
- Companies should consider paying a substantial portion (e.g., for some companies, as much as 50% or more) of director compensation in stock, performance stock units or similar equity-like instruments. Companies also should consider requiring directors to retain a significant portion of their equity compensation for the duration of their tenure to further directors’ economic alignment with the long-term performance of the company.

e. Board committee structure and service

- Companies should conduct a thorough and robust orientation program for their new directors, including background on the industry and the competitive landscape in which the company operates, the company’s business, its operations, and important legal and regulatory issues, etc.
- A board should have a well-developed committee structure with clearly understood responsibilities. Disclosures to shareholders should describe the structure and function of each board committee.
- Boards should consider periodic rotation of board leadership roles (i.e., committee chairs and the lead independent director), balancing the benefits of rotation against the benefits of continuity, experience and expertise.

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- f. Director tenure and retirement age
 - It is essential that a company attract and retain strong, experienced and knowledgeable board members.
 - Some boards have rules around maximum length of service and mandatory retirement age for directors; others have such rules but permit exceptions; and still others have no such rules at all. Whatever the case, companies should clearly articulate their approach on term limits and retirement age. And insofar as a board permits exceptions, the board should explain (ordinarily in the company's proxy statement) why a particular exception was warranted in the context of the board's assessment of its performance and composition.
 - Board refreshment should always be considered in order to ensure that the board's skill set and perspectives remain sufficiently current and broad in dealing with fast-changing business dynamics. But the importance of fresh thinking and new perspectives should be tempered with the understanding that age and experience often bring wisdom, judgment and knowledge.
 - g. Director effectiveness
 - Boards should have a robust process to evaluate themselves on a regular basis, led by the non-executive chair, lead independent director or appropriate committee chair. The board should have the fortitude to replace ineffective directors.
- II. Board of Directors' Responsibilities
- a. Director communication with third parties
 - Robust communication of a board's thinking to the company's shareholders is important. There are multiple ways of going about it. For example, companies may wish to designate certain directors – as and when appropriate and in coordination with management – to communicate directly with shareholders on governance and key shareholder issues, such as CEO compensation. Directors who communicate directly with shareholders ideally will be experienced in such matters.
 - Directors should speak with the media about the company only if authorized by the board and in accordance with company policy.
 - In addition, the CEO should actively engage on corporate governance and key shareholder issues (other than the CEO's own compensation) when meeting with shareholders.
 - b. Critical activities of the board; setting the agenda
 - The full board (including, where appropriate, through the non-executive chair or lead independent director) should have input into the setting of the board agenda.

COMMONSENSE PRINCIPLES OF CORPORATE GOVERNANCE

- Over the course of the year, the agenda should include and focus on the following items, among others:
 - ❖ A robust, forward-looking discussion of the business.
 - ❖ The performance of the current CEO and other key members of management and succession planning for each of them. One of the board's most important jobs is making sure the company has the right CEO. If the company does not have the appropriate CEO, the board should act promptly to address the issue.
 - ❖ Creation of shareholder value, with a focus on the long term. This means encouraging the sort of long-term thinking owners of a private company might bring to their strategic discussions, including investments that may not pay off in the short run.
 - ❖ Major strategic issues (including material mergers and acquisitions and major capital commitments) and long-term strategy, including thorough consideration of operational and financial plans, quantitative and qualitative key performance indicators, and assessment of organic and inorganic growth, among others.
 - ❖ The board should receive a balanced assessment on strategic fit, risks and valuation in connection with material mergers and acquisitions. The board should consider establishing an ad hoc Transaction Committee if significant board time is otherwise required to consider a material merger or acquisition. If the company's stock is to be used in such a transaction, the board should carefully assess the company's valuation relative to the valuation implied in the acquisition. The objective is to properly evaluate the value of what you are giving vs. the value of what you are getting.
 - ❖ Significant risks, including reputational risks. The board should not be reflexively risk averse; it should seek the proper calibration of risk and reward as it focuses on the long-term interests of the company's shareholders.
 - ❖ Standards of performance, including the maintaining and strengthening of the company's culture and values.
 - ❖ Material corporate responsibility matters.
 - ❖ Shareholder proposals and key shareholder concerns.
 - ❖ The board (or appropriate board committee) should determine the best approach to compensate management, taking into account all the factors it deems appropriate, including corporate and individual performance and

COMMONSENSE PRINCIPLES OF CORPORATE GOVERNANCE

other qualitative and quantitative factors (see below at VII., “Compensation of Management”).

- A board should be continually educated on the company and its industry. If a Board feels it would be productive, outside experts and advisors should be brought in to inform directors on issues and events affecting the company.
- The board should minimize the amount of time it spends on frivolous or non-essential matters – the goal is to provide perspective and make decisions to build real value for the company and its shareholders.
- As authorized and coordinated by the board, directors should have unfettered access to management, including those below the CEO’s direct reports.
- At each meeting, to ensure open and free discussion, the board should meet in executive session without the CEO or other members of management. The independent directors should ensure that they have enough time to do this properly.
- The board (or appropriate board committee) should discuss and approve the CEO’s compensation.
- In addition to its other responsibilities, the Audit Committee should focus on whether the company’s financial statements would be prepared or disclosed in a materially different manner if the external auditor itself were solely responsible for their preparation.

III. Shareholder Rights

- a. Many public companies and asset managers have recently reviewed their approach to proxy access. Others have not yet undertaken such a review or may have one under way. Among the larger market capitalization companies that have adopted proxy access provisions, generally a shareholder (or group of up to 20 shareholders) who has continuously held a minimum of 3% of the company’s outstanding shares for three years is eligible to include on the company’s proxy statement nominees for a minimum of 20% (and, in some cases, 25%) of the company’s board seats. Generally, only shares in which the shareholder has full, unhedged economic interest count toward satisfaction of the ownership/holding period requirements. A higher threshold of ownership (e.g., 5%) often has been adopted for smaller market capitalization companies (e.g., less than \$2 billion).
- b. Dual class voting is not a best practice. If a company has dual class voting, which sometimes is intended to protect the company from short-term behavior, the company should consider having specific sunset provisions based upon time or a triggering event, which eliminate dual class voting. In addition, all shareholders should be treated equally in any corporate transaction.

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- c. Written consent and special meeting provisions can be important mechanisms for shareholder action. Where they are adopted, there should be a reasonable minimum amount of outstanding shares required in order to prevent a small minority of shareholders from being able to abuse the rights or waste corporate time and resources.

IV. Public Reporting

- a. Transparency around quarterly financial results is important.
- b. Companies should frame their required quarterly reporting in the broader context of their articulated strategy and provide an outlook, as appropriate, for trends and metrics that reflect progress (or not) on long-term goals. A company should not feel obligated to provide earnings guidance – and should determine whether providing earnings guidance for the company’s shareholders does more harm than good. If a company does provide earnings guidance, the company should be realistic and avoid inflated projections. Making short-term decisions to beat guidance (or any performance benchmark) is likely to be value destructive in the long run.
- c. As appropriate, long-term goals should be disclosed and explained in a specific and measurable way.
- d. A company should take a long-term strategic view, as though the company were private, and explain clearly to shareholders how material decisions and actions are consistent with that view.
- e. Companies should explain when and why they are undertaking material mergers or acquisitions or major capital commitments.
- f. Companies are required to report their results in accordance with Generally Accepted Accounting Principles (“GAAP”). While it is acceptable in certain instances to use non-GAAP measures to explain and clarify results for shareholders, such measures should be sensible and should not be used to obscure GAAP results. In this regard, it is important to note that *all* compensation, including equity compensation, is plainly a cost of doing business and should be reflected in any non-GAAP measurement of earnings in precisely the same manner it is reflected in GAAP earnings.

V. Board Leadership (Including the Lead Independent Director’s Role)

- a. The board’s independent directors should decide, based upon the circumstances at the time, whether it is appropriate for the company to have separate or combined chair and CEO roles. The board should explain clearly (ordinarily in the company’s proxy statement) to shareholders why it has separated or combined the roles.
- b. If a board decides to combine the chair and CEO roles, it is critical that the board has in place a strong designated lead independent director and governance structure.

COMMONSENSE PRINCIPLES OF CORPORATE GOVERNANCE

- c. Depending on the circumstances, a lead independent director's responsibilities may include:
- Serving as liaison between the chair and the independent directors
 - Presiding over meetings of the board at which the chair is not present, including executive sessions of the independent directors
 - Ensuring that the board has proper input into meeting agendas for, and information sent to, the board
 - Having the authority to call meetings of the independent directors
 - Insofar as the company's board wishes to communicate directly with shareholders, engaging (or overseeing the board's process for engaging) with those shareholders
 - Guiding the annual board self-assessment
 - Guiding the board's consideration of CEO compensation
 - Guiding the CEO succession planning process

VI. Management Succession Planning

- a. Senior management bench strength can be evaluated by the board and shareholders through an assessment of key company employees; direct exposure to those employees is helpful in making that assessment.
- b. Companies should inform shareholders of the process the board has for succession planning and also should have an appropriate plan if an unexpected, emergency succession is necessary.

VII. Compensation of Management

- a. To be successful, companies must attract and retain the best people – and competitive compensation of management is critical in this regard. To this end, compensation plans should be appropriately tailored to the nature of the company's business and the industry in which it competes. Varied forms of compensation may be necessary for different types of businesses and different types of employees. While a company's compensation plans will evolve over time, they should have continuity over multiple years and ensure alignment with long-term performance.
- b. Compensation should have both a current component and a long-term component.
- c. Benchmarks and performance measurements ordinarily should be disclosed to enable shareholders to evaluate the rigor of the company's goals and the goal-setting process.

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That said, compensation should not be entirely formula based, and companies should retain discretion (appropriately disclosed) to consider qualitative factors, such as integrity, work ethic, effectiveness, openness, etc. Those matters are essential to a company's long-term health and ordinarily should be part of how compensation is determined.

- d. Companies should consider paying a substantial portion (e.g., for some companies, as much as 50% or more) of compensation for senior management in the form of stock, performance stock units or similar equity-like instruments. The vesting or holding period for such equity compensation should be appropriate for the business to further senior management's economic alignment with the long-term performance of the company. With properly designed performance hurdles, stock options may be one element of effective compensation plans, particularly for the CEO. All equity grants (whether stock or options) should be made at fair market value, or higher, at the time of the grant, with particular attention given to any dilutive effect of such grants on existing shareholders.
- e. Companies should clearly articulate their compensation plans to shareholders. While companies should not, in the design of their compensation plans, feel constrained by the preferences of their competitors or the models of proxy advisors, they should be prepared to articulate how their approach links compensation to performance and aligns the interests of management and shareholders over the long term. If a company has well-designed compensation plans and clearly explains its rationale for those plans, shareholders should consider giving the company latitude in connection with individual annual compensation decisions.
- f. If large special compensation awards (not normally recurring annual or biannual awards but those considered special awards or special retention awards) are given to management, they should be carefully evaluated and – in the case of the CEO and other “Named Executive Officers” whose compensation is set forth in the company's proxy statement – clearly explained.
- g. Companies should maintain clawback policies for both cash and equity compensation.

VIII. Asset Managers' Role in Corporate Governance

Asset managers, on behalf of their clients, are significant owners of public companies, and, therefore, often are in a position to influence the corporate governance practices of those companies. Asset managers should exercise their voting rights thoughtfully and act in what they believe to be the long-term economic interests of their clients.

- a. Asset managers should devote sufficient time and resources to evaluate matters presented for shareholder vote in the context of long-term value creation. Asset managers should actively engage, as appropriate, based on the issues, with the management and/or board of the company, both to convey the asset manager's point of view and to understand the company's perspective. Asset managers should give due consideration to the company's rationale for its positions, including its perspective on certain governance issues where the company might take a novel or unconventional approach.

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- b. Given their importance to long-term investment success, proxy voting and corporate governance activities should receive appropriate senior-level oversight by the asset manager.
- c. Asset managers, on behalf of their clients, should evaluate the performance of boards of directors, including thorough consideration of the following:
 - To the extent directors are speaking directly with shareholders, the directors' (i) knowledge of their company's corporate governance and policies and (ii) interest in understanding the key concerns of the company's shareholders
 - The board's focus on a thoughtful, long-term strategic plan and on performance against that plan
- d. An asset manager's ultimate decision makers on proxy issues important to long-term value creation should have access to the company, its management and, in some circumstances, the company's board. Similarly, a company, its management and board should have access to an asset manager's ultimate decision makers on those issues.
- e. Asset managers should raise critical issues to companies (and vice versa) as early as possible in a constructive and proactive way. Building trust between the shareholders and the company is a healthy objective.
- f. Asset managers may rely on a variety of information sources to support their evaluation and decision-making processes. While data and recommendations from proxy advisors may form pieces of the information mosaic on which asset managers rely in their analysis, ultimately, their votes should be based on independent application of their own voting guidelines and policies.
- g. Asset managers should make public their proxy voting process and voting guidelines and have clear engagement protocols and procedures.
- h. Asset managers should consider sharing their issues and concerns (including, as appropriate, voting intentions and rationales therefor) with the company (especially where they oppose the board's recommendations) in order to facilitate a robust dialogue if they believe that doing so is in the best interests of their clients.

BLACKROCK

Text of letter sent by Larry Fink, BlackRock's Chairman and CEO, encouraging a focus on long-term growth strategies.

March 21, 2014

Dear Chairman or CEO,

As a fiduciary investor, one of BlackRock's primary objectives is to secure better financial futures for our clients and the people they serve. This responsibility requires that we be good stewards of their capital, addressing short-term challenges but always with a focus on the longer term.

To meet our clients' needs, we believe the companies we invest in should similarly be focused on achieving sustainable returns over the longer term. Good corporate governance is critical to that goal. That is why, two years ago, I wrote to the CEOs of the companies in which BlackRock held significant investments on behalf of our clients urging them to engage with us on issues of corporate governance. While important work remains to be done, good progress has been made on company-shareholder engagement. I write today re-iterating our call for engagement with a particular focus on companies' strategies to drive longer term growth.

Many commentators lament the short-term demands of the capital markets. We share those concerns, and believe it is part of our collective role as actors in the global capital markets to challenge that trend. Corporate leaders can play their part by persuasively communicating their company's long-term strategy for growth. They must set the stage to attract the patient capital they seek: explaining to investors what drives real value, how and when far-sighted investments will deliver returns, and, perhaps most importantly, what metrics shareholders should use to assess their management team's success over time.

It concerns us that, in the wake of the financial crisis, many companies have shied away from investing in the future growth of their companies. Too many companies have cut capital expenditure and even increased debt to boost dividends and increase share buybacks. We certainly believe that returning cash to shareholders should be part of a balanced capital strategy; however, when done for the wrong reasons and at the expense of capital investment, it can jeopardize a company's ability to generate sustainable long-term returns.

We do recognize the balance that must be achieved to drive near-term performance while simultaneously making those investments – in innovation and product enhancements, capital and plant equipment, employee development, and internal controls and technology – that will sustain growth.

BlackRock's mission is to earn the trust of our clients by helping them meet their long-term investment goals. We see this mission as indistinguishable from also aiming to be a trusted, responsible shareholder with a longer term horizon. Much progress has been made on company-shareholder engagement and we will continue to play our part as a provider of patient capital in ensuring robust dialogue. We ask that you help us, and other shareholders, to understand the investments you are making to deliver the sustainable, long-term returns on which our clients depend and in which we seek to support you.

Yours sincerely,

Laurence D. Fink



February 1, 2016

Dear [REDACTED],

Over the past several years, I have written to the CEOs of leading companies urging resistance to the powerful forces of short-termism afflicting corporate behavior. Reducing these 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.

While we've heard strong support from corporate leaders for taking such a long-term view, many companies continue to engage in practices that may undermine their ability to invest for the future. Dividends paid out by S&P 500 companies in 2015 amounted to the highest proportion of their earnings since 2009. As of the end of the third quarter of 2015, buybacks were up 27% over 12 months. We certainly support returning excess cash to shareholders, but not at the expense of value-creating investment. We continue to urge companies to adopt balanced capital plans, appropriate for their respective industries, that support strategies for long-term growth.

We also believe that companies have an obligation to be open and transparent about their growth plans so that shareholders can evaluate them and companies' progress in executing on those plans.

We are asking that every CEO lay out for shareholders each year a strategic framework for long-term value creation. Additionally, because boards have a critical role to play in strategic planning, we believe CEOs should explicitly affirm that their boards have reviewed those plans. BlackRock's corporate governance team, in their engagement with companies, will be looking for this framework and board review.

Annual shareholder letters and other communications to shareholders are too often backwards-looking and don't do enough to articulate management's vision and plans for the future. This perspective on the future, however, is what investors and all stakeholders truly need, including, for example, how the company is navigating the competitive landscape, how it is innovating, how it is adapting to technological disruption or geopolitical events, where it is investing and how it is developing its talent. As part of this effort, companies should work to develop financial metrics, suitable for each company and industry, that support a framework for long-term growth. Components of long-term compensation should be linked to these metrics.

Text of Larry Fink's 2016 Corporate Governance Letter to CEOs

We recognize that companies operate in fluid environments and face a challenging mix of external dynamics. Given the right context, long-term shareholders will understand, and even expect, that you will need to pivot in response to the changing environments you are navigating. But one reason for investors' short-term horizons is that companies have not sufficiently educated them about the ecosystems they are operating in, what their competitive threats are and how technology and other innovations are impacting their businesses.

Without clearly articulated plans, companies risk losing the faith of long-term investors. Companies also expose themselves to the pressures of investors focused on maximizing near-term profit at the expense of long-term value. Indeed, some short-term investors (and analysts) offer more compelling visions for companies than the companies themselves, allowing these perspectives to fill the void and build support for potentially destabilizing actions.

Those activists who focus on long-term value creation sometimes *do* offer better strategies than management. In those cases, BlackRock's corporate governance team will support activist plans. During the 2015 proxy season, in the 18 largest U.S. proxy contests (as measured by market cap), BlackRock voted with activists 39% of the time.

Nonetheless, we believe that companies are usually better served when ideas for value creation are part of an overall framework developed and driven by the company, rather than forced upon them in a proxy fight. With a better understanding of your long-term strategy, the process by which it is determined, and the external factors affecting your business, shareholders can put your annual financial results in the proper context.

Over time, as companies do a better job laying out their long-term growth frameworks, the need diminishes for quarterly EPS guidance, and we would urge companies to move away from providing it. Today's culture of quarterly earnings hysteria is totally contrary to the long-term approach we need. To be clear, we do believe companies should still report quarterly results – "long-termism" should not be a substitute for transparency – but CEOs should be more focused in these reports on demonstrating progress against their strategic plans than a one-penny deviation from their EPS targets or analyst consensus estimates.

With clearly communicated and understood long-term plans in place, quarterly earnings reports would be transformed from an instrument of incessant short-termism into a building block of long-term behavior. They would serve as a useful "electrocardiogram" for companies, providing information on how companies are performing against the "baseline EKG" of their long-term plan for value creation.

We also are proposing that companies explicitly affirm to shareholders that their boards have reviewed their strategic plans. This review should be a rigorous process that provides the board the necessary context and allows for a robust debate. Boards have an obligation to review, understand, discuss and challenge a company's strategy.

Text of Larry Fink's 2016 Corporate Governance Letter to CEOs

Generating sustainable returns over time requires a sharper focus not only on governance, but also on environmental and social factors facing companies today. These issues offer both risks and opportunities, but for too long, companies have not considered them core to their business – even when the world's political leaders are increasingly focused on them, as demonstrated by the Paris Climate Accord. Over the long-term, environmental, social and governance (ESG) issues – ranging from climate change to diversity to board effectiveness – have real and quantifiable financial impacts.

At companies where ESG issues are handled well, they are often a signal of operational excellence. BlackRock has been undertaking a multi-year effort to integrate ESG considerations into our investment processes, and we expect companies to have strategies to manage these issues. Recent action from the U.S. Department of Labor makes clear that pension fund fiduciaries can include ESG factors in their decision making as well.

We recognize that the culture of short-term results is not something that can be solved by CEOs and their boards alone. Investors, the media and public officials all have a role to play. In Washington (and other capitals), long-term is often defined as simply the next election cycle, an attitude that is eroding the economic foundations of our country.

Public officials must adopt policies that will support long-term value creation. Companies, for their part, must recognize that while advocating for more infrastructure or comprehensive tax reform may not bear fruit in the next quarter or two, the absence of effective long-term policies in these areas undermines the economic ecosystem in which companies function – and with it, their chances for long-term growth.

We note two areas, in particular, where policymakers taking a longer-term perspective could help support the growth of companies and the entire economy:

- First, tax policy too often lacks proper incentives for long-term behavior. With capital gains, for example, one year shouldn't qualify as a long-term holding period. As I wrote last year, we need a capital gains regime that rewards long-term investment – with long-term treatment only after three years, and a decreasing tax rate for each year of ownership beyond that (potentially dropping to zero after 10 years).
- Second, chronic underinvestment in infrastructure in the U.S. – from roads to sewers to the power grid – will not only cost businesses and consumers \$1.8 trillion over the next five years, but clearly represents a threat to the ability of companies to grow. At a time of massive global inequality, investment in infrastructure – and all its benefits, including job creation – is also critical for growth in most emerging markets around the world. Companies and investors must advocate for action to fill the gaping chasm between our massive infrastructure needs and squeezed government funding, including strategies for developing private-sector financing mechanisms.

Over the past few years, we've seen more and more discussion around how to foster a long-term mindset. While these discussions are encouraging, we will only achieve our

Text of Larry Fink's 2016 Corporate Governance Letter to CEOs

goal by changing practices and policies, and CEOs of America's leading companies have a vital role to play in that debate.

Corporate leaders have historically been a source of optimism about the future of our economy. At a time when there is so much anxiety and uncertainty in the capital markets, in our political discourse and across our society more broadly, it is critical that investors in particular hear a forward-looking vision about your own company's prospects and the public policy you need to achieve consistent, sustainable growth. The solutions to these challenges are in our hands, and I ask that you join me in helping to answer them.

Sincerely,

Laurence D. Fink



Text of a letter sent by F. William McNabb III, Vanguard's Chairman and CEO, to the independent leaders of the boards of directors of the Vanguard funds' largest portfolio holdings.

February 27, 2015

Dear [Name of Independent Chairman or Lead Director]:

As a substantial investor in [Company Name], we are writing to share Vanguard's views on corporate governance and to provide perspective on the way we think about engagement between shareholders and directors.

Vanguard-sponsored mutual funds and other investment portfolios we manage own a significant number of your company's outstanding shares. We depend on you and your fellow directors to serve as the ultimate stewards of our significant investment. We look to your leadership in matters of governance, compensation, succession planning, and oversight of strategy and risk. Thank you for taking on these critical and weighty responsibilities on behalf of investors.

Vanguard's principles for corporate governance

Today, Vanguard is one of the largest investment managers in the world, with more than \$3 trillion in client assets under management. More than half of the money that we manage is in index equity funds and represents essentially permanent investments in our portfolio companies. An additional \$400 billion is in actively managed equity funds that are run with a distinctly long-term perspective. We are large, we don't make a lot of noise, we are focused on the long term, and we don't tend to rush into and out of investments.

In the past, some have mistakenly assumed that our predominantly passive management style suggests a passive attitude with respect to corporate governance. Nothing could be further from the truth. We will be investors in your company during good times and bad. We want to see our clients' investments grow over the long term, and good governance is a key to helping companies maximize their returns to shareholders. We have no interest in telling companies how to run their businesses, but we have valuable governance insights to share with the board of directors. In our view, a good governance program is distinguished by the following principles:

| | |
|--|---|
| Independent oversight | Board should be substantially independent of management and have independent leadership (i.e., chair or lead director). |
| Accountability | Management should be accountable to the board and directors should be accountable to shareholders. |
| Shareholder voting rights consistent with economic interests | This means one share, one vote. No special share classes for added voting power. |
| Annual director elections and minimal anti-takeover devices | Minimize use of anti-takeover devices such as classified boards or poison pills. |
| Sensible compensation tied to performance | Executive pay should be tied to the creation of long-term shareholder value. |
| Shareholder engagement | We encourage boards to have a thoughtful process to communicate with shareholders. |

Engagement in focus: Why it's important

The relationship between corporate boards and large shareholders is important, but too often, there's precious little communication between the two parties. The case for effective engagement is compelling for both shareholders *and* boards.

We've observed that the best boards work hard to develop "self-awareness," and seek feedback and perspectives independent of management. They ask the right questions to understand how their company may be different than peers, and whether those differences are strengths or vulnerabilities. We believe boards that provide such context to investors are less likely to be surprised by activists or proxy votes, and more likely to have stronger support of large long-term shareholders. We also believe that engagement is a dialogue, with both parties listening to and informing each other.

Different avenues for engagement

While we advocate for shareholder engagement, we don't presume to know what the optimal structure for engagement looks like for your board. To be sure, there is no one-size-fits-all engagement program. We encourage you to speak to your board about engagement, and create a process that meets your needs and those of your shareholders. We've found that having an established channel or process for shareholder interaction works better than handling engagement requests in an ad hoc or reactive manner.

We have suggested the creation of a "Shareholder Liaison Committee" as one possible means to promote better and richer communication between shareholders and boards, and believe such a committee can provide an appropriate structure for communicating with significant shareholders. We've also seen boards successfully assign engagement expectations to existing committees, or embed such expectations into certain board roles (e.g., independent chair, lead independent director, committee chairs). Ultimately, it's more about the behavior than the framework. 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. Some investors may be primarily interested in engaging on environmental, social, or governance considerations. Other investors may have a particular perspective to share regarding the company's strategy or management relative to peers. In any event, these perspectives represent the views of the investors on whose behalf directors serve, and we believe that directors should understand them. In addition to providing a venue to gather unfiltered shareholder perspectives, directors should invite communication with those shareholders who may have a legitimate interest in gaining a deeper understanding of board oversight of succession, compensation, or risk management—without encroaching on management's primary role to communicate with investors regarding the business.

Don't be dissuaded by common concerns

As with any change in behavior, there may be questions or objections from those who have yet to fully embrace more significant engagement. That said, we do not believe these should be insurmountable barriers to progress. Among the perspectives we've heard in this regard are the following:

- *"Strong shareholder-director engagement will disintermediate management."* This is not what large shareholders seek in an engagement program. Boards often choose to include management for legal support and to discuss operational issues. There are also matters that are the exclusive province of the board (e.g., CEO compensation), which we believe are appropriate for discussion with the board alone.

- *"We'll get tripped up on Reg FD issues."* To be clear, we are not seeking inside information on strategy or future expectations. Rather, we are seeking to provide the perspective of a long-term investor. Individual firms should decide how to manage this risk. You may choose to train directors, include your legal counsel in shareholder conversations, and/or set clear boundaries for discussions.
- *"There is no time in our agenda."* Individual boards can decide how much time to allot to engagement. Respectfully, we'd submit that time for engagement with significant shareholders deserves consideration on a board's agenda. After all, investors are an important constituency whom boards represent.
- *"This would be too difficult to implement."* Many companies already have substantive engagement programs in place. The Shareholder-Director Exchange (SDX) Protocol, available at sdxprotocol.com, offers guidance for such programs. This protocol also provides specific considerations for companies that may be concerned about Regulation FD.

Share your perspective

I encourage all boards to actively communicate how they engage with investors. Do you already have an engagement process in place? Have previous engagements with investors resulted in positive outcomes? Large shareholders like Vanguard want to know your approach and how you plan to engage.

Please know that when you talk, we listen. When you provide updates in your proxy materials or post statements on your company's website, we read them. We pledge to be clear and transparent about our expectations, and we ask that you do the same. We look forward to partnering with you as you consider how to effectively engage with your large and long-term shareholders. Our governance team, reachable at CorporateGovernance@vanguard.com, stands ready to work with you to understand how best to promote meaningful communication between shareholders and directors for our mutual benefit.

Thank you for serving as the stewards of our investment in your company.

Sincerely,

A handwritten signature in black ink that reads "F. William McNabb III". The signature is written in a cursive, slightly stylized font.

F. William McNabb III
Chairman and Chief Executive Officer

February 26, 2016

Ronald P. O'Hanley
President and CEO

State Street Financial Center
One Lincoln Street
Boston, MA 02111
USA
ssga.com

Dear Board Member:

A robust and healthy debate is ongoing about the perils of companies focusing on short-term results at the expense of long-term value creation. As one of the world's largest asset managers working on behalf of millions of investors who receive benefits from pension funds, save for retirement through workplace savings plans or trust an advisor to help them reach their financial goals, we share those concerns. Long-term value creation can happen only when companies have in place effective, independent board leadership. Whether strong independent leadership exists on company boards will be a key focus of our 2016 corporate governance engagement program. With proxy season about to begin, we want to share with you our point of view and guidance on this important matter.

Simply put, we believe effective independent board leadership is needed to oversee a company's long-term strategy, assess management's performance, ensure board and board committee effectiveness and provide a voice independent from management and accountable directly to investors, regulators and other stakeholders. No one element constitutes effective independent board leadership. Rather we believe that an overall board oversight program, tailored to individual companies, must be devised and sustained.

Corporate boards have come a long way since the financial crisis, becoming more actively involved in setting strategy, mitigating risk, and providing guidance on ethical and governance issues. In fact, data show that there has been a positive shift toward more independent leadership on corporate boards since 2008. However, still 23% of S&P 500 companies and 34% of the Russell 3000 have no independent leadership structure – either an independent chair or an independent lead director – and in Europe 86% of the CAC 40 in France, 47% of the DAX 30 in Germany, and 24% of the FTSE 350 in the UK are led by boards without an independent chair. Moreover, many boards have skill gaps. These factors are cause for concern.

Some investors believe that the solution to independent board leadership is dividing the CEO and board chair roles, similar to market practices that exist today in the UK and Australia. However, the act of simply separating the CEO and chair roles does not guarantee independence, effectiveness or long-term focus. As is often the case with simple solutions, it may make some investors feel better, but it does not address the underlying issues and root causes that undermine strong independent board leadership.

We believe attention should be placed on the overall manner in which a company empowers their board to be more independent. This requires us to ask tough questions and truly engage with company leadership and their boards to understand the effectiveness of their governance structures.

We will be looking to confirm that company guidelines and procedures are in place to ensure independent board leadership and a clear articulation of the roles and responsibilities of an independent board leader in overseeing management. For some companies the best independent

leadership model may be an independent board chair and for others it may be a lead independent board director who serves with a combined CEO and chair.

Our preferred approach to drive greater board independence is through an active dialogue and engagement with company and board leadership. In the event that companies fail to take action, despite our best efforts to actively engage with them, we will use our proxy voting power to effect change. In fact, over the last several years we have voted on numerous occasions to separate the CEO and board chair roles and against the re-election of long-tenured board members. Our goal was to create change and force greater board independence where we thought it was necessary. In other cases, after active engagement, we have determined that effective independent leadership exists with a combined CEO and chair and an independent lead director working together.

We want all of the companies we invest in to fully understand our expectation – that companies have sufficient attributes of an effective board and independent leadership in place to convince us that their focus is on long-term value creation. As one of the largest passive managers in the world we feel we have a heightened responsibility to our investors to engage companies on the issue of board independence to ensure long-term focus. Unlike active managers who can sell a company when they do not agree with management, we are required to own companies that are part of an index.

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.

We believe robust engagement between independent board leaders and their investors will have lasting mutual benefits. In that spirit, we have created the attached guidelines we will be using to evaluate a company's board leadership structure and to help inform our voting decisions.

Finally, we are currently working with some of the world's largest and most sophisticated asset owners and managers to codify principles that address not only independent board leadership, but other important corporate governance matters as well. As this work is finalized, we will ensure that this group shares these principles with you.

Sincerely,



Guidelines and Attributes for Effective Independent Board Leadership

February 2016

We believe effective independent board leadership is a key component of good corporate governance and long-term value creation. Our guidance below is based on discussions we have had with over 100 independent chairs and/or lead independent directors from multiple jurisdictions over the past two years. In addition to the functions and responsibilities for independent board leaders, we identify the governance structures that can enhance their effectiveness as well as the skills and expertise necessary for effective, independent oversight of management.

Attributes of Effective Independent Board Leadership

- A skilled independent leader of the board
- Effective board processes
- Rich mix of board skills and experiences, including deep industry expertise
- Clear delineation of roles/accountability between board and management

Governance Structures That Enhance Effectiveness:

- **Robust Selection Process:** In our experience, very few portfolio companies have institutionalized the process for selecting an independent chair or a lead independent director. We encourage companies and boards to adopt a framework that specifies relevant skills and characteristics.
- **The Position Should Be Sufficiently Tenured:** A reasonable tenure allows an individual time to develop in the role and build good working relations with management and other stakeholders. We believe a minimum of three years is required, with the prospect of additional terms based on performance.
- **Performance Evaluation of the Board Leader:** Independent board members should evaluate the effectiveness of the board leader on a regular basis. Further, the job description should also be periodically reviewed and updated to evolve with market and regulatory expectations.
- **Planning for Succession:** Given the importance of the role, boards should plan for an orderly succession of a director serving in the leadership position.

Effective Board Leaders Must:

- **Be Good Communicators:** Since the role requires facilitating discussions among board members, between directors and the CEO/management, and engaging with shareholders/stakeholders, strong communication skills are necessary.
- **Have the Required Time Commitment:** Given the key functions of the position, we estimate that the role requires a significant time commitment to execute responsibilities effectively. Based on our engagement sample, the time commitment can range from one day a month (about 100 hours a year) to 2 days a week (over 800 hours a year). On average, the time commitment is between 300–400 hours a year.
- **Have Relevant Industry Expertise:** Independent board leaders tend to act as sounding boards to CEOs. Relevant industry expertise enhances the effectiveness of the individual and reduces the risk of a “management-knowledge-captured board.”¹
- **Have Personal Effectiveness:** This includes personal integrity and professional credibility; ability to earn the support of other directors and management; good problem-solving skills; sound judgment and leadership.

SSGA Engagement and Proxy Voting Focus

Independent board leadership will be a key focus in 2016 for our engagement with our global portfolio companies, especially in North America and Europe. In particular we will examine:

- Board leadership philosophy and structure
- Responsibilities of the independent/executive chair and/or lead independent directors as the case may be
- Attributes and measures of independence and whether the leadership structure allows for independent oversight of management and execution of key board responsibilities
- Processes in place to empower independent board leaders

In addition, over the past five years in the US, we have seen a steady increase in the number of shareholder proposals that require a company to adopt an independent chair structure. We will evaluate a company’s board leadership structure against the guidelines laid out in this paper and engage with the independent leader of the board to help inform our voting decision in each particular case.

We hope board members of our portfolio companies find this guidance useful. Any questions or comments may be directed to Rakhi Kumar, Managing Director and Head of Corporate Governance, at Rakhi_Kumar@ssga.com

¹ Ann. C. Mulé and Charles M. Elson, “A New Kind of Captured Board,” Weinberg Center, University of Delaware, Q1 2014.

Key Functions and Responsibilities for Independent Board Leaders

| Function | Description | Responsibilities |
|--|---|---|
| Board Leadership | Leads group of independent directors and acts as a liaison between independent directors and the CEO/senior executives. | <ul style="list-style-type: none"> Acts as liaison between independent directors and the CEO. Acts as a sounding board and advisor to the CEO. Has the authority to call for a meeting of independent directors. Sets the agenda for the meeting of independent directors with inputs from other directors. Leads meetings of independent directors. Oversees conflicts of interest of all directors including the CEO. Authorizes retention of outside advisors and consultants who report directly to the board. Leads or contributes to annual performance review of the CEO. Leads or participates in CEO succession planning and talent retention/development of senior executives. Leads board in time of crisis. |
| Board Culture | Fosters an environment of open dialogue and constructive feedback; encourages independent director participation at board meetings. | <ul style="list-style-type: none"> Assists in promoting corporate governance best practices. Encourages director participation by fostering environment of open dialogue and constructive feedback among independent directors. Helps ensure efficient and effective board performance and functioning. Establishes code of conduct for directors on the board including the CEO. |
| Board Oversight of Strategy | Ensures board ownership of strategy and provides guidance to the CEO on execution of the strategy, when needed. | <ul style="list-style-type: none"> Ensures that the board develops and periodically reviews the company's long-term strategy. Ensures that the board oversees management's execution of the long-term strategy. Assists in aligning governance structures with the company's long-term strategy. Provides guidance to the CEO on executing the long-term strategy. |
| Board Meetings | Plans, reviews and approves board meeting agendas; follows up on meeting outcomes and management deliverables. | <ul style="list-style-type: none"> Ensures effective functioning of key board committees and provides inputs on functioning of the committee, when required. Coordinates activities of board committees and receives feedback from the chairs of board committees. Leads or provides guidance on director succession and development. Facilitates cross-committee feedback and provides inputs on committee meeting agenda, if required. Leads or participates in ad-hoc committees established to deal with extraordinary matters such as investigations, M&As etc. |
| Board Committee Coordination and Effectiveness | Ensures effective functioning of board level committees and facilitates communication coordination across committees. | <ul style="list-style-type: none"> Plans, reviews and approves board meeting agendas and schedules in coordination with the CEO. Advises the CEO of the board's information needs and approves information sent to the board. Follows up on meeting outcomes and management deliverables. |
| Shareholder and Stakeholder Engagement | Meets with shareholders and stakeholders such as regulators, employees and clients when needed. | <ul style="list-style-type: none"> Engages and consults with major shareholders, when requested. Engages with key regulators to discuss board process and oversight of management and company, when necessary. Represents independent board members with other stakeholders, when necessary. Attends shareholder meetings as representative of the board. |

Source: SSGA's Corporate Governance Team and Russell Reynolds.

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INTERNATIONAL BUSINESS COUNCIL OF THE WORLD ECONOMIC FORUM

The New Paradigm

A Roadmap for an Implicit Corporate Governance Partnership
Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth

Document prepared by Martin Lipton, Lawyer, Wachtell Lipton Rosen & Katz¹

The “New Paradigm” is an emerging corporate governance framework that derives from the recognition by corporations, their CEOs and boards of directors, and by leading institutional investors and asset managers (“investors”), that short-termism and attacks by short-term financial activists significantly impede long-term economic prosperity. The economic impact of a short-term myopic approach to managing and investing in businesses has become abundantly clear and has been generating rising levels of concern across a broad spectrum of stakeholders, including corporations, investors, policymakers and academics. The proposition that short-term financial activists and reactive corporate behavior spur sustainable improvements in corporate performance, and thereby systemically increase rather than undermine long-term economic prosperity and social welfare, has been overwhelmingly disproved by the real world experience of corporate decision-makers as well as a growing body of academic research. This emerging consensus has reached a tipping point, and decisive action is imperative. The New Paradigm is premised on the idea that corporations and institutional investors can forge a meaningful and successful private-sector solution, which may preempt a new wave of legislation and regulation such as adumbrated in the recent policy statement by Prime Minister Theresa May in the U.K.

In essence, the New Paradigm recalibrates the relationship between public corporations and their major institutional investors and conceives of corporate governance as a collaboration among corporations, shareholders and other stakeholders working together to achieve long-term value and resist short-termism. In this framework, if a corporation, its board of directors and its CEO and management team are diligently pursuing well-conceived strategies that were developed with the participation of independent, competent and engaged directors, and its operations are in the hands of competent executives, investors will support the corporation and refuse to support short-term financial activists seeking to force short-term value enhancements without regard to long-term value implications. As part of their stewardship role, institutional investors will work to understand corporations’ strategies and operations and engage with them to provide corporations with opportunities to understand the investors’ opinions and to adjust strategies and operations in order to receive the investors’ support.

While the New Paradigm draws heavily from U.S. and U.K. studies, reports and practices, it also draws from the 2015 G20/OED Principles of Corporate Governance, the 2016 Commonsense Corporate Governance Principles, the 2015 discussion report of the Long-Term Value Summit Meeting of Focusing Capital on the Long Term, the 2016 International Corporate Governance Network, Global Stewardship Principles, the Hermes 2014 Corporate Governance Principles and other international sources. It is intended to be a template for an implicit governance partnership in any market.

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The International Business Council of the World Economic Forum believes that recognition and acceptance of the New Paradigm by corporations, their CEOs and boards of directors, and by leading institutional investors and asset managers, will create a corporate governance framework that will facilitate sustainable long-term value. The New Paradigm, by design and intention, will further this goal.

For corporations, the New Paradigm will:

- *alleviate pressures to maximize profits and equity share value in the short term at the expense of the long term;*
- *encourage corporations to pursue thoughtful strategies for maximizing profits and equity share value in the long term;*
- *encourage corporations to incorporate relevant sustainability, ESG (environmental, social and governance) and CSR (corporate social responsibility) considerations in developing their long-term strategies and operations planning;*
- *encourage corporations to be transparent in their financial reporting; and*
- *encourage a corporation to periodically review governance and thoughtfully consider the principles promulgated or endorsed by its major investors.*

For investors, the New Paradigm will:

- *increase the willingness to withstand cyclical headwinds and short-term market fluctuations in the pursuit of long-term value;*
- *minimize reliance on short-term financial performance metrics and promote a more holistic understanding of corporations' businesses;*
- *encourage investors to consistently support the pursuit of well-designed long-term strategies by the corporations in which they invest;*
- *discourage investors from supporting short-term financial activists that advocate only short-term profit and value maximization;*
- *discourage investors from outsourcing proxy voting decisions to proxy advisory firms or otherwise basing such decisions on "check-the-box" principles, scores or formulas;*
- *not discourage investors from entertaining proposals by responsible activist shareholders for support in improving the strategy or operations of under-performing corporations; and*
- *encourage investors to address relevant sustainability, ESG and CSR matters.*

At the interface between corporations and investors, the New Paradigm will:

- *encourage investors to communicate directly their preferences, expectations and policies to corporations;*
- *encourage corporations to provide meaningful communications about strategy, long-term objectives and governance, and encourage investors to actively listen to corporations and review these communications;*
- *encourage corporations to establish and maintain meaningful, direct long-term relationships with significant investors in corporations and encourage those investors to have the appropriate policies, personnel and procedures for meaningful reciprocity in the relationship; and*
- *where corporations are pursuing subpar strategies that are unlikely to bring long-term success, encourage investors to use behind-the-scenes, direct engagement with those corporations as a first line of action.*

In a broader context, we hope that the New Paradigm will:

- *encourage corporations and investors to support tax policies that will promote long-term investment;*
- *encourage corporations and investors to work together in organizations like Focusing Capital on the Long Term to alleviate pressures for quarterly earnings forecasts and guidance and to otherwise promote long-term value creation;*
- *be embraced by all investors, both passive and active, and all corporations, (practical considerations might limit initial uptake to larger investors and corporations); and*
- *through voluntary cooperation by corporations and institutional investors, obviate the need for regulation and legislation to enforce a longer-term approach.*

I. SUMMARY ROADMAP FOR THE NEW PARADIGM

The Corporation, its CEO and its Board of Directors. The following is a snapshot of key expectations and responsibilities for boards of directors and CEOs in the New Paradigm. While the New Paradigm should be available to all corporations, it is recognized that the engagement condition may limit it to the larger listed corporations and the larger investors. In sum, in the New Paradigm a board and the corporation's senior leadership should jointly:

- Long-Term Strategy and Performance. Guide, debate and oversee a thoughtful long-term strategy for the corporation and the communication of that strategy to investors using clear, non-boilerplate language. Define the corporation's business model and its vision, taking into account key drivers of strategy, risks and business outcomes. Play a front-and-center role in ensuring that the corporation pursues sustainable long-term value creation.
- Engagement. Develop an understanding of shareholder perspectives on the corporation and foster long-term relationships with investors by using appropriate methods of engagement. Establish communication channels with investors and be open to dialogue between independent directors and investors on a "clear day," not just in the midst of a crisis or activist challenge. Respond to investor requests for meetings to discuss governance, the business portfolio and operating strategy, and for greater transparency into the board's practices and priorities. Consider cultivating relationships with government, community and other stakeholders.
- Social Responsibility and ESG/CSR. Set high standards for the corporation, including with respect to human rights, and the integration of relevant sustainability and environmental, social and governance ("ESG") and corporate social responsibility ("CSR") matters into strategic and operational planning for the achievement of long-term value.
- Risk Management. Determine the corporation's reasonable risk appetite, oversee the implementation of state-of-the-art standards for managing risks and seek to ensure that necessary steps are taken to foster a culture of risk-aware and risk-adjusted decision-making. Oversee the implementation by management of standards for compliance with legal and regulatory requirements, monitor compliance and respond appropriately to "red flags."
- Monitoring and Partnering with Management. Maintain a close relationship with the CEO and work with management to encourage entrepreneurship, appropriate risk-taking and investment to promote the long-term success of the corporation and to navigate changes in domestic and world-wide economic, social and political conditions. Monitor management's execution of the corporation's long-term strategy and provide advice to management as a strategic partner. Maintain a CEO succession plan in case the CEO becomes unavailable or fails to meet expectations.
- Tone at the Top. Establish the appropriate "tone at the top" to actively cultivate a corporate culture that gives high priority to ethical standards, principles of fair dealing, professionalism, integrity, full compliance with legal requirements, ethically sound strategic goals and long-term sustainable value creation.

Specifically, the corporate board should:

- Business of the Board. Organize the business, and maintain the collegiality, of the board and its committees so that each of the increasingly time-consuming matters that the board and its committees are expected to oversee receives appropriate director attention.
- Governance. Periodically review bylaws, corporate governance guidelines, committee charters and other governance policies. Thoughtfully and pragmatically consider shareholder proposals, making changes that the board believes will improve governance and resisting changes that the board believes will not be constructive.
- Board Composition. Meet the challenge of recruiting and retaining highly qualified directors who are willing to shoulder the escalating work load and time commitment required for board service, while at the same time facing pressure from shareholders and governance advocates to embrace

“board refreshment,” taking into account factors relating to age, length of service, independence, expertise, gender and diversity.

- Director Compensation. Provide compensation for directors that fairly reflects the significantly increased time and energy that they must now spend in serving as board and board committee members. Avoid any form of compensation that could be viewed as inconsistent with the corporation’s long-term strategy.
- Executive Compensation. Design reasonable executive compensation to allow the corporation to recruit, retain and incentivize the most talented executives to generate long-term value, while avoiding incentive compensation that might cause executives to pursue short-term results at the expense of long-term results and taking into account the views of investors as expressed through “say-on-pay” votes or otherwise.
- Director Education and Evaluations. Continually educate directors and evaluate, or arrange for the evaluation of, the performance of the directors, the board and the board committees, and show that these are substantive exercises that inform board roles, succession planning and refreshment objectives.
- Extraordinary Transactions. Carefully consider extraordinary transactions on an informed basis. Recognize that shareholder litigation against the corporation and its directors is part of modern corporate life and should not deter the board from exercising its business judgment to approve a significant acquisition or other material transaction, or accept or reject a merger proposal or takeover bid.
- Conflict Transactions. Take center stage whenever there is a proposed transaction that creates a real or perceived conflict between the interests of shareholders and those of management, including attacks by short-term financial activists focused on the CEO.

Investors. The following is a snapshot of key expectations and responsibilities for institutional investors in the New Paradigm. In sum, an investor should:

- Consistent Support for Long-Term Strategies. Provide steadfast support for the corporation in pursuing reasonable strategies for long-term growth. Speak out publicly against short-term demands in order to minimize the disruptive impact of activists.
- Integrated Long-Term Investment Approach. Establish a firm-wide culture of long-term thinking and patient capital that discourages over-reliance on short-term performance metrics. Promote stewardship principles by encouraging portfolio managers to act consistently with the long-term time horizons of its clients and asset owners. Design employee compensation to discourage sacrificing long-term value to capture short-term swings in stock prices. Consider value-relevant sustainability, citizenship and ESG/CSR factors when developing its own investment strategies.
- Engagement. Actively listen to corporations and review their communications about strategy, long-term objectives and governance. Communicate preferences and expectations with respect to engagement with the corporation. Provide candid, direct feedback on the corporation’s strategy, performance, management, board, governance and engagement.
- Collaboration and Feedback. If the investor is concerned about a corporation’s strategy or performance, give prompt notice to the corporation of its concerns and invite the corporation to privately engage with the investor. If the investor publicly discloses a negative opinion about the strategy, performance, compensation or management of a corporation, as part of that disclosure, state whether the investor provided an opportunity to the corporation to engage.
- Voting Decisions. Actively vote, or refrain from voting, shares on an informed basis in a manner consistent with the best interests of its clients that have long-term investment goals, without abdicating decision-making to proxy advisory firms.

- Disclosures. Proactively disclose the investor's policies and preferences, including with respect to its adoption of the New Paradigm, preferred procedures and contacts for engagement, long-term investment policies and evaluation metrics, positions on ESG and CSR matters, policies on outside consultants, governance procedures it considers significant, views on quarterly reports and earnings guidance, guidelines for its relations with short-term financial activists and voting policies.

II. **SHORT-TERMISM**

The Threat of Short-Termism

A short-term mindset in managing and investing in businesses has become pervasive and is profoundly destructive to the long-term health of the economy. Short-termism erodes the foundation for future innovation, ingenuity in product enhancements and the research and development that makes possible medical breakthroughs, technological progress and scientific advances. It undercuts investments in employees, factories and equipment, expansion into new markets and the pursuit of other long-term projects that require up-front costs but have the potential for sustainable value creation and social impact. As the *Report of the Commission on Inclusive Prosperity*, convened by the Center for American Progress and co-chaired by Lawrence Summers and Ed Balls, explains:

The effects of short-termism are damaging to the economy as a whole. A firm that invests for the long term will make more investments in future productivity, whether that's developing lifesaving medicine; building or buying newer, more efficient machinery; or paying for training for its workforce. All of these investments show up immediately as expenses . . . and reduce profits in the current quarter but raise future productivity of the firm. Incentivizing a continuing short-term focus lowers future output, reduces long-term competitiveness, and diminishes future worker productivity and the higher wages that it can bring. . . . To provide greater macroeconomic and financial stability and to raise productivity, it is essential that markets work in the public interest and for the long term rather than focusing only on short-term returns.

This link between short-termism and economic decline has been further validated by Pavlos Masouros in *Corporate Law and Economic Stagnation: How Shareholder Value and Short-Termism Contribute to the Decline of the Western Economies*, which uses macroeconomic data to show that increasing short-termism in France, Germany, the Netherlands, the United Kingdom and the United States has contributed to low gross domestic product growth rates in those countries. Likewise, in their 2014 article in the Harvard Business Review, "Focusing Capital on the Long Term," Dominic Barton and Mark Wiseman concluded, "the ongoing short-termism in the business world is undermining corporate investment, holding back economic growth." In *The Kay Review of UK Equity Markets and Long-Term Decision Making*, John Kay emphasized the impact of institutional investors on corporate decision-making, concluding that "The appointment and monitoring of active asset managers is too often based on short-term relative performance...but competition between asset managers on the basis of relative performance is inherently a zero sum game...this conflict between the imperatives of the business model of asset managers, and the interests of UK business and those who invest in it, is at the heart of our analysis of the problem of short-termism."

In addition, a growing body of academic research has confirmed that short-term financial activists are a major contributor to systemic short-termism in managing businesses and investments. The notion that activist attacks increase, rather than undermine, long-term value creation has been resoundingly discredited. Economists Yvan Allaire and François Dauphin, for example, demonstrated in a *series of papers issued by the Institute for Governance of Private and Public Corporations* that the "benefits" of activism cited by its proponents were, to the extent not temporary, marginal at best, largely the result of basic short-term financial maneuvers (such as asset sales, spin-offs, buybacks and cost cuts) and not of any superior long-term strategies and may simply constitute a wealth transfer from employees and creditors to shareholders rather than actual wealth creation. An article by professors John C. Coffee, Jr. and Darius Palia, "The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance," pointed out serious flaws in the so-called empirical evidence used to justify activist attacks, showing that such studies omitted important control variables, used improper specifications, contained errors and methodological flaws, suffered from selection bias, lacked real evidence of causality and ignored other significant studies reaching contrary conclusions. A January 2016 study, by professors Martijn Cremers,

Ankur Pareek and Zacharias Sautner, *Short-Term Investors, Long-Term Investors, and Firm Value*, reached similar conclusions, finding that corporations tend to decrease spending on research and development and experience temporarily increased earnings and stock prices after short-term investors become shareholders, so that after the short-term investors exit their investment, “only long-term shareholders suffer from the reduction in long-term investment and firm value.” A 2016 report by the Center for American Progress *Workers or Waste? How Companies Disclose—or Do Not Disclose—Human Capital Investments and What to Do About It*, argued that the short-termism of financial markets “may not just excessively discount but actively penalize investments in the human capital and skills of a company’s workforce.”

For an excellent discussion of short-termism, “quarterly capitalism,” the impact of short-term financial activists and the decline in investment for long-term growth and value creation, see the 2015 report by The Conference Board, *Is Short-Term Behavior Jeopardizing the Future Prosperity of Business?* See also a Brookings Institution paper by Steven Pearlstein, *Social Capital, Corporate Purpose and the Revival of American Capitalism*, and a 2009 Aspen Institute report, *Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management*.

The Emerging New Paradigm of Corporate Governance

In response to the acute threat presented by short-termism, a broad-based consensus is developing around the parameters of a new paradigm of corporate governance that will promote the long-term investment required for economic prosperity. Several leading institutional investors have recently called for a new approach to corporate governance that will restore a long-term perspective consistent with the investment horizon of the clients for whom they manage investments. As observed in *Securing Our Nation’s Economic Future: A Sensible, Nonpartisan Agenda to Increase Long-Term Investment and Job Creation in the United States*, by Leo E. Strine Jr., Chief Justice of the Delaware Supreme Court, despite the pressures on money managers to deliver immediate returns, “the investment horizon of the ultimate source of most equity capital—human beings who must give their money to institutional investors to save for retirement and college for their kids—is long.” The New Paradigm is a synthesis of the corporate governance codes applicable in a number of markets and various efforts underway to articulate a new corporate governance framework, including *Common Sense Principles of Corporate Governance* issued by a group of CEO’s of major corporations and investors on July 21, 2016 and the Business Roundtable’s, *Principles of Corporate Governance* issued on August 4, 2016. At its core, the New Paradigm is a simple quid pro quo that recalibrates the relationship between public corporations and their major institutional investors.

With respect to corporations, the New Paradigm accepts the best corporate governance policies and principles that have been advocated by leading institutional investors, codified in rules and policies and voluntarily adopted by most public corporations, together with an amplified emphasis on engagement and collaboration with institutional investors to achieve long-term value. Pursuant to the New Paradigm, corporations will embrace core principles of good governance and, in seeking to cultivate relationships with investors, will demonstrate that they have engaged, thoughtful boards overseeing reasonable, long-term business strategies. Institutional investors are seeking not simply accountability, but also active involvement and credibility, from CEOs and boards of directors. Corporations that meet these standards will be given the benefit of the doubt by institutional investors, so that their daily stock price and quarterly results are considered in the context of long-term objectives, and they will be supported in making strategic investments that require patient capital.

With respect to institutional investors, the New Paradigm contemplates that, in exchange for corporations’ commitment to corporate governance principles, investors will consistently provide the support and patience needed to permit the realization of long-term value and engage in constructive dialogue as the primary means for addressing subpar strategies or operations. Institutional investors will embrace stewardship principles and develop an understanding of a corporation’s governance and long-term business strategy. This requires going beyond check-the-box governance mandates and formulaic governance scores and, instead, working to develop relationships with corporations and thoughtful analyses of the needs and goals of each corporation. Financial metrics such as total shareholder return and earnings targets will be balanced against a more holistic understanding of firm value. And in situations where institutional investors have concerns about governance, strategy or other aspects of a corporation, they will use behind-the-scenes, direct engagement with the corporation as a first line of action. In addition, investors will clearly communicate their expectations and policies, including their expectations for engagement and long-term investment by a corporation, how they define and evaluate a

corporation's success in meeting expectations and steps they have taken in structuring their own business and their own compensation policies to enable a long-term perspective.

In sum, the New Paradigm recognizes the power of institutional investors to influence corporations, and, by extension, to fulfill the promise of the New Paradigm in restoring a focus on long-term investment. Indeed, the New Paradigm acknowledges and is premised on the significant influence that institutional investors now have on corporate decision-making, and does not attempt to shift back toward a director-centric model of governance. Instead, it is a recalibration of governance principles—and the relationships and responsibilities of corporations and investors—that is designed to ensure that this new balance of power can be compatible with, and can foster, long-term economic sustainability.

The Prospect of Regulatory Reforms

The New Paradigm does not require new legislation or regulation and relies instead on the initiatives, commitments and follow-through of corporations and investors. Without a meaningful private-sector consensus around the New Paradigm, there is a virtual certainty that the unprecedented power of a relatively small number of institutional investors over virtually all major business corporations, and the demonstrated success of activists in exploiting short-term mindsets, will provoke regulatory and legislative reforms. Over the course of history, the concentration of power in the hands of a few has provided fertile grounds for a governmental backlash with sweeping reforms. The corporate form is a creation of the state, conceived originally as a privilege for the public good and welfare, and it is accordingly the prerogative of government to alter the rules governing corporations to enhance their economic and social utility, or at least to prevent their economic and social disutility, notwithstanding any claims by shareholders to “intrinsic” rights.

Indeed, the wheels have already been set in motion, with a variety of regulatory reforms being actively considered across jurisdictions. Proponents have adopted a range of suggested approaches in tackling the problems of short-termism—including imposing robust fiduciary duties on institutional investors and asset managers to take into account the long-term objectives of the ultimate beneficiaries of securities under management when engaging with issuers or voting, using tax laws to encourage long-term investment or to significantly discourage short-term trading, prohibiting quarterly reports and quarterly guidance, regulating executive compensation to discourage managing and risk taking in pursuit of short-term incentives, imposing enhanced disclosure obligations on both corporations and institutional investors, reversing shareholder governance rights in order to restore a more director-centric governance model, imposing higher standards with respect to institutional investors' independence and other changes intended to curb short-termism. For a comprehensive discussion of European Commission proposed legislation, see Therese Strand, *“Re-thinking Short-Termism and the Role of Patient Capital in Europe: Perspectives on the New Shareholder Rights Directive.”*

Any regulatory mandates and restrictions imposed on institutional investors and corporations to address the problems of short-termism may well include heavy-handed, overly broad or costly mandates that do not afford investors and corporations flexibility in tailoring solutions that will best promote a long-term perspective. Private ordering through the New Paradigm by corporations and investors who best know their respective concerns and needs is more likely to result in effective and balanced solutions than government intervention. In a June 15, 2016 *Wall Street Journal* article, Ed Garden, chief investment officer of Triam Fund Management, an activist investor with a long-term growth strategy, said, “[T]he way to build strong companies and create jobs is not through government mandate or protecting weak management teams. It will happen because market forces will reward the companies in which management teams and highly engaged shareowners work together to achieve sustained, lasting growth.”

While the New Paradigm does not require legislative or regulatory reforms, it will be critical that any such reform proposals are carefully monitored and reviewed to understand their impact on long-term investment and the broader economy so that they do not exacerbate the problems of short-termism. Corporations and investors should work together to ensure that rules and laws promote, or at least do not deter, long-term investment, and equally importantly, corporations and investors should band together to resist legislation and regulation that may discourage long-term investment or that presumes that the long-term health of society is not aligned with the long-term interests of business. Legislation, regulations and agency staff interpretations that, for example, place more power in the hands of short-term financial activists and other investors with short-term perspectives, or that weaken the ability of corporate boards and management to make long-term investments or resist short-term pressures, should be opposed. In this regard, it is notable that a lobbying consortium, consisting of Pershing Square, Carl Icahn, Elliott

Management, Third Point and JANA Partners, has formed the *Council for Investor Rights and Corporate Accountability* to advocate for legislation to protect the agendas of short-term financial activists.

Working hand-in-hand with corporations, institutional investors are uniquely positioned to use their influence to recalibrate the system and act as a counterweight to the disproportionate influence of activists. Investors' publicly stated support for long-termism, real world experience, meaningful stakes and the investment goals and horizons of their clients and underlying beneficiaries, all put them at odds with the goals of short-term financial activists and other short-term shareholders. The endorsement and adoption of the New Paradigm by investors and corporations is entirely consistent with their objectives and responsibilities, and has the potential for significant and meaningful change.

III. ROLE OF THE CORPORATION IN THE NEW PARADIGM

In the New Paradigm, the CEO, who leads the management of the corporation, and board of directors, which oversees the management, play a front-and-center role in ensuring that the corporation pursues sustainable long-term value creation and fosters meaningful relationships with investors. While the specific procedures that a corporation chooses to follow in adapting to the New Paradigm should be carefully tailored to the unique needs and circumstances of each corporation, there are a number of practices that are hallmarks of the robust governance, expected in the New Paradigm.

Prioritize Long-Term Strategy and Performance. In the New Paradigm, the corporation's long-term strategy, its implementation plan and its progress in achieving the long-term strategy should be a primary focus.

Develop, Implement, Oversee and Communicate Long-Term Strategy. The board should be actively involved in the development, implementation and oversight of a thoughtful long-term strategy and the communication of this strategy to investors. Typically, the initial strategy and business plans will be formulated by management. The board, however, should go beyond a "review and concur" role to ensure that it understands the strategic assumptions, uncertainties, judgments and alternatives, is sufficiently involved in the process to be able to recognize potential forces that could affect the strategy and is satisfied that the strategy is the right one for the corporation.

Both management and directors should understand, and be able to effectively articulate to investors: the corporation's core identity—what it does, what it makes or provides, and who it serves; the corporation's vision for the future; the key drivers of business outcomes; how the corporation's portfolio of assets and businesses fit together; key risks and how those affect and drive strategy; mitigation methods for such risks; and how the corporation evaluates whether the strategy remains viable as the business, competition and regulatory environments change. In developing a long-term strategy, consideration should be given not only to shareholders, but also to the corporation's broader group of stakeholders, including employees, suppliers, customers, creditors and the community. These constituencies are important to the corporation's ability to develop and maintain long-term, sustainable value for the corporation and its shareholders.

Frame Quarterly Reporting in Context of Long-Term Plans. Quarterly reporting of financial results runs the risk of exacerbating short-term pressures. To mitigate this risk, the corporation should use quarterly reports as an opportunity to show progress toward long-term plans. For example, a corporation may choose to disclose a qualitative assessment of the underlying fundamentals of the business that is focused on short-term fluctuations, and to frame short-term hits and misses in the broader context of corporate goals and strategies.

Take into Account Relevant Sustainability, ESG and CSR Factors. Appropriate ESG and CSR factors can be integrated into strategic and operational planning, budgeting, resource allocation and compensation structures. The corporation should communicate its policies on these subjects to investors.

Design Executive Compensation to Incentivize Long-Term Results. The corporation should structure compensation to encourage and reward executives for achieving business goals in furtherance of the corporation's long-term strategy and to avoid incentives that could encourage undue risks or managing inconsistently with the long-term strategy. Appropriate stock ownership requirements should be implemented to promote continued alignment between the corporation's executives and its shareholders, and consideration should also be given to appropriate compensation recovery policies to recoup compensation from executive officers resulting from specified failures.

In developing these compensation structures, the board and compensation committee should prepare in advance for the “say-on-pay” vote, bearing in mind the media, populist and investor sensitivity to pay packages that could be deemed “excessive” and the policies of proxy advisory services and investors. However, the board should not abdicate its role in deciding what works best for the corporation. It should articulate its rationale for executive compensation in a manner that highlights the link between compensation design and long-term corporate strategy, and when major investors have questions, it is appropriate for directors to participate in discussions with them.

Engage, Communicate and Foster Meaningful Long-Term Relationships with Investors. In the New Paradigm, effective engagement by the corporation with investors and other stakeholders is key to developing long-term relationships, understanding stakeholder perspectives, communicating board practices and priorities and the corporation’s commitment to long-term value creation, and cultivating stakeholders’ understanding of the corporation’s point of view, particularly with respect to investments that have a long-term horizon.

Communicate the Right Things. In order to cultivate credibility and build the mutual trust between corporations and investors that underlies the New Paradigm, the corporation should effectively communicate to investors that it is holding up its end of the bargain—namely, that it has an engaged, thoughtful board overseeing a reasonable, long-term business strategy that is on track to achieve long-term value creation. In particular, such communications should address the following:

- *Describe the Strategy and Confirm Board Involvement in the Strategy.* The corporation should clearly articulate for investors the corporation’s vision and strategy, including key drivers of performance, key risks, evolution of the corporation’s business model and how the corporation thinks about its strategy, performance, assets, competitors and alternatives. The corporation should also affirm to investors the board’s active involvement with its long-term strategy, including the development of the strategic plan through interactive dialogue between directors and management, the board’s commitment to reviewing long-term plans regularly, directors’ exercise of robust oversight to test and challenge both strategy and implementation and the board’s role in guiding, debating and overseeing strategic choices.
- *Make the Case for Long-Term Investments.* The corporation should explain and make the case for capital projects and investments in equipment and technology, employee education and workforce training, out-of-the ordinary increases in wages and benefits, research and development, innovation and other significant initiatives. In particular, the corporation should be able to explain how such investments are reviewed and why and how they matter to long-term growth and competitiveness, productivity and retention of talent. For investments that will take time to bear fruit, the corporation should acknowledge the time horizon and explain the importance, timing and progress of these investments. Particularly when short-term pressures are at their peak, adhering to a strategy that prioritizes long-term investments can demonstrate the board’s conviction in the benefits of its long-term strategy.
- *Describe Capital Allocation Priorities.* The board should have a thoughtful process for reviewing and approving capital allocation policies and communicate its thinking about capital allocation to investors. Where return of capital to shareholders is part of the corporation’s value creation framework, the board should consider the appropriate timing, pace and quantum of buybacks and/or dividends and the relative tradeoffs. If maintaining an investment-grade balance sheet is a priority, the board should understand and be able to explain the reasons for this priority.
- *Address Sustainability, Citizenship and ESG/CSR.* The corporation should communicate how it addresses relevant sustainability, citizenship and ESG/CSR matters, including by sharing corporate responsibility initiatives and progress publicly on the corporation’s website, discussing the impact of ESG and CSR factors in shareholder communications and bringing to investors’ attention how management and directors view relevant sustainability matters in relation to firm value and strategy.
- *Articulate the Link Between Compensation Design and Corporate Strategy.* The corporation should describe how compensation practices encourage and reward long-term growth, promote implementation of the strategy and achievement of business goals and protect shareholder value.
- *Explain Why the Right Mix of Directors Is in the Boardroom.* The corporation should present the diverse skills, expertise and attributes of the board as a whole and of individual members and link them to the corporation’s needs and risks. It is important to be transparent about director

recruitment processes and how they are designed to allow board composition and practices to evolve with the needs of the corporation, including views on balance, tenure, retaining institutional knowledge, board refreshment and presence or absence of age or term limits. The corporation should explain procedures for maintaining or increasing the diversity of the board and for ensuring that directors possess the requisite skills, including by means of director orientation, tutorials and retreats for in-depth review of key issues. The corporation should affirm that board, committee and director evaluations are substantive exercises that inform board roles, succession planning and refreshment objectives.

- *Discuss How Board Practices and Board Culture Support Independent Oversight.* The corporation should clearly articulate the actual practices and responsibilities of the lead director or non-executive chair, independent directors, committee chairs and the board as a whole in providing effective oversight, understanding shareholder perspectives, evaluating CEO performance and organizing the board to ensure priorities are met.

Use the Right Methods of Engagement. Both corporations and investors should be realistic about the extent to which they call for in-person meetings and should recognize that effective engagement is not limited to in-person meetings between corporations and investors. Direct engagement through disclosure—including earnings calls, periodic reports, proxy statements and other SEC filings, the corporation’s website and the corporation’s social media presence is often the most practical means of engagement. In other cases, in-person meetings, one-on-one calls or interactive communications (such as at conferences or Investor Days) may be more effective or efficient. Whatever approach is taken, the key is quality rather than quantity. Establishing channels of communication in advance of a crisis or activist challenge is extremely important.

Opportunities to engage and communicate with investors include:

- *Periodic Letters to Investors.* Periodic letters to investors from management can articulate management’s vision and plans for the future, explain what the corporation is trying to achieve and discuss how it plans to achieve its objectives. Letters from the board can convey board-level priorities and involvement. Depending on the circumstances, statements or letters may be separate, jointly signed by the CEO and the lead director or non-executive chair, come from particular committees as to matters within their ambit or come from the full board.
- *Investor Days.* The corporation may use Investor Days to articulate a long-term perspective on prospects and opportunities and provide a detailed review of strategy, performance and capital allocation. Challenges should also be candidly addressed and responsive initiatives outlined, and long-term metrics, goals and targets should be reviewed. All of the corporation’s major investors should be extended an invitation. Key materials from a completed Investor Day can be separately circulated to investors and made available on the corporation’s website. In certain cases, it may be useful for directors to participate in an Investor Day to validate and communicate board involvement and priorities.
- *Quarterly Communications.* Quarterly earnings rituals remain, for now, a fact of life in the U.S. and some other countries. Nevertheless, the corporation can mitigate the short-term perspective they facilitate by placing quarterly results in the context of long-term strategy and objectives, discussing progress towards larger goals and articulating higher priorities, all the while eschewing quarterly guidance.
- *Proxy Statements, Annual Reports, Other Filings and the Corporation’s Online Presence.* Proxy statements, annual reports/10-Ks, SEC and stock exchange filings, presentations and voluntary disclosures provide communication opportunities. For example, the customary proxy section entitled “The Board’s Role in Risk Oversight” may ultimately evolve into sections covering “Board Oversight of Strategy and Risk.” The corporation should present information online in readily accessible, user-friendly and well-organized formats. In carrying out its recently announced initiative to review and modernize the business and financial disclosure required by Regulation S-K, the SEC should seek to craft its reforms with the New Paradigm in mind, so that the disclosure system facilitates the communication of information that investors want to hear and that corporations want to convey. So too with respect to similar initiatives by other regulators.

Determine Appropriate Director Involvement in Engagement Activities. Major institutional investors expect that a corporation will provide access to its independent directors, and these investors have stated that it will color their attitude toward a corporation if the corporation first begins to provide

such access only after it has been attacked by an activist. While management has historically been the primary caretaker of investor and constituent relationships, it may be desirable in certain circumstances (e.g., to signal board support of management or to explain the board's perspective) for directors to accommodate requests from major investors for a meeting or other direct communication. The policies and arrangements best suited for any given corporation will depend on, among other things, the preferences of directors, the nature and extent of existing relationships with investors, the preferences of those investors and the structure and staffing of the corporation's existing investor relations program. In any event, participating directors should be thoroughly briefed on discussion topics as well as the constraints of disclosure rules. In coordinating engagement, having experienced corporate governance and investor relations executives is important.

Oversee and Partner with the CEO and Management Team. A strong, capable and committed CEO and management team, subject to both robust oversight by the board and collaborative teamwork with the board, is essential to long-term value creation.

Prioritize CEO Selection and Succession Planning. The board's role in selecting and evaluating the CEO and senior leadership, and planning for their succession, is a critical element of the corporation's strategic plan and should be approached with an "expect the unexpected" mindset. A leadership gap or protracted delay in finding a suitable replacement can detract significantly from the stability of the corporation and can undermine public confidence in the future of the corporation as well as its ability to navigate challenges. In particular, the integrity and dedication of the CEO is vital to enabling the board to meet all of its responsibilities and, in large measure, the fate of each of the board and the CEO is in the hands of the other. Succession planning should be a top priority that is addressed on a regular rather than reactive basis.

In making succession planning decisions, directors should not unduly defer to the current CEO, rely on résumés or otherwise outsource the process. Instead, the directors leading the process should take it upon themselves to get to know each of the candidates personally. A board should be involved in identifying talented leaders and developing an expanded pipeline of qualified internal and external candidates, and directors should seek first-hand exposure to the corporation's most promising executives at board meetings, board dinners and other opportunities. Although succession planning can be a sensitive topic, the board should address this challenge head-on by developing a profile for future CEOs, and other key executives, that is specific to the needs of the corporation, and by working with the incumbent CEO to establish policies and procedures for the identification and evaluation of internal candidates.

Establish the Appropriate "Tone at the Top." One of the most important factors in ensuring that a board functions effectively and is able to meet all of its responsibilities is having the right "tone at the top" of the corporation. The tone at the top shapes corporate culture and permeates the corporation's relationships with investors, employees, customers, suppliers, regulators, local communities and other constituents. An outstanding report, *Corporate Culture and the Role of Boards*, was issued by the U.K. Financial Reporting Council in July 2016. The board should work with the CEO and the management team to actively cultivate a corporate culture that gives high priority to ethical standards, principles of fair dealing, professionalism, integrity, full compliance with legal requirements, ethically sound strategic goals and long-term sustainable value creation. Promoting an environment that understands enterprise-wide risk management, incorporates it into overall corporate strategy and day-to-day business operations and emphasizes risk aware and risk-adjusted decision-making is a critical component of effective risk management and should not be viewed as hindering corporate progress, or isolated as a specialized corporate function, but instead should be treated as an essential part of how the corporation measures and rewards its success. In setting the right tone at the top, transparency, consistency and communication are key—the board's vision for the corporation should be communicated effectively throughout the organization and to investors.

Balance the Role of the Board as Monitor and Partner. The board has two key roles with respect to management — oversight of management and partnership with management. When properly balanced, these roles are not inconsistent but rather mutually reinforcing. The interests of the corporation are best served when directors and management work together as business partners to promote and improve the business, operations and strategy of the corporation. So long as independent directors are able and willing to assert their independent judgment, there is nothing wrong with directors and management developing relationships of mutual respect, trust and friendship. This type of relationship facilitates the ability of directors to have meaningful input into the key business decisions of the

corporation and the ability of management to draw on the expertise, judgment, experience and knowledge of directors.

Organize the Business of the Board. The business of the board and its committees should be organized in a way that ensures matters requiring board or committee attention receive such attention and are prioritized appropriately, while also maintaining the collegiality of the board.

Continually Educate Directors. For the board to be effective, directors need to have an understanding of the corporation, its business and the industry in which it operates. The corporation should structure new-director-orientation programs to enable directors to gain insight into the corporation's business, strategy and risk profile, as well as ongoing director development and training to help directors keep abreast of industry- and corporation-specific developments and specialized issues. These programs should be periodically reviewed to ensure their continued usefulness. The corporation may find it useful to have an annual two- to three-day board retreat with the senior executives and, where appropriate, outside advisors, at which there is a full review of the corporation's strategy and long-range plans, budget, objectives and mission, financial statements and disclosure policies, risk profile, succession planning and current developments in corporate governance.

The board and CEO should together determine the information the board should receive and periodically reassess its information needs. The key is to provide useful and timely information without overloading the board. In addition to current financial and operating information, the board should receive significant security analysts' reports and relevant press articles and other media reports on the corporation. Director education can be supplemented with specialized tutorials and site visits. The board should promote lines of communication that will foster open and frank discussions with senior management. In each case, director training and information should be customized to the issues most important to the particular corporation.

Conduct Candid Self-Assessments. Ongoing candid assessments of director, board, and committee performance are a necessary tool in evaluating effectiveness and determining areas for improvement. There are a variety of approaches to formulating an effective evaluation process, and the board should not feel compelled to adopt any particular form of board review. Many consulting firms have published their recommended forms and procedures for conducting evaluations and have established advisory services in which they meet with a board and committee members to lead them through the evaluation process. While these services may be helpful, it is not required that the board receive outside assistance or that multiple-choice questionnaires and/or essays be the means of evaluation.

Manage Risk Effectively. One of the most challenging tasks facing the board is risk management. The corporation must manage a host of complex business, financial, legal and other risks that require vigilance, technical expertise and resources. Risk management has evolved from being viewed primarily as a business and operational responsibility of management to being characterized also as a key governance issue that is squarely within the purview of the board, and accordingly, oversight of risk management should be a priority for the board and an area of regular assessment.

In fulfilling its risk management function, the board's role is one of informed oversight rather than direct management of risk. The board cannot and should not be involved in the corporation's day-to-day risk management activities. Rather, directors should determine the corporation's reasonable risk appetite and satisfy themselves that the risk management processes designed and implemented by risk managers are adapted to the corporation's strategy and are functioning as expected, and that necessary steps have been taken to foster a culture of risk-adjusted decision-making throughout the corporation. Through its oversight role, the board can send a message to management and employees that comprehensive risk management is neither an impediment to the conduct of business nor a mere supplement to the corporation's overall compliance program, but is instead an integral component of corporate strategy, culture and the value-generation process. Where board committees are responsible for overseeing different areas of risk management, the work of these committees should be coordinated in a coherent manner so that the entire board can be satisfied as to the adequacy of the risk oversight function.

Manage Crises Carefully and Proactively. Even with effective risk management, crises will emerge and test the board, with potential situations ranging from unexpected departures of the CEO and other senior executives, rapid deterioration of business conditions, impending liquidity shortfalls, compliance violations, risk management failures or major disasters, public uproar over executive compensation and other challenges. The board should be carefully attuned to the risk profile and vulnerabilities of the corporation with a view toward anticipating and preparing for potential crises. 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 management team. Once a crisis starts to unfold, the board needs to be proactive and provide careful guidance and leadership in steering the corporation 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, however, should be mindful not to overreact, including by reflexively displacing management or ceding control to outside lawyers, accountants and other outside consultants.

Cybersecurity Matters. Online security breaches, theft of proprietary or commercially sensitive information and damage to information technology infrastructure can have a significant financial and reputational impact on a corporation. Given the increasing pervasiveness of cloud computing, mobile technology and social media, and an increasing number of high-profile corporate cyber-attacks, the importance of active and informed board oversight of cybersecurity matters has become a key concern of investors. The board's oversight of cybersecurity has two critical components: risk management and crisis management.

Carefully Consider Extraordinary Transactions on an Informed Basis. When evaluating a board's decision with respect to a major corporate transaction, such as a merger, significant acquisition, spin-off, investment or financing, or rejecting a merger proposal or hostile takeover bid, courts will generally respect the business judgment of the board so long as directors act on an informed basis, in good faith and not in their personal self-interest. Care should be taken so that the board receives the information necessary in order to make an informed and reasoned decision. Management should build a strong foundation to support a major transaction, including an appropriate due diligence investigation. Unless for documented good reasons it is not practical, the board should have ample time to consider a major transaction.

If the corporation has the internal expertise to analyze the requisite data and present it in a manner that enables the board to consider the alternatives and assess the risks and rewards, the board is fully justified in relying on management presentations without the advice of outside experts. However, while outside experts are not always necessary, it may be desirable for the board to retain experienced outside advisors to assist with major transactions, particularly where there are complicated financial, legal, integration, culture or other issues or where it is useful for the board to obtain independent objective outside guidance. In any event, the board should recognize that shareholder litigation against the corporation and its directors is part of modern corporate life, and such litigation should not deter the board from approving a significant acquisition or other material transaction, or accepting or rejecting a merger proposal or takeover bid.

Periodically Review Governance and Thoughtfully Consider Shareholder Proposals. The board and its committees should periodically review bylaws, corporate governance guidelines, committee charters, codes of conduct and other governance policies and tailor them to promote effective board functioning. When faced with shareholder proposals or other governance activism, directors should pragmatically evaluate whether the proposed changes will in fact promote long-term value creation. As part of a pragmatic approach, directors should consider whether shareholder proposals can be accommodated without significant difficulty or harm to the corporation, bearing in mind that their receptiveness to shareholder proposals is monitored by activists and proxy advisors. In some circumstances it may be advisable to adopt a "wait and see" approach, while other situations may warrant a more proactive approach. By paying attention to changes in the governance landscape, and by being proactive in shareholder communications and disclosure, a board is more likely to create the right environment for acting on shareholder proposals regardless of whether the ultimate determination is to accept or reject them. In the New Paradigm, corporations and investors alike must distinguish between governance changes that are meaningful to long-term value creation and governance changes intended simply to increase the pressure that short-term financial activists can exert when advocating for short-sighted strategies.

Fairly Compensate Directors. The board should provide compensation for directors that fairly reflects the significantly increased time commitment, responsibility, energy and exposure to public scrutiny and potential liability now involved with board and committee service. The compensation committee or the nominating and governance committee should determine or recommend to the board the form and amount of director compensation with appropriate benchmarking against peer companies. In addition to determining compensation, the board should determine appropriate stock holding requirements in order to promote continued alignment between directors and shareholders. It is legal and appropriate for basic directors' fees to be supplemented by additional amounts to chairs of committees and to members of committees that meet more frequently or for longer periods of time, including special

committees formed to review major transactions or litigation. While there has been a trend to establish stock-based compensation programs for directors, the form of such programs should be carefully considered to ensure that they do not create the wrong types of incentives for directors. In the current environment, restricted stock grants, for example, may be preferable to option grants, given that stock grants will align director and shareholder interests more directly and avoid the perception that option grants may encourage directors to support more aggressive risk-taking on the part of management to maximize option values.

Protect Confidentiality of Boardroom Discussions. Confidentiality is essential for an effective board process and for the protection of the corporation. 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 corporation with respect to information they learn about the corporation in the course of their duties. Maintaining confidentiality is also essential for the protection of individual directors, given that directors can be responsible for any misleading statements attributable to them. Even when a director believes the subject matter of his or her statements is within the public domain, it is good practice for an individual director to avoid commenting on matters concerning the corporation. A director who receives an inquiry may or may not have all of the relevant information, and his or her response could involve the corporation, as well as the director, in a disclosure violation. Directing public communications through a single spokesperson, such as the CEO, allows the corporation to speak with a unified voice. Director confidentiality is not inconsistent with engagement pursuant to the New Paradigm. Prior to a director meeting with an investor, the director should review with counsel for the corporation how to comply with the disclosure regulations.

Determine Appropriate Frequency and Agenda of Executive Sessions. If an executive session is not scheduled for each regular meeting of the board, the board should establish a schedule of regular executive sessions. The board should establish the agenda for each executive session. Executive sessions provide the opportunity for meaningful review of management performance and succession planning and can serve as a safety valve to deal with problems. They should not be used as a forum for revisiting matters already considered by the full board and should not usurp functions that are properly the province of the full board. A board should be careful that the use of executive sessions does not have a corrosive effect on board collegiality and relations with the CEO.

Use Committees Appropriately. With respect to the committees required by regulations and stock exchange listing rules, the corporation should carefully consider which directors satisfy the requirements for service on such committees, and questionnaires may be used to determine and document both independence and qualifications. The committees should have the authority to retain consultants and advisors. However, committees should be careful to exercise their own independent judgment and not to over-rely on consultants. The corporation's own general counsel or CFO can often provide more pertinent advice and insight than that available from outside sources. In addition to the core committees, the board may wish to establish additional standing committees to meet ongoing governance or oversight needs appropriate to the corporation's business or industry, such as a risk management committee (if this function is not being performed by the audit committee), a compliance committee or a committee on social responsibility.

The board may also use special committees from time to time to deal with conflict transactions (such as a management buyout) or other major corporate events (such as shareholder litigation) or to address particular investigations or projects. While the use of special committees is appropriate and useful in many circumstances, such committees are also often used in situations where it might be best to keep the matter before the full board or all of the non-executive members of the full board. Special committees can sometimes become divisive in sensitive situations, and there is a risk that the special committee and its outside advisors may take a matter in a direction that would be different than that desired by the full board.

The work of the board will be facilitated by establishing the appropriate relationship between the board as a whole and each of its committees, regular and special. The board should take care to oversee the coordination and staffing of its committees to ensure that the work of the committees is neither duplicated nor ignored by the board as a whole. It is particularly important that committees keep the full board, as well as management, apprised of significant actions.

Get the Right Mix of Directors in the Boardroom. The effectiveness of any corporate governance structure in facilitating the long-term success of the corporation is largely dependent on the quality of the individuals implementing it. In the New Paradigm, it is important to have the right directors in the boardroom, both individually and collectively. In recent years, the concept of board refreshment

has gained traction with corporate governance advocates. This catchphrase is an amalgamation of several issues relating to board composition—including director independence, tenure, age, retirement and diversity. The risk, however, is that refreshment is being advocated as an end in itself rather than as a means to achieve a well-functioning board. Board composition is more an art than a science and should include consideration of the following factors:

Independence. One of the key themes of the governance activism agenda has been advocacy of boards consisting almost exclusively of independent directors as well as increasingly narrow standards of independence for directors. While independence is an important consideration, it is only one of several. The emphasis on director independence should not cause the board to lose sight of the importance of other qualifications, such as diversity and expertise. What the corporation needs are directors who possess sufficient character and integrity to allow them to make judgments that are unbiased by personal considerations.

Diversity. Directors with diverse backgrounds and experiences strengthen board performance. Boards should develop a system for identifying diverse candidates. Women and minority candidates should be regularly considered for open directorships. If necessary to create a diverse board, the size of the board should be increased.

Age and Tenure. While age and tenure may be relevant factors in ensuring a balanced board, bright-line rules that presume directors to be non-independent after a specified period of board service should be resisted, as they can force the arbitrary loss of valuable directors and are a poor proxy for what really matters. Substantive director evaluations and re-nomination decisions that are taken seriously by the board will serve the corporation better than arbitrary tests. An assessment of independence requires a more nuanced determination than calculating a person's age or tenure. In some cases, lengthy service may in fact suggest *enhanced* independence — for example, a director who has been part of the board since long before the current management team, or is a generation older than the CEO, may be more likely to challenge management if the need arises. In addition, long-serving directors with a deep understanding of the corporation's business and culture and first-hand knowledge of the ways in which the corporation has evolved, and who continue to be motivated and engaged, can be truly irreplaceable.

Competence and Integrity. The most important criteria for a director are competence and integrity. A competent board consists of intelligent, dedicated and well-qualified individuals with appropriate skills, experience, expertise, education, background and perspectives. The composition of the board, as a whole, should reflect a mix of qualities and attributes that are appropriate for the corporation given its circumstances and that, collectively, enables the board to function effectively. In addition, each director should comport himself or herself with integrity, character and professionalism and exercise sound judgment. Every director should represent the interests of all shareholders and other stakeholders and demonstrate a commitment to the corporation, its business plans and long-term value.

Collegiality. After competence and integrity, the next most important (yet often underemphasized) consideration is collegiality. A director's personality, leadership style, communication style and existing business, civic and philanthropic relationships should be considered when anticipating how a new director will affect overall board dynamics. A board works best when it functions as a unified whole, without factions and without internal divisions. While qualities such as mutual respect, trust, sense of common purpose, energy, business sense and openness may be difficult to quantify or describe with precision, they are very much at the heart of effective board functioning. In thinking about board composition, 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 in handling the multi-dimensional responsibilities inherent in its role 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.

Commitment to Director Responsibilities. The corporation should seek to ensure that the board consists of individuals who understand and are willing to shoulder the substantial (and increasing) work load and time commitment required for board service. To maintain the requisite standing board committees and ensure that the increasingly complex and time-consuming matters that the board and committees are expected to oversee receive the appropriate attention of directors, the corporation should consider limitations on the number of other boards on which a director sits. While not easily reduced to a formula, it is undeniable that serving on multiple outside boards, especially with committee involvement, may place significant and conflicting demands on time. Additionally, directors must also be sufficiently "thick-skinned" and willing to subject themselves to the scrutiny of public corporation board service.

Recruiting and retaining directors has become challenging, particularly with respect to directors who possess skills and experiences that are in high demand, as many candidates may be discouraged from serving on boards due to the reputational risks of withhold-the-vote campaigns, proxy contests and associated public and personal attacks on directors, sensationalist publicity over executive compensation, shareholder litigation and the potential for high-profile risk management lapses.

Board Leadership. The board should have an independent board leader, whether such role is fulfilled by a non-executive chairman or by a lead independent director. There is no conclusive evidence one way or another that separating the CEO and chairman roles will enhance the accountability of the CEO to the board, strengthen the board's independence from management or ultimately improve firm performance. Subject to regulation or established policies, the corporation should determine what makes sense for it at a given point in time based on the corporation's particular needs and circumstances. In some cases, a strong, cohesive board may find that it is most effective in performing its monitoring and oversight role by acting as a unified whole, rather than designating an independent chairman to organize this function, and may determine that the advantages of having a CEO chairman with extensive knowledge of the corporation, and who can serve as a bridge between the board and management, outweigh potential disadvantages. In any event, a corporation that does not have an independent chairman should have an independent lead director to supplement the chairman's role by, for example: (i) presiding at board meetings at which the chairman is not present, including executive sessions of independent directors, (ii) serving as a liaison between the CEO chairman and the independent directors, (iii) overseeing information sent to the board, (iv) approving meeting agendas and meeting schedules of the board to assure there is sufficient time for discussion of all agenda items, (v) having the ability to call meetings of the independent directors and (vi) being available for consultation and direct communication with major shareholders where appropriate. The specific contours of a lead director's role should be determined based on the specific needs of the corporation and the views of its major investors.

IV. ROLE OF INVESTORS IN THE NEW PARADIGM

A cornerstone principle of the New Paradigm is engaged, responsible stewardship of corporations by institutional investors who take an active but measured role in supporting long-term investment by corporations. The New Paradigm contemplates that engagement will be a two-way street, with investors holding up their end of the bargain by (i) actively listening and reviewing company communications about strategy, long-term objectives and governance, (ii) participating in meetings or other bilateral communications where the investors feel that further engagement is warranted, and (iii) communicating their own preferences, expectations and policies that they use to engage with and evaluate corporations. The purpose of such engagement is for investors to delve beyond check-the-box-governance mandates and quarterly or annual financial metrics in order to develop a more nuanced understanding of a corporation's governance and long-term business strategy. And, where a corporation satisfies its investors that it has an engaged, thoughtful board that has embraced good governance principles and is overseeing a reasonable, long-term strategy, investors will demonstrate steadfast support for the corporation in the face of short-termist pressures.

In March 2016, *The Investment Association*, a British organization that represents leading institutional investors, issued a report with the encouragement and participation of the British government that describes stewardship principles in a manner appropriate for the New Paradigm:

While the primary responsibility for promoting the success of a company rests with the Board and its oversight of management, investors play a crucial role in holding the Board to account for the fulfillment of its responsibilities. Shareholder stewardship should aim to promote the long-term success of companies in such a way that the ultimate providers of capital will also prosper. In this sense, there should be a natural alignment of interests: effective stewardship should benefit companies, investors and the economy as a whole.

Supporting long-term investment and productivity requires effective dialogue between investors and companies. By exercising stewardship responsibilities effectively, investors are well placed to ensure companies adopt a long-term approach. For example, through purposeful dialogue, shareholders can demonstrate support for expenditures that will boost productivity and challenge companies compromising it as a result of poor capital management.

So, too, the *2016 International Corporate Governance Network Stewardship Principles*.

Engage and Communicate with Corporations. Investors should be active listeners and, where appropriate, they should be proactive in engaging in dialogue with a corporation as part of a long-term relationship. Engagement can be an especially effective means of bringing about change when the relationship between a corporation and an investor is based on trust, respect and a collaborative mentality, all of which require time and energy to develop. In order to dedicate sufficient time and attention to effective engagement, investors should increase their in-house staffing and capabilities, should not hire a consultant that will not engage with a corporation on the same basis on which the investor will engage and should take the time to understand a corporation's business plan and long-term strategy and get to know its management. In this regard, the *U.K. Stewardship Code* published by the Financial Reporting Council serves as a useful template, insofar as it seeks to "enhance the quality of engagement between asset managers and companies to help improve long-term risk-adjusted returns to shareholders." The key principles of the Stewardship Code are that institutional investors should (i) publicly disclose their policy on how they will discharge their stewardship responsibilities, (ii) have a robust policy on managing conflicts of interest in relation to stewardship, which should be publicly disclosed, (iii) monitor their investee corporations, (iv) establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value, (v) be willing to act collectively with other investors where appropriate, (vi) have a clear policy on voting and disclosure of voting activity and (vii) report periodically on their stewardship and voting activities.

As part of effective engagement, an investor should state its expectations for a corporation clearly and unequivocally and provide candid and constructive feedback to the corporation. This includes the investor's expectations with respect to, among other things, its preferences for engagement—for example, whether it prefers an in-person meeting, enhanced or different disclosure in periodic reports or some other form of engagement and whether, if it wants a meeting, the investor prefers such meeting to include independent directors or specific executives. To the extent that an investor's expectations for any given corporation evolve over time, the investor should proactively communicate those changes to the corporation. Relatedly, in the course of its engagement with a corporation, an investor should provide its view of the corporation's performance, management, board, governance and engagement.

In addition, the concept of engaged ownership calls for an investor to actively vote, or refrain from voting, its shares on an informed basis in a manner consistent with the best interests of its long-term beneficiaries, without abdicating decision-making to proxy advisory firms. An investor should develop the internal expertise and staffing necessary to formulate its own voting guidelines, communicate with corporations and evaluate matters presented to a shareholder vote. At a minimum, an investor should not outsource to a proxy advisory firm that uses inflexible metrics to make its recommendations, does not have qualified personnel or does not provide ample notice and opportunity for discussion with a corporation about the advisory firm's proposed recommendation. In a contested vote, an investor should promptly inform the corporation of its position and its reasons for taking such position.

Support Long-Term Strategies. An investor should support a corporation in pursuing strategies for long-term growth and value creation, including with respect to the corporation's development of strategies that promote long-term investment, value human capital, appropriately integrate ESG/CSR factors into long-term strategy and implement compensation structures that encourage and reward executives for long-term value creation. This includes standing by a corporation during cyclical downturns or short-term market turbulence, or during periods in which the benefits of long-term investments have not yet been fully realized, so long as the corporation's long-term strategy continues to be valid. An investor's support should be expressed through constructive engagement, public expressions of support, and voting in favor of management proposals. In addition, an investor can promote a long-term perspective by supporting corporations in moving away from quarterly earnings guidance and using its influence to discourage sell-side analysts from "whisper" earnings and similar short-term targets. To the extent an investor believes the corporation should consider adjustments to its long-term strategy, it should communicate its views directly to the corporation, but this does not mean that the investor needs to abandon its support for the corporation in resisting the short-termism advocated by activists. In the New Paradigm, investors and corporations should seek to work together toward the creation of sustainable long-term value.

As part of its stewardship role, investors should be prepared to support corporations facing short-termist pressures from activists. By going on the public record to speak out against short-term demands, institutional investors can serve as a “buffer” and minimize the outsized disruption and impact that outspoken activists can have when they operate unchallenged by the vast majority of other shareholders whose interests are inconsistent with the short-term investment horizon of the activists. The support of institutional investors, and the vocal endorsement from respected and influential investors to act as a “champion” for the corporation, can be decisive.

Importantly, in considering whether to support an activist attack on a corporation, investors should be mindful of the message that any such support will send to other corporations that are considering whether to tailor their business strategies to meet short-term objectives and avoid interest from a short-term financial activist. Even periodic or minor deviations by major institutional investors in favor of short-termism can significantly undermine the confidence and resolve of boards and management teams to maintain a long-term focus.

Help Corporations Correct Long-Term Strategies or Failures to Execute on Long-Term Strategies. If an investor believes a corporation is headed in the wrong direction, the investor should provide the corporation with prompt notice of its concerns and invite the corporation to engage with the investor. Such matters are best addressed in the first instance through private engagement and cooperation between corporations and investors, in the joint pursuit of their common goal—the creation of long-term value—and not through support for activists who engage in public battles over strategy. An investor should seek to work collaboratively with boards and management to correct subpar strategies and operations, without the need to publicly embarrass them or take credit for positive changes. If an investor publicly discloses a negative opinion about a corporation, the investor should state as part of that disclosure whether it provided an opportunity to the corporation to engage. In the New Paradigm, institutional investors should recognize that public battles and proxy contests have real costs beyond the corporation in question and should accordingly view such measures as a last resort where constructive engagement has failed. If an investor feels that the board of a corporation would be strengthened by adding an independent director, it should engage with the corporation to suggest a candidate to be considered by the nominating committee.

Adopt Integrated Long-Term Investment Approach. As part of its efforts to combat short-termism, an investor should consider appropriate policies and actions it can take to promote a long-term perspective throughout its own organization. The March 2015 *“Long-Term Portfolio Guide”* by Focusing Capital on the Long Term provides a number of useful suggestions in this regard. These suggestions include an integrated long-term investment approach that, among other things, establishes a firm-wide culture of long-term thinking and patient capital that persists through cycles of short-term turbulence, emphasizes disciplined research of corporations’ fundamentals that have the ability to generate real long-term value, discourages over-reliance on stock price and short-term quantitative metrics as performance indicators, and allows portfolio managers to remain focused on long-term outcomes and to act consistently with the time horizons of its clients and asset owners (who are often investing for retirement, financial stability and wealth to pass on to heirs). An integrated long-term investment approach should also aim to ensure that investment professionals are compensated by the institutional investors for whom they work in a way that encourages them to invest for the long term and discourages them from sacrificing long-term value in order to capture short-term swings in stock prices. This is undoubtedly a challenge, and institutions will need to develop customized approaches. Some institutions, for example, have implemented clawback arrangements or required employees to invest in “parallel portfolios.” Evaluations and compensation based on qualitative assessments, such as consistent adherence to agreed-upon strategies, may also be useful.

Integrate Relevant Sustainability, Citizenship and ESG/CSR Matters into Investment Strategy. Just as corporations should take into account relevant ESG/CSR, citizenship and sustainability factors when developing their long-term strategies, institutional investors should likewise consider such factors in their investment strategies. While there is no single method for integration of sustainability, citizenship and ESG/CSR considerations, institutional investors may wish to consider the following, some of which are already underway by leading institutional investors: (i) creation of portfolio ESG risk profiles to stimulate discussion among portfolio managers on ESG factors; (ii) incorporation of ESG metrics into firm-wide risk management and investment platforms; (iii) training of portfolio managers on identifying material ESG factors for corporations to help them engage corporations and clients on these issues; (iv) research of individual ESG factors and their materiality to corporations in specific sectors to help inform

investment analysis and risk measurement; and (v) engagement in robust dialogue with corporations with respect to the thinking of management and boards on the importance of ESG factors.

Disclose its Policies and Preferences. As part of their engagement efforts, investors should be proactive in communicating their policies and preferences. In particular, an investor should consider disclosing:

- whether it has adopted the New Paradigm as a framework for its relationship with a corporation;
- its preferred procedures for engagement and its primary contacts for engagement with corporations;
- its investment policies, the metrics it will use to evaluate a corporation's success and any other expectations that the investor has for corporations;
- its position on ESG and CSR matters, including with respect to integration of relevant metrics into strategy, effects on long-term firm value and a corporation's disclosure of such matters;
- whether it uses consultants to evaluate strategy, performance and transactions and how a corporation can engage with those consultants;
- the governance procedures it considers significant and how the investor considers those procedures in evaluating strategy, performance and transactions;
- its views as to the manner in which a corporation should make its mandatory quarterly reports and its views as to the desirability of a corporation giving guidance as to quarterly earnings;
- whether it invests in short-term financial activists and its policy with respect to discussing its questions or concerns about a corporation's performance with short-term financial activists; and
- its procedures and policies with respect to voting, or refraining from voting, on issues submitted by a corporation for shareholder approval, including the identity and qualifications of the investor's employees who are making those decisions.

* * * * *

V. CONCLUSION

The World Economic Forum has long been concerned with facilitating an environment that is conducive to long-term investment and sustainable growth. The enabling factors of corporate social responsibility, quality employment, and human capital are important levers against the dangers of rising inequality and political tensions. The resurgence and momentum of the recent focus on deploying capital to generate long-term wealth creation and economic prosperity is encouraging. This project organized by the International Business Council of the World Economic Forum is a testament to the global desire and efforts to restore a focus on the long-term sustainability of corporations. We are optimistic that the endorsement and implementation by corporations and investors of the New Paradigm outlined in this report will effect meaningful and lasting change.

2 September 2016 /MDR

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Selected Thought Leadership on Short-Termism and Public Trust

This document presents a selection of the most influential articles and studies on the topic of “short-termism”. It is meant as a quick reference piece, including key take-aways and insights from the articles. Readers are encouraged to review the articles in more detail for a better understanding of the views presented.

1. **The Misguided Practice of Earnings Guidance.** McKinsey & Company Insights and Publications, <http://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/the-misguided-practice-of-earnings-guidance>, **March 2006.**
 - a. Contrary to popular belief, bottom-line earnings guidance does not improve shareholder returns or reduce stock price volatility, yet it comes with a significant cost in management time and attention and drives an excessive focus on quarterly results.

2. **Long-Term Value Creation,** The Aspen Institute, **June 2007.**
https://assets.aspeninstitute.org/content/uploads/files/content/docs/pubs/Aspen_Principles_with_signers_April_09.pdf
 - a. Define metrics for your firm’s long-term value creation
 - b. Focus corporate/investor communication around long-term metrics
 - c. Align company and investor compensation policies with long-term metrics

3. **Overcoming Short-Termism,** The Aspen Institute, **September 2009.**
<https://assets.aspeninstitute.org/content/uploads/files/content/images/BSPonlineBroch.pdf>
 - a. Call to action on three points: encourage more patient capital through tax changes and enhancing rights for longer term shareholders; better align interests of financial intermediaries and investors; and strengthen investor disclosures.
 - b. Endorsed by prominent institutional investors, CEOs of major corporations, and others.

4. **The Impact of Corporate Sustainability on Organizational Processes and Performance.** Robert G. Eccles, Ioannis Ioannou, and George Serafeim,
http://www.hbs.edu/faculty/Publication%20Files/SSRN-id1964011_6791edac-7daa-4603-a220-4a0c6c7a3f7a.pdf. **November 2011.**
 - a. Widely cited study of 180 U.S. companies over an 18-year period demonstrates that companies with long-term strategies outperform companies that are short-term oriented.
 - b. Longer term oriented companies out-perform shorter term focused companies in both stock price performance and accounting measures.

5. **Focusing Capital on the Long-Term**, Dominic Barton and Mark Wiseman. Harvard Business Review, January-February 2014, <https://hbr.org/2014/01/focusing-capital-on-the-long-term><https://hbr.org/2014/01/focusing-capital-on-the-long-term>.
 - a. Companies are less able to invest and build value for the long-term, undermining economic growth and lowering returns on investment for savers.
 - b. Pressure to deliver strong short-term results stems from boards of directors, who are channeling increased short-term pressures from institutional shareholders.
 - c. Action must start with large asset owners, such as pension funds, then other key players – asset managers, corporate boards and company executives – will likely follow suit.

6. **Focusing Capital on the Long-Term Initiative**. Website contains discussion papers and other resources. <http://www.fclt.org/en/home.html>

7. **The Conference Board Governance Center White Paper: What is the Optimal Role of Management, Directors and Investors in the Governance of Public Corporations?** <https://www.conference-board.org/publications/publicationdetail.cfm?publicationid=2711> March 2014.
 - a. Provides a comprehensive overview of the evolution of US corporate governance and describes the principal issues in corporate governance today, including short-termism.

8. **Recommendations of the Task Force on Corporate/Investor Engagement**. The Conference Board Governance Center Task Force Report <https://www.conference-board.org/publications/publicationdetail.cfm?publicationid=2712>. March 2014.
 - a. Recommends that investors and directors endorse the proposition that the interests of all stakeholders must be taken into account to achieve sustainable shareholder value. “...executives must infuse their organizations with the perspective that serving the interests of all stakeholders – employees, suppliers, customers, creditors, communities, the environment – is not at odds with the goal of maximizing corporate value; on the contrary, it’s essential to achieving that goal.”
 - b. Directors should take into account investors’ viewpoints on the governance and strategy of the corporation in the exercise of their fiduciary duties to all investors and to the company as a whole.
 - c. Regulators should examine the proxy voting system as corporate elections have become less routine and more contested.

9. **How Finance Gutted Manufacturing.** Suzanne Berger, Boston Review, <https://bostonreview.net/forum/suzanne-berger-how-finance-gutted-manufacturing> April 2014
- a. A concise analysis of the decline of US manufacturing based on MIT research and a case study of Timken, a manufacturing company broken up by a California pension plan and a hedge fund activist.
 - b. Concludes that since the 1980's, financial market pressures have driven companies to hive off activities that sustained manufacturing.
10. **Is Short-Term Behavior Jeopardizing the Future Prosperity of Business?** The Conference Board, <https://corpgov.law.harvard.edu/2015/10/30/is-short-term-behavior-jeopardizing-the-future-prosperity-of-business> (summary), <https://www.conference-board.org/publications/publicationdetail.cfm?publicationid=5041> (full report) October 2015
- a. What is short-term or long-term depends on the industry. The issue is how to deliver strong performance today while investing for tomorrow, not the time period.
 - b. In the last decade business investment has steeply declined as compared with profits available for investment, while payouts to shareholders have dramatically increased.
 - c. A number of economists have concluded that this short-term focus is taking a toll on the overall economy, contributing to the slowdown in growth in advanced economies since the recession of 2008. For example:
 - i. Pavlos Masouros: the shift from “retain and invest” to “downsize and distribute” has contributed to low GDP growth rates in France, Germany, the Netherlands, the United Kingdom and the United States.
 - ii. Stephen Terry: one consequence of quarterly capitalism is R&D inefficiency, as companies cut or expand R&D spending to meet earnings estimates. He calculates the macroeconomic effect on the US economy of approximate \$50 billion per year from this issue alone.
 - d. Activist hedge funds are a significant driver of short-term behavior and shareholder primacy thinking, but do they create long-term value?
 - i. Evidence is clear there is a positive impact to stock price at the announcement of an intervention.
 - ii. Evidence is mixed whether there is a long-term effect. The success of most activist interventions comes largely from jump starting a takeover or bust up.
 - e. Recommendations for public companies include:
 - i. Substitute progress against long-term metrics for bottom line quarterly earnings guidance.
 - ii. When making capital allocation decisions, consider stock buybacks and dividends in the context of capital allocations to support growth strategies and investments in people.
 - iii. Reward long-

- iv. term thinking in executive compensation design.
- v. Consider rewards for longer term investors. Specific examples are provided of companies that have implemented rewards for longer term investors.

11. The Board and Long-Term Value Creation, Report of the NACD Blue Ribbon Commission, October 2015

- a. Factors encouraging a short-term focus are stronger now than ever before. Some are external, but others are directly within the board's sphere of responsibilities, including the strategy development process; capital allocation; management incentives; oversight of corporate culture; and communication with analysts, investors, and other constituencies.
- b. Makes 10 recommendations for boards to support long-term value creation:
 - i. The board's role is to ensure alignment with long-term strategy is well established and clearly articulated by management.
 - ii. Directors need to factor substantial preparation time into their board duties.
 - iii. CEO selection and evaluation processes should include an assessment of the extent to which the CEO is an effective advocate for the firm's long-term strategy.
 - iv. Directors should seek information—about the business environment, the company's relative performance, and emerging risks and opportunities—from a range of internal and external sources.
 - v. Boards should ensure that major capital allocation and annual budget decisions reflect long-term strategic objectives as well as short-term priorities.
 - vi. Include a component related to progress against long-term goals and objectives in the annual incentive plans.
 - vii. The nominating and governance committee should approach board composition and succession planning with long-term needs in mind, based on the director skills that will be most relevant to the company's strategy in 3, 5, or more years.
 - viii. Make clarifying the connection between the company's short- and medium-term actions and its longer-term strategic objectives a primary objective of investor communications.
 - ix. Boards should consider recommending a move away from quarterly earnings guidance.
 - x. The company's shareholder communications plan should include preparing designated members of the board to engage directly with investors on selected governance matters, including oversight of long-term strategy.

12. **Hedge Fund Activism: A Guide for the Perplexed**, John C. Coffee, Jr., <http://clsbluesky.law.columbia.edu/2016/01/25/hedge-fund-activism-a-guide-for-the-perplexed/> **January 2016**.
- Concise review of research on whether hedge fund activism creates long-term value, concluding that it does not.
 - Offers policy recommendations to make “wolf pack” attacks by hedge funds working in concert more difficult; e.g., by shortening the 10-day window for reporting a 5% interest and defining a “group,” which may be the most important change.
13. **Makers and Takers: The Rise of Finance and the Fall of American Business**. Rana Foroohar, <https://www.amazon.com/Makers-Takers-Finance-American-Business/dp/0553447238>, **May 2016**
- Traces the rise of finance in the economy, and argues that capital markets should be rebalanced to better support business.
 - Contains an analysis of the effects of activist shareholders on business thinking, including the rise of financial engineering among public companies, using Apple as a case study. From Steve Jobs: “Manage the top line, which is your business strategy, your people – the talent you have – and your products. Do all that stuff right, and the bottom line will follow” to Tim Cook, who, after prodding from Carl Icahn, launched a massive stock buy-back program to boost the share price.
14. **Commonsense Principles of Corporate Governance**, http://www.governanceprinciples.org/wp-content/uploads/2016/07/GovernancePrinciples_Principles.pdf. Endorsed by CEOs of major public companies, institutional investors, and an activist investor, organized by Jamie Dimon. See website at <http://www.governanceprinciples.org/> **July 2016**
- Truly independent corporate boards are vital to effective governance, so no board should be beholden to the CEO or management. Every board should meet regularly without the CEO present, and every board should have active and direct engagement with executives below the CEO level;
 - Diverse boards make better decisions, so every board should have members with complementary and diverse skills, backgrounds and experiences. It’s also important to balance wisdom and judgment that accompany experience and tenure with the need for fresh thinking and perspectives of new board members;
 - Every board needs a strong leader who is independent of management. The board’s independent directors usually are in the best position to evaluate whether the roles of chairman and CEO should be separate or combined; and if the board decides on a combined role, it is essential that the board have a strong lead independent director with clearly defined authorities and responsibilities;
 - Our financial markets have become too obsessed with quarterly earnings forecasts. Companies should not feel obligated to provide earnings guidance – and should do so only if they believe that providing such guidance is beneficial to shareholders;

- e. A common accounting standard is critical for corporate transparency, so while companies may use non-Generally Accepted Accounting Principles (“GAAP”) to explain and clarify their results, they never should do so in such a way as to obscure GAAP-reported results; and in particular, since stock- or options-based compensation is plainly a cost of doing business, it always should be reflected in non-GAAP measurements of earnings; and
 - f. Effective governance requires constructive engagement between a company and its shareholders. So the company’s institutional investors making decisions on proxy issues important to long-term value creation should have access to the company, its management and, in some circumstances, the board; similarly, a company, its management and board should have access to institutional investors’ ultimate decision makers on those issues.
15. **Buy Backs and the Board**, IRRRC Institute and Tapestry Network, <http://irrcinstitute.org/wp-content/uploads/2016/08/FINAL-Buybacks-Report-Aug-22-2016.pdf>, August 2016
- a. The data on stock buy backs are clear. Between 2003 and 2013, S&P 500 companies doubled their spending on share repurchases and dividends while cutting their spending on investments in new plants and equipment. According to data from McKinsey, buybacks have accounted for 47% of US companies’ income since 2011, up from 23% in the early 1990s and less than 10% in the early 1980s.
 - b. This report reviews research on the key issues raised with stock buy backs and then summarizes the perspectives of 44 directors of 95 public companies. The directors tend to respond that buybacks are well considered and justified, although some agree with critics that buybacks have adverse effects contributing to a lack of investment and over spending on compensation.
 - i. The reasons directors cite for approving buy backs are to: return capital to shareholders, invest in the company’s shares, offset dilution, and alter the company’s capital structure reducing equity and increasing debt.
 - ii. Directors generally acknowledge that pressure from shareholders is a key factor leading to buy backs.



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