



Corporate Governance for the 21st Century

Initial report and readings



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About this work

The research presented here started in 2016, when High Meadows Institute and Tapestry Networks personnel noted an apparent divergence between the CEOs and independent directors of some leading public companies. The CEOs were speaking about the dangers of short-termism, the importance of long-term capital, and their responsibility to look beyond the near-term interests of equity shareholders. The directors were more focused on quarterly results. In some cases, they were unaware of their CEOs' views on ESG (environmental, social, governance) investing; some directors viewed these as secondary to delivering near-term performance. Many others expressed commitment to a long-term perspective and to ESG, but noted how difficult this could be to maintain in the face of market pressure.

We found this divergence surprising, and undertook to understand its causes, and to facilitate progress toward a governance system in which directors, executives, regulators, institutional investors and other market participants can be better aligned on both short- and long-term objectives. We're pleased to say that we have seen positive change since 2016, but remain convinced that there is a long way to travel.

Our approach throughout has been to look at this as a multitasking issue – a series of tradeoffs between different objectives and choices about how directors and boards spend their time. As a first step, Tapestry and High Meadows conducted a series of interviews and organized a meeting involving directors, the CEO of proxy advisor Institutional Shareholder Services (ISS), and company director and MIT economist Bengt Holmström, awarded the 2016 Nobel Prize for his work on multitasking problems.

This first effort clarified challenges for the leaders of large public companies in making investments with a long-term payoff but a short-term penalty. Directors insisted on robust business cases for ESG investments. We learned that relationships of trust within the capital markets system – e.g., between companies and their investors, or between boards and management – could not be wished into existence. Trust required specific actions: breaking a major project into stages, for instance, and ensuring performance measurement and future flexibility at each stage.

We decided to expand the scope of our research, looking more broadly at how the boards and directors of large public companies create strategy and execute long-term plans, in a turbulent geopolitical and business environment. Our own long-term aim is to produce a field guide to corporate governance in the 21st century, a handbook that boards and directors can use as they carry out their work. This report is a step toward that goal.

Change will not happen without the involvement of actors across the capital markets system: investors, companies, regulators, and many others. We hope that this work stimulates debate and inspires action in ways that we, and the many directors and investors we have spoken with, have not imagined. We welcome your comments.

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Executive summary and overview of this report

The governance of major public companies is at the threshold of fundamental change, operating in a model that is becoming increasingly stressed. We observe that:

- The workload of the boards of these firms has increased to the point that, especially in highly regulated industries, board service has become less than attractive to many talented and experienced directors. Proxy advisory firms now subject directors to intense scrutiny – for example, they strongly discourage sitting CEOs from serving on more than one external board. Today, fewer current CEOs serve as independent directors of other companies; this shift deprives boards of current market exposure and insight.
- Broader social expectations on corporate leaders, and especially on boards of directors, are very high – not only to deliver financial performance, but, according to many, to identify and enact a high ‘purpose’. This purpose is not necessarily a social one, but it would go beyond profit maximization: a concrete goal or objective that employees and customers alike can find deeply meaningful.¹
- No single ‘board of the future’ solution has yet gained widespread acceptance, though many have been proposed. Directors of the world’s largest companies – roughly speaking, those with annual revenue in excess of \$10 billion – express frustration with their roles, their workloads, and, increasingly, their compensation. But boards continue to operate with agendas and processes that have not radically changed in many decades.

Meanwhile, many company directors are adopting pragmatic approaches to alleviate current shortcomings – as one example, restructuring the annual cycle

of board meetings to allow more time for strategy discussion. These ‘coping’ strategies are not sufficient to resolve some of the fundamental challenges facing boards, but they are useful steps in that direction.

Our aim is not to offer a single solution, but to provoke debate about new models of governance. This will need to involve many parties: directors themselves, institutional investment executives, corporate executives, regulators, and policymakers.

We begin with a discussion of the work of boards, and how this has changed; the readings for this section focus on the evolution of governance, the duties that directors are now expected to perform, and the barriers to delivering those duties.

Then, we turn to a series of practical approaches that directors and thought leaders have identified for making this delivery possible.

We then outline more radical models for governance that some academics and political leaders have proposed, and discuss why these have been slow to achieve implementation.

Finally, we raise questions for further debate.

The readings associated with this report have been prepared either by Tapestry and High Meadows Institute, or by practitioners and thinkers associated with the two groups. We have not sought to harmonize or conform the readings, and they present a range of views – for example, on how far board structures and processes need to change. Nonetheless, we hope that they demonstrate the need for robust debate about how to govern the modern public corporation.

Introduction

The best way to govern and regulate a large public corporation has long been a matter of debate, amongst practitioners and academics alike, dating at least back to Adolf Berle and Gardiner Means’s classic work in 1932.² Notable governance failures, over many decades, have led to calls for new approaches to the oversight of the world’s largest enterprises.

Recent years have seen the debate rekindled. Directors, investment managers, policymakers and thought leaders have called for new approaches to the oversight of giant global companies. Such demands for renewal are not limited to the political ‘left’ or ‘right’.

The overview and readings presented here reflect research carried out by Tapestry Networks, with the support and collaboration of High Meadows Institute. This report does not attempt to provide a definitive answer to the question of corporate governance. Its intent is different: to set up and elaborate the question, as a prelude to further discussions involving top executives, directors, and other leading market participants.

Our research focuses on the experience of non-executive directors of very large public companies, primarily in North America but also in Europe.

Tapestry speaks with around 400 such directors annually, in highly confidential individual and group conversations. For this report, we further conducted focused interviews with 16 directors of public companies and seven executives of very large investment management firms. We are confident that this window into the boardroom provides a distinctive perspective on emerging governance.

The main question we have chosen is the role of a corporate board in determining the fundamental direction of the company – not just its statutory compliance or management of control risks, but its basic strategy. In other words, how do boards direct their companies?

Supplementing the main report, we have provided a series of readings – essays, analyses, points of view – that expand on many of its themes. Throughout the document, quotes from interviews conducted by Tapestry are presented without attribution, in order to encourage candor; these are printed in italic type.

How has the board's job changed?

Analyses of 'the corporate world in 2020' typically focus on forces such as shifts in globalization, the rise of technology, and the growth in size and geographic reach of the world's largest firms. Have these changes fundamentally affected the work of corporate boards?

Our view is that the fundamental role of a corporate board has not been altered by these changes, but the range of issues that a board must now tackle and the quantum of work required to manage these issues have materially increased. In particular, boards face pressure from institutional investors, regulators and public opinion to 'think beyond the quarter', and find strategies that both work in the long term and deliver strong near-term financial performance.

The largest companies are operating with scale and geographic reach that are orders of magnitude greater than at the middle of the 20th century, when the term 'corporate governance' came into more common parlance. Advances in global finance, information technology, and telecommunication contributed to a series of merger waves – in the mid-1960s, in the early '80s, throughout the '90s, and, with a pause for the financial crisis, from 2003 to the present – that helped build the behemoths that we see today. Mergers, among other factors, have led to a decline in the number of US public companies (from 6,797 in 1997 to 3,485 in 2013); a threefold increase in sales

of the median public firm from 2006 to 2016; and a consolidation in value creation: the McKinsey Global Institute reckons that 10% of the world's public companies generate 80% of the profits.³

Reading 1, 'Developmental eras of the modern public company', presents a simplified view of the work of boards and how this has changed over time.

In addition, governments, investors, and the public increasingly realize that giant firms affect the world in ways that go far beyond the immediate scope of their business operations. The direct impact of corporate operations on the natural environment is an old story, but more complex effects, not limited to environmental impact, have begun to surface. For example:

- The potential use of social media for illicit political ends
- The impact of vastly expanded internet use on electricity demand
- The impact of widespread adoption of robotic process automation, machine learning and other technologies on labor markets and, consequently, on local communities
- E-commerce and ride sharing as potential drivers of road traffic and urban congestion

- The consequences of soft-drink consumption on human health, particularly obesity
- The erosion of trust when information that customers thought was private is stolen by criminals or released to the public

With the rapid ascent of passive investments, which accounted for almost 45% of all equity assets in US mutual funds and exchange-traded products at the end of 2017,⁴ public corporations are feeling increased pressure to perform over the long term, primarily because passive investors cannot sell the shares of companies with which they are unhappy.

In some cases, this long-term focus has been framed as a wider social purpose; for example, in his 2018 annual letter to CEOs, BlackRock CEO Larry Fink wrote:

We also see many governments failing to prepare for the future ... As a result, society increasingly is turning to the private sector and asking that companies respond to broader societal challenges. Indeed, the public expectations of your company have never been greater. Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.⁵

Modern boards are increasingly expected to be aware of the wider impact of their business models and operations, and, more importantly, to incorporate this awareness into their strategies. For example, Fink's letter has had a widespread impact on boardroom discussions, although the directors and investors that we interviewed expressed mixed views of it. One director said, "Larry Fink's letter came as a gift ... discussed at every board on which I sit. Overall reaction

was positive. It's a prompt to reflect on that larger agenda. Several boards are doing that. We are going to lean in even more because investors like it. I think it's great." Another was less enthusiastic: "Fink's letter was a little over the top from my personal perspective, but my boards are paying attention. For one company, it's the centerpiece of what we do with investors and in our filings."

Reading 2, 'Business as a social institution', offers a stronger view of the role of large firms, suggesting that they share some responsibilities with government for social well-being.

A growing number of outside constituencies – regulators, investment management executives, proxy advisory firms, lawmakers, and leaders of influential NGOs – demand direct contact with boards, and sometimes with individual directors. The work of a corporate director has become increasingly public.

Although a board's fundamental task in governance has not changed, the breadth of board responsibilities has increased. Corporate lawyer and corporate governance pundit Martin Lipton expanded on these demands in a recent article; "Today," he writes, "boards are expected to:

- Oversee corporate strategy and the communication of that strategy to investors, keeping in mind that investors want to be assured not just about current risks and problems, but threats to long-term strategy from global, political, social, and technological developments;
- Be aware that ESG and sustainability have become major, mainstream governance topics that encompass a wide range of issues, such as climate change and other environmental risks, systemic financial stability, labor standards, employee training, and consumer and product safety;

- Recognize the current focus of investors on ‘purpose’ and an expanded notion of stakeholder interests that includes employees, customers, communities, and the economy and society as a whole and work with management to develop metrics to enable the company to demonstrate their long-term value to shareholders, society and the economy.”⁶

Notably, more and more capital market participants – institutional investors, regulators, and some leading directors – now insist that boards provide active, committed, and continuous engagement with key outside constituents, even in companies endowed with the best management teams. Boards cannot delegate fundamental strategy or leadership on social externalities to management.

Reading 3, ‘A contemporary perspective on directors’ duties’, offers a view of changing legal approaches to corporations’ responsibility toward the continued vitality of social and economic institutions.

Reading 4, ‘Challenges facing the modern board’, describes why many boards are struggling to deliver on their expanded responsibilities.

Yet, amid such profound, whirlwind changes – the growth in the size and complexity of firms, the accelerating pace of change owing to advances in technology and other forces, and the increasing demands placed upon directors – the structures of boards have remained largely static. Public company boards are still supposed to be made up of roughly 10 to 12 individuals, most of them ‘independent’ and part-time, meeting between four and eight times per year. For the most part, directors – including board and committee chairs of very large public companies – operate without staff.

What is a pragmatic way forward?

We noted above that the fundamental task of a board has not changed, but that the burden a board must carry has increased: the breadth of issues involved, the depth of engagement with management, and the increasingly public nature of a board's work.

Our view is that today's directors and institutional investors will not call for radical changes in the capital markets system, but for new levels of time allocation and discipline on the part of boards and their directors. This may entail increased director pay, especially in the largest companies, or in sectors such as banking where the regulatory burden is very high. Most of all, boards will need to act with greater courage and conviction.

Several directors strongly asserted the need for discipline and determination on the part of the board. If boards aren't given enough time for strategy discussions, said one, and compliance matters are crowding strategy conversations, *"it is because boards are badly run or their directors are lazy."* Others pointed out that neither regulation nor accepted best practice limits the time that directors may spend on a board. Others said that boards should push back on strategy proposals that arrive in a near-finished state in the boardroom.

At the same time, directors insisted that trust and alignment between boards and top managers needed to be strengthened. Larger time commitments on the

part of boards and more active board engagement in strategy need to be done in ways that build, rather than erode, trust and collaboration. A board or a director that intervenes continuously and seems to be second-guessing the CEO can foster adverse behavior on the part of management.

Reading 5, 'Future boards of public companies: more engagement, more time', makes a case for greater time commitments from the directors of large companies, and correspondingly higher director pay.

Directors cited several process improvements, described below, that boards could make immediately.

Revamp the board's agenda to create more time for strategic issues

In many boardrooms, routine matters often crowd out more critical activities. *"If we could clean up 20% of the non-value-added activities in the governance world, it would free up the time we need for more value add,"* said one director.

Moreover, some boards suffer from information overload. According to one director, *"One of my boards has 2,000-page board books. It's an extraordinary amount of work, and I struggle to pull out the most important information. There is some inefficiency in that process that could definitely be improved."* An investor we spoke with concurred: *"Too many boards are overwhelmed with information that is not helping them hone their attention on the risks of the business."*

Some directors felt they were spending too much time engaging with shareholders and not receiving enough value from it. One said, “We get a lot of groups who want to meet with us and tell us their recommendations for us to do better on their specific issue or cause. A lot of the time, what they are looking for is already being addressed in our reports, but they haven’t taken the time to understand what we are doing before making a recommendation. It’s a distraction that takes up board time, and I don’t know how to address it because everything out there will tell you about the importance of meeting with shareholders.”

One investor noted that some boards were overthinking activist intervention: “Boards are overinvesting their time engaging with shareholders on governance issues. Companies that are not on anyone’s radar are holding back on allocation decisions for fear that an activist will come after them. They should take that time and use it elsewhere.”

Another director discussed delegating more work to committees to free up time for strategic discussions during board meetings: “Something practical that all boards can do is to tighten up the efficiency of the committees and push some work to them that frees up the full board because having that time is critical. It won’t work at every board meeting because each committee has certain peak work times but be intentional about it and see if the lion’s share of work can be done at the committee level.”

Historically, boards focused on strategy once annually, often at a one- to two-day off-site retreat. Today, in most firms, discussions on strategy take place at each board meeting to ensure that progress is being made and that new competition or technology is taken into consideration.⁷ Many directors support frequent evaluation of strategy, deeper engagement, and greater board involvement at an earlier stage.

One director shared the evolution of the strategy process at their company: “Boards used to be informed of the strategy by the CEO at the annual strategy session – there were few questions and limited engagement. Now

the process we have started is much more robust; now we work strategy into every board meeting, as well as scenario planning. We look at first cuts, provide feedback to the executive team, bring in board expertise earlier on and then discuss second cuts in the next meeting. It gives the board time offline to consider the strategy and make changes over a period of time as opposed to just one day of strategy.”

Reading 6, ‘A practitioner’s perspective’, presents an experienced director’s insights on organizing the board agenda.

Organize boards to handle the expected workload

Given the demands on today’s boards, their composition must be reviewed regularly to ensure that they remain fit for purpose. According to one investor, “It’s difficult to ask a board member to step down, but a company may need change and may need to learn something new. Board representatives need skill growth, or they need to be replaced if they no longer add value.”

Directors emphasized the importance of board refreshment: regularly examining board skills and acting swiftly when changes are needed. Some boards enforce mandatory retirement ages; others gain diversity by adding new directors, increasing the size of the board.

On board size, there are pros and cons to different board sizes. A larger board might be able to more easily manage the workload and can contribute more perspectives, but some individuals might be less engaged if the board gets too big and calendars become more difficult to manage.⁸ A smaller board provides a forum for easier communication and interaction, but the heavier workload could cause burnout among members.⁹

Directors and investors indicated preference for boards that are not overly large. One director said, *“I don’t believe in large boards. Thirteen people was the biggest board I was a part of, due to a merger, and we made it work, but I think nine to 11 people on the board is ideal for a large company. That way, there is enough muscle power to deal with all the issues on committees and have the right mix of skills. When you get past 11, it’s a challenge with schedules, especially in times of crisis.”* Another said, *“We started with seven members and now we have nine; growth was to account for succession planning and to add diversity. So eight to 10 members has been my experience, and I think smaller is better generally.”*

One investor saw large boards as a negative factor when evaluating companies: *“The size of the board has been a red flag for us. If it’s a huge number, we get concerned and wonder, How can you be effective with so many people?”*

Importantly, corporate directors will likely need to dedicate more time to their board duties. While some directors complain that the biggest challenge for boards is a lack of time to cover all of their responsibilities, one investor argued that *“there is no rule that the board needs to meet [only] once a month for one or two days. Boards are choosing these time frames and should feel empowered to change them.”*

Improve director education, especially around strategy

Some of the directors we spoke with emphasized the value of director-education programs. One said, *“Every company I have been involved in has a director-education budget. We can use this for seminars on strategy, etcetera—anything related to board governance.”* Another added, *“I would expect my fellow board members to enhance their knowledge base. In terms of programs, I prefer gatherings of small groups of talented people where you can share experiences without attribution. I find it very valuable to go back to my committees armed with new data to have more intelligent discussions.”* Another echoed support for

smaller group meetings as an opportunity for further board learning: *“I’m not a fan of large group meetings. I prefer smaller settings where you can have intimate discussions. I don’t enjoy someone in a big room yapping at you, and I don’t find much value in panel discussions either. There is opportunity to do a much better job of director education.”*

Adopt new approaches to help boards engage with strategy

Directors discussed a variety of practices to enhance strategy discussions. One spoke of scenario planning: *“We do a lot of work on our purpose, mission, and values as a way of taking a step back and evaluating where you are at. Scenario planning is important, too – you must think through what would happen to the company if the world went a certain way. Would we survive? Are we prepared? If you aren’t having those discussions periodically, then you aren’t doing enough work.”*

Many interviewees discussed the value of engaging with a diverse set of outside experts. One director said, *“It’s so important for the board to understand what’s really going on in the outside world, to understand the role of technology, the industry, the customer. We bring in experts once or twice a year to educate our board; sometimes what they say really scares you, but at the same time, it opens you up to new ideas.”* Another director said, *“We bring in outside experts when we don’t have in-depth skills on the board. They help inform robust discussions of what is going on.”*

Some directors also make visits to competitor, distributor, or supplier sites as part of their strategy oversight responsibility. This can give boards a better real-life look and understanding of what is really going on in the company. As directors learn more and more about company operations, they can better challenge management’s assumptions and critically evaluate strategy proposals.¹⁰ Directors also discussed the value of holding strategy offsites at operating facilities in different geographies.

Act with conviction

Despite the short-term pressures on boards and management, our interviews indicate the importance of acting courageously. One investment executive shared an example: *“When allocating capital, as long as a company can describe the long-term benefit and short-term trade-off in a way that is credible, they can rely on our support. There will still be noise, but it is less and less well informed. What it comes down to – in activist situations, too – is that boards need to listen to what they hear but have courage of conviction when they believe they are doing the right thing for the company and its stakeholders.”*

On sustainability, directors emphasized the need to contextualize a company within the broader ESG landscape. One said, *“Based on the nature of our business, we have a big sustainability impact. If we don’t take care of the environment, we could be out of business, so we discuss these megatrends, global warming and the like, over our planning horizon. It’s an interesting backdrop for consideration and we are sure not to underestimate it.”* Another said, *“It’s not just about ESG, it’s about looking ahead. Investing in communities is just good business.”* Another director, however, suggested that in the case of an economic downturn, firms might see a fall in the focus on ESG: *“You can’t give a lot away if you didn’t earn it. Community spending and corporate social responsibility will be cut back when economic times are tougher.”*

Reduce outside pressures that force attention to the short term

“One of my fears as a director is the focus of the capital markets on quarterly earnings and short-term results – that’s not hard to do. What’s hard to do is to create long-term, enduring value, especially when technological disruption is happening so fast,” said one director. As indicated earlier, President Trump has asked the SEC to consider eliminating quarterly reporting, relieving some of the short-term pressures on results. Companies, however, will still need to contend with

investors that are short-term oriented, whether due to style or incentives. Yet, directors told us, because short-term investors tend to be the noisiest, it is easy to forget that long-term investors own 75% of U.S. stocks and are less concerned about quarterly earnings than about news that affects long-term performance.¹¹

Enhance disclosure to satisfy outside stakeholders

According to a recent survey, one of the top three most important topics on which investors seek enhanced disclosures is around matters of significance to a company and sustainability metrics linked to long-term business strategy.¹² Companies willing to make such disclosures could achieve closer relations with investors.

One director agreed that disclosures in the United States need work: *“We disclose the bare minimum in the US, and that leads to distrust because shareholders don’t know what we are doing, so they assume it’s nothing.”* Others noted that they have started to improve their disclosures, particularly around ESG-related items. One director said, *“We have been recognized as one of the most philanthropic organizations in the world. When you get Fink’s letter to CEOs, it paints the picture that all businesses are not doing the job and grows the public view of business as evil. There should be more acknowledgement in those letters of what is actually being done.”*

An investor did point out a few exemplary companies providing disclosures helpful to investors: *“In the US, it’s the usual suspects – Prudential, Coca-Cola, Microsoft. It’s the companies with really good corporate secretaries or general counsel who really understand the informational interests of long-term investors as opposed to disclosures being driven from investor relations, which tend to be concerned about communication to make investment decisions, not governance.”*

Reading 7, 'The new paradigm', calls for a new relationship between companies and their institutional shareholders.

Most directors we have spoken with are clear that, even with efficient processes and streamlined agendas, the workload on directors will not change, because the duties imposed on boards are growing, not shrinking. As one director put it, *"There is probably a three-level conversation here: what are our minimum fiduciary duties? What reasonable duties are expected by a broader stakeholder group beyond the minimum set? What is an aspirational set that the board might choose to migrate toward over time?"*

Where might the system change further?

In recent years a number of academics, public intellectuals, and political leaders have offered proposals even broader than the pragmatic approaches we outlined in the previous section. They are calling for a fundamental overhaul, not only of how boards do their work, but of the existing corporate governance system, and, in some cases, the structure of capital markets.

Proponents of these perspectives believe that the incremental improvements described above are insufficient. Fundamentally, many of these individuals advocate moving away from a narrow focus on shareholder-value maximization and toward a greater emphasis on all key stakeholders—shareholders, employees, customers, and the community. But they go beyond simply giving lip service to the idea, by setting out the structural changes they seek to get implemented.

Our point of view is that systematic change is needed; we base this not only on a look at the external environment (rampant inequality, political distrust and instability) but also on views that the current model is becoming too difficult even for diligent directors to execute. However, there are material barriers to the implementation of major change.

Reading 8, ‘Fixing the Game’, calls for a shift in focus, away from share prices and toward ‘the real market’: trading goods and services, rather than speculation about other investors’ views. The author identifies substantial implications of this shift, including an end to stock-based compensation, and major changes in the directors of public companies.

Reading 9, ‘The Shareholder Value Myth’, advocates a return to a ‘managerialist’ model of corporate purpose, with a much wider focus than equity shareholders. It also calls for a reversal of recent corporate governance changes that many market participants have supported – for example, the dismantling of dual share classes and anti-takeover defenses.

Reading 10, ‘Prosperity’, praises ownership structures that buttress leaders’ commitment to broader and prosocial purposes. The author speaks highly of structures such as family foundations that own companies, or ‘anchor’ owners who can insulate firms from short-term pressures.

Reading 11, ‘The Accountable Capitalism Act’, calls for Federal incorporation of large companies, and substantial, mandatory employee representation on boards of directors.

The directors and investment executives we have spoken with are aware of some of these proposals, but virtually all of the directors' energies have been directed toward improvements within the current system. We also believe the systemic proposals have not gained greater traction because they:

- call for deep and simultaneous changes on many, many fronts – investors, management, boards, government, disclosure regime, etc.;
- identify additional stakeholders to whom boards have a fiduciary duty (customers, communities, various employee groups) without giving much guidance as to how competing claims from those groups should be adjudicated; and
- offer few transition plans or implementation pathways.

None of these are necessarily flaws in the more radical proposals, but implementing any of them will require high levels of cooperation – for example, between boards, investment executives, and corporate regulators in multiple jurisdictions.

Paradoxically, the diligence and energy that directors and investment executives have exerted to create better governance within the current system may be competing with efforts to change it.¹³ Some of these tensions are evident even within the interviews and readings in this report: for example, some practitioners call for strong pay for performance (e.g., in reading 6), where several academic authors would urge caution in this area.

Our interviews and research convince us that further dialogue is needed: without it, the collaboration and coordination needed to create sustainable capital markets is unlikely to come about.

Questions for reflection

In closing this report, and to help foster further dialogue, we offer a series of questions for different groups to consider.

For boards and directors

- Has our company's purpose been articulated in a way that employees at multiple levels find convincing and meaningful? Does our stated purpose arise 'organically' from the company and its multiple constituencies (customers, shareholders, communities, etc.)?
- Does it translate into concrete actions and commitments – e.g., toward maintaining a positive corporate culture? Are these reflected in executive performance appraisal and compensation? Does the board discuss these actions and commitments?
- Do we have a framework for including ESG issues in strategy, identifying which could be material to performance, including maintenance of our firm's 'social license to operate'?
- Does our board have sufficient time and support to engage on fundamental strategy?
- Does strategy include not only success with customers, suppliers and regulators but also wider stakeholders – employees, for example, and local communities?
- Do board and management operate as trustful partners in forming and evaluating strategic alternatives?

For advocates of pragmatic or incremental governance reform

- Are these incremental steps sufficient to drive real change?
- How well have they been pressure tested in real boards, in a variety of industries?
- What conflicting priorities would create 'immunities to change?' For example, many board members told us that they needed to maintain strong levels of trust with management, and with the CEO in particular. Will the need for trust stop boards from engaging more intensively with strategy issues?
- What impact would the tactical proposals have on the cost of running boards and the time commitment required of board members?

For advocates of more fundamental change

- Are more radical proposals – such as mandated worker representation on boards – sufficient to address the role of business in solving major social problems? What other measures are required?
- What unintended adverse consequences could these proposals have? For example, if board service is seen as more like public service, with severely limited director pay, will this limit board roles to those already wealthy?
- How will they fare under political leadership either on the left (e.g., from Jeremy Corbyn in the UK) or the right (e.g., from President Trump in the US)?
- What would the implementation path be?

Readings

Reading 1

Developmental eras of the modern public company

Tapestry Networks

Broadly speaking, since the mid-19th century, the modern public company has gone through three developmental eras:

- **First era.** The board ran the firm. Management was an optional extra – a ‘best practice’, useful to cope with growing scale and complexity but far from essential. This persists in the foundations of company law, both in the United States and the United Kingdom, where the Companies Act scarcely mentions a CEO or a management team. It survives today when boards are suddenly called into action; for example, when a crisis emerges, a CEO’s performance or integrity is called into question, or a transforming takeover is proposed. In more than a few of these cases, the CEO is pushed aside, and the board again runs the firm.
- **Second era.** After World War II, companies grew in scale and scope. Singer, for example, diversified into calculators, flight simulators, handguns, and minicomputers, among other lines of business, after achieving dominance for domestic sewing machines. In many cases, these postwar giants were led by chairmen/CEOs who treated their boards as, at best, useful appendages. Governance in the second era received criticism for several decades, but things did not change much as a result. This period was marked by the collapse of the conglomerate wave of the 1960s; the rise of leveraged buyouts and private equity in the ‘70s and ‘80s, as an alternative to public company governance; a series of mergers in the ‘90s, many of which were subsequently unwound; and spectacular governance failures in the first internet boom: Enron, Xerox, MCI WorldCom, Tyco.
- **Third era.** The Sarbanes-Oxley Act of 2002 sought to enhance board independence and engagement; it was an early step into an era where boards and directors are expected to be far more active in the leadership of their companies. This third era has only partially arrived. In private conversation, some CEOs still refer to public company boards as nuisances that need to be managed. Even nuanced sources continue to draw a bright line between the roles of board and management, a division that, as the third era advances, may become more permeable. For example, the highly respected Millstein Center, in a 2011 paper, echoed an aphorism often used to limit the role of boards and their chairs: “The CEO runs the company, the chair runs the board. That is the basic starting point for all discussion.”¹⁴

Reading 2

Business as a social institution: the challenge to corporate governance

Chris Pinney, CEO, High Meadows Institute

For most of the latter half of the 20th century, the business of business was business. Governments, supported in part through corporate taxes, took care of society. In this context, it is not surprising that the evolution of corporate governance over the last fifty years has focused almost exclusively on the firm's 'contractual' obligations to shareholders primarily to deliver financial performance, not on the firms' social role and impact. As famously noted by economist Milton Friedman in 1970, "There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."

Today, this construct is fast unravelling. In a global economy where capital flows freely, governments of sovereign states are losing their ability to control their economic future and are proving increasingly incapable of delivering on their mandates and ensuring social welfare. As a result, we see public trust in governments and transnational institutions falling dramatically while populism and anti-globalization forces are on the increase.

While governments have struggled under globalization, business has prospered. 70 of the top 100 global 'economies' are now global firms. These firms are some of the most powerful institutions we have, with a profound impact

on the societies in which they operate. It is not surprising that in this environment, society is now looking to firms to take more direct responsibility for managing their social impacts and play a leadership role in helping address social challenges. A survey¹⁵ conducted by the Stanford Rock Center for Corporate Governance found that 63% of Americans believe that CEOs have a responsibility to take a stand on important social issues. CEOs and their companies have begun taking stands on issues from immigration to gun control to global warming to transgender rights, often taking positions well ahead of public policy. 85% of S&P 500 companies now publish Sustainability or Corporate Social Responsibility reports detailing their social and environmental performance.

How companies manage their social impact and take leadership on social issues is no longer simply of interest to external stakeholders, it is increasingly a focus of concern for shareholders as social issues create a new landscape of risk and opportunity for firms and their long-term viability.

As Larry Fink, CEO of BlackRock, notes in his 2019 letter to companies: "Stakeholders are pushing companies to wade into sensitive social and political issues – especially as they see governments failing to do so effectively... Companies cannot solve every issue of public importance, but there are many – from retirement to infrastructure to preparing workers for the jobs of the future – that cannot be solved without corporate leadership."

BlackRock and other large institutional investors now want to know how companies and their boards are addressing these changing expectations of the role of business in society. They are staffing up their investment stewardship teams to engage with companies and learn how they are integrating these expectations into corporate strategy, starting with a clear definition, as Fink put it in his 2018 letter, of their “social purpose.”

Our interviews with directors and independent research suggest that the current framework for corporate governance for most companies is not equipped to meet these challenges. A good illustration of this can be seen in the response to increased shareholder activism on environment, social and governance issues. A 2016 analysis by Harvard Professor George Serafeim showed that companies responded with equal thoroughness to ESG-related proxies, regardless of their financial materiality. Unsurprisingly, the study showed that companies that responded to issues not material to the company’s primary social impacts were associated with subsequent declines in firm valuation, while action on proposals on material issues were associated with subsequent increases in firm valuation.

The challenge, now, is to develop a more robust framework for corporate governance that reflects the new rules of the game for business: a world where license to operate no longer comes simply from government but must be negotiated with a variety of stakeholders with competing interests and demands. Boards now need to help the firm navigate a path forward through a complex ‘politicized’ operating environment. They need to be able to assist management in identifying which ESG issues are material to long-term value creation

and should be acted on and which are not. They need to ensure a corporate culture and tone at the top that can mobilize employees around the firm’s purpose and mission and attract a new generation of employees prepared to make employment and investment decisions on ESG performance.

Among the questions companies and their boards now need to consider are:

- Does the board mandate provide sufficient time and resources for the board to execute on its fiduciary responsibilities in an environment where license to operate is no longer assured simply by compliance with government regulations but also by the firm’s capacity to manage a complex set of stakeholder concerns and expectations around ESG issues?
- Does the firm have an ESG strategy that monitors and identifies which current and emerging social issues are potentially financially material for the firm?
- Are social issues of potential materiality to the firm included in conversations on the firm’s long-term corporate strategy?
- How is corporate performance against material ESG issues tracked and reported to internal and external stakeholders?
- Does the firm engage regularly with key external stakeholders and shareholders concerned with the issues material to the firm?
- Does the board have good oversight of the company’s culture and morale of its employees?

- How does the board review or provide guidance to the CEO or other senior executives when they wish to speak out on social issues?
- Does the board play an active role in corporate strategy and ensure consideration of the above factors in strategy?

Depending on the size and scope of operations, the importance of, and answers to, these questions will vary widely among firms. In a world, however, where the ‘rules of the game’ are increasingly in flux, we can expect these questions to come increasingly into focus as institutional investors look to the board for assurance on their firm’s long-term value creation strategy.

As Vanguard, with ownership in over 13,000 public companies, notes it in its guidance to boards:

“As near-permanent owners of the companies in which we invest, we like to focus our discussions on the long term. In most situations, we are more interested in understanding the board’s oversight of matters that will affect the company over the next decade than over the next quarter.”

The stakes are high. Failure of corporate governance to proactively step up to the challenge of the new rules of the game could result in another wave of complicated government intervention as we see in proposals such the Accountable Capitalism Act put forth by Senator and presidential hopeful Elizabeth Warren. In this context, it is of note that in 2018, only a slim majority of Americans had a positive view of capitalism and among those aged 18 to 29, socialism is winning.

Reading 3

A contemporary perspective on directors' duties

Ed Waitzer, Adviser, High Meadows Institute; Professor, Osgoode Hall Law School and the Schulich School of Business, York University

The corporation is a creature of statute – historically, legislators helped define the responsibilities of corporations (and markets), through statutes, taxation and other forms of regulation. They have become increasingly constrained in doing so, both by power imbalances and a general inability to address long-term, systemic policy issues given the short-term incentives that tend to inform political processes. Hence more robust legal regimes, rooted in the concepts of “reasonable expectations” and a broader understanding of fiduciary duties, have taken hold.

Protecting reasonable expectations is a central organizing principle for legal rules. Private law generally emphasizes the more subjective aspect of expectations (i.e., those of stakeholders) while public law focuses on objective ‘reasonableness’ (viewed from the perspective of society as a whole). As the Supreme Court of Canada has stated, the doctrine “looks beyond legality to what is fair, given all of the interests at play” to address conduct that is “wrongful, even if it is not actually unlawful”.¹⁶ Contextual and dynamic, reasonable expectations can be thought of as legal polyfilla – molding around other structures to plug the gaps.

Fiduciary duties provide a second legal pathway towards longer-term, systemic responsibility. Fiduciary law promotes trust by imposing strict legal obligations when one party to a relationship

gains discretionary power over another in circumstances where both would ‘reasonably expect’ such power to be exercised in the best interests of the beneficiary or stakeholder.¹⁷ Like the concept of reasonable expectations, fiduciary duties are open ended – prescribing broad principles, the content of which varies depending on the circumstances and evolve over time.

It is in this context that corporate directors’ and officers’ statutory duties – to act honestly and in good faith with a view to the best interests of the corporation (the duty of loyalty) and to manage, or supervise the management of, the business and affairs of the corporation and, in doing so, to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances (the duty of care) – should be considered.

The courts have played an important role in modernizing these duties to reflect the challenges involved in supervising large enterprises – both the shift in focus on the part of boards of directors from actively managing a business to supervising its management, as well as the outsized, potentially irreversible impacts the actions that these enterprises can have on stakeholders and financial, environmental, and social systems more broadly. In particular, the courts have read three obligations as flowing from these statutory duties: (i) a duty to monitor the management of the

corporation to address risk and misconduct, (ii) a duty to treat stakeholders fairly, and (iii) a duty to act ethically.

The Duty to Monitor

In *Caremark*,¹⁸ the Delaware Court of Chancery fashioned a new accountability mechanism reflecting the role one can reasonably expect directors to play in large, complex enterprises. The duty to monitor requires directors to: “assur[e] themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation’s compliance with law and its business performance.”¹⁹

Recent litigation regarding misconduct at Wells Fargo provided further guidance on the scope of the duty: directors are not permitted to review individual instances of misconduct in isolation, without turning their minds to whether these instances might reflect a broader pattern.²⁰ Further, the U.S. Federal Reserve’s enforcement action against Wells Fargo emphasized directors’ responsibility for risk management.²¹ The Federal Reserve characterized compliance breakdowns as failures of board oversight and expressed the view that business growth strategies should be supported by a system for managing all key risks, including the risk that business goals will motivate compliance violations and improper practices.²²

Directors must take a holistic view when carrying out their duty to monitor, looking at not only discrete events, but the connections between

them. For example, recent litigation alleged that directors of Duke Energy violated their duty to monitor by supporting a business strategy that purposely skirted environmental laws and relied on a captured state regulator to protect it from liability. While not resulting in personal liability on the part of directors, the case illustrates a trend in judicial opinion towards greater attention to directors’ obligations to monitor systemic risks.

Moreover, Duke Energy raises the question of whether directors have a broader obligation to oversee risk-taking by the corporation. The reality is that risk oversight is now typically viewed as a key responsibility of directors.²³ Regulatory and judicial activism have resulted in today’s calculated risks becoming tomorrow’s compliance problems.²⁴

Duty to Treat Stakeholders Fairly

Over time, the duty of loyalty has evolved from a narrow duty focused on avoiding conflicts of interest and having regard for shareholder interests, to a broader one encompassing a positive obligation to promote the long-term success of the corporation, having due regard for the interests of all stakeholders.

In the United Kingdom, this shift was fostered by statutory reform. The Companies Act, 2006 reformulated the duty of loyalty as a duty to act in good faith to “promote the success of the company for the benefit of its [shareholders] as a whole,” having due regard for, among other things, impacts on the community, the environment, and employees.²⁵ In Canada, a similar shift occurred through court decisions. In *Peoples*,²⁶ the Supreme Court of Canada stated that “in

determining whether they are acting with a view to the best interests of the corporation, it may be legitimate, given all the circumstances of a given case, for the board of directors to consider, *inter alia*, the interests of shareholders, employees, suppliers, creditors, consumers, governments and the environment.”²⁷ In BCE, the court went further, stating that the duty of loyalty includes a “‘fair treatment’ component” requiring directors to balance stakeholders’ conflicting interests fairly, in a way that reflects these stakeholders’ reasonable expectations.²⁸

Within the OECD, a growing number of jurisdictions are allowing corporations the option to establish a two-tier board, with one tier expressly providing for stakeholder representation, in line with EU law.²⁹ While the Delaware courts’ interpretation of the duty of loyalty continues to reflect a shareholder-centric viewpoint, this viewpoint is increasingly oriented to the long-term³⁰ – a time horizon in which the interests of shareholders and other stakeholders tend to converge.

A Duty to Act Ethically

A related development has been the integration of ethical considerations into the duty of loyalty. The Delaware courts have concluded that the duty of loyalty incorporates norms of good faith and obedience to law, with Chief Justice Strine’s dissent in *Good* indicating that these norms may ultimately be interpreted to mean more than

fostering compliance with existing law, but also paying attention to activity that ‘skirts’ legal requirements despite arguably being in technical compliance with them.

The UK Companies Act requires that directors have regard for “the desirability of the company maintaining a reputation for high standards of business conduct.”³¹ In BCE, the Supreme Court of Canada characterized the duty of loyalty as a “duty to act in the best interests of the corporation, viewed as a good corporate citizen.”³² Both standards imply that directors should cause corporations to not only comply with existing law, but to act ethically.

In summary, the trajectory of the law has tended towards greater recognition of stakeholder interests and ethical behavior as components of directors’ and officers’ duties to the corporation. It reflects the magnitude of the effects that corporate acts and omissions can have on external stakeholders, as well as corporations’ dependence on, and corresponding responsibility to help foster, the continued vitality of social and economic institutions. Ironically, the obsession with corporate governance has fueled an inevitable desire for standardization which, in turn, tends to frustrate dynamic adaptation and has led to governance systems that underperform. Improving connectivity between boards and corporate stakeholders will require thinking differently about how the elements of governance interact and produce results.

Reading 4

Challenges facing the modern board

Tapestry Networks

Boards of large companies – even those that are well-organized and resourced – struggle to deal effectively with their expanded set of responsibilities, ranging from shaping corporate strategy to responding to a growing variety of stakeholders who demand access to the board.

Many directors tell us that their boards find it challenging to devote enough time to the most critical matters, that they find it difficult to adopt a long-term horizon, and that they do not possess the full set of requisite skills and experience to lead strategy in today's complex and fast-changing world.

Insufficient time on the most critical matters

While large company boards have long moved away from being passive bodies that primarily rubber-stamp management decisions, our interviews and research reveal that many are not spending sufficient time on the most essential matters.

Boards have traditionally been responsible for 'approving' corporate strategies developed by management, but at times this was little more than a final review of work that had been developed in great detail, with little or no prior board involvement.

Increasingly, boards are expected to actively and continuously shape corporate strategy and

getting strategy right is no easy feat in a dynamic environment characterized by intense competition and continuous threats of disruption.

In 2014, a National Association of Corporate Directors (NACD) report³³ called for boards to change their mindset around strategy from "review and concur" to continuous engagement: "shape and monitor." One director agreed: "*Strategy cannot be a once-a-year event.*"

However, many interviewees noted challenges to engaging more deeply on strategy. One director said, "*The boards I am on will tell you that we don't spend enough time on strategy.*" One lamented about management waiting until the strategy is fully baked before letting the board in on it: "*One company had a year-long management focus on strategy and the CEO came to have it blessed ... It misses the opportunity for a lot of very rich input from the board.*"

The findings from our interviews are consistent with a recent NACD survey that found that 44% of directors did not think they had enough time in meetings for strategy discussions. On CEO succession, boards have always been responsible for hiring and firing a CEO; many directors tell us that this is their single most important responsibility.

Institutional investors are expecting boards to deepen their involvement on succession and leadership development. As one investor explained, "*For larger company boards, we expect them to do a deep*

dive at board meetings into talent and succession planning and culture and employee engagement – particularly in businesses that don't have physical capital and it's all intellectual and employee capital. If the board doesn't think management is getting optimal productivity out of employees, then the company is not being run effectively."

However, in another NACD survey, 58% of directors indicated that improving succession planning remained a critical priority.³⁴

According to one director, the passivity of boards on CEO succession is a serious problem. He said, *"The reality is that outside board members, even in really good companies, don't want to rock the boat. So, if the CEO is not leading the succession process, it won't get done."*

In addition, managing an effective CEO succession, particularly when a company is struggling, can be extremely time consuming. As a non-executive chairman explained, *"CEO succession has occupied 25% of my time for the past 9 months and I have had to set aside other commitments. But I was 'all-in' when I accepted this role so I am not complaining."*

Focusing too much on short-term issues and not enough on long-term matters

Due in part to the tendency of our capital markets to overweight short-term performance, a further challenge for boards is the demands on them to deal with short-term issues. As one director explained, *"The focus in our capital markets is on quarterly earnings. Succeeding there is not hard to do; what is hard is creating long-term enduring value, especially when technological disruption is happening so fast."*

According to a recent NACD survey, 29% of respondents felt pressure to focus attention almost

exclusively on short-term performance matters.³⁵ One director said, *"Boards spend a tremendous amount of time putting together financials every three months and waiting to see the stock react to that. We would all benefit from not being judged from quarter to quarter."*

At the same time, no doubt affected by the intense pressure on them to deliver short-term performance, management – and, by extension, boards – may not be adopting a sufficiently long-term horizon when making critical decisions.

On capital allocation, for instance, one director warned, *"Beware executives whose time frame is limited to two or three years. They either have unintentional blind spots or are deliberately ignoring long-term issues that will endure after their tenure ends."* Achieving this may not be easy: 82% of directors surveyed by PwC in 2017 said that it was at least somewhat challenging to balance short-term and long-term focus.³⁶

Climate change and other long-term ESG issues have become priorities for more investors. In the 2016 proxy season, a record-breaking 89 climate-change resolutions were filed.³⁷ Yet, only 6% of NACD survey respondents in 2017 considered climate change to be a top-five trend and only 2% believed that the role of business in society was a key trend impacting their company; in fact, only 24% of respondents considered it important or very important that their board improve oversight of ESG matters.³⁸

Lack of a robust framework to judge the materiality of ESG issues

Large companies are being pressured by shareholders, stakeholders and, in certain

industries, regulators to address a growing suite of ESG issues. As they seek to sort out competing demands, corporate leaders need a way to determine which priorities are most significant and then to integrate these into strategy and operations.

One investor said, *“The most persuasive way for a company to incorporate ESG issues is to look at what is truly material to running the business. For example, PepsiCo can discuss why they are training farmers on sustainable farming – it’s because that is where cocoa is grown and if they can invest in that and develop a better quality product, and on top of that, create a positive externality of higher yield and lower pollution and land degradation. When you focus on the business model you can really get to the materiality of the issues.”*

Directors we interviewed agreed that, with top institutional investors like BlackRock and Vanguard focusing on ESG issues, boards needed to change their strategy discussions. They spoke of the short-term versus long-term trade-offs in prioritizing ESG: for example, higher labor costs, increased costs of human capital, and increased cost of goods sold. The benefits of investing in ESG include attracting better talent, creating more reliable supply chains, avoiding conflicts and media backlash, and spurring the development of new products.³⁹

Although more discussions on ESG are taking place in boardrooms, it appears that many boards are struggling to apply a robust framework to analyzing ESG issues. According to one investor, *“I think there is confusion on boards right now about ESG – boards are trying to figure out their relevance. Some enlightened boards that see their future in climate change will focus on the E and make that a strategic issue. But for the most part, boards are not there yet.”*

One director admitted that *“there are more and more disclosures and more and more programs and minutia [pertaining to ESG] that are not adding any value.”*

New board skills to meet today’s demands

Deep board engagement and effective oversight of the areas discussed in this report begins with having the right set of directors in the boardroom. *“The right directors create enormous value and find big opportunities,”* said one director. In his 2018 letter to CEOs, Mr. Fink stated, *“Boards with a diverse mix of genders, ethnicities, career experiences, and ways of thinking have, as a result, a more diverse and aware mindset. They are less likely to succumb to groupthink or miss new threats to a company’s business model. And they are better able to identify opportunities that promote long-term growth.”*⁴⁰

Another investor discussed how their team views board composition: *“Every governance conversation starts with the board. We want to make sure the right people are on the board. Diversity of thought, experience, expertise, tenure. Are the directors independent? Are they elected annually? This is what we are looking for.”*

According to the above-mentioned PwC survey, while almost all directors said they were satisfied with the level of deep industry expertise in their boardrooms, 72% said they needed more IT/digital expertise on their boards.⁴¹ In addition, board gender balance is getting attention around the world. California, for example, recently enacted a new law requiring all public companies headquartered in the state to have at least one female director on the board by the end of 2019, with subsequent increases in female representation by the close of calendar year 2021 dependent on the size of the board.⁴²

Continuing regulatory pressure

Technological shifts and investor demands are not the only challenges confronting the boards of large public companies. Starting in the early 2000s, with the passage of the Sarbanes-Oxley Act in the U.S. and legislative and regulatory developments in Europe, companies and their boards have been subject to stronger regulatory intervention, especially regarding internal controls and public company audits. These have been particularly

challenging in the financial sector, where post-crisis regulation has led to unprecedented public scrutiny, including regulatory intervention on the appointment of directors and top executives. Directors of large banks are expected to have a deep personal understanding of risk matters once delegated to expert executives. Whatever the positive or negative effects of these changes, one consequence is clear: in large public companies, compliance and regulatory matters now claim a high share of an already pressured board agenda.

Reading 5

Future boards of public companies: more engagement, more time

Jonathan Day, Chief Executive, Tapestry Networks

For several decades, pundits in Europe and the United States have predicted an imminent revolution in the governance of large public companies. But the revolution has yet to arrive. The vast majority of the hundreds of directors with whom Tapestry Networks speaks each year tell us that they are working to improve their effectiveness in the current paradigm, rather than waiting for the arrival of a fundamentally new model.

Nonetheless, our interviews, network discussions and external research convince us significant change is in the wind. As demands on boards grow, the boards of large public companies will increasingly employ highly engaged directors, a good number of whom will allocate a minimum of 60% of their time – three days per week – to a single board. The chairs of major committees and of boards will often view board service as a full-time commitment. And these directors will be paid accordingly. The result will be a major shift in public company governance.

Many directors admit that their jobs are becoming harder to do. A surprising number tell us that they regret having taken up public company directorships, given the personal risk that the roles entail. The major issue is the amount of work to be done and the time available to do it.

Most governance observers assume the following:

- Large public companies can grow without limit, increasing their scale, geographic reach, and diversification of their activities.
- Major responsibilities can be handed to boards, who are expected to make decisions with great independence from management on matters ranging from cybersecurity resilience to the development of long-term strategy.
- These responsibilities can be discharged by groups of eight to 14 part-time directors, each spending between 10% and 25% of his or her time on each company, and compensated accordingly.

Although the first assumption is deeply flawed, the winds of opinion blow against challenges to firm size. Regulators have levied big fines on the banking and tech giants, but few have actively sought to break them up.

The second assumption is also difficult to question. Since at least 2002, legislators and regulators have demanded that boards increase their independence and direct engagement with the companies they govern. A passive board, appointed by and subservient to a CEO, ‘presiding over’ rather than actively steering a company, seems almost quaint these days. And the range of issues that boards are expected to deal with seems to grow by the month. Directors, people say, should set and monitor the firm’s tone at the top and culture; ensure the

diversity of many levels of management; and be aware not only of current risks but of over-the-horizon risks confronting their firms. They should do a lot of ‘walking around’ – visiting company sites, getting to know employees, engaging with investors, and understanding stakeholder concerns well beyond short-term quarterly results.

Investment management firms have become more vocal about their expectations. Describing what he termed “a new model for corporate governance,” BlackRock’s Larry Fink, recently wrote,

The board’s engagement in developing ... long-term strategy is essential because an engaged board and a long-term approach are valuable indicators of a company’s ability to create long-term value for shareholders. Just as we seek deeper conversation between companies and shareholders, we also ask that directors assume deeper involvement with a firm’s long-term strategy ... Directors whose knowledge is derived only from sporadic meetings are not fulfilling their duty to shareholders. Likewise, executives who view boards as a nuisance only undermine themselves and the company’s prospects for long-term growth.⁴³

These developments challenge the notion of a sharp divide between governance and management. They point toward boards more actively engaged in company activities, making more and deeper decisions, and, in the process, becoming less ‘independent’ of management.

Paradoxically, this looks back to the historical and legal foundations of governance. Founding legislation such as the UK Companies Act (1862,

subsequently amended) and decisions of major courts made almost no distinction between directors and managers; the focus was on the differences between the board of directors and the collective stockholders of the firm. As my colleague Simon Wong points out, a CEO and a management team were ‘a best practice’ – one that developed in response to growing company size and complexity, rather than a fundamental component of the corporate structure.

It is the third of the above assumptions that can and must be challenged. If large companies are to keep getting larger, and if directors are to become more and more engaged, we will begin to see more boards with full-time independent directors.

Governance in large banks, both in Europe and the United States, reflects this trend. Where a board chair and CEO hold separate roles, as with Citibank in the United States and every large UK bank, the chair is typically paid in excess of US\$1 million and holds few other roles, even with nonprofit organizations. Chairs of audit and risk committees have similar job profiles. Bank directors regularly tell us that even those who do not hold committee chair roles spend more than 50% of their time on board service.

Banking is not an aberrant sector, but a bellwether for other industries populated by large, complex firms. Those in swiftly moving areas, or ones that create large externalities, will move toward full-time committee and board chairs, relatively few full-time executives on boards, and far deeper engagement between very active boards and management teams.

Increasing director time will not be easy. Creating more active, engaged boards will require altering deeply held assumptions about corporate governance. For example:

- Substantial increases in **director pay** could be required. Yet even if higher pay reflects big increases in director time, it can attract adverse publicity and even litigation, because boards set their own pay.
- Effective **relationships between nonexecutive directors and managers** could be threatened or questioned, which raises the following concerns:
 - » How can directors not only avoid becoming ‘captured’ by management but also avoid appearing to lose their independence?
 - » When some directors are nearly full time with a single company, will management teams resist their request for access to managers at multiple levels?
- If nonexecutive engagement increases, will CEOs lose a sense of urgency or of personal responsibility for risk management?
- More fundamentally, good governance requires high levels of trust between boards and their CEOs. Will more engaged boards undermine this?
- If nonexecutive directors increase their time commitments, some serving full time on a single board, it could become difficult for current executives to serve on public company boards outside their own firms. How will new directors be trained when simultaneous executive and nonexecutive roles are rarer?
- Many directors, even some chairs of very large companies, have little or no staff support. This could pose challenges for more deeply engaged directors.

Reading 6

A Practitioner's Perspective

Raj Gupta, Chairman, Aptiv PLC and Avantor, Inc.;
formerly chairman, CEO and president of Rohm and Haas.

The role of the board has been steadily changing and evolving in response to developments in technology, geopolitics and the capital markets, as well as new regulations coming out of the 'dotcom' bust in the late 1990s and the 2008-2009 financial crisis. This has resulted in changes in six different board priorities.

The first is to make sure that the tone at the top is right – to assure that there is an ethical, moral compass in everything the company does.

The second is the selection of the CEO and the talent in the organization. At the end of the day, there's plenty of capital available, and there are a lot of people with great ideas. But corporate success is all about identifying, attracting and motivating the people who can really execute in this fast-changing world. And so I think management talent, not only at the level of CEO, but well down the chain, is a critically important focus for boards.

The third important responsibility of boards – and this is where we get into the 'partnership' concept – is an active and meaningful engagement with management over the company's strategy. Although boards in the past tended to rely solely on management for strategic direction, today's boards have to ensure that the company has a strategy and business plan that make the most of its capabilities and opportunities. And it's not

just the strategy that's critical, but getting an organizational structure – including well-designed internal performance metrics and incentives – that helps management carry out the plan. By "well-designed," I mean an incentive system tied to performance measures that encourage operating managers to keep investing in the drivers of the company's long-term performance and value. But while helping to drive performance in this way, boards should also deal with the possibility of disruptive change by requiring CEOs and their management teams to present strategic initiatives or options to deal with such change, and then get the input of the board and outside advisors in deciding the optimal course to pursue. One big reason I recommend this kind of board involvement in strategy is that if you live and work in a company day in and day out, you develop a tendency to look at the world from inside out. The role of effective board members is to provide the CEO and management team with the outside-in perspective they've gained from running businesses in different industries. Though the big issues in their industries may be different from those facing the CEO, I've often found that board members' experience to deal with such issues can be used to shed light on the current situation.

The fourth big responsibility of boards is oversight of the risk management function. Especially for companies that are experiencing disruptive

change, board members really need to understand the risk profile of their companies. And this means understanding risks that are internal to, as well as external to, the company, and management's mitigation plan in the event those risks materialize. So, a good understanding of a company's major risks, and its plans to respond to them, is critical for a well-functioning board.

A fifth major board responsibility that I'll mention – and though it remains somewhat controversial, I view it as a big opportunity – is effective communication with the company's largest investors. If you think back to my earlier point that in the vast majority of U.S. public companies as

few as 25 investors own 60-65% of the stock, this concentration of ownership means that a proactive board has an opportunity to get a real sense of its investors' expectations and concerns just by going out and listening to them!

The sixth and final responsibility for boards is to have true pay for performance. This is an area where I think that public company boards have a lot to learn from private equity and the boards of private companies. Private company boards – and I've served on five of them – are often very effective in ensuring pay for performance, and in aligning the priorities of managers with those of the owners.

Reading 7

Martin Lipton, *The New Paradigm* (2016)

Summarized by Tapestry Networks

In a white paper for the World Economic Forum titled *The New Paradigm*,⁴⁴ corporate lawyer Martin Lipton proposes a recalibration of the relationship between companies and their major institutional shareholders in order to address concerns that “short-termism and attacks by short-term financial activists significantly impede long-term economic prosperity.”⁴⁵ Under this new framework, if a company is pursuing a well-conceived strategy that is jointly developed by a competent and engaged board and top management, its institutional investors should back the company and refuse to support short-term financial activists.

Lipton acknowledges the growing influence of institutional investors on corporate decisionmaking, noting that his report reflects the changing power dynamics between companies and their investors and “does not attempt to shift back toward a director-centric model of governance.”⁴⁶

Spelling out responsibilities for companies and their institutional investors, Lipton advises that every company adopt the following practices:

- **Prioritize long-term strategy and performance.** The board should be actively involved in the development and implementation of the long-term strategy. When developing strategy, it should consider the interests not only of shareholders but of employees, suppliers, customers, creditors, and the broader community, and incorporate relevant ESG and corporate social responsibility (CSR) factors. The board should also ensure that executive compensation plans encourage and reward the achievement of a long-term strategy.
- **Engage, communicate, and foster meaningful long-term relationships with investors.** Boards must communicate the company’s strategy using clear, non-boilerplate language, confirm the board’s active involvement in developing and overseeing strategy, and focus on the quality (rather than quantity) of engagement with investors using a variety of communication channels (e.g., periodic letters to investors, investor days, in-person meetings).
- **Ensure the board effectively oversees and partners with the CEO and management team.** Boards should proactively plan CEO succession, with an ‘expect the unexpected’ mind-set, ensuring the right ‘tone at the top.’
- **Organize the business of the board to ensure important matters requiring board attention are prioritized.** Every board needs opportunities to build its understanding of a company and its industry. A board should determine a reasonable risk appetite for the company and carefully monitor its risk profile and vulnerabilities.

- **Get the right mix of directors in the boardroom.** Key factors to consider include independence, diversity, age and tenure, competence, integrity, collegiality, and commitment to director responsibilities.

On their part, major institutional investors should adopt these practices:

- **Engage and communicate with corporations.** Investors should state their expectations for a company and provide candid and constructive feedback, be active listeners, strengthen in-house capabilities, and take time to understand a company's long-term strategy. Investors should disclose their policies and preferences.
- **Provide steadfast support for reasonable, long-term strategies of investee companies.** Investors should stand by a company during a cyclical downturn or periodic market turbulence and in the interim period before long-term investments have fully borne fruit, as well as support a company confronted by short-term activists.
- **Help companies correct long-term strategies or failures to execute on long-term strategies.** Investors should engage with a company through private dialogue rather than support activists, and should work collaboratively with the board and management.

- **Adopt an integrated long-term investment approach and integrate relevant sustainability, citizenship, and ESG/CSR matters into investment strategy.**

In Lipton's view, embracing this "new paradigm" could reduce pressure on companies to maximize short-term profits and share price at the expense of long-term success and encourage them to incorporate relevant ESG and CSR considerations in their long-term strategy and other decisions. In addition, he notes, investors (and the general public) will benefit from better communication with companies on strategy, long-term objectives, and governance, and both companies and investors will strengthen mutual trust.

Since its release, more than 100 companies and investors have committed to aligning their practices with The New Paradigm.⁴⁷

Reading 8

Roger Martin, *Fixing the Game* (2011)

Summarized by Tapestry Networks

In *Fixing the Game*,⁴⁸ University of Toronto business school professor Roger Martin takes issue with the shareholder-value maximization model and argues that the widespread use of stock-based incentives for corporate executives threatens to “destroy our economy and rot out the core of American capitalism.”⁴⁹

In his view, a significant problem has emerged from focusing on shareholder-value maximization as the singular corporate aim and the corresponding awarding of substantial amounts of stock-based incentives to CEOs to reduce the principal-agent problem – the tying together of the ‘real market’ and the ‘expectations market.’ Whereas the real market consists of a “world in which factories are built, products are designed and produced, real products and services are bought and sold, revenues are earned, expenses are paid, and real dollars of profit show up on the bottom line,” the expectations market is the world where shares are traded between investors, who “form expectations as to how the company is likely to perform in the future. The consensus view of all investors and potential investors as to expectations of future performance shapes the stock price of the company.”⁵⁰

Mr. Martin believes that because the bulk of their compensation is tied to share price performance, CEOs will be tempted to focus on raising expectations – such as by hyping the company’s stock with aggressive guidance or engaging in aggressive accounting – to raise the company’s share price and thereby realize their equity-based awards rather than improving

the company’s real market performance.⁵¹ Moreover, as CEOs come to realize that they can’t “keep expectations on the rise forever, nor can they continue to meet them as they grow forever,” they may attempt to manage share price over the short term by focusing on shorter and shorter time horizons.⁵²

To remedy this “distressing flaw,” Martin proposes eliminating stock-based compensation as an incentive or, if employed, allowing the vesting of such incentives only after the CEO’s retirement from the company (preferably at least three years after departure).

Mr. Martin also asserts that, as board directors are themselves agents, they face the same set of self-interested behavior as executives. According to Mr. Martin, independent directors’ desire to remain on the board – because of the prestige associated with board membership, attractive compensation, opportunities for personal growth, and so forth – suggests that they are unlikely to “take a stand against executive management or fellow executives, even to stop them from doing something that would hurt the shareholders or the company long term.”⁵³ Mr. Martin’s solution is to recruit individuals who view joining a public company board as public service, although he acknowledges such people may be hard to find.

Mr. Martin urges companies to shift their focus away from shareholder value and back to delighting customers. In his estimation, focusing on the real market will also “restore authenticity to the lives of executives.”

Reading 9

Lynn A. Stout, *The Shareholder Value Myth* (2012)

Summarized by Tapestry Networks

In *The Shareholder Value Myth*⁵⁴ and related writings,⁵⁵ the late Cornell Law School professor Lynn Stout seeks a return to the ‘managerialist’ model of corporate purpose that prevailed in the United States prior to shareholder-value maximization becoming dominant from the 1980s onwards.

Under the managerialist philosophy, a company should be managed to serve a wide variety of stakeholders – shareholders, employees, customers, and broader society. According to Ms. Stout, 50 years ago, a typical corporate director or executive would have likely said that a firm had many purposes: “To produce satisfactory returns for investors, but also to provide good jobs to employees, make reliable products for consumers, and to be a good corporate citizen.”⁵⁶

Ms. Stout argues that the focus on shareholder-value maximization has not improved the performance of the corporate sector but rather has contributed to a “daisy chain of costly corporate scandals and disasters” at such companies as Enron, HealthSouth, WorldCom, and BP as well as the near collapse of the financial sector in 2008.⁵⁷

According to Ms. Stout, the notion that companies are required to maximize shareholder value as their exclusive aim is a myth. She notes, as an example, that “Delaware’s corporate code does not say anything about corporate purpose other than to

reaffirm that corporations ‘can be formed to conduct or promote any lawful business or purposes’” and that the legal doctrine known as the “business judgment rule” gives boards wide discretion to decide a company’s aims.⁵⁸ In addition, Ms. Stout points out that “most judicial opinions describe directors’ duties as being owed ‘to the corporation and its shareholders,’” implying that the two are not the same; furthermore, some judges have expressly declared that boards can “look beyond shareholder wealth in deciding what is best for ‘the corporation.’”⁵⁹

Ms. Stout also argues that shareholder-value maximization as indicated by stock price is too simplistic to be useful to boards and management. For example, she notes that boards are required to mediate between the interests of different shareholders, from those looking for a short-term bump in the share price to individuals who are planning to hold the stock for a much longer time horizon and who are concerned about the company’s ethical conduct.

More worryingly, an incessant focus on increasing share price may lead a CEO to “avoid the slow, hard, thankless task of developing new products, hiring new employees, and increasing sales and profits, and focus instead on cost-cutting (firing employees, reducing [research and development]) or financial engineering (selling off assets, making massive share repurchases) that temporarily raises stock prices without adding real long-term value.”⁶⁰

Ms. Stout criticizes certain corporate governance ‘improvements’ intended to make boards more accountable, such as dismantling anti-takeover defences and dual share classes. In her view, these mechanisms can help a board resist pressures from opportunistic (short-term) shareholders and promote investments in “complex, long-term projects with uncertain results – building brand names, inventing new technologies, developing new drugs or software.”⁶¹

Similarly, Ms. Stout takes aim at common practices designed to boost shareholder value, including closely linking director and management compensation to share price

performance, outsourcing jobs abroad, and reducing research and development expenditures in order to meet short-term earnings expectations.

Lastly, Ms. Stout argues that a managerialist philosophy is better aligned with the basic ‘prosocial’ nature of most investors. Whereas the shareholder-value maximization theory assumes that shareholders are concerned only about financial outcomes, she asserts that in reality they generally care about how the companies in which they invest treat employees and other stakeholders, and that they would be willing to “sacrifice some profits in return for greater corporate social responsibility.”⁶²

Reading 10

Colin Mayer, *Prosperity: Better Business Makes the Greater Good* (2018)

Summarized by Tapestry Networks

In *Prosperity*,⁶³ and an earlier book, *Firm Commitment*,⁶⁴ University of Oxford professor Colin Mayer offers a new vision that centers on companies pursuing a variety of purposes – including but not limited to the pursuit of shareholder interests – for the greater well-being of society.

While recognizing that the corporation is a remarkable creation that has contributed to wealth creation, employment, technological advancement, and the fulfillment of numerous consumer needs, Mr. Mayer also argues that it is “the source of inequality, deprivation, and environmental degradation, and the problems are getting worse.”⁶⁵

As a matter of basic principle, Mr. Mayer wants the function of corporate governance to shift from addressing agency problems and ensuring the company is run for the benefit of shareholders to promoting “the interests of the firm as a whole and, in particular, to assist it with achieving its corporate purposes.”⁶⁶

According to Mr. Mayer, a company should be able to pursue any number of purposes – provided that they are not at variance with social interests – and shouldn’t be constrained by the need to enhance or maximize profits. Similarly, he believes that success for each company should be evaluated according to the achievement of its purpose and not by profits alone.⁶⁷ Lastly, Mr. Mayer argues that “shareholders

do not and should not have rights to do with their companies what they please.”⁶⁸

Under Mr. Mayer’s framework, “it is the ownership, governance, and leadership of firms that together establish the commitment of corporations to their purpose and their capacity to create the greater good.”⁶⁹ To that end, Mr. Mayer commends ‘anchor’ owners – shareholders such as families who own a large or controlling stake in a company – and the establishment of trusts and foundations that own companies – as exemplified at such companies as Bertelsmann, Bosch, Carlsberg, Hershey, and Tata – to help ensure that companies abide by their stated purpose.⁷⁰ His research indicates that such owners exhibit stronger commitment to their companies and aims beyond maximizing profits.

According to Mr. Mayer, control of companies should not necessarily be given to suppliers of financial capital (e.g., outside investors) but to those who make the contributions that are most essential to the company’s success. For example, “where intellectual capital is critical then the allocation of control to entrepreneurs or founders [in the form of, say, super-voting shares] is required.”⁷¹

Mr. Mayer argues that it is necessary to measure the various inputs contributed – such as human, social, and natural as well as financial capital – to help determine how “gains to trade should be shared between the different parties to the firm.”⁷²

He further says that laws and regulations should be amended to “enable corporations to adopt public as well as private purposes, accountability to parties other than shareholders and forms of custodianship as trustees and foundations as well as agents of investors.” Importantly, “there should be no presumption in company law of either shareholder primacy or stakeholder

pluralism. One or other may sometimes be appropriate but never consistently so.” To help ensure that companies remain faithful to their stated aims, corporate law should “require companies to articulate their purposes, incorporate them in their articles of association, and above all demonstrate how they credibly commit to the delivery of purpose.”⁷³

Reading 11

Senator Elizabeth Warren, Accountable Capitalism Act (2018)

Summarized by Tapestry Networks

The Accountable Capitalism Act, a bill introduced by Senator Elizabeth Warren (D-MA) in 2018,⁷⁴ seeks to federalize the incorporation of large US companies and move these enterprises away from the current shareholder primacy model.

Under this act, all companies with revenues of more than \$1 billion would be required to reincorporate at the federal level. Modelled after 'benefit corporation' statutes that exist in 33 states and the District of Columbia, the act calls for boards to take into account the interests of all major stakeholders – including employees, customers, shareholders, and the community – in company decisions.

Moreover, employees would be accorded the right to appoint at least 40% of directors, and any political expenditure would require assent from

75% of directors and 75% of shareholders in separate votes. Lastly, directors and officers of a company would be required to hold any shares received for a minimum of five years or within three years of a stock buyback.

Sen. Warren argues that since limited liability for corporations is a privilege conferred by the American people, corporate success should be shared more broadly – not just with investors but with employees and the community as well. She laments that American companies' embrace of shareholder value maximization has resulted in 93% of corporate earnings funneled to shareholders over the last decade while real wages stagnated.

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Corporate Governance for the 21st Century

Initial report and readings

