© Yoo Jaechang/TongRo Images/Corbis

Governance Priorities for 2014

In her regular column on corporate governance issues, Holly Gregory explores key governance priorities for both shareholders and boards in the year ahead.

HOLLY J. GREGORY
PARTNER
SIDLEY AUSTIN LLP

Holly counsels clients on the full range of governance issues, including fiduciary duties, risk oversight, conflicts of interest, board and committee structure, board leadership structures, special committee investigations, board audits and self-evaluations, shareholder initiatives, proxy contests, relationships with shareholders and proxy advisors, compliance with legislative, regulatory and listing rule requirements, and governance best practice.

As the fallout from the financial crisis recedes and both institutional investors and corporate boards gain experience with expanded corporate governance regulation, the coming year holds some promise of decreased tensions in board-shareholder relations. With governance settling in to a "new normal," influential shareholders and boards should refocus their attention on the fundamental aspects of their roles as they relate to the creation of long-term value.

Institutional investors and their beneficiaries, and society at large, have a decided interest in the long-term health of the corporation and in the effectiveness of its governing body. Corporate governance is likely to work best in supporting the creation of value when the decision rights and responsibilities of shareholders and boards set out in state corporate law are effectuated.

This article identifies and examines the key areas of focus that institutional investors and boards should prioritize in 2014.

INSTITUTIONAL INVESTORS

Institutional investors have a considerable and growing influence on corporate affairs, yet given the size of their portfolios, they often face challenges in applying that influence on a company-specific basis. With portfolios of hundreds or even thousands of

© 2014 Thomson Reuters. All rights reserved.

companies, many institutional investors rely on blanket policies to vote their shares regarding particular issues or outsource voting decisions to proxy advisors who rely on similar policies (for information on recent developments in regulating proxy advisors see *Box, Regulation of Proxy Advisors*).

At the same time, expectations of institutional investors are rising. These funds are often relied on for the retirement security or education funding needs of their beneficiaries. Also, as noted by the World Economic Forum, many governments are now looking to large institutional investors, including public pension funds and sovereign wealth funds, to help finance infrastructure improvements and other critical investments. Institutional investors also face calls for better stewardship of the assets in their portfolios.

For the past decade the focus has been on more active involvement by institutional investors as shareholders in attempting to influence company decisions. However, in the new normal, attention is turning to the need for institutional investors and their advisors to act on a more informed company-specific and long-term basis. In particular, institutional investors should:

- Apply a long-term value approach.
- Vote on a company-specific basis where possible.
- Focus on core issues.

LONG-TERM VALUE APPROACH

For pension funds and many other institutional investors, the interests of their beneficiaries are aligned with the successful performance of portfolio companies over the long term. Shareholders generally benefit from healthy companies and a strong US economy measured in years, not quarters. Long-term success requires investment in activities that may not provide returns for some period of time. Institutional investors need to consider whether their own incentive structures adequately encourage the support of long-term investment strategies by portfolio companies.

COMPANY-SPECIFIC VOTING

Applying voting power on a case-by-case, company-specific basis that considers company performance requires significant investment in analytic capacity. Institutional investors should assess whether they:

- Are well-positioned to vote their shares on an informed basis.
- Have designed screens that consider company performance and other factors that may support a change from standard policy, if relying on the application of pre-set policies.

When institutional investors turn to proxy advisors to make voting decisions, they should evaluate how the proxy advisor is positioned to make sophisticated case-by-case determinations. Due diligence is prudent given the significance of the issues on which investors are asked to vote. Board composition is also important, and institutional investors need to rethink using electoral votes to protest a single governance practice where it is unlikely to have a material impact on company performance.

FOCUS ON CORE ISSUES

One way to prioritize the use of analytic resources for proxy voting is to focus tailored analytics on issues that shareholders decide under state corporate law. Shareholder decision rights generally include rights to elect the board, amend the by-laws and approve actions by the board that would work a fundamental change in the structure of share ownership or in the nature of the corporation.

A key shareholder decision is the election of the board. The board should be comprised of persons capable of "managing and directing the affairs of the corporation." This requires a mix of skill sets, experiences and viewpoints, and a board culture of trust in which views can be debated and resolutions reached. Shareholders should consider the make-up of the board as a whole and the rationale provided by the board in advancing a particular director candidate.

Shareholders should vote against a director when they believe that the director has not performed well. With the advent of majority voting in the election of directors, shareholders have real electoral power and should use it accordingly.

Shareholders should also respect that as fiduciaries, directors cannot simply abdicate their business judgment on issues within their purview, by deferring to a majority of the shareholders. Institutional investors should therefore be cautious in using votes in a director election to protest the failure of the board to take a particular action that is unlikely to have any material impact on company performance. The threat of protest votes may chill the type of objective board decision-making that will benefit institutional investors and their beneficiaries in the long term.

THE BOARD

Despite increased shareholder decision rights and influence, the board's fundamental mandate remains to direct the affairs of the company. Key areas for boards to focus on include:

- Defining board priorities.
- Monitoring company performance and setting strategic direction.
- Selecting and compensating the CEO and planning for succession.
- Attending to internal controls, risk management and compliance.
- Preparing for a crisis.
- Engaging with shareholders and responding to shareholder activism.
- Determining board composition needs and leadership structure.

BOARD PRIORITIES

Boards determine how to apportion their very limited time based on board responsibilities and the unique needs of the company. Each board must define the priorities that will shape its agenda and determine the information it needs to govern, driven by the needs of

© 2014 Thomson Reuters. All rights reserved.

the business. Boards add value when they help management cope with the complex context in which the company operates, and when they support management in focusing on the long-term interests of the company and its shareholders.

Active board engagement in overseeing company performance, strategy and the culture of ethics should help to align the company's approach to compensation, financial disclosure, internal controls, risk management and compliance. Therefore, in most circumstances the majority of board time should be reserved for matters related to company performance and strategy, and the ethical tone within the company.

Outside directors require considerable amounts of information as they get to know the business and the environment in which the company operates. Active involvement in prioritizing the agenda and defining information needs positions outside directors to provide objective guidance and judgment. The board should not leave decisions about the board agenda and information needs to management alone.

COMPANY PERFORMANCE AND STRATEGIC DIRECTION

The board bears ultimate responsibility for company performance. While the board delegates day-to-day management to the CEO and the team of professionals the CEO selects, the board must actively oversee the performance of management and provide strategic guidance. Monitoring company performance and determining strategy (through an iterative process with the CEO and senior management) are central to the board's role and will typically account for a significant portion of the board agenda.

Challenges for boards include:

- Reserving appropriate time for review and discussion of company performance.
- Taking an active role in strategic planning while maintaining objectivity. (This is especially critical in enabling the board to assess the positions of activist shareholders versus management's plans.)
- Supporting appropriate long-term investment and prudent risk-taking in the face of significant short-term pressures for immediate returns or other conflicts.
- Balancing guidance and support of management with objective assessment and constructive criticism.
- Holding management accountable for results in light of the agreed strategy by determining and applying performance benchmarks.
- Helping management anticipate and understand the potential for abrupt and long-term changes in the company's economic, political and social environment.
- Testing key assumptions that underpin management's proposed strategic plans and major transactions, including assumptions about risks.
- Maintaining appropriate deference to management on day-to-day operations without becoming unduly passive.

CEO SELECTION, COMPENSATION AND SUCCESSION

Because boards typically delegate significant authority to the CEO, the selection and compensation of the CEO, as well as succession planning, are closely intertwined with the board's role in monitoring performance and setting strategic direction. The board also should help coach and guide the CEO in a manner that encourages appropriate entrepreneurial leadership, long-term focus and attention to the company's ethical culture.

Challenges for boards include:

- Setting goals for the CEO (and other key executives) in line with corporate strategy, objectives and plans.
- Providing appropriate support, guidance and deference to the CEO while maintaining objectivity about performance.
- Designing compensation to attract and retain talent while aligning it with performance.
- Considering the CEO's contributions in the context of the contributions of the broader team, an issue that will be highlighted with the new pay ratio disclosures.
- Discussing management development and succession planning on a regular basis, even regarding a new, young or high-performing CEO.
- Understanding and considering shareholder views about CEO compensation and succession without substituting those views for the board's own objective judgment.
- Ensuring that company disclosures adequately communicate the board's views and activities regarding compensation and succession planning.

Boards need to be prepared for business disruptions, risk management failures, employee malfeasance and other events that may or may not be in the company's control.

© 2014 Thomson Reuters. All rights reserved.

INTERNAL CONTROLS, RISK MANAGEMENT AND COMPLIANCE

Expectations of boards continue to expand with respect to establishing and monitoring internal controls, reviewing and overseeing risk management and ensuring that appropriate legal and regulatory compliance and reporting systems are in place. These areas are intertwined with the ethical culture of the company and with perceptions about the company's broader social responsibility. Given the centrality of an appropriate ethical culture to effective internal controls, risk management and compliance, board and management attention to corporate culture is critical.

Challenges for boards include:

- Ensuring that appropriate time is devoted to these key issues without becoming overly focused on controls and compliance.
- Using board committees efficiently to address these issues while keeping the entire board appropriately informed and involved.
- Remaining vigilant for red flags, which are often a series of yellow flags.
- Creating incentives for management to establish and maintain an appropriate control, risk management and compliance environment.
- Ensuring that the company has adopted appropriate standards of corporate social responsibility consistent with evolving societal expectations.
- Monitoring compliance with legal and ethical standards.

PREPARING FOR CRISIS

Boards need to be prepared for business disruptions, risk management failures, employee malfeasance and other events that may or may not be in the company's control. Boards also need to be ready to take a more active role in certain types of crisis. Effective crisis management requires:

- A solid foundation of internal controls, risk management processes and governance practices.
- A strong board culture in which sensitive topics are not avoided, a variety of viewpoints are raised and explored, disagreements are resolved efficiently and boardroom confidentiality is maintained.

Search Corporate Crisis: Board Preparation and Response for more on crisis preparedness.

SHAREHOLDER ENGAGEMENT AND ACTIVISM

Directors will need to be especially attuned to the interests and concerns of significant shareholders, while continuing to apply their own judgment about the best interests of the company. This requires active outreach and engagement with the company's core shareholders. Caution, balance and effective communication are also necessary to ensure that director judgment is not replaced with shareholder appeasement.

Acting as a prudent fiduciary, rather than reacting to shareholder pressure, poses particular challenges due to:

- Increasing levels of shareholder activism.
- The sophistication of activist tactics.
- The likelihood that proxy advisors will support activist agendas.

Boards need to carefully assess shareholder requests for a particular course of action, whether the request relates to corporate strategy, CEO succession, risk management, leadership structure, shareholder decision rights or environmental and social issues.

Boards must reach out to shareholders and other constituents to understand their views and explain board decisions. Boards need to identify the company's key shareholders and the issues about which they care most. Together with management, the board should make extra efforts to engage with these shareholders. Effective engagement often requires moving beyond management's typical investor relations focus.

Search Shareholder Engagement: Looking Back and Planning Ahead for more on shareholder engagement tactics.

Regulation of Proxy Advisors

Interest in regulating proxy advisors has been more evident in the past year than at any time since the SEC issued its "proxy plumbing" release in July 2010.

The European Securities and Markets Authority (ESMA) recommended in February 2013 that the proxy advisory industry develop a Code of Conduct to focus on identifying, disclosing and managing conflicts of interest, and fostering transparency to ensure the accuracy and reliability of advice. In October 2013, proxy advisors, including Institutional Shareholder Services Inc. (ISS), Glass, Lewis & Co., LLC, IVOX, Manifest, PIRC Limited and Proxinvest released a draft set of international principles. Final principles are expected to be issued in early 2014.

US developments include:

- In June 2013, a House subcommittee held a hearing on the effect of the proxy advisory industry on corporate governance standards, proxy advisor voting policies and market power, and potential conflicts of interest.
- In October 2013, NASDAQ filed a petition with the SEC seeking interpretive changes that would require proxy advisors to disclose the models, formulas and methodologies pursuant to which they make voting recommendations and all relationships that may pose conflicts of interest.
- In December 2013, the SEC held a roundtable discussion on the use of proxy advisors by investment advisers and institutional investors.

© 2014 Thomson Reuters. All rights reserved.

Dealing with proxy advisors is necessary but not sufficient. While engaging with buy-side analysts and proxy advisors is important, it should not be substituted for getting to know the company's large institutional shareholders and, in particular, the persons responsible for voting proxies and setting the governance policies that often drive voting decisions.

Challenges for boards include:

- Objectively assessing performance and strategy through activists' eyes, including by:
  - identifying areas in which the company may be subject to activism; and
  - developing company positions in these areas and preparing to respond to inquiries and public overtures.
- Monitoring governance and activist updates to keep abreast of "hot topic" issues.
- Reviewing governance structures and practices for vulnerabilities compared to evolving best practice.
- Effectively communicating long-term plans with respect to strategy and performance pressures.

BOARD COMPOSITION AND LEADERSHIP

Board composition is central to the ability of the board to provide effective guidance and oversight. Notwithstanding the move by many companies to majority voting in the election of directors, boards continue to have significant influence in selecting directors absent a contested election. Decisions to nominate candidates to the board and re-nominate current directors should be thoughtfully undertaken based on an assessment of the company's needs in relation to its strategic direction.

Regular refreshment of the board through director evaluation or service limits based on age or term length should also be considered. Boards should be aware of increasing concern in the institutional shareholder community about the length of director terms and in the general public about gender and racial diversity.

Independent board leadership, whether in the form of an independent chair or a lead director with significant powers relating to the board agenda and information flow, is also an issue that needs careful consideration periodically to ensure that the board is positioned for objective oversight.

Search Corporate Governance Practices: Commentary for more on issues related to board composition.

The views stated above are solely attributable to Ms. Gregory and do not reflect the views of Sidley Austin LLP or its clients.

Practical Law™

"RELEVANT, HIGH QUALITY CONTENT, INTELLIGENTLY ORGANIZED. THANKS FOR PROVIDING SUCH AN OUTSTANDING RESOURCE."

— John Scanlon, Attorney, Axiom

PRACTICAL LAW provides legal know-how that gives lawyers a better starting point. Our expert team of attorney editors creates and maintains thousands of up-to-date, practical resources across all major practice areas. We go beyond primary law and traditional legal research to give you the resources needed to practice more efficiently, improve client service and add more value.

REQUEST A FREE TRIAL TODAY practicallaw.com | 646.562.3405

© 2014 Thomson Reuters. All rights reserved. Use of Practical Law websites and services is subject to the Terms of Use (http://us.practicallaw.com/2-383-6690) and Privacy Policy (http://us.practicallaw.com/8-383-6692).