Public Corporation Boards: Looking Forward

Columbia Law School

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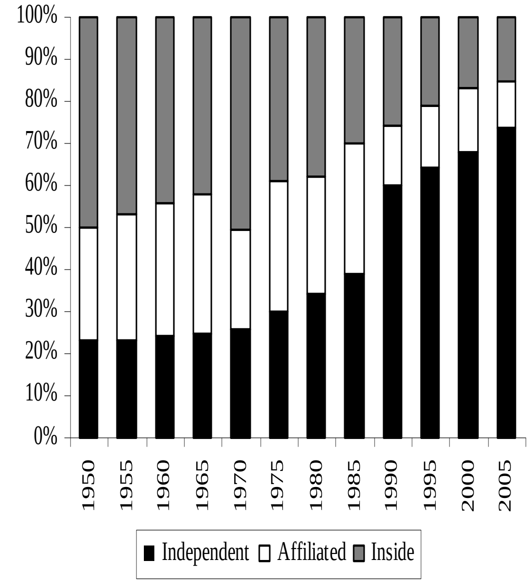
Agenda and Organization

- Today's question
  - Is the public corporation board structure up to the demands now being placed on it?
    - Focus of regulation
    - Focus of activism
  - No priors – note only that a lot has changed
- Organization of the day
  - Jeff will speak for no more than 15 minutes framing the question.
  - A number of you have been asked to prepare 10 minute interventions on particular elements of the analysis
  - These interventions will be requested when they are relevant to the ongoing discussion

History of the Independent Monitoring Board Concept

- Mel Eisenberg's 1976 book (integration of earlier law review articles): **THE STRUCTURE OF THE CORPORATION**
- Hugely successful

Figure 1. Board Composition, 1950-2005



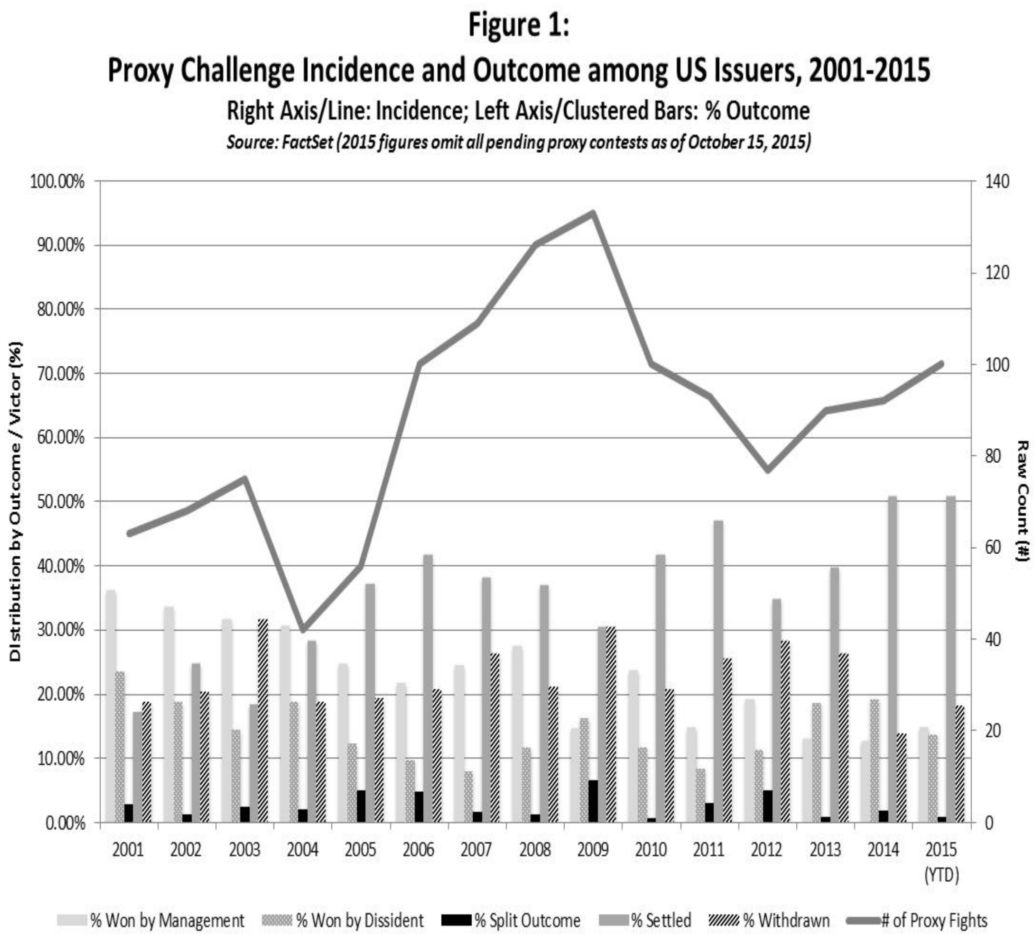
Sources of Success

- Allowed Delaware courts to avoid tasks they disliked – Gave companies an incentive to extend independent structure
  - Independents could
    - Dismiss derivative suits
    - Approve interested transaction
    - Buttress use of defensive tactics
- No emphasis on board's role in strategy or real performance monitoring
  - Push/pull of *Caremark*
  - Stress on addressing conflicts
- Independent structure was useful Federal regulatory tool
  - In response to board failure to prevent bad behavior, Feds expand independent directors responsibility
    - Great expansion of compliance function
      - SOX
      - Dodd-Frank
  - SROs follow similar strategy

Current Heightened Focus on Board Role

- Now: focus on strategy and performance-monitoring, not compliance
  - Activists make board central
  - Activist slate increasingly focuses sharply on skill/industry experience
- Sources of pressure
  - Large increase in uncertainty
  - Structural results of Great Recession
    - Large increase in firm specific volatility (Fox, Fox & Gilson 2015)
  - Disruptive technology and resulting business models
    - "Second half of the chess board" (Brynjolfsson & McAffee)
  - Alternative strategies
    - Pay out cash
    - Sell or break up company
    - Directors as "wartime consigliori"

Proxy Challenges 2001-2015



The Private Equity Governance Comparison

- The same institutional investors who vote (sometimes) for activists' slates also invest in "blind pools" established by private equity firms, with 10 year lockups.
- Hypothesis: perhaps greater faith in PE governance of portfolio companies than in current public company governance. Jensen (1989)
- Stylized fact about PE boards: directors more more deeply engaged is strategy/performance monitoring

Greater returns to “high powered” performance-monitoring?

- Recall Fox, Fox, & Gilson (large increase in firm-specific volatility; “idiosyncratic” risk)
- Hypothesis: “low-powered” performance monitoring via the stock price (annual TSR, firm vs. itself and also vs. peers) becomes less useful in a noisy, uncertain, volatile environment
- The returns to "high powered" performance-monitoring may be increasing
- Yet current independent director model may provide only low-powered monitoring from a “thinly-informed” director, not high-powered monitoring from a “thickly-informed” director (like PE model)

Potential Barriers to Strategic Performance- Monitoring Role: *Does the Independence Model Scale?*

- Change in environment from when present independent director model was developed
  - The scope of responsibilities has grown enormously
  - Businesses and strategies have become more complex
  - Regulatory burden has become much heavier
  - Information needs have correspondingly increased

Potential Barriers to Strategic Performance- Monitoring Role: *Does the Independence Model Scale?*

- Time
- Skills
- Complexity
- Information required

Potential Barriers to Strategic Performance Monitoring: *Does the Independence Model Scale*?

- Need time for strategic/performance monitoring
  - Amount of information needed goes up
  - But how much board time does expanded compliance role require?
- If time and therefore compensation go up, risk to independence also goes up
- If increased skills/focused experience necessary for strategy/performance-monitoring have gone up, then pool may decrease
  - Reduced availability of CEOs – limits imposed by CEOs' own boards
  - Note shift in backgrounds of activist slates

JP Morgan Example: 1993 to 2015

- Size and complexity of business has grown enormously
  - 1993 net revenue: $1.224B
  - 2014 net revenue: $94.205B (78.5x 1993)
  - Now large international bank with significant and sophisticated derivative and trading businesses
  - Vast expansion of regulatory regimes
    - SOX, Dodd-Frank, FCPA
    - Federal Reserve stress tests
  - Global strategy has become vastly more complex

JP Morgan Example: 1993 to 2015

- Yet number of directors can’t increase because of diseconomies of scale
- Time spent can’t increase much because of resulting compensation/independence concerns
- Number of JP Morgan directors
  - 14 directors in1995
  - 11 directors in 2015
- How increase skills/time without compromising incentives?

Different way to frame current stress on board role

- Governance is different when the second derivative of change is positive
  - Information needs go up as uncertainty of future goes up
  - The better activists pose strategic/performance arguments
  - Board confronted with dueling slide decks
    - Seems to be truce in 30 year war
    - Both sides believe institutions will back the board if there is a persuasive plan in place
  - Activists put board at center stage
- Board task: distinguishing between management's claim of market myopia and activist's claim of managerial hyperopia

Conclusion

- Changing business environment and role of activists in agency capitalism world puts independent directors at center stage
  - Increased demands for strategy/performance monitoring
  - Decreased time available as compliance demands increase
  - Greater focus on industry skills/experience
- Is this right?
- What might boards do?
- Start with 10 minute intervention