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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 & Katz[1]

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.

[1] This paper was prepared by Martin Lipton, Steven A. Rosenblum, Sabastian V. Niles, Sara J. Lewis and Kisho Watanabe at Wachtell Lipton Rosen & Katz in coordination with Michael Drexler, Head of Investors Industries, World Economic Forum

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 competiveness, 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 Trian 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

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

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