

January 2018

**Engagement-Succeeding in the New Paradigm
for Corporate Governance**

The accelerated interest in sustainability, ESG, corporate social responsibility and investment for long-term growth and value creation (the new paradigm) as most cogently exemplified by Value Act's newly formed Spring Fund focusing on promoting environmental and social goals of the companies in which it invests; by the promotion by the World Economic Forum of *The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth*; by the creation of the Investors' Stewardship Group and its issuance of its principles for stewardship which embrace ESG and long-term investment; and, finally, by the policy positions of the three largest index fund managers, BlackRock, State Street and Vanguard as to what they expect in the way of governance and engagement, especially the January 12, 2018 letter from Larry Fink, BlackRock's CEO, to the CEOs of the companies in which BlackRock invests in which "corporate purpose" is stressed, prompts us to update our January 2017 memo on engagement with investors,

The [BlackRock letter](#) states:

Without a sense of purpose, no company, either public or private, can achieve its full potential. It will ultimately lose the license to operate from key stakeholders. It will succumb to short-term pressures to distribute earnings, and, in the process, sacrifice investments in employee development, innovation, and capital expenditures that are necessary for long-term growth. It will remain exposed to activist campaigns that articulate a clearer goal, even if that goal serves only the shortest and narrowest of objectives. And ultimately, that company will provide subpar returns to the investors who depend on it to finance their retirement, home purchases, or higher education.

Then, most importantly, the letter sets out the type of engagement between corporations and their shareholders that BlackRock expects in order to secure its support against activist pressure. While the whole letter needs to be carefully considered in developing investor relations engagement practices, the following is of special note,

In order to make engagement with shareholders as productive as possible, companies must be able to describe their strategy for long-term growth. I want to reiterate our request, outlined in past letters, that you publicly articulate your company's strategic framework for long-term value creation and explicitly affirm that it has been reviewed by your board of directors. This demonstrates to investors that your board is engaged with the strategic direction of the company. When we meet with directors, we also expect them to describe the board process for overseeing your strategy.

The statement of long-term strategy is essential to understanding a company's actions and policies, its preparation for potential challenges, and the context of its shorter-term decisions. Your company's strategy must articulate a path to achieve financial performance. To sustain that performance, however, you must also understand the societal impact of your business as well as the ways that broad, structural trends – from slow wage growth to rising automation to climate change – affect your potential for growth.

While the BlackRock letter is a major step in rejecting activism and short-termism and is a practical guide as to investor relations, it stops short of a critical step in assuring corporations that their efforts are bearing fruit—it does not commit BlackRock to publicly state its support for a corporation under attack by an activist seeking to impose financial engineering or other short-term action before the corporation has to endure a proxy fight. This type of early concrete support would be a major factor in supporting sustainability and long-term investment. That being said, it does not in any way diminish the importance of understanding and appropriately reacting to the letter and the views of BlackRock and other investors.

In designing its engagement program and practices, each company should make its own independent decision as to content, persons, venues and intensity of its communications and what adjustments, if any, to its strategy and operations may be appropriate to meet the expectations of investors who have embraced the new paradigm.

What to Communicate

Lead with the Purpose and the Strategy. In the new paradigm, the company's purpose and long-term strategy, its implementation and the company's progress in achieving it take center stage. Check-the-box governance fades into the background. Define the company and its vision, explain key drivers of strategy and business outcomes and articulate how a portfolio of businesses and assets fit together and are reviewed. Discuss key risks and mitigation methods and share how the company evaluates whether the strategy remains viable as the business environment, competitive landscape and regulatory dynamic change. Discuss how a business model has transformed, and if the company is in the midst of a strategic transformation or a well-conceived turnaround plan that requires time to execute, explain it. The BlackRock letter advises:

Companies must ask themselves: What role do we play in the community? How are we managing our impact on the environment? Are we working to create a diverse workforce? Are we adapting to technological change? Are we providing the retraining and opportunities that our employees and our business will need to adjust to an increasingly automated world? Are we using behavioral finance and other tools to prepare workers for retirement, so that they invest in a way that that will help them achieve their goals?

Confirm Board Involvement in the Strategy. The company should explicitly describe how the board has actively reviewed long-term plans and that it is committed to doing so regularly. Proactively share with these investors how directors are integrated into strategic planning, exercise robust oversight and test and challenge both strategy and implementation. In the new paradigm, be clear and direct about the board's role in guiding, debating and overseeing strategic choices.

Make the Case for Long-Term Investments, Reinvesting in the Business for Growth and Pursuing R&D and Innovation. The company should clearly explain how such investments are reviewed and articulate why and how they matter to long-term growth and value creation. For investments that will take time to bear fruit, acknowledge that and explain their importance, timing and progress.

Describe Capital Allocation Priorities. This also includes discussing the board's process for reviewing and approving capital allocation policies. Where return of capital is a pillar of the company's value creation framework, demonstrate thoughtfulness about the timing, pacing and quantum of buybacks and/or dividends and an awareness of relative tradeoffs. If maintaining an investment-grade or fortress balance sheet is a priority, clarify why.

Explain Why the Right Mix of Directors Is in the Boardroom. Present the diverse skills, expertise and attributes of the board as a whole and of individual members and link those to the company's needs and risks. Be transparent about director recruitment processes that address future company and board needs. Disclose the policy for ensuring that board composition and practices evolve with the needs of the company, including views on balance, tenure, retaining institutional knowledge, board refreshment and presence or absence of age or term limits. Carefully explain procedures for increasing the diversity of the board and for ensuring that directors possess the skills required to direct the course of the company. Discuss director orientation, tutorials and retreats for in-depth review of key issues. Show that board, committee and director evaluations are substantive exercises that inform board roles, succession planning and refreshment objectives.

Address Sustainability, Citizenship and ESG/CSR. The company should integrate relevant sustainability and ESG matters into strategic and operational planning and communicate these subjects effectively. Sharing sustainability information, corporate responsibility initiatives and progress publicly on the company's website and bringing them to these investors' attention are significant actions in the new paradigm.

Articulate the Link Between Compensation Design and Corporate Strategy and Risk Management. Describe how compensation practices encourage and reward long-term growth, promote implementation of the strategy and achievement of business goals and protect shareholder value.

Discuss How Board Practices and Board Culture Support Independent Oversight. Clearly articulate the actual practices and responsibilities of the lead independent director or non-executive chair, independent directors, committee chairs and the board as a whole in providing effective oversight, understanding shareholder perspectives, evaluating CEO performance and organizing themselves to ensure priorities are met.

How to Deal With an Activist. A paragraph in the BlackRock letter sums it up well:

Where activists do offer valuable ideas – which is more often than some detractors suggest – we encourage companies to begin discussions early, to engage with shareholders like BlackRock, and to bring other critical stakeholders to the table. But when a company waits until a proxy proposal to engage or fails to express its long-term strategy in a compelling manner, we believe the opportunity for meaningful dialogue has often already been missed.

How to Communicate

Periodic “Letters” to Investors. Periodic “letters” to shareholders on behalf of the management and/or board focusing on the issues deemed important for satisfaction of the new paradigm are valuable. Letters from management can articulate management’s vision and plans for the future, explain what the company is trying to achieve and discuss how it plans to win in the market. Letters from the board can convey board-level priorities and involvement. Depending on the circumstances, statements or letters may be separate, jointly signed by the CEO and the lead independent director or non-executive chair, come from particular committees as to matters within their ambit or be from the full board.

Investor Days. The company should use “Investor Days” to articulate a long-term perspective on company prospects and opportunities and provide “deep dives” into strategy, performance and capital allocation. Challenges should also be candidly addressed and responsive initiatives outlined. Deciding which long-term metrics, goals and targets should be shared is an area in active evolution. All of the company’s major long-term investors, including “passive” investors and index funds, should be extended an invitation. Key materials from a completed Investor

Day can also be separately circulated to investors. The company may also invite directors to attend. In certain cases, it may be useful for a director to participate in an Investor Day to validate and communicate board involvement and priorities.

Quarterly Communications. Quarterly earnings rituals remain, for now, a fact of life in the U.S. Nevertheless, the company can place quarterly results in the context of long-term strategy and objectives, discuss progress towards larger goals and articulate higher priorities, all while eschewing quarterly guidance.

Proxy Statements, Annual Reports, Other Filings and the Company's Online Presence. Proxy statements, annual reports/10-Ks, SEC filings, presentations and voluntary disclosures provide communication opportunities. For example, the customary proxy section entitled "The Board's Role in Risk Oversight" will ultimately evolve into section(s) covering "Board Oversight of Strategy and Risk." The company should present information online in readily accessible, user-friendly and well-organized formats.

Investor Engagement. Disciplined, direct and periodic two-way dialogue with institutional investors is advisable, supported by written communications and tailored presentations. Opening channels of communication in advance of a crisis or activist challenge is extremely important. Communicate engagement procedures and activity. Prepare for director-level interactions with major shareholders and know when and how to involve directors – proactively or upon appropriate request – without encroaching upon management effectiveness. Do not hesitate to reach out to investors, even during proxy season, if there is a matter of importance to discuss. Coordinate internal outreach across the different categories of shareholders and have a superstar corporate governance executive and a superstar investor relations executive. A number of the major investors are increasing substantially their stewardship teams that meet with investors.

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