sodali ALIGNING INTERESTS

The Autonomous Board

by John C. Wilcox, Chairman, Sodali

"Can we end the long tradition of the boardroom as a sealed chamber ...? Can we move toward more transparency about the boardroom process ...?"

*Leon Panetta **

Companies preparing for their annual shareholder meetings in 2014 should be aware of a new governance challenge: opposition to the election of individual directors is becoming a strategy of choice not only for activists but for "responsible" investors seeking change at portfolio companies. Withholding (or threatening to withhold) votes for incumbent directors, supporting short slate campaigns, or voting for dissident candidates in proxy contests are no longer considered hardball tactics for use only in extreme cases. Institutional investors who in the past would routinely support incumbent directors have learned an important lesson from the success of hedge funds and activists: targeting directors gets the immediate attention of companies, promotes dialogue, attracts media coverage and increases pressure on other investors to support shareholder initiatives.

The willingness of institutional investors to oppose director elections should come as no surprise. It represents an endgame of the corporate governance reform movement. After years of focusing on governance externalities, shareholders are turning their attention inside the boardroom. At the same time, this new approach to director accountability represents a fundamental shift away from the wholesale tactics that governance advocates have relied on for nearly three decades. Instead of just sponsoring policy resolutions, box-ticking board members' credentials and demanding compliance with governance norms, institutional investors are now looking more deeply into boardroom activities and targeting individual directors - often committee chairs, lead directors or CEOs - deemed responsible for policy failures or poor performance.

Director accountability

The push to make individual directors personally accountable through the ballot box has been accelerated by a number of recent governance developments:

1. Proxy advisory firms are increasingly recommending that votes be cast against or withheld from incumbent directors on the basis of governance failures or refusal by boards to adopt policies supported by shareholders. This trend will accelerate as proxy advisors come under increasing pressure from regulators in the U.S. and the European Union to provide more detailed justifications for their vote recommendations.

2. The number of election contests and board-related shareholder proposals continues to increase in most countries around the world.

3. Regulators, primarily in the UK and the European Union, are calling for companies to provide higher quality "explanations" of boardroom decisions under the comply-or-explain governance model.

4. Stewardship codes are pressuring institutional investors to increase their oversight of portfolio companies and exercise their proxy voting rights more diligently. At the same time, institutions are beginning to acknowledge what companies have understood all along – that external governance metrics don't tell the whole story. Environmental, social, governance (ESG) and non-financial performance metrics are being factored into institutions' investment decisions as well as their voting policies, increasing demand for portfolio companies to provide this data.

5. In a few markets institutional investors are taking a more active role in the selection of board candidates. The recent announcement that Norges Bank Investment Management (which oversees Norway's sovereign wealth fund) has created a governance advisory committee of UK experts and has joined the Swedish director selection committee is expected to stimulate a global conversation about issues relating to director nomination and selection, the role of responsible institutional investors and board accountability.

6. In the aftermath of the financial crisis, business and political leaders around the world continue to explore ways to "break the short-term cycle." Economists and academics have abandoned the theory of "shareholder primacy" that was a justification for short-termism at companies and in the financial markets. In this changing environment companies and boards will be expected to redefine business strategy and develop performance metrics based on sustainability and long-term results rather than stock price and quarterly earnings.

7. Private organizations, NGOs and entities serving institutional investors (including membership groups such as the ICGN) have adopted policies mandating greater diligence in the exercise of voting rights by institutional investors, most notably in director elections.

8. Hedge funds and activist investors from the U.S., where proxy fights are integral to the regulatory scheme, have targeted directors of non-U.S. portfolio companies in their efforts to implement strategic change and improve performance. In addition to full election contests, activists' tactics include withholding votes, waging "short slate" campaigns and directing media attention at targeted CEOs and directors.

9. Media coverage of high-profile corporate scandals, fraud, mismanagement, self-dealing, poor risk oversight, abusive pay practices, inadequate succession planning, financial underperformance, etc., has increasingly focused public attention on problems inside the boardroom, underscoring the need to hold directors personally accountable.

These trends point to one conclusion: Boards must be more transparent and more willing to communicate with shareholders. Companies can no longer rely on director credentials and compliance with governance norms to convince shareholders that the board is functioning effectively. In the words of TIAA-CREF president and CEO Roger Ferguson, corporate governance "hardware" is in place, but corporate governance "software" is not.**

The board's competing imperatives

Mr. Ferguson's distinction between hardware and software provides a useful shorthand for understanding the governance challenge faced by boards today. Hardware that defines governance policies and best practices is important, but it falls short of satisfying shareholders' growing demand for information about how decisions are made inside the boardroom. New governance software is needed to fill the gap. It must reveal more details about how the board sets priorities, mediates conflicts and links its policies to business strategy and performance. To do so, governance software must provide answers to questions that go well beyond traditional governance concerns:

- What are the roles of the CEO and senior management in corporate governance?
- How does the work of the board and its committees actually get done?
- What mechanisms does the board use to oversee management, assess business risks and monitor the company's performance?
- How proactive is the board in challenging management and shaping the company's strategic direction?
- How does the board balance short-term and long-term business goals and incentivize management to do so?
- How does the board deal with conflicts of interest, related-party transactions and ethical issues?
- What is the right balance between transparency and confidentiality in the boardroom?
- How does management provide information, support and resources to the board without compromising its autonomy?
- Conversely, how effective is the board as a resource and support for management?

From the perspective of company management, these inquiries give rise to serious concerns. There is a perceived legal risk that information about boardroom deliberations could exceed disclosure requirements or involve "inside" information. Companies worry that such disclosures could reveal proprietary or competitive information, encourage micromanagement, violate boardroom privacy, threaten teamwork and collegiality, inhibit candor in boardroom discussions, make boards more risk-averse and undermine their willingness to exercise business judgment. These concerns arise particularly in rules-based governance jurisdictions such as the United States.

From the board's perspective, the concerns are more fundamental. By definition, every board of directors is subject to competing imperatives. It must balance its inside strategic role and its outside representative role without the benefit of Chinese walls. The board occupies a position that is wholly within the corporate structure. It works part-time and lacks dedicated resources. It does not have a separate budget; its bills are paid by management. On many matters it works in partnership with the CEO, who combines board and management roles, and it relies on the company secretary, CFO, Human Resources, Investor Relations and other members of senior management for administrative support, information, financial data and performance metrics. Yet despite the embedded connections and dependence on management, the board is expected to function autonomously.

Given the complexity of these arrangements, it is clear that board autonomy must be grounded in a working relationship between the directors and the executive management team that combines respect, deference, trust and active collaboration. Both must be committed to a governance program that integrates business and governance goals, educates and informs directors, opens a window into the boardroom and creates opportunities for directors as well as management to communicate with constituencies inside and outside the company.

Corporate governance software - a program for achieving board autonomy

The Board of Directors Corporate Governance Program should include the following activities:

I. *The board should compose a written Statement of Corporate Governance Principles*. The Statement of Corporate Governance Principles should describe the board's duties, committee structure and corporate governance policies in the context of the company's specific business goals and values. The statement should do more than just spell out how the company complies (or not) with external corporate governance requirements. It should explain how the board prioritizes competing imperatives and balances short and long-term interests. The Statement should serve a constitutional function, delineating the specific duties and responsibilities assigned to the board as distinct from the duties and responsibilities assigned to management. The board's responsibilities should include at a minimum: strategic business oversight; CEO succession planning; director selection and evaluation; executive compensation; risk oversight; ethics and business conduct; engagement and communication with shareholders; policies relating to sustainability, corporate governance, the environment and societal issues. Committee charters should amplify how these responsibilities are delegated within the board structure. The Statement of Corporate Governance Principles together with the Mission Statement and Code of Conduct should define the culture and values of the enterprise. These documents should be subject to periodic review by the board.

II. *The board should periodically benchmark its governance policies*. A comprehensive corporate governance review from an external perspective – essentially a compliance and diagnostic exercise – can provide directors with answers to important questions: How is the company's governance perceived by regulators, shareholders, proxy advisors and other stakeholders? What are the implications? Are the policies appropriate for the company's circumstances? The benchmarking process compares the company's governance to a matrix of global standards, local requirements, proxy advisors and selected peer companies. Differences and anomalies should be carefully analyzed by the board and management. The exercise can reveal whether the board's governance practices score well, whether they should be amended or whether more convincing explanations are needed.

III. *The board should regularly review the company's ownership profile*. The board should know and understand the constituencies it represents. Accordingly, it should work with management to prepare a periodic analysis of the share register that (1) identifies key institutional investors, beneficial owners and debt holders, (2) explains their governance policies, voting practices and investment style and (3) measures whether the company exceeds or falls short of investor expectations. The ownership profile should also include an analysis of the results of recent shareholder meetings, proxy voting, shareholder communications, media coverage, sell-side analyst reports, trading activity, stock price movements and data from investor relations road shows and surveys. A comprehensive report that compiles and analyzes these data will assist the board and management in assessing the company's strengths and vulnerabilities and developing strategies to deal with shareholders and the financial markets.

IV. *The board should conduct an annual self-assessment*. While the external diagnostics described above reveal the perceptions of outside audiences, the board's most important challenge is to evaluate what goes on inside the boardroom. The annual board evaluation is the primary tool for this internal analysis.

    First, the board should examine whether the standing committees are fulfilling the responsibilities assigned to them in the Statement of Principles.

Second, it should examine key questions about the board's capabilities and function:

a. Are the directors individually competent, knowledgeable, productive and willing to ask tough questions?
b. Does the board collectively have the full range of expertise and diversity needed to understand and oversee the company's business and develop strategy for the future?
c. Do the directors work well together?
d. Does the board deal effectively with conflicts and ethical issues?
e. Does the board have adequate and timely information in advance of board meetings?
f. Does the board have access to outside experts when needed?
g. Is the board satisfied with the level of support and resources provided by management?
h. Does the board provide value to management?
i. What issues keep directors awake at night?

The annual self-assessment can be conducted through a combination of questionnaires and confidential one-on-one interviews under the supervision of the board chair or nominating committee chair. An independent outside expert specializing in board assessment should be retained to ensure that the process is conducted neutrally and objectively. An independent advisor is particularly important for IPO companies and for companies with family leadership, majority control groups, state ownership, or structural conflicts of interest. Best practice mandates that all companies should retain an outside expert for the board evaluation at least every three years. Even though the results of the board evaluation should be kept confidential, the process should be disclosed in sufficient detail to convince shareholders that it is rigorous and objective.

V. *The board should publish an annual corporate governance report*. The board should tell its story annually in narrative form, either in a letter to shareholders or a separate annual corporate governance report published at the time of the AGM. The list of specific board responsibilities outlined in the Statement of Corporate Governance Principles should serve as the framework for the annual board governance report. It should highlight important decisions made during the year and explain the business rationale for the board's handling of sensitive or controversial matters such as succession planning, director selection, related party transactions, compensation, shareholder rights and activist initiatives. The report can also address governance anomalies revealed by the benchmarking, particulars of the board self-assessment process and ad hoc issues. The report provides an opportunity for the board to describe its decision-making process, explain its policies and verify its autonomy. It is an important corollary to the company's annual Management Discussion and Analysis.

VI. *The board should have the discretion and the means to engage in dialogue with shareholders*. An autonomous board needs an independent voice. Shareholders question the credibility of boards whose decisions are always communicated through management, particularly on matters that relate to the board's primary duties. Companies are beginning to recognize that the risk of selective disclosure, contradictory messages or confusion in the marketplace can be avoided if directors adhere to a strict policy of speaking only about the responsibilities assigned to them in the Statement of Principles. In many jurisdictions outside the U.S., the voluntary, principles-based governance system already mandates an independent voice for boards and provides a framework for determining whether management or directors should speak. During the past several years this comply-or-explain approach has crept into U.S. governance practice

through the say-on-pay vote process. Following the example of companies in the European Union and other jurisdictions, U.S. directors are emerging from the boardroom to engage in dialogue with shareholders about pay decisions. Over time, expanding use of the comply-or-explain approach will bring directors into dialogue with shareholders on a wide range of issues.

VII. *The board should participate in the company's Investor Relations program*. Investor relations programs should be expanded to accommodate a proactive role for directors. Road shows should include ESG information and non-financial performance metrics in addition to earnings announcements and financial communications, with individual directors selected to participate as appropriate. Investor relations programs should reach out not only to portfolio managers and financial analysts but also to the less familiar audience of institutional decision makers responsible for governance and proxy voting. Investor relations executives and company secretaries should also rethink their annual meeting preparations so as to showcase the board of directors, improve cross-border proxy solicitation, provide more details about ESG policies, anticipate issues of concern to shareholders, eliminate misperceptions and thereby reduce the likelihood of being targeted by activists.

VIII. *The Board should have an active role in the preparation and conduct of the Annual General Meeting*. The AGM should be treated as a corporate governance event. The shareholder vote for the election of directors should be recognized as a referendum on how well the board is doing its job. The board should participate in the preparation of AGM disclosure documents to ensure that they showcase the board's activities and establish the basis for dialogue with shareholders, particularly on issues where a vote is required. The board should also oversee the company's response to shareholder proposals and resolutions submitted in opposition to the meeting agenda. During the months leading up to the AGM institutional investors are focused on governance and willing to meet with company representatives, creating an opportunity for boards and managers to initiate dialogue in favorable conditions.

IX. *The company should maintain a program of continuing education for directors*. Board members should have the opportunity to attend director education programs that will keep them informed about their responsibilities and teach them new skills, such as mobile and social media and digital technology that are essential to maintaining market share and competitive position for most companies today. The company should provide research and reading materials, organize internal training sessions, select high-quality experts and cover the expenses of continuing education for directors.

X. *The agenda for the company's annual strategic retreat should feature corporate governance and board autonomy*. When a company's board members and executive management team meet for their annual strategic sessions, the agenda should include: (1) a detailed review of issues raised in the conduct of the nine program activities described above, with attention to how the board prioritizes competing demands and balances short and long-term goals; (2) a comprehensive and candid discussion of the relationship between the CEO, the executive team and the board of directors; (3) an evaluation of the company's governance and financial performance with specific reference to feedback from shareholders, investors and stakeholders as well as management; (4) a review of current governance trends and hot topics and their potential impact on the company. Outside advisors and experts should be engaged to facilitate discussion of these topics.

Conclusion

The board of directors is a uniquely complex institution, situated inside the business, representing outside interests and expected to act autonomously. The autonomous board is not just a theoretical concept. It envisions the board as a self-governing oversight body composed of highly competent , independent-minded individuals with diverse characteristics and background, who are well-informed, diligent, knowledgeable about the company's business, focused on long-term performance, committed to serve the interests of the company's owners and stakeholders and willing to take a high public profile in fulfilling their responsibilities. This vision can be achieved only when corporate governance hardware and software are both securely in place and functioning effectively.

Ira Millstein famously stated many years ago that "Good corporate governance is not rocket science." He might qualify that statement today. Good corporate governance can no longer be achieved simply by adopting the right policies and complying with the rules. As scrutiny of the board's competing imperatives intensifies, both directors and management must be willing to respect the boundaries that define their roles while working together to ensure that their actions support the goals of the business enterprise and its stakeholders.

* Leon Panetta, It's Not Just What You Do, It's The Way You Do It, DIRECTORS & BOARDS, Winter 2003, at p. 17, 21.

** Comments delivered by Mr. Ferguson at the annual conference of the International Corporate Governance Network, New York, June 27, 2013.