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SESSION REPORT

567

The Corporate Balancing Act: How Can Directors Manage Conflicting Pressures?



SALZBURG GLOBAL FORUM ON CORPORATE GOVERNANCE

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The Corporate Balancing Act: How Can Directors Manage Conflicting Pressures?

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Introduction

Difficult at the best of times, the role of non-employee directors of publicly-held corporations – to guide and oversee management in enhancing long-term value – has become even more challenging in today's uncertain economic environment. Prominent examples in recent years of poor performance, failure to comply with legal obligations, and other corporate misconduct arguably point to inadequate oversight by directors – or perhaps the impossibility, notwithstanding active monitoring by boards, of ensuring consistent corporate compliance, appropriate risk management, and good behavior.

It is broadly agreed that the effectiveness of a board of directors requires independence, diversity of expertise and backgrounds, sound organization, energy, and focus. However, examination of the monitoring role raises many questions which underscore the complexities and challenges facing the directors of the modern corporation. In addition, boards of directors have come under increasing pressures from politicians, regulators, international institutions, traditional and social media, special interest groups (including organized labor, environmentalists, and human rights advocates), consumers, employees, creditors, and shareholders. Even where such demands initially seem irrelevant to the core profit-making purpose of the corporate enterprise, they can often raise legitimate concerns for directors to consider. Facilitated by social media and instantaneous communication, the objectives of one interest group can quickly grow into a mass movement affecting consumer behavior, influencing the views of important shareholders, and even leading to mandatory regulation of corporate activity.



The Salzburg Global Forum on Corporate Governance was launched in 2015 to facilitate critical thinking about changing regulatory and economic environments, comparative practices, and the roles and duties of directors. At the first session, *Corporate Governance in the Global Economy: The Changing Role of Directors*, participants agreed that enhancing corporate profit and shareholder gain remain the foremost purpose of corporations worldwide, however they prioritized the need to develop practical techniques to improve board effectiveness in monitoring or guiding corporate behavior. They stressed that growing pressures for corporations to behave as good citizens may not always be easy to reconcile with fundamental economic objectives, and may anyway differ significantly over time, across jurisdictions, and in the eyes of various constituencies.

Therefore, the 2016 session, *The Corporate Balancing Act: How Can Directors Manage Conflicting Pressures?* looked at how directors could improve governance practices while balancing conflicting norms across the global economy, complying with legal requirements in multiple jurisdictions, and taking into account shifting societal expectations.

Key questions addressed included:

1. How can directors of multinational corporations effectively perform their obligations, balancing the challenges of globalization, complex and conflicting local legal requirements, and changing normative pressures from shareholders and non-shareholder constituencies?
2. How should boards be composed and organized?
3. What governance practices can best keep boards active, alert, and effective?
4. How can directors withstand market pressures for short-term performance in order to achieve long-term goals?
5. Should directors view good citizenship as a principal objective of the corporation? If so, what would make a corporation a “good citizen?” Can it be reconciled with the fiduciary duties of directors to act “in the interests of the company?”

This report highlights significant outcomes from the discussions at the session. It once again took place under the Chatham House Rule¹ to allow the participants to share their personal thoughts and opinions off the record rather than as representatives of their respective firms and institutions.

¹ “The Chatham House Rule reads as follows: When a meeting, or part thereof, is held under the Chatham House Rule, participants are free to use the information received, but neither the identity nor the affiliation of the speaker(s), nor that of any other participant, may be revealed.”
<https://www.chathamhouse.org/about/chatham-house-rule>

Session Report

Non-employee directors of public corporations face ever-expanding pressures to balance the variety of challenges and responsibilities in their roles as board members. As the title suggests, participants in the Salzburg Global Seminar session on *The Corporate Balancing Act, How Can Directors Manage Conflicting Pressures?* were invited to explore several key aspects, including: the nature of the board's role in managing and governing the corporation; the emphasis on independent directors and whether they are the key to effectiveness; board composition and strategies for helping boards remain active, alert and effective; the impact of activist investors and short-termism on the board; and the role of the corporation in the broader society.

Boards as Monitors

Shareholders appoint corporate boards for the purpose of managing the business and affairs of corporations. This mandate translates into a broad set of responsibilities ranging from establishing a corporation's mission and vision, to setting its strategy and structure, to overseeing and monitoring management's performance. Historically, corporate boards were populated with insiders who primarily acted as advisors to management. In the United States, this concept of the board began to change in the 1970s, with the emergence of the "monitoring model" under which the board's primary role is the monitoring of management by independent directors. In the wake of



corporate scandals and the 2008 financial crisis, the monitoring model of the board has expanded beyond the US, influencing corporate governance and board structure in many other countries. There has been a consequent shift in the role of boards away from strategic planning and advising in favor of monitoring and compliance functions. The ongoing balancing of these two primary roles by corporate boards, and the validity of this “monitoring model” for other jurisdictions, comprised a key subject of the participants’ discussion during the Salzburg session.

Although the general consensus of the group was that the board’s role should include strategy and advising, there was debate regarding the extent to which the board should be involved in driving strategy. As one participant argued: “Because of all that we have been through throughout the years, we have been highlighting this role of the board of monitoring the company and management. But boards are much more than this. Boards should be designing the future of the organization.” Conversely, another opinion put forward and shared by many in the session was that management, and not corporate boards, should play the lead role in the development and implementation of corporate strategy. One creative description analogized



the respective roles of board and management to the tango: you need two to dance and both groups must be involved, with management designing and executing strategy, subject to the board's monitoring and oversight. The discussion of the board's balancing act between its advisory and monitoring roles also raised a number of questions: Should the board be responsible for corporate culture? Is it the board's role to help the company run better? What proportion of time should board members dedicate to strategy and business planning given the time commitment currently demanded by the expanded monitoring role? How effective can the board be at monitoring if it is not intimately involved in the development of strategy?

However, questions arose regarding the suitability of the monitoring model in jurisdictions outside the United States and Western Europe. For example, participants with experience in Brazil, India, China and other emerging markets observed that whereas US public corporations often have diffuse shareholder bases, companies in emerging market countries tend to be controlled companies or family businesses with concentrated ownership. As noted in this regard, an independent director in a controlled company context likely may not act as a dissenting voice due to their conflicting relationship with the controlling shareholder, who has appointed them as a board member. Such tensions notwithstanding, it was asserted that independent directors in such companies can play a beneficial role by providing an outsider's perspective often missing from such organizations. In this case, controlling shareholders look to the independent director for their view on how a particular action or policy might be perceived externally. The independent director at the controlled company may also aid in the transition from one generation to the next in a family-controlled company scenario. It was also noted that cultural factors may render the monitoring model inapplicable. For example, Japanese corporate boards are primarily composed of insiders who seek to maintain comity and consensus for cultural reasons. This in turn discourages active oversight and monitoring by members as it may disrupt board harmony.

It is not only in emerging markets where this US-originated model is not applied. German corporations have a two-tier dual board system with a *Vorstand* (management board) consisting of insiders who are responsible for managing the company and an *Aufsichtsrat* (supervisory board) composed exclusively of outside directors who appoint and monitor management. Could this model be more effective and implementable elsewhere? A European participant observed that the German system was effective because it created a strong dialogue between the management board and supervisory board regarding the development and execution of strategy, which in turn leads to more effective monitoring. Another participant agreed with the view that the dual board system may have advantages over the US unitary board model, adding that US corporations in reality operate more like the German system

The respective roles of board and management [are like] the tango: you need two to dance and both groups must be involved, with management designing and executing strategy, subject to the board's monitoring and oversight.

“Management will not be comfortable when receiving advice from the ones with the stick in the hand.”

in practice, with senior management functioning as the *Vorstand* and the board of directors (composed almost exclusively of independent directors) as the *Aufsichtsrat*.

Many participants had a financial services background and a portion of the discussion revolved around the current regulatory landscape for these organizations. Several participants noted increased pressure from regulators on directors of financial institutions to “get into the weeds” of company management, which directly impacts the scope of the directors’ monitoring duties. As described by one participant: “Since the [2008 financial] crisis, the regulators have blamed the boards for not doing a good job. So now, monitoring is the key word and requires more involvement, greater time and more micromanagement.” This increased regulatory burden has weighted the board’s responsibilities towards the monitoring function at the expense of its role as a strategic advisor to management. It has also created an environment where management may be less eager to involve the board in matters of strategy. As one participant noted, “management will not be comfortable when receiving advice from the ones with the stick in the hand.”





Hypothetical Scenario: Buyout of a public corporation by a controlling shareholder

Throughout the session, the group examined hypothetical scenarios and how they would advise a board of directors to act. In the first such scenario, participants considered the proposed buyout of a public corporation by a controlling shareholder, who is also the CEO and Chairman of the company:

Schmidt and family own 62% of the common stock of Controlled Company. 38% of the common stock is publicly owned with half of those holdings in the hands of institutional shareholders. In accordance with corporate governance best practices, 70% of the board of directors (5/7) is independent. Schmidt is the CEO and Chairman of the board. The stock price of Controlled Company has been depressed for the past 18 months and presently trades at \$20. Schmidt thinks this price significantly undervalues the stock. He has determined to offer to buy the company at \$25 per share. He has also made clear that he is unwilling to sell his and his family's shares. The board of Controlled Company has created a three-person committee, made up entirely of independent directors. The committee was delegated the power to turn down any purchase offer and the board stated that it would not accept any offer turned down by the committee. The committee was also authorized to hire its own investment banking and legal advisers. After two months of studying the Schmidt proposal and negotiation with Schmidt, the committee agreed to recommend a sale of the company at \$27 per share. Should shareholders who think \$27 is too cheap a price to sell the company have any remedies at this stage? Should there be a right for such shareholders

to have a court determine the fair value of the corporation as a stand-alone entity (appraisal right)? Suppose 60% of the non-Schmidt holdings vote to approve the sale at \$27. Would that event overcome any objections to the transaction?

The participants discussed the differences in various jurisdictions with respect to possible remedies for the minority shareholders, including the availability of shareholder appraisal rights and the role of special committees. It was noted by a participant with emerging markets experience that in the controlled company context, one of the roles of the board is to protect the rights of minority shareholders. Even with such mandate, skepticism was expressed as to whether the special committee of independent directors in this scenario would be truly independent given the existence of a controlling shareholder. It was recognized by participants that the fundamental question is whether one can rely on the independent directors to monitor transactions with a controlling shareholder or whether courts should carefully scrutinize the fairness of such transactions. The participants also raised a number of questions regarding how directors in the scenario were determined to be independent, including the process by which they were selected, whether the directors are in the same social circle or have the same background as the controlling stockholder and whether the directors are in a position to act as a strong adversary to the CEO. These questions, among others, were discussed in Salzburg and are addressed further in this report.

FELLOW'S INSIGHT

*Directors' Liabilities: Civil vs. Criminal***Patrick C. Leyens***Chair of Empirical Legal Studies, Erasmus University Rotterdam Law School, The Netherlands*

For directors of large entities, liability dangers most likely arise from a lack of oversight of the business or of important transactions. There are at least two forms of possible oversight failures: One relates to not understanding the risks, the other to not preventing misbehavior. We will probably see soon whether the directors of Volkswagen breached their duties by what led to the “Dieselgate” affair. If yes, they will be liable towards the company. Rightly so. Civil liabilities do have severe consequences for the individual director. The public opinion, however, seems to be that civil liabilities fall short of preventing careless or disloyal conduct. The recent rise of criminal charges against directors can be seen as a reaction to this perception. One of the currently most intensively discussed cases of civil vs. criminal liability is that of the German HSH Nordbank. This case will be reported here together with some of its wider implications on directors' liabilities.

The HSH Nordbank case

In 2007, HSH Nordbank, registered in Hamburg, was close to an IPO. The creeping financial market crises had made it more and more difficult for HSH to maintain an attractive equity ratio. Upon increased pressure, HSH entered into a transaction named Omega 55 with the French BNP Paribas. The goal was to reduce risk exposure and hence to increase the equity ratio under regulatory capital requirements. To achieve this goal the transaction foresaw a replacement of the high risks of a multitude of creditors by the low risks of the single creditor BNP. It turned out that the assumed regulatory loopholes were not big enough. The transaction caused a loss of €140m.

Criminal charges were filed against executive directors, most prominently against CFO Dirk Nonnenmacher (later CEO). The most far reaching

charges are based on the pretty abstract offence of embezzlement (*Veruntreuung*). In 2014, directors won acquittal but the Supreme Court in Criminal Matters (*Bundesgerichtshof*) will soon review this judgment. The hearings commenced two weeks after *The Corporate Balancing Act: How Can Directors Manage Conflicting Pressures?*

It is important background knowledge that around 85% of HSH is owned by two German Federal States. Accordingly, losses are, for a large part, shouldered by taxpayers. This explains why the press treats the (alleged) failures of the board as spectacular. The criminal charges against HSH directors are by far no exception. In many countries, including the US, charges have been filed against bankers. More or less all banks had suffered from failures of identifying the risks arising from subprime loans and their securitizations, but many also from non-related developments. HSH, for example, was hit – as basically all Hamburg banks – by a souring market for shipping loans.

Criminal liabilities for business judgments?

There is one peculiarity of the charges filed against the HSH directors. Different from Enron-type transactions, Omega 55 was, as far as we know, not negotiated with a view to commit a fraud or to cover an earlier non-compliance. The directors rather considered Omega 55 as a possible legal way to help the company out of a finance problem. The decision could thus be seen as a simple (if certainly a bad) business judgment that was made in the corporate interest.

Still, a criminal charge was filed. The prosecutor argued that the HSH directors gave their consent to Omega 55 on the basis of insufficient information. The information provided to the HSH directors by

their in-house departments is (in parts) included in the 224-page print version of the judgment. It is complex information, directors had to base decisions on similarly complex information in a number of other occasions. Decisions regarding Omega 55 as well as regarding other transactions had to be taken under time pressure. With a view to Omega 55 the stakes were high given the negative market perception of the bank.

To be sure, we should remember that the business judgment rule foresees a safe harbor for civil liabilities towards the company, provided that directors act upon sufficient information. What is sufficient information depends on the specific circumstances. The business judgment rule is accepted in many countries as a rule for abstention of court review, last not least to avoid second-guessing of business decisions by judges.

Criminal charges follow a different logic. Embezzlement, the charge filed against HSH directors, serves to punish the agent for causing losses by intentionally (*dolus*) misusing the principal's assets. The obvious danger is that a charge will be filed merely on grounds of a not-so-good outcome of a business decision. To make the problem clear: Under an unconstrained legal test of embezzlement courts could review the merger of Daimler/Chrysler or, in few years, that of Deutsche Börse Frankfurt and London Stock Exchange or in any other case, should the public be unhappy with the outcomes of a merger. This would be, not doubt, the least useful approach to reviewing business decisions.

Reconciling the concepts of civil and criminal liability is difficult. The German Constitutional Court demands to tie the somehow wide offence of embezzlement in business cases to strict criteria. The German Supreme Court in Civil Matters that will try the HSH case again will most probably use the criteria of severity and obviousness of the breach to justify review or denial of review. The outcome is unclear but the chosen criteria might, in principle, be adequate to foreclose charges based on *ex post*

disappointments of the public. Nevertheless it seems that further efforts are needed to sufficiently fill the criteria with content.

Trade-offs between civil and criminal sanctions

Criminal charges are, no doubt, an important component of a viable constraint strategy. Constraints essentially serve to safeguard directors' good behavior *ex ante*. Some have argued that prosecutors and criminal courts are generally not capable of understanding business. This is not necessarily true although insiders observe that the prosecutors in the HSH case were not fully aware of the large dimensions of daily business decisions made by bank directors.

Further, it is not exactly clear to what extent we could or should bar criminal charges. For cases of outright fraud criminal charges are indispensable. Should they also be used to alleviate civil enforcement problems? State prosecutions are not subject to the cost/benefit calculations private actors need to make prior to filing a suit. Charges under criminal law could thus well overcome collective action problems of shareholders and help to enforce duties where directors would otherwise be judgment-proof.

It should be kept in mind though that criminal proceedings in cases of badly made business decisions shift the costs of investigating directors' failures from shareholders to the general public. Civil compensation claims can and will be built on the investigations of the prosecutor and on the findings of the criminal court. In fact, the HSH judgment explicitly states that although directors did not commit a criminal offence they still breached their duties towards the company. Such findings might not bind a civil court but, of course, they carry strong power of persuasion.

Possible distinctions

Taking these thoughts a bit further some distinctions can be made. Blatant failures and reckless ignorance of monitoring duties might well

justify to supersede any attempts made under civil law to balance out sanctions. Nicholas Leeson's trades remained uncontrolled until Barings Bank finally filed insolvency. Similarly, the \$2bn losses of Morgan Stanley caused by Bruno Iksil, the "London Whale," would not have been possible had the board directors provided for suitable risk management and for early red flags.

It would be inappropriate though to believe that directors do or must have full knowledge of all information that exists within the company. Such belief would ultimately preclude any division of labor, i.e. the very reason for why corporations exist and for why they contribute to public welfare.

Failures of gathering information or of processing information accordingly need a more careful approach. Leaving sanctioning power to private parties, i.e. shareholders and investors ideally leads to a balanced use of suits. No doubt, private enforcement systems are imperfect. This is true for basically all forms of derivative suits, and possibly even more for class actions. However, many other governance strategies can be used to supplement liabilities. We might think of remuneration claw backs and informal sanctions, or more generally on sound arrangements of internal supervision by non-executive directors.

Considering the flaws of criminal prosecution those of private enforcement might be less problematic. The degree to that this statement is true is certainly worth further discussion. At least three problems of criminal sanctions should be kept in mind: First, the stigma of criminal charges lead to a stand-still not only in the individual career of the charged person but also in the execution of the tasks as a director. Second, a serious threat of criminal charges can severely hamper the appointment of qualified candidates and will, no doubt, aggravate risk aversion. This especially applies to regulated industries or to businesses in so-called high-risk jurisdictions. Third, criminal law precludes useful attempts to tailor liability. For example, tailored

indemnification can be advisable especially with a view to strengthen individual engagement for high-risk tasks like restructuring a distressed firm.

Open questions and future tasks

The main point to be made from the analysis above is that criminal liabilities are imprecise (a "claymore") and that they should be used only very carefully and only in the most fragrant cases. We need to make sure that prosecutors and criminal courts do not start to tell directors how to manage risks. In other words, we need to build up a better understanding of what does and what does not amount to a breach of duties which is so severe and obvious that it will justify filing a criminal charge.

Formulating directors' duties is a demanding task. To name three possible priorities: First, standard setting is important. Outside regulated industries this is mainly the responsibility of commissions to whom we entrust the administration of codes of conduct and the formulation of best practice recommendations. Code commissions should be active rule makers. They should not abstain from changing, amending or inserting recommendations when this can guide directors on how to reliably execute their tasks.

Second, there is no-one-size-fits-all, neither for small nor for large entities. Any box-ticking option will fail to provide viable guidance, especially with a view to liabilities. Boards should be encouraged to discuss the appropriate arrangements and, in case of listed companies, be obliged to give meaningful explanations to the public for the choice they made.

Third, the perhaps most pervasive risks of being charged for failures to gather or to process information will be minimized best when directors can prove that they have set up operative internal reporting structures and suitable information channels. With a view to non-executive directors (or monitoring directors in a two-tier board model) this does require regular and random information exchanges with employees in key functions.

Strategic Oversight and the Redefinition of Context

Stephanie P. Bertels

*Director of the Centre for Corporate Governance and Sustainability,
Beedie School of Business, Simon Fraser University, Canada*

Corporate boards face an increasingly complex world. The pace of innovation and discovery is on a scale unseen since the Renaissance^{1,2}. Coupled with this, the effects of breaching key environmental thresholds³ are becoming more evident as the impacts of climate change rise in frequency and intensity and water scarcity becomes more prevalent in many regions. In such challenging circumstances, strategic oversight is an ever more important responsibility of boards. And as pressure mounts for companies to take action on sustainability issues – boards find themselves asking: “How much is enough?”

Boards must oversee the development of resilient corporate strategies that are responsive to these dynamic and increasingly interconnected global trends. Almost 40 years ago, Michael Porter⁴ alerted companies to the need to look beyond their own corporate boundaries by factoring their industry environment into their strategy-making process. Soon thereafter, Edward Freeman⁵ developed the stakeholder view of the firm, proposing that companies needed to consider the interests of a broader set of stakeholders beyond shareholders. Fast forward to the present and increasing

resource scarcity, heightened social uncertainty, and continued instability in the financial markets are driving boards to broaden their contextual understanding to include key environmental and social megatrends and the constraints these thresholds create for their businesses.

Over the last year, I have interviewed over 100 chairpersons, CEOs, and directors from global companies from a range of industries and ownership structures, asking them whether and how environmental and social issues factor into boardroom discussions about the core strategy of the business and what shifts are needed with respect to how companies are currently governed. I heard that conversations in the boardroom are slowly but surely evolving from whether there *is* an obligation, mandate, or benefit to board engagement around environmental, social and governance (ESG) issues to *how* best to incorporate and address them. In particular, there was a growing sense that strategic oversight processes that did not properly account for the short and long-term impact of significant environmental and social trends would negatively impact shareholder value, and ultimately be seen as a failure with respect to fiduciary duty.

When asked about the key drivers of this evolution, three key themes emerged from these conversations:

Managing Disruptive Risk

Companies across all sectors are experiencing profound change, heightened volatility, and increasing uncertainty, exacerbated by the increasingly interconnected nature of these risks. To anticipate these complex and potentially disruptive risks, boards need to engage in thorough, proactive scanning. Including social and resource/

- 1 Schwab, Klaus. “The Fourth Industrial Revolution.” Geneva: World Economic Forum, 2016.
- 2 Goldin, Ian, and Chris Kutarna. *Age of Discovery: Navigating the Risks and Rewards of Our New Renaissance*. Bloomsbury Publishing, 2016.
- 3 Rockström, Johan, et al. “A safe operating space for humanity.” *Nature* 461.7263 (2009): 472-475.
- 4 Porter, Michael, E. *Competitive Strategy: Techniques for Analyzing Industries and Competitors*. New York: Free Press, 1980.
- 5 Freeman, R. Edward. “Stakeholder management: framework and philosophy.” Pitman, Mansfield, MA (1984).

environmental trends in long-term risk conversation helps to surface potential sources of disruption, helping your company to be more proactive in its response.

Maintaining Social License

The last half century has seen immense shifts in terms of what society deems acceptable business practice. Increasing pressures on scarce resources mean that companies will increasingly compete to maintain their social license and access to key resources. Boards must anticipate and understand these shifting pressures. The consideration of environmental constraints and shifting societal expectations is a natural evolution and an inevitable shift in the need to maintain social license to operate.

Setting Defensible Limits to your Involvement

Companies are under increasing pressures to play a role in solving environmental and social issues; no company succeeds in the long term in a failing society. While expectations are ratcheting, there is only a limited amount of capital that any company can direct toward addressing these issues. Many directors are asking: How do we know how much is “enough”? How do we prioritize our investments into addressing these issues? By taking a more systemic approach to understanding the company’s key social and environmental impacts and its biggest levers for positive change, the board can prioritize where it makes the most sense to direct scarce resources (which may include beyond its own boundaries).

“I think over the last decade it’s the same forces that have driven our growth that have been prominent in a lot of the literature about sustainability: large megatrends like mass urbanization and globalization. Our business is really facilitating the build-out of the world’s essential infrastructure. A lot of that is driven by mass urbanization in places like China, India, and Brazil. Those are very resource-intensive megatrends – people aspiring to be in the middle

class becoming more energy-intensive, tapping increasingly those non-renewable resources and driving constraints. Those trends are going to affect the sustainability of the globe, and they’re going to affect the sustainability of our industry, so they’re very much interlinked.”

(CEO, global manufacturing company)

Considering your context

While many companies have made the shift to “triple bottom line” thinking, leading companies are beginning to view their operations as part of a nested system bounded by the social and environmental systems that surround them (what is starting to be called “a nested view” or “sustainability context” or simply “contextualized”).

What came out clearly from our conversations with CEOs and board chairpersons in a broad range of industries is that the consideration of sustainability context and key social and environmental megatrends is edging its way into the boardroom. An increasing number of firms are starting to articulate public positions with respect to impactful global trends (such as climate change, water scarcity, and inequality) and to describe and disclose their exposure to social and environmental risks, particularly those that could be material for investors.

“I would say that most companies and boards are still stuck in [...] that compliance mentality of minimizing one’s footprint, rather than reimagining the very mission of the business in terms of planetary boundaries, in terms of the opportunities that those factors may create around the definition of the business.”

(Non-executive director, global oil and gas company)

Leading companies in this space are moving beyond simply reporting on their percentage reductions in greenhouse gas emissions or their contributions to local communities, and instead contemplating their own interests and roles in upholding resilient

ecosystems, resilient social systems, and resilient economies. Early leaders are engaging in structured processes that help them prioritize which strategic investments will help increase their own resilience and bring positive impact to the communities in which they operate.

“It’s about institutionalizing, in the strategic planning process, key global mega-trends including trends around planetary boundaries and sustainability. Then what’s also really important is once you set out these frameworks how do you make sure that on an ongoing basis you communicate them, measure them, and then link your reward systems to the delivery of strategy? What’s happening to your brand value from the way that you behave, also the way that society perceives you to behave, in the way that you’re achieving your goals?”

(CEO, banking)

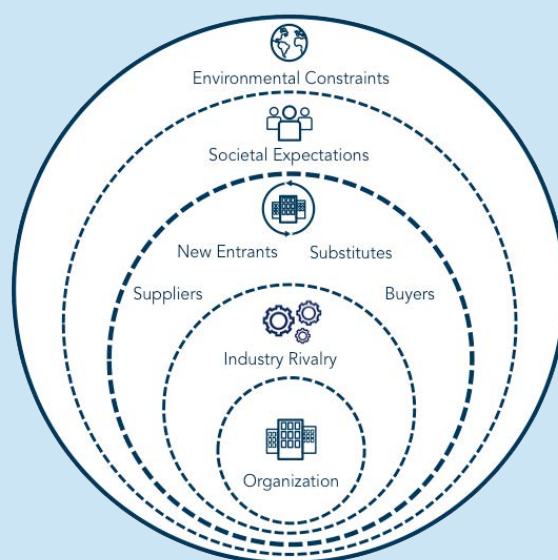
Many of the early leaders on context stressed the need to understand how megatrends such as climate change, increasing income inequality, and increasing political instability will constrain their growth and how the risk and opportunities that they present will impact financial returns and the welfare of both shareholders and stakeholders over the long term. Of note also was the sense that companies will find themselves increasingly pressured to both consider and disclose their company’s performance with respect to key environmental and social thresholds determined with reference to natural and social science understandings of the limits of ecosystems and social systems.

So, for instance, instead of asking “how much could we reduce our emissions?” or “how much will we reduce our greenhouse gas emissions over the next five years?” the question becomes “how much do we need to reduce our own greenhouse gas emissions (and in what timeframe) to do our part in meeting the long-term goal of keeping the increase in global average temperature to well below 2°C above pre-industrial levels?” Companies

are already starting to being asked to set “science-based” or “context-based” goals and targets. As part of their annual disclosure process, the CDP (formerly the Carbon Disclosure Project) has started asking companies whether they are committing to greenhouse gas emissions reduction targets that support the global effort to limit warming to 2°C.⁶

Exercising responsible strategic oversight includes ensuring that the strategy process led by management acknowledges, analyzes and institutionalizes the need to address social and environmental constraints.

A key part of the process of implementing contextualized thinking involves developing an understanding of social and environmental mega-trends and thresholds, understanding the magnitude of change required and determining what portion of the change your company will commit to addressing (and in what timeframe). Some companies are already starting to set corporate goals in line with these principles.



⁶ Science Based Targets, available at: <http://sciencebasedtargets.org>

What would help promote more contextual thinking?

Devote more time to strategic oversight on the board agenda

Boards were counseled to ask themselves what role the company plays in the broader system and how the company's role might need to evolve. Interestingly, while strategic oversight is considered a core function of corporate boards, many respondents remarked how little of the board agenda is devoted to these high level conversations.

“I was involved with our national committee on good governance, one thing we advised boards to do, is simply to have the secretary track how much time they spend on reporting and financials and how much time they spent on strategy. It turned out that, instead of having strategy be an integrated part of all discussions, it only came up in slots where you would discuss the strategy. We also found out that something like 80-90% of the board meeting time was spent looking at numbers and what had already happened instead of what will happen.”

(Former chairman, pharmaceuticals)

Make sure your board has access to the right expertise

We heard repeated concerns that boards do not have the depth of expertise in environmental and social issues that may be required to properly oversee the evolving risks and opportunities associated with these trends. Currently, directors are often recruited on the basis of their specific field of expertise. We heard that as a result, they tend to limit themselves to raising concerns or providing input on those topics or discussions that particularly pertain to where they are meant to have expertise. Few companies currently include environmental or social expertise in their board competency matrix. This means boards may need to augment their board competency matrix, engage in director training or draw upon internal or external expertise.



“I think it starts with the board members actually knowing what they’re talking about, which we are fortunate with. We ask the right questions because they have the right knowledge. Our chairman and several of our directors are people who are deeply knowledgeable about [environmental and social issues]. They continually ask us, ‘What are we doing? Are we focused on the right things? Are our programs delivering?’”

(CEO, global retailer)

Broaden the experience that you bring to the table

It was suggested that most current board members are trained as lawyers or accountants, and as a result, these discussions can be perceived as overly politicized or overly scientific. It was suggested that boards need to broaden the diversity of their membership to properly oversee the evolving risks and opportunities associated with these mega trends.

“The point is to understand whether things are changing, you need to have a broad set of inputs. If we’re all actuaries, all accountants, all engineers, we see the world so much the same that we can’t listen, we can’t hear, we can’t see it...Then the challenge of course is to make sure you listen to the counter voice once you have an opinion. You shouldn’t forget there’s another side. You need to have more voices. It can’t just be the one voice.”

(Chairman/Chief Executive, global financial services group)

Independent Directors: The Key to Board Effectiveness?

Independence is core to the monitoring model of the board and commonly viewed as the key to effectiveness. Independent directors, generally defined as non-executive directors who have no material relationship to management of the company, are viewed as being able to provide expert advice and oversight over the company without undue influence from management. In addition, independent directors can act as a counterpoint to the CEO and management.

In the United States, public corporate boards are almost exclusively composed of independent directors. This trend is expanding to other countries across the world due in part to regulatory pressures. For example, as described by one participant, under Hong Kong Stock Exchange rules, at least one-third of the members of an IPO company board must be independent non-executive directors. Another Salzburg participant with experience in the financial services industry criticized this development, noting that “there is a sense [among regulators] that companies and management can’t do it themselves; they have to be held accountable, they have to be controlled... You must have an independent board to oversee these folks whose baser instincts will take over unless you have independent monitoring.”

This preference for independent directors is not without adverse consequences. By excluding insiders from board membership, boards are losing deep knowledge and expertise of the company’s affairs and

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“The demands that are being placed on the independent directors now have never been greater. These are not people who are subject matter experts, by and large, in the industry in which they are sitting. Sometimes you get lucky and get them, but most of the time they are not, so you are asking smart, experienced people who don’t have the skillset to apply themselves to strategy, to apply themselves to helping companies figure out what their capital structure will be – that’s a lot of burden on these independent directors.”

strategy. Independent directors are at best “part-timers” due to their other commitments, including full-time jobs, thereby limiting the time they have to dedicate to their board responsibilities. This part-time nature of outside board directors can present challenges for building the detailed knowledge of the company required to be an effective board member, as reflected by a board advisor in Salzburg:

“Everybody likes independence, theoretically, and there is a lot of good that comes from the independent monitoring, but the demands that are being placed on the independent directors now have never been greater. These are not people who are subject matter experts, by and large, in the industry in which they are sitting. Sometimes you get lucky and get them, but most of the time they are not, so you are asking smart, experienced people who don’t have the skillset to apply themselves to strategy, to apply themselves to helping companies figure out what their capital structure will be – that’s a lot of burden on these independent directors.”

The possibility of personal liability of board members has also discouraged potential candidates from serving on boards. This view was supported by anecdotes shared in Salzburg, with various participants describing the refusal by board members to become committee chairpersons due to the fear of additional liability exposure. It was also suggested that any additional expansion of personal liability may result in more risk-averse decision-making by directors, which in turn could negatively impact the company’s performance and shareholder return.

To determine if a director is indeed independent, major stock exchanges around the world have set out specific standards or tests. These standards generally look at the director’s relationship with the company and senior

management to determine if the director has a material relationship or other conflict of interest. Participants discussed whether such standards of independence are sufficient, with one noting: “It is not so easy to say what is independent and what’s not independent. What is independent of mind and spirit and who has the interest of the shareholders, for whom are they there, whom they represent, it is more complicated than just a rule.” It was suggested that independence determinations should also take into account personal relationships and social circles, not only between the director and management but also among the directors: “You can have a situation in the board because of social ties or networking ties [where] one director does not raise a point because of another director in the room due to the social relationship.” One way some companies have attempted to minimize the impact of social ties is by using external recruiting firms to identify potential board members who do not have prior relationships with, or are in the same social circle as, other directors or management.

But is independence actually key to the effectiveness of every company’s board? Some participants challenged this notion, arguing that private equity and venture capital portfolio companies have been very successful despite lacking independent directors. In fact, they argued, technology companies deliberately seek directors with strategic relationships to help build the company. Portfolio company boards may be populated with insiders, but private equity and venture capital investors are able to act as strong counterpoints to management because they have the resources and staff necessary to effectively analyze the company and hold management accountable. Despite these views, many in Salzburg did still agree that independent directors are important in widely-held public companies, where there is a concern that the interests of public shareholders may not otherwise be protected relative to the interests of management and/or a controlling shareholder.

However, if independent board members are in place to protect the interests of the shareholders, can being shareholders themselves impair directors’ independence? Although there was agreement in Salzburg that generally de minimis shareholdings by directors should not impact independence, it was noted that “there is some level of ownership where you just need to make sure that the individual is acting in the best interest of all shareholders as opposed to herself.” Given the growing importance of corporate social responsibility, “one could see a linkage between corporate social responsibility concerns and shareholdings as interfering with independence,” foreshadowing potential future disagreements on whether independence and substantial shareholding are compatible.

Another means of eliciting greater independence of thought and behavior of boards could come through changes in their overall structure. One such

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structural change that has been suggested is to split the roles of CEO and Chairman as it is argued this will enable better monitoring by the board and will help avoid potential conflicts of interest or undue influence regarding the CEO’s compensation and tenure. More effective monitoring was also noted as a core rationale for populating certain board committees, such as audit, compensation and nominating, exclusively with independent directors. In Japan, having a separate Chairman is beneficial as this connotes additional authority and respect, enabling the Chairman to act as an effective counterpoint to the CEO. In contrast, in the US context, it was argued that shareholders may not feel strongly about separating the two as reflected by the fact that shareholder proposals in the United States have rarely passed. This, however, might be explained in part by shareholders believing that an independent lead director, today a common feature at US public companies, renders an independent chairperson unnecessary. Executive sessions for independent directors were viewed as a beneficial practice by participants from all jurisdictions as such sessions provide independent directors with the opportunity to meet without management to discuss issues amongst themselves, including topics that may be controversial to management. However, as noted by participants from several different jurisdictions, executive sessions contribute to the effectiveness of the board only if the key discussion points at the session and any action items are timely conveyed to the CEO or senior management more generally.

The Obsession with Independent Directors

Mariana S. Pargendler

Professor, FGV School of Law in São Paulo, Brazil

Strengthening board independence has been the most important and recurring prescription of the corporate governance movement. The central ideal behind this recommendation is clear: the absence of significant relationships with the corporation and its officers is an essential prerequisite for the impartial monitoring of the company's business by the board of directors. In principle, this makes sense. It is difficult to be an effective monitor of one's own actions.

What ends, then, should the board's monitoring efforts serve? Since the emergence of the corporate governance movement in the late 1970s, the growing and ever more exacting independence requirements have appeared as a solution for a vast array of social and economic ills. This is so even though the existing empirical evidence has largely failed to offer support to the view that independent directors make a distinctly positive contribution to corporate performance and responsibility.

In the early days of the corporate governance movement, independent directors appeared as a solution to the corruption problems of the Watergate era in the United States. In the following decades, the idea that independent directors should protect outside investors and promote the maximization of share prices progressively gained ground. Following the accounting scandals of the early 2000s, independent directors appeared as an effective mechanism to ensure corporate integrity and prevent fraud. More recently, following the financial crisis of 2008, policymakers have hoped that independent directors may help curb systemic risk. And, if all of this were not enough, stakeholders have long expected independent directors to also promote corporate social responsibility. In other words, the rise of independent directors followed

a "chicken soup" logic, a remedy that "can't hurt, but might help" numerous economic and social maladies.

These developments have placed outsized expectations on independent directors. The different objectives that independent directors are expected to pursue can easily conflict with one another. Independent directors are no panacea for the variety of challenges that plague the modern business corporation and capitalism more generally.

At any rate, for the independent director mechanism to work as intended, actual independence is crucial. Commentators have long observed that independence "on paper" does not necessarily entail effectively independent judgment. If ensuring actual independence has been difficult in the United States – where dispersed ownership and a board-centric model of corporate governance have traditionally prevailed – these challenges are compounded when the independent director model is transplanted to different contexts.

In most countries in the world, and especially in emerging markets, the presence of controlling shareholders is the norm. In these cases, an important question arises: to what extent can independent directors be effectively independent from controlling shareholders? One could argue that, irrespective of formal definitions, independent directors are structurally dependent on controlling shareholders, who appoint them and can remove them at any time. In state-owned enterprises, ensuring independence may be even more difficult. In response to a major corruption scandal and governance crises, Brazil has recently enacted a new statute prescribing the presence of independent directors on the boards of state-controlled

firms. However, in a state-heavy economy, is it plausible that such state appointees will be strictly independent from the government?

More fundamentally, the turn to independent directors first emerged in the United States, whose corporate governance system has been notoriously board-centric. If the board plays a central role in corporate decisions, then a focus on board independence makes sense (at least in principle). Yet other systems are far more shareholder-centric. Brazil provides an extreme version of shareholder power in corporate governance: shareholders can not only adjudicate the vast majority of corporate decisions on their own without board interference, but they can also bind directors' votes through shareholder agreements. In this context, the role of even the most competent and independently-minded independent director is much diminished.

The relentless emphasis on independent directors to solve copious problems in very diverse contexts,

despite the lack of empirical evidence supporting their effectiveness, is somewhat puzzling. I would like to suggest that one reason for the recurrent emphasis on independent directors is that the idea turns out to be politically palatable. In periods of scandals and crises, the focus on the board's role and composition offers a compromise solution that simultaneously combines a private sector focus with a reformist overtone. As such, the idea appeals to progressives as a path for social and economic change in the face of political resistance to greater state intervention, while pleasing conservative forces as an acceptable concession to deflect growing governmental intrusion in private affairs.

None of this is to suggest, however, that the independent directors project is necessarily misguided. Nevertheless, the importance of independent directors should not be a foregone conclusion. Institutional design is crucial. As with most things, the devil is in the details.



Keeping the Board Active, Alert, and Effective

Board refreshment is a critical means to ensuring that the board remains active, alert, and effective. Discussions on board succession practices and board skills assessment have been driven largely by institutional investors and activist shareholders who are critical of current refreshment practices (or lack thereof). The board's ability to anticipate and handle emerging risks and oversee changing strategies can be compromised in boards where membership does not change. Board refreshment is seen as key to ensuring the board has the right competencies to handle an ever-changing and technology-driven economic environment, and a diverse set of voices and perspectives to ensure robust and thoughtful assessment of risks and opportunities.

Board diversity

Participants in Salzburg echoed this view, generally agreeing that a board with a diverse set of members yields better results. Optimal board composition is like a “jigsaw puzzle [that] must work as a whole.” Each member must bring different, but complementary skills, background and experience. However, the group agreed that no one particular board composition or structure is best and that the appropriate board composition for a company depends on that particular company's specific needs. Broadly speaking, board diversity is seen as an effective way to promote good decision-making as it reduces the risk of groupthink (i.e., decision-making based on achieving harmony or conformity that may impact the board's ability to effectively assess alternative or diverse solutions). Diverse boards were generally seen as a positive development by the group, however, debate ensued regarding what “diversity” means with respect to board membership. In this regard, the group explored whether desired board diversity entails diversity of thought, background, skillset, gender, race, age or some combination thereof. As argued by one participant, the board's ultimate goal should be to have effective governance, and by seeking different attitudes and aptitudes, the board can achieve diversity – but diversity should not be a goal in itself.

Some jurisdictions, particularly in Europe (but notably not in the US), have introduced legally-mandated quotas as a means to increase gender and racial diversity on company boards. This approach can prove controversial, however, with disputes over whether this is appropriate and effective. As described by a proponent of gender quotas, without such quotas, female representation on boards would have remained stagnant in Europe. In further support of this position, another participant described the board membership opportunities for women prior to mandatory quotas as a “Catch-22”: in order to be considered for a board seat, a candidate needed prior board experience, which

Optimal board composition is like a “jigsaw puzzle [that] must work as a whole.”

“The threat of quotas is what lights a fire under boards, and we know that would never happen in the US, so that is why progress is so slow.”

women did not have or were at a disadvantage to gain. Mandatory quotas provided women with the opportunity to acquire such experience, thereby creating and increasing the pipeline of female board member candidates. Although the UK employed voluntary gender diversity targets to successfully increase the number of women directors on British corporate boards, the specter of mandatory quotas was in the background. In contrast, the percentage of women on US corporate boards has stalled because, as observed by one participant, “the threat of quotas is what lights a fire under boards, and we know that would never happen in the US, so that is why progress is so slow.” In addition to quotas, other diversification methods, such as the use of all-women and minority slates for board vacancy interviews, were also explored in Salzburg. As a counterpoint to the US and European experience, it was noted that Japanese corporate boards generally do not consider diversity to be a priority.

Board tenure

In addition to experience and gender diversity, age and length of tenure are also key points in the board refreshment and effectiveness debate. Should board members be required to leave after a set number of years or at a certain age? No, if you want board members to develop a deep understanding of a company, was the opinion held by many in Salzburg. By artificially enforcing board refreshment, some argued, boards may lose their most effective members. The UK Corporate Governance Code stipulates that a director that has served more than nine years on a board is no longer considered independent. In recounting several examples in which boards replaced members due to tenure and term limits, a participant explained that the new directors did not understand their respective companies as well and pushed for decisions that led to the “tremendous destruction of shareholder value.” A counterpoint made to this argument was that new directors bring new perspectives, experience, and skills, which in turn may make the board more effective at discharging its duties.

Another significant topic that emerged during the session revolved around information – how to get it, how much is too much and how to use it. Information was generally seen as the key to effectiveness, but concerns were raised that board packages and materials are now too voluminous and too difficult for directors to digest and synthesize in a meaningful manner. This information overload is exacerbated by the part-time nature of directors, who have conflicting commitments and limited time to dedicate to the review of board materials prior to the meeting. Participants discussed how best to handle the information flow and what mechanisms, if any, boards can employ to more effectively manage information. It was suggested that management should provide boards with analysts to review and synthesize background material for directors prior to meetings or prepare better and more fulsome executive summaries of the board materials highlighting key issues. Some



boards have begun utilizing specialists to supplement areas where the board does not have expertise, such as compensation programs or climate change impacts. Engaging directly and building ongoing, rather than quarterly, dialogue between boards and CEOs and senior executives in charge of control functions can help board members build an understanding of potential risks faced by the corporation. Another method suggested for bridging information gaps and developing a better understanding of the business is for the board to conduct strategic retreats with the CEO and senior management.

Board self-evaluation

The board's own self-evaluation process is another important method a board can use to remain active and effective. Board self-evaluations can take a variety of forms and some are better than others, with use of a third party emerging among the group as a preferred method. In this scenario, a third party is engaged to speak individually with board members, consolidate and synthesize the information collected, and report back the results of the evaluation to the board and chair of the nominating and governance committee. One participant highlighted that the most important benefit of the evaluation process is the identification of skill gaps on the board. In addition, self-evaluation provides the board with opportunities to assess whether individual directors may need to be rotated off the board due to lack of engagement, skills, or other issues. However, a board's self-evaluation is only as effective as its questionnaire and related follow-up, and it was noted that sometimes the companies that are most in need of proper board evaluations are the worst at conducting them.

A board's self-evaluation is only as effective as its questionnaire and related follow-up... Sometimes the companies that are most in need of proper board evaluations are the worst at conducting them.

INTERVIEW

Sandra Guerra: Corporate boards need “diversity in every sense”

Former chairwoman of the Brazilian Institute for Corporate Governance and founding partner of Better Governance discusses the importance of diversity on governing boards in a rapidly changing world

At the second session of the *Salzburg Global Forum on Corporate Governance*, participants used their own experiences, differing backgrounds, and varying perspectives to address questions of governance within corporations. One such topic was diversity on boards, how this diversity can be improved – and indeed if it should be.

During *The Corporate Balancing Act: How can Directors Manage Conflicting Pressures?* Salzburg Global spoke with Sandra Guerra, independent director of Vix Logística and founder of Better Governance, a Brazilian consultancy firm focused on improving corporate governance in the country. She not only highlighted the need for gender diversity on boards, but also expanded on the traditional ideas of board diversity.

“My experience on boards is being alone as a woman,” says Guerra, who has served on several listed and non-listed companies’ boards as a member or chair, and was the former chair of the Brazilian Institute for Corporate Governance (IBGC). Despite her experience of male-dominated boards, she believes diversity is not solely about gender: “Diversity is really important to boards, and I’m not just talking about gender diversity... Gender, age, geographical location, academic background – I mean diversity in every sense.”

Guerra acknowledges the difficulties involved in ensuring that boards are diverse but insists on its importance: “A board would be unmanageable if you have 20 people on it, so it’s challenging to find the perfect board.... There’s a limit to the size of the board, but you should try to have at least a fair amount of diversity on the board.”

While gender diversity is often highlighted, Guerra makes a clear case that it is also important to have age diversity on corporate boards. She cites innovations such as Airbnb, the largest room-sharing provider in the world: “How would a 65 or 70 year old, who has spent their whole life living in hotels, even think of this kind of thing?”

Innovation is identified as one of the major disruptions to modern business. Guerra believes younger generations are at a distinct advantage in dealing with technological changes, and this shouldn’t be ignored. When it comes to innovation and disruption, young people are not a novelty – they’re a necessity. She believes having young people on boards will mean they are better prepared for these disruptions: “You have to have some young people who are able to speak up.”

“Boards take decisions all the time, so for you to have a more robust process of decision-making, you should have different perspectives, in order to challenge perspectives,” she adds. However, diversity doesn’t guarantee the outcomes of these decisions will always be the best they possibly can be: “You can never tell if the decision would be better or not.” It is the process that benefits from diversity, not necessarily the outcome.

Guerra’s fundamental message is in that of “vision” on a board: Vision is achieved through diversity on boards with members who have varying experiences, opinions and backgrounds; it keeps companies ahead of the game, ready to incorporate innovation and react to disruptions – and remain successful.

Board Diversity: Thoughts and Predictions

Rupa Briggs

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Board diversity continues to be an important topic in US corporate governance. In a June 2016 speech regarding the state of diversity on corporate boards, then-Chair of the US Securities and Exchange Commission Mary Jo White urged “CEOs and boards of public companies [to] act aggressively to alter this landscape and do so quickly.”¹ With institutional investors and diversity advocates increasing their focus on board composition and tenure, US corporate boards are likely to face greater pressure to examine and change their policies.

State of diversity on US corporate boards

A recent article in *The Financial Times* characterized the state of US corporate boards as “maler, staler and frailer,” finding that the average US director is older than his European counterpart, and is twice as likely to be over 65 years old.² The trend is towards a “graying” of the US board, with the average age for Standard & Poor’s (S&P) 500 independent directors rising from 62.1 years in 2010 to 63.1 years in 2015.³ *The Financial Times* article also found that European boards on average have greater female representation (approximately 25%) as compared with the United States (roughly 15%). The overall percentage of women on all S&P 500 boards

increased to 20% in 2015 from 16% in 2010, with the percentage of S&P 500 boards having at least one woman director rising (from 90% in 2010 to 97% in 2015).⁴ The trend towards gender and racial diversity has continued. In 2015, women made up 31% of new independent directors, compared with 21% in 2010 and 20% in 2005.⁵ Minority directors made up 18% of new independent directors in 2015 up from 12% in the prior year.⁶ However, the percentage of minority directors in the largest 200 S&P 500 companies has stagnated at 15%.⁷

Current strategies for board diversification

A number of European countries have enacted legally-mandated gender quotas for board membership to increase diversity on boards.⁸ Norway, the first mover in gender quotas, requires that at least 40% of company board members be women, with non-compliance resulting in penalties. France, Italy and Belgium have enacted similar mandatory quotas with penalties, while Spain, Iceland, the Netherlands and Germany, among others, have adopted mandatory quotas without sanctions. Many other countries have gender quotas for the boards of state-owned enterprises, including Denmark, Finland, Greece, Israel, Kenya

1 Mary Jo White, Keynote Address, International Corporate Governance Network Annual Conference: “Focusing the Lens of Disclosure to Set the Path Forward on Board Diversity, Non-GAAP, and Sustainability” (June 27, 2016), available at: www.sec.gov/news/speech/chair-white-icgn-speech.html.

2 Stephen Foley, Jennifer Bissell and David Oakley, “US Board Composition: Male, Stale and Frail?,” *The Financial Times* (August 16, 2016), available at: <https://ig.ft.com/sites/us-board-diversity>. *The Financial Times* analyzed ISS Analytics data of more than 45,000 directors across 5,000 companies in 30 markets.

3 Spencer Stuart, *2015 Spencer Stuart Board Index* (November 2015), available at: www.spencerstuart.com/~media/pdf%20files/research%20and%20insight%20pdfs/ssbi-2015_110215-web.pdf.

4 Ibid.

5 Ibid.

6 Ibid. Spencer Stuart Index defines “minority director” as African-American, Hispanic/Latino and Asian.

7 See White, note 1. See also Spencer Stuart, note 3.

8 Neeka Choobineh (2016). “Gender Quotas for Corporate Boards: A Holistic Analysis,” *Joseph Wharton Research Scholars*, available at: http://repository.upenn.edu/joseph_wharton_scholars/21. See also Tyler Winters and Madhuri Jacobs-Sharma, “Gender Diversity on Corporate Boards: The Competing Perspectives in the US and the EU” (2016), *Comparative Corporate Governance and Regulation*, Paper 13, available at: http://scholarship.law.upenn.edu/fisch_2016/13.

and Brazil. By contrast, the United Kingdom has demonstrated that voluntary quotas can be effective, with the percentage of women on FTSE 100 boards increasing from 12.5% in 2011 to over 25% in 2015.

In the United States, institutional investors and diversity advocates have been key motivators of board diversity changes. In recent years, institutional investors have pressured companies to concentrate on environmental, social and governance (“ESG”) issues, including board diversity and board refreshment, as investors view these as important to a company’s reputation and financial performance. This focus on ESG has accelerated, with institutional investors flexing their governance muscles, so to speak, as seen in the push for proxy access and more substantive shareholder engagement. White also brought additional attention to board diversity issues with several speeches on the topic,⁹ and by indicating that the SEC may revise its current rule on board diversity to enhance the quality of disclosures.¹⁰ Moreover, a growing number of multinational companies have initiated voluntary expansion of diversity disclosure in proxy statements (e.g., pie charts and bar graphs describing gender, racial and age composition of the board).¹¹ As more companies adopt expanded disclosure policies, other companies likely will face increasing pressure from investors to include similar disclosures. Companies are also actively seeking to diversify their boards and are employing new strategies for

board recruitment, such as interviewing slates of only women and minorities candidates for open board seats.¹²

The value of diverse boards

Arguments in favor of increased diversity on corporate boards often highlight the positive correlation between gender and racial diversity and company financial performance. Several studies have supported this assertion.¹³ However, a recent analysis has shown that the research on this relationship has produced mixed results and is highly dependent on the methodology used in measuring performance.¹⁴ Although a conclusive link between diversity and financial advantage has not been shown, there are other powerful rationales for increasing board diversity, including reflecting the demographics of a company’s customers and reaping the positive reputational impact from a social justice and equal opportunity perspective. In addition, diversity on boards may positively alter small-group dynamics to help boards function better by enhancing monitoring ability. Diverse viewpoints or backgrounds enhance the deliberative process and can reduce the occurrence of “groupthink” (i.e., decision-making based on

9 See White, note 1. See also Mary Jo White, Keynote Remarks at the Women’s Forum of New York Breakfast of Corporate Champions: “The Pursuit of Gender Parity in the American Boardroom” (Nov. 19, 2015), available at: www.sec.gov/news/speech/gender-parity-in-the-american-boardroom.html.

10 Ibid.

11 For example, see 2016 Proxy Statement for General Electric Co., available at: <https://www.ge.com/investor-relations/governance> and 2016 Proxy Statement for PepsiCo, Inc., available at: www.sec.gov/Archives/edgar/data/77476/000120677416005007/pepsico_def14a.htm.

12 See Joann S. Lublin, “Some Firms Intensify Push for Gender Parity at Board Level” (Aug. 16, 2016), *Wall Street Journal*, available at: www.wsj.com/articles/some-firms-intensify-push-for-gender-parity-at-board-level-1471357128.

13 See McKinsey & Co., *Diversity Matters* (Jan. 2015), available at: www.mckinsey.com/business-functions/organization/our-insights/why-diversity-matters; Catalyst, *The Bottom Line: Corporate Performance and Women’s Representation on Boards* (Oct. 15, 2007), available at: www.catalyst.org/knowledge/bottom-line-corporate-performance-and-womens-representation-boards.

14 Deborah L. Rhode & Amanda K. Packel, “Diversity on Corporate Boards: How Much Difference Does Difference Make,” 39 *Delaware Journal of Corporate Law*, 2 (2014), available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685615. See also Bart Frijns, Olga Dodd, Helena Cimerova, “The Impact of Cultural Diversity in Corporate Boards on Firm Performance,” *Journal of Corporate Finance* (forthcoming), available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2817642.

achieving harmony or conformity that may impact the board's ability to effectively assess alternative or diverse solutions).

However, the mere presence of a diverse director on a board may not effectively promote such goals, especially if there is only one such director. In this case, the diverse director may not have the leverage to enact change or may have their voice silenced. Furthermore, diverse directors may come from similar socioeconomic, professional or educational backgrounds as other directors, therefore limiting the potential for "disruption" of the status quo in boardrooms.¹⁵ Interestingly, a recent Equilar analysis of CEO pay concluded that companies with a higher percentage of women on their boards paid their CEOs 15% more than companies with less diverse boards.¹⁶ One of the reasons posed is that membership on boards is very difficult for a woman to achieve and therefore they do not want to rock the boat and jeopardize their standing with the

other members of the board.¹⁷ In addition, the lack of diverse candidates may result in the same diverse candidates holding multiple directorships. Boards have tried to address this problem by expanding the criteria (and pool) of candidates that they will interview. For example, boards are now willing to accept candidates who have not had previous public company board experience.

Conclusion: Predictions for board diversity

Ultimately, investor and public perception and reputational risk will be the biggest drivers of change for board diversity at the midsize and smaller company level. As noted above, large multinational companies have recognized the need and benefit of diverse boards and have begun to make necessary changes. As more company boards diversify, midsize and smaller companies will begin to feel investor and public pressure to change. As social media continues to expand in influence, companies will be contending with other stakeholders, including, potentially, the general public, which will likely influence the composition of corporate boards in the future.

15 See Rhode & Packel, note 7.

16 Gretchen Morgenson, "Where More Women Are on Boards, Executive Pay is Higher," *The New York Times* (May 27, 2016), available at: www.nytimes.com/2016/05/29/business/where-more-women-are-on-boards-executive-pay-is-higher.html.

17 Ibid. Nell Minow, a vice chairwoman at ValueEdge Advisors, a compensation and corporate governance consultancy, in the article observed: "It's very difficult for women to get on boards, and I think they are under even more pressure to go along and get along."



“In the 1980s and 1990s, these guys were called ‘corporate raiders’ and also ‘arbitrageurs,’ then in the late ‘90s and the 2000s, they were called ‘activist investors,’ and now you are seeing terms such as ‘engaged managers’ or ‘responsible owners.’”

Activism and Short-Termism

Activist shareholders, who purchase shares in a publicly traded company with the goal of influencing company strategy to increase shareholder return, have sparked much debate: are they helpful or destructive to businesses? Participants in Salzburg generally had a positive view of such shareholders, noting that the presence of an activist can have a salutary impact on other board members and raise the level of sophistication of board meeting discussions, because they have the resources and staff to analyze a company and its strategy in order to develop and push for shareholder value enhancing ideas. It was cautioned, however, that as with any new board member, an activist board member must be sensitive to the board’s culture, taking care not to alienate other directors with whom she needs to build consensus.

Shareholder activism is much more prevalent in the United States, however participants indicated that activism is expanding to other regions, in some cases resulting in positive changes. For example, Japanese corporations have invited large foreign investors to become investors in order to push for necessary changes, such as restructuring and workforce streamlining, which would otherwise be unacceptable due to cultural factors. In addition, another advisor noted that short-sellers in Chinese listed companies raised questions regarding practices being undertaken by the companies, potentially uncovering malfeasance. Several European participants also noted that activist investors are beginning to emerge in Europe, but that their level of activity is still minor.

Proxy Advisory Firms

Proxy advisory firms, such as Institutional Shareholder Services (“ISS”) and Glass Lewis, are also increasing in prominence and importance. Historically, American activist investors faced challenges in rallying other investors to vote for their proposals due to the diffuse shareholder base of US public corporations. This collective action problem has been addressed by ISS and Glass Lewis, which set out voting standards that can be followed by the shareholder base. It was observed by one participant that due to the influence of these organizations on shareholder voting, activist investors expend significant efforts on lobbying ISS and Glass Lewis to accept the activists’ position on key corporate actions. However, even though activists still continue to use traditional and social media to pressure companies and boards to act in the activists’ favor, activists often seek board seats in order to shape company strategy directly. A deft summary of the evolution of the activist investor reflected the generally positive tone and views of the group towards activists: “In the 1980s and 1990s, these guys were called ‘corporate raiders’ and also ‘arbitrageurs,’ then in the late ‘90s and the 2000s, they were called ‘activist investors,’ and now you are seeing terms such as ‘engaged managers’ or ‘responsible owners.’”

An often-voiced criticism of activist investors is that such investors promote short-termism as they are only interested in making a quick return on their investment and force companies to sacrifice long-term planning for short-term gain. Activist investors are not the only source of short-termism, as suggested by several participants who asserted that the financial reporting cycle of public companies largely favors and encourages short-termism. In this regard, it was argued that senior executives manage their businesses on a quarterly cycle in order to meet market and analyst expectations so as to avoid a negative price impact on their stock. This view was challenged by the argument that short-termism is primarily being driven by technological disruption and shorter product life cycles that require boards to be ever nimble and more reactive. Another participant observed that not all short-termism is negative, especially in the private equity and venture capital spaces, where short investment time frames enforce discipline in decision making. However, short-termism is not a universal concern; Japanese corporations are facing the opposite problem – long-termism – which has resulted in risk-averse corporate boards and stagnant growth.

Short-Termism

Short-termism can also impact executive compensation. As one participant explained, US executive compensation structures changed 30 years ago to tie compensation to performance and better align the interests of management with shareholders because of investor demand for higher corporate profits. After the 2008 financial crisis, executive compensation has been subject to renewed scrutiny. Concerns were raised during the discussion that new compensation regulations in the finance sector will lead to a brain drain in the industry, while others questioned whether such a brain drain would be a bad consequence. However, participants generally agreed that in structuring executive compensation: “You have to be very careful on what sort of incentives you provide. What we have known for centuries is not that incentives don’t work – it is that incentives work too well.”



“You have to be very careful on what sort of incentives you provide. What we have known for centuries is not that incentives don’t work – it is that incentives work too well.”

FELLOW'S INSIGHT

*Short-Termism: Problems, Evidence and Solutions***Edward B. Rock***Director, Institute for Corporate Governance and Finance;
Professor, New York University School of Law, USA*

Concern over “short-termism” is wide spread. Hillary Clinton, in a speech in July 2015 at New York University’s Stern School of Business, argued that “[P]ublicly-held companies [that face] pressure from shareholders are less likely to invest in growth opportunities than their privately-held counterparts. Large public companies now return \$8 or \$9 out of every \$10 they earn directly back to shareholders, either in the form of dividends or stock buybacks, which can temporarily boost share prices.”¹ She went on to call for action “to address the influence of increasingly assertive shareholders determined to extract maximum profit in the minimum amount of time, even at the expense of future growth. Now, so-called ‘activist shareholders’ can have a positive influence on companies. It’s a good thing when investors put pressure on management to stay nimble and accountable, or, press for social and environmental progress. But that’s very different from these hit-and-run activists, whose goal is to force an immediate payout, no matter how much it discourages and distracts management from pursuing strategies that would add the most long-term value for the company.”

In 2009, a blue-ribbon group meeting at the Aspen Institute issued a widely read report on “Overcoming Short-termism” that argued that “boards, managers, shareholders with varying agendas, and regulators, all, to one degree or another, have allowed short-term considerations to overwhelm the desirable long-term growth and sustainable profit objectives of the corporation. We believe that short-term objectives have eroded faith

in corporations continuing to be the foundation of the American free enterprise system, which has been, in turn, the foundation of our economy. Restoring that faith critically requires restoring a long-term focus for boards, managers, and most particularly, shareholders—if not voluntarily, then by appropriate regulation.”² Lots of others, including prominent Delaware judges, have likewise expressed concern.³

This is not a new concern. Thirty years ago, Peter Drucker wrote that “Everyone who has worked with American management can testify that the need to satisfy the pension fund manager’s quest for higher earnings next quarter, together with the panicky fear of the raider, constantly pushes top managements toward decisions they know to be costly, if not suicidal, mistakes.”⁴

What is the “Short-Termism” problem?

Although a variety of concerns are swept up into the broad category of “short-termism,” for our

1 Transcript available at: <https://medium.com/hillary-for-america/moving-beyond-quarterly-capitalism-7abec53733f6#.p45dk1rhc>.

2 The Aspen Institute, “Overcoming Short-termism: A Call for a More Responsible Approach to Investment and Business Management,” available at: www.aspeninstitute.org/publications/overcoming-short-termism-call-more-responsible-approach-investment-business-management.

3 Leo E. Strine, Jr., “One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?,” 66 *Business Lawyer* 1 (2010); Leo Strine, Jr., “Can We Do Better by Ordinary Investors: A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law,” 114 *Columbia Law Review*, 449 (2014); Jack Jacobs, “Patient Capital: Can Delaware Corporate Law Help Revive It?” Vol. 68 *Washington and Lee Law Review*, 1645 (2011), available at: <http://scholarlycommons.law.wlu.edu/wlulr/vol68/iss4/2>.

4 Peter F. Drucker, “Drucker on Management: A Crisis of Capitalism,” *Wall Street Journal* (Sep 30, 1986).



purposes, the basic concern is that long-term objectives are neglected because of too much concentration on short-term goals. This can be driven by different forces including: shareholder pressure; compensation schemes; taxes; securities regulation; and technology.

In the 1980s, the focus was on hostile takeovers, and the worry that, under pressure from “raiders,” companies were being sold at a premium to their market value but below what they would be worth in the future, if only shareholders would trust in managers more.

Today’s story focuses on a different version: “managing to the market.” The basic idea is that, under pressure from shareholders, managers are being pushed into choosing lower valued but easy to understand projects over higher valued but more complex projects.⁵ The repeated claim is that “the markets relentlessly demand profit growth this quarter. Executives respond by underinvesting in long-term growth and buying back stock or paying large dividends.”⁶

There is also a more general concern, namely, that in managing corporations, managers and shareholders *both* fail to take into account the risks of climate change (or some other long-term but hard to quantify risk).

Is there a problem?

The evidence is quite mixed on whether there is a problem and on its magnitude.

Evidence in Support

As the public discourse shows, there is widespread agreement among CEOs that there is a substantial problem and short term pressures interfere with long term investment choices.

On the academic side, those who are concerned about short-termism frequently point to a 2005 study in which John Graham, Campbell Harvey, and Shiva Rajgopal interviewed 400 CFOs of large US public companies.⁷ Almost 80% of them said that they would sacrifice economic value for the firm in order to meet that quarter’s earnings expectations. That 80% of CFOs would *admit* to earnings manipulation is pretty astonishing, and should not be ignored.

⁵ William Bratton & Michael Wachter, “The Case Against Shareholder Empowerment,” 158 *University of Pennsylvania Law Review* 653, (2010).

⁶ Roger Martin, “Yes, Short-Termism Really is a Problem,” *Harvard Business Review*, (Oct 9, 2015).

⁷ John R. Graham, Campbell R. Harvey, and Shiva Rajgopal, “The Economic Implications of Corporate Financial Reporting,” 40 *Journal of Accounting and Economics*, 3-73 (2005).

Furthermore, there is clear evidence that stock buybacks and dividends are at a very high level.⁸ In addition, there are a variety of finance studies that find substantial short-term bias in public corporations.⁹

On the other hand...

There is substantial econometric evidence pointing in the other direction. For example, there are studies showing that managers whose compensation is tied to volatile stock prices overinvest in research and development (R&D).¹⁰ Other studies cast doubt on the assertion that institutional investors impose short-term pressure by showing a positive link between institutional investor ownership and investment in R&D.¹¹ The uncertain relationship is unsurprising. Long-term investment – e.g., in R&D – fluctuates over time and depends on a host of factors. This makes identifying a causal link between market pressures and the level of R&D exceedingly difficult.

The anecdotal evidence likewise points both ways. On the one hand, we hear a chorus of CEOs complaining about short-termism. On the other hand, as we order our books or groceries or music or housewares from Amazon, we can easily identify companies that have gone years without earnings as they have devoted billions of dollars to building what they hope will be long term value, investments that have been rewarded by high market caps. “Market” evidence is likewise indeterminate. The average holding period of shares, or, equivalently, the annual turnover of shares, is impressively high. On the other hand, a huge amount of the “churn” is a result of frequent trading by a small number of investors, while the *average* holding period for

the largest institutional investors, who collectively hold a very substantial percentage of the shares, has lengthened.¹² An index fund will have a nearly infinite holding period.

If there is a problem, what can be done about it?

A variety of solutions have been proposed to address the problem of short-termism. Each encounters problems either with regard to effectiveness or side effects or both.

Time phased voting

Although one share one vote is the default rule in most jurisdictions, alternatives exist. Under Delaware law, a company may opt by charter to give longer term shareholders more votes than short-term shareholders, e.g., four votes per share to shareholders who have held for two years or more, one vote per share for everyone else. Unlike dual class structures, there is a single class of shares and all shares revert to one vote per share upon sale. A few companies have adopted this structure (Smucker’s, the American jam company, is the best known). US institutional investors do not like this structure, so it is rare. Whether shareholders who have held for more than two years (without regard to how long into the future they will hold) will vote differently than shareholders who just acquired their shares (perhaps with the intention to hold indefinitely) is an open question. Time phased voting is permitted under French law and is common in France.¹³

8 See summary of evidence in Bratton & Wachter.

9 For a very useful analysis with a survey of the evidence, see Mark Roe, “Corporate Short-Termism – In the Boardroom and in the Courtroom,” 68 *Business Lawyer*, 977, 986-87 (August 2013).

10 Ibid at 994.

11 Ibid.

12 Ibid at 998-1001.

13 Lynne Dallas & Jordan Barry, “Long-Term Shareholders and Time-Phased Voting,” 40 *Delaware Journal of Corporate Law*, 541, N. 17 (2015) (citing Shearman & Sterling LLP et al., “Report On The Proportionality Principle In The European Union” (2007) at 44-45 (finding that 10 of the 20 largest French companies, and 12 of the 20 most recently listed French companies, had TPV)); Chiraz Ben Ali, *Disclosure and Minority Expropriation: A Study of French Listed Firms* at 18 (looking at 84 of the largest French public companies and finding TPV in 64% of the sample).

Loyalty shares with increased dividends

Some have proposed defining a class of long-term shares which will get a higher dividend in exchange for restrictions on selling.

Tax treatment

Some argue that the tax system should be used to incentivize long-term holding, e.g., by decreasing the capital gains rate the longer a shareholder holds the shares. Others argue that the inability under US tax law to deduct long-term losses against ordinary income induces shorter holding periods.

Disclosure obligations

Some argue that quarterly disclosure focuses investors on quarterly results. Others argue that it is not the quarterly disclosure so much as the earnings guidance in anticipation of quarterly disclosure that focuses attention on quarterly results. For these, eliminating quarterly disclosure or prohibiting guidance will tend to lengthen investors' time horizons. On the other hand, doing so reduces the amount of information available to investors.

Executive compensation

There is evidence that short-term incentives in executive compensation induce short-term behavior. Given the effectiveness of incentives on shaping human behavior, this should not be surprising. To the extent that boards of directors wish to better align managers' horizons with those of their long-term shareholders, they may have sufficiently leeway to do so.

CEOs hold large amounts of equity (stock and options) and are typically discouraged from selling that equity while serving as CEO. New equity compensation typically vests over a four year period. Directors are typically compensated half in cash, half in stock, and encouraged or required to accumulate a substantial position (relative to their annual compensation). This compensation structure provides incentives to consider both short term and long term stock price.

On the other hand, boards do not have unlimited flexibility. The best CEOs are typically in demand by other firms, and may be reluctant to wait years before collecting their pay, especially if they have to wait years after they have already left the firm. In addition, excessively long holding periods can provide an incentive for CEOs who are nearing the end of their tenure to sell the company as a way of cashing out their positions.

Changing shareholder and board "ideology"

Much of the response to short-termism can perhaps best be understood as trying to shift shareholders' and directors' understanding of the goals of corporate governance and their role, that is, what some might call "ideology." The idea seems to be that directors should be convinced to think long-term and that shareholders should be more willing to support directors who do so by supporting boards' long-term strategy and giving boards the benefit of the doubt when there are reverses. If we do this, the claim is, we can shift the balance back towards long-term wealth creation. Although one might be skeptical that such an effort can succeed, it is not unprecedented: between say 1950 and 2000, directors' self-understanding of the goals of corporate governance arguably shifted from some notion of managing the corporation for the benefit of all of its stakeholders to a stronger emphasis (now decried) on "shareholder primacy." As *BusinessWeek* said in a critical piece on the role of business schools in the financial crisis, "If business school were a church, shareholder value maximization would be its religion."¹⁴

The problem of implementation

Although leaders of some of the largest institutional investors have signed on to various proclamations

14 N. Craig Smith & Luk Van Wassenhove, "How Business Schools Lost Their Way," *BusinessWeek* (Jan. 11, 2010), available at: <https://www.bloomberg.com/news/articles/2010-01-11/how-business-schools-lost-their-way>.

supporting long-term value creation, it is unclear whether these proclamations can or will be implemented even within their own firms. It is very hard to fight the market.

The money management business is fiercely competitive, with money flowing to firms with the best (short-term) returns. Portfolio managers are typically incentivized based on a combination of short-term and longer-term returns. The labor market for portfolio managers likewise focuses on returns over various time horizons. Without limiting competition among money managers or competition for money managers – steps no one has proposed – market pressures will continue to focus attention on short-term returns, especially when the short-term alternative is certain (e.g., the sale of the company at a premium), while the longer-term returns (e.g., executing on a strategic plan) are more speculative. Firms likewise often operate in hyper-competitive global product markets that impose relentless pressure on costs. This limits firms' ability to invest in long term innovation, and limits discretionary expenditures by even the most long term oriented shareholders and managers.

The oldest “solution”: director judgment

A board of directors, when it takes its role seriously, is expected to exercise judgment in a context of incomplete information. To the extent the firm has flexibility, what is the optimal time horizon for decisions? Will treating employees well increase long term profitability? Can the firm afford to invest in speculative R & D given product market pressures? Is production best moved off-shore? Does the firm have the right CEO to take the company to the next level? Has the firm struck the right balance between responding to pressures from investors and investing for the long term? How should the CEO's pay be structured?

In the range of decisions that a board makes, there is rarely an obviously correct answer, but decisions must be made. The oldest “solution” to the “short-termism” problem is also the least sexy and, for many, the least satisfying: director judgment. In the absence of a silver bullet, can we do better?



Ko-Yung Tung: “We need to be more nuanced and more knowledgeable as we tackle issues relating to globalization”

Senior Counselor with Morrison & Foerster and former Vice-President of the World Bank discusses business in different cultures and globalization

Cultural attitudes, traditions and norms can influence the make-up of a board and the board's relationship with stakeholders. Ko Yung Tung, Senior Counselor with Morrison & Foerster LLP and former Vice-President of the World Bank, discussed these differences, and spoke specifically about US and Japanese approaches to their stakeholders when he attended the 2016 *Salzburg Global Forum on Corporate Governance*.

One of the major themes to emerge from the session was how it is often difficult to address issues of corporate governance and the role of boards of directors across cultures and geographic boundaries. This is because business culture often varies based on geographic and cultural boundaries, especially in the case of the US and Japanese companies.

As Tung explains, the Japanese attitude defines the purpose of a company loosely: “In Japan a corporation is seen as a social player, and therefore they are responsible not only to the shareholders, but what they refer to as their stakeholders.”

The most important “stakeholders” to Japanese companies are usually their employees, to whom the company has an obligation that exceeds just paying their salary, providing benefits such as housing subsidies. In return they expect loyalty and long-term service from their employees. “If you expect an employee to be there for a long time you can invest more in them.”

This long-term service and investment can lead to a well-trained and highly-skilled workforce, however, it can have negative outcomes too, Tung notes: “If they have too much job security maybe they're not incentivized to perform at their highest level.”

The US approach, on the other hand, Tung says, is “shareholder-centric” where “the primary objective is to increase financial returns for shareholders.” Maximizing profit for the shareholders is the main, and often the only, concern. Provisions like those from Japanese companies to their employees make for a stark contrast when compared to the US culture, which sees companies invest little in their employees resulting in a “very fast turnover of employees” compared to the decades of loyal service found at Japanese companies.

There are also noticeable differences in the moral philosophies of US and Japanese companies, which Tung explained: “Japanese companies tend to act as good citizens within their family. They see the world through ever-expanding concentric circles, first its employees, next its shareholders, next its suppliers and so on.” If you're within the “circle,” you can expect “good” treatment, but if outside, you're not thought of as that company's responsibility at all.

In contrast to this, “Americans talk about morals and they're very mission-orientated – they propagate good principles and good morals, yet at the same time they may believe their morals are the correct ones.” They try to spread their morals, but they assume they're in the right, possibly without considering cultural differences.

These differences in company expectations and moral philosophies highlight just a few of the differences worth considering when doing business on a global level, and they lead Tung to conclude: “We need to be more nuanced and more knowledgeable as we tackle issues relating to globalization.”

The Corporation as a Good Citizen

In recent years, the movement for corporate social responsibility (“CSR”)—business practices and initiatives for social good, such as ethical labor practices, charitable contributions and sustainability—has grown in scope and influence. The European Union has mandated CSR disclosure by 2017 for companies with over 500 employees and over 90% of Fortune 250 companies in the US voluntarily publish sustainability reports. CSR at its core challenges the notion of shareholder primacy and champions the view that boards must take into account the interests of other stakeholders and society-at-large when making decisions. Against this backdrop, participants from all jurisdictions engaged in a robust discussion regarding a number of hypothetical scenarios involving boards tackling issues related to corporate good citizenship.

Hypothetical Scenario: Corporate social responsibility considerations for manufacturers

The first scenario asked participants to consider whether a manufacturing company struggling to maintain profits should implement a series of clean energy programs in its manufacturing operations:

Big Company has been a successful manufacturing company (producing a variety of goods) with operations in a number of countries including the UK, France, Germany, and India. Although it has shown profits of \$50 million or better in each of the last three years, it expects serious difficulties in maintaining any profits in this year or 2017 because of the disruptions created by Brexit. For the last two years, Keep the Environment Clean has privately urged Big Company to adopt a series of clean energy programs in its manufacturing operations. It has threatened a public campaign if the company does not respond vigorously to its suggestions. Implementing such a program company-wide is estimated to cost \$900 million over the next three years and to be depreciated over the next ten years. Energy cost savings are estimated to be \$25-50 million a year beginning in 2019. Senior management is unenthusiastic about implementing the program because of its impact on net earnings and consequently on Big Company’s stock price.

The group primarily focused on economic rationales for the clean energy program and, in particular, whether the program would enhance shareholder value. There was disagreement over whether the investment would be prudent given that some elements of the cost-benefit analysis may be difficult to calculate due to the long time horizon. Several participants took an adamant position that they would not agree to implement the program in any case given the speculative nature of the potential cost savings and long time frame for recoupment of the investment. In this regard, participants considered what “long-term” entails and discussed the appropriate time period over which one should measure costs and benefits. In addition, the group debated whether such time frame has an outside boundary. Relatedly, one participant with experience in Asia suggested that the conservative course of action may be to postpone a decision on the program, observing that the current \$900 million cost may decrease as a result of technological advances. Other topics that the participants addressed included the potential reputational boost from the investment and the legitimacy of the environmental group’s threat from a public relations standpoint.

Hypothetical Scenario: Outsourcing to child labor-using subcontractors

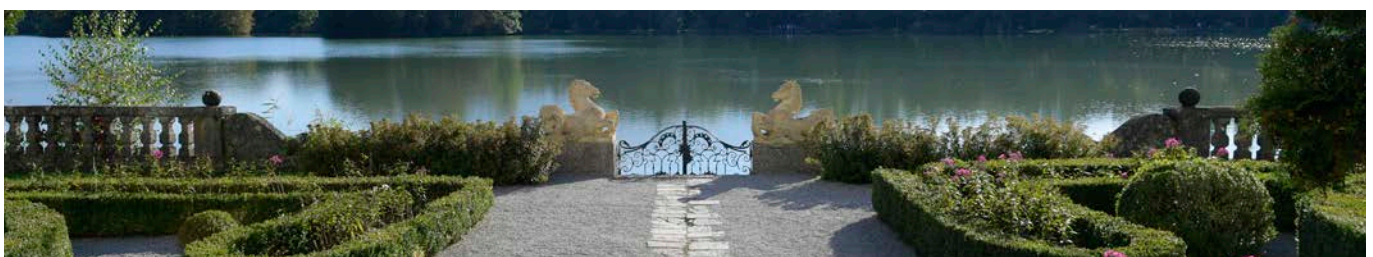
Another hypothetical scenario involved a company outsourcing the manufacture of certain products to subcontractors that use child labor, as described below:

Big Company outsources manufacture of certain products it incorporates into products it sells worldwide. A number of the outsourced manufacturers use child labor working in difficult circumstances. The countries in which the child labor is used do not prohibit it. However, use of such labor would be prohibited in many of the countries in which the products are sold. A church-related group has written a public letter to the Chair of the Board of Big Company, asserting that selling goods produced by child labor is immoral and should stop. This group has also pressured the relevant regulators to force companies like Big Company to disclose the extent to which they sell goods which are produced, in whole or in part, by child labor. Senior management believes that as long as its suppliers do not violate the law, it is not sensible for Big Company not to use these suppliers. Cutting them off would give a significant competitive advantage to companies who continue to use them. Senior management believes that Big Company would suffer roughly \$20 million annual reduction in profitability if Big Company acceded to the proposal. In addition, it recommends hiring legal and lobbying resources to head off any regulatory action, and a public relations firm to counter the publicity campaign of the church-related group.

This scenario prompted spirited debate among the participants, many of whom framed their arguments on the use of child labor in terms of reputational damage

and long-term impact on shareholder value. This analytical framework and underlying assumptions were challenged by a participant with experience in Latin America: “The discussion we had really assumed that the socially or environmentally-oriented action was always consistent with long-term value so there is alignment between both objectives. We also heard the argument, which I find convincing, that such area of alignment has been increasing because of the pressure of social groups, social media, and regulatory action. But I still find it implausible that such area of alignment is complete, so [that] all externalities are now internalized and what is good for society corresponds always to long-term value creation for the corporation. Even after factoring in the reputational concerns, possible sanctions, changes in the regulatory environment, and the response from consumers –it is still worth it to continue the child labor practices or other similarly repugnant practices?”

A contrasting view point was presented regarding whether the interest group’s campaign to end child labor practices by the company would yield unintended results. As an advisor with Asian company experience argued: “The knee jerk reaction is to say that child labor is bad and therefore we will not allow our subcontractors to use them even if it is legal. But experience has shown that actions like that have other consequences which may be even worse, because we have seen this. What happens to the children that you want to protect? They go into prostitution and other situations worse than working at the textile [industry].”



In addition to the hypotheticals, the group also discussed how a corporation can better align its obligation to maximize shareholder profit with social good, including the use of sustainability development measures and other CSR benchmarks. The United Nations Global Compact and United Nations Principles for Responsible Investment were offered by one academic as soft law guides that a corporate board can use to reconcile CSR with its profit-making mandate. However, the usefulness of these and similar initiatives was questioned, because, as was noted by a European participant, the threat of expulsion or other public shaming is minimal, which thereby allows corporations to make empty commitments.

Board policy statements on CSR-related topics help boards better integrate broader social issues into their decision-making process, and also providing a method by which stakeholders can hold boards accountable. Corporate boards around the world have created such statements on various CSR topics, including climate change and labor standards. These statements clearly set forth what a company's policy is with respect to a specific CSR topic and what actions, if any, the company is undertaking or will undertake with respect to the issue. They can be an effective tool for boards because they provide directors with a clear framework on how to tackle the CSR-related elements of a decision. Shareholders are not usually engaged by directors when crafting such statements but given the growing interest in these topics, as demonstrated by the prevalence of CSR-related shareholder proposals, it was recommended that they should be.



Rodrigo Gallegos: In Mexico good citizenship isn't just about publicity – it's a necessity for the future of business and state

Executive Director of the Mexican Business Council discusses the importance of business in advancing the state and the Mexican people's wellbeing

Taking part in the recent Salzburg Global Seminar session *The Corporate Balancing Act: How Can Directors Manage Conflicting Pressures?* Rodrigo Gallegos shared his worries for the future of his country: “We’ve seen up-and-coming countries, like Brazil and Venezuela and Argentina, that have fallen back because of the huge risks that political systems and rule of law systems are holding in these countries that has led to their current situations, and it’s a reality that could also happen in Mexico.”

Gallegos heads the Mexican Business Council – a group of Mexican Fortune-50 companies trying to affect change in Mexico through collaborating in the pursuit of common goals. He’s seen Brazil, Venezuela and more succumb to failures that could have been avoided by the government. As head of the Business Council, his job is to coordinate companies and help them work together to protect their own and the state’s interests, which often overlap.

“Many global firms do good citizenship because their boards, shareholders and owners want to do it; in Mexico firms need to do it – if we don’t change things, the government won’t change anything,” he explains. In Mexico, the business community has been “building stronger civil society organizations and helping civil society organize best.”

Gallegos sees the business sector as being in a prime position to affect change: “Businesses have a lot of power. They control a lot of economic power and employ a lot of people. But this power isn’t being used.” He believes that by coordinating the businesses in Mexico, he can harness this economic and social power.

This doesn’t come without challenges. “It’s always difficult to coordinate people, but even more so if they’re 50 of the most important businessmen and women in the world,” he adds. As the first permanent head of the Mexican Business Council he will provide constant and stable guidance, which is necessary to tackle the deep issues that Mexico has.

But what gives the private sector the right to try to reform the political and social systems of a state? Gallegos believes it’s the need for justice at all levels of society. “It doesn’t matter where you come from – whether you’re the richest or at the base level – we all need access to transparent and fair justice and a system that provides it.” According to Gallego, the private sector in Mexico is uniquely able to pursue this goal.

Gallegos calls this coordination in the business sector “altruism out of necessity.” It’s clear that the line between private and public has become blurred in Mexico. The primary function of business remains profit, but the profit of a company is inextricably tied to the health of the state, and the health of the state to the wellbeing of the people.

Perhaps if Venezuelan, Brazilian or Argentinian business had adopted the same strategy that Gallegos is now pushing in Mexico, their current situation may be different. Whether or not these countries can recover remains to be seen, but Gallegos is determined that this model of the business sector providing where the government isn’t able works for the private sector, the state and the people of Mexico.

FELLOW'S INSIGHT

Shareholder Pressures and the Evolving Expectations of US Corporate Boards for Climate Change and Sustainability

Veena Ramani

Senior Director, Ceres, USA/India

The past two years have seen tremendous progress in the climate change and sustainability space. COP 21 resulted¹ in unprecedented greenhouse gas-reducing pledges from 186 countries representing more than 95 percent of global greenhouse gas emissions; a binding commitment to limit global temperature rise to well under 2°C; and a long-term goal of achieving peak global emissions as soon as possible and rapid reductions thereafter. The Agreement has also entered into force, having been ratified by 112 of the 119 Convention Parties in record time.

What has been just as remarkable has been the scale and the scope of financial actors who jumped in the fray as a part of the run up to the negotiations. Groups as diverse as global institutional investors² to insurers³ – to even commercial banks in the US⁴ – released statements noting that climate change posed risks to their investments and to the global economy writ large. The groups that galvanized around the negotiations underscored that climate change was now a concern of the global financial community, and there is no doubt that their voices lent some of the additional

weight that helped propel the global agreement through.

What continues to be remarkable is the extent to which the financial community has maintained the drumbeat around climate change in the months following Paris. In January, the Financial Stability Board chaired by Bank of England CEO Mark Carney announced the establishment of a Task Force on Climate Related Financial Disclosures⁵ to make recommendations on company disclosures that would best help financial market actors understand their exposure to climate related risks. Task Force members include JPMorgan Chase, BlackRock, Barclays, CPP Investment Board and the like. By the beginning of the Salzburg Global Forum on Corporate Governance, the US 2016 Proxy season had included a record breaking 89 resolutions on climate change.⁶ This number does not include resolutions that addressed climate change indirectly, such as sustainability reporting, climate change-related lobbying efforts, and resolutions that indirectly relate to climate change, like palm oil, deforestation, and recycling.

In addition to addressing climate change broadly, investors are also starting to zero in on the role of the board as the way to get companies to address climate change, and at the pace and the scope necessary to tackle the issue. While proxy access is the headline from the 2016 US proxy season, it is

1 Historic Paris Agreement on Climate Change,” UNFCCC, 2015, available at: <http://newsroom.unfccc.int/unfccc-newsroom/finale-cop21>.

2 “Global Investor Statement on Climate Change,” *Investor Platform for Climate Action*, 2014, available at: <http://investorsonclimatechange.org/statement>.

3 “Special session on climate change and insurance sector,” *OECD*, 2015, available at: <http://www.oecd.org/finance/special-session-climate-change-insurance-2015.htm>.

4 “In Support of prosperity and growth: Financial sector statement on climate change,” *Ceres*, 2015, available at: <https://www.ceres.org/files/bank-statement-on-climate-policy>.

5 “Task Force on Climate-related Financial Disclosures,” *TCFD*, available at: <https://www.fsb-tcfid.org>.

6 “Proxy Season Preview: U.S. Environmental & Social Issues” *ISS*, 2016, available at: <https://www.issgovernance.com/proxy-season-preview-u-s-environmental-social-issues>.

worth keeping in mind that climate change exposure was one of the criteria that the investors kept in mind when choosing relevant companies.⁷ Other investors have been more direct. The California Public Employees' Retirement System (CalPERS)⁸ and the California State Teachers' Retirement System (CalSTRS)⁹ have updated their global governance principles calling for their portfolio companies to onboard directors with expertise in climate change. State Street Global Advisors (SSGA) has released guidance on climate change¹⁰ that they want boards in their portfolio companies to pay attention to.

What does all this mean for corporate boards and the question of their responsibility to act on environmental and social issues which may not yet be regulated? Given that boards are fiduciaries to investors, it seems most prudent for them to pay close attention to the issues that their owners care about. Yet, US companies and corporate boards have been slow to address sustainability issues like climate change and integrate them into their strategy and risk assessment in a demonstrably meaningful manner. Research shows that less than a third of large US companies had systems in place for board sustainability oversight – and even for those strong systems, there was no discernible

linkage to improved performance on issues like climate change.¹¹ In fact, interviews that I have conducted with corporate board members reveal that most companies still see environmental and social issues as immaterial to corporate performance. This is reflected in their disclosures, with most of the Standard & Poor's 500 providing only brief and largely boiler plate disclosure of climate change in their financial filings, with minimal quantification of risks and impacts.¹²

US boards find themselves caught up in the horns of an apparent dilemma. On one hand, they are facing a growing call from a segment of shareholders for their involvement and oversight of sustainability issues like climate change. On the other hand, laws and regulations have not caught up to these investor expectations.

Leading companies and boards are starting to address this dilemma by proactively putting in place systems for sustainability oversight that respond to evolving investor expectations, while still remaining true to their fundamental responsibility to steward a corporation for long-term value creation. Such companies do not see a focus on sustainability and a focus on value creation as necessarily being contradictions. After all, the overwhelming majority of research has underlined that high performing sustainability companies in fact outperform their peers on a range of financial metrics,¹³ including

7 "Boardroom Accountability Project," *New York City Comptroller*, 2014, available at: <http://comptroller.nyc.gov/boardroom-accountability>.

8 Veema Ramani, "CalPERS raises bar on corporate directors' role in tackling climate change," *Ceres*, 2016, available at: <https://www.ceres.org/press/blog-posts/calpers-raises-bar-on-corporate-directors2019-role-in-tackling-climate-change>.

9 Krista Noonan, "CalPERS raises bar on corporate directors' role in tackling climate change," *CalPERS*, 2016, available at: <http://www.calstrs.com/news-release/calstrs-enhances-corporate-governance-principles-expanded-board-directors>.

10 Rakhi Kumar & Michael Younis, "Climate Change Risk Oversight Framework For Directors," *State Street Global Advisors*, 2016, available at: <https://www.ssga.com/investment-topics/environmental-social-governance/2016/Climate-Change-Risk-Oversight-Framework-For-Directors.pdf>.

11 "View From the Top: How Corporate Boards Engage on Sustainability Performance," *Ceres*, 2015, available at: <https://www.ceres.org/view-from-the-top>.

12 Jim Coburn & Jackie Cook, "Cool Response: The SEC & Corporate Climate Change Reporting," *Ceres*, 2014, available at: <https://www.ceres.org/resources/reports/cool-response-the-sec-corporate-climate-change-reporting>.

13 Gunner Friede, Timo Busch, and Alexander Bassen, "ESG and financial performance: aggregated evidence from more than 2000 empirical studies," *Journal of Sustainable Finance & Investment* 5:4 (2015), available at: https://www.db.com/newsroom_news/2016/ghp/esg-and-financial-performance-aggregated-evidence-from-more-than-200-empirical-studies-en-11363.htm.

cost of capital, operational efficiency and share price in the long term.

Last October, I released a report outlining evolving investor expectations of how a company's board should oversee sustainability issues. Titled "View from the top: How corporate boards can oversee sustainability performance,"¹⁴ the report was built on interviews conducted with corporate board members, corporate secretaries and leading US investors involved in this space. Some of the questions that the investors noted as a core part of their analysis of corporate boards, and how companies are responding are detailed below.

Does sustainability even belong on the board's agenda?

Investors do not believe that every corporate board should consider every sustainability issue, or even that all boards should consider some sustainability issues. However, where an environmental or social issue materially impacts business performance in the short or the long term, it clearly belongs on the board's agenda. This focus on materiality is critical. Research has shown that shareholder resolutions filed on material sustainability issues can be associated with increases in corporate value.¹⁵

Most companies have formal processes in place to assess what issues can be prioritized as material. A number of US companies explicitly engage investors in the process to identifying material issues to incorporate their perspective; corporate boards are engaged to review and provide sign off on key issues identified. As a part of their involvement, corporate directors could oversee whether the materiality process considers critical environmental

or social issues that have been raised as relevant to the company or the sector.

The other role that directors can play is to ask questions about the timeframe over which issues are considered material. Many environmental and social issues demonstrate financial impact in the medium and long term, rather than the quarterly timeframe. Materiality processes should reflect this. This approach to identifying issues that are material in the long term is another way for corporate boards to make the connections between sustainability and corporate business and financial performance, which is most relevant to investors.

Once an issue has been determined as material, there a growing call for corporate boards to disclose issues that they consider to be material. Noted sustainability thought leader Bob Eccles is calling on corporate companies to issue a Statement of Significant Audiences and Materiality,¹⁶ disclosing audiences that a company's board considers to be significant and issues that are material to each of these audiences.

How is the board addressing sustainability issues?

Once an issue has been identified as material, investors expect corporate boards to ensure that the issues in question have been integrated into the company's strategy, risk assessment and decision making in a thoughtful manner.

Investor expectations on how this should work as it relates to climate change can be seen from the resolutions filed with companies that were seen as particularly at risk from climate change after the global Paris Agreement. The resolutions, largely filed with energy companies, sought clarity on the plans of the companies to evolve their business

¹⁴ Op. cit. "View From the Top."

¹⁵ George Serafeim, "Shareholder Activism on Sustainability Issues" *Harvard Law School Forum on Corporate Governance and Financial Regulation*, 2016, available at: <https://corpgov.law.harvard.edu/2016/07/25/shareholder-activism-on-sustainability-issues>.

¹⁶ Robert G. Eccles and Tim Youmans, "Why Boards Must Look Beyond Shareholders," *MIT Sloan Management Review*, 2015, available at: <http://sloanreview.mit.edu/article/why-boards-must-look-beyond-shareholders>.

model post Paris, and specifically asked that the companies stress-test their business models against the Agreement's goal to reduce carbon pollution in order to limit global temperature rise to below 2°C.¹⁷ Resolutions filed at Exxon and Chevron received record shareholder support during the 2016 proxy season. Companies like BHP Billiton have produced such a report¹⁸ as a board level document, which was endorsed by the Board Sustainability Committee.

Leadership might involve addressing such issues in a systematized manner. Every six months, UK retailer Marks & Spencer's board reviews a group risk profile in which environmental and risks are factored in as contributing to broader risks such as reputation and supply chain.¹⁹ Plan A, the company's integrated sustainability and business strategy, is a summary of the business response to mitigate these risks. The main board is updated on Plan A at least once a year.

Who is involved in the decision making?

The final issue that investors are growing increasingly focused on is the question of who on the board is involved in decision making on sustainability. After all, the ability to assess sustainability issues in an informed manner is fundamental to thoughtful decision making.

One way in which this plays out is through a consideration of which board committee considers the sustainability issues in question. Research has shown that US companies are formalizing sustainability at the board level in a number of ways, including through standalone

sustainability or environmental committees, or integrating sustainability responsibilities into the mandates of existing board committees, largely board governance committees.²⁰ However, given investor expectations that boards should integrate sustainability into strategy, risk, and decision making, my research recommends that irrespective of where sustainability is housed at the board level, board discussions on sustainability should be cross-pollinated with board deliberations on strategy, risk, and revenue.

The second consideration as a part of the discussion on "who" is a more explicit consideration of the expertise of directors to assess and make decisions on the sustainability issues that may be material to their enterprise. As noted earlier, "climate competence" is a hot topic in the US right now, and we are slowly seeing shareholder resolutions calling companies to onboard directors with environmental expertise. Leading companies are proactively assessing the sustainability areas of expertise that are required on their board and explicitly including key issues in board qualifications. For example, Prudential Financial explicitly identifies "expertise in CSR" as a qualification in its board qualifications matrix.²¹

The final consideration that investors have been paying attention to related to this has to do with where directors obtain their information on sustainability and climate change. More and more, investors are calling on corporate boards to look beyond management to inform themselves on key issues, and ideally engage directly with some of

17 Peyton Fleming, "Investors Raising Heat on Fossil Fuel Companies and Their Strategies for Emerging Low-carbon Economy," *Ceres*, 2016, available at: <https://www.ceres.org/press/press-releases/investors-raising-heat-on-fossil-fuel-companies>.

18 "Climate Change: Portfolio Analysis," *BHP Billiton*, 2015, available at: <http://www.bhpbilliton.com/~media/5874999cef0a41a59403d13e3f8de4ee.ashx>.

19 Op. cit. "View From the Top."

20 Peter DeSimone, "Board Oversight of Sustainability Issues," *Investor Responsibility Research Center Institute (IRRCI)*, 2014, available at: http://irrcinstitute.org/wp-content/uploads/2015/09/final_2014_si2_irrci_report_on_board_oversight_of_sustainability_issues_public1.pdf.

21 "Proxy Statement 2015: Notice of Annual Meeting of Shareholders to be held on May 12, 2015," *Prudential*, 2015, available at: <https://www.prudential.com/documents/public/Prudential-Proxy2015.pdf>.

the stakeholders and shareholders involved. The Shareholder-Director Exchange (SDX) developed a framework describing the circumstances under which shareholder-director engagement is appropriate and how to make the engagements valuable.²² Vanguard, one of the world's largest asset managers, proposed the creation of "shareholder liaison committees" in the boards of companies that it invests in.²³ The organization believes this will promote consistent exchanges between shareholders and directors that could help anticipate risks and help boards learn about best practices in other companies. Sustainability issues are a prime example of how this exchange could be used.

It has been fascinating to see how shareholder pressure is slowly but surely causing a change in which US corporate boards are starting to consider sustainability issues. Despite the results of the recent US elections, and the anticipated rollbacks in some climate change related policy measures, the feedback that we have seen is that the US financial community will stand firm on this issue. The involvement of investors has ensured that the evolution is based not on "good citizenship" – but on long-term value creation. I believe that the evolving understanding of the fiduciary responsibility²⁴ of investors for sustainability will eventually lead to an enhanced understanding of the duty of corporate directors in this regard also. Until then, it is worthwhile to watch how enlightened companies are leading the way.

22 "SDX Protocol," *SDX*, 2016, available at: <http://www.sdxprotocol.com>.

23 Stephen Foley & David Oakley, "Vanguard calls for boardrooms shake-up," *The Financial Times*, 2014, available at: <https://www.ft.com/content/543c3b72-7b4c-11e4-87d4-00144feabdc0>.

24 Rory Sullivan, Will Martindale, Elodie Feller and Anna Bordon "Fiduciary Duty in the 21st Century," *UNEP Financial Initiative*, 2015, available at: http://www.unepfi.org/fileadmin/documents/fiduciary_duty_21st_century.pdf.



Conclusions of the Session

1. **The monitoring role of the board will continue to grow in prominence as long as the regulatory landscape demands more active participation by directors in overseeing the management of corporations.** However, boards have multi-faceted responsibilities and must perform a balancing act between monitoring and strategic advisory roles in order to be effective.
2. **Determinations of director independence must consider factors other than business and employment relationships, including personal relationships and social ties, which may result in conflicts of interest and inhibit a director's ability to act independently.** Independent directors are at best “part-timers” due to their other commitments. These limit the time such directors have to dedicate to their board responsibilities. This part-time nature of external board directors can present challenges for building the detailed knowledge of the company required to be an effective board member.
3. **Board refreshment and access to information are critical components in ensuring an active, alert, and effective board.** Proper assessment of board composition and the capabilities of individual board members can ensure the board has the needed competencies to tackle an ever-changing economic environment and a diverse set of voices and perspectives to encourage robust and thoughtful assessment of risks and opportunities. While information is the key to board effectiveness, the sheer volume of data requires boards to adopt strategies to help synthesize and digest materials efficiently.





4. **Activist investors can have a salutary impact on other board members and raise the level of sophistication of board meeting discussions.** Although activist shareholders are most prevalent in the United States, other jurisdictions have seen an increase in activity. Relatedly, proxy advisory firms are playing an ever-expanding and important role in shareholder voting and corporate governance. The speed of technological change, in addition to the public company quarterly reporting cycle and shareholder activism, has encouraged short-termism.
5. **Corporate social responsibility (CSR) has grown in scope and influence and is impacting boardroom discussions and decision-making.** There has been increased alignment of CSR goals and long-term shareholder value due to pressure from social groups, social media and regulatory action. However, boards face difficulty in measuring the economic value of social goals due to their intangible nature and lengthy time horizons. CSR benchmarks and board policy statements, among other tools, can provide boards with a framework to assess and reconcile CSR goals with their profit-making mandate.

Next Steps for the Salzburg Global Forum on Corporate Governance

The final day's discussion opened a vivid debate on the role and definition of "good citizenship." The participants looked beyond just classical corporate social responsibility and into how principles of good citizenship fit into the governance mechanisms of corporations. Expectations vary within different cultures, but current trends suggest changes afoot even in countries with a greater tradition of maximizing shareholder value. The participants felt the need to continue this discussion in 2017, looking at corporate citizenship and responsibility in the context of different jurisdictions and intellectual perspectives.

Corporate governance implies ethical leadership through ensuring accurate reporting, sustainable finances, delivery of long-term strategic goals, good relationships with consumers, regulators, and stakeholders, and a safe and functional work environment. Failures of governance impact shareholder value by harming brands, profits, and the ability to plan for the future. New technologies and disruptors are running ahead of legislators. The more that corporate scandals trigger regulatory responses, the more money and board time is eaten up by reactive compliance at the expense of strategy, without necessarily showing a return in better or more ethical performance. Less diverse boards may miss new perspectives, trends, and risks entirely.

Courageous directors, many with their roots in entrepreneurship, have unprecedented opportunities to serve as global influencers to remain connected to their communities and popular opinion. The private sector will have a pivotal role to play in achieving the United Nations' Sustainable Development Goals by 2030. This can turn a profit and create new jobs – building new and better technology, financing projects to optimize human potential or build infrastructure, opening new markets, and maximizing use of scarce resources or devising new ones. Successful and diverse boards can realize this potential and contribute to better governance, better returns, and better social behavior through the institutionalization of global trends, ability to measure and determine exposure to risk (including social and economic factors), and communicating objectives internally and externally.

Looking forward, boards of directors will need to remain ahead of rapidly-evolving trends and address deceptively simple questions. What does the company seek to achieve, and where does it see its place in society? We will explore these topics at the next session of the Salzburg Global Forum on Corporate Governance, *The Courageous Director: Can Corporations Better Serve People, Planet, and Profit?*, October 5-7, 2017 in Salzburg.

Session Participants

(Biographies correct at time of session – October 2016)



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Stephanie Bertels is the Director of the Centre for Corporate Governance and Sustainability at Simon Fraser University's Beedie School of Business in Vancouver, Canada. Dr. Bertels founded and leads the Embedding Project (www.embeddingproject.org), a collaborative initiative between researchers and practitioners working to embed sustainability. She has developed an online knowledge portal featuring a curated selection of the most relevant tools and resources – including practical guides and worksheets developed through her own research – to help practitioners everywhere more effectively embed sustainability into their organizations. Her latest work on CEO decision-making for sustainability and next generation corporate governance is based on interviews with almost 200 global CEOs and Board chairs. Dr. Bertels has a B.Sc. in Geological Environmental Engineering from Queen's University, Canada, a M.Sc. in Petroleum Engineering from Stanford University, USA, a Ph.D. in Strategy and Global Management and Sustainable Development from the University of Calgary, Canada, and was a post-doctoral fellow at the Erb Institute at the University of Michigan, USA.



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Rodrigo Gallegos is the Executive Director of the Mexican Business Council where he is building the strategic agenda to advance some of Mexico's most pressing issues including lack of rule of law, poor education and faster growth. Prior to his current position he worked at the Mexican Competitiveness Institute, one of Mexico's leading think tanks, as an associate director for almost 12 years, where he specialized in public policy consultancy on three main areas: entrepreneurship, climate change, and information technologies. He also analyzed some strategic sectors. Previously, Mr. Gallegos has worked as an economist for Instituto Tecnológico Autónomo de México (ITAM) Mexico's leading economic school, has founded an educational NGO, has consulted for the United Nations Development Program in Bhutan, and has managed risk for Mexico's Central Bank. Mr. Gallegos has also been very active in media, having published a monthly opinion column in *El Economista* Newspaper for over 8 years and still publishing regularly in different magazines such as *Foreign Affairs*. Mr. Gallegos received a B.A. in Economics from ITAM, and a M.A. in Public Policy from Harvard University, USA.



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Manfred Gentz is Chairman of the German Corporate Governance Commission. In addition this he also serves in a number of scientific and cultural institutions. He was a member respectively Chairman of several Boards, including Zurich Financial Services Ltd. and Deutsche Börse AG and Chairman of the International Chamber of Commerce. In 1970, he joined Daimler-Benz AG where he assumed various positions. In 1983, he was appointed member of the Board of Management of Daimler-Benz AG, responsible for Human Resources. From 1990 to 1995 he was also Chief Executive Officer of Daimler-Benz Interservices (debis) in Berlin and he subsequently became Chief Financial Officer of Daimler-Benz AG in 1995. In December 1998, Dr. Gentz was appointed CFO in the Board of Management of DaimlerChrysler AG until he retired in December 2004. Dr. Gentz studied law at the universities of Berlin, Germany, and Lausanne, Switzerland, and graduated with a doctorate in law from the Berlin Free University.

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Simon Lorne is the vice chairman and chief legal officer of Millennium Management LLC, a hedge fund manager responsible for over \$30 billion in assets under management, with offices throughout the world. He is also the incoming Chair of the Alternative Investment Management Association (AIMA). Prior to joining Millennium Management, he was a partner in the Los Angeles based law firm of Munger, Tolles & Olson LLP, the global head of internal audit at Salomon Brothers and the global head of compliance at Citigroup. He also serves on the board of directors and chairs the audit committee of Teledyne Technologies, Inc. (New York Stock Exchange: TDY) Mr. Lorne has served in a wide variety of public sector, academic and private sector positions during the course of his career. He served as general counsel of the US Securities and Exchange Commission. He served for 17 years (until 2016) as the co-director of Stanford Law School's Directors' College and is an adjunct professor at the New York University Law School and the NYU Stern School of Business. Mr. Lorne has authored two books, three practitioner-oriented monographs and a number of articles in law reviews, magazines, and other publications. Mr. Lorne holds an A.B. from Occidental College and a J.D. from the University of Michigan Law School. Mr. Lorne is a Salzburg Global Fellow.



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Kevin McCarthy is a senior executive vice president and general counsel of Bank of New York Mellon (BNY Mellon), where he heads the bank's legal department and has overall responsibility for government affairs, the corporate secretary function, and global corporate security. He is also a member of the bank's executive committee, its most senior management body, which oversees day-to-day operations. Mr. McCarthy joined BNY Mellon as deputy general counsel in 2010 and led the litigation, enforcement and employment law functions. Later, he was appointed senior deputy general counsel and assumed additional responsibility for the legal team supporting the company's asset servicing business and corporate center functions. Prior to joining BNY Mellon, Mr. McCarthy served as general counsel at Cowen Group, Inc., a diversified investment bank and financial services firm. Prior to that, he was a partner at Wilmer Hale, focused on securities and litigation matters. Before that, Mr. McCarthy was at Credit Suisse First Boston in a variety of roles, most recently as managing director and global head of litigation. He began his legal career as an associate at Willkie Farr & Gallagher. Mr. McCarthy holds a B.A. from Siena College and a J.D. from Albany Law School of Union University, USA. Mr. McCarthy is a Salzburg Global Fellow.





Christian Mikosch, Austria

Christian Mikosch is a partner at Wolf Theiss, specializing in corporate law, international commercial law and mergers and acquisitions. He is the responsible partner for the Austrian firm's work in China and Kosovo, and has particular interest and expertise in the Central and Eastern Europe (CEE/SEE region), where he was involved in establishing the firm's presence. Mr. Mikosch has developed a unique know-how in privatizations and negotiations with governments. Prior to joining the firm, he gained valuable experience while working in New York. Mr. Mikosch holds LL.M. degrees from both the University of Manchester, UK, and the University of Rotterdam, the Netherlands, and regularly lectures on legal topics at various universities. Mr. Mikosch is admitted to the bar in Austria and in the Czech Republic, and he is a Fellow of Salzburg Global Seminar.



Robert H. Mundheim, USA

Robert Mundheim is of counsel to Shearman & Sterling and formerly senior executive vice president and general counsel of Salomon Smith Barney Holdings Inc. Prior to joining Salomon Inc., he was co-chairman of the New York law firm of Fried, Frank, Harris, Shriver & Jacobson. He served as university professor of law and finance at the University of Pennsylvania Law School, where he had taught since 1965, and was dean of the law school for seven and a half years. Among his other professional activities, Mr. Mundheim has been general counsel to the US Treasury Department (1977-1980); special counsel to the Securities and Exchange Commission (1962-1963); and vice chairman, governor-at-large and a member of the Executive Committee of the National Association of Securities Dealers (1988-1991). He was chairman of the Board of Directors of Quadra Realty Trust, a director of eCollege, Benjamin Moore, Commerce Clearing House, Arnhold & S. Bleichroeder Holdings, Inc. and First Pennsylvania Bank. Mr. Mundheim is a member of the Board of Trustees of New School University and of the Curtis Institute of Music. He is an emeritus member of the Council of the American Law Institute. He served as a member of the American Bar Association Task Force on Corporate Responsibility and has been a faculty member of the Vanderbilt Directors' College, the Duke Directors' Education Institute and the Stanford Directors' College. He was the president of the American Academy in Berlin and received the Officer's Cross of the Order of Merit of the Federal Republic of Germany. He holds a B.A. (magna cum laude) from Harvard College, as well as a LL.B. (magna cum laude) from Harvard University Law School, and an M.A. (hons) from the University of Pennsylvania. Mr. Mundheim is a member of the Board of Salzburg Global Seminar.



Jackie L. Newbury, Germany/United Kingdom

Jackie Newbury was appointed to the Supervisory Board (Verwaltungsrat) of the Sächsische AufbauBank in Dresden in September 2016. She is the Executive Director of the Königswinter Conference series. In 2000 she started her own company advising small and medium sized European companies on their business plans, growth and employment strategies, as well as Initial Public Offerings in Germany and the UK, and is closely involved with a world-ranking UK University with their intellectual property and spin off activities. Ms. Newbury has done public policy work for the Asian Development Bank and World Bank on the development of capital markets in transitional and emerging economies. Her work has been in collaboration with a network of leaders in the fields of valuation, pensions, taxation and balance sheet restructuring. She has worked in international banking and investments, working in London, Tokyo and Frankfurt. Ms. Newbury holds a B.A. Hons from the University of Oxford and an M.P.A. from Harvard University.

Melissa Obegi, *China/USA*

Melissa Obegi is Asia general counsel for Bain Capital, based in Hong Kong, China. Her work covers transactional, portfolio, and operational legal matters and risk management for Bain Capital's private equity operations and investments in the Asia Pacific region. Prior to joining Bain Capital in 2012, Ms. Obegi was the managing director with Oaktree Capital's Asia Principal Opportunities group and also served as Asia regional counsel for Oaktree in Hong Kong. She started with Oaktree Capital as associate general counsel at its Los Angeles headquarters in 2002. Prior to that, she held various positions with the Overseas Private Investment Corporation, a U.S. government agency that supports investment in global emerging markets with private equity investment funds, project finance, and political risk insurance. Ms. Obegi began her career with Coudert Brothers in New York as an associate in the International Banking group. She holds a B.Sc. in foreign service from the Foreign Service School at Georgetown University, USA, and a J.D. from the School of Law at the University of California, Los Angeles, USA. Ms. Obegi is a Salzburg Global Fellow.



Mariana S. Pargendler, *Brazil*

Mariana Pargendler is Professor of Law at Fundação Getulio Vargas Law School in São Paulo, Brazil, where she serves as director of the Center for Law, Economics, and Governance. She is also Global Associate Professor of Law at New York University School of Law and has been Visiting Professor of Law at Stanford Law School. Her scholarship examines problems in corporate law, corporate governance, and contract law from an economic and comparative perspective. At Yale University, she was a research fellow at the Millstein Center for Corporate Governance and Performance at the Yale School of Management, as well as an Olin fellow at the Center for Studies in Law, Economics, and Public Policy at Yale Law School. Prior to joining academia, she was a corporate associate at the New York office of Weil, Gotshal & Manges LLP. Dr. Pargendler holds an LL.B. and a Ph.D. (Law) from the Federal University of Rio Grande do Sul, Brazil, as well LL.M. and J.S.D. degrees from Yale Law School, USA.



Veena Ramani, *USA/India*

Veena Ramani is a Senior Director at Ceres, and leads Ceres' work on governance for sustainability, which focuses on systems and processes that companies should put in place at the corporate board level to allow for "effective" board sustainability oversight. As a part of this work, she authored the report, "View from the top: How corporate boards can engage on sustainability performance." Prior to this, Ms. Ramani managed the relationships with a wide portfolio of Ceres network companies as a part of the Ceres Corporate Program, including the financial services sector and the electric power sector. Prior to Ceres, she worked as a Management Consultant with CDM, an environmental consulting firm and focused on providing a variety of sustainability services to clients in the public and private sectors. Ms. Ramani has an LL.M from Washington University in St. Louis and a B.A./LL.B. (Hons) from National Law School from India University, Bangalore.





Edward B. Rock, USA

Edward Rock is a Professor of Law at New York University (NYU) School of Law where he teaches corporate law, mergers and acquisitions, and a variety of other courses. He is also the director of NYU's Institute for Corporate Governance and Finance. Prior to these appointments, he was the Saul A. Fox distinguished professor of business law at the University of Pennsylvania Law School, USA. Prof. Rock has also taught as a visiting professor at Columbia University, New York, and Hebrew University, Israel. He publishes widely on various issues in corporate law and corporate governance, including the role of hedge funds, the intricacies of corporate voting, and corporate governance politics, and has consulted for a variety of government agencies and law firms. Mr. Rock is one of the authors of "The Anatomy of Corporate Law", a widely used text on comparative corporate law. He started his career as a plaintiff side class action lawyer specializing in antitrust and shareholder class actions. He holds a B.S. in physics and mathematics from Yale University, USA, a B.A. in philosophy, politics, and economics from the University of Oxford, UK, and a J.D. from the University of Pennsylvania Law School, USA. He is a Salzburg Global Fellow.



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Raimund Röhrich is head corporate legal at UBS AG in Zurich, Switzerland. In this role, he deals with governance issues and questions regarding UBS Group and its subsidiaries, in particular in light of the newly established holding structure and new Swiss subsidiary as well as the U.S. Intermediate Holding Company and Service Company. Previously, Mr. Röhrich held various positions as private practice and in-house lawyer, including serving as a partner of a litigation boutique in Munich, Germany, serving as head of legal Europe at a London based Market Maker, as a senior corporate investigator at Accenture, and as head Litigation & Investigation at UBS Deutschland AG, as well as special counsel to the group general counsel at UBS AG. He also has a teaching appointment at the School of Governance, Risk & Compliance for corporate governance in Germany. Mr. Röhrich studied law at the Ludwig-Maximilians Universität in Munich, Germany and holds an M.B.A. from the School of Governance, Risk & Compliance in Berlin, Germany. Mr. Röhrich is a Salzburg Global Fellow.



Timothy A. Steinert, China/USA

Tim Steinert has been the general counsel and secretary of the Alibaba Group since July 2007. From 1999 until he joined Alibaba, Mr. Steinert was a partner in the Hong Kong office of Freshfields Bruckhaus Deringer. From 1994 to 1999, he was an associate attorney at Davis Polk & Wardell in Hong Kong and New York, and from 1989 to 1994, he was an associate attorney at Courdert Brothers in Beijing and New York. Mr. Steinert is qualified to practice law in the State of New York and in Hong Kong. He received a B.A. in history from Yale College and a J.D. from Columbia University School of Law.

Vikas Thapar, *Canada*

Vikas Thapar is founder and managing partner of Indus Capital Ltd, a private equity firm focused on Asia and the Middle East. Mr. Thapar previously held a number of senior positions with the International Finance Corporation (IFC), the private sector arm of the World Bank Group, where his responsibilities included head of IFC's European office based in Paris; head of IFC's Central European office based in Prague, and principal investment officer for Asia and the Middle East. Mr. Thapar has extensive experience in emerging markets in direct equity investments, project and infrastructure finance, developing capital markets, setting up and managing private equity funds. He has advised governments, central banks and corporations on privatization, restructurings, setting up capital markets, banking sector reform, and other topics. He is a member of the Board of Directors / Investment Committees of several financial institutions and private equity funds. Mr. Thapar holds a B.Tech. in electrical engineering and an M.B.A. from McGill University, Canada. He undertook advanced management programs at Harvard Business School and John F. Kennedy School of Government, Harvard University. Mr. Thapar is a member of the Board of Salzburg Global Seminar.



Ko-Yung Tung, *USA/Japan*

Ko-Yung Tung is Senior Counsellor with the international law firm of Morrison & Foerster LLP and also Lecturer of Law at Harvard Law School where he will teach a course on "Globalization, Development, and the Law." He served as the Vice President and General Counsel of the World Bank and the Secretary General of the International Centre for the Settlement of Investment Disputes. His private law practice involves sovereign lending, international investments and disputes, and cross-border financial transactions. Mr. Tung serves and has served as a board member of numerous public and private entities, including Global Health Innovative Technology Fund (a public-private partnership among the Japanese Government, Gates Foundation and pharmaceutical companies), Human Rights Watch-Asia, Transparency International-USA, International Development Law Organization in Rome, London Forum on Development Law, and Eisai Inc. (a global pharmaceutical company based in Japan). In the past he has served as a member of President Clinton's Commission on United States Pacific Trade and Investment Policy, and the Trilateral Commission, and was the Chairman of the East-West Center Board of Governors. He received his B.A. and J.D. from Harvard University, Cambridge, Massachusetts, and was a Fellow at the University of Tokyo, Faculty of Law. Mr. Tung is a Salzburg Global Fellow.



Gregory V. Varallo, *USA*

Gregory Varallo is president of Richards, Layton & Finger. His practice focuses on complex corporate and business litigation, arbitration, corporate governance, and corporate transactions. Mr. Varallo has litigated numerous complex business disputes in the Delaware courts, and has appeared on behalf of his clients in state and federal courts throughout the United States. He has co-taught classes at New York University School of Law, the University of Pennsylvania Law School, and Harvard Law School. He received a B.A. in international relations from the University of Pennsylvania, and a J.D. from Temple University's James E. Beasley School of Law.





Philip J. Weights, Switzerland

Philip Weights is the founder and Managing Director of Enhanced Banking Governance (EBG) GmbH in Zurich, Switzerland, and Dubai, UAE. EBG provides corporate governance services to the boards of directors, audit committees and executives management of banks. Mr. Weights is the Chairman of the Board of Lavaux Capital SA in Montreux. He is also Chairman of the Global Municipal Finance Steering Committee established by the International City Leaders NGA. ICL is a partner to the UN-Habitat in the City Prosperity Initiative (CPI), a global initiative to measure sustainable urban development. Mr. Weights is also a Senior Lecturer in Banking Governance with the Swiss Finance Institute. Mr. Weights was previously the Chief Audit Executive for EFG Bank, a stock exchange listed private banking group headquartered in Zurich, and also worked many years with HSBC and Citibank. He is a Salzburg Global Fellow.



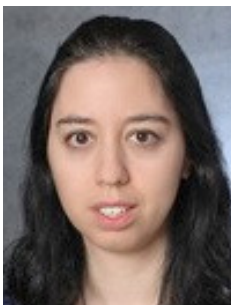
Christianna Wood, USA

Christianna Wood is the Chair of the Board of the Global Reporting Initiative based in the Netherlands, the leading standard-setter of global sustainability reporting standards. Previously, Ms. Wood was the CEO of Capital Z Asset Management, the largest dedicated sponsor of hedge funds, having sponsored 17 hedge funds totaling almost \$7 billion. Ms. Wood was also the Senior Investment Officer for the Global Equity unit of the California Public Employees' Retirement System (CalPERS), where she was responsible for over \$150 billion in equity, bond and alternative assets. She is also on the boards of the H&R Block Corporation, one of the world's largest tax preparers, Grange Insurance, a multi-line mutual insurance company, The Merger Fund, a merger arbitrage hedge fund, and Vassar College. Ms. Wood has a B.A. in Economics cum laude from Vassar College, and an M.B.A. in Finance from New York University.



Samer T. Yaghnem, Greece

Samer Yaghnem is group general counsel of the Olayan Group, which he joined in 1995, based in the Group's head office in Athens, Greece. His responsibilities include legal affairs, compliance, regulatory affairs and tax planning. Mr. Yaghnem also serves as the Executive Assistant to the CEO and sits on various boards in the Groups' investments. Prior to joining Olayan, Mr. Yaghnem worked as an attorney in the Chicago law firm of Hoogendoorn and Talbot. He attended university in the United States where he received his B.A., J.D. and an M.B.A. He also holds an equivalency J.D. from Canada. He is a member of the bar in the state of Illinois and the US District Court in the Northern District of Illinois.



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Abigail Yevnin is an associate in Sullivan & Cromwell's Capital Markets, Leveraged Finance & Lending Group and its Financial Services Group. Ms. Yevnin's practice involves equity and debt capital markets activities, advising on a variety of registered and unregistered securities offerings, including initial public offerings, secondary offerings, debt issuances and ongoing public company matters. Ms. Yevnin's practice also involves leveraged finance transactions and advising financial institutions in connection with mergers and acquisitions and other regulatory and corporate matters. She is a member of the Firm's Opinion Practice Committee and its Women's Initiative Committee. Ms. Yevnin worked for a large Israeli law firm from 2006 to 2008, where she advised clients on a variety of corporate, capital markets, M&A and regulatory matters. Ms. Yevnin received her LL.B. from the Hebrew University of Jerusalem, and her LL.M. from the University of Pennsylvania Law School, USA.

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Charles E. Ehrlich joined Salzburg Global Seminar as a Program Director in May 2014. He has particular responsibility for designing, developing, and implementing programs on justice, democracy, economics, and rule of law. He has practical experience in legal development working in over a dozen countries, including in the Balkans, the Caucasus, and the Russian Federation, advising governments and public institutions on strategic planning, drafting legislation, and implementing comprehensive reforms in the justice sector, public administration, property rights, freedom of the media, and constitutional law. Charles has also worked as legal counsel for the Organization for Security and Cooperation in Europe (OSCE) in Kosovo, in Georgia, and at its Secretariat in Vienna. At the Claims Resolution Tribunal in Switzerland, he adjudicated claims to Nazi-era bank accounts. He remains affiliated with Wolfson College, Oxford, and has published a book, *Lliga Regionalista – Lliga Catalana, 1901-1936* (in Catalan), and numerous academic articles on constitutional law, justice, and political history. Charles holds an A.B. in history and classics (Latin) from Harvard University, a J.D. from the College of William and Mary, an M.Sc.Econs. in European studies from the London School of Economics, and a D.Phil. on contemporary Spanish history from the University of Oxford.



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Kevin Kolesnikoff is a trainee Program Associate at Salzburg Global Seminar, and joined the organization in May 2016, having interned with the Program Office for three months in 2015. In his role, he aids in the preparation, organization and conduction of Core sessions through both research and administrative support. Prior to joining Salzburg Global he worked on the staff of the American International School of Salzburg, Austria. While there he was responsible for the daily safety and supervision of students. He has also worked for Three Bays Preservation, an environmental non-profit on Cape Cod, and as an ocean lifeguard. Kevin graduated in 2012 with a B.A. in English from Wheaton College in Norton, MA, USA.



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