

Task Force Mission Statement and Background

The Conference Board Task Force on
Corporate/Investor Engagement



Task Force Members

Simon M. Lorne (co-chair)

Vice Chairman and Chief Legal Officer
Millennium Partners, LP;
Director of Teledyne Technologies, Inc.;
former General Counsel, United States
Securities & Exchange Commission

Patricia F. Russo (co-chair)

former Chief Executive Officer,
Alcatel-Lucent;
Director, Alcoa Inc, General Motors Co,
Hewlett-Packard Co, KKR & Co LP,
Merck & Co., Inc.

Christian L. Campbell

Senior Vice President, General Counsel,
Secretary and Chief Franchise Policy Officer
Yum! Brands, Inc.

Charles M. Elson

Edgar S. Woolard Professor, Finance
Professor, Legal Studies
Director, John L. Weinberg Center for
Corporate Governance, Lerner College of
Business and Economics, University of
Delaware;
Director, HealthSouth Corporation

Peggy Foran

Director, Occidental Petroleum Corporation;
Chief Governance Officer, Vice President
and Corporate Secretary
Prudential Financial, Inc.

Fred Hassan

Managing Director & Partner, Warburg
Pincus, LLC;
former Chairman and Chief Executive
Officer Schering-Plough Corporation;
Chairman, Avon Products, Inc., Bausch &

Lomb Incorporated;
Director, Time Warner Inc.

Lord Charles David Powell of Bayswater

Director, Caterpillar Inc., Hongkong Land
Holdings Ltd., Magna Holding
International, Mandarin Oriental International
Ltd., Matheson and Co., Northern Trust
Global Services, Schindler Holding AG,
Textron Inc.

Steven S. Reinemund

The Sisel Distinguished Dean of Business;
Professor of Leadership and Strategy
Wake Forest University School of Business;
former Chairman and Chief Executive
Officer, PepsiCo, Inc.;
Director, American Express Company,
Exxon Mobil Corporation, Wal-Mart Stores,
Inc., Marriott International, Inc.

Paula Rosput Reynolds

President and Chief Executive Officer,
PreferWest, LLC;
former President and Chief Executive
Officer, Safeco Corporation;
Director, Anadarko Petroleum Corporation,
Delta Air Lines, Inc., BAE Systems plc.

Brian C. Rogers

Chairman, T. Rowe Price Group, Inc.

Ralph V. Whitworth

Founder, Principal, and Investment
Committee member, Relational Investors
LLC;
Director, Hewlett-Packard Co

Task Force Advisory Board

Donna F. Anderson

Vice President and Head of Global
Corporate Governance
T. Rowe Price Associates, Inc.

David M. Becker

Partner
Cleary Gottlieb Steen & Hamilton LLP

Lydia I. Beebe

Corporate Secretary and Chief Governance
Officer, Chevron Corporation

Glenn Booraem

Principal & Fund Controller,
Vanguard Group, Inc.

Shelley J. Dropkin

General Counsel, Corporate Governance
CitiGroup

Michelle Edkins

Global Head of Corporate Governance &
Responsible Investment, BlackRock

Kayla J. Gillan

Leader, PwC Investor Resource Institute
PwC

Bess Joffe

Vice President, Investor Relations
Goldman Sachs

Matthew Lepore

Corporate Secretary and Chief Governance
Counsel, Pfizer Inc.

Michael P. McCauley

Senior Officer, Investment Programs &
Governance, Florida State Board of
Administration

Ann C. Mulé

Associate Director
John L. Weinberg Center for Corporate
Governance, University of Delaware

Charles Nathan

Partner, Senior Advisor, RLM Finsbury

Mark E. Preisinger

Director, Corporate Governance
The Coca-Cola Company

Edward B. Rock

Saul A. Fox Distinguished Professor of
Business Law
University of Pennsylvania Law School

Anne Sheehan

Director of Corporate Governance
California State Teachers Retirement
System (CalSTRS)

John A. Seethoff

Vice President and Deputy General Counsel
Microsoft Corporation

Lynn Stout

Distinguished Professor of Corporate &
Business Law,
Cornell University Law School

William Ultan

Senior Managing Director – Corporate
Governance, Morrow & Co., LLC

Paul Verbinnen

President
Sard Verbinnen & Co.

Paul F. Washington

Senior Vice President, Deputy General
Counsel & Corporate Secretary
Time Warner, Inc

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Task Force Mission

Public corporations have been an engine of growth and economic prosperity for Americans, driving a 20th century expansion of the middle class and unprecedented opportunities for increasing standards of living.

Since the turn of the 21st Century, there have been some high profile scandals – at some public companies – from the accounting improprieties at companies such as Enron and WorldCom, to the unsustainable investments made by financial institutions that were major players in the recent global financial crisis. These events had a devastating impact not only on the companies involved, their employees, shareholders, retirees, partners and other stakeholders, but in the case of the global financial crisis, on entire societies.

These events also have contributed significantly to distrust of business in general. Globally, according to a recent Edelman survey, less than 20 percentⁱ of respondents trust business leaders.

Regulators and many others have concluded these events were a result of governance failures. For most of the 20th century, public corporations were largely run by professional management with relatively limited oversight by the board of directors and investors. After the accounting scandals of the early 2000s, Congress increased the role and responsibilities of independent directors in the oversight of management through the Sarbanes-Oxley legislation. At the same time, there was a growing and successful movement to increase the power of institutional investors in their oversight of publicly held corporations. In the aftermath of the financial crisis, Congress gave significant support to this movement under the Dodd-Frank legislation through requirements such as “say on pay”.

These shifts in the relative governance roles of management, directors, and investors in public companies have occurred reactively as a response to specific events, rather than as a result of a thoughtful strategic analysis of how each action affects the total allocation of roles and responsibilities in our system of corporate governance. What is missing is a thoughtful and objective analysis of the best governance system to maximize the potential of public companies where boards and investors are aligned to pursue common goals.

The Task Force will examine the facts, the issues and the policy implications of the current state of US corporate governance with the objective of addressing the following questions:

1. What is the optimal balance in the relative roles of management, directors and investors in the governance of public corporations?
2. What are the gaps between the optimally balanced system and the current system?
3. How should boards and investors engage with one another to lead to an optimally balanced system?

In examining these questions, the Task Force will consider how the current system and alternative approaches impact long term

ⁱThe 2013 Edelman Trust Barometer[®] found that “trust in business leaders to tell the truth is 18 percent” (www.edelman.com/news/2013-edelman-trust-barometer-finds-a-crisis-in-leadership/)

sustainable growth of companies and society at large and public trust in business.

We intend our research and recommendations to influence corporate directors, investors in public corporations and public policy makers in decisions regarding investor engagement in the governance of public corporations.

A Brief History of Investor Engagement on Corporate Governance Issues

In the mid-20th century, when the US experienced a prolonged economic boom following the end of WW II, public company governance was characterized by dispersed stock ownership among individuals and reliance on management to govern public companies. In the early 1950s, institutional investors accounted for only an estimated 10 percent of the stock of the largest 1000 public companies.

In the mid-70s, the Penn Central bankruptcy and well publicized bribery incidents involving US company activities outside the US, accompanied by falsification of corporate records, led to early calls for more board oversight, focused on heightening the independence and oversight role of the boards of public companies. The selection of the board as the focus of attention was largely a default choice: faith in management was declining; we remained a capitalist society unwilling to grant general oversight to government; and there was no other readily available body to which to turn.

Beginning in the 1980s, several developments awakened the desire of many of the growing number of institutional investors to increase their participation in public company decision-making:

1. Institutional investor ownership in the largest 1000 public companies increased to almost 50 percent.
2. The first round of corporate raiders, leveraged buyouts and corporate takeovers took actions that often benefited the raiders — but not all investors — ultimately leading to the formation of The Council of Institutional Investors, an association of pension funds, organized in 1985 to provide a forum for the promotion of investor rights in public company governance.

3. The Department of Labor issued regulations requiring pension plans to vote their shares and Institutional Shareholder Services (ISS) was formed to provide institutional investors advice in voting their shares.
4. Despite this increased interest in corporate governance, investor activism on governance issues initially met with limited success.

At the beginning of the 21st century, Enron-era scandals, widely seen as a failure of corporate governance, led to new regulations that were still focused on the board and its oversight of management and internal controls. “Independence” was thought to be a talisman that would ensure the efficacy of governance, and was embedded in many of the new reforms. Investor activists, primarily individuals and pension plans, were successful with investor proposals intended to increase the accountability of directors to investors. Many corporations voluntarily adopted such policies in the interest of improving the perception of good governance. These measures included:

1. Increasing prevalence of the practice of electing of directors by majority vote;
2. Elimination of staggered boards; and
3. Elimination of “standing” poison pills.

These changes also had the effect of increasing the ability of institutional investors to negotiate, or to launch proxy contests, to appoint directors to boards of public companies.

In 2003, the SEC required mutual funds to publish their voting policies and to report how they voted, but many of these funds’ investment strategies were not driven by corporate governance issues.

Executive compensation emerged as an area of particular concern:

1. Investors advocated for aligning executive compensation with the interests of investors by providing equity compensation.
2. This emphasis on equity compensation was supported by the regulatory framework - the tax code allowed corporations to deduct stock option expenses while other forms of compensation were subject to a \$1 million

- cap on deductibility unless certain conditions were met. Further, until 2004, accounting rules permitted stock options to be issued without creating an expense against income if granted at fair market value on the date of grant.
3. “In 1984, equity based compensation accounted for zero percent of the median executive’s compensation at S&P 500 firms; by 2001, this figure had risen to 66 percent.”ⁱⁱ During the same period, the ratio of CEO pay rose from an average of 140 times that of an average worker’s pay to 500 times.
 4. In 2006, the SEC adopted new executive compensation disclosure rules that aggregated all forms of executive compensation into one summary compensation table and required preparation of a comprehensive analysis and discussion of executive pay. These disclosures were closely followed by the media and public concern over the size of executive compensation became even more vocal.
 5. Ultimately, these concerns led to a call for investor approval rights with respect to executive compensation.

Failures in corporate governance were again blamed for aspects of the 2008-2009 financial crisis, as many perceived that short term profit seeking, systemic incentives and lack of risk management at financial institutions contributed to or even caused the financial crisis.

CEO pay and rising societal income inequality added to public dissatisfaction and lack of trust.

As a result, many perceived both boards and management to be unable to provide adequate oversight of public companies, at least within the current structure. Investors—primarily the emergent institutional investors—were seen by some as the logical counter-balance.

1. Additional regulations were adopted to give investors more power over corporate governance matters historically determined by the board of directors — notably to vote on executive compensation.

2. The SEC expanded the types of proposals that investors can require companies to include in proxy statements for annual votes, including proxy access and other issues formerly decided by management or the board of directors.
3. At the same time, certain actions were taken that had the effect of concentrating voting power with institutional investors by decreasing direct or indirect individual investor participation in the voting process
 - a. The NYSE limited the discretion of brokers to vote uninstructed proxies except in limited matters; and
 - b. The SEC approved electronic access to proxy statements.
4. By this time, institutional investors held approximately 76 percent of the stock in the 1000 largest public companies in the US.
5. In the first year of the investor advisory vote to approve executive compensation (or “say on pay”), proxy advisers (ISS and Glass Lewis) were credited with influencing nearly 40 percent of the vote by institutional investors.ⁱⁱⁱ

The rapid rise in the number and types of issues coming for a vote provided the opportunity for proxy advisory firms to play an increasing role and exert greater influence in investor votes and corporate governance.

At the same time, a growing group of investors had little or no incentive to participate in the process.

1. Estimates predict that during the next ten years, the proportion of institutional investor asset allocation to index funds and other passive investing will increase from 25-33 percent to 50 percent.

ⁱⁱ Jill E. Fisch, “Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy,” 31 *Journal of Corporation Law*, 639 n. 5 (Spring 2006).

ⁱⁱⁱ Proxy Advisors account for 37.9% of vote on Say on Pay. Study of the impact of ISS and Glass Lewis of 2011 Say on Pay votes, based on interviews with and data from ISS and Glass Lewis concludes that a negative recommendation from ISS (GL) results in 24.7% (12.9%) more votes against. When both advisors have a negative recommendation, the effect is 37.9% against a Say on Pay proposal. Shareholder Votes and Proxy Advisors: Evidence from Say on Pay. Yonca Ertimur (Duke University); Fabrizio Ferri (Columbia University) and David Oesch (University of St. Gallen) ssrn.com/abstract=2019239

2. A shift from investing and holding shares to trading shares became prevalent in the last decade as a result, in part, of rapid technological advances which have enabled high speed trading and a reduction in the transaction cost of trading shares.

Another group of investors, such as hedge funds, “raiders” and short term investors, often have financial engineering strategies focused on increasing their returns by using claims of inadequate corporate governance to pressure boards to make decisions favorable to them, such as paying dividends, repurchasing stock, spinning off a portion of a company or selling the company as a whole.

The increasing power of investors, coupled with divergent interests among groups of institutional investors, has led to closer examination of whether investors, too, have contributed to the systemic issues that have driven companies to focus on short-term behavior:

1. Heavily discounting the value of long term investments by public corporations;
2. Emphasis on meeting or exceeding analysts’ quarterly estimates of earnings;
3. Competition for investment funds based on short-term yield comparisons;
4. Compensation systems for the investment managers based on short-term returns, which, in turn, encourage investment managers to pressure management to take actions that lead to short-term stock price increases;
5. Limited resources allocated to governance issues, which may lead to an undue reliance on proxy advisory firms;
6. Lack of coordination in some institutions between portfolio managers and internal governance professionals on voting; and
7. Growth of hedge funds focused on creating above average stock price movements through short term financial restructuring.

