Lead Director Network
ViewPoints
August 3, 2015

The board's role in corporate strategy

Members of the Lead Director Network (LDN)[1] convened in New York on June 30 to discuss the development and oversight of corporate strategy. This *ViewPoints* addresses the ways board directors work alongside management to ensure that a company makes the right strategic choices.[2] In a separate session, members debriefed the 2015 proxy season with King & Spalding partners Cal Smith and Jeff Stein.

For a summary of the proxy season discussion, see page 5. For further information about the LDN, see "About this document," on page 9. For a list of participants, see page 10.

Executive summary

The meeting focused on three aspects of the board's role in corporate strategy:

- **Balancing long- and short-termism in the strategy debate** *(page 2)*

  Faced with the pressure to simultaneously deliver strong quarterly results and create long-term value, boards must balance these competing interests to help make the right decisions for the future of the company. McKinsey & Company defines strategy as "an integrated set of actions designed to create a sustainable advantage over competitors."[3] As boards play a more prominent role in shaping strategy, they have the potential to advocate for longer-term strategic choices. Boards bring considerable outside experience to companies and are able to help management consider a broader range of options when setting strategy. The prevalence of shareholder activism is just one force of many encouraging greater board involvement in developing strategy.

- **Pursuing the best strategic options through collaboration** *(page 6)*

  Lead directors say that boards are most effective at developing strategy when directors form a partnership with management that is based upon mutual trust. This means working together throughout the year to share information so all parties are able to identify important topics, consider strategic risks, and answer hard questions. Many lead directors also find beneficial an annual strategy event where leaders – free from day-to-day distractions – can take a deeper look at the drivers of the business and directors can gain a better perspective about longer-term issues by spending more time with managers. Lead directors see their own role as developing the agenda for the offsite with management and using executive sessions without management present to elicit feedback and further questions on the strategy.

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[1] LDN documents use the term "lead director" to refer interchangeably to the titles lead director, presiding director, and non-executive chair, unless otherwise stated.

[2] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

[3] Frederick W. Gluck et al., "Thinking Strategically," *McKinsey Quarterly*, June 2000.

- **Enabling the company to execute its strategy** *(page 8)*

  Directors play a critical role after a strategy has been agreed. This includes monitoring the right metrics, asking the right questions, and, sometimes, making the right decisions about when to abandon a strategy that is not meeting expectations or when to replace a senior leader who is not able to execute the agreed strategy.

Balancing long- and short-termism in the strategy debate

Lead directors said that a successful strategy requires a group of stakeholders, including the board, working together to identify ways for a company to create both immediate and lasting value. One explained, *"Strategy is about what we are doing and where we are going. It is important for directors to have a clear understanding of both."*

Strategy is a priority for boards

In recent years boards have become more involved in the details of strategy. A 2014 Blue Ribbon Commission of the National Association of Corporate Directors (NACD) recommended that "directors recognize that board engagement on strategy is a continual process, and should be the central focus of board activity year round."[4] LDN members made the same recommendation as far back as the network's second meeting in 2008. On this central tenet their view has not changed: *"Strategy can't be something the board does once a year. Directors must be willing to think of strategy as something that is never complete and therefore requires our attention at every meeting."*

Recent surveys of corporate directors have also highlighted the importance of the board's role in strategy:

- Sixty-two percent of directors want to spend more time on strategy (and almost 20% want to spend much more time on it).[5]
- Ninety-one percent of directors said that the board's review of short- and long-term strategic plans was a "very important" board activity.[6]
- Sixty-nine percent of directors said that understanding and agreeing on strategy and key performance objectives was their board's biggest strength.[7]
- Directors on self-identified higher-impact boards were more likely than average to consider strategy their board's strength, while those who said their boards have less impact were more likely than average to consider core governance and compliance their board's strength.[8]

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[4] National Association of Corporate Directors, *Report of the Blue Ribbon Commission on Strategy Development* (Washington, DC: National Association of Corporate Directors, 2014), 7.

[5] PwC, *Trends Shaping Governance and the Board of the Future: PwC's 2014 Annual Corporate Directors Survey* (London: PricewaterhouseCoopers, 2014), 7.

[6] Kimberly Crowe and Deborah Scally, *What Directors Think* (New York: Corporate Board Member and Spencer Stuart, 2014), 3.

[7] Ibid., 5.

Lead directors pointed out that board members bring years of experience and diverse opinions about whether the company is pursuing the right course. They highlighted directors' experience in areas like mergers and acquisitions, capital allocation, and geographic expansion and noted that directors are more likely to be comfortable with strategy when they have a hand in developing it. According to a report in *Harvard Business Review* that drew on conversations with chief executives, CEOs prefer board engagement because it both tests the strength of the strategy and creates mutual faith in the plan as the company moves into the execution phase.[9]

Having a hand in strategy creation is also important for directors now that they are spending more time engaging directly with investors.[10] Lead directors said participating in every aspect of the strategy discussion makes them better prepared to reinforce the company's message effectively. One noted, *"It is critical for the board to understand the strategy and articulate it coherently in order to respond to more pointed questions and pressures from investors."*

A focus on strategy means a focus on the longer term

In principle, one benefit of getting the board more engaged in strategy is the longer-term perspective that directors can bring to discussions. However, the results of a *McKinsey Quarterly* survey suggest that directors, too, are focused on short-term financial performance and that companies use too short a time horizon when setting strategy.[11] One response to these findings was the formation of a group called Focusing Capital on the Long Term, which is working with directors and investors to develop a more practical approach to encouraging a long-term outlook in the investment and business worlds.[12]

Nearly 60% of respondents to an NACD survey of public company directors said that their boards only look one to three years into the future, and only 5% reported an outlook beyond five years.[13] One member was concerned about this trend: *"You can take a lot of value out of a company if your time frame is only two or three years. It is really hard to create sustained, long-term value when shareholders are so focused on the quarter."*

Lead directors agreed that a number of forces make it challenging to execute a long-term vision. One explained, *"We operate in a world where stock-holding time is down, average CEO tenure is down, and no one pays attention to news unless it says 'breaking news.'"* Some feel pressure from shareholder activists, proxy advisory firms, and even institutional investors to generate short-term results, often without regard for long-term strategic choices. For more on activist shareholder pressures, see below.

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[8] McKinsey & Company, "Improving Board Governance: McKinsey Global Survey Results," *Insights & Publications*, August 2013.

[9] Jeffrey Sonnenfeld, Melanie Kusin, and Elise Walton, "What CEOs Really Think of Their Boards," *Harvard Business Review,* April 2013.

[10] In a 2014 PwC survey, 48% of investors and 25% of directors reported an increase in communications with one another from a year prior. PwC, *What Matters in the Boardroom? Director and Investor Views on Trends Shaping Governance and the Board of the Future* (PricewaterhouseCoopers, 2014), 3.

[11] Dominic Barton and Mark Wiseman, "Focusing Capital on the Long Term," *Harvard Business Review,* January–February 2014.

[12] "The Initiative," Focusing Capital on the Long Term, accessed July 21, 2015.

[13] National Association of Corporate Directors, *NACD Nominating and Governance Committee Chair Advisory Council: Rethinking Strategy Development* (Washington, DC: National Association of Corporate Directors, 2015), 2.

Despite all of this, lead directors said that their boards do bring a long-term focus to strategy discussions. One said that while formal budget plans may only look a few years out, *"Boards are making strategic investments that are focused on a much longer time horizon."* Others said that a board's push for short-term returns should not be confused with a short-term focus. *"Management can get the idea that we don't want to do a deal where the profits are more than three years out because we are focused on the short term. But we are really trying to make sure the deal can actually deliver value,"* one member said.

Another way that boards emphasize the long-term nature of the strategy is through executive compensation choices. One lead director said, *"If you have a long-term strategy, it is important to measure long-term performance. There are short-term incentives and long-term incentives, but all of them can be tied to the long-term strategy."*

Activist shareholders create new pressures on strategy

Lead directors said shareholder activism – whether or not an activist actually invests in the company – can influence the board's mind-set on strategy. One lead director said, *"We look at how an activist would look at our company and make sure that we are not asleep at the switch. Even if we don't change what we do, we need to be aware."* Other members, however, said that the board should be focused on making the right decisions regardless of the activist's agenda. One said, *"Thinking like an activist worries me. As directors we must always understand multiple perspectives, but we need to be careful not to focus on activists."*

As noted above, in some cases, pressure from an activist to return capital to shareholders or do a deal can cause boards to focus on the shorter term. However, members said that shareholder activism should not be equated with short-termism. One explained, *"It depends on which activist and under what circumstances. Some activists have been really long-term focused and want to help build a company."* Lead directors said that activists, even when focused on the long term, have caused their boards to pick up the pace on strategic decisions. One member noted, *"Activists bring a cadence and urgency to boards that we sometimes need. I like that they see an issue and try to address it, as opposed to kicking things down the road for another year."*

Activists also cause boards to reconsider strategic decisions that have failed to meet expectations. One lead director said, *"Sometimes companies make mistakes and don't want to fix them. An activist gives the board permission to get rid of a bad decision."* Activists may also cause boards to debate strategic choices that are not favored by management. For example, one member said that activists often lead the board to consider spinoffs or splits: *"Management may have a fear about reducing the size of the assets they are managing, so they won't present a plan to split the company in two. But if an activist proposes it to the board and we determine that the two companies would be more efficient, we should do the deal."*

Trends from the 2015 proxy season

In a separate session, King & Spalding's Mr. Smith and Mr. Stein discussed recent proxy campaigns. Mr. Stein said five events created a *"perfect storm"* for proxy access during the 2015 season:

- New York City Comptroller Scott Stringer submitted proxy access proposals at 75 companies to allow shareholders that have owned 3% or more of a company for more than three years to add their own nominees for up to 25% of the board's seats to the company's proxy materials. These resolutions were based on the SEC's original but vacated rule authorized by the Dodd-Frank Act of 2010.[14]
- Institutional investors signaled early support for these 3%–3 years–25% of seats proposals.
- The SEC retracted a December 2014 no-action letter to Whole Foods that originally permitted the exclusion of a 3%–3 years–20% of seats proposal on the grounds that it conflicted with Whole Foods' own proposal of 9%–5 years–10% of seats.[15]
- Monsanto's shareholders approved a proxy access proposal very early in the proxy season.[16]
- Companies like General Electric and Bank of America voluntarily adopted proxy access.[17]

Mr. Stein explained that as a result, shareholders supported proxy access at a majority of companies where there was a vote. Looking ahead, Mr. Smith said, *"Proxy access will happen at most companies. Those companies that prevailed this proxy season were just able to buy a little time."* One member suggested boards get out in front: *"It's a tidal wave, so the best thing to do is to try to write a proxy access rule ourselves, rather than wait for a proposal."*

Other lead directors were concerned that, once implemented, proxy access could open the door for activist nominees to the board. One said, *"Index funds are cooperating more with activists, so activists could go to them to create the 3%–3-year coalition."* Mr. Smith added that investors, rather than running candidates to win seats, may use proxy access as an alternative to a withhold campaign: *"They may say, 'How many votes can we get to embarrass the current directors?'"*

Shareholder activism continued to generate board-level attention during the 2015 proxy season. Some members said that DuPont's victory over Nelson Peltz and Trian Fund marked a turning point in activism at large-cap companies. Mr. Smith cautioned, however, that DuPont may represent less of a sea change than a strong defense run by a successful company: *"They did a great job telling a simple story and getting out the vote – particularly with retirees, retail investors, and index funds."*

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[14] "Boardroom Accountability Project," New York City Comptroller, accessed July 21, 2015.
[15] US Securities and Exchange Commission to James McRitchie, January 16, 2015.
[16] Josh Beckerman, "Monsanto Shareholders Approve Nonbinding Proxy-Access Proposal," *Wall Street Journal*, January 30, 2015.
[17] Christina Rexrode, "Bank of America Changes Bylaws to Allow Some Investors to Nominate Directors," *Wall Street Journal*, March 20, 2015.

Pursuing the best strategic options through collaboration

In the past, many companies followed a strategy review process like the one described recently by a *Forbes* commentator: "The CEO, perhaps along with his/her top few executives, would present a multi-page document [to directors], attaching ample appendices including elaborate spreadsheets and charts … There might have been polite discussion, but the Board only had one available action, either approve the strategy, or reject it."[18]

Today, the process is far different. Before the meeting, one member described it as follows: *"There is frequent interchange and discussion between the board and management well before the strategy has been decided. As management does its strategy work, they have the full benefit of the collective wisdom of the board. By the time you get to a decision, the board has been a full participant, so there are no surprises."*

Lead directors at the meeting outlined the best ways for boards to provide meaningful input in the strategy development process.

Find time for strategy

Lead directors said that fitting education and discussion on strategy development into the board's agenda must be a priority. *McKinsey Quarterly* reports that despite the uptick in strategy development work, it is still common for a board to spend about 70% of its time on governance and compliance responsibilities.[19] Members shared methods they use as lead directors to carve out enough time for strategy discussions:

- **Delegation of non-strategy work to committees.** One member said, *"We push as much of the regulation and compliance as we can to the committees so that the full board meetings are focused on the important things like strategy."* Members said that many of the non-essential items can be covered by brief committee report-outs and that further discussion by the full board should be the exception rather than the rule.
- **More dialogue, less presentation.** Lead directors said they free up time by cutting down on presentation time in board meetings. One explained, *"We unplugged the projector and said, 'No more presentations. Let's start with the questions.'"* This approach requires the whole board to arrive at the meetings prepared, which, in turn, requires management to distribute focused materials sufficiently in advance of meetings.
- **Strategy-focused meetings.** Members said that while their boards consider strategy many times over the course of the year, there is still value in holding an annual session in which the board and senior management focus exclusively on strategy. One lead director said, *"There is a benefit in getting away from everything to focus on strategy. The board and management need to find time to work with each other, think together, and dream together."* Another added that going to a separate room for strategic discussions during a regular board meeting provides a helpful *"psychological distinction between*

[18] Adam Hartung, "A Call to Action – More Board Involvement in Strategy," *Forbes*, October 21, 2014.

[19] Christian Casal and Christian Casper, "Building a Forward-Looking Board," *McKinsey Quarterly*, February 2014.

strategic discussion and regular board discussion." Members said that strategy sessions are most useful when the lead director, in consultation with the rest of the board, sets the agenda for the meeting. One explained, *"Planning is exceptionally important to the success of the offsite. A good agenda allows us to pull together the threads of a number of different discussions over the course of the year."*

- **Executive sessions.** Lead directors stressed the necessity of executive sessions to ensure that directors are on the same page about strategy. One said, *"Executive sessions are the most unsung but reliable part of a board meeting."* Members explained that unscheduled time, either before or after a board meeting, allows directors to figure out the right questions to ask management. Members said it was the lead director's responsibility to capture the messages from the executive session and go back to management to ask for clarification or further discussion.

Leverage resources to inform strategic choices

As boards play a more substantial role in strategy development, they need enough information to make well-informed decisions. One of the challenges is the asymmetry between the information available to the board and to management. Lead directors highlighted the ways that their boards gather the information they need to make educated choices:

- **Deep dives with management.** Despite the need to balance presentations with discussion time, lead directors said that their boards rely heavily on management's boardroom presentations to understand the details of the business. When the board is interested in more information on a particular topic, they make an exception to their typical preference for brevity and ask management for a longer presentation.

- **Briefings from outside experts.** In some cases, boards bring in third-party expertise for additional perspectives. Most lead directors said it was uncommon for their boards to hire independent consultants to assist with strategy development; however, members said that their boards regularly have outsiders present to the board to enhance the board's worldview. One member said, *"We look to outside voices for an update on potential disruptors. It is tough, even for the best management team, to spend enough time on what is happening outside the company."* In a recent speech, Vanguard CEO F. William McNabb III said it is healthy for the board to push to get outside perspectives: "Some boards bring in sell-side analysts that have a 'sell' on the company to tell them what they're missing."[20]

- **Review of externally generated materials.** Members said that externally generated information, including analyst reports, market share data, and competitors' quarterly filings, help inform their opinions on strategy.

Weigh strategic risks and test risk appetite

In order to provide meaningful contributions on strategy development, directors must understand the risks associated with their strategic choices. One lead director said, *"We expect in a strategy discussion for*

[20] F. William McNabb III, "Getting to Know You: The Case for Significant Shareholder Engagement," *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), June 24, 2015.

people to talk about the risks associated with the strategy and how they are going to be mitigated." One study found that strategic risk has become more important for boards and CEOs: "Managing strategic risks effectively can do more than just protect value by avoiding potential downsides; it can actually help create value by taking advantage of uncertainty and volatility to maximize gains and improve competitive positioning."[21]

One way that boards manage strategic risk is by adopting and reviewing a risk appetite framework that considers strategy and risk together. These frameworks are common in financial services but are not yet common among companies in other sectors. The creators of one widely used risk management framework define risk appetite as "the amount of risk, on a broad level, an organization is willing to accept in pursuit of value."[22] One lead director said, *"I have never seen a business plan that didn't work well at the base-case assumption. We need to take it a step further and ask, 'What is the worst possible thing that can happen and still leave us standing?'"*

Enabling the company to execute its strategy

While much attention is devoted to formulating strategy, lead directors emphasized that the board's role in strategy does not end once a plan is adopted. Directors play an important role in ensuring the company's ongoing success. They also have an obligation to make difficult choices when a strategy fails to deliver.

Adopting metrics to monitor progress

Lead directors said companies should already have a framework for monitoring the outcomes of a strategic decision at the time the decision is made. One said, *"When someone presents a strategy, the first question should be 'What are the milestones?'"* Members said that this allows the board to understand the value that the company should expect from an investment. One member explained, *"There can be a strategy that is terrific, but the financials that go with it have no great benefit."*

Lead directors acknowledged that market forces often dictate changes in the metrics used to measure performance once a strategy is being executed. They cautioned that a board must be willing to alter the ways it evaluates performance, whether the company exceeds or fails to meet initial expectations. One noted, *"Every strategy has certain variables that are subject to mid-course changes. The board and management must readjust the key assumptions on a regular basis."* Using this approach, a board's review is more about making sure that prior choices are still delivering value when compared with alternatives. One member said before the meeting, *"We should always weigh our performance against the other options we can pursue, including returning cash to shareholders through dividends or buybacks."*

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[21] Deloitte, *Exploring Strategic Risk: 300 Executives around the World Say Their View of Strategic Risk Is Changing* (London: Deloitte Touche Tohmatsu Limited, 2013), 5.

[22] Larry Rittenberg and Frank Martens, *Understanding and Communicating Risk Appetite* Committee of Sponsoring Organizations of the Treadway Commission, 2012), 1.

Dealing with underperformance

Boards face some of their most difficult challenges when a strategy fails. Members said that these situations are handled best when managers and the board are willing to reconsider their options. One explained, *"If none of the original assumptions turn out to be the right assumptions, it might be time to call the strategy. You want to do that sooner rather than later."*

When performance does not match expectations, the board must determine whether poor strategy or poor execution is to blame. Sometimes, the board may need to consider a change in management. One member said, *"If you believe management is not getting it, rather than redirect the strategy, you need a good CEO. Boards can't run companies."* However, lead directors acknowledged that it is not always management's fault. One explained, *"When a bad business meets a good management team, the bad business wins every time."* In those cases, it falls on the board to determine whether the incumbent management team can resurrect the company by pursuing a different strategy.

Conclusion

Today's competitive marketplace requires companies to constantly consider and reconsider their strategic options. Board will be most effective when working closely with management in an iterative process, perhaps punctuated with annual deep-dives at strategy retreats. Boards have to balance the urgent with a more long-term view of the business and are often better placed than management to do so. Directors must not only find the time to assess strategy and strategic risk but also identify the best resources to help inform their decisions. Boards must also work with management to determine when a strategy has failed because of unanticipated challenges or poor execution and act accordingly.

About this document

The Lead Director Network (LDN) is sponsored by King & Spalding and convened by Tapestry Networks. The LDN is a group of lead independent directors, presiding directors, and non-executive chairmen drawn from America's leading corporations who are committed to improving the performance of their companies and to earning the trust of their shareholders through more effective board leadership. The views expressed in this document do not constitute the advice of network members, their companies, King & Spalding, or Tapestry Networks.

Appendix: Network participants

The following directors participated in all or part of the meeting:

- Alan Bennett, Guest, Director at Fluor, Halliburton, and TJX
- Loren Carroll, Non-Executive Chair, KBR
- Sandy Cloud, Lead Trustee, Eversource Energy
- Ann Hackett, Lead Director, Capital One Financial
- Phil Humann, Presiding Director, Coca-Cola Enterprises, Equifax; Lead Director, Haverty Furniture
- Linda Fayne Levinson, Non-Executive Chair, Hertz
- Ellen Marram, Lead Director, Eli Lilly; Presiding Director, Ford
- Steve Miller, Non-Executive Chair, AIG
- Jack O'Brien, Non-Executive Chair, Cabot; Lead Director, TJX
- Ed Rust, Presiding Director, Caterpillar; Lead Director, McGraw-Hill Financial

The following network members took part in pre-meeting discussions:

- Peter Browning, Lead Director, Acuity Brands
- Don Felsinger, Lead Director, Archer Daniels Midland Corporation and Northrop Grumman Corporation
- Ann Maynard Gray, Non-Executive Chair, Duke Energy Corporation
- Ed Kangas, Non-Executive Chair, Tenet Healthcare and United Technologies
- Wes von Schack, Lead Director, Bank of New York Mellon and Edwards Lifesciences

The following King & Spalding attorneys participated in all or part of the meeting:

- Dixie Johnson, Partner; Special Matters and Government Investigations Practice Group
- Cal Smith, Partner; Corporate Practice Group
- Jeff Stein, Partner; Corporate Practice Group
- Michael Smith, Partner; Co-Chair, Securities Litigation Practice Group