NETFLIX APPROACH TO GOVERNANCE

GENUINE TRANSPARENCY WITH THE BOARD

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INTRODUCTION

The hallmark of good corporate governance is an independent-minded board of directors to oversee management and represent the interests of shareholders. Its primary responsibilities are to hire and replace the CEO as needed, monitor performance, review and approve strategy, and assess financial reporting and risk management. In a typical corporation, the vast majority of this work is carried out through board meetings and specialized board committees.[1]

However, it is not clear that directors receive the information they need to make fully informed decisions on all key matters. Partly, this is due to an "information gap" that exists between management and the board: Directors have a less-complete understanding of the company and the market than executives because of their limited exposure to day-to-day activities and their independence from the business. Directors only meet 4 to 8 times per year in full board meetings, and 2 to 8 times in committee meetings.[2] The information they review generally consists of dense PowerPoint presentations with extensive tables and graphs that span, in a typical large corporation, hundreds of pages. Some directors find these presentations heavy on data but light on the analysis and insights needed to fully understand the quality of management, decision making, and performance.[3]

Boardroom dynamics can further impede information flow, particularly in settings where the CEO maintains strict control over the content presented, when presentations are carefully scripted, when follow-up beyond one or two questions is discouraged due to time, and when presentations are made by only a limited number of executives—such as the CEO, CFO, general counsel, and not others. While fiduciary rules allow directors to rely exclusively on information provided by management, dynamics such as these can reduce the quality of that information and impair their ability to make good decisions on behalf of shareholders.

NETFLIX BOARD PRACTICES

Netflix takes a radically different approach to information sharing with the goal of significantly and efficiently increasing transparency among the CEO, executive team, and board of directors.[4] The Netflix approach incorporates two highly unique practices: (1) board members periodically attend (in an observing capacity only) monthly and quarterly senior management meetings, and (2) board communications are structured as approximately 30-page online memos in narrative form that not only include links to supporting analysis but also allow open access to *all data and information* on the company's internal shared systems, including the ability to ask clarifying questions of the subject authors. This quarterly memo is written by and shared with the top 90 executives as well as the board.

Founder and CEO Reed Hastings believes that these two practices improve the ability of the board to provide what he calls an "extreme duty of care" to the corporation: "The board isn't going to have the confidence to make hard decisions unless they really understand the market and the company."[5]

Netflix board members embrace the Netflix approach to board governance. In the words of one board member:

> *Reed's belief is that a competent and honest executive team knows dramatically more about what's going on in the company than a board, and so the board's involvement should be at very strategic levels. ... For a board to function well in that regard, it has to know a lot about the company.*

According to another:

> *To make sure that you have the right CEO in the chair, you need to understand the issues of the day, and you need to understand what qualities, attributes, and background experience would make this the right CEO to run this company for maximum shareholder return. This level of data, this level of access, and this level of conversation greatly facilitates our ability to be good board members.*

BOARD ATTENDANCE AT MANAGEMENT MEETINGS

The first element of the Netflix approach to governance is board attendance at executive and senior executive meetings. Netflix holds three regularly scheduled executive meetings:

- Reed's Staff meetings (R-Staff) are monthly meetings of the top 7 executives to discuss the most important strategic and organizational issues facing the company.
- Executive Staff meetings (E-Staff) are quarterly meetings of the top 90 executives consisting of presentations and breakout sessions to review strategic issues, competitive threats, workplace issues, and policies.
- Quarterly Business Reviews (QBR) are 2-day gatherings of the top 500 employees of the company that include a quarterly review of the business, presentations, crowd-sourced discussion topics, and group dinners.

One board member attends R-Staff meetings, 1 to 2 attend E-Staff meetings, and 2 to 4 attend Quarterly Business Reviews.[6] Directors who attend these meetings are expected to observe but not influence or participate in the discussion. According to Hastings, "I don't want the management meeting to be any different because they're there." Directors can follow up with the CEO or other executives after the meetings with questions. They are also free to share what they have learned with fellow board members in subsequent board meetings.

The purpose of director attendance is primarily educational: By directly observing management, directors will have a greater understanding of the range of issues facing the company, the analytical approach that underpins managerial decisions, and the full scope of the tradeoffs involved. Ultimately, the aspiration is that this will translate to significantly more confidence in management and its choices. According to Hastings:

> *It's an efficient way for the board to understand the company better. In the early days, it was mostly [to ensure] that if we got an over-the-top offer, the board wouldn't sell too cheap, because they would really understand and be confident that there is a long-term play here. That was my motivation. ... Now, seeing how helpful it is for them to do their role well, we've made it our standard practice.*

Board members value direct attendance of these meetings because it increases their knowledge of the company and its management:

> *It's a good opportunity for board members to see the team in action and to meet several layers of the team. ... You end up with a more committed board, a more knowledgeable board, not people who just drop in for dinner and a meeting.*

> *It just gives you a far better understanding of the company. You get to know all of the operating players. You get a feel for the move, the cadence, how people think, how people contribute, how people interact with each other. And of course, you get an understanding of the issues of the day.*

> *You see a different level of dynamic of the executive team. You really see how different individuals contribute, you see their expertise, you see the voice that they have around the table, and you see the dynamic with the CEO. You see how the topics that have been discussed, resolved, and reported on in a board meeting actually got processed.*

> *The fact that directors are invited to all those, and encouraged to come, and encouraged to meet and mingle with people up and down the organization is unique and shows an immense amount of confidence on the part of the senior leadership.*

Netflix directors believe that direct exposure to active strategic discussions gives them substantially deeper knowledge of the company than orchestrated visits to company offices or facilities. One director contrasts Netflix with another company where interactions between the board and executives are "much more scripted, more formal, … all very carefully orchestrated. This is definitely more natural." In the words of a Netflix executive, "Reed doesn't try to edit us or tell us what to present."

Beyond informing directors about the company, board attendance at senior executive meetings builds rapport and trust between the board and senior managers. It also positions the board well for an eventual CEO succession:

> *Board members have a very high understanding of what would make for a great CEO of this company. We understand the landscape, we understand how the company operates, etc. And so when we do get to a conversation about succession planning, there is a high level of understanding. ... We would be starting from a much better position.*[7]

BOARD MEMOS AND OPEN ACCESS TO DATA

The second element of the Netflix approach to governance is a board memo with links to supporting analysis and open access to all shared files on the company's secured intranet. The board memo itself consists of 20 to 40 pages of written text that highlights business performance, industry trends, competitive developments, and other strategic and organizational issues.[8] High-level data is summarized in charts and graphs, but the memo's emphasis is primarily the written discussion and analysis of issues. Embedded links within each section of the memo connect the reader to supplemental analysis, data, and details that support and expand the written discussion.

Board members receive the memo a few days prior to board meetings and are self-directed in reviewing the material and clicking through to review supplemental analysis on topics or issues they believe are most important, interesting, or require the most attention from a fiduciary standpoint. Directors estimate they spend 4 to 6 hours in preparation, which is more than they spend preparing for their other directorships but also claim it is more interesting. They have the ability to pose questions or ask for clarification directly within the digital memo, to which senior management responds prior to the meeting.[9] Directors take active advantage of this capability.

According to Hastings:

> *The memo is shared among all the VPs, the top 90 executives, and so it's a way of alignment because I backbone it and captain it, but there are a bunch of sections written by the specialist in the functions. That is shared, the whole management team reads this, and they all have access to the board memo. … Directors then have full-view rights across the company's documents, so they just click and explore and click and explore to see the analysis of various programs. It's all interconnected.*

According to David Wells, Netflix chief financial officer:

> *[The board memo] is part of the evolution from a presentation culture to a memo-based culture [internally across the company]. Once you have the ability to effectively write collaboratively, you can then graduate to a memo that is collaboratively written. … The central coordinator, if there is one, is likely Reed himself or my Financial Planning & Analysis group. Or, for each of the areas that are writing these deeper memos, they have the C-level owner take responsibility for that.*

Because directors are extensively prepared, board meetings themselves are significantly more efficient, with a focus on questions and discussion rather than presentation. Meetings are only 3 to 4 hours in length (compared to all day or multiple days at many large corporations). They begin with the CEO and directors listing the main questions on a white board and proceed immediately to discussion. Senior executives attend board meetings and answer questions if needed.[10]

Netflix directors are very positive about the level of information they receive through the memo and supporting analysis, and the impact that these have on board meetings and discussion:

> *I think it makes a board more nimble. It makes the board more connected than they would otherwise be to the business, and it's mobile. I don't have to be in a specific room to get information. The information is always with me. I can always refer back.*
>
> *I've never seen anything like that with any other board that I've been on. We're exposed to a huge amount of information about the company. As a result, the board meetings are a relatively small amount of presentation and a fair amount of questions, and those questions are pretty well informed.*
>
> *It's not that the board memo is the board meeting. It isn't. It's all of your background reading before you go into the room so that you can have an intelligent and informed conversation. People are up to speed when they show up.*
>
> *The general notion of open access, I think, is very useful across the board. … The degree to which you have access is the degree to which you can be helpful.*
>
> *It is a process that takes what is the accumulation of a huge amount of data that is processed on a daily basis by the company and distills it down in a consumable format for the board. It then allows us to tease out the questions that are most important to the business in the board meeting. … It has made the board meetings incredibly more efficient. … Not everybody is a data-centric kind of thinker, and not everybody thinks well through slides, but almost everybody thinks well through a narrative.*

CULTURE AND LEADERSHIP

The Netflix approach to board governance is rooted in and reflective of the company's culture and leadership. The Netflix culture emphasizes individual initiative, the sharing of information, and a focus on results rather than processes.[11] According to David Hyman, the company's general counsel:

> *Our culture deck and the way in which we operate with the board are intertwined. Everything from "freedom and responsibility," "candor," "context not control," and "transparency." All of those play together and work well. It would be incongruous to have this interesting culture and then have a board that was kept in a box.*[12]

Board members speak very highly of the company culture and its application to the boardroom:

> *Reed has always been masterful at hiring really good people, pushing decision making to those people, and not micromanaging. Letting decisions roll up and be debated rather than micromanaged. That style, that kind of management philosophy rolls up into the board meetings where any one of the members of Reed's staff can*

comment or disagree, or take questions from any of us around the table and answer them openly.

A lot of CEOs like the notion of transparency. The difference is that Reed has decided to put mechanisms in place like QBR, E-Staff, and R-Staff that actually make it happen.

The overall tone Reed has set, really from early days, is around transparency. ... There is no editorializing. There's no censorship.

It's just a deep desire to hear rational, well-argued pros and cons of any decision.

IMPACT

While Netflix has been highly successful as a corporation, its success has not come without challenges. The company faced fierce competition with (at the time) a much larger Blockbuster video for a dominant position in the DVD-subscription market. It has made significant and costly decisions to invest in extensive third-party content for its website, expand in international markets, and invest significant dollars in the production of proprietary content. It made a significant mistake by deciding to separate its DVD-subscription business from its streaming business in a standalone company called Qwikster.[13] The outcomes of these decisions were not known in advance. As Hastings acknowledges, "If you look at the volatility in our stock chart as a proxy, it has not been a smooth kind of rise" (see Exhibits 1 and 2).

Netflix directors believe that its board processes gave the board confidence in management during these challenges:

There are so many radical major transformative steps that Netflix has done since I've been on the board: DVD distribution into streaming over the web, moving into international, committing millions of dollars in content, committing money to making the production. It's fascinating as a board member. ... The management team is so thoughtful and open to dissension in the decision-making process that it makes very challenging decisions relatively easier because of the rigor of the process.

Netflix has made two big "chasm crossings" and most companies don't even do one. One was getting from DVD to streaming, and number two going to streaming licensing to original content. It was a huge leap, and it's hard to imagine we could have done it without the intimate knowledge of the operations and the people.

We would have been much slower to invest so much money in content. There would have been more second-guessing if there wasn't this completely open perspective.

How we implemented Qwikster was a little ham-handed. ... If we did not have that level of transparency and comfort with fellow board members and executives, I do not think we could have had the level of productive discussion that we needed to move forward.

TRANSFERABILITY TO OTHER COMPANIES

An unanswered question is whether the Netflix approach to board governance would work at other companies. Some directors are unequivocal advocates: "The things that Reed does that we do at the board are things that should become best practices." Others offer a more tempered view: "I think it could be replicated in a small company. I don't know how you could do it at an older, established company." … "A modified version of it could work at other companies. Board members would really have to be trained to use the tools. You'd have to do it in a way that works with the culture."

Hastings cautions that directors granted this level of access to management discussion and documentation need to exercise self-restraint about influencing decisions outside the boardroom.

WHY THIS MATTERS

1. The Netflix approach to board governance rests on two practices—periodic board attendance at management meetings and a board memo in narrative form with open access to supporting data—the purposes of which are to significantly increase transparency, data, and information flow between management and directors. Does "genuine transparency" improve board decisions? How important have Netflix's board practices been to the company's success? Do they have a tangible impact on strategic decisions and financial performance?
2. Fiduciary rules allow directors to rely on information provided by management to inform its decisions and satisfy their fiduciary duties. Are these standards sufficient, or do they allow some CEOs to control and effectively limit the information presented to the board? Would boards benefit from more active interaction with the management team and an open view of its decision-making processes? Are there downsides to greater information flow?
3. Netflix directors are overwhelmingly positive about the company's approach to board governance. How transferable are these practices to other companies? Would they work at all companies, or do they require a specific culture, leadership, or phase of development to be effective? What qualities are required of a CEO to be willing to engage and interact with the board in this manner? Are these practices divisible? Could a company adopt one but not the other and still benefit from greater transparency? ■

1 See David F. Larcker, Brian Tayan, and Christina Zhu, "A Meeting of the Minds: How Do Companies Distribute Knowledge and Workload Across Board Committees?" Stanford Closer Look Series (December 8, 2014).

2 National Association of Corporate Directors, "2013–2014 NACD Public Company Governance Survey," (2014).

3 See Alex Baum, David F. Larcker, Brian Tayan, and Jacob Welch, "Building a Better Board Book," Stanford Closer Look Series (October 9, 2017).

4 For a list of Netflix officers and directors, see: https://ir.netflix.com/management.

5 All quotations in this Closer Look are from interviews with the authors in February and March 2018. Interviews were conducted with Reed Hastings (CEO), David Wells (CFO), David Hyman (General Counsel), and 7 outside board members. Some quotations are edited lightly for clarity.

6 Attendance is voluntary. R-staff and E-staff meetings are limited to this number of directors, because of the size of the meetings. Director attendance at QBR is not limited.

7 Directors noted that any eventual succession process would include both internal and external candidates.

8 The company credits Amazon with the original concept of using memos to organize managerial meetings. Netflix extends this practice significantly by applying it to the boardroom and by using the memo as a gateway to provide open access to all internal supporting documents.

9 To the extent there are concerns that the memos or comments may be subject to discovery in a legal matter, the company's general counsel is mindful but believes that enabling candid discussion and efficient information flow outweigh such discovery risk.

10 Committee meetings—such as audit, compensation, and nominating and governance—retain the standard format, and take place prior to the full board meetings.

11 The company's culture statement notes: "We share documents internally broadly and systematically. Nearly every document is fully open for anyone to read and comment on, and everything is cross-linked. Memos on each title's performance, on every strategy decision, on every competitor, and on every product feature test are open for all employees to read. Despite this huge access, we've had very few leaks, due to our ethos of self-discipline and responsibility." See "Netflix Culture," available at: https://jobs.netflix.com/culture, (accessed April 2018).

12 See Netflix culture statement, Ibid.

13 Netflix stock fell 19 percent on the announcement and as much as 70 percent over the subsequent year before reversing. The decline provided an opening for activist investor Carl Icahn to acquire a 9.9 percent stake and agitate for a sale of the company. (Netflix was valued at approximately $4.5 billion at the time. By April 2018, its market capitalization was $130 billion.) The Netflix board adopted a poison pill, and Icahn eventually liquidated his position.

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EXHIBIT 1 — NETFLIX TIMELINE

1997 – Netflix is founded

1998 – Netflix launches DVD rental site

1999 – Netflix launches subscription service for unlimited DVD rentals at a fixed monthly price

2002 – Netflix conducts Initial Public Offering

2003 – Netflix surpasses 1 million DVD subscribers

2006 – Netflix surpasses 5 million DVD subscribers

2007 – Netflix introduces streaming service

2010 – Hollywood Video parent company Movie Gallery files for bankruptcy
Blockbuster files for bankruptcy
Netflix surpasses 20 million DVD + streaming subscribers

2011 – Netflix launches in Latin America and the Caribbean
Netflix announces separation of DVD and streaming subscription businesses
Netflix cancels plans to separate DVD and streaming businesses

2012 – Netflix launches in United Kingdom and Europe
Activist investor Carl Icahn acquires 9.9% stake in the company
Netflix board adopts poison pill

2013 – Netflix launches first proprietary series *House of Cards*
Netflix wins first Primetime Emmy Awards for *House of Cards*
Activist investor Carl Icahn sells stake in the company

2014 – Netflix significantly expands in Europe

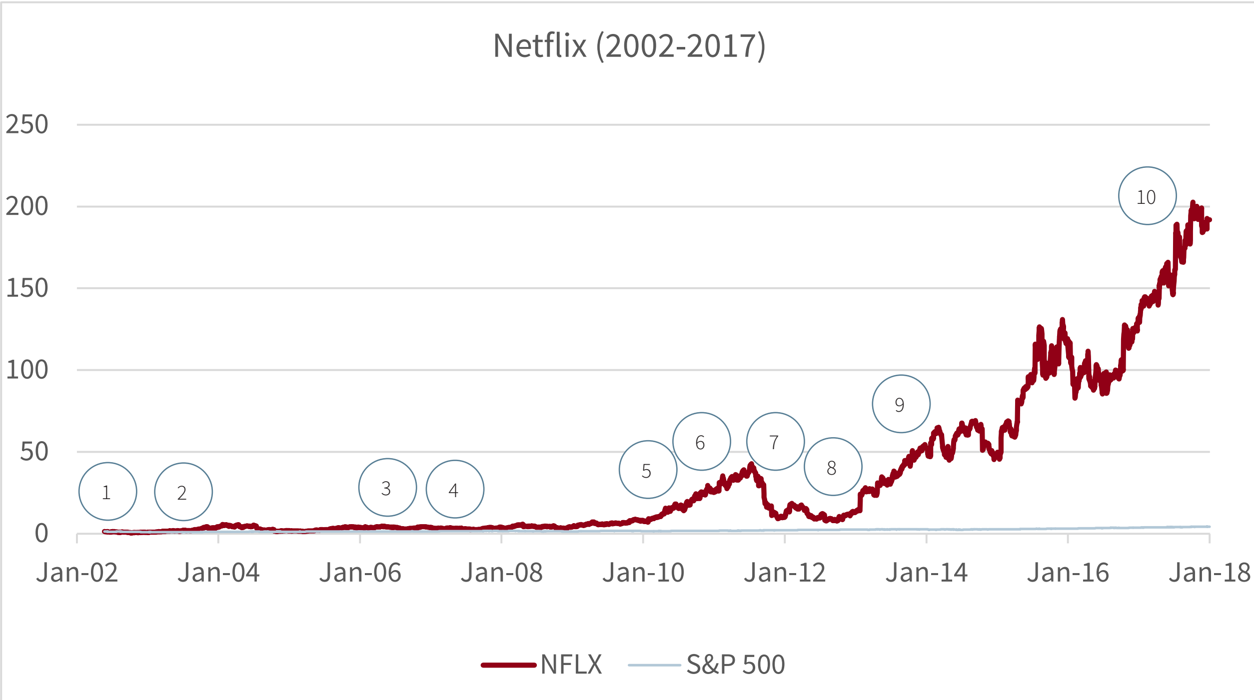
2015 – Netflix launches in Australia, New Zealand, and Japan

2017 – Netflix surpasses 100 million DVD + streaming subscribers

2018 – Netflix operates in 190 national markets

Source: Netflix. Research by the authors.

EXHIBIT 2 — STOCK CHART WITH KEY MILESTONES



1. Netflix conducts Initial Public Offering
2. Netflix surpasses 1 million subscribers
3. Netflix surpasses 5 million subscribers
4. Netflix introduces streaming service
5. Blockbuster files for bankruptcy
6. Netflix surpasses 20 million subscribers
7. Netflix announces Qwikster; cancels Qwikster
8. Carl Icahn accumulates stake in Netflix; board adopts poison pill
9. Netflix releases first proprietary content; wins Emmy
10. Netflix surpasses 100 million subscribers

Note: Adjusted for 2-for-1 split February 2004 and 7-for-1 split in July 2015.

Source: Factiva. Center for Research in Securities Prices (University of Chicago).