EXECUTIVE SUMMARY

Yale SCHOOL OF MANAGEMENT

CEO summit

Transforming with Transparency:
Investing in Innovation amid Public Scrutiny

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Yale SCHOOL OF MANAGEMENT
Chief Executive Leadership Institute
Transforming with Transparency: Investing in Innovation amid Public Scrutiny

The 77th Yale CEO Summit, led by Yale Professor Jeffrey Sonnenfeld, was held on June 3 and 4, 2014 at the New York Stock Exchange. This Summit brought together business executives, government officials, leading academics, and other thought leaders with the theme of “Transforming with Transparency: Investing in Innovation amid Public Scrutiny.” Participants included renowned leaders such as:

Frank Blake, Chairman & Chief Executive Officer, The Home Depot
Richard C. Breeden, 24th Chairman, U.S. Securities and Exchange Commission
Roger W. Crandall, Chairman, President & CEO, MassMutual
Robert E. Diamond Jr., Former President & CEO, Barclays PLC
Christopher J. Dodd, Chairman & CEO, Motion Picture Association of America
William H. Donaldson, 27th Chairman, U.S. Securities and Exchange Commission
Kelly Evans, Co-Anchor, Closing Bell, CNBC
Gregory J. Fleming, President, Investment Management, Morgan Stanley
Kenneth C. Frazier, Chairman, President & CEO, Merck & Co.

Robert Hormats, Under Secretary (2009-2013), U.S. Department of State
Andrew N. Liveris, Chairman & Chief Executive Officer, The Dow Chemical Company
Robert S. Miller, Chairman, American International Group
Stuart A. Miller, President & Chief Executive Officer, Lennar Corporation
Duncan L. Niederauer, Chief Executive Officer (2007-2014), NYSE Euronext
Rory P. Read, President & Chief Executive Officer, AMD
Kevin Rudd, 26th Prime Minister, Commonwealth of Australia
Lynn Tilton, Chief Executive Officer, Patriarch Partners
Myron E. Ullman, Chief Executive Officer, JC Penney Company
Margaret C. Whitman, President & Chief Executive Officer, HP
Ralph V. Whitworth, Principal, Relational Investors
Niansha XU, Chairman, China Poly Group

This Summit focused on transformation: transformation and public scrutiny relating to mayors and city leadership; transformation and markets; transformation and invention across borders; and transformation and innovation in the age of activist investors. Two legends in leadership were also honored: retiring NYSE CEO Duncan Niederauer and Home Depot CEO Frank Blake.

Transformation and Public Scrutiny: Mayors and City Leadership

A city can be described as an entity between a business and a nation, with similarities to both, and a mayor can be thought of as the CEO of a city—though a CEO under tremendous public scrutiny.

There are distinct advantages to creating de novo “startup” cities. Professor Paul Romer of the NYU Urbanization Project examined why the world needs charter cities. XU Niansha, Chairman of China Poly Group, discussed the role of private investment in startup cities in China. And Stuart Miller, CEO of Lennar Corporation, described his company’s experience creating startup communities in the United States.

Startup cities have many of the same advantages of startup companies: leaders have a blank slate and can be creative in making decisions, unencumbered by baggage or legacy issues. Those creating new cities have wide latitude in making decisions about urban design, the provision of services, and infrastructure. Like any startup, a leader must be able to sell their vision and attract capital. (For charter cities, once rules are established the private sector can come in and invest.) And as with a business startup, even with careful planning, it is difficult to predict the path that a startup city will actually take, what its culture and personality will be, and how it will evolve.

While startup cities mirror startup businesses in many ways, the challenges of managing and transforming an existing city rival the challenges of transforming an existing business. As the mayors of 10 American cities (Akron, Albuquerque, Anaheim, Carmel, Irving, Nashville, Oklahoma City, Shreveport, Stamford, and St. Paul) shared, the challenges of transforming a city, while under intense public scrutiny are formidable. Mayors must be able to articulate transformative long-term visions, while delivering short-term results to satisfy diverse stakeholders, who have wide-ranging interests.

Mayors must understand how the changing business climate and changes in specific industries are affecting their city and must work with business leaders to support their transformations. Mayors must innovate and take risks, but must be cautious because if they make a
Transformation and Markets: Technology, Risk Taking, and Restoring Market Trust

Main Street America still doesn’t trust Wall Street. In a real-time poll of CELI participants, 73% said they do not believe that market trust has returned for the individual investor. Growing income inequality and lingering fears of economic insecurity contribute to an overall lack of trust in the financial system.

And this lack of trust isn’t limited to the individual investor or the general public. With the increased use of sophisticated technology for high-speed and high-frequency trading—which some argue is a positive innovation for the financial markets—even some knowledgeable, sophisticated experts believe that technology enables “front running.” The concern is that technological innovations intended to improve market speed and efficiency are in fact fueling perceptions that the market is “rigged.” Among CELI participants, 72% are concerned about HFT (high-frequency trading) in the exchanges. (This topic is getting increased attention due to Michael Lewis’ new book Flash Boys.) More than 35% of CELI participants agree with the statement that the markets are rigged and 88% believe there are “unfair edges” in trading systems. Such concerns, whether justified or not, undermine investor confidence in the markets and can inhibit investment and risk taking.

The key question is, “What can be done to restore market trust?” Politicians often advocate litigation and prosecution—against corpora-

tions and individuals—as a politically popular, kneejerk way to satisfy the angry mob. However, while some CELI participants acknowledge that there may have been insufficient prosecution, increased prosecution is not seen as the way to restore trust. It comes at great cost and collateral damage, and is a major distraction for executives and boards; dragging companies through the mud is not a formula for improving trust.

Though few business leaders are fans of more regulation, greater regulatory intervention is a possibility in acting to restore trust. Some CELI participants advocated for a principles-based system as opposed to a rules-based system, with some seeing the need for a hybrid—a principles-based system with rules. Senator Chris Dodd, the co-sponsor of Dodd-Frank, acknowledged that regulation can impose costs and add complexities, but said there are times when regulation, though unpopular, may be necessary.

To restore greater trust in the financial markets, several CELI participants believe that in particular, the SEC—which has tools at its disposal—must play a greater role, which could include regulations around HFT.

Transformation and Invention across Borders: the U.S./China Relationship

The relationship between the U.S. and China is going through a period of transition, as China continues to transform itself both economically and politically.

There was general agreement that China’s economy is now growing more slowly than it has in the past as the country attempts to transform itself from an investment- and production-driven economy to one driven by domestic consumption. At the same time, China’s leaders are attempting to implement various economic, financial, and political reforms, which some argue are proceeding at a slower pace than was planned.

The pessimists are worried about the sustainability of China’s economy. They argue that stated economic growth rates of 7-8% are being artificially propped up by government stimulus, such as the unnecessary building of millions of condos. There are concerns about China’s political stability as the country’s new leader is consolidating power in an unprecedented way and is pursuing an anti-corruption campaign that poses a threat to many.

The pessimists are also worried about China’s foreign policy. Some participants commented that “the U.S.-China relationship is in rapid decline,” as China is increasingly contesting U.S. actions. There are also growing regional security concerns, resulting in what some see as the most fragile situation in the region in several decades. Among those expressing concerns were individuals who had previously been more bullish on the U.S.-China relationship and on China’s economy.

But others—including several attendees from China—were more optimistic, and believe that the U.S. tends to have an overly pessimistic perspective. While economic growth has slowed somewhat, it remains strong; the slight dip in growth is not surprising or worrisome as the country shifts from production to consumption and from goods to services. Participants were reminded of the astounding progress that China has made in just the 25 years since Tiananmen Square. In this short period China has created a flourishing stock market, become a member of the WTO, established laws for the protection of private property, and become a hotbed of entrepreneurial activity—all developments that were previously unthinkable.
But many companies and CEOs prefer to avoid an external activist investor by proactively behaving as “internal activists.” They work to identify critical inflection points in industries when behaving the same way will no longer work and transformation is required. Internal activists focus on long-term value creation and recognize that constant innovation is imperative to avoid commoditization or cannibalization. The need for innovation—or invention of entirely new technologies and products—is essential in every industry, ranging from chemicals to pharmaceuticals to information technology. Companies that don’t constantly invent, innovate, and transform themselves will be overtaken. Financial engineering may provide a short-term band aid but doesn’t replace sustained innovation.

In assessing important characteristics of companies that have transformed themselves, CELI participants mentioned the ability of CEOs to communicate a clear vision to investors and employees; leaders who can change the culture and boost employee engagement; and companies that can maintain their relationships with loyal customers, while entering adjacent markets to attract new customers with new products. Among the characteristics of CEOs who successfully lead transformations are having passion and discipline, thriving on pressure, having the courage to make bold bets, and demonstrating the confidence to lead the organization in an often difficult new direction.

Transformation and Innovation in the Age of Activist Investors

After focusing on the transformation of cities, financial markets, and relationships between countries, the conversation turned to why and how companies must transform themselves.

One driver of corporate transformation is the presence of activist investors, of which there are different types with different styles. The term “activist investor” typically conjures up the image of an antagonistic, abrasive investor who plans to replace the CEO, change the management team, and fundamentally change the strategy. But there are other types of activist investors, as exemplified by Ralph Whitworth, who was termed an “ambassador” and who is known for collaborating with CEOs and other board members to increase enterprise value. When Whitworth decides to invest in a company and expresses his desire to join a company’s board, unlike most activist investors he is typically received enthusiastically by a company’s CEO. This is because Whitworth and his partner have real-world experience in operating companies and have served on numerous boards of successful turnarounds. They bring operating experience and understanding, financial savvy, discipline, focus, and patience, which has helped companies such as Home Depot and HP.

The optimists believe that the U.S.-China relationship remains strong and through mutual understanding and further engagement will only deepen. They continue to see benefits for consumers and businesses around the world as Chinese companies spread their wings internationally, and they see significant opportunities in China for foreign companies, including favorable investment and business opportunities in Guandong Province. Just one example is the growing film industry in China. Each day 15 new movie screens are being erected in China, yet more than 100 cities with one million people or more still have no movie screens. China is also beginning to produce much more content, and while lack of IP protection remains an issue, since China is now a content producer the country is doing a somewhat better job of protecting intellectual property.

Several CELI participants indicated that countries are closely watching how the U.S. acts regarding China, both economically and politically. Some CELI participants expressed the view that countries have been disappointed with the perceived lack of leadership, consistency, and staying power of the U.S. and the Obama administration in dealing with China. However, historically, the economic relationship has continued to grow between China and the U.S. even during periods of political tension. How the relationship continues to evolve is uncertain. Some are optimistic about an even stronger relationship, with others are concerned that rising tensions based on China’s geopolitical aspirations could ultimately derail this critical relationship.