

Anticipating the Future of Corporate Governance at the Society's National Conference

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Cognitive bias leads to faulty decisionmaking, warned Vice Chancellor J. Travis Laster at the National Conference of the Society of Corporate Secretaries and Governance Professionals. In his address, he used an example of a Delaware case to demonstrate the collective desire to develop information to support a preconceived goal rather than reach independent conclusions, the fallacy of groupthink that avoids hard questions, the tendency to prefer data that confirms a prior belief and the likelihood of taking immense risks to avoid losses, noting that the Court looks for the presence of those biases in examining cases. We also heard from the leaders of two influential proxy advisers, ISS and Glass Lewis, that each firm will change to new methodologies in the coming proxy season for constructing the all-important peer group against which they assess CEO compensation and form say-on-pay recommendations, making predictability an ever elusive goal for now.

Such were the examples of the range of discussions focused on effective corporate governance, from thoughtful debates on the relationship between companies and their shareholders to practical advice on the nuts and bolts for board functions, all centered around the conference theme ? The Shape of Things to Come. Over 800 attendees gathered to hear from an impressive roster of experts, including investors, regulators, academics, consultants and counsel, and also to learn from each other given the unique opportunity to gather with other like-minded professionals whose primary role is to support boards. Since one regret is that it was not possible to attend all the sessions and take advantage of everything being offered, the following is a somewhat random selection of highlights arranged around the theme of anticipating what may be in store in the near future:

Regulators. In his speech, Commissioner Troy Parades underscored SEC efforts toward rigorous rulemaking, including quality cost-benefit analysis based on solid economics. He stressed the need for pragmatic regulation that avoids being overly burdensome for companies in terms of compliance, but also informs investors without engulfing them in too much unnecessary information. SEC staff from the Division of Corporation Finance were present to discuss their hard work writing rules as mandated by first Dodd-Frank, and now the JOBS Act. Rules with deadlines have clear priority, but otherwise both sets of legislation are being tackled simultaneously. The staff specifically declined to address the timing for when we will see proposals on the remaining executive compensation rules under Dodd-Frank, affectionately known as the ?gang of four? (pay-for-performance, hedging policy, clawback and internal pay ratio). During this past proxy season, 332 Rule 14a-8 no-action letter requests were processed, a 5% increase from last year, with average response periods of 38 days. The SEC whistleblower program is receiving about 8 complaints a day, with a significant number of those reports also being made to companies at the same time. The staff is keenly aware of the anti-retaliation provisions and may even ask companies for personnel files to confirm the absence of negative actions toward employees who came forward.

Active, or Activist, Investors. In his keynote, Ralph Whitworth, founder of Relational Investors and a board member at Hewlett-Packard, stressed the importance of not letting the emphasis on board collegiality suppress directors from asking tough questions. He captured it succinctly with a statement about the need for a director to be likeable, without having others believe that the director wants to be liked. There was active and vigorous debate at another session on whether the Section 13D 10-day reporting period should be shortened, during which a representative from Pershing Square argued that all shareholders benefit from the increased liquidity and stock price brought on by activist actions, and claimed that the available data shows that it is quite rare that investors who are required to file 13Ds ultimately accumulate more than a 10% ownership stake.

Shareholder Engagement. BlackRock's willingness to devote 20 people to their engagement effort on a global basis is due in part to its inability to merely walk away from a vast majority of its investments that are made on an indexed basis. The firm talks to companies privately when they perceive issues, and expect directors to be available for discussions when there are significant say-on-pay problems. They recommend that off-season engagement focus primarily on the effectiveness of company boards, with executive pay being only a part, but not the key point, of the discussion. Engagement this year has increased exponentially, CalSTRS indicated, while the AFL-CIO announced that over half of the shareholder proposals it submits are withdrawn after negotiations with companies. One example of the divide between companies and proponents appears in the wide ranging views of which information should be captured when companies decide to adopt a policy to disclose political spending.

Board Dynamics and Elections. The need for directors to be willing to challenge what they are being told, even at the cost of being perceived as disruptive, was discussed in more than one session. The recent emphasis on individual director qualifications raised the concern that other directors may place over-reliance on board members who are labeled as having functional expertise, obscuring the need for all directors to have a general understanding of the company. Director elections (and as a byproduct, proxy access) continue to be a hot topic. While only a few directors receive a majority lack of support, those tend to be at companies that have plurality voting and thereby able to fully ignore shareholder sentiment. Some investors have developed a short list of problem directors and will vote against those directors at every company where the directors serve.

Executive Compensation. Speculation abounds over the rising number of companies that are disclosing realizable, or realized, pay, with some 40% of large-caps including this element in their proxy statements. But others lamented the lack of a cohesive and recognized method that would allow for comparability. Over 100 companies filed supplemental materials this season. While most investors thought they were somewhat helpful, they generally do not change investor voting and in some situations triggered criticism when new information was presented that was not found in proxy statements. There was widespread agreement among investors that those filings, and subsequent investor discussions, should avoid being merely, or even largely, an attack on the proxy advisory firms' recommendations.

These brief highlights represent only a small portion of the active dialogue and discourse that made the conference a valuable resource as governance matters continues to gain prominence and affect both the workings and reputations of companies, in particular, as Chancellor Laster indicated, the underlying state law itself has changed very little while there has been enormous shift in the reality of the power balance between shareholders and companies. These are suitable times to have author Bethany McLean, known for her writing on Enron and the financial crisis, provide the closing address. She explored the causes of one financial scandal after another, questioning whether company leadership were willing to engage in candid assessments of their organizations' risks and problems.

Doug Chia, the Chairman of this 66th national conference and Assistant General Counsel and Corporate Secretary at Johnson & Johnson, reiterated his support for providing a forum where complex governance issues can be aired and understood, "We wanted to give governance professionals who support management and boards an opportunity to hear from and discuss the perspectives of the numerous constituents who influence the debate on effective corporate governance, and also a chance to engage with and learn from each other."

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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