US Corporate Governance: Boards of Directors Remain Under the Microscope

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For a number of years, the message for directors of U.S. public companies has been that their decisions face greater and greater scrutiny. While some of this enhanced scrutiny has come from federal and state governments, regulators, the press and the courts, one of the principal sources has been investors, including activist investors, governance activists such as state and labor pension funds, mutual funds and other long investors. This trend is part of the paradigm shift from a more deferential, board-centric model of corporate governance for public companies to a more skeptical, shareholder-centric model. Looking to 2015 and beyond, there is every reason to believe that the scrutiny and attendant second-guessing of board action or perceived inaction will continue and intensify.

This scrutiny, second-guessing and the associated campaigns for certain corporate actions by activist investors has engendered debate on the role of the corporation in society, short-termism and whether shareholder activism is a good or bad thing. Laurence D. Fink, CEO of BlackRock, the world's largest asset manager, has expressed the view that strategies pursued by activist investors often destroy jobs and that companies must be free to invest today in order to generate long-term future growth.

Shareholder Activism. Perhaps the largest, most powerful microscope brought to bear on directors is that of activist investors. These investors come armed with financial acumen and detailed data and analyses in their quest to find so-called undervalued companies. Perhaps more important, they bring significant amounts of capital and the ability to invest it in a concentrated fashion. As a result of the returns generated by some activist investors over the years, activist investing is now recognized as its own asset class. The number of activist funds has continued to increase as the protégés of well-known activists set up their own funds, and the level of assets under management by activist funds continues to increase rapidly. As a result, the days of large market-cap companies having some level of immunity from activists are long gone. Over the last few years, activists have launched campaigns at large-cap companies such as Apple, Microsoft, Dow Chemical, P&G and PepsiCo.

The areas in which activist investors are willing to scrutinize and second-guess directors' decisions are wide-ranging. They have criticized companies and agitated for change on matters such as companies' portfolios of businesses, capital allocation policy, operating performance, stock price performance, corporate governance and executive compensation. Moreover, activists will not hesitate to question incumbent management's ability to implement necessary changes in business strategy, both as part of a campaign for board seats and once they are on the board. Nor will they hesitate to question the abilities of boards of directors to oversee management and a company's business strategy.

It is critical to keep in mind that activist investors do not exist in a vacuum. Rather, they have a critical ally in traditional long investors, including many state and local pension funds. This alliance takes many forms, including voting support, direct investments in the activist funds, the sharing of ideas as to underperforming portfolio companies, and sometimes direct and public teaming up. In 2013 the California State Teachers' Retirement System (CalSTRS) paired with Relational Investors to push the Timken Company to separate its steel and ball bearing businesses, and in 2014 CalSTRS publicly supported efforts by Trian Partners to

achieve breakups of PepsiCo and DuPont. Finally, a new type of alliance occurred when Pershing Square Capital and Valeant Pharmaceuticals joined forces in connection with Valeant's pursuit of Allergan. Although it is unclear whether we will see additional instances of public companies teaming with activist funds in connection with the pursuit of acquisition targets, it is a reminder of the myriad alliances that are possible.

Governance Activism and Proxy Access. The hand of activist investors has been strengthened meaningfully by the efforts of some state and local pension funds and other investors to change the framework of director elections and otherwise eliminate so-called anti-takeover protections. For most large-cap companies and a segment of mid-cap companies, governance activists have succeeded in eliminating classified boards and plurality voting, so that directors at these companies are elected to one-year terms and must submit their resignations if not supported by holders of a majority of the shares voting at a stockholders' meeting. In addition, a growing percentage of these companies permit stockholders to call special meetings or to act by written consent in lieu of a meeting, abilities that traditionally have been utilized to attempt to remove directors between annual meetings in order to advance hostile takeovers or activist agendas that boards believed were not in the best interests of stockholders.

Governance activists are on the verge of causing another major change to the framework of director elections, one that has the potential to increase significantly the number of contested elections and provide an easier path to further scrutinize and second-guess directors. "Proxy access" would provide a means for certain stockholders or groups of stockholders to nominate candidates for election to the board and — rather than requiring the stockholders to prepare, file with the SEC and disseminate their own proxy materials — have the stockholder nominees appear in the company's proxy materials, thereby making it easier (and significantly less costly) for a stockholder to contest an election.

There is a developing consensus among investors to support proxy access shareholder proposals — modeled on the SEC rule that was successfully challenged and invalidated on procedural grounds — that provide the access right to holders or groups of holders owning at least 3 percent of a company's shares for at least three years, allowing for the nomination of candidates for 20-25 percent of board seats. In 2014, three-year, 3 percent of shares, one-quarter of the board proxy access shareholder proposals received majority support at Abercrombie & Fitch, Big Lots, Boston Properties, International Game Technology, Nabors Industries and SLM Corp. Also, Nabors and Kilroy Realty adopted three-year, 5 percent proxy access bylaws, and McKesson Corp. agreed to propose a proxy access bylaw at its 2015 annual meeting. In addition, shareholders approved company sponsored proxy access proposals at CenturyLink, Chesapeake Energy, Darden Restaurants and Verizon (implementing shareholder proposals that received majority support in 2012 or 2013).

Seeking to capitalize on this development, the New York City comptroller, on behalf of various New York City pension funds, has submitted three-year, 3 percent, one-quarter of the board proxy access shareholder proposals to 75 companies for consideration at 2015 annual meetings. This campaign, under the banner "The Boardroom Accountability Project," targets

companies with perceived issues relating to CEO compensation, board diversity or climate change. CalPERS has indicated that it also may launch a proxy access initiative, and other institutional investors may follow suit. While many of the companies receiving proxy access proposals will include the proposals in their proxy statements and recommend that shareholders vote against proxy access, more than 20 companies had sought to exclude the proposals on the basis that they will be submitting their own proxy access proposals (with different parameters) for stockholder approval. This approach was upended by the recent announcement that the SEC staff has been directed to review the application of the rule on conflicting proposals and would no longer express no-action views under that rule. In any event, over time this campaign is likely to result in a significant increase in the number of companies with some form of proxy access. And, inevitably, stockholders who disagree with a board's judgments will utilize the proxy access mechanism to attempt to translate that disagreement into a change in board composition.

Risk Oversight. Not surprisingly, in a post-financial crisis environment, investors continue to emphasize boards' capabilities to oversee risk management. Further, as governments, companies, universities, individuals and other organizations grapple with the challenges and vulnerabilities laid bare by cybersecurity breaches, there is continued second-guessing over the role and activities of boards of directors in overseeing these risks. In 2014, certain directors of Duke Energy were the subject of a "vote no" campaign by CalPERS and the New York City comptroller concerning board oversight of risks presented by a coal ash spill earlier that year, and a majority of directors of Target Corporation faced negative Institutional Shareholder Services recommendations as part of the aftermath of a major cybersecurity breach at the company. Although these campaigns and negative recommendations failed to impact the ultimate outcome of the elections, these instances serve as warnings that the perceived failure of a board of directors to properly oversee a company's risk profile and risk management has the potential to impact director elections. In fact, if the New York City comptroller targets companies for proxy access shareholder proposals based on issues such as climate change, there is no reason to believe that companies with perceived gaps in risk oversight might not find themselves with proxy access shareholder proposals sooner rather than later.

Board Composition. Investors continue to question whether boards have the right people on them in order to effectively oversee management. These questions go to expertise, independence and diversity. Activist investors have grown more sophisticated in their selection of nominees, often finding very credible candidates with extensive industry knowledge and experience. The lack of gender and racial diversity on boards was one of the criteria used by the New York City comptroller in selecting companies at which to submit proxy access proposals.

The question of director tenure, and the purported impact of tenure on director independence, is a particularly vexing issue. In some instances, long-tenured directors, especially those who have outlasted multiple CEOs, may be the directors most likely to ask the challenging and insightful questions and bring tremendous industry knowledge to the board discussion. Nevertheless, some investors question whether long-tenured directors may become "too

close" to management or the company such that they lose their independent perspective. State Street Global Advisors (SSgA) engaged in a letter writing campaign in 2014 to highlight its focus on this topic. Specifically, SSgA sought greater engagement at companies with average board tenure in excess of 13 years (its calculation of one standard deviation from average tenure) and where one-third or more of the nonmanagement directors had tenures in excess of 16 years (two standard deviations from average tenure). SSgA policy states that it may vote against the nominating/governance committee chair for failure to address board refreshment, long-tenured directors serving on key committees, or members of the nominating/governance committee and long-tenured directors on classified boards. In practice, SSgA reports that many companies engaged with it on the topic of board refreshment such that SSgA voted against few directors under this policy. More recently, governance activist John Chevedden, on behalf of James McRitchie and Myra Young, submitted a stockholder proposal to Costco Wholesale, for consideration at an annual meeting in early 2015, that requests the Costco board adopt a bylaw requiring that at least two-thirds of the board have less than 15 years tenure on the company's board. Although some investors are wary of arbitrary limits that risk the loss of well-qualified directors, the voting results on this proposal will be watched with great interest from all sides of the debate.

Where Do We Go From Here. In the current environment, it is unlikely that there will be any diminishment in activists and institutional investors second-guessing the decisions and qualifications of public company boards of directors, particularly when a company's stock price fails to keep up with peer companies. Nevertheless, directors can be proactive, asking themselves the same hard questions that investors may ask. Recently, Vanguard, one of the largest fund managers and one of the largest stockholders in many public companies, raised the prospect of board "shareholder liaison committees." Putting aside the question of whether yet another board committee is necessary versus having chairmen and lead independent directors form the principal board point of contact for engagement with major stockholders, the underlying premise is valid: Directors ought to understand the questions and views of stockholders. One goal of a robust shareholder engagement effort, spearheaded by management under the direction of the board and incorporating board members when and if appropriate, is to listen to investors and hear their concerns. Getting that feedback and addressing it before small concerns grow into broader investor dissatisfaction with a board can be critical to establishing board credibility with institutional investors. Moreover, viewing their companies through the eyes of investors, including activist investors, is one way to best prepare for — and perhaps even pre-empt — some of the second-guessing directors face. Doing so may put the company and management in a better position to respond to suggestions by activists and other shareholders. Companies will be well-served by indicating that the board has already considered the idea raised and rejected it in favor of the company's strategy for credible, articulable reasons or, alternatively, that the company is in the process of implementing changes to address the concerns raised. Scrutiny and second-guessing of boards cannot be eliminated, but robust and vigorous governance processes and shareholder engagement efforts should enable companies to manage those issues as part of the broader governance landscape.